



HITTING'EM WHERE IT HURTS: PUNITIVE DAMAGES, ARE YOU COVERED?

By Catherine A. Asaro

Being hit with a punitive damages award can strike a cord of fear in the heart of any executive. Given the unpredictable methods from which these multi-million dollar awards are issued, these fears are more than justified. With both the frequency and size of these damages continuing to rise, their insurability is a highly controversial and important issue that raises a myriad of public policy concerns.

In 2003, an Alabama jury returned an award against a giant in the oil industry for nearly \$103 million in compensatory damages and a staggering \$11.8 billion in punitive damages ringing in as the state's and year's largest jury verdict. Although the punitive damages award was subsequently reduced, it still amounted to \$3.5 billion.¹ In 2005, a Texas jury issued a \$229 million award against a pharmaceutical company.² Although this award is likely to be reduced, upon issuance of the verdict the company's stock price significantly fell wiping out billions in market capitalization. From these decisions it is evident that punitive damages mean big money. Moreover, regardless of a company's size the ramifications of these astronomical awards can be

devastating to business, reputation, and good will.

Punitive damages are intended to serve a few key purposes. First, for the injured, they right a wrong when an offender is found to have engaged in reprehensible conduct. Second, for the offending party they represent quasi-criminal punishment intended to impact their bottom line. This aspect of these damages raises serious issues regarding their insurability as there is no unanimity among the states on this issue. Third, for anyone else even considering similar conduct, it is intended to send an ominous message deterring them from proceeding any further. While punishing the wrongdoer, punitive, or exemplary, damages speak to the industry as a whole. Bearing that in mind, oftentimes juries subscribe to the theory that the higher the number condemning the behavior the less likely of its repetition. What better way is there for a jury to send a message than levying a multi-million dollar punishment which is sure to make national, if not worldwide news.

With minimal guidance in the past, juries have awarded punitive damages with a vengeance. Many have embraced the "retribution" aspect of the damages by seeking to financially cripple the wrongdoer for egregious behavior. In the late 1970's and 1980's, there was a dramatic increase in the size of punitive

¹ On March 29, 2004, Montgomery Cty Circuit Judge Tracy McCooey reduced punitive damages award. Exxon has appealed the reduced punitive damages award.

² Case is being appealed.

damages awards with a significant number of awards resulting from product liability and other mass tort cases. With a series of decisions beginning in 1991, the courts have attempted to rein in juries by demystifying their methods of computation. Unfortunately, despite judicial guidance, their efforts are still being met with resistance from juries and state courts as well.

I. DOES THE PUNISHMENT FIT THE CRIME?

The enormity of some awards exceeding hundreds of millions of dollars with ratios in excess of a hundred times compensatory damages has raised significant constitutional issues prompting judicial review. Determined to strike some balance between the award and the degree of harm, the U.S. Supreme Court has attempted to take a more active role in the computation process. Although there is no standard mathematical calculation to gauge the reasonableness of the award, the Court is providing guidance in terms of acceptable ratios of punitive to compensatory damages.

Since arriving at an equitable figure is not an exact science, in BMW of North America, Inc. v. Gore, 517 U.S. 559 (1996), the Court established a few guideposts in determining whether an award comported with Constitutional Due Process rights. In weighing the reasonableness of the award, the courts should look to the reprehensibility of the conduct, the ratio between compensatory and punitive damage awards, and the difference between punitive damage awards and possible civil or criminal sanctions for comparable misconduct.³

³ See BMW at 560.

In a landmark decision, State Farm Mutual Automobile Insurance v. Campbell, 538 U.S. 408 (2003)⁴, the U.S. Supreme Court took their decision in BMW a step further by setting an instructional framework for the computation of punitive damages on a case involving a bad faith against an insurer. In State Farm, the Court reversed the award of \$145 million in punitive damages finding that the award, amounting to 145 times the actual damages, was an unconstitutional violation of due process. In State Farm, the Court held that “few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process.”⁵ In fact, referencing prior decisions the Court stated an award four times the compensatory damages might even be pushing constitutional limits.⁶ These ratios are not dispositive but are meant to provide some guidance in calculating awards. Furthermore, in circumstances where compensatory damages are substantial, the Court remarked that an even lesser ratio is warranted to satisfy due process.⁷

In April, 2004, only one year after the Supreme Court decision in State Farm, the Utah Supreme Court in Campbell v. State Farm Mutual Insurance Co.⁸

⁴ In State Farm, an award of \$1 million in compensatory damages was issued for the insurer’s refusal to settle a serious automobile liability claim within its policy limits and declination to pay the excess judgment until it was affirmed by the Utah Supreme Court.

⁵ *Id.* at 425. Justice Anthony M. Kennedy wrote for the six-justice majority

⁶ Pacific Mutual Life Insurance Company v. Haslip, 499 U.S. 1 at 23-24 (1991) and Gore, *supra*, at 581.

⁷ Due Process Clause of the Fourteenth Amendment prohibits grossly excessive or arbitrary punishments.

⁸ 2004 UT 34 (April 23, 2004)

reduced the punitive damages award but took it right up to the U.S. Supreme Court's line awarding \$9 million, the highest amount allowable based on single digit multipliers of the \$1 million award of compensatory damages. In issuing this award, the Utah Court exercised its independent judgment based on their interpretation of the gravity of the harm. Whether other states will opt to follow along with Utah's rationale is an open question and one that could significantly impact the intended effect of *State Farm*.

Moreover, contrary to the guidance offered by the Court in *State Farm*, verdicts well in excess of triple digit multipliers of compensatory damages are still being awarded. How the U.S. Supreme Court will handle cases involving physical harm remains to be seen. Whether application of the *State Farm* single digit multiplier will carry over is yet another open question that could significantly impact the size of future punitive damage awards.

II. INSURABILITY OF PUNITIVE DAMAGES

Regardless of the acceptable ratios, insurability of these damages is a significant public policy concern garnering much debate. Does insuring punitive damages undermine the fundamental purpose of the damages? Insuring punitive damages raises concerns on both sides of the spectrum. Some courts have concluded that these damages should not be insurable because it transfers the burden from the wrongdoer to innocent premium paying insureds while others contend that the presence of coverage does not undermine the deterrent effect of the damages.

There is no unanimity among the states on the issue of insurability of punitive damages. In fact, a few states have not yet spoken on the issue. Each state sets its own guidelines as to the type of acts that can be covered and some set a cap on amounts. In a number of states, punitive damages are not insurable for intentional conduct. Additionally, the states have drawn a distinction between "directly" assessed damages that are based on the insured's wrongful acts and "vicariously" assessed damages based on the wrongful acts of another for whom the insured is legally liable. For instance, vicariously assessed damages frequently come into play in employer-employee relationships. For the most part, states that permit coverage for one set of damages will permit it for the other as well. Therefore, before purchasing or renewing a liability policy an insured should inquire about availability of this coverage in their jurisdiction.

Punitive damages are an important exposure in Executive Liability coverages, particularly, Employment Practices Liability. Where insurable, it is important to negotiate a "most favorable venue" clause in your policy. This clause provides that insurability of punitive damages is governed by the applicable state law that most favors insurability.

What can you do if punitive damages are not insurable in your jurisdiction? For instance, New York does not permit coverage for punitive damages. In these situations, there are punitive wrap policies addressing this exposure available through off-shore markets. These policies attempt to fill in gaps by providing coverage in situations where an insured may be faced with certain jurisdictional restrictions. These types

of policies are available for all lines of business where the domestic policy intends to cover these damages in jurisdictions that permit such coverage. There are several benefits to purchasing these policies. One of the benefits is that they do not erode the aggregate limits of the domestic policy. There are different ways to structure these policies to suit your individual needs.

Being hit with a punitive damages award can be devastating to a company. Once the litigation commences it can be an uphill battle with far-reaching economic ramifications to a company. Despite guidance from the U.S. Supreme Court, state courts are continuing to sanction multi-million dollar awards. With all of the options available in the markets, figuring out how to deal with a punitive damages award once it's issued is an expensive proposition that promises to divert precious time and resources from your business. This is an exposure that should be addressed given the growing frequency with which these damages are sought as well as the extraordinary size of these awards. There are many ways to protect your company from exposure to punitive damage awards. Exploring your options with punitive damage coverage with a knowledgeable broker is a good start. Your broker can assist in conducting an annual coverage analysis, update you on changes in law, and trends in the market. Taking proactive steps to protect your company from the losses associated with punitive damages awards goes a long to ensuring your company's financial health.

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