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FEDERAL APPEALS COURT HOLDS TEXAS PUBLIC POLICY BARS INSURANCE OF PUNITIVE DAMAGES FOR CORPORATE MISCONDUCT

As we reported in our February 2008 Special Edition, the majority of the justices on the Texas Supreme Court refused to answer the broad question certified by the U.S. Court of Appeals for the Fifth Circuit of whether Texas public policy bars insurance coverage for punitive damages. Instead, the majority opinion in *Fairfield Ins. Co. v. Stephens Martin Paving*¹ issued a narrow ruling on the facts before it² and set out guideposts for making that determination in future cases. The analysis in the *Fairfield* opinion indicated that Texas would not join the seven states—California,³ Colorado,⁴ New York,⁵ Ohio,⁶ Rhode Island,⁷ South Dakota⁸ and Utah⁹—that have imposed a blanket prohibition against insuring punitive damages on public policy grounds, but left open the possibility that public policy could be invoked to bar coverage of punitive damages where circumstances warrant punishment of the insured. Now, in the case of *American International Specialty Lines Ins. Co. v. Res-Care Inc.*,¹⁰ the Fifth Circuit has followed the guideposts established by the majority opinion in *Fairfield*, as well as the rationale provided by four concurring justices, and held that Texas public policy prohibits coverage of punitive damages assessed against a corporate insured for acts of the business as a whole.

The *Res-Care* decision thus establishes the general rule that, unless there exists some compelling

consideration to the contrary, such as an expression of legislative intent or regulatory action, coverage of punitive damages assessed against a business for the acts of the business as a whole or its management contravenes the public policy of Texas. However, it can be inferred from the *Fairfield* and *Res-Care* cases that coverage is permitted when a business is held vicariously liable for an award of punitive damages assessed as a result of the malfeasance of an employee or agent.

The *Res-Care* case arose out of a wrongful death claim asserted against a group home operated by the insured. An employee poured bleach and another cleaning product on a mentally and physically disabled resident and left her sitting on the floor for several hours. Other staff members later administered improper treatment for her resulting burns. She was not seen by the staff doctor until 17 hours after the incident, at which time the severity of her burns was misdiagnosed. Nurses examining her failed to follow up, because she had been seen by the doctor. Three days after the incident, the resident was taken to an emergency room and diagnosed with extensive chemical burns covering 40% of her body. She died the following day of complications resulting from the burns. The group home employee who caused the initial injury was convicted of recklessly causing bodily injury to a disabled individual.

Res-Care had in place a commercial general liability policy with a limit of \$1 million and an umbrella policy with a limit of \$15 million. The primary policy covered damages arising out of an occurrence, to which the policy applied the standard definition of “an accident, including continuous

exposure to substantially the same general harmful conditions.” Both policies contained intentional acts exclusions. The umbrella policy also contained an express exclusion of punitive or exemplary damages.

The family filed a wrongful death and survival suit, during the course of which they made a \$16 million settlement demand. After receiving the settlement demand, the insurer issued a reservation of rights letter. In response to the insured’s urging that the insurer settle for an amount within the policy limits, the insurer refused to make an offer for more than \$2.5 million, representing its estimate of the compensatory damages at issue. Thereafter, the insurer and Res-Care entered into a non-waiver agreement authorizing the insurer to attempt to settle the underlying lawsuit. In the agreement, Res-Care acknowledged that the plaintiffs were seeking both compensatory and punitive damages and that the insurer believed that only compensatory damages were covered, but Res-Care believed the insurer had an opportunity to settle all claims within the available coverage limits. The parties agreed that if the insurer was able to negotiate a settlement of the underlying lawsuit, the insurer would have a right to proceed with a claim to recoup from Res-Care all sums the insurer paid that were attributable to claims not covered under the policies. Once the non-waiver agreement was in place, the insurer settled the underlying litigation for \$9 million.

The insurer then sued Res-Care in federal court for breach of the non-waiver agreement, arguing that Res-Care’s refusal to reimburse the settlement of uncovered damages constituted a breach of the agreement. The district court conducted a bench trial to apportion the settlement, and determined that the family’s actual damages were \$4 million, and the remaining \$5 million were punitive damages. Because punitive damages were not covered under the umbrella policy, the district court entered judgment for \$5 million in favor of the insurer.

On appeal, the Fifth Circuit analyzed the question of coverage for punitive damages under the primary policy by utilizing the two-step process prescribed by the Texas Supreme Court in *Fairfield*. Under this approach, the court must first determine whether the plain language of the policy covers

punitive damages. If so, the court’s next task is to determine whether Texas public policy allows or prohibits such coverage. At the second step of the inquiry, the court must first determine whether the Texas Legislature has made an express policy decision. In the absence of a legislative policy decision, the court must consider general public policies.

The court noted that the umbrella policy contained an express exclusion of punitive damages, and the primary policy made no mention of such damages. Because the insurer failed to raise its policy construction argument in its initial briefing, the court ruled that such argument had been waived and presumed that the primary policy language covered punitive damages by its silence on the subject.

Turning to the issue of public policy, the Fifth Circuit noted that there were no legislative pronouncements on coverage of punitive damages that were applicable to Res-Care and thus proceeded to an examination of general public policy. The court observed that, in the absence of a specific legislative policy directive, courts determine whether an agreement is unenforceable on public policy grounds by weighing the strong interest in preserving freedom of contract against the extent to which enforcement of a particular agreement would frustrate important public policy. In the case of punitive damages, the countervailing public policy interests are the punishment and deterrence purposes served by such awards. In recent years, the deterrence purpose has been downplayed in favor of the punitive aspect, leading the *Fairfield* court to observe that “punishment imposed through exemplary damages is to be directed at the wrongdoer.”¹¹

Res-Care argued that the underlying case fell within the exception the *Fairfield* court recognized for businesses held vicariously liable for damages due to the conduct of one of its employees. This exception permits coverage of punitive damages in cases in which “other employees and management are not involved in or aware of an employee’s wrongful act” in order to avoid “penaliz[ing] many for the wrongful act of one.”¹² The Fifth Circuit rejected this argument, concluding that the *Res-Care* case did not fall within this exception, but

rather involved the type of extreme circumstances described by the *Fairfield* court as warranting a different set of considerations so as not to eviscerate the punitive purpose behind awarding exemplary damages, as well as the court's traditional role in deterring conscious indifference.¹³

The Fifth Circuit pointed out that the complaint in the underlying action alleged that all defendants, including Res-Care, were grossly negligent in their actions, not only for direct participation in the incident that caused the initial injury, but also for failure to take reasonable steps to prevent the situation from occurring, and for failure to mitigate the harm caused by the incident. Among the allegations of gross negligence on the part of the corporate insured, Res-Care, was failure to ensure a safe environment, failure to maintain acceptable standards in hiring, failure to train its employees adequately and failure to ensure that the resident received proper medical care. The complaint also alleged that Res-Care employees failed to respond to the incident in a timely manner and failed to seek appropriate medical care for the injured resident. The court also noted that state regulators determined that Res-Care operated other facilities poorly, thereby establishing a course of conduct warranting exemplary damages. The court deemed it significant that the report by the State of Texas concluded that the failure of care of the decedent evidenced systemic problems at the facility, and recommended that the facility be closed. On this basis, the Fifth Circuit concluded that the circumstances of the injury and death on which the underlying lawsuit were based "were so extreme that the purposes of punishment and deterrence of conscious indifference outweigh the normally strong public policy of permitting the right to contract between insurer and insured." According to the court, the *Res-Care* case demonstrates the kind of avoidable, injury-causing conduct for which "public policy is best served by requiring the insured to bear the costs of punitive damages."

In future cases, insureds undoubtedly will argue to confine *Res-Care* to its extreme facts.¹⁴ However, this argument ignores the fact that, despite the frequency with which juries award them, punitive damages are intended to be reserved for those extreme instances in which the conduct at issue

is so reprehensible that it is deserving of punishment.¹⁵

The *Res-Care* opinion, together with the concurring opinion of four Texas Supreme Court justices issued in *Fairfield*, provide substantial support for the argument that indemnity for punitive damages awarded for injuries attributable, not to the isolated actions of a single rogue employee, but to corporate policies, systemic indifference or lack of proper supervision and discipline, violates the public policy of Texas. As a result, Texas has joined Connecticut¹⁶, Florida¹⁷, Illinois,¹⁸ Indiana,¹⁹ Kansas²⁰, Minnesota²¹, Oklahoma²² and Pennsylvania²³ in permitting coverage of punitive damages when the insured is held vicariously liable, but not when punitive damages are assessed as a result of conduct attributable to the insured entity as a whole.²⁴ Thus, in cases that do not involve issues of vicarious liability, insurers should not hesitate to argue that, under Texas law, the standard insuring language used in commercial general liability and aviation liability policies cannot be interpreted to cover punitive damages.

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¹ 246 S.W.3d 653 (Tex. 2008).

² Specifically, the *Fairfield* court ruled that Texas public policy is not violated by coverage of punitive damages under the standard form employers' liability policy prescribed by the Texas Department of Insurance. 246 S.W.3d at 670.

³ *PPG Indus. v. Transamerica Ins. Co.*, 20 Cal. 4th 310, 317, 975 P.2d 652, 657, 84 Cal. Rptr. 2d 455, 460 (1999) ("our public policy prohibits indemnification for punitive damages").

⁴ *Lira v. Shelter Ins. Co.*, 913 P.2d 514 (Colo. 1996). See also *Bohrer v. Church Mut. Ins. Co.*, 12 P.3d 854, 856 (Colo. App. 2000) ("Because punitive damages are intended to punish the defendant for wrongful acts and to deter similar conduct in the future, public policy prohibits an insurance carrier from providing insurance coverage for punitive damages.").

⁵ *In re September 11th Litigation*, 494 F. Supp. 2d 232, 240 (S.D. N.Y. 2007) (under New York law, "an insurer cannot be compelled to indemnify an insured for punitive damages under any circumstances").

⁶ OHIO REV. CODE § 3937.182(b) (2008).

⁷ *Allen v. Simmons*, 533 A.2d 541 (R.I. 1987).

⁸ *Fort Pierre v. United Fire & Cas. Co.*, 463 N.W.2d 845 (S.D. 1990).

⁹ UTAH CODE § 31-A-20-101(4) (2007).

¹⁰ Docket No. 04-20389, 2008 WL 2249612 (5th Cir. June 2, 2008). The official publication references are not yet available.

¹¹ 246 S.W.3d at 667.

¹² *Id.*

¹³ *Id.*

¹⁴ We are not alone in predicting this continuing conflict. Commentary on the *Res-Care* case posted on the Internet by the National Insurance Law Forum expressed the same view: "There should not be a continuing debate over this issue, but there will be as the policyholder counsel bar continues to argue for an over-expansive reading of *Fairfield* to permit the coverage of all punitive damage findings under all liability policies." *Coverage for Punitive Damages: The Debate Rages*, Posting of Chris Martin to the National Insurance Law Forum, <http://www.insurancelawforum.com/2008/07/articles/coverage/coverage/> (Jul. 4, 2008, 1:52 PM).

¹⁵ Indeed, David Pruessner, counsel for the insurer in the *Fairfield* case, has pointed out that cases in which punitive damages are sustained on appeal are those which arise out of extreme circumstances. After his defeat in the *Fairfield* case, Mr. Pruessner was concerned that punitive damage coverage might not be excluded in any case in Texas, but he believes the *Res-Care* ruling demonstrates that the exception the *Fairfield* court described "may turn out to be extremely broad." Mary Alice Robbins, *Insurance Doesn't Cover Punitives for Wrongful Death*, TEXAS LAWYER, June 16, 2008, available at

<http://www.law.com/jsp/tx/PubArticleFriendlyTX.jsp?id=1202422248808>.

¹⁶ *Bodner v. United Serv. Automobile Assoc.*, 222 Conn. 480, 610 A.2d 1212 (1992).

¹⁷ *Concrete Pipe Co. v. Bould*, 437 So. 2d 1061 (Fla. 1983).

¹⁸ *Beaver v. Country Mut. Ins. Co.*, 95 Ill. App. 3d 1122, 420 N.E.2d 1058 (Ill. App. Ct. 1981).

¹⁹ *Stevenson v. Hamilton Mut. Ins. Co.*, 672 N.E.2d 467 (Ind. Ct. App. 1997).

²⁰ *Hartford Acc. & Indem. Co. v. American Red Ball Transit Co.*, 262 Kan. 570, 938 P.2d 1281 (1997).

²¹ The Supreme Court of Minnesota has stated that, "in most instances, public policy should prohibit a person from insuring himself against misconduct of a character serious enough to warrant punitive damages." *Wojciak v. Northern Package Corp.*, 310 N.W.2d 675, 680 (Minn. 1981). However, that court ruled that, where the insured entity is held vicariously liable for punitive damages, there is no public policy prohibition against coverage. *Perl v. St. Paul Fire and Marine Insurance Co.*, 345 N.W.2d 209, 216 (Minn. 1984).

²² *Aetna Cas. & Sur. Co. v. Craig*, 771 P.2d 212 (Okla. 1989).

²³ *Pennbank v. St. Paul Fire and Marine Ins. Co.*, 669 F. Supp. 122 (W.D. Pa. 1987).

²⁴ It had been assumed that New Jersey took the same position on punitive damages.²⁴ However, on June 26, 2008, the New Jersey Supreme Court dispelled this notion, and announced that there are no public policy constraints to insurance coverage of punitive damages in that state:

there has never been a declaration by this Court or the Legislature that punitive damages are uninsurable. We have, in fact, allowed punitive damages against a public entity despite the obvious absence of deterrence and retribution against the wrongdoer. [Citation omitted.] It is exactly that scenario that is the underpinning of the notion that punitive damages should not be insurable. [Citation omitted.] Moreover, the Legislature has at least implicitly recognized that insurance of punitive damages does not violate the public policy of this State. N.J.S.A. 17:30A-5 (prohibiting recovery of punitive damages "unless covered by the policy").

Chubb Custom Ins. Co. v. Prudential Ins. Co., 195 N.J. 231, 245 n.3, 948 A.2d 1285, 1293 n.3 (June 26, 2008).