

Punitive Damages—Setting an Example

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The Insurance Services Office, Inc., commercial general liability (CGL) policy will not pay punitive damages imposed on an insured. This is so because we believe it to be so—a matter of faith.

by [Craig F. Stanovich](#)
[Austin & Stanovich Risk Managers, LLC](#)

The most common reason given for this belief is that punitive or exemplary damages are *always* uninsurable as a matter of law—public policy does not allow payment of such damages. Some will also assert that the CGL policy does not provide coverage for punitive damages, either because the CGL policy automatically includes an express exclusion or because ... well, it just doesn't cover punitive damages.

Punitive Damages Defined

According to *Black's Law Dictionary* (8th edition), punitive damages are assessed to penalize the wrongdoer or to make an example to others. As a general matter, the purpose of awarding punitive or exemplary damages, which are imposed *in addition* to sums to compensate the injured party for actual loss, is to punish and deter blameworthy conduct.

When Imposed

The nature of the conduct that permits juries to punish or make an example of the defendant may vary considerably. At one end of the spectrum is the view that punitive damages are awarded to punish conduct that is tantamount to *criminal* behavior.

Exemplary or punitive damages ... are authorized to be inflicted when the wrong done partakes of a criminal character, though not punishable as an offense against the state, or consists of aggravated misconduct or a lawless act.

Winn & Lovett Grocery Co. v. Archer, 126 Fla. 308, 171 So. 214 (1936)

A little further along this spectrum is the view that punitive damages are appropriate where the defendant's conduct constitutes *willful or intentional wrongdoing*.

Such damages are allowed, after an award for compensatory damages, in negligence cases when there has been some willful misconduct...

Lazenby v. Universal Underwriters Ins. Co., 383 S.W.2d 1 (Tenn. 1964)

The misconduct we have in mind is intentional or malicious wrongdoing....

Northwestern Nat'l Cas. Co. v. McNulty, 307 F.2d 432 (5th Cir. 1962)

And further along the spectrum still, punitive damages are awarded for injuries for acts of gross negligence.

Thus, in North Carolina punitive damages may be awarded in negligence cases for wanton or gross acts.

Mazza v. Medical Mut. Ins. Co. of N.C., 319 S.E.2d 217 (N.C. 1984)

The "Public Policy" Issue

Whether by statute or caselaw, most states have addressed the issue of the insurability of punitive damages—that is, deciding whether it is contrary to public policy to allow insurance to pay punitive damages. But the answers here are often complex. What is considered appropriate public policy is a difficult question at best. Such conclusions require the balancing of interests and are ever evolving. A simple "yes" or "no" usually does not emerge.

Prohibition of the Insurability of Punitive Damages

The prohibition of the insurability of punitive damages based on public policy typically hinges on the answer to one overriding question: whether the purposes of punishment and deterrence are defeated by allowing insurance to pay for such damages. Why punitive damages may be against public policy is well explained in the seminal case of *Northwestern Nat'l Cas. Co. v. McNulty*, 307 F.2d 432 (5th Cir. 1962):

Where a person is able to insure himself against punishment he gains a freedom of misconduct inconsistent with the establishment of sanctions against such misconduct. It is not disputed that insurance against criminal fines or penalties would be void as violative of public policy. The same public policy should invalidate any contract of insurance against the civil punishment that punitive damages represent.

... punitive damages are awarded for punishment and deterrence would seem to require that the damages ultimately rest ... on the party actually responsible for the wrong. If the person were permitted to shift the burden to an insurance company, punitive damages would serve no useful purpose.

In actual fact, of course, and considering the extent to which the public is insured, the burden would ultimately come to rest not on the insurance companies but on the public, since the added liability to the insurance companies would be passed along to the premium payers. Society would then be punishing itself for the wrong committed by the insured.

Uninsured and Underinsured Motorists Coverage

Several states view uninsured motorists (UM) or underinsured motorists (UIM) coverage a bit differently as respects punitive damages. As UM and UIM coverage is paid by the insurer of the *innocent party*, most states have concluded that requiring payment of punitive damages to the insured under UM or UIM coverage would not be justified.

... most jurisdictions holding that punitive damages are not recoverable under the injured party's UM coverage also note that it would be antithetical to require the UM carrier to pay a penalty assessed against the wrongdoer, because the burden of payment would fall not upon the wrongdoer, or even the insurer of the wrongdoer, but upon the insurer of the innocent party.

Kentucky Cent. Ins. Co. v. Schneider, 15 S.W.3d 373 (Ky. 2000)

A similar observation was made regarding UIM coverage, with the added observation that the "statutory scheme" of the legislature did not intend for the insurer to pay punitive damages to the insured.

We do not think that the Legislature, in devising a statutory scheme by which the victim of an underinsured motorist may be compensated for his or her losses, obligated the insurer to provide coverage for punitive damages. Allowing recovery of punitive damages would not serve the purpose of compensating the injured party ... rather, it would result in payment of punitive damages by a party who was not a wrongdoer.

Santos v. Lumbermens Mut. Cas. Co., 556 N.E. 983 (Mass. 1990)

The Vicarious Liability Exception

Those states that disallow insurance for punitive damages often do *not* apply the public policy prohibition to punitive damages imposed on a person or organization for the actions of another. In other words, punitive damages vicariously imposed may not be against public policy to insure, even in those states that have concluded that punitive damages are uninsurable for direct liability. In *McNulty*, above, the court observed:

A different situation is present where the sole liability of the insured arises out of the relation of master and servant. In this situation where there was no direct or indirect volition upon the part of the master in the commission of the act, no public policy is violated by protecting him from the unauthorized and unnatural act of his servant. Public policy is not violated by insurance in such a situation....

The Supreme Court of Oklahoma considered punitive damages imposed vicariously and commented:

In almost all jurisdictions which disallow insurance coverage for punitive damages, an exception is recognized for those torts in which liability is vicariously imposed on the employer for a wrong of his servant. In that class of litigation, public policy does not inhibit a shift in liability incidence to the insurer unless the employer's volition was either directly or indirectly an element in the commission of the harm. We are in accord with this view and hold that public policy against insurance protection for punitive damages does not preclude recovery of indemnity from the insurer by an employer to whom either willfulness or gross negligence of his harm-dealing employee became imputable for imposition of liability under the Oklahoma application of the *respondeat superior* doctrine.

Dayton Hudson Corp. v. American Mut. Ins. Co., 621 P.2d 1155 (Okla. 1980)

Permitting the Insurability of Punitive Damages

Many states have concluded (in some instances by statute¹) that insuring punitive damages is *not* against public policy *in many cases*²—and is thus permitted. The typical reasons stated for the allowance of insurance to pay for punitive damages are that there is little evidence that punitive damages have the effect of deterring the wrongdoing and that the punishment would, if insurance is not allowed, be on the general public as the cost of punitive damages would not be borne by the premium payers but instead by the society at large in the increased costs of products and services.

Deterrence

It would be pure speculation to conclude that by denying coverage that accidents on the highways would decrease or that operators of automobiles would be any more careful in their driving habits.

Lazenby v. Universal Underwriters Ins. Co., 383 S.W.2d 1 (Tenn. 1964)

Since punitive damages are recoverable in North Carolina in cases where intentional injury is not involved, there is a compelling reason that this Court should not create a new public policy prohibiting insurance coverage for punitive damages. The insurance company in this case would not contend that doctors would be more reckless or would more frequently commit gross negligence simply because they are insured under a professional liability insurance policy that covers punitive damages.

Mazza v. Medical Mut. Ins. Co. of N.C., 319 S.E.2d 217 (N.C. 1984)

Punishment

The court of appeals observed that while allowing exemplary damages coverage shifts the burden of the punishment to "the innocent members of society who purchase insurance," contrary to the purpose of such damages, disallowing coverage for a large corporation means that exemplary damages for the misconduct of perhaps one or only a few employees will "inevitably be passed on to the consumers of its products—who are also innocent," also contrary to the damages' purpose.

Fairfield Ins. Co. v. Stephen Martin Paving LP, 246 S.W.3d 653 (Tex. 2008)

Further, some courts have questioned whether the situations in which punitive damages are awarded can be readily distinguished from situations in which only compensatory damages are awarded. For example, in cases where facts are virtually identical, one jury may award only compensatory damages (to which the insurance applies) while another jury (based on the same facts) may also award punitive damages, which public policy disallows as insurable.

Compensatory versus Punitive Damages

In the *McNulty* case insurance protection was disallowed in order that the insured might be punished for his wrongdoing and to deter him and others from similar conduct. Yet, on identical facts, another jury might have returned an award limited to compensatory damages only in which case the wrongdoer would be fully protected under provisions of a policy such as here. The line of demarcation between the allowance of punitive damages and compensatory only is too thin and exacting in my opinion to apply coverage in the one case and deny coverage in the other. Verdicts of juries are unpredictable.

Lazenby v. Universal Underwriters Ins. Co., 383 S.W.2d 1 (Tenn. 1964)

Does the Policy Provide Coverage?

While many of the cases deciding whether insurance provides coverage for punitive damages are automobile liability cases, the focus has been on the insuring agreement. Specifically, do "damages" because of bodily injury or property damage include only compensatory (or actual) damages? Or do "damages" because of bodily injury or property damage include all damages?

The insurer contends the policy does not include punitive damages recovered against the insured because its terms do not expressly provide for payment of that class of damages. Instead, the provision covers "damages because of injury" which the insurer claims is confined to payment for actual damages.

The policy provisions in the case at bar *make no distinction between actual and punitive damages*. Punitive damages are not specifically excluded. Under the plain language of the policy the company promises to pay on behalf of the insured *all sums* which the insured shall be legally obligated to pay as damages because of injury.... Hence the policy provision—"for all sums which the insured might become legally obligated to pay"—*is sufficiently broad to include liability for punitive damages*. (Emphasis added)

Dayton Hudson Corp. v. American Mut. Ins. Co., 621 P.2d 1155 (Okla. 1980)

Similarly, courts have noted that the insuring agreement (or policy) contains no exclusion for punitive damages:

The plain and ordinary meaning of the language used in the policy, particularly from the viewpoint of a layman, covers "all damages" and contains no exclusion for punitive damages.

Mazza v. Medical Mut. Ins. Co. of N.C., 319 S.E.2d 217 (N.C. 1984)

My conclusion is that if the insurance industry feels that punitive damages protection should not be afforded under automobile liability policies, it can very easily make a provision in the exclusions section to that effect. Until this is done, I am of the opinion that the insured should receive the coverage sought to be denied in this case.

Lazenby v. Universal Underwriters Ins. Co., 383 S.W.2d 1 (Tenn. 1964)

The CGL Policy

A CGL insurance policy does *not* automatically exclude coverage for *punitive damages*—although a punitive damages exclusion may be added by endorsement. Absent such an exclusion, the vast majority of courts that have ruled on the matter have found that the CGL does provide coverage for punitive damages awards.

... an insurance company which admittedly took a premium for [indemnifying against] *all liability for damages*, should honor its obligation." ... We held, therefore, that an *express exclusion was required to eliminate* coverage for punitive damages from *general liability insurance* because the insured was personally at risk if his liability insurance did not cover those damages. The essence of the transaction was the insured's purchase of indemnification against all damages for which he might be held liable. (Emphasis added)

State Farm Mut. Auto Ins. Co. v. Wilson, 782 P.2d 727 (Ariz. 1989)

Caveat—All Other Terms and Conditions Still Apply

It is critical to keep in mind, however, that the obligation to pay punitive damages by a CGL insurer is *always* subject to *all other terms and conditions of the CGL policy*. For example, if punitive damages are imposed on an insured for an excluded act—intentional infliction of injury, for example—the CGL policy either does not provide coverage for that insured (not an occurrence) or excludes coverage (intended bodily injury). But what is excluded is not the punitive damages but

rather the *intentional wrongdoing* of the insured that resulted in the award of punitive damages.

All Sums

Today's CGL insurance policies do not contain the phrase "all sums" but rather "those sums" as respects the damages payable. At least one court has addressed the lack of "all sums" wording directly, finding coverage and rejecting the contention that removing "all sums" acted to exclude punitive damages.

While General Accident could have contracted to exclude punitive damages, it did not do so by the language it chose to use. It argues that the "uniform net loss" provision used in almost all liability insurance contracts typically states that the insurance company will pay "all sums" which the insured shall become legally obligated to pay arising from bodily injury or property damage, and that, therefore, *General Accident excluded punitive damages by not agreeing to pay "all sums."* As the phrase was so artfully turned in oral argument, we agree that, "rich and resourceful as is the English language," *General Accident could have excluded punitive damages by means other than forgoing use of the words "all sums."* (Emphasis added)

Baker v. Armstrong, 744 P.2d 170 (N.M. 1987)

Conclusion

To categorically state that the CGL policy will *never* pay punitive damages because punitive damages are *always* uninsurable as a matter of law is clearly erroneous. Texas's highest court provides some recent (2008) perspective on the insurability of punitive damages throughout the United States.

Forty-five states have addressed the insurability of punitive or exemplary damages. Of those, 25 generally *do not* prohibit insurability on public policy grounds—but do prohibit in some instances for UM or UIM coverage. Eight states have a broad prohibition against insuring punitive damages, and seven states allow coverage for punitive damages only if imposed vicariously but otherwise prohibit insurance for punitive damages. The court concluded:

Thus, the majority of states that have considered whether public policy prohibits insurance coverage of exemplary damages for gross negligence, either by legislation or under the common law, *have decided that it does not.* (Emphasis added)

Fairfield Ins. Co. v. Stephen Martin Paving LP, 246 S.W.3d 653 (Tex. 2008)

Further, the conclusion that the CGL policy wording *always* excludes or otherwise does not provide coverage for punitive damages has little, if any, support. The oft-cited contention that "damages" include only "actual" damages in a CGL (or other) policy and do not include punitive damages has not generally been upheld.

However, too narrow a focus on whether punitive damages are insurable as a matter of law and whether the CGL policy includes coverage as "damages" may result in overlooking an essential point—the CGL policy is always subject to all terms, limitations, conditions, and exclusions. The character of the wrongdoing that resulted in award of punitive damages or the nature of the bodily injury or property damage itself may be excluded from coverage. Punitive damages awarded against

an insured for pollution will likely be excluded because of the CGL pollution exclusion—not because of the types of damages that may result.

Justice Gewin addressed the issue of focusing too closely on the type of damages rather than the conduct that resulted in the award of damages in *McNulty*:

The more appropriate basis upon which to hold that public policy prohibits insurance against liability is the *nature of the conduct of the wrongdoer—not the nature of the damages awarded*. If the defendant acted willfully, intentionally, maliciously or fraudulently, coverage should be denied; because, in such circumstances, he should not be able to avoid punishment by shifting the penalty to an insurance carrier. I doubt that such protection is ever afforded by insurance, because the companies who are experienced in such matters and who write the contracts, expressly exclude such conduct from the protection afforded by the policy. (Emphasis added)

Northwestern Nat'l Cas. Co. v. McNulty, 307 F.2d 432 (5th Cir. 1962)

Justice Gewin's comments in *McNulty* add some insight into why a state may conclude that punitive damages are not insurable—to the extent that punitive damages are imposed because of conduct that is similar to criminal conduct or actions that constitute intentional wrongdoing or fraudulent or malicious conduct, insurance should not apply as the element of fortuity is utterly lacking.

Punitive damages imposed for gross negligence present an entirely different set of circumstances and should be viewed accordingly.

Thus, Justice Gewin's admonition is well reasoned—consider the nature of the conduct rather than only the types of damages awarded.

¹Virginia Code Section 38.20227: "It is not against public policy of the Commonwealth for any person to purchase insurance providing coverage for punitive damages arising out of the death or injury of any persons as the result of negligence, including willful and wanton negligence, but excluding intentional acts."

²... it is important to note that punitive damages are recoverable for injuries *other than those intentionally inflicted*," (emphasis added) *Mazza v. Medical Mut. Ins. Co. of N.C.*, 319 S.E.2d 217 (N.C. 1984).

Craig F. Stanovich is co-founder and principal of Austin & Stanovich Risk Managers, LLC, a risk management and insurance advisory consulting firm specializing in all aspects of commercial insurance and risk management, providing risk management and insurance solutions, not insurance sales. Services include fee-based "rent-a-risk manager" outsourcing, expert witness and litigation support, and technical/educational support to insurance companies, agents, and brokers. Website: www.austinstanovich.com. E-mail: cstanovich@austinstanovich.com

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