

Punitive Damages: What Can Your Company Do To Increase the Odds of Coverage?

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In some ways, it would be easy for businesses to underestimate the risk posed by punitive damages. As a statistical matter, punitive damages are fairly rare, being awarded in only 5% of federal civil trials in recent years. No one likes to imagine their company behaving in the sort of willful or egregious manner that would justify incurring such an unusual award. But the risk of punitive damages is multiplied exponentially by the sheer size and unpredictability of the typical award. It is not uncommon for juries to award punitive damages in amounts that are 10, 20, or even 100 times the amount of compensatory damages. And juries sometime reach vastly different decisions about whether to award punitive damages, or how much to award, even in cases with seemingly similar facts.

The risk of being hit with a large or unexpected damage award makes it wise for businesses to try to limit their exposure as much as possible, including by maintaining insurance that covers punitive damages. Unfortunately, this is often easier said than done. Many insurance policies contain exclusions for punitive damages, or are at least vague about whether punitive damages are covered. Worse yet, even if a policy would otherwise cover punitive damages, a number of states prohibit such coverage, in whole or in part, as a matter of public policy. This article provides guidance on these issues as your company looks for ways to control the risk of punitive damages.

Overview

Unlike compensatory damages, punitive damages are awarded to punish the wrongdoer and deter others from similar conduct. Most U.S. states permit the recovery of punitive damages, with Michigan being one of the very few exceptions.

Determining whether your company is insured against punitive damages is a two-step process. The first step is to determine whether the company's policy provides coverage for punitive damages. Assuming the answer is yes, the next step is to determine, under applicable state law, whether punitive damages are insurable as a matter of public policy. The following sections address each of these issues in turn.

Policy Analysis

Most insurance policies exclude coverage for damages arising from the intentional acts of the insured. This is usually accomplished by way of an express exclusion, or by defining "occurrence" to exclude damages that are "expected or intended from the standpoint of the insured." Thus, when analyzing coverage for punitive damages, the first step is to determine whether the underlying conduct involved



intentional acts. If the answer is yes, any damages related to those acts – whether punitive or compensatory – will be excluded from coverage under the policy.

Assuming the punitive damage award was based on unintentional conduct, the next question is whether it is otherwise covered by the policy. A few policies provide a clear answer to this question by expressly including or excluding punitive damages, making it easy to determine whether punitive damages are covered.

Unfortunately, the vast majority of policies on the market today – likely including your policy – do not fall into either of these categories. The standard form general liability policy drafted by the insurance industry states that the insurer agrees to pay "those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage'. . . ." The policy does not define "damages," and contains no exclusion for punitive damages. As a result, it neither expressly includes nor excludes punitive damages. Deciding whether the policy provides such coverage is left to the courts.

Nationwide, most courts faced with the issue have held that the language of the standard policy is broad enough to include punitive damages. In *Southern American Insurance Company v. Gabbert-Jones*, Inc., 13 Kan. App.2d 324, 328 (1989), for example, the court reasoned: "The policy does not say that all sums awarded as *compensatory* damages will be paid nor that all sums awarded *except punitive damages* will be paid. As we view it, upon issuance of the policy [the insurer] bound itself to pay all sums [the policyholder] might be required to pay as damages, both compensatory and punitive, because of bodily injury caused by an accident."

While a majority of courts find the standard policy to include coverage for punitive damages, a few courts disagree. These courts generally focus on the terms "bodily injury" and "property damage," holding that punitive damages, which are assessed to punish and not to compensate for injury or damage, do not fit within the scope of the policy. While this is a questionable result as a matter of policy interpretation, the important point is that some courts do not find punitive damages to fit within the coverage of the standard form policy.

Because of this lack of certainty, the safest way for your business to ensure that it is covered for punitive damages is to purchase a policy that expressly includes it. As discussed below, however, depending on what state's law applies, even a policy that expressly covers punitive damages may not always be sufficient.

Public Policy Analysis

The coverage analysis for punitive damages does not end with the four corners of your company's policy: even if the policy would otherwise provide coverage, a few states prohibit such coverage as a matter of public policy. These states have concluded that the underlying goals of punitive damages – to punish and deter misconduct – would be undermined if insureds were permitted to shift the risk of liability for such damages to an insurance company, effectively avoiding the punishment imposed. Thus, by statute or



court decision, these states have banned or significantly limited coverage for punitive damages.

The majority of states, however, reject this view and are willing to enforce punitive damages coverage. These courts conclude that, where the parties have bargained for a policy that covers punitive damages, it would be unjust to deny the policyholder the benefit of its bargain and allow the insurer to escape the coverage it was paid to provide.

Many of the jurisdictions that prohibit coverage for punitive damages recognize an exception for cases where the insured's liability is strictly vicarious, since the insured is relatively innocent and is being punished for someone else's conduct. In *United States Fidelity & Guaranty Co. v. Open Sesame Child Care Center*, 819 F. Supp. 756 (N.D. III. 1993), for example, the court permitted coverage for a child care center that incurred punitive damages based on the misconduct of one of its employees.

The following breakdown shows the public policy judgments of the 50 states regarding the insurability of punitive damages:

- 24 states permit punitive damages coverage in all cases: Alabama, Alaska, Arizona, Arkansas, Delaware, Georgia, Hawaii, Idaho, Iowa, Louisiana, Maryland, Mississippi, Montana, New Hampshire, New Mexico, North Carolina, Oregon, South Carolina, Tennessee, Texas, Vermont, Washington, Wisconsin, and Wyoming.
- 3 states allow coverage for damages arising from grossly negligent conduct, but not reckless or intentional conduct: Nevada, Virginia, and West Virginia.
- 8 states prohibit coverage in all cases: California, Colorado, New York, North Dakota, Ohio, Rhode Island, South Dakota, and Utah.
- 10 states otherwise prohibit coverage, but allow it for cases of vicarious liability: Connecticut, Florida, Illinois, Indiana, Kansas, Kentucky, Minnesota, New Jersey, Oklahoma, and Pennsylvania.
- 2 states prohibit coverage in the uninsured-motorist context, but have not otherwise addressed the issue: Maine and Massachusetts.
- 3 states have not yet addressed the issue or the law is unclear: Michigan, Missouri, and Nebraska.

A further discussion of Michigan law follows.

Does Michigan permit punitive damages coverage?

The law in Michigan is unusually complex when it comes to punitive damages. Unlike the vast majority of states, Michigan does not recognize the concept of punitive damages, no matter how reprehensible the



defendant's conduct. Michigan instead permits recovery for what it calls "exemplary damages," awarded not to punish the wrongdoer but to compensate the plaintiff for emotional injuries. As the Michigan Supreme Court has explained: "An award of exemplary damages is considered proper if it compensates a plaintiff for the 'humiliation, sense of outrage, and indignity' resulting from injuries 'maliciously, wilfully and wantonly' inflicted by the defendant." *Kewin v. Massachusetts Mutual Life Insurance Company*, 409 Mich. 401, 419 (1980).

To date, no Michigan court has yet addressed the insurability of exemplary damages under Michigan law. However, because such damages are strictly compensatory and are not intended to punish or deter misconduct, there appears to be no reason they would not be insurable, even applying the public policy considerations followed by states that prohibit coverage for punitive damages. A Michigan insurance policy should therefore cover exemplary damages unless it expressly excludes them.

But what about punitive damages? Because punitive damages are not recognized in Michigan, the question of their insurability will rarely arise here. However, it would arise if a policyholder were found liable for punitive damages in another state and held an insurance policy governed by Michigan law. Unfortunately, no Michigan court has yet addressed such a scenario. As a result, it is unclear whether Michigan courts would find punitive damages to be insurable as a matter of public policy.

Notwithstanding this, there is some reason to believe Michigan courts might approve of punitive damages coverage. In *Meijer, Inc. v. General Star Indemnity Co.*, 826 F. Supp. 241 (W.D. Mich. 1993), the policyholder was found liable for punitive damages under Ohio law and held a insurance policy governed by Michigan law. The United States District Court for the Western District of Michigan held that Michigan law required enforcement of the policy: "To hold that punitive damages are not recoverable would create, in effect, an exclusion for which the parties did not negotiate and allow insurance companies to collect premiums for coverage . . . and then escape their obligation to pay on a claim by a mere judicial declaration that the contract is void by reason of public policy. . . . No reason exists under Michigan law for this Court to aid an insurer that fails to exclude coverage for punitive damages."

Although the federal court's decision in *Meijer* is not binding on Michigan courts, it does provide clues as to how a Michigan court might approach the insurability of punitive damages. Until a Michigan court has the opportunity to consider the issue directly, however, it remains unclear whether punitive damages are insurable under Michigan law.

Increasing the Odds of Coverage

As all of this shows, there are two primary hurdles that must be cleared in order to have coverage for punitive damages: (1) the policy itself must provide coverage; and (2) there must be no applicable public policy restrictions. To the extent either of these hurdles presents a problem, there are a number of things your business can do to maximize the odds of coverage.



For the first hurdle, the safest strategy is to bargain, in exchange for additional premium, for the inclusion of a provision that expressly covers punitive damages. This is advisable even if your company is located in a state that does not permit punitive damages coverage, or in a state (like Michigan) that does not recognize punitive damages at all, because, as we have seen, it is possible to be hit with a punitive damages award in a court proceeding in another state.

For the second hurdle, there are several options for getting around – or at least minimizing – any applicable public policy restrictions. First, the insured could purchase its policy in a state that permits coverage for punitive damages, and attempt to bargain for a choice of law provision stating that the policy will be interpreted according to that state's law. This is far from an air-tight solution, however, since a court, applying applicable choice of law rules, might refuse to enforce this type of provision if the claim otherwise has no connection with the chosen state – for example, if neither the insured nor the insurer are residents of the state and the underlying injury and damage award occurred elsewhere.

To get around this problem, the insured could instead attempt to negotiate for a "most favorable venue" clause, which typically states that the insurability of punitive damages will be governed by the law of the state that most favors insurability, so long as it is the state where: (a) the punitive damages were awarded; (b) the act giving rise to the punitive damages award occurred; (c) the insured is incorporated or maintains its principal place of business; or (d) the insurer is incorporated or maintains its principal place of surviving a court challenge. To date, however, it does not appear that such a provision has been tested in court.

One final option – in place of or in addition to a choice of law provision – is to purchase a punitive damages "wrap" policy, primarily available in off-shore markets, aimed at filling any gaps left by jurisdictional restrictions on punitive damages coverage. While each of these options will be more difficult and costly to obtain, they will provide an otherwise absent measure of comfort about your company's coverage for punitive damages.

If you have questions about this or any other insurance issue, please contact Joe Kuiper, chair of the Insurance Practice Group, at 616.752.2481 or <u>jkuiper@wnj.com</u>.