

## Insurance Coverage for Punitive Damage Awards



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Despite the chronic efforts of their opponents, punitive damages are not likely to just disappear. On October 11, the Supreme Court heard oral arguments on a case concerning the constitutionality of punitive damage awards for the fifth time in six years.

In *BMW v. Gore*, an Alabama jury awarded \$4,000 in compensatory damages and \$4 million in punitive damages to the purchaser of a BMW automobile because BMW did not disclose that it had refinished paint damage to the car before selling it. BMW's conduct was not regulated in Alabama, and was expressly legal in many states nationwide.

Nonetheless, the jury awarded the \$4 million in punitives based specifically on BMW's nationwide refinishing over a 10-year period, including conduct in states where this activity was legal. The Alabama Supreme Court reduced the punitive damages award to \$2 million. The U.S. Supreme Court is expected to announce its ruling next year.

It is a foolish corporate lawyer or risk management professional who concludes that "This won't happen here." It is equally naive to believe that punitive damages are only assessed against knowing deliberate contact akin to criminal activity. Awards such as the one in *BMW v. Gore* illustrate the need, and provide the rationale, for insurance coverage for punitive damage awards.

### *Insurance Companies Ignore Their Underwriters' Intent*

It is clear beyond doubt that the drafters and sellers of standard form commercial general liability insurance policies (formerly comprehensive

general liability insurance policies) intended to include punitive damages within the scope of coverage. In the late 1970's, the insurance industry considered a specific punitive damage exclusion and roundly rejected the idea (*Business Insurance*, April 3, 1978).

Despite this, insurance companies frequently offer two reasons for refusing to pay punitive damage claims. First, they assert that it is against public policy for insurance to cover wrongdoers whose wrongs have been labeled by a jury as sufficiently severe as to warrant punitive damages. Second, they contend that they never intended to cover punitive damages, and that the policy does not in fact provide for such coverage.

### *The Rationales*

Proponents and opponents of insurance coverage can point to diverse and conflicting public policy values to support their positions.

Courts, legislatures, and commentators who oppose insurance coverage for punitive damages make the following arguments:

- (1) The punitive and deterrent purposes of punitive damages will be voided if it is possible to purchase insurance against punitive damages;
- (2) Policyholders should not escape punishment by shifting punitive damage awards to the insurance company and eventually to the general public through increased premiums; and
- (3) If policyholders are able to avoid paying punitive damage awards through insurance, then such awards become nothing more than windfall payments to claimants, far in excess of necessary compensatory damages.

On the pro-coverage side, those who favor allowing insurance coverage for punitive damages make the following arguments:

- (1) The freedom of contract between private parties should not be interfered with by the courts or the government;
- (2) The average policyholder usually expects that standard form commercial general liability insurance includes coverage for punitive damages and to hold otherwise is an unreasonable interference with that expectation;
- (3) Punitive damage awards have a very questionable deterrent effect since business people see them as random and erratic; and
- (4) Insurance coverage should be available to avoid the potential bankruptcy of individuals and businesses resulting from extremely large (and often seemingly arbitrary) punitive damage awards.

At the heart of this debate are assumptions which are often more about punitive damages than they are about insurance. Many believe that punitive damages are already arbitrary windfalls doled out to plaintiffs on a random basis. Under this view, businesses need and deserve protection from such unpredictable costs.

### *Nationwide Overview*

Nationwide, vastly divergent state law rules apply to insurance coverage for punitive damages under standard form commercial general liability insurance policies.

At one end of the spectrum, states such as New York do not allow punitive damages to be covered under any circumstances.

At the other end, states such as Iowa not only allow punitive damages to be covered by insurance under all circumstances, but further require that an insurance company specifically exclude insurance coverage for punitive damages from their insurance policies if the insurance company does not intend to provide such coverage.

In between, some states allow punitive damages to be covered only if one or more of the following conditions exist:

- (1) Punitive damages coverage is specifically provided for in the insurance policy;
- (2) The damages are vicariously assessed—that is, the damages are assessed for the

wrongdoing of another, as when an employer is liable for the unauthorized actions of an employee;

- (3) The policyholder is a municipality;
- (4) The punitive damages are awarded for unintentional behavior; or
- (5) Any combination of the above.

### *One Form, One View*

Policyholders require the benefits of certainty and uniformity. It simply is not fair for a policyholder to purchase an insurance policy which purports to cover punitive damages, only to have that coverage whisked away by a court. The only way to create an environment in which the reasonable expectations of policyholders can be met is for there to be more uniformity in the rules of the states. At a minimum, certain basic provisions should be uniform.

First, general liability insurance policies should be interpreted to allow insurance coverage for punitive damages unless specifically, and clearly, excluded. Imprecise language, such as an exclusion for “fines and penalties” should not exclude punitive damages awards; nor should a policy which requires the insurance company to “compensate others for loss” exclude punitive damages under the rationale that punitive damages are not compensatory in nature (*DeShong v. Mid-States Adjustment, Inc.*, Mo. Ct. App., 1994). These are just the sort of imprecise exclusions that pave the way for misunderstanding.

Second, at a minimum, punitive damages for vicarious liability should be insurable under the law. Application of this principle would provide policyholders with some protection against punitive damages awards which are not based upon directly morally reprehensible behavior, while allowing those states that wish to emphasize the deterrent nature of punitive damages to do so for the most blameworthy conduct. Yet even this rule might not guarantee insurance coverage for awards such as those in *BMW v. Gore*.

### *Policyholder Options*

In the meantime, because of the possibility of being sued and subject to punitive damages awards in unexpected venues, policyholders interested in obtaining insurance coverage for punitive damages should request language specifically providing insurance coverage for punitive damages.

They should do so even if they reside in a state which does not allow insurance coverage for such awards, or if their state does not require punitive damages to be specifically mentioned in order for insurance coverage to exist. In addition, policyholders should consider purchasing their insurance in states that allow such insurance coverage, and adding a choice-of-law clause to the policy to try to ensure which state's law will apply. ■

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