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Texas Supreme Court Allows Coverage of Punitive Damages for Gross Negligence in Workers Compensation Case

On February 15, 2008, the Texas Supreme Court issued its opinion in *Fairfield Insurance Co. v. Stephens Martin Paving, LP*, No. 04-0728, 2008 WL 400397, in which it held, in a workers' compensation setting, that Texas public policy did not prohibit insurance coverage for "exemplary" damages¹ resulting from an employer's gross negligence. This opinion, issued in response to a certified question from the Fifth Circuit Court of Appeals, is the first time the Texas Supreme Court has addressed the issue, and is consistent with the trend of decisions elsewhere elevating the principle of freedom of contract above concerns about undermining the purposes of punitive relief. However, the court declined to make a broader statement beyond the workers' compensation context, and a concurrence joined by four justices raised significant questions over whether the consequences of egregious conduct should be avoided by insurance.

In *Fairfield*, the surviving family of the decedent employee of defendant Stephens Martin Paving (SMP) brought suit against SMP seeking exemplary damages, alleging that SMP failed to create a safe workplace when the decedent was killed due to a rollover accident at work. In addition to filing suit, the family also received workers' compensation benefits. Under the Texas workers' compensation statute, receipt of those benefits did not prohibit the family from seeking exemplary damages based on allegations that the decedent's death was the result of his employer's gross negligence.

Subsequently, *Fairfield*, which provided the workers' compensation and employer's liability insurance to SMP, brought suit in the U.S. District Court for the Northern District of Texas against SMP and the surviving family members, seeking a declaration that *Fairfield* owed neither a duty to defend nor to indemnify SMP in connection with the underlying lawsuit. When the district court held that the policy issued by *Fairfield* did in fact

cover exemplary damages, *Fairfield* appealed to the Fifth Circuit. The Fifth Circuit then requested that the Texas Supreme Court provide guidance on the public policy of Texas with respect to the insurability of exemplary damages for gross negligence.

The Texas Supreme Court, in an opinion authored by Justice Wainwright, applied a two-prong test to analyze the issue: (1) are exemplary damages covered under the plain language of the policy; and, if so, (2) does the public policy of Texas otherwise prohibit coverage of exemplary damages?

While most of the opinion centered on the second part of the test, the court cursorily examined the relevant policy language. The employer's liability portion of the policy obligated *Fairfield* to pay "all sums [SMP] legally must pay as damages because of bodily injury to [its] employees" but excluded damages arising from injuries caused by intentional acts. There was no broad exclusion for exemplary damages although the policy contained other provisions that excluded "punitive or exemplary damages because of bodily injury to an employee employed in violation of law," but only if the violation "caused or contributed to the bodily injury." After setting forth these provisions, however, the court did not analyze them in any detail. Instead, because the Fifth Circuit's question pertained only to the "public policy" issue, the court presumed that the policy language covered the exemplary damages sought.

On the question of whether Texas public policy prohibited insurance coverage of exemplary damages for gross negligence in the workers compensation context, the court first looked at whether any statutory provisions prohibited such coverage elsewhere. It identified two specific instances in which coverage of exemplary damages was prohibited in Texas: in matters involving health care providers and insolvent insurers. The court found that because the state legislature

¹Other jurisdictions more commonly refer to these types of damages as "punitive" and the two terms -- "punitive damages" and "exemplary damages" -- are synonymous.

expressly prohibited coverage of exemplary damages in these instances, the legislature was cognizant of the issue and knew that it could exercise its authority where it deemed appropriate. However, because the legislature authorized the Texas Department of Insurance to create a policy that provided insurance coverage for exemplary damages in workers' compensation cases, the court found that allowing coverage in the case before it was not against Texas public policy.

While acknowledging that its analysis could have ended there, the court went on to discuss coverage of exemplary damages in a context broader than workers' compensation, and examined the relevant law throughout the rest of the country as set forth in statutes and judicial opinions. Regardless of whether these statutes and opinions prohibit insurability, virtually all recognize the purpose of exemplary damages in the first place: to punish wrongdoing and deter future similar conduct. From that starting point, however, views diverge on insurability. (See attached chart for a state-by-state breakdown of the law.) With varying conditions, a majority of states do not prohibit insurability of exemplary damages. In those states that do prohibit coverage, it is prohibited based primarily on the principle that insuring a "wrongdoer" insulates the wrongdoer from the effects of punishment.

For its part, the Texas Supreme Court recognized the high premium placed upon the freedom of contract in Texas and held that without a directive from the state legislature to curtail such freedom, it would be reluctant to do so on its own. But the court also recognized that contracting to insure such damages could undermine certain factors codified by the Texas legislature to assist in determining the appropriate amount of exemplary damages to assess in a particular case. In addition, the court expressed concern that insuring exemplary

damages could lead to increased reckless conduct. After a lengthy discussion of these competing public policies, it decided to limit its holding to the context of workers' compensation: "Without clear legislative intent to generally prohibit or allow the insurance of exemplary damages arising from gross negligence, we decline to make a broad proclamation of public policy here but instead offer some considerations applicable to the analysis in other cases."

Justice Johnson concurred in the opinion, agreeing with the main holding but declining to join the additional public policy analysis because, in his view, such analysis was unnecessary to answer the Fifth Circuit's question.

Justice Hecht authored a lengthier concurrence, joined by three other justices (Brister, Medina and Willett). In contrast to Justice Johnson, Justice Hecht believed that the Fifth Circuit's question called for a discussion beyond the arena of workers' compensation. His concurrence acknowledged the value of the freedom to contract, but not at the expense of other public policies which can, at times, outweigh that freedom.

The concurring justices ultimately agreed with the majority that, in the workers' compensation context, insuring exemplary damages for the death of an employee caused by the employer's gross negligence was not against public policy. However, had a different circumstance been presented before the concurring justices, e.g., insuring exemplary damages under state-mandated uninsured / underinsured motorist coverage, a different result likely would have been reached. Justice Hecht wrote that "there is no formulaic answer to the public policy question" and a number of factors needed to be considered in each situation. He further explained that Texas law "provides for punishment of a person who knows full well that his con-

duct 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."

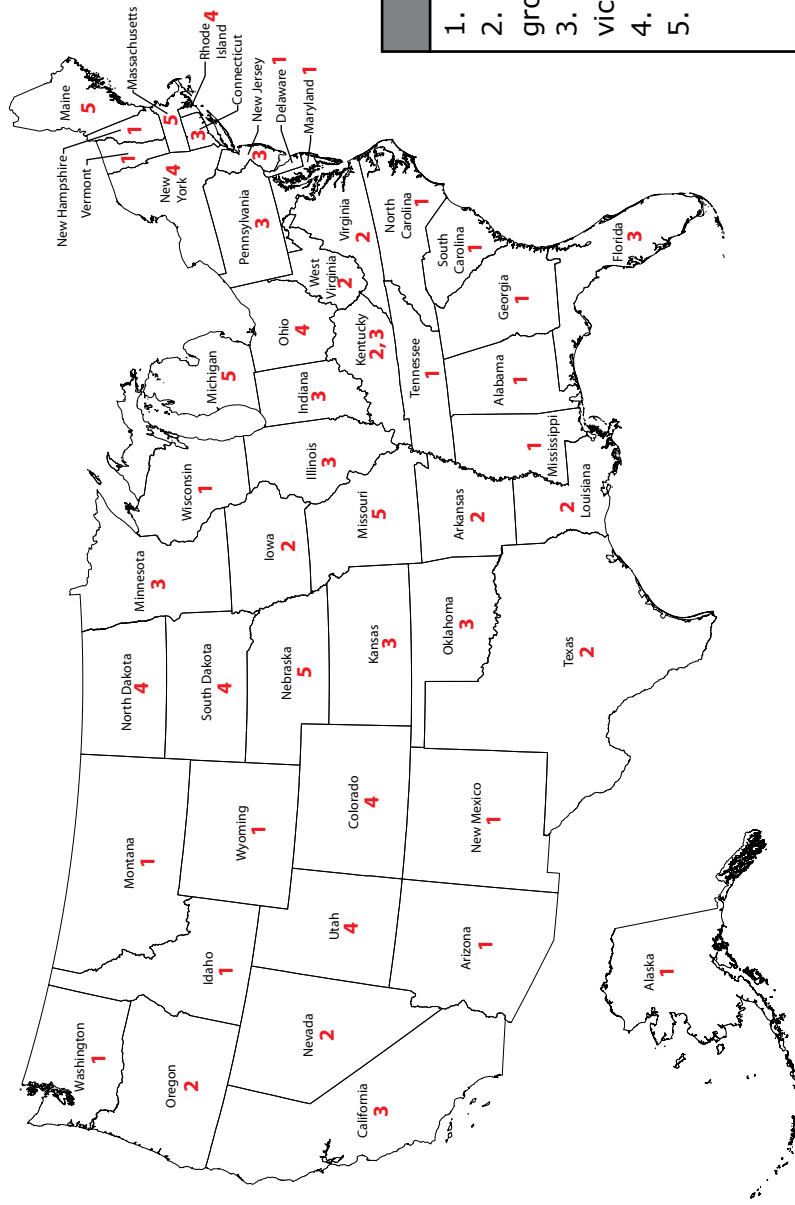
With this opinion, Texas joins the ranks of most states which allow, with varying degrees of limitations, the insurability of punitive damages.² Given the high premium placed upon freedom of contract, and the potential sway of the concurring justices to reach a different conclusion under different circumstances, if insurers intend for coverage of punitive damages to be excluded under Texas law, such exclusion must be made clear in the policy. If the policy language itself clearly excludes coverage for punitive damages, a court may end its inquiry there regardless of public policy. If, however, insurers are contemplating offering such coverage, business decisions need to be made as to the scope of punitive risk accepted and also whether to accept the risk of potential litigation involving the interpretation of the contractual language at issue. The Fairfield decision makes clear that freedom of contract, as important as it is in Texas, nevertheless has its limits.

ABOUT THE AUTHORS

Joe Hinkhouse and Rich McDermott are attorneys in the firm's litigation department, and concentrate on the representation of insurers and reinsurers in complex commercial disputes, including disputes involving questions of coverage and extra-contractual liability. Joe also chairs the firm's Direct Insurance Practice Group. Theresa Duckett focuses her practice in environmental law, with a broad spectrum of experience in regulatory and transactional matters as well as in litigation, where her experience also includes reinsurance and complex commercial disputes.

²Interestingly, the trend of allowing the insurability of punitive damages is taking place at the same time as the trend of courts to place limitations on the amount of punitive damages permitted in the first place. Most recently, on March 6, 2008, the Oregon Supreme Court, following the lead of recent U.S. Supreme Court decisions (*BMW v. Gore*, 517 U.S. 559 (1996) and *State Farm v. Campbell*, 538 U.S. 408 (2003)), set a general guideline for lawsuits involving punitive damages (at least those that arise out of economic, as opposed to physical, harm) by concluding that four times the actual damages should be the limit in Oregon. *Goddard v. Farmers Ins. Co.*, SC S053405.

A STATE-BY-STATE LOOK AT INSURABILITY OF PUNITIVE DAMAGES



Legend

1. Generally permits coverage of punitive damages
2. Generally permits coverage of punitive damages for grossly negligent conduct but not for more serious conduct
3. Generally permits coverage of punitive damages for viciously-assessed liability but not directly-assessed
4. Generally prohibits coverage of punitive damages
5. Silent, undecided or otherwise unclear