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Punitive damages: Defendant's ability to pay

Net worth is the most common measure of defendant's financial condition, but focusing on "ability to pay" the punitive award may be a better strategy

By Solange E. Ritchie

Punitive damage awards are under attack. Defendants use all kinds of strategies to escape responsibility for their conduct. A tool often used to overturn a jury's award of substantial punitive damages is a defendant's cry that the size of the award can financially destroy them.

Following a jury's finding under Civil Code section 3294 of oppression, malice or fraud, defendants produce evidence that they have a negative net worth during the punitive-damage phrase of trial. In the alternative, they argue that a punitive-damage award in the amount requested by plaintiff's counsel would put them out of business. Although elements of this argument overlap with a federal due-process challenge to a punitive-damage award, much of it is grounded on a claim that the award is "excessive" under state-law principles.

This was exactly the defense argument in *Bankhead v. ArvinMeritor, Inc.* (2012) 205 Cal.App.4th 68, 78-84.

The case was a mesothelioma asbestos personal injury case where a jury found Defendant ArvinMeritor, Inc. (ArvinMeritor) liable to plaintiffs Gordon and Emily Bankhead for compensatory and punitive damages. On appeal, ArvinMeritor did not challenge the jury's verdict as to liability or the amount of compensatory damages, contending only that the trial court erred in declining to reduce the punitive damages awarded by the jury. (The ratio of compensatory to punitive damages awarded by the jury was 2.4 to one). The Court of Appeal for the First Appellate District, Division 4, Ruvolo, P.J., held that:

(1) net worth is not the only measure of wealth that may be used to determine excessiveness of punitive damages;

(2) $4.5 million punitive damages award was not excessive in comparison to manufacturer's wealth; and

(3) $4.5 million punitive damages award was not excessive in violation of federal due process clause.

This case is a wonderful primer on punitive damages. It details the analysis that an economic expert should be prepared to discuss regarding a company's net worth and ability to withstand a large verdict to overcome common usual defense arguments on net worth.

The cases cited point to many factors other than net worth that a trial court can consider in determining if a defendant can pay the punitive damage award and if the award may stand. These include a review of loan documents, net worth statements, a review of cash on hand, checking account balances, amounts of credit lines carried by a company, corporate resolutions and corporate salaries

and other compensation provided to executives. The case also confirms that a simple percentage argument, i.e., that the punitive damage award should not exceed a specified percentage, as a matter of law, are outdated arguments based on current California law.

Punitive phase trial in *Bankhead*

A separate trial was held to determine the amount of punitive damages to be assessed against each defendant. By the time of that trial, all defendants except ArvinMeritor and Abex had settled. At the punitive-damages trial, respondents presented an expert witness, Robert Johnson, to testify about ArvinMeritor's financial condition. In evaluating ArvinMeritor's economic status, he reviewed publicly available documents filed with the Securities and Exchange Commission, including ArvinMeritor's 2008, 2009, and 2010 annual 10-K reports; its adjusted 2009 10-K reports; a 2010 proxy statement sent to shareholders; and data regarding its market capitalization. These are "generally accepted financial documents used and relied upon by economists or experts in finance to evaluate a company." (*Id.,* 205 Cal.App.4th at p.74.)

Johnson testified that between 2006 and 2010, ArvinMeritor attained over $3 billion in sales revenue each year, and an average annual cash-flow profit of $111 million. ArvinMeritor's lowest performing year during that period was 2009, but even in that year, it had $95 million in cash available to it. In 2010, ArvinMeritor's annual sales revenues reached $3.59 billion; its annual report indicated it had earned $211 million in cash-flow profit; and it reported to its shareholders that it had earned a $12 million net profit – a conservative figure, as Johnson explained, because companies seek to reduce their reported net income, using legally available deductions such as depreciation, in order to minimize their tax liability. At the end of 2010, ArvinMeritor had on hand some $343 million in cash and cash equivalents, and its outstanding stock had a total market value of almost $2 billion.

Johnson explained that cash flow profit is derived by subtracting from revenue those expense items that actually have to be paid, such as cost of goods sold and salaries, but not subtracting any deductions that do not actually require an expenditure of cash, such as depreciation. (*Id.,* 205 Cal.App.4th at p. 75, n. 6.)

ArvinMeritor's chief executive officer, who also served as its board chair and corporate president, earned over $7.6 million in 2010, and stood to receive between $19.9 million and $26.9 million upon leaving the company. Johnson explained that a company's willingness and ability to pay sums of this magnitude to its chief executive is an indicator of financial strength.

Johnson acknowledged that ArvinMeritor reported that as of 2010, it had a negative net worth of $1.023 billion. He opined, however, that this number, taken on its own, did not "reflect the full context of ArvinMeritor's financial condition and ability to pay." He explained that net worth is only one of "a number of different tools that we use to assess a company's financial health, wealth and condition," and opined that "net worth is probably one of the least reliable financial metrics or statistics you can use," because there are "a number of financial or accounting transactions" in which a company can engage to lower its net worth, while remaining profitable. (*Id.,* 205 Cal.App.4th at p. 75.) Johnson testified that net worth "is not a measure of a company's financial condition totally or their ability to pay," because "even within the guidelines of the generally accepted accounting principles ... net worth is something that can be pretty easily manipulated." As an example, Johnson noted that a company can reduce its net worth simply by repurchasing shares of its stock. (*Ibid.*)

Johnson explained that because net worth can be unreliable, banks look instead to a company's cash flow and profits, which are the most reliable indicators of its ability to repay debt, in determining whether to lend money to it. For this reason, companies with a negative net worth are still able to borrow money. Indeed, ArvinMeritor itself borrowed a total of $245 million in 2010, and still had $539 million available on its line of credit as of September 30 of that year. (*Id.,* 205 Cal.App.4th at pp. 75-76.)

Johnson also acknowledged that over the past couple of years, ArvinMeritor had been "weathering ... the financial travails of the economy"; its sales had not gone up, and it had lost some money. He believed, however, that ArvinMeritor was "still a financially sound company" that was "able to meet all of its obligations," was "not anywhere near on the verge of bankruptcy," and had "generally turned the corner."

ArvinMeritor's trial counsel cross-examined Johnson, but ArvinMeritor did not offer any expert witness or other evidence to cast doubt on Johnson's methodology or his conclusions.

Importance of defendant's wealth

The *Bankhead* court explained that, Under California law, "[w]ealth is an important consideration in determining the excessiveness of a punitive damage award. Because the purposes of punitive damages are to punish the wrongdoer and to make an example of him, the wealthier the wrongdoer, the larger the award of punitive damages." (*Id.*, 205 Cal.App.4th at p. 78, citations omitted.)

The court noted that the function of deterrence will not be served if the wealth of the defendant allows him to absorb the award with little or no discomfort. (*Ibid.*) And it noted that both California law and federal law agree that profits earned from tortious activity that supports an award of punitive damages are appropriately considered in the amount awarded. (*Id.*, citing *Boeken v. Philip Morris, Inc*. (2005) 127 Cal.App.4th 1640, 1697.)

The *Bankhead* court further explained that a defendant's wealth cannot justify a punitive damages award that would otherwise be that unconstitutional. Deterrence is one of the primary purposes of punitive damages. Therefore nothing in the due-process cases precludes California courts from relying in part on a defendant's wealth in assessing the appropriate amount of punitive damages. (*Id*., 205 Cal.App.4th at p. 78, n. 8.)

The court canvassed earlier California decisions that assessed whether a punitive damages award is excessive relative to the defendant's wealth, noting that "the key question" is whether the amount of damages exceeds the level necessary to properly punish and deter. In *Devlin v. Kearny Mesa AMC/Jeep/Renault, Inc.* (1984) 155 Cal.App.3d 381, 390, the court explained that the calculation of punitive damages "involves ... a fluid process of adding or subtracting depending on the nature of the acts and the effect on the parties and the worth of the defendants."

These factors are not evaluated under a rigid formula. "Whether punitive damages should be awarded and the amount of such an award are issues for the jury and for the trial court on a new trial motion. All presumptions favor the correctness of the verdict and judgment. (*Devlin*, 155 Cal.App.3d at pp. 387-388.) Juries have a wide discretion in determining what is proper. (*Ibid.*)

Nonetheless, "[b]ecause the important question is whether the punitive damages will have the deterrent effect without being excessive, an award that is reasonable in light of the ... reprehensibility of the defendant's conduct and injury to the victims, may nevertheless 'be so disproportionate to the defendant's ability to pay that the award is excessive' for that reason alone. The purpose of punitive damages is not served by financially destroying a defendant. The purpose is to deter, not to destroy.' (*Rufo v. Simpson* (2001) 86 Cal.App.4th 573, 620 (citations omitted.)

Net worth is not the only measure of wealth

Although net worth is the most common measure of the defendant's financial condition, it is not the only measure for determining whether punitive damages are excessive in relation to that condition. (*Rufo v. Simpson,* 86 Cal.App.4th at p. 624). For example, in *Rufo*, the court upheld a punitive damages award that "technically exceed[ed]" the wealthy individual defendant's net worth, because the evidence showed that the defendant would not be financially "destroyed by the award." (*Id.,* at p. 62.)

"Indeed, it is likely that blind adherence to any one standard [of determining wealth] could sometimes result in awards which neither deter nor punish or which deter or punish too much." (*Lara v. Cadag* (1993) 13 Cal.App.4th 1061, 1064-1065 & fn. 3.)

Moreover, *Lara* notes that "[n]et worth' is subject to easy manipulation and ... should not be the only permissible standard." (*Lara,* 13 Cal.App.4th at p. 1065, fn. 3.) For example, in *Michelson v. Hamada* (1994) 29 Cal.App.4th 1566, the evidence of the defendant's financial condition included net-worth statements for two successive years. The first statement, which was prepared for submission to a bank as part of a loan application, showed a far higher net-worth figure than the second, which was prepared for litigation. The trial judge called the lower figure "'patently crooked,'" and the Court of Appeal, although holding the punitive award excessive, agreed that the higher figure was the appropriate one to use for the purpose of determining that question. (*Id*. at pp. 1595-1596.)

In *Zaxis Wireless Communications, Inc. v. Motor Sound Corp*. (2001) 89 Cal.App.4th 577, the court affirmed an award of punitive damages of $300,000, even though the defendant had a negative net worth of $6.3 million, because the evidence showed that the defendant had the ability to pay the award. The court noted that "the [California] Supreme Court has expressly declined to adopt net worth as the standard for determining a defendant's ability to pay in any given situation." (*Id*. at p. 582.) It agreed that "[n]et worth is too easily subject to manipulation to be the sole standard for measuring a defendant's ability to pay." (*Id.* at pp. 582-583.) Noting the ease with which net worth is subject to adjustment for amortization and depreciation, the court pointed out that in the case before it, "the net worth calculation included accumulated depreciation...and a note to the sole shareholder," which "represent[ed] a loss for accounting purposes," but "did not impact" the defendant's ability to pay in the same way that salary and wage expenses would. (*Zaxis*, 89 Cal.App.4th at p. 583.)

The *Zaxis* court also noted that the defendant's financial statement showed it had "cash on hand and a checking account balance of over $19 million," as well as a credit line of $50 million, of which $5.3 million remained available to the defendant. The extension of the line of credit "indicate[d] the lender made a determination [the defendant] had the ability to pay amounts well in excess of the...punitive damage award." (*Zaxis*, 89 Cal.App.4th at p. 583.) Accordingly, the court held that the award was not "excessive as a matter of law or so disproportionate to the ability to pay as to indicate passion or prejudice on the part of the jury." (*Ibid.*)

Similarly, in *Devlin* the court affirmed a punitive damages verdict against a corporation that represented 17.5 percent of its annualized net worth, or almost four months' net profit. In rejecting the defendant's argument that the award was excessive, the court relied in part on an unexplained accounting adjustment in the company's financial records that operated to reduce its net worth. The court also took note of a resolution authorizing the corporation to borrow money, opining that a resolution to borrow "serves as an indicator of the continuing health and viability of a business."

The *Devlin* court compiled a list of cases in an attempt to discover a formula for determining whether a given percentage of net worth is excessive ultimately concluded there is no formula, and that each case must be decided on its own facts, considering various indicators of wealth." (*Rufo*, 86 Cal.App.4th at p. 625.) Thus, the court held that in arriving at the amount of punitive damages, the trial court properly took into account the defendant's "net worth plus a variety of other figures relating to [the defendant's] wealth," and noted that "[o]ther courts have considered various asset and income figures relevant to the issue of punitive damages." (*Devlin*, at p. 391.)

Bankhead **rejects the simple percentage argument**

ArvinMeritor's challenge to the punitive damages award relied primarily on a plethora of older California cases to the effect that punitive damages amounting to more than 10 percent of the defendant's net worth are excessive:

• *Sierra Club Foundation v. Graham* (1999) 72 Cal.App.4th 1135, 1162-1163, (punitive damage award of between two and three percent of defendant's net worth was "far less than the 10 percent cap generally recognized by our courts.")

• *Weeks v. Baker & McKenzie* (1998) 63 Cal.App.4th 1128, 1137-1138, (court affirmed punitive damage award to five percent of the defendant's net worth, noting "[i]t has been recognized that punitive damages awards generally are not permitted to exceed 10 percent of the defendant's net worth."]

• *Michelson v. Hamada, supra*, 29 Cal.App.4th at pp1595-1596, (punitive damages equal to 28 percent of the defendant's net worth found excessive because "awards generally are not allowed to exceed 10 percent of the net worth of the defendant.")

• *Storage Services v. Oosterbaan* (1989) 214 Cal.App.3d 498, 514-516, (award that was 33 percent of the defendant's net worth held excessive since "punitive damage awards are generally not allowed to exceed 10 percent of the defendant's net worth.")

• *Seeley v. Seymour* (1987) 190 Cal.App.3d 844, (while expressly declining to compare the punitive damages to the defendant's net worth, the court remarked in dictum that "awards totalling more than 10 percent of a defendant's net worth have been disfavored by our courts....")

• *Burnett v. National Enquirer, Inc.* (1983) 144 Cal.App.3d 991, (reduced award was still excessive because it amounted to 35 percent of the defendant's $2.6 million net worth)

• *Goshgarian v. George* (1984) 161 Cal.App.3d 1214, 1229-1230, 208 ("punitive damage awards exceeding 10 percent of a defendant's net worth have generally been disfavored by the appellate courts" but award amounting to approximately 10.7 percent of the defendant's net worth was not unduly disproportionate to his wealth.)

• *Little v. Stuyvesant Life Ins. Co.* (1977) 67 Cal.App.3d 451, 469-470, (punitive damages award of $2.5 million, which was more than 15 percent of the defendant's net worth, and 14 times the compensatory damages, was excessive as a matter of law.)

• *Merlo v. Standard Life & Acc. Ins. Co.* (1976) 59 Cal.App.3d 5, 18, (court reversed punitive damage award on a number of grounds, including that the amount of the award was almost one-third of the defendant's net worth but made no mention of any fixed limitation on punitive damages as a percentage of the defendant's net worth.)

ArvinMeritor argued these cases establish, as a matter of law, that punitive damages may not exceed 10 percent of the defendant's net worth, which represents a "cap" on allowable punitive damage awards. But as shown by the court's summaries in the preceding paragraphs, none of the cited cases actually held that punitive damages exceeding 10 percent of the defendant's net worth are *per se* impermissible. Moreover, these cases cannot be read as requiring punitive damages to be measured only against the defendant's net worth despite undisputed expert testimony that the defendant's net worth is not an accurate measure of its wealth. (*ArvinMeritor*, 205 Cal.App.4th at p. 82.)

The court held that the jury was entitled to credit the expert's uncontroverted testimony that ArvinMeritor was far wealthier than its stated net worth would indicate, and that net worth alone is an untrustworthy standard, because it is so easily manipulated. Johnson's caveat about the perils of relying solely on a net worth valuation standard echoed the same concerns expressed by the courts in the relatively more recent *Zaxis*, *Rufo*, *Lara*, and *Devlin* cases (citations omitted). Thus, the court rejected the argument that 10 percent of net worth constitutes a ceiling above which juries may not go in setting the amount of punitive damages. (*Id.* at pp. 82-83.)

The court stated that its task simply is to determine whether, "considering all the factors, the punitive damages award, in light of the defendant's wealth and the gravity of the particular act, exceeds the level necessary to properly punish and deter." (*Id.*, citing *Rufo,* 86 Cal.App.4th at p. 625, internal quotations marks and other punctuation omitted.)

The court found that the size of the jury's punitive damage verdict, and the trial judge's denial of ArvinMeritor's motions for judgment notwithstanding the verdict and for new trial, imply that both the jury and the trial judge accepted Johnson's assessment as to ArvinMeritor's ability to pay the $4.5 million punitive damages award. This implied factual finding is fully supported by the evidence.

The jury's punitive damages award of $4.5 million amounted to 37.5 percent of ArvinMeritor's net profit for 2010. While this was hardly a slap on the wrist, $4.5 million is only a small percentage – about 1.3 percent – of ArvinMeritor's immediately available funds as of the end of 2010. It is significantly less than what

ArvinMeritor paid its CEO that year, and less than one-fourth of the amount ArvinMeritor had promised to pay its CEO if he were fired without cause ($24.5 million) or replaced if the company were sold ($26.9 million). Johnson's testimony that the company was financially sound was uncontroverted, and ArvinMeritor chose not to introduce evidence tending to show that it would be financially destroyed by an award of $4.5 million in punitive damages.

ArvinMeritor's counsel warned that affirming the punitive damages award in this case could lead to plant closures, layoffs, and other dire consequences. The court found that nothing in the record supported those speculative contentions. ArvinMeritor also argued that it should not be faulted for its failure to controvert Johnson's testimony about its financial condition, because the burden of proof fell on the plaintiff to establish its financial wherewithal, citing *Adams v. Murakami* (1991) 54 Cal.3d 105, 109-110. In that case, the Supreme Court cautioned that it is inherently prejudicial to require a defendant to introduce evidence of personal finances, and that defendants face a risk, if they present mitigating evidence, that the jury would regard it as a tacit admission that punitive damages are appropriate. (*Id.*, at pp. 120, 121.) But *Adams* did not hold that a defendant facing a punitive damages claim cannot or should not present evidence to controvert the plaintiff's factual showing regarding the defendant's financial condition. It held only that plaintiffs who seek punitive damages have the burden of presenting evidence, as well as the burden of proof, regarding the defendant's finances.

Conclusion: Focus on the ability to pay

The *Bankhead* court concluded that it could not "say that the jury's punitive damages award, though large, is so disproportionate to ArvinMeritor's ability to pay as to lead ineluctably to the conclusion that the award resulted from passion or prejudice." Rather, it stated "the jury was justified by the evidence in concluding that an award of that magnitude was necessary and appropriate in order to punish ArvinMeritor for its contribution to causing the disease that took Bankhead's life, and to deter ArvinMeritor and other manufacturers from failing to take every available precaution to mitigate workers' exposure to life-threatening toxic substances." (*Id.*, 205 Cal.App.4th at p. 84.)

The lesson? Line up your forensic expert to focus on the defendant's ability to pay which is unconstrained by easily manipulated net worth. Only then can defendants effectively be punished and deterred from behavior destructive to society.


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