Legal Opinion Letter

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NEW CALIFORNIA LAW GRANTS STATE 75% OF PUNITIVE DAMAGE AWARD

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On August 16, 2004, California Governor Arnold Schwarzenegger signed an appropriations bill (S.B. 1102) that requires 75% of any punitive damage recovery to be directed to a Public Benefit Trust Fund for the state to spend on "purposes consistent with the nature of the award." The Governor has estimated that the state may raise as much as $450 million from the law. California courts awarded about $6.4 billion in punitive damages between 1991 and 2000, according to a University of the Pacific, McGeorge School of Law study.

When the Governor first proposed the split-recovery proposal, business groups embraced it because other punitive damage reforms were part of the package. As this LEGAL OPINION LETTER discusses, however, amendments made during the legislative process resulted in changes that may encourage higher and more frequent punitive damages verdicts. Ultimately, the budget agreement is not likely to raise the type of revenue the state had hoped to earn, and businesses are not likely to see the California litigation climate worsen dramatically. The upside for the state and downside for businesses will be limited because the law only applies to new filings and will sunset in June 2006.

Nevertheless, the issue bears careful watching. The legislature could decide to extend the law beyond its sunset date. In addition, the enactment of a split-recovery law in a trend-setting state like California may encourage other states to adopt similar laws, particularly during this time of tight state budgets. (A handful of states now have split-recovery laws). It is unlikely that other states would limit the time frame for their laws the way California has done.

The Problem with Split-Recovery Laws. Laws requiring a successful plaintiff to share his or her punitive damage award with the state may be superficially attractive to state legislators and the business community. Some may view the approach as a way to lower the economic incentive for plaintiffs' lawyers to pursue punitive damages, while providing the state with a convenient additional source of revenue to address public needs.

In practice, however, legislation is inevitably amended to allow plaintiffs' lawyers to receive a fee based on the entire recovery. Moreover, directing punitive damages to the state can raise serious problems, including the potential to make punitive damages exposure even worse than it is today. *See* Victor Schwartz, Mark Behrens & Cary Silverman, *I'll Take That: Legal and Public Policy Problems Raised by Statutes that Require Punitive Damages Awards to be Shared with the State*, 68 MO. L. REV. 525 (2003). For instance, jurors may be more likely to award punitive damages (and in larger amounts) if the money will go to the "public good" rather than to a single "windfall plaintiff." Jurors also might be influenced by their charitable instinct to fulfill a social good, or their own self-interest in reducing their tax burden, or supporting state programs that will help them, their

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family, or their community. The problem of potential juror bias is especially likely to occur when the defendant is an out-of-state corporate defendant.

In addition, split-recovery laws may lead states to become more reliant on punitive damages to supplement the state treasury or to fund social programs. This could encourage states to expand the availability of punitive damage awards or to undertake policies that promote such awards. The laws also may promote "regulation through litigation" by encouraging state attorneys general to team up with private law firms to attack lawful industries, thereby producing an even larger recovery for the state. Finally, split-recovery laws can exacerbate conflicts of interest between plaintiffs and their attorneys. The laws may lead to the odd result of a lawyer receiving a greater recovery than his or her client – making the lawyer the primary beneficiary of the award.

Original Proposal. The Governor's original proposal called for 75% of any punitive damage award to be directed to the Public Benefit Trust Fund, with plaintiffs' lawyers receiving their fee out of the client's 25%. The proposal also attempted to address some of the problems with split-recovery laws: (1) punitive damages could be awarded only once for "any act or omission." Judges would be required to consider punitive damage judgments in other states to determine whether the defendant had already been punished for its conduct; (2) the jury could not be informed that any portion of the award would go to the state; (3) the state could not become a party or intervene in the case; and (4) punitive damages awards against small businesses would be capped.

Modified Proposal. In late June, the proposal was amended to provide that a plaintiffs' attorney could receive his or her fee based on the entire amount of the award, not just from the client's share. This change restored the full economic incentive for plaintiffs' lawyers to pursue punitive damages. The revised proposal also eliminated the tort reform protections in the original proposal, including the one-award limitation. These changes led the Civil Justice Association of California to withdraw its support for the bill and declare that the proposal was "overall a step backward on the path to California's economic recovery."

The New Law. The new law deviates in several ways from the modified proposal. The 75/25% split remains unchanged, but a plaintiffs' attorney's fee is limited to 25% of the 75% awarded to the state. An attorney may continue to charge a contingency fee of one-third or more from the client's share of the recovery. The nominal fee cap is not likely to deter plaintiffs' lawyers from pursuing punitive awards. In fact, the arrangement has the peculiar effect of providing a greater portion of the punitive damage award to the attorney than his or her client. There are no tort reforms in the new law.

The new law does include several provisions to try to address the concern that allocating punitive damages to the state could encourage higher and more frequent punitive damage awards. First, in order to ensure that judges are not biased toward awarding punitive damages, the law provides that the funds received by the state cannot be used to fund the courts or judicial programs. Second, the state cannot be a party in interest, intervene, or file an *amicus curiae* brief "regarding the propriety of, or the amount of, any punitive damages award in any action in which its sole interest is the potential recovery of a portion of a punitive damage award." Third, neither the parties nor the court may inform the jury that a portion of an award may go to the state.

The Law is Likely to Have Little Impact, but Could Fuel Future Legislation. What may be most striking about the punitive damages provision in the new budget agreement is that it is not likely to have much impact, if any, on the state's budget. The law applies only to cases filed after its effective date; pending cases are not impacted. Furthermore, a sunset provision provides that the division of punitive damages will apply only to cases finally adjudicated, including all mandatory and discretionary appeals, before June 30, 2006. It is unlikely the law will affect many cases during its less than two-year operational window. Plaintiffs' lawyers may simply choose to file cases later, delay discovery, seek extensions on motions or trial dates, file appeals or settle a case to avoid a final judgment before the sunset date.

The limited time in which the new law will be in effect should help neutralize potential negative impacts from the fees-splitting proposal for now. Nevertheless, the enactment of a split-recovery law in California may provide support for split-recovery proposals in other states that are experiencing budgetary shortfalls. These other states might not limit the scope of their laws the way California has done. Furthermore, despite a statement in the California law that the agreement is a "uniquely extraordinary legislative action" that is to form no policy or precedent for future legislatures, it is quite possible that the General Assembly could extend or repeal the sunset date, particularly if the law demonstrates the potential to generate substantial revenue for the state.

For these reasons, the limited impact of the new law in California should not be viewed as a problem solved, but as an issue to watch in other states next year, and again in California as the sunset date approaches.

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