

With Compliments of

CONDON & FORSYTH LLP

7 TIMES SQUARE
NEW YORK, NEW YORK 10036
TEL: 212.490.9100
FAX: 212.370.4453

1901 AVENUE OF THE STARS
LOS ANGELES, CALIFORNIA 90067
TEL: 310.557.2030
FAX: 310.557.1299

Special Edition February 2008

LONG-ANTICIPATED DECISION IN TEXAS ON INSURABILITY OF PUNITIVE DAMAGES

On February 15, 2008, the Texas Supreme Court issued a long-anticipated decision on coverage of punitive damages. In *Fairfield Insurance Co. v. Stephens Martin Paving*, Docket No. 04-0728, 2008 WL 400397 (Tex. 2008),¹ the court was expected to respond to the following question certified to it by the United States Court of Appeals for the Fifth Circuit: whether Texas public policy prohibits a liability insurer from indemnifying an award of punitive damages imposed on its insured due to a finding of gross negligence. Instead, the court issued a narrow ruling confined to the facts of the case in which the question was certified, holding that Texas public policy does *not* prohibit coverage under an employers' liability insurance policy written on the standard form prescribed by the Texas Department of Insurance.

Recognizing that the Fifth Circuit had certified a broader question, the majority of the court offered an analysis of some of the factors the justices consider to be important in determining whether public policy prohibits insurance coverage of punitive damages in other types of cases.² This analysis suggests that the court is inclined to permit coverage of punitive damages in situations where a corporation is held liable for punitive damages arising out of the wrongful acts of an individual employee, or a defendant is otherwise held vicariously liable for the wrongful acts of another.

A concurring opinion to which four of the justices subscribed offers a more in-depth analysis and concludes that insurance for punitive damages

assessed against individuals does contravene the public policy of Texas. The four concurring justices strongly suggest 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 would likewise contravene the public policy of Texas.

Thus, while the *Fairfield Insurance* case is not the final word on insurability of punitive damages in Texas in any context other than workers' compensation and employer liability coverage, the majority and one concurring opinion provide analytical guideposts (and quotable language) for future cases.

MAJORITY OPINION

History of the Underlying Litigation and Declaratory Judgment Action

The *Fairfield Insurance* case arose out of a fatal accident involving an employee of Stephen Martin Paving, a highway paving company that had a workers' compensation and employer's liability policy issued by Fairfield. The family of the decedent sued the employer for gross negligence, seeking exemplary damages because the employer allegedly failed to provide a safe place to work, failed to follow and enforce OSHA regulations and failed to train and supervise its employees properly. Under Texas law, the survivors are permitted to seek exemplary damages in a suit against the decedent's employer, but are barred from seeking compensatory damages once they receive workers'

compensation benefits. Fairfield brought a declaratory judgment action in federal court, claiming that it had no duty to defend or indemnify its insured for claims premised solely on exemplary damages. The federal district court concluded that the language of the policy covers punitive damages and that Texas public policy does not preclude such coverage. Fairfield appealed and the Fifth Circuit certified the public policy question to the Texas Supreme Court.

Decision on the Facts of the Case

The Supreme Court engaged in a two-step analysis, first determining that the plain language of the policy covers the exemplary damages sought in the suit against the insured. The court noted that the workers' compensation portion of the policy excludes from coverage any payments in excess of the benefits regularly provided by the workers' compensation law, including those required due to serious and willful misconduct on the part of the employer and failure to comply with a health or safety law or regulation. The employer's liability portion of the policy excludes coverage of damages arising from injuries caused by intentional acts.

The court noted that the survivors' claim seeks only exemplary damages for gross negligence. As such, the coverage issue involved only the employer's liability portion of the policy. The Supreme Court presumed that the policy language covered the exemplary damages sought.

The second step of the analysis was to determine whether the public policy of Texas allows or prohibits coverage in the circumstances of the underlying lawsuit. In this regard, the Texas Supreme Court noted that the Texas Department of Insurance approves standard workers' compensation policies and endorsements. The court concluded that, by including the additional coverage in its approved form—the only policy form workers' compensation insurers are permitted to use—the statutory scheme and the execution of that scheme by the Texas Department of Insurance reveal an intent to provide additional insurance coverage for an employer's gross negligence. Under the approved standard form, employers have coverage for workers' compensation claims and claims based on gross negligence, but not intentional acts. The

court interpreted this fact as an expression of legislative intent that Texas public policy does not prohibit insurance coverage for claims of gross negligence in this context. 2008 WL 400397 at *4.

Analysis of Broader Certified Question

The court deemed its inquiry in the case before it to have been concluded with its determination of the Legislature's express intent with respect to coverage of punitive damages in gross negligence claims asserted against employers. However, recognizing that the Fifth Circuit certified a broad inquiry into Texas public policy and the coverage of exemplary damages, the court offered additional insights after expressing its hesitation to opine on policy language and fact situations not before it. The majority would only go so far as to discuss some of the considerations relevant to determining whether Texas public policy prohibits insurance coverage of exemplary damages in other contexts in the absence of the type of clear legislative policy decision it discerned in the workers' compensation and employer's liability context. 2008 WL 400397 at *5.

The Law in Other States

The court began its analysis of the broader question with a review of the law in other states. According to the court's survey, of the 45 states in which the highest court of the state or the legislature has addressed the insurability of punitive damages, 25 have stated that their public policy does not prohibit coverage. Eight states have adopted a broad prohibition against insuring punitive damages.³ Seven states allow insurance coverage of punitive damages only when the insured is held vicariously liable for the acts of another.⁴ Thus, the majority of states that have considered the question of whether public policy prohibits insurance coverage of gross negligence have decided that it does not. 2008 WL 400397 at *5.

Public Policy Considerations

The court noted its 150-year history of holding that exemplary damages serve to punish the wrongdoer and set a public example to prevent the repetition of the act. 2008 WL 400397 at *9. The court observed that legislative enactments in the last

decade have clarified that compensatory recovery is not a component of exemplary damages, and the most recent enactments downplay the role of deterrence and focus squarely on the punitive aspect. *Id.* According to the Texas Supreme Court, there exists some inherent tension between the policies fostering freedom of contract and the policy underlying awards of punitive damages.

Conclusions

While the court did not take any definitive positions beyond the facts of the case before it, it cited with approval the reasoning in two intermediate court opinions, *American Home Assurance Co. v. Safway Steel Products Co.*, 743 S.W.2d 693 (Tex. Ct. App. 1987), and *DaimlerChrysler Insurance Co. v. Apple*, 2007 WL 3105899 (Tex. Ct. App. 2007), which permitted insurance coverage of punitive damages awarded against a corporation held liable for the acts of its employees or agents. The Supreme Court stated that, where other employees and management are not involved in or aware of an employee's wrongful act, the purpose of exemplary damages may be achieved by permitting coverage so as not to penalize many for the wrongful act of one. "When a party seeks damages in these circumstances, courts should consider valid arguments that businesses be permitted to insure against them." 2008 WL 400397 at *12. However, "strong public policies may compel a serious analysis into whether a court may legitimately bar contracts of insurance for extreme and avoidable conduct that causes injury." *Id.* In this regard, the court cited as an example the fact that liability policies normally exclude coverage for intentional conduct. "The fact that insurance coverage for exemplary damages may encourage reckless conduct likewise gives us pause. Were the existence of insurance coverage to completely eviscerate the punitive purpose behind awarding exemplary damages, it could defeat not only an explicit legislative policy but also the court's traditional role in deterring conscious indifference." *Id.*

CONCURRING OPINION

The concurring opinion to which four of the nine justices subscribed provides a more in-depth

analysis, and is more direct in the conclusions it reaches.

Purpose of Punitive Damages

The concurrence pointed out that the first, and most important public policy consideration on this issue is that the purpose of punitive damages is to punish. The concurrence traced the history of the Section 41.001(3) of the Texas Civil Practice and Remedies Code and noted that earlier versions of the statute encompassed other purposes, such as deterrence and compensation, but that those purposes were eliminated in successive amendments. Under the current version of Chapter 41, the Texas statute governing civil remedies, punishment is the sole purpose of punitive, or exemplary damages. 2008 WL 400397 at *15.

Statutory Considerations

The justices noted further that the statute makes clear that punishment imposed through punitive damages is to be directed at the wrongdoer. 2008 WL 400397 at *16. An award of punitive damages must be specific as to a defendant, and each defendant is liable only for the amount of the award made against that defendant. *Id.* The concurrence observed: "If punitive damages are covered by insurance and paid from policyholders' premiums, so that the wrongdoer suffers no more than a sliver of the sanction, the sting of punishment is dissipated." *Id.* Insurance "would indisputably spread" the consequences of punitive damages "among many who deserve no punishment at all, which would contravene the policy clearly reflected in" the statute. 2008 WL 400397 at *17. "Rather clearly, insuring against punitive damages impairs their purpose." *Id.*

The concurring justices next examined whether insuring against punitive damages is consistent with the manner in which they are assessed. The justices noted that the Texas civil remedies statute lists six factors to be considered when determining the amount of exemplary damages to be awarded. Three of these factors are objective, for which the identity of the defendant is irrelevant;⁵ only the nature of the conduct matters. The remaining three factors—the degree of culpability of the wrongdoer; the situation and sensibilities of the parties

concerned; and the net worth of the defendant—are subjective.⁶ Such factors help determine what a specific defendant should be required to pay a specific plaintiff. “If punitive damages are covered by insurance, and the burden of payment thus shared in effect by the insurer’s policyholders, it makes no sense to set the amount based on whether the plaintiff was trusting or the defendant was calculating or wealthy....From individual, subjective circumstances one cannot extrapolate what penalty the community should bear.” 2008 WL 400397 at *18.

The justices concluded that insurance coverage makes it impossible to fulfill the Legislature’s requirement that the specific circumstances of a plaintiff and a defendant be taken into account in determining what amount of punitive damages should be assessed in a particular case. As such, insuring against punitive damages conflicts with the manner in which such damages must be assessed under the Texas statute governing civil remedies. *Id.*

Additional Considerations

The concurring justices examined specific instances in which the Texas Legislature expressly prohibited or limited insurance for punitive damages and found such actions to have been “sporadic over three decades, directed to specific, narrow circumstances, and largely unexplained.” As a result, the justices concluded “it is difficult to find an indication of public policy in the legislative limitations on, and express approvals of, punitive damages coverage.” 2008 WL 400397 at *20.

The concurrence, like the majority opinion, examined the actions of the Texas Department of Insurance in approving standard insurance forms such as the one at issue in the *Fairfield Insurance* case, as well as decisions from the intermediate appellate courts of Texas and the pronouncements on insurability of punitive damages from other states.

Guideposts for Future Cases

To address the broader question certified by the Fifth Circuit, the concurrence listed the following considerations to be taken into account:

- Contracts must be respected, and the right to contract freely should not be restricted without compelling reasons.
- Punitive damages may be assessed only as punishment and not for any other purpose, and thus they must be directed at the specific conduct of an individual defendant and must be based on his particular circumstances, including his net worth.
- Punitive damages coverage may pose an undesirable cost to insureds and to the public.
- Insurance is highly regulated, and the Commissioner of Insurance must have broad discretion to determine when punitive damages coverage may be offered.

2008 WL 400397 at *24.

CONCLUSION

When the insured is a corporation or other business that must pay punitive damages for the conduct of one or more employees when stockholders, other employees and management as a larger group “have done little to deserve punishment,” the concurring justices are of the view that “a valid argument can be made that businesses should be permitted to insure against” such punitive damages awards “so that the burden is shared by others in like situations.” This is due to the fact that, when punitive damages are assessed against an entire business for one employee’s wrongdoing, “the punishment is at best indirect.” *Id.*

However, the concurring justices also concluded that public policy considerations “counsel against extending that coverage to the wrongdoer himself,” because insuring “an individual against punitive damages for his own gross negligence entirely defeats the punitive purpose of such damages and reduces the disincentive for misconduct.” *Id.*

Taking into account the policy favoring freedom of contract, I would hold that when Chapter 41’s punitive purpose would be significantly impaired, and a defendant’s net worth could not be meaningfully incorporated in the assessment, as Chapter 41 requires, insurance against punitive damages would violate Texas public policy unless these considerations are outweighed by other factors, such as expressions of legislative will, or regulatory approval of the coverage, or the attenuation of the burden of liability from the misconduct. In these situations, in my view, there is no formulaic answer to the public policy question. Chapter 41 provides for punishment of a person who knows full well that his conduct poses an extreme risk of harm to others and yet does not care. That, in essence, is gross negligence. The public policy analysis must answer why punitive damages for such egregious behavior should be avoided by insurance.

2008 WL 400397 at *24.

CONTRIBUTOR
SPECIAL EDITION FEBRUARY 2008

KATHERINE B. POSNER
PARTNER, NEW YORK OFFICE
kposner@condonlaw.com

<http://www.condonlaw.com>

This Condon & Forsyth LLP Newsletter is intended to provide a summary of aspects of the subject matters covered, not to render comprehensive legal or other professional advice.

© 2008 CONDON & FORSYTH LLP

¹ The opinion has yet to be released for publication in the permanent law reports and thus, by rule, is subject to potential revision or withdrawal.

² One justice concurred in the holding but declined to join in the advisory portion of the opinion, and four of the justices joined in a separate concurring opinion that delved deeper into the considerations relevant to a determination of whether insurance policies can provide coverage for punitive damages.

³ The court cited authority for definitive statements that insuring punitive damages violates public policy from California, Colorado, Illinois, New York, Ohio, Rhode Island, South Dakota and Utah.

⁴ Connecticut, Florida, Kansas, Minnesota, New Jersey, Oklahoma and Pennsylvania currently permit insurance coverage of punitive damages only when the insured is held vicariously liable.

⁵ The three objective factors are the nature of the wrong; the character of the conduct involved; and the extent to which such conduct offends a public sense of justice and propriety. TEX. CIV. P. & REMEDIES CODE § 41.011(a)(1), (2) and (5).

⁶ TEX. CIV. P. & REMEDIES CODE § 41.011(a)(3), (4) and (6).