



International Association  
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# Reinsurance, Excess and Surplus Lines Committee Newsletter

June 2008

## **Fifth Circuit Applies *Fairfield* to Find That Texas Public Policy Prohibits Coverage for Punitive Damages Under a CGC Policy**

BY ROBERT D. ALLEN, ESQUIRE

It took over three years after the oral argument for the Texas Supreme Court to issue its opinion in *Fairfield Ins. Co. v. Stephens Martin Paving*, 246 S.W.3d 653 (Tex 2008), (“*Fairfield*”) earlier this year. In a very limited holding, the Texas Supreme Court held that it was not against Texas public policy to insure punitive damages in the context of a workers compensation policy insuring an employer for gross negligence wrongful death cases. From that precedent, it took only four months for the Federal Fifth Circuit Court of Appeals to hold that it is against Texas public policy to insure punitive damages under a primary Commercial General Liability policy in *American International Specialty Lines Ins. Co. v. Res-Care, Inc.* 2008 U.S. App. LEXIS 11758 (5th Cir. June 2, 2008).

### **Background Facts**

Underlying this coverage case was a particularly volatile wrongful death case brought by the family of Trena Wright against Res-Care, its pertinent subsidiaries and several employees (“*Wright v. Res-Care*”). According to the pleadings, Trena Wright was a 37 year old woman who suffered from cerebral palsy and other mental disabilities. She resided at a home, Appleridge, which was owned by Res-Care, that provided services to mentally disabled individuals. For the critical time period, Res-Care, its subsidiaries and employees were covered by primary and umbrella liability policies issued by American International Specialty Lines Insurance Co. (“AISLIC”).

The background facts of the events leading up to Ms. Wright’s death are horrible and they are set out in detail in the Fifth Circuit’s opinion in *AISLIC v. Res-Care*. Suffice it to say, she died, in a most undignified way, from complications emanating from a fall four days earlier. The first employee who happened upon her after the fall was convicted of recklessly causing bodily injury to a disabled individual.

As the underlying *Wright v. Res-Care* case proceeded, Res-Care demanded AISLIC to settle the claims against it and AISLIC urged Res-Care to contribute to the settlement

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because it believed that the punitive damage exposure was not covered. AISLIC and Res-Care, then, executed a non-waiver agreement that allowed AISLIC to settle the *Wright v. Res-Care* litigation and then possess the "right to proceed with a claim for recoupment from the Res-Care Defendants of all sums paid by [AISLIC] attributable to any claims not covered under the applicable Policies." Eventually, AISLIC settled on behalf of Res-Care for \$9 million and then sued Res-Care for recoupment of the non-covered portion of the settlement.

In the instant recoupment litigation, AISLIC took the position that the actual damages in the *Wright v. Res-Care* settlement were between \$2 million and \$3.5 million and that the remainder of the settlement was attributable to non-covered punitive damages. Res-Care posited that the entire \$9 million settlement was covered. The district court presided over a bench trial to apportion the non-covered and covered portions of the settlement pursuant to *Enserch Corporation v. Shand Morahan & Co.*, 952 F.2d 1485 (5th Cir. 1992).

The district court determined that the entire \$9 million settlement was attributable to the injuries emanating from the fall (even though other non-related incidents were also alleged in the suit). The district court apportioned the settlement as \$4 million for actual damages and \$5 million in punitive damages. The district court then rendered judgment that AISLIC recoup \$5 million from Res-Care.

### **Fifth Circuit Analysis**

The Fifth Circuit's analysis of the legal issues arising from the underlying settlement involved waiver and estoppel, number of occurrences, trigger, burden of proof and whether Texas public policy precluded the insurability of the punitive damages aspect of the settlement. While all of these issues and the Fifth Circuit's treatment of them are noteworthy, this casenote will focus solely on the court's treatment of the insurability of punitive damages.

To begin with, it should be noted that the subject AISLIC umbrella policy specifically excluded coverage for punitive damages, so that policy was not in play for the punitive damages aspect of the settlement. The relevant AISLIC primary policy did not contain a punitive damages exclusion, so the Fifth Circuit analyzed whether it is against Texas public policy to insure the punitive damages aspect of the settlement under that policy in light of the specific facts of this case.

The Fifth Circuit followed the process for determining whether punitive damages are insurable as set out in the very recent Texas Supreme Court opinion in *Fairfield*. In *Fairfield*, the Texas Supreme Court held that a two-step process should be employed in determining whether punitive damages are recoverable. In this regard, the first step is

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whether the policy covers punitive damages. Since the only policy at issue was the primary policy that did not include a punitive damages exclusion, the Fifth Circuit held that as a threshold matter, punitive damages were covered.

The second step is whether Texas public policy precludes the insurability of punitive damages. To determine this, *Fairfield* requires the court to determine whether the Texas legislature has expressed an explicit public policy. If not, then, the court is free to "consider general public policies."

With respect to the public policy issue, the Fifth Circuit quoted *Fairfield* for the proposition that "the Texas legislature has been sensitive to the issue of insurance coverage for punitive damages and has made the policy decision to preclude such coverage in certain circumstances." *Fairfield*, 246 S.W.3d at 656. In this regard, the Fifth Circuit noted that the home in question, Appleridge, operated as an Intermediate Care Facility for the Mentally Retarded (ICF/MR) and that "[t]he Texas legislature has not included ICF/MRs in the definition of 'health care providers' found in the Texas Insurance Code." *American International Specialty Lines Ins. Co. v. Res-Care, Inc.*, 2008 U.S. App. LEXIS 11758 at 27-28 (5th Cir. June 2, 2008).

This is important because "health care providers have generally been prohibited from obtaining insurance coverage for punitive damages," *id* at 26, although there are exceptions to this rule.

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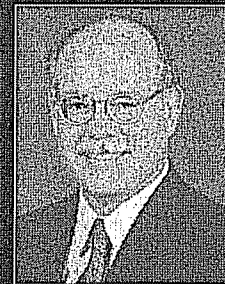
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This allowed the Fifth Circuit to determine whether “general public policy” precludes the insurability of punitive damages in this instance. Under *Fairfield*, this requires a court to consider the interest of freedom of contract with whether enforcing the contract as written “would frustrate important public policy.” *Fairfield*, 246 S.W.3d at 663-64. All of this, bearing in mind, “a strong public policy in favor of preserving freedom of contract.” *Id.* at 664.

In determining whether “general public policy” precludes the insurability of punitive damages in this matter, the Fifth Circuit initially noted that the modern purpose of punitive damages is to punish the wrongdoer. *Fairfield* noted that in the corporate setting there may be some circumstances where it might be possible to insure punitive damages. In this regard, the *Fairfield* opinion states: “[w]here other employees and management are not involved in or aware of an employee’s wrongful act, the purpose of exemplary damages may be achieved by permitting coverage so as not to penalize many for the wrongful act of one.” *Id.* at 670.

Nonetheless, the Fifth Circuit rejected Res-Care’s argument that as a corporation it should receive coverage for punitive damages. Interestingly, the Fifth Circuit relied heavily on the pleadings to note the allegations that “all defendants, including Res-Care, were grossly negligent” and that there were “many allegations of gross negligence on the part of Res-Care.” *Res-Care*, 2008 U.S. App. LEXIS 11758 at 31. Also, there were additional allegations, which supported the Fifth Circuit’s finding that the gross negligence allegations should not permit Res-Care to shift the responsibility for those actions on to AISLIC. For example, the pleadings alleged that a State of Texas report “showed [that] Res-Care poorly operated other facilities, thereby establishing a course of conduct warranting exemplary damages . . . [and] [i]t therefore recommended that the Appleridge facility be closed.” *Id.* at 33-34.

The Fifth Circuit then concluded that the circumstances:

were so extreme that the purposes of punishment and deterrence of conscious indifference outweigh the normally strong public policy of permitting the right to contract between insurer and insured. [citing *Fairfield*]. This case demonstrates the kind of “avoidable conduct that causes injury” where public policy is best served by requiring the insured to bear the costs of punitive damages. [citing *Fairfield*]. The district court did not err by failing to apportion any of the punitive damages to the primary policy.

*Id.* at 34.



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## Practical Impact

The *AISLIC v. Res-Care* opinion, then, will provide insurers with considerable leverage in negotiating settlements, not only with claimants, but their own corporate insureds. How this will actually materialize, however, is another story. This is because in light of *Texas Ass'n of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, as more recently reaffirmed in *Excess Underwriters at Lloyd's London v. Frank's Casing Crew and Rental Tools, Inc.*, 246 S.W.3d 42 (Tex. 2008) an insurer can seek reimbursement from the insured "only if it obtains the insured's clear and unequivocal consent to the settlement and the insurer's right to seek reimbursement." *Matagorda County*, 52 S.W.3d at 135.

In the event that the insured does not provide such consent, an insurer could not settle a case with punitive damages exposure and then bring an action to recover from the insured for the amounts attributable to the punitive damages exposure. What effect an insured's refusal to either contribute to a settlement or agree to a subsequent reimbursement suit will bear on insurers in cases involving punitive damages exposure remains to be seen. For example, an insured's refusal to contribute to a settlement or agree to a reimbursement suit might motivate an insurer to reject a settlement offer and let the case go to trial. As a practical matter, if the case includes punitive damage exposure, a financially solvent insured might find it risky to be obstinate about contributing to a settlement or reject a request to consent to a reimbursement suit. This is because if such conduct prevents such a case to be settled, the insured might eventually be forced to pay for an uncovered punitive damage award that might far exceed its requested contribution to a settlement.

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