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# insurance law newsletter

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STEPHENS MARTIN  
PAVING:**

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## ***Fairfield Insurance v. Stephens Martin Paving: Insuring Punitive Damages Is Not Against Public Policy, But Is It Covered???***

In another important case regarding the intricacies of Texas insurance law, the Supreme Court of Texas answered a certified question from the U.S. Fifth Circuit Court of Appeals in *Fairfield Insurance Co. v. Stephens Martin Paving, LP*, 2008 WL 400397 (Tex. Feb. 15, 2008). The Court held that Texas public policy did not prohibit coverage for punitive damages under the workers' compensation and employer's liability insurance policy at issue in the instant case. The Court did not address whether such damages actually are covered by such insurance policies, or whether the same answer held true for other types of liability insurance policies. Nevertheless, the Court's holding provides some insight as to how it might address such issues in the future.

### **A. Background Facts**

Stephens Martin Paving, LP ("SMP") is a highway paving company, which employed Roy Edward Bennett ("Bennett") as an operator of a brooming machine. On December 20, 2002, Bennett died as a result of injuries he suffered after being rolled over by a brooming machine. Fairfield Insurance Company ("Fairfield") insured SMP under a workers' compensation and employer's liability insurance policy, and Fairfield paid workers' compensation benefits under the policy to Bennett's family according to Texas workers' compensation law.

Approximately a year later, the Bennett family sued SMP for gross negligence and sought recovery of only exemplary damages. Because the family had received workers' compensation benefits, it could not seek actual damages, which were barred by the exclusive remedy provision of the Workers' Compensation Act. In February 2003, Fairfield filed a declaratory judgment action against SMP and the Bennett family and sought a declaration that it owed no duty to defend or indemnify SMP in the suit for exemplary damages. The federal district court, relying on *Ridgway v. Gulf Life Insurance Co.*, 578 F.2d 1026, 1029 (5th Cir. 1978), held that the Fairfield policy covered exemplary damages and that Texas public policy did not prohibit insurance coverage of those damages. Accordingly, that court denied Fairfield's motion for summary judgment and ruled that it had a duty to defend SMP. Fairfield appealed to the Fifth Circuit, which certified to the Supreme Court of Texas the question of whether exemplary damages for gross negligence are insurable. *Fairfield Ins. Co. v. Stephens Martin Paving, LP*, 381 F.3d 435, 437 (5th Cir. 2004).

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**CASES TO WATCH:**

*Ulico Cas. Co. v. Allied Pilots Ass'n*, 187 S.W.3d 91 (Tex. App.—Ft. Worth 2005, pet. granted) (argued on April 11, 2007) (whether Texas recognizes coverage by waiver and/or estoppel when an insurer undertakes the defense without adequately reserving rights)

*American Home Assur. Co., Inc. v. Unauthorized Practice of Law Comm.*, 121 S.W.3d 831 (Tex. App.—Eastland 2003, pet granted) (argued on September 28, 2005) (scope of the tripartite relationship between insurer, insured, and defense counsel retained by insurer)

*OneBeacon Ins. Co. v. Don's Building Supply, Inc.*, 2007 WL 2258192 (5th Cir. Aug. 8, 2007) (certifying trigger issue to the Supreme Court of Texas)

*Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, pet. granted) (scope of the eight-corners rule and proper trigger theory to apply to "property damage" cases)

**B. Punitive Damages are Insurable under the Workers' Compensation Act**

Initially, the Court acknowledged that the question before it required a two-step process: (1) does the plain language of the policy cover the exemplary damages sought in the underlying lawsuit; and (2) if so, does Texas public policy allow coverage in the circumstances of the underlying suit. With regard to the first question, the Court quickly decided that the only part of the policy possibly implicated was the employer's liability portion of the policy. The Court, however, assumed without deciding that the language of the employer's liability portion of the policy covered exemplary damages. "Because the Fifth Circuit's question is directed only at the public policy of Texas, we limit our discussion to the second prong of the analysis and presume that the policy language covers the exemplary damages sought." *Fairfield Ins. Co.*, 2008 WL 400397, at \*2.

Turning to the question of public policy, the Court recognized that the Texas legislature "is aware of and sensitive to issues of insurance coverage of exemplary damages." *Id.* at \*3. In fact, the legislature previously had decided that coverage of exemplary damages is unacceptable in select circumstances involving health care providers and guaranty funds and excess liability pools. Turning to the Workers' Compensation Act, the Court noted that the insurance policies allowed under the Act provide broad coverage for an employee's injuries. But, in exchange for that coverage, employers are protected from common law claims by an injured party unless the claims involve the death of an employee caused by an employer's intentional or grossly negligent conduct. *Id.* An employee that fails to "opt out" of that system waives claims not provided by the Act. Thus, at least in most cases, workers' compensation insurance provides the exclusive remedy for the injury or death of a participating employee. The Court explained, though, that the exclusive remedy does not prohibit recovery of exemplary damages if the employee's death is caused by the employer's gross negligence. *Id.* at \*4 (citing TEX. INS. CODE § 408.001(b)-(c)).

Further, the Court noted, the Legislature had delegated to the Texas Department of Insurance ("TDI") the authority to make and enforce the rules and regulations necessary to carry out the provisions of the Act, including but not limited to the power to approve standard workers' compensation policies and endorsements. The only form approved by TDI is a dual-coverage form in which the workers' compensation part provides coverage only for the benefits required by the workers' compensation laws and other enumerated costs, excluding exemplary damages. Because, that policy also provides additional liability insurance under the employer's liability part, the Court reasoned that the statutory scheme and TDI's execution of it reveal the Legislature's intent to provide additional insurance coverage for an employer's gross negligence. The Court said:

Under TDI's policy, a participating employer would have coverage for workers' compensation claims and claims based on gross negligence. The Legislature's expressed intent is that Texas public policy does not prohibit insurance coverage for claims of gross negligence in this context.

*Id.*

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**CASES TO WATCH:**  
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*Johnson v. State Farm Lloyds*, 204 S.W.2d 897 (Tex. App.—Dallas 2006, pet. granted) (scope of the standard appraisal clause)

*Mid-Continent Cas. Co. v. JHP Development, Inc.*, 2005 WL 1123759 (W.D. Tex. Apr. 21, 2005) (appealed to the Fifth Circuit Court of Appeals) (application of exclusions j(5) and j(6))

*D.R. Horton—Texas, Ltd. v. Markel International Ins. Co., Ltd.*, 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006, pet. filed) (scope of the eight-corners rule and the relationship between the duty to defend and the duty to indemnify)

**C. Public Policy Outside The Texas Legislature**

Although the above discussion was sufficient to answer the question of whether exemplary damages are insurable in the instant case, the Court nonetheless addressed important considerations relevant to determining whether Texas public policy prohibits such coverage in different contexts in the absence of a clear legislative policy decision. The Court, consistent with other recent opinions in which it attempted to stay within the mainstream, first acknowledged that the debate surrounding the insurability of punitive damages was widespread in the United States. The forty-five states that have addressed the issue in some form—whether in the courts or in the legislature—have reached several different conclusions in the matter. Some opine that their public policy generally does not prohibit such coverage except for maybe in the context of uninsured motorists or vicarious liability. Others have instituted a broad prohibition of such coverage regardless of context. And still others only have addressed the issue in the specific context of a particular type of insurance (e.g., uninsured motorist coverage). In sum, the Court concluded that the majority of courts have held that public policy does not prohibit coverage of exemplary damages for gross negligence. *Fairfield Ins. Co.*, 2008 WL 400397, at \*5

Addressing the arguments under Texas law, the Court emphasized that the resolution of the issue required weighing Texas' general policy favoring freedom of contract versus the extent to which an agreement insuring exemplary damages frustrates important public policy. Regarding freedom of contract, the Court explained that it has long recognized the state's strong public policy in favor of such freedom. *Id.* at \*7 (citing, for example, *Lawrence v. CDB Servs., Inc.*, 44 S.W.3d 544, 553 (Tex. 2001)). At the same time, the Court recognized that the freedom has an "indispensable partner"—that is, the enforcement of contracts. Thus, "[a]s a rule, parties have the right to contract as they see fit as long as their agreement does not violate the law or public policy." *Id.* at \*8 (citations omitted). And, absent strong public policy for holding otherwise, the preservation of such freedoms equally is applicable in the relationship between an insured and an insurer. *Id.* (citing *Fortis Benefits v. Cantu*, 234 S.W.3d 642, 648, 649 (Tex. 2007)).

Looking specifically at exemplary damages, the Court explained that when the Legislature is silent on the insurability of such damages, it must look at the purpose of exemplary damages. That purpose is found in the common law and legislative developments in Texas. Accordingly, the Court discussed the longstanding principle behind punitive damages, which is to punish a wrongdoer. Having done so, the Court noted that "[t]here is some inherent tension between the policies recognized by freedom of contract and the policy behind awarding exemplary damages." *Id.* at \*11. The Court reviewed one appellate court case where allowing coverage of exemplary damages in the context of uninsured or underinsured motorist policies was found to entirely defeat the purpose of such damages because the liability for those payments falls entirely on the insurers and its policyholders and not on the tortfeasor. *Id.* (citing *State Farm Mut. Ins. Co. v. Shaffer*, 888 S.W.2d 146, 147 (Tex. App.—Houston [1st Dist.] 1994, writ denied)). The Court also examined cases that discussed whether exemplary damages should be covered when the basis for damages is the conduct of the insured's

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employees or agents. *Id.* (citing *Am. Home Assurance Co. v. Safway Steel Prods. Co.*, 743 S.W.2d 693, 695–96 (Tex. App.—Austin 1987, writ denied); *DaimlerChrysler Ins. Co. v. Apple*, 2007 WL 3105899, at \*1-\*2 (Tex. App.—Houston [1st Dist.] Oct. 25, 2007, reh’g filed)).

Summarizing the aforementioned cases, the Court said in regard to the uninsured/underinsured motorist context: “[T]he purpose of exemplary damages may not be achieved by penalizing those who obtain the insurance required by law for the wrongful acts of those who do not.” *Id.* at \*12. In the context of vicarious liability, however, “the purpose of exemplary damages may be achieved by permitting coverage so as not to penalize many for the wrongful act of one.” Thus, the Court found that “[t]he touchstone is freedom of contract, but 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. In addition, the Court said: “The fact that insurance coverage for exemplary damages may encourage reckless conduct likewise gives us pause.”

Based on the foregoing, the Court refused to invalidate the parties’ workers’ compensation contract in order to enforce a public policy raised by Fairfield but not yet addressed by the Legislature. Accordingly, in answering the certified question, the Court answered that “the public policy of Texas does not prohibit insurance coverage of exemplary damages for gross negligence in the workers’ compensation context.” *Id.* at \*13. Because of the limits of the certified question, however, the Court refused to make a broad statement as to public policy on the matter in other contexts.

#### **Commentary:**

The Supreme Court of Texas’ opinion in *Fairfield Ins. Co.* actually may raise more questions than it answers. The Court was clear in limiting its ruling to the certified question before it. Thus, while it found that public policy did not prohibit the insurability of exemplary damages in the context before it, the Court did not *specifically* rule on the insurability of punitive damages outside of that context. Even so, albeit in dicta, the Court did address general principles regarding the insurability of such damages that may be considered in other contexts. Along the way, the Court hinted that in some contexts it may find such insurance prohibited (e.g., uninsured/underinsured motorist coverage) but in others find it acceptable (e.g., vicarious liability cases). Accordingly, while it is clear that in this case, under these facts, public policy does not prohibit coverage, it is not entirely clear how the public policy issues will be applied in other contexts. And, in fact, there were two concurring opinions—one of which went into great detail into the relevant considerations of when punitive damages should be and should not be insurable under Texas public policy. The length of the concurring opinion, which was joined by three other justices, demonstrates that some disagreement exists on the Court as to when public policy would prohibit the insurability of punitive damages in other contexts.

Moreover, it is important to recognize that the Supreme Court was answering a question of public policy. As the Court noted, for example, liability policies normally bar insurance for damages caused by intentional conduct. Therefore, even if the insurability of punitive damages is not against public policy, it is quite possible that the conduct that would give

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rise to a punitive damage award would fall outside of a particular policy's coverage. In other words, after *Fairfield Ins. Co.*, it cannot be assumed that coverage exists for punitive damages outside of the narrow context of this case. Some policies, for example, specifically exclude punitive damages. Other policies are silent on punitive damages, but have exclusions for "expected or intended injuries" or have "occurrence" requirements that may or may not be satisfied if the conduct in question rises to the level that punitive damages may be awarded.



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Lee H. Shidlofsky is a founding partner of Visser Shidlofsky LLP. His practice is devoted to representing and counseling corporate policyholders in the area of insurance law, risk management, contractual risk transfer, and extra-contractual issues. He is Treasurer of the Insurance Law Section and holds a council position in the Construction Law Section of the State Bar of Texas. He is the author of numerous articles and seminar papers and is a frequent speaker at continuing legal education seminars in Texas and across the country. Mr. Shidlofsky has been named a "Super Lawyer" by Texas Monthly Magazine each year since 2004, including a ranking as a Top 50 attorney in the Central and West Texas Region for 2007, and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal.

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