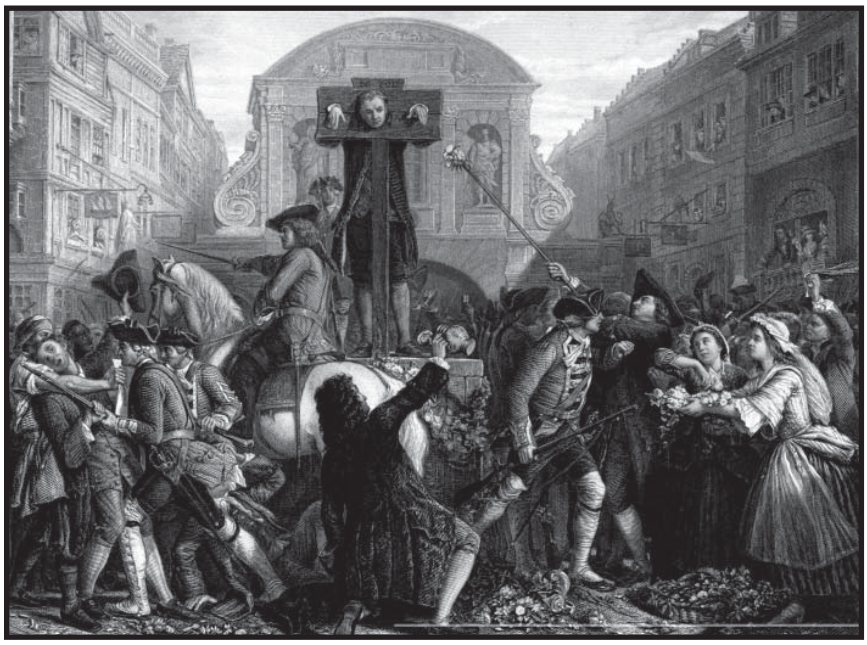
Imposing Punitive Damages On An Entity



A Corporation That Is Not Guilty Should Not Be Punished

By Limor Lehavi

Punitive damage awards have been receiving a lot of attention from the courts lately. Following the seminal United States Supreme Court opinion in *State Farm v. Campbell* (2003) 538 U.S. 408, most challenges to punitive damages are based on due process violations and focus on the excessive *amount* of punitive damages awarded. The most recent example is *Philip Morris USA, v. Williams* (2007) 127 S.Ct. 1057, where the Supreme Court accepted a due process challenge and remanded the case back to Oregon because the Oregon trial court failed to instruct the jury that harm to nonparties could not be considered when determining the proper amount of punitive damages against the tobacco company.

No doubt about it, in the current litigation climate challenges to the *amount* of punitive damages awarded can be a very powerful tool for defense attorneys. But in focusing on the appropriate amount of punitive damages that can pass constitutional muster, there is a danger that available challenges to the *liability* underlying the penalty might get lost. This article takes the punitive damages issue a step back, to remind defense practitioners that the requirements of California Civil Code §3294 subd. (b) can provide strong challenges to *liability* for punitive damages when defending an entity, in addition to due process challenges to the amount.

Entities are creations of law. They do not have minds and cannot form malicious intentions. Any attempt to punish an entity must by necessity rest on its employees and agents, natural people who have minds that are often capable of forming evil intents. But unlike vicarious liability, which can be imposed on an entity simply by authorizing a person to act on its behalf, an entity's liability for punitive damages must rest on severely wrongful conduct by the entity's leadership group: its officers, directors, and managing agents.

In the following paragraphs, I will discuss the requirements for imposing punitive damages in California with a focus on entity punitive damage liability, and conclude with some general practical advice for defense of such cases.

Punitive Damages Are An Anomaly Where Criminal Law Crosses Over Into Tort Law, Requiring Heightened Safeguards

Torts represent a body of law directed toward compensation of individuals for losses which they have suffered within the scope of their legally recognized interests. Crimes, on the other hand, are offenses against the public at large. For that reason crimes are prosecuted by the government. Punishment of the offender vindicates the interests of the

public as a whole. In contrast, a civil action for a tort is commenced and maintained by the injured party. Its primary purpose is to provide the injured party a sum of money, at the expense of the wrongdoer, for the damage suffered. Prosser & Keeton, *On The Law of Torts*, 5th Ed. West 1984 (Hornbook Ser. Student Ed.) pp. 5-7.

Exemplary (punitive) damages are the one anomalous aspect in which the ideas underlying the criminal justice system invade the field of torts. *Id.* at p.9. Punitive damages pose an acute danger of arbitrary deprivation of property because they are akin to criminal penalties. Yet civil defendants are not accorded the protections afforded criminal defendants. *State Farm Mut. Auto. Ins. Co. v. Campbell, supra,* 538 U.S. at 417. Because compensatory damages are designed to make the plaintiff "whole," punitive damages are considered to be a "windfall" form of recovery. *College Hospital, Inc. v. Superior Court* (1994) 8 Cal.4th 704, 721.

Although not as strong as the protections given to criminal defendants, the California punitive damages statute, Civil Code §3294, includes important heightened safeguards to ensure that a defendant will not be improperly "punished" for the mere commission of a tort. See e.g. *Taylor v. Superior Court* (1979) 24 Cal.3d 890, 894 [something more than mere commission of a tort is always required for punitive damage liability.] Thus, in addition to proving an underlying tort, a plaintiff suing any defendant for punitive damages need also prove, by "clear and convincing evidence" that defendant is "guilty of oppression, fraud, or malice". Then, and only then, can a plaintiff recover "damages for the sake of example and by way of punishing the defendant" in addition to actual (compensatory) damages. Civ. Code §3294 subd. (a).

The punishable acts which fall under the "oppression" "fraud" and "malice" categories are *strictly* defined by subd. (c). Each involves "intentional," "willful," or "conscious" wrongdoing of a "despicable" or "injur[ious]" nature. *College Hospital, Inc. v. Superior Court, supra,* 8 Cal.4th at 721. See also *Cruz v. HomeBase* (2000) 83 Cal.App.4th 160, 167.

Under Civ. Code §3294 subd. (c):

> (1) "Malice" means conduct which is intended by the defendant to cause injury to the plaintiff or despicable conduct which is carried on by the defendant with a willful and conscious disregard of the rights or safety of others.
>
> (2) "Oppression" means despicable conduct that subjects a person to cruel and unjust hardship in conscious disregard of that person's rights.
>
> (3) "Fraud" means an intentional misrepresentation, deceit, or concealment of a material fact known to the defendant with the intention on the part of the defendant of thereby depriving a person of property or legal rights or otherwise causing injury.

The Judicial Council of California Civil Jury Instructions ("CACI") include a series of instructions regarding punitive damages. CACI 3940-3948. These instructions add regarding "malice" that "[a] person acts with knowing disregard when he or she is aware of the probable dangerous consequences of his or her conduct and deliberately fails to avoid those consequences." These instructions also define "despicable conduct" in the context of the punitive damages statute as "conduct that is so vile, base, or contemptible that it would be looked down on and despised by reasonable people." Strong words indeed.

Plaintiff must prove this horrendous conduct by the highest possible burden of proof which exists in the civil system: "clear and convincing evidence." "Clear and convincing evidence requires a finding of high probability... requiring that the evidence be so clear as to leave no substantial doubt [and] sufficiently strong to command the unhesitating assent of every reasonable mind." *In re Angelia P.* (1981) 28 Cal.3d 908, 919 (citations omitted); *Shade Foods Inc. v. Innovative Products Sales & Marketing, Inc.* (2000) 78 Cal. App.4th 847, 891.

In overabbreviated language, CACI 201 explains that "clear and convincing evidence" means that the plaintiff must persuade the jury "that it is highly probable that the fact is true." The prior approved jury instruction of BAJI 2.62 used a similar definition: "Clear and convincing evidence means evidence of such convincing force that it demonstrates, in contrast to opposing evidence, a high probability of the truth of the facts for which it is offered as proof." This instruction was criticized by the Second Appellate District in *In re Marriage of Weaver* (1990) 224 Cal.App.3d 478, 487, but the First Appellate District held that a jury instruction based on the overabbreviated language did not require reversal. *Weeks v. Baker & McKenzie* (1998) 63 Cal.App.4th 1128, 1164-65.

Punitive Damages Against An Entity Can Only Be Awarded For Wrongful Conduct By The Entity

The danger of arbitrary deprivation of property is particularly acute when imposing punitive damages upon entities. California courts hold that punitive damages against an employer may only be awarded "for the employer's *own* wrongful conduct." *Weeks v. Baker & McKenzie, supra,* 63 Cal.App.4th at 1154. (Italics in the original.) That being said, as everybody knows, corporations can only act through individuals:

> Corporations are legal entities which do not have minds capable of recklessness,

wickedness, or intent to injure or deceive. An award of punitive damages against a corporation therefore must rest on the malice of the corporation's employees.

But the law does not impute every employee's malice to the corporation. Instead, **the punitive damage statute requires proof of malice among corporate leaders**." *Cruz*, *supra*, 83 Cal. App.4th at 167. (Emphasis added.)

The California punitive damages statute references those corporate leaders by the terms "officer[s], director[s], and managing agent[s]". Civ. Code §3294, subd. (b). "This is **the group whose intentions guide corporate conduct**. By so confining liability, the statute avoids punishing the corporation for malice of low-level employees which does not reflect the corporate 'state of mind' or the intentions of corporate leaders. This assures that punishment is imposed only if the *corporation* can be fairly viewed as guilty of the evil intent sought to be punished." *Cruz, supra*. (Bold emphasis added, italics in original.) "To award [punitive] damages against the master for the criminality of the servant is to punish a man for that of which he is not guilty.'" *White v. Ultramar, Inc.* (1999) 21 Cal.4th 563, 569, quoting *Warner v. Southern Pacific Co*. (1896) 113 Cal. 105, 112.

Under section 3294, subd. (b), punitive damages can be imposed against an entity employer only when the plaintiff proves, again by clear and convincing evidence, that an "officer, director or managing agent" of the entity employer either:

(1) had advance knowledge of the unfitness of the fraudulent, malicious or oppressive employee and employed him or her with a knowing disregard of the rights or safety of others; or

(2) committed, ratified, or authorized the fraudulent, malicious or oppressive conduct.

Subd. (b) thus requires a multi-tiered analysis regarding entity employers. First, the status of the employees involved must be analyzed to determine whether any of them is an "officer, director or managing agent" of the defendant entity. If that hurdle is cleared, a determination must be made whether that "officer, director or managing agent" committed, ratified, or authorized any conduct constituting "oppression, malice or fraud" or whether that "officer, director or managing agent" had advance knowledge of the unfitness of a fraudulent, malicious or oppressive employee and employed him or her with a knowing disregard of the rights or safety of others.

Who Is a Managing Agent?

The terms "officer" and "director" are titles of corporate functionaries which have a clear meaning in corporate jargon. As a result, the status of someone as a director or officer of a corporation is typically not a fact that is disputed in litigation. The same cannot be said regarding the term "managing agent".

The legislative history of the term "managing agent" in §3294 is detailed in *Weeks v. Baker & McKenzie, supra,* 63 Cal.App.4th at 1148-1152. The term was added to the punitive damages statute by Senate Bill No. 1989 ("SB 1989"), which was adopted in 1980 following lobbying efforts by proponents of tort reform, trying to make it harder for plaintiffs to obtain punitive damages. (Because of this legislative history, pre-1980 cases imposing punitive damages on corporations should be used with caution).

Senator Kenneth L. Maddy, who introduced SB 1989, explained the addition of the term "managing agent" in this context:

> [T]he term 'managing agent' is used to describe the lowest level person within a corporation who must be 'personally guilty of oppression, fraud [or] malice' or possess the requisite 'advance knowledge' and 'authorize or ratify' the conduct at issue before punitive damages can be assessed against the corporation. The term 'managing agent' is, of course, a term of art that refers to a function, and not a mere title. **It remains for the 'judiciary' to flesh out a meaning for 'managing agent' in the factual context of each case before it**. *Weeks v. Baker & McKenzie, supra,* 63 Cal.App.4th at 1151. (Emphasis added.)

Following the 1980 amendments of SB 1989, the judiciary proceeded to "flesh out" the meaning of the term "managing agent." One line of cases concluded that the mere ability to hire and fire employees renders a supervisory employee a managing agent under section 3294, subdivision (b). See e.g. *Stephens v. Coldwell Banker Commercial Group, Inc.* (1988) 199 Cal.App.3d 1394, 1404. A second line of cases held that even when employees have authority to hire and fire others, employees are not managing agents under §3294, subd. (b), unless they in fact exercise substantial discretion in their decision making capability. See e.g. *Kelly-Zurian v. Wohl Shoe Co*. (1994) 22 Cal.App.4th 397, 421.

In *White v. Ultramar, Inc., supra,* the California Supreme Court was called upon to resolve these conflicting lines of authority. The Supreme Court rejected the broad definition of the first line of cases (which was the definition adopted by the lower court). Instead, the Supreme Court adopted the narrow definition of the second line of cases. In reaching its conclusion, the Supreme Court relied on the legislative history analysis performed by the court in *Weeks, supra*. In addition, the Supreme Court found that by placing the term "managing agent" in the same category as "officer" and "director", the Legislature intended to limit the class of employees whose exercise of discretion could result in a corporate employer's

liability for punitive damages. *White, supra* at 571-573. The Supreme Court held:

> [T]he Legislature intended the term 'managing agent' to include **only those corporate employees who exercise independent authority and judgment over decisions that ultimately determine corporate policy**. *White v. Ultramar, Inc., supra* 21 Cal.4th at 566-567. (Emphasis added).

In *White*, the California Supreme Court found that a regional director of eight stores who supervised 65 employees and had "most if not all" responsibility for running those eight stores, represented a significant aspect of the corporate defendant's business. The regional director exercised substantial discretionary authority over vital aspects of the business that included managing numerous stores on a daily basis and making significant decisions affecting both store and company policy. Viewing the facts in favor of the trial court judgment which imposed liability, the court affirmed the finding that the regional director was a "managing agent". As a result, the regional director's malicious, oppressive or fraudulent termination of an employee in violation of public policy, subjected the corporation to punitive damages. *Id.* at 577.

Cruz, supra, and *Kelly-Zurian*, *supra* both found the supervisory employees at issue to *not* be managing agents. The employer in *Kelly-Zurian* was found liable for sexual harassment performed by a supervisory employee upon the plaintiff. The court held that the sexually harassing supervisor was not a "managing agent" since he did not have the authority to "change or establish business policy." That authority rested with the St. Louis office of the company, which set the policies and guidelines, and administered salaries and reviews. While the supervisor at issue could advise and make recommendations regarding such matters, he could not set the plaintiff's salary or give her a raise without authority from St. Louis. *Id* at 422. The court stressed that to be considered a managing agent, the employee must be in a policy *making* (as opposed to implementing) position. *Ibid*.

The facts described in *Cruz* are quite dreadful. Cruz was accused by a security guard of stealing a sheet of plywood, although he had a receipt and offered to display it. The security guard and his supervisor detained Cruz, handcuffed him, kicked him, pushed him into a bench and a wall, spilled his wallet and its contents on the floor, called him derogatory names and caused him to arrested and jailed. 83 Cal.App.4th at 163.

Cruz successfully sued the guard, supervisor, and HomeBase for battery, false imprisonment and malicious prosecution. The jury also awarded punitive damages against all the defendants. The question for the court's determination was whether the supervisor was a "managing agent" of HomeBase for purposes of imposing punitive damages against HomeBase regarding his conduct towards Cruz.

In performing its analysis to answer this question, *Cruz* explained that certainly the decisions of the supervisor regarding Cruz had significant consequences. "But, then, every corporate employee's reckless or malicious conduct has the potential to cause serious injury. Whether the corporation will be liable for punitive damages depends, not on the nature of the consequences, but rather on whether the malicious employee belongs to the leadership group of 'officers, directors, and managing agents.'" 83 Cal.App.4th at 168. The evidence showed that the supervisor at issue was subordinate to a store manager in a single outlet of a multi-store chain, supervised only a few employees, and had authority only over one narrow area (security) of the store's multifaceted operations. The court held that under these facts, the supervisor was not a managing agent as a matter of law. *Id.*

Fine tuning *White*'s definition of "managing agents" as employees who "exercise substantial discretionary authority over decisions that ultimately determine *corporate policy*", *Cruz* clarified that "'corporate policy' is the general principles which guide a corporation, or rules intended to be followed consistently over time in corporate operations. A 'managing agent' is one with substantial authority over decisions that set these general principles and rules." *Cruz, supra,* 83 Cal.App.4th at 167-168 (internal citation omitted.)

CACI defines "managing agent" as an employee who "exercises substantial independent authority and judgment in his or her corporate decision making so that his or her decisions ultimately determine corporate policy." CACI 3943-3947. The appropriate CACI instruction should be read to the jury in any case involving a determination of managing agent status for purpose of imposing punitive damages.

When Does A Corporate Leader Authorize Or Ratify Malicious, Fraudulent Or Oppressive Conduct?

Ratification is the "confirmation and acceptance of a previous act." *Cruz*, *supra* at 168. The CACIs do not use the word "ratification", instead using plain language requiring a plaintiff to prove that an "officer, director or managing agent" of defendant "knew of the wrongful conduct and adopted or approved the conduct after it occurred." See e.g. CACI 3943-3944.

As an alternative to his argument that the security supervisor was a man-

aging agent, the plaintiff in *Cruz, supra*, argued that HomeBase corporate officials ratified the conduct of the security guard and his supervisor. No evidence was presented that showed that the supervisor's superiors actually knew that the security guard and supervisor had committed the intentional torts towards Cruz. *Id*. at 164. Rather, Cruz argued that the corporate apex "had an opportunity to learn" of the misconduct of the security guard and his supervisor from written reports that were provided to them, and ratified the conduct by retaining the employees. *Id*. at 166. The court rejected this argument.

The court explained that "[a] corporation cannot confirm and accept that which it does not actually know about." *Cruz, supra* at 168, citing *College Hospital Inc., supra,* at 726 [for ratification sufficient to justify punitive damages against a corporation, there must be proof by the plaintiff that officers, directors, or managing agents had actual knowledge of the malicious conduct and its outrageous character]. Evidence of an opportunity to learn of the misconduct is not enough. The plaintiff must prove *actual knowledge*. *Ibid.*

Plaintiff Has The Burden Of Proving The Elements of Subd. (b) By Clear And Convincing Evidence

It is one of the basic rules of evidence that a plaintiff must prove all elements of his or her case. Evid. Code §500; *Roddenberry v. Roddenberry* (1996) 44 Cal.App.4th 634, 654. As detailed above, §3294 subd. (a) specifies that the burden of proof regarding punitive damages is by clear and convincing evidence.

Because the "clear and convincing" requirement appears in subd. (a), there was some confusion whether it also applied to subd. (b). For example, the Use Note to BAJI No. 14.73 (9th ed.2002), states: "The committee believes that there is a substantial issue as to whether the requirement of clear and convincing evidence applies to the findings required by [Civil Code section 3294] subdivision (b). Therefore, the trial judge will have to make that choice pending legislative or appellate court clarification."

This confusion was resolved in *Barton v. Alexander Hamilton Life Ins. Co*. (2003) 110 Cal.App.4th 1640. The jury in *Barton* found that an insurance broker committed a fraud. The trial court granted the entity defendant a motion for non-suit on punitive damages because plaintiff did not submit any evidence that the agent was a managing agent of the insurance company, or in the alternative, that the insurance company ratified the fraud. *Id*. at 1643-1644.

On appeal, plaintiff argued that the trial court should have applied the lower preponderance of the evidence standard to determine the managing agent status or conduct alleged to be ratification. The Court of Appeals affirmed the non-suit, holding that *any* of the findings required under §3294 must be made by clear and convincing evidence. *Id*. at 1644. The CACIs now specifically state that a plaintiff must prove any applicable requirement of subd. (b) by clear and convincing evidence. See e.g. CACI 3943-3944.

Using Subd. (b) In Defense Of Entity Punitive Damages Cases

Upon receipt of a case involving potential liability for punitive damages and continuing through trial preparation, defense counsel should interview all the employees involved. Determine facts such as the hierarchy of the employees involved in the alleged misconduct, the level and nature of discretion provided to each involved employee, management duties, the number and level of employees each employee involved

supervised, the amount of layers between each involved employee and the corporate apex, and the ability to set company policy.

Once the personnel involved and their hierarchy is clear, for each employee involved, determine whether he or she (1) committed "oppression, malice or fraud"; (2) authorized "oppression, malice or fraud"; (3) knew of the unfitness of an employee who committed "oppression, malice or fraud" and employed the employee with a knowing disregard of the rights or safety of others; (4) learned of the "oppression, malice of fraud" and adopted or approved it after it occurred.

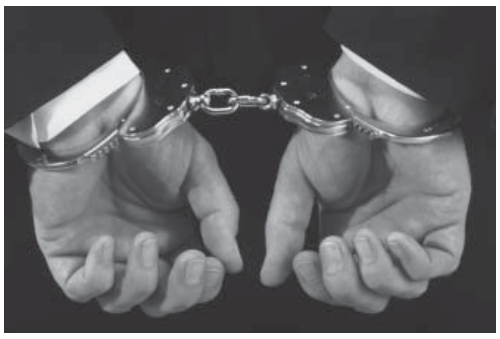
Defense counsel should also ensure that the information found through such interviews is consistent, supported, and not contradicted by written documentation. Prepare responses to written discovery and testimony at depositions accordingly.

Issues like whether or not someone is a managing agent, or whether misconduct was ratified or not are typically issues of fact, and can rarely support a summary judgment. But they do lend themselves nicely to nonsuit or direct verdict motions (or judgment as a matter of law in federal court) once plaintiff has presented its case.

Most attorneys defending an entity in a case where punitive damages are sought will move for nonsuit or directed verdict at the close of plaintiff's case regarding the elements of §3294(a) – failure to provide clear and convincing proof of oppression, malice or fraud. Subd. (b) is not used quite as often for this purpose. That is unfortunate, as it can be just as effective.

Consider the recent case of *Gelfo v. Lockheed Martin Corp*. (2006) 140 Cal.App.4th 34. The court granted directed verdict for defendant Lockheed on the punitive damages claim on the ground that plaintiff "failed to present sufficiently clear and convincing evidence to permit the jury to find a corporate decision-maker was involved in rescinding his job offer." *Id*. at 63. The highest employee involved was a Lockheed vice-president, MacPherson, who did not testify at trial. Plaintiff did not introduce any evidence to establish MacPherson's position in Lockheed's corporate hierarchy. Plaintiff did not introduce any evidence regarding MacPherson's duties or authority, let alone substantial evidence that he exercised substantial discretionary authority over decisions that ultimately determine corporate policy. *Ibid*, citing *White, supra*.

The plaintiff argued that the issue of managing agent is an issue of fact for the jury, and that the trial court invaded the jury's province by granting the motion for a directed verdict. The court agreed, quoting *White* that "[w]hether an employee is a managing agent must be made on a case-by-case basis. [Citation.] However, where insufficient evidence supports a verdict in the plaintiff's favor, no factual issue remains for the jury to decide. *Ibid*. Were this not the case, motions for directed verdict and nonsuit would not exist. Viewing the evidence in the light most favorable to [plaintiff], we similarly conclude no substantial evidence showed MacPherson was a managing agent." *Ibid*. See also *Kelly-Zurian*, supra at 421-422 [no evidence in the record to show supervisor was in policymaking position, and substantial evidence was presented to the contrary].



If the motion for nonsuit or directed verdict fails and the issue of liability for punitive damages does go to the jury, remember to include the relevant components of Civ. Code §3294 subd. (b) in your jury instructions as well as your special verdict form.

Jury instructions should include: (1) the heightened burden of proof; (2) the definitions of "malice," "oppression," "fraud" and "despicable conduct"; (3) the requirement that the malice, oppression or fraud must be found, by clear and convincing evidence, to have been committed, ratified, or authorized by a director, officer or managing agent of the defendant; and (4) the definitions of "managing agent," and "ratified".

The special verdict form should include questions specifically requiring the jury to answer whether it finds, by clear and convincing evidence, that an officer, director or managing agent of the defendant entity committed, authorized or ratified malice, fraud or oppression.

Of course, if the jury still returns a supported verdict for punitive damages against the defendant, you can always challenge for being excessive under *State Farm v. Campbell*!

Limor Lehavi is a partner at the Newport Beach office of Archer Norris. Her practice focuses on insurance related litigation, including insurance coverage, insurance bad faith, E & O, in-house counsel issues and unfair business practice cases. Many of her cases involve litigation of punitive damage claims.