Coverage for Punitive Damages: You May Not Get What You Pay For

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Once an insurance policy has been purchased and is gathering dust in a file drawer, all questions about the type of coverage that it provides are supposed to be over. Such questions should have been addressed and resolved before the premium was set, the policy was written, and the policyholder's check was cashed.

Yet, in certain circumstances, the scope of an insurance policy can change long after the policy was bought and paid for. One such circumstance is when courts suddenly decide that a particular type of coverage – a type that has been sold for years – now offends public policy and is unenforceable.

This issue is on the front burner in Texas with regard to the question of insurance coverage for punitive damages. Even though lower courts in Texas have held that such coverage is allowed, the U.S. Court of Appeals for the Fifth Circuit recently submitted a certified question about this issue to the Texas Supreme Court. In early November, that court heard heated arguments from policyholders and insurance companies about whether it offends public policy to allow such coverage. As of the date of publication, the case – *Fairfield Insurance Co. v. Stephens Martin Paving* -- had not yet been decided.

A decision by the Texas Supreme Court to ban such coverage may wreak havoc on policyholders who already have purchased the coverage – typically, for pricey premiums. Such a decision could cause the immediate forfeiture of that existing coverage. It also could create a windfall of considerable scope for the insurance companies who were lucky enough to have sold it.

This situation raises questions about the viability of the policies that are stored away in a corporation's file drawers. It also illustrates an interesting dilemma for corporations to consider, going forward. Should they pay for coverage for punitive damages if it is offered, and hope that the coverage still exists if they ever need it? Or should they pass on this coverage, and use their valuable premium dollars for coverage that is not at risk of being forfeited?

The answers lie in part in a determination of what state law applies. In at least 18 states so far, the highest court has determined that insurance coverage for punitive damages does not violate public policy. Those states are: Arizona, Arkansas, Delaware, Georgia, Idaho, Iowa, Kentucky, Maryland, Mississippi, Montana, New Mexico, North Carolina, Oregon, Tennessee, Vermont, West Virginia, Wisconsin and Wyoming.[1] Corporations that are subject to the laws in those states have reason to feel confident about the viability of their coverage for punitive damages.

Twenty-Nine States and the District of Columbia Allow Coverage for Punitive Damages. Five States Do Not Allow This Coverage.

Corporations in 11 more states, and the District of Columbia, should feel confident as well – but more cautiously so. In those states, courts and/or legislatures have held that punitive damages assessed directly against a policyholder, as opposed to an agent or employee, are insurable. But these decisions are not grounded in public policy and, in some cases, have not been rendered by the state's highest court. Those states are: Alabama, Alaska, Connecticut, Hawaii, Louisiana, Michigan, Missouri, New Hampshire, South Carolina, Texas and Virginia.[2]

For good or for bad, the decision of whether to buy coverage for punitive damages should not arise at all for certain corporations – namely, the ones that are governed by the law of states that do not permit such coverage. As of the date of publication, those states were limited to Colorado, New York, Ohio, Rhode Island, and Utah.[3] Yet even in these states, the restrictions are varied, and corporations should make sure they understand exactly what is and is not allowed, at coverage-buying time.

Depending on the circumstances, policyholders may be able to argue that even these bans are of limited effect. Typically, the states that have precluded coverage for punitive damages are states that restrict the award of punitive damages to egregious situations. The argument would be that these bans never extend to states that are more lenient with such awards.

For example, New York strictly limits punitive-damage awards to situations where the tort-feasor engaged in "morally culpable conduct."[4] Thus, New York's ban on coverage for such awards can be seen as nothing more than a ban on coverage for morally culpable conduct – acts which may not be coverable in the first place.[5] Texas, in contrast, has allowed punitive damages to be granted under a relatively low standard of gross negligence.[6] In allowing coverage for punitive damages – at least thus far – Texas has conformed to a basic tenet of liability insurance, which is that gross negligence is insurable.

Even though, as the above summary shows, the trend favors coverage for punitive damages, policyholders should not sit by quietly, purchasing punitive-damage coverage for expensive premiums and trusting that the law will develop as it should. Instead, they can, and should, protect themselves as much as possible against courts that may go the wrong way.

One such action may be to keep a careful watch on the developing caselaw on this issue. Knowledge is power in most circumstances, and that certainly applies here. Before deciding whether to pay the hefty price that typically is charged for insurance coverage for punitive damages, policyholders should be up-to-date about the legal trends.

Another appropriate action may be to discuss this problem with a broker at the moment of acquisition. It may be possible, for example, to build in a reimbursement clause that would be triggered by a decision that such coverage is illegal. It also may be possible, depending upon the precedent within a particular state, to craft an endorsement that would provide extra protection. An open discussion may reveal that a number of alternatives are available.

A third action may be to cast a vote in favor of insurance coverage, through filing amicus briefs in leading cases and participating in organizations that express pro-policyholder views. The insurance industry speaks with one voice on such issues, and is effective at having its voice heard.[7] Unless policyholders do the same, they run the risk of being steamrollered.

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1. See *Cassel v. Schacht,* 683 P.2d 294 (Ariz. 1984); *California Union Ins. Co. v. Arkansas Louisiana Gas Co.*, 572 S.W.2d 393 (Ark. 1978); *Whalen v. On-Deck, Inc.*, 514 A.2d 1072 (Del. 1986); *Greenwood Cemetery, Inc. v. Travelers Indemn. Co.*, 232 S.E.2d 910 (Ga. 1977) (per curiam); *Abbie Uriguen Oldsmobile Buick, Inc. v. United States Fire Ins. Co.*, 511 P.2d 783 (Idaho 1973); *Skyline Harvestore Sys., Inc. v. Centennial Ins. Co.*, 331 N.W.2d 106 (Iowa 1983); *Continental Ins. Co. v. Hancock*, 507 S.W.2d 146 (Ky. 1974); *First National Bank of St. Mary's v. Fidelity & Deposit Co.*, 389 A.2d 359 (Md. 1978); *Anthony v. Frith*, 394, So.2d 867 (Miss. 1981); *First Bank (N.A.) Billings v. Transamerica Ins. Co.*, 679, P.2d 1217 (Mont. 1984); *S.Z. Wolff v. General Cas. Co. of Am.*, 361 P.2d 330 (N.M. 1961); *Mazza v. Medical Mut. Ins. Co. of N.C.*, 319 S.E.2d 217 (N.C. 1984); *Harrell v. Travelers Indem. Co.*, 567 P.2d 1013 (Or. 1977) (*en banc*); *Lazenby v. Universal Underwriters Ins. Co.*, 383 S.W.2d 1 (Tenn. 1964); *State v. Glens Falls Ins. Co.*, 404 A.2d 101 (Vt. 1979); *Hensley v. Erie Ins. Co.*, 283 S.E.2d 277 (W.Va. 1981); *Brown v. Maxey*, 369 N.W.2d 677 (Wis. 1985); *Sinclair Oil Corp. v. Columbia Cas. Co.*, 682 P.2d 975 (Wyo. 1984).

2. See *Capital Motor Lines v. Loring*,189 So. 897 (Ala. 1939); *LeDoux v. Continental Ins. Co.*, 666 F. Supp. 178 (D. Alaska 1987); *Berry v. Loiseau*, 614 A.2d 414 (Conn. 1992); *Salus Corp. v. Continental Cas. Co.*, 478 A.2d 1067 (D.C. App. 1984); HAW. REV. STAT. § 431:10-240 (Hawaii 1998); *Creech v. Aetna Cas. & Sur. Co.*, 516 So.2d 1168 (La. Ct. App. 1987); *Peisner v. Detroit Free Press, Inc.*, 304 N.W.2d 814 (Mich. Ct. App. 1981), aff'd, modified on other grounds, 364 N.W.2d 600 (Mich. 1984); *Colson v. Lloyd's of London*, 435 S.W.2d 42 (Mo. Ct. App. 1968); *Weeks v. St. Paul Fire & Marine Ins. Co.*, 673 A.2d 772 (N.H. 1996); *Carroway v. Johnson*, 139 S.E.2d 908 (S.C. 1965); *Ridgeway v. Gulf Line Ins. Co.*, 578 F.2d 1026 (5th Cir. 1978); *Dairyland County Mut. Ins. Co. v. Wallgren*, 477 S.W.2d 341 (Tex. Civ. App.-Fort Worth 1972); *Lerner v. General Ins. Co. of Am.*, 245 S.E.2d 249 (Va. 1978). It is reasonable to anticipate that Texas will move off this list soon, once the *Fairfield* case is decided.

3. See *Lira v. Shelter Ins. Co.*, 913 P.2d 514, 517 (Colo. 1996); *Soto v. State Farm Ins. Co.*, 635 N.E.2d 1222, 1224 (N.Y. 1994); but cf. *Zurich Ins. Co. v. Shearson Lehman Hutton, Inc.*, 642 N.E.2d 1065, 1067 (N.Y. 1994) (punitive damages may be insurable if the punitive award rendered in another state has a compensatory element); OHIO REV. CODE. ANN. § 3937.182; but cf *Corintian v. Hartford Fire Ins. Co.,* 758 N.E.2d 218, 221-22 (Ohio Ct. App. 2001) (noting this policy does not apply to statute permitting nursing home residents to collect punitive damages without a showing of intent, malice, willfullness, or recklessness); *Allen v. Simmons*, 533 A.2d 541, 542-44 (R.I. 1987); UTAH CODE ANN. § 31A-20-101.

4. *Walker v. Sheldon,* 10 N.Y.2d 401 (1961).

5. The New York Court of Appeals, which is that state's highest court, has held that the first step to analyzing whether to permit coverage in New York for a punitive damage award rendered out of state is to compare that state's standards to the standards in New York. *Home Ins. Co. v. American Home Products Corp.*, 75 N.Y.2d 196 (1990). The implication is clear that the coverage ban may not apply to awards rendered in states with lesser standards.

6. *American Home Assur. Co. v. Safway Steel Prods. Co.*, 743 S.W.2d 693, 700-01 (Tex. App. - Austin 1988)

7. *Outboard Marine Corp. v. Liberty Mut. Ins Co.*, 607 N.E.2d 1204, 1218 (Ill. 1992) (noting that "[t]he insurance industry is powerful and closely knit").

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