NO.: 04-0728
IN THE SUPREME COURT OF TEXAS
Austin, Texas

FAIRFIELD INSURANCE COMPANY,
Plaintiff-Appellant

VS.

STEPHENS MARTIN PAVING, LP,
AND CARRIE BENNETT,
Defendants-Appellees.

Certified Question From The
United States Fifth Circuit Court of Appeals
Case No. 03-10982

Originally on Appeal from the United States District Court
For the Northern District of Texas, Abilene Division, No. 1:03-CV-37

BRIEF OF AMICUS CURIAE UNITED POLICYHOLDERS IN SUPPORT OF APPELLEES

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I. STATEMENT OF INTEREST OF AMICUS CURIAE

United Policyholders was founded in 1991 as a non-profit organization dedicated to educating the public on insurance issues and consumer rights. The organization is tax-exempt under Internal Revenue Code § 501(c)(3). United Policyholders is funded by donations and grants from individuals, businesses, and foundations.

In addition to serving as a resource on insurance claims for disaster victims and commercial policyholders, United Policyholders actively monitors legal and marketplace developments affecting the interests of all policyholders. United Policyholders receives frequent invitations to testify at legislative and other public hearings, and to participate in regulatory proceedings on rate and policy issues.

A diverse range of policyholders throughout the United States communicate on a regular basis with United Policyholders, which allows us to provide important and topical information to courts throughout the country via the submission of *amicus curiae* briefs in cases involving insurance principles that are likely to impact large segments of the public.

II. SUMMARY OF ARGUMENT

The Petitioner Fairfield Insurance Company seeks to have this Court nullify a contract that it entered into voluntarily, for which it received substantial consideration and drafted through its industry representatives. The language of the contract at issue and the public policy considerations associated with that language do not justify such a harsh result.

The fundamental issue presented by this certified question is whether Texas public policy prohibits an insurance company, which sold liability insurance coverage to a Texas company, including coverage for punitive damages, from indemnifying its policyholder for a punitive damage award based on acts that are not otherwise excluded from the language of the policy. Permitting insurance coverage for punitive damages awarded in such circumstances does not violate Texas public policy. This Court has never held that punitive damages, per se, are uninsurable. Several courts in Texas have held, based on the language of the policies and Texas public policy that strongly upholds the sanctity of contracts, that punitive damages are insurable, particularly in instances of gross negligence.

It is respectfully submitted that this Court, presented with an insurance company's attempt to avoid its obligations to provide coverage, should consider the insurance industry's interpretation of the contracts it sold to the public, Texas' interest in protecting its citizens' right to freely enter into contracts, the reasonable expectations of its citizens and well-reasoned cases in Texas that correctly apply the standards for gross negligence. Moreover, the Texas legislature has not prohibited insurance coverage for punitive damages, and Texas regulators have not prohibited insuring punitive damages under the "all sums" language of insurance policies. Disallowing coverage would reward insurance companies with a windfall on the premiums they have collected and will continue to collect in return for their obligation to cover punitive damage awards. Accordingly, this Court should answer the certified question in the negative.

III. ARGUMENT

A. Liability Insurance Policies Are Constructed To Provide Coverage For Gross Negligence And Punitive Damages.

1. The "Occurrence" or Accident Definition Encompasses Acts of Gross Negligence.

(a) Drafting History.

The policy at issue here, like most liability insurance policies, provides coverage for an "occurrence" or accident. Excepted from coverage for bodily injury or property damage caused to a third party are acts that are "expected or intended" from the standpoint of the policyholder. The level of intent required for an act or omission to constitute gross negligence[1] is far below the level of intent required to trigger the exception to the coverage grant. The original drafters of the "expected or intended" exception intended for it to be governed by the policyholder's state of mind. Case law nationally has also recognized that there must be a showing of subjective intent to cause damage in order to come within this "expected or intended" language. Further, members of the insurance industry have represented to the insurance purchasing public that whether damage is "expected or intended" is dependent upon the policyholder's "subjective" intent to cause specific damage.

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[1] Under Texas law, "gross negligence" has the following definition:

"Gross negligence" means an act or omission:

(A) which when viewed objectively from the standpoint of the actor at the time of its occurrence involves an extreme degree of risk, considering the probability and magnitude of the potential harm to others; and

(B) of which the actor has actual, subjective awareness of the risk involved, but nevertheless proceeds with conscious indifference to the rights, safety, or welfare of others.

V.T.C.A., Civil Practice & Remedies Code § 41.001 (11).

The drafting history of the "expected or intended" language reflects the drafters' determination that a subjective, rather than an objective, standard should apply. The drafters of the 1966 standard comprehensive general liability insurance policy chose the "expected or intended" language for two reasons: (1) they wanted to eliminate the need for a special exclusion for "assaults and battery" and (2) to avoid prior case law applying the requirement from the standpoint of the injured party, as opposed to that of the policyholder. See, e.g., Norman Nachman, The New Policy Provisions for General Liability Insurance, 18 The Annals 197, 199-200 (1965), pages 82a to 93a,[2] attached hereto as Exhibit 1.

In late 1965, Norman Nachman explained that the definition of "occurrence" "requires that the injury be fortuitous from the standpoint of the insured." Id. In addition, Mr. Willard J. Obrist, Assistant Manager of the General Accident Insurance Group ("GAIG") stated in 1966 that the "expected or intended" phrase was "intended to eliminate the necessity for an 'assault and battery condition or exclusion'" and "eliminate the precedent of the court decisions which . . . applied the concept of fortuity from the point of view of the injured party rather than the insured." Obrist, The New Comprehensive General Liability Insurance Policy – A Coverage Analysis, DRI (Nov. 1966), reprinted in General Liability Insurance 1973 Revisions, at 37, 39 DRI (Jan. 1974), attached hereto as Ex. 2.

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[2] Mr. Nachman was employed by the National Bureau of Casualty Underwriters ("NBCU"), a trade organization which drafted the "expected or intended" language. The NBCU was one of the predecessors of the Insurance Services Office, Inc. ("ISO"), the current insurance industry rating and drafting organization.

Herbert P. Schoen, General Counsel and later President of Hartford Accident and Indemnity Company and another principal drafter of the 1966 comprehensive general liability insurance policy, testified in the California Asbestos Insurance Coverage Cases that an "objective" standard was rejected because it was "too rough":

> I would say that as the exclusion which we concluded was too rough to inflict upon our insured and would lead to the demand of its deletion.
>
> I think it was because it tries to spell out the fortuitous nature of the word accident and caused more problems than it resolved. See, one of the original reasons for using 'accident' was –caused by accident'—was it fortuitous from the point of the insured.
>
> We obviously did not want to cover the intentional results, of intentional acts, such as murder. We didn't want to cover that. This is an intentional act with an intentional result.
>
> When we tried to spell it out, although it was in the concept of accident, it caused problems for everyone and when we agreed that it be deleted.

Testimony of Herbert P. Schoen, Hartford Accident and Indemnity Co., at 15901, Mar. 4, 1986, In re Asbestos Insurance Coverage Cases, Judicial Counsel Coordination Proceeding No. 1072 (Cal. Super. Ct., San Francisco Cty.), attached hereto as Ex. 3.

The insurance industry drafters, in 1962, considered and specifically rejected an exclusion called "objective standard exclusion". This proposed version would have created the following objective standard:

> This policy does not apply to bodily injury or property damage resulting from deliberate acts or omissions of the

> insured which with reasonable certainty may be expected to produce injury or damage.

Id. In this case, although the policy at issue is an employer's liability policy, the language and intent are consistent with the history of the language found in comprehensive general liability policies. Specifically, the policy at issue here applies to bodily injury by "accident" and excludes bodily injury "intentionally caused."

(b) Texas Law Requires A Subjective Standard To Fall Within The Exception To The Coverage Grant.

Under Texas law, the focus is not on whether the policyholder's conduct or actions were intentional, but on whether the policyholder specifically intended the injuries or damages that were the subject of the underlying claim. See, e.g., Bituminous Cas. Corp. v. Vacuum Tanks, Inc., 75 F.3d 1048 (5th Cir. 1996) (applying Texas law); American Home Assur. Co. v. Safway Steel Prods. Co., 743 S.W.2d 693 (Tex. App. - Austin 1988) (holding that coverage exists for unintended damage that results from intentional or negligent acts); Travelers Ins. Co. v. Volentine, 578 S.W.2d 501, 503 (Tex. Civ. App. - Texarkana 1979) (finding that the destruction of an engine was an occurrence, even though it allegedly arose from defective work, as it was an accident, i.e., "an unexpected, unforeseen or unsigned happening or consequence from either a known or unknown cause").

Courts applying Texas law also use a "subjective" test to determine whether damage was expected or intended, meaning they examine whether the damage or injury was expected or intended by the policyholder. For example, in Union Pacific Resources Co. v. Aetna Casualty & Surety Co., the court held that "[t]he relevant inquiry . . . is whether the policyholder expected the landfill to discharge the

waste into the surrounding environment." 894 S.W.2d 401, 404 (Tex. App. - Fort Worth 1994).

Several federal courts interpreting Texas law have held the same. See, e.g., Hartford Cas. Co. v. Cruse, 938 F.2d 601 (5th Cir. 1991) (Texas law) ("Cruse"). In Cruse, the United States Court of Appeals for the Fifth Circuit overturned the district court's determination that coverage for the underlying claims — for damage to a house that resulted from defective foundation work — were barred because there was no occurrence. The court held that, although the policyholder's actions were intentional, the damage was still unexpected and unintended by the policyholder, and thus there was an occurrence:

> A builder who fails to abide by the specifications of a contract, for example by substituting a weaker building material, may by that breach produce expected property damage to his or her work, and may thus fail to show a covered "occurrence."
>
> But "an occurrence takes place where the resulting injury or damage was unexpected and unintended, regardless of whether the policyholder's acts were intentional." The requisite accident may inhere in the scope of the damages. With the extensive damage to the Cruses' home, we find an occurrence sufficient to trigger coverage.

Id. at 604-05 (quoting Dayton Indep. Sch. Dist. v. National Gypsum Co., 692 F. Supp. 1403, 1408 (E.D. Tex. 1988), rev'd on other grounds sub nom., W.R. Grace & Co. v. Continental Cas. Co., 896 F.2d 865 (5th Cir. 1990)).

In the instant case, where the conduct at issue is gross negligence and not intentional conduct, the result should be the same. Where there is no subjective

intent to cause the harm, the injury must be covered regardless of whether the act constitutes gross negligence.

(c) Other Jurisdictions Require Subjective Intent To Fall Within The Exception To The Coverage Grant.

There also exists substantial authority nationwide for the requirement that there be a showing of subjective intent to cause damage to defeat coverage under the "expected or intended" language. See, e.g., United States Fid. & Guar. Co. v. Armstrong, 479 So. 2d 1164, 1167 (Ala. 1985) (legal standard to determine "expected or intended" is a purely subjective standard that governs the "expected or intended" inquiry); United Servs. Auto. Ass'n v. Elitzky, 517 A.2d 982, 991 (Pa. Super. Ct. 1986) ("expected or intended" rests on "conscious awareness" by policyholder that harm will result); Voorhees v. Preferred Mut. Ins. Co., 607 A.2d 1255, 1265 (N.J. 1992) ("[a]bsent exceptional circumstance that objectively establish the insured's intent to injure, we will look to the insured's subjective intent to determine intent to injure"); James Graham Brown Found., Inc. v. St. Paul Fire & Marine Ins. Co., 814 S.W.2d 273, 280 (Ky. 1991) modified, No. 90-SC-242-109 1991 Ky. LEXIS 149 (Ky. Sept. 26, 1991) (policyholder entitled to coverage unless it has specific and subjective intent to cause the specific damage at issue); Fire Ins. Exch. v. Berray, 694 P.2d 191, 194 (Ariz. 1984) (clause excludes coverage only for harm that policyholder "subjectively wanted to result from this conduct"); City of Boise v. Planet Ins. Co., 878 P.2d 750, 757 (Idaho 1994) (Idaho Supreme Court held that where there existed no evidence that plaintiff expected to cause the damage which had resulted from his intentional actions, a covered "occurrence" had taken place because the event "resulted in an injury or damage that was neither expected nor intended").

(d) Gross Negligence Does Not Trigger the "Expected or Intended" Exception To The "Occurrence" or Accident Definition.

Texas courts addressing the issue of the level of intent required to trigger the "expected or intended" exception have held that an "expected or intended" exception does not exclude coverage for gross negligence. Philadelphia Indem. Ins. Co. v. Stebbins Five Cos., No. Civ. A. 302CV1279M, 2004 WL 210636, at *4 (N.D. Tex. Jan. 27, 2004); Safway Steel, 743 S. W.2d at 701 n.8 ("We refuse to extend the 'intentional injury exclusion' to include conduct amounting to gross negligence."); Westchester Fire Ins. Co. v. Admiral Ins. Co., No. 2-01-227-CV, 2003 WL 21475423, at *10 (Tex. App. - Fort Worth 2003) (a policy that provides insurance coverage only for injuries that were "neither expected nor intended" by the insured nonetheless provides insurance coverage for injuries resulting from gross negligence).

Texas courts' refusal to extend the "expected or intended" exception is consistent with the "subjective" test requirement that there be a showing of a subjective intent to cause harm. This is also consistent with the seminal case on the gross negligence standard under Texas law as set forth in Transportation Insurance Co. v. Moriel, 879 S.W.2d 10 (Tex. 1994). In explaining the gross negligence standard, the Texas Supreme Court stated, "[o]nly if the act or omission is unjustifiable and likely to cause serious harm can it be grossly negligent." The Court stressed the importance of establishing "actual conscious indifference" to the right of or welfare of the persons affected by an act or omission. Id. at 19.

Subsequently, the Texas Court of Appeals in Westchester held that the "expected or intended" exception did not preclude coverage for grossly negligent behavior. Id., 2003 WL 21475423, at *10. The trial court in the underlying case had

found that a healthcare provider was grossly negligent in its treatment of a patient. The excess insurance company obtained a partial summary judgment holding that insurance coverage for punitive damages violates Texas public policy. On appeal, after setting forth the definition of gross negligence, the court cited Moriel's holding that, "[o]nly if the act or omission is unjustifiable and likely to cause serious harm can it be grossly negligent." Id. The court went on to explain, "[h]owever, [the healthcare provider's] awareness of the risk does not necessarily translate into an expectation of the resulting injury." Id. The court reasoned that it is possible to know that an act or omission is likely to cause serious harm, but not anticipate or consider it probable that the harm will actually occur. Thus, the Court of Appeals held that the "expected or intended" exception did not preclude insurance coverage for grossly negligent acts.

2. The "All Sums" Language Includes Coverage For Punitive Damages.

Under the generally accepted rules of insurance policy construction, a court should give effect to the policy language as a whole. Any ambiguity in the language must be construed in favor of the policyholder. Blaylock v. American Guarantee Bank Liab. Ins., 632 S.W.2d 719, 721 (Tex. 1982). A review of the drafting history of the language at issue in this case and the pertinent case law interpreting that language demonstrates that punitive damages are covered under liability policies unless explicitly excluded.

The starting point for any insurance coverage question is the plain language of the insurance policy. Breed v. Insurance Co. of N. Am., 385 N.E.2d 1280, 1282 (N.Y. 1978). Under the insurance policy purchased by Stephens Paving, Fairfield

agreed to indemnify Stephens Paving for "all sums" that Stephens Paving became legally obligated to pay as a result of third party bodily injury or property damage.

The insurance industry drafts the standard-form language contained in most liability insurance policies. Like the policy at issue in this case, the standard-form language provides that the insurance company will pay "all sums" the policyholder is legally obligated to pay as "damages" because of bodily injury or property damage arising from a covered incident. Skyline Harvestore Sys., Inc. v. Centennial Ins. Co., 331 N.W.2d 106, 107-108 (Iowa 1983). Since as early as the 1960s, standard-form liability policies generally have not defined "damages." Id. This lack of distinction between compensatory and punitive damages shows that the term "damages" encompasses both. Ridgway v. Gulf Life Ins. Co., 578 F.2d 1026, 1030 (5th Cir. 1978).

The omission of a definition for damages in the standard-form liability insurance policy is not the result of a mistake or the insurance industry's failure to anticipate the potential interpretation of the "all sums" language. The insurance industry has been on notice since at least the 1960s that courts construe the standard-form insurance policy language to cover punitive damages. Lazenby v. Universal Underwriters Ins. Co., 383 S.W.2d 1, 5 (Tenn. 1964). Insurance companies continue to sell liability policies that do not exclude punitive damages, or as in this case, exclude punitive damages under very specific circumstances, despite their knowledge that punitive damages have been held to be covered. The insurance industry's failure to add simple exclusionary language has persuaded courts that punitive damages are intended to be covered:

> We place great emphasis on the fact that there is no specific exclusion in the insurance contract for punitive damages. If the insurance carrier to this insurance contract intended to eliminate coverage for punitive damages it could and should have inserted a single provision stating "this policy does not include recovery for punitive damages."

Mazza v. Medical Mut. Ins. Co. of N.C., 319 S.E.2d 217, 223 (N.C. 1984).

Because a growing number of courts were correctly interpreting the "all sums" policy language, certain insurance companies proposed a revision to the language as early as 1972: "[I]t would be wise, in the light of judicial construction of broad policy conditions, to exclude [punitive damages coverage] by expressed policy language." See Lorelie Masters, Punitive Damages, Covered or Not, 55 Bus. Law. 283, 299 (1999). The insurance industry's national policy writing organization, ISO, proposed a punitive damages exclusion five years later. Id. That exclusion stated: "[r]egardless of any other provision of this policy, this policy does not apply to punitive or exemplary damages." Id. (citing James D. Ghiardi & John J. Kirchner, Punitive Damages Law and Practice § 7.10 at 32-33 (1999). ISO withdrew its recommendation only four months after it proposed the exclusion due to widespread criticism within the industry. Id.

Texas courts have also held that "all sums" language, identical to that contained in the policy in the instant case, provides insurance coverage for punitive or exemplary damages awards. Unless expressly excluded, exemplary damages are included within the meaning of "all sums." Westchester, 2003 WL 21475423, at *4; Safway Steel, 743 S.W.2d at 701; Dairlyland Cty. Mut. Ins. Co. v. Wallgren, 477 S.W.2d 341 (Tex. Civ. App. - Fort Worth 1972). As these Texas appellate courts confirm, where

an insurance policy does not differentiate between compensatory and punitive damages, and where punitive damages are not clearly excluded, punitive damages are covered.

3. Internal Insurance Industry Documents Demonstrate That Punitive Damages For Gross Negligence Are Insurable.

The insurance industry has long recognized that punitive damages are insurable for acts such as gross negligence. As a result and to avoid the meaning of the plain language of the policies, the industry has attempted to latch onto case law that might justify its position. Internal industry documents explicitly state the industry's position in this regard.

The American Insurance Association's Claims Administration Reference Guide, in explaining the difference between intentional acts and non-intentional acts, specifically states that "negligent conduct may be so wanton as to support punitive damages and still fall short of deliberateness of intention." See Claims Administration Reference Guide, at 5 American Insurance Association, attached hereto as Ex. 4. The Guide goes on to state that under this scenario, insurance coverage is possible if not voided by public policy. The Guide does not say coverage is unavailable based on policy language, but instead, consistently states that the law of the applicable jurisdiction should be followed in making a coverage determination.

Other internal documents reference the fact that the policy language does not exclude punitive damages. An internal memorandum from The Home Insurance Companies states that with respect to punitive damages coverage:

1. We do not unilaterally proceed to use an exclusionary endorsement but await the results of ISO's forthcoming meeting on the matter.

2. We are to exercise whatever influence we can on the members of ISO's Liability Governing Committee and the appropriate ISO staff members to come up with an exclusionary endorsement which the industry could be expected to adopt and use.

3. In the interim, institute the practice in the unsettled states of a Reservation of Rights and initiate an action for Declaratory Judgment on a select state by state basis.

See Office Memorandum, The Home Insurance Companies (Feb. 11, 1976), attached hereto as Ex. 5.

Additional internal documents state that "our payment or non-payment of claims for punitive damages is related to the law of the specific jurisdiction in which an action for punitive damages is commenced." See Loss Claim Technical Procedures Manual, The Home Insurance Companies (Oct. 19, 1973), attached hereto as Ex. 6. The documents further state that the it is the insurance company's policy to protect the interest of the policyholder where punitive damages are claimed provided no statute or court decision has determined the coverage to be unlawful; the punitive damages are awarded in connection with an occurrence otherwise covered by the policy; and there is no policy exclusion for punitive damages. See id.

These internal documents demonstrate the insurance industry's longstanding knowledge that under the policy language, punitive damages for acts of gross negligence are covered. The insurance industry's knowledge of the meaning of the terms of its contracts require that the industry fulfill its contractual obligations as a matter of law and public policy.

B. Insuring Punitive Damages For Gross Negligence Does Not Violate Public Policy.

1. The Goal of Deterrence Does Not Prohibit Insurance Coverage for Punitive Damages.

The public policy argument most frequently advanced against insurance coverage for punitive damages is that such coverage will rob punitive damages of their desired deterrent effect. Nevertheless, many courts across the country have expressly rejected this argument.

Insuring against punitive damages does not result in wanton conduct because such conduct cannot be engaged in with impunity. In Price v. Hartford Accident & Indemnity Co., 502 P.2d 522 (Ariz. 1972), the Supreme Court of Arizona found that the threat of incurring criminal fines and penalties, as well as the fear of skyrocketing insurance premiums, serve as realistic and strong deterrents.

In addition, courts have found that there has been "no solid evidence that the denial of coverage for punitive damages has any significant impact in the jurisdictions so holding." State of Vermont v. Glens Falls Ins. Co., 404 A.2d 101, 105 (Vt. 1979) (citing Price, 502 P.2d at 524); Lazenby, 383 S.W.2d 1 ("Those who are demonstrated by experience to be poor risks encounter substantial difficulty in obtaining insurance."); First Nat'l Bank of St. Mary's v. Fidelity and Deposit Co., 389 A.2d 359, 366 (Md. 1978). See also Whalen v. On-Deck, Inc., 514 A.2d 1072 (Del. 1986) (wrongdoer who is insured against punitive damages may still be punished through higher insurance premiums or the loss of insurance altogether).

These courts have tacitly recognized that insurance companies act as "surrogate regulators." When an insurance company chooses to insure a given activity, either initially or upon renewal, it evaluates and monitors a policyholder's performance. Premium rates reflect insurance companies' assessments of the risks connected with their policyholders. The insurability of punitive damages will force insurance companies to regulate their policyholders' behavior through its premiums, as well as by conditioning the sale of insurance on adequate loss-control measures. Insurance companies have touted their role as "surrogate regulators" to the public and to the courts. It does not make sense to promote this role of insurance when it comes to negligence and yet deny policyholders the benefit of surrogate regulation when it comes to more serious conduct.[3]

In Lazenby, the Supreme Court of Tennessee found that it was clearly not against public policy to insure punitive damages. Justice White of that court, in a concurring opinion expressed his exasperation with the notion of rejecting such coverage, stating that:

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[3] In fact, the insurance industry writes policies which provide coverage for such intentional acts as false arrest, entry, eviction or other invasions of the right of private occupancy. See 1 S.J. MILLER AND P.LEFEBRE, MILLER STANDARD INSURANCE POLICIES 436 (1986). Many courts have construed such policy provisions to provide coverage for punitive damages as well. See Providence Washington Ins. Co. of Alaska v. City of Valadex, 684 P.2d 861 (Alaska 1984) (policy covered alleged wrongful termination of lease by insured city, including claim for punitive damages; public policy does not permit municipal corporations from insuring against punitive damage awards); First Nat'l Bank of St. Mary's v. Fidelity and Deposit Co., 389 A.2d 359 (Md. 1978) (public policy does not preclude insurance coverage for exemplary damages); First Bank N.A. Billings v. Transamerica Ins. Co., 679 P.2d 1217 (Mont. 1984) (insurance coverage of punitive damages does not violate Montana public policy); Koehring Co. v. American Mut. Liab. Ins. Co., 564 F. Supp. 303 (E.D. Wis. 1983) (policy covered punitive damages).

> The line of demarcation between the allowance of punitive damages and compensatory only is too thin and exacting ... to apply coverage in the one case and deny coverage in the other.
>
> In the gross or wanton negligence case, the wrongdoer is protected by his insurance policy without question. How then can it be logically argued that as a general rule, a denial of insurance protection for payment of punitive damages will deter the wrongdoer?

383 S.W.2d at 10 (emphasis added).

Several Texas courts have acknowledged that even where an insurance policy covers punitive damages for gross negligence, the policyholder may still be punished and deterred from future conduct. Where a large punitive damages award is assessed against a policyholder, the policyholder may have to pay much higher premiums, or may even be unable to obtain insurance coverage at all. See Westchester, 2003 WL 21475423, at *6 (citing Milligan v. State Farm Mut. Auto. Ins. Co., 940 S.W.2d 228, 232 (Tex. App. - Houston 1997) ("as long as insurance companies are willing, for a price, to provide protection against liability for punitive damages to corporations they deem 'good risks,' ... we see no reason why these contracts should not be enforced") (quoting Safway Steel, 743 S. W.2d at 705).

In addressing whether insurance coverage robs punitive damages of their desired deterrent and punitive effect, the Westchester court reasoned that where the insurance company directly contracts with the policyholder, the public policy question turns on how the goals of punishment and deterrence are best achieved: by requiring the wrongdoer with insurance coverage to personally pay a punitive damages award or by allowing the insurance company, who contracted for such coverage knowing the plain language of its policy covered punitive damages, to evaluate the impact of the

punitive damages award on the policyholder through its underwriting practices. Id. at *9.

Deterrence, therefore, is accomplished by far more concrete methods than the fear that one may not be indemnified for an award of punitive damages. In addition, because awards of punitive damages are often imposed for conduct ordinarily entitling a party only to compensatory damages, it is congruous to say that a policy against insuring one type of damage award over the other will serve as a deterrent.

Fairfield's reliance on cases that address the issue of whether insurance coverage for punitive damages is contrary to public policy are in the context of uninsured motorist insurance and inapposite here. In Milligan, the court held that the objectives of punishment and deterrence cannot be accomplished by covering exemplary damages in an uninsured motorist claim because the wrongdoer uninsured motorist is not even involved, and does not bear any responsibility for its actions. Milligan, 940 S.W.2d 228, 232.

None of the objectives of exemplary damages are achieved in these cases because it is the victim's own insurance company that would end up paying for the grossly negligent conduct of the uninsured motorist. The Milligan court noted that the policy considerations which permit an insurance company to obligate itself for punitive damages based on the conduct of its policyholder are completely different than the

policy considerations involved in insurance coverage for exemplary damages assessed against an uninsured motorist. Id.[4]

2. The Texas Legislature Has Not Precluded Coverage For Punitive Damages Awarded For Grossly Negligent Acts.

In Whalen v. On-Deck, Inc., 514 A.2d 1072, 1074 (Del. 1986), the Delaware Supreme Court held that the public policy of Delaware "does not prohibit the issuance of an insurance contract that covers punitive damages." The court reasoned that since the Delaware legislature formulated no policy prohibiting the issuance of insurance covering punitive damages it could not infer that the purpose of punitive damages would be frustrated if such damages were insurable.

Likewise, the legislature of Texas has never enunciated a policy prohibiting the insurability of punitive damages. The regulators in Texas charged with overseeing approval of insurance policies[5] have not disapproved of policies which

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[4] Several courts since Milligan have neglected to recognize these policy distinctions, including Hartford, relied on heavily by Appellant. Applying Moriel and its progeny, the District Court for the Northern District of Texas made an "Erie guess" that insuring against punitive damages violated public policy. Hartford Cas. Ins. Co. v. Powell, 19 F. Supp. 2d 678 (N.D. Tex. 1998). That decision was based on the premise that public policy in Texas is to ensure that a defendant deserving to be punished receives an appropriate amount of punishment. The court in Hartford makes a quantum leap from its analysis of punitive damages is against the public policy of punishment and deterrence in all cases. Id. at 694. The Hartford court relies on Northwestern Nat'l Cas. Co. v. McNulty, 307 F.2d 432, 440-42 (5th Cir. 1962), as persuasive authority for its "Erie guess." The McNulty holding, however, is also in the uninsured motorist context, where, it would be against public policy to allow the delinquent driver to "transfer [...] his responsibility for punitive damages the very people the driving public-to whom he is a menace." Id. at 442.

[5] The Texas Department of Insurance "is the agency legislatively charged with 'regulat[ing] the business of insurance in this state' and 'ensur[ing] that [the Insurance Code] and other laws regarding insurance and insurance companies are executed.'" Argonaut Ins. Co. v. Baker, 87 S.W.3d 526, 532 (Tex. 2002) (citations omitted).

provide coverage for punitive damages under the "all sums" language. Moreover, even though punitive damages are awarded for acts of gross negligence, case law and the statutory scheme in Texas support a finding that the level of intent under the gross negligence standard is separate from the level of intent for intentional torts. Accordingly, the current statutory scheme in Texas is not inconsistent with allowing insurance for punitive damages.

The Texas Court of Appeals held in Safway Steel that as long as insurance companies are willing to sell liability insurance to provide protection against liability for punitive damages to corporations they deem "good risks," and as long as punitive damage liability continues to extend to "gross negligence," there was absolutely no reason not to enforce these contracts. The insurance companies in Safway brought a declaratory judgment action seeking a ruling that liability policies did not provide insurance coverage for the punitive damages assessed against their policyholders. The court's holding in that case fell into three sections; (1) any conflict of law question would be resolved in favor of applying Texas law; (2) the plain language of the policies did not exclude punitive damages; and (3) that insuring against punitive damages is not contrary to Texas public policy. 743 S.W.2d 693, 701.

Most notably, in analyzing whether a true conflict existed between New York and Texas law, the court compared the public policy considerations and statutory language of New York and Texas. New York allows an award for punitive damages only when the offending party's conduct amounts to a conscious disregard of the rights of others, or for conduct so reckless as to amount to such disregard. Texas, on the other hand, allows punitive damages based on gross negligence.

> Although the argument may be made that gross negligence as defined under Texas law encompasses the New York standard, the reverse proposition is not true. By not imposing punitive damages simply based on gross negligence, New York has purposefully limited the availability of punitive damages.

Id. at 700.

New York does not provide insurance coverage for punitive damages because it only awards them in the most extreme cases involving intentional conduct. Texas, on the other hand, has not eliminated gross negligence as a grounds for obtaining punitive damages. Because Texas law awards punitive damages more liberally than New York, for example, it should not shock the conscience to provide insurance coverage for them. There have been no statutes or case law that contradict this view. Westchester, 2003 WL 21475423, at *9. There are, in fact, several Texas statutes that support this contention, including an express provision that the insurance commissioner may approve insurance coverage for exemplary damages to be used on a policy of medical professional liability. See Tex. Ins. Code Ann. Art. 5.15-1 (Vernon 1981 & Supp. 2003).

Moreover, the Moriel case on which the Insurance Company heavily relies, does not preclude the insurability of punitive damages. Moriel is cited as the seminal case on the definition of gross negligence in Texas, as well as for the clarification of the purpose of punitive damages. The Texas legislature found Moriel's definitions so persuasive that they codified them. Moriel does not stand, however, for the proposition that punitive damages are uninsurable as against public policy.

The waters become very muddy after the Moriel decision. Moriel's progeny improperly conflate malice and gross negligence. For example, in Hartford, the court states: "The current (1995) version of § 41.003 deletes gross negligence as a

separate basis for an award of punitive damages, and makes the definition of gross negligence articulated in Moriel a part of the § 41.001(7) definition of malice." Hartford Casualty Ins. Co. v. Powell, 19 F. Supp. 2d 678, 683 (N.D. Tex. 1998). This assertion is blatantly wrong. The Texas legislature did not combine, or intend to combine the two standards. A reading of the statutory definition section plainly shows that malice and gross negligence are two distinct standards, with different levels of intent.

> "Malice" means a specific intent by the defendant to cause substantial injury or harm to the claimant.
>
> "Gross negligence" means an act or omission:
>
> (A) which when viewed objectively from the standpoint of the actor at the time of its occurrence involves an extreme degree of risk, considering the probability and magnitude of the potential harm to others; and
>
> (B) of which the actor has actual, subjective awareness of the risk involved, but nevertheless proceeds with conscious indifference to the rights, safety, or welfare of others.

V.T.C.A., Civil Practice & Remedies Code § 41.001 (7), (11).

Additionally, pursuant to § 41.003 Standards for Recovery of Exemplary damages, the Texas legislature has codified three separate grounds for which exemplary damages may be awarded, namely, fraud, malice, or gross negligence. According to basic principles of statutory interpretation, if the Texas legislature had intended to combine the definitions of malice and gross negligence, or eliminate recovery of exemplary damages resulting from gross negligence, they would have done so explicitly, similar to New York. See Argonaut Ins. Co. v. Baker, 87 S.W.3d at 529 ("we construe a statute, 'first, by looking to the plain and common meaning of the statute's words'") (citations omitted).

3. Insurance Coverage For Punitive Damages Is Permitted In A Significant Number of Jurisdictions.

Currently, twenty-nine states and the District of Columbia hold that punitive damages assessed directly against a policyholder, as opposed to an agent or employee, are insurable.[6] The remaining states rule that they are not insurable or are undecided. The highest courts of eighteen states have explicitly found that their public policy does not preclude coverage for punitive damages.[7] The statistics demonstrate

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[6] The following cases and statutes indicate the jurisdictions which allow insurance coverage of punitive damages: Capital Motor Lines v. Loring,189 So. 897 (Ala. 1939); LeDoux v. Continental Ins. Co., 666 F. Supp. 178 (D. Alaska 1987); Cassel v. Schacht, 683 P.2d 294 (Ariz. 1984); Southern Farm Bureau Cas. Ins. Co. v. Daniel, 440 S.W.2d 582 (Ark. 1969); Berry v. Loiseau, 614 A.2d 414 (Conn. 1992); Whalen v. On-Deck, Inc., 514 A.2d 1072 (Del. 1986); Salus Corp. v. Continental Cas. Co., 478 A.2d 1067 (D.C. App. 1984); Thrift-Mart, Inc. v. Commercial Union Assurance Cos., 268 S.E.2d 397 (Ga. Ct. App. 1980); HAW. REV. STAT. § 431:10-240 (Hawaii 1998); Abbie Uriguen Oldsmobile Buick, Inc. v. United States Fire Ins. Co., 511 P.2d 783 (Idaho 1973); Skyline Harvestore Sys., Inc. v. Centennial Ins. Co., 331 N.W.2d 106 (Iowa 1983); Continental Ins. Cos. v. Hancock, 507 S.W.2d 146 (Ky. 1973); Creech v. Aetna Cas. & Sur. Co., 516 So.2d 1168 (La. Ct. App. 1987); First Nat'l Bank of St. Mary's v. Fidelity and Deposit Co., 389 A.2d 359 (Md. 1978); Peisner v. Detroit Free Press, Inc., 304 N.W.2d 814 (Mich. Ct. App. 1981), aff'd, modified on other grounds, 364 N.W.2d 600 (Mich. 1984); Anthony v. Frith, 394 So.2d 867 (Miss. 1981); Colson v. Lloyd's of London, 435 S.W.2d 42 (Mo. Ct. App. 1968); First Bank (N.A.) Billings v. Transamerica Ins. Co., 679 P.2d 1217 (Mont. 1984); Baker v. Armstrong, 744 P.2d 170 (N.M. 1987); Mazza v. Medical Mut. Ins. Co. of N.C., 319 S.E.2d 217 (N.C. 1984); Weeks v. St. Paul Fire & Marine Ins. Co., 673 A.2d 772 (N.H. 1996); Harrell v. Travelers Indem. Co., 567 P.2d 1013 (Or. 1977); Carroway v. Johnson, 139 S.E.2d 908 (S.C. 1965); Lazenby v. Universal Underwriters Ins. Co., 383 S.W.2d 1 (Tenn. 1964); Ridgeway v Gulf Line Ins. Co., 578 F.2d 1026 (5th Cir. 1978); Dairyland County Mut. Ins. Co. v. Wallgren, 477 S.W.2d 341 (Tex. Civ. App.-Fort Worth 1972); Lerner v. General Ins. Co. of Am., 245 S.E.2d 249 (Va. 1978); Hensley v. Erie Ins. Co., 283 S.E.2d 227 (W.Va. 1981); Brown Koehring Co. v. American Mutual Liab. Ins. Co., 564 F. Supp. 303 (E.D. Wis. 1983); Sinclair Oil Corp. v. Columbia Cas Co., 682 P.2d 975 (Wyo. 1984).

[7] See Cassel v. Schacht, 683 P.2d 294 (Ariz. 1984); California Union Ins. Co. v. Arkansas Louisiana Gas Co., 572 S.W.2d 393 (Ark. 1978); Whalen v. On-Deck, Inc., 514 A.2d 1072 (Del. 1986); Greenwood Cemetery, Inc. v. Travelers Indemn. Co., 232 S.E.2d 910 (Ga. 1977) (per curiam); Abbie Uriguen Oldsmobile Buick, Inc. v. United States Fire Ins. Co., 511 P.2d 783 (Idaho 1973); Skyline Harvestore Sys., Inc. v. Centennial Ins. Co., 331 N.W.2d 106 (Iowa 1983); Continental Ins. Co. v. Hancock, 507 S.W.2d 146 (Ky. 1974); First National Bank of St. Mary's v. Fidelity & Deposit Co., 389 A.2d 359 (Md. 1978); Anthony v. Frith, 394, So.2d 867 (Miss. 1981); First Bank (N.A.) Billings v. Transamerica Ins. Co., 679, P.2d 1217 (Mont. 1984); S.Z. Wolff v. General Cas. Co. of

that there is significant support nationwide for providing insurance coverage for punitive damage awards.

4. Texas Public Policy Requires The Enforcement of Contracts.

The issue should not be whether it is against public policy for an insurance company to sell policies that include coverage for punitive damages. The insurance company has already sold insurance coverage for punitive damages. The real issue, then, is whether it is against public policy for the insurance companies to fulfill their obligations under the contracts that they negotiated and sold. If insurance coverage for punitive damages is against public policy, this would be a decision of the state department of insurance to determine. If it is not against public policy to sell it, logically, it should not be against public policy to enforce it.

Generally, given a party's broad freedom to contract as he chooses and to avoid an impairment of the general freedom of contract, contracts of insurance should not be voided for a public policy violation except in cases that are free from doubt. See Conrellier v. American Cas. Co., 389 F.2d 641 (2d Cir. 1968) (provision must be so unreasonable as to be held contrary to the public interest and void); Sparks v. St. Paul Ins. Co., 495 A.2d 406, 411-12 (N.J. 1985) ("Although it is a well-established principle that insurance contracts will not be enforced if they violate public policy, the application

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Am., 361 P.2d 330 (N.M. 1961); Mazza v. Medical Mut. Ins. Co. of N.C., 319 S.E.2d 217 (N.C. 1984); Harrell v. Travelers Indem. Co., 567 P.2d 1013 (Or. 1977) (en banc); Lazenby v. Universal Underwriters Ins. Co., 383 S.W.2d 1 (Tenn. 1964); State v. Glens Falls Ins. Co., 404 A.2d 101 (Vt. 1979); Hensley v. Erie Ins. Co., 283 S.E.2d 277 (W.Va. 1981); Brown v. Maxey, 369 N.W.2d 677 (Wis. 1985); Sinclair Oil Corp. v. Columbia Cas. Co., 682 P.2d 975 (Wyo. 1984).

of that principle has been limited in order that freedom of contract is not impaired unreasonably ... .") (citation omitted).

Courts have taken an assertive stance in upholding the sanctity of private contracts between policyholders and insurance companies. The Supreme Court of Tennessee ruled that where denying coverage of punitive damages would partially void a private contract, such action should only be taken in a clear case. See Lazenby, 383 S.W.2d at 1.

The Wisconsin Supreme Court astutely noted that states have more than one public policy, one being the "public policy favor[ing] freedom of contract, in the absence of overriding reasons for depriving the parties of that freedom." Cieslewicz v. Mut. Serv. Cas. Ins. Co., 267 N.W.2d 595, 601 (Wis. 1978).

The Supreme Court of Wyoming also urged extreme caution when undertaking to invalidate a private contract on public policy grounds. Sinclair Oil Corp. v. Columbia Gas Corp., 682 P.2d 975 (Wyo. 1984). The court refused to invalidate a contract insuring punitive damages "entered into freely by competent parties on the basis of public policy unless that policy is well settled, unambiguous, and not in conflict with another public policy equally or more compelling." Id. at 979. The court followed Lazenby in concluding that neither punishment nor deterrence of others establishes the overpowering policy necessary to override an otherwise enforceable contract insuring punitive damages.

The Texas Supreme Court has held that public policy mandates the enforcement of contracts. "[C]ontracts, when entered into freely and voluntarily, shall be

held sacred, and shall be enforced by courts of justice." Westchester, 2003 WL 21475423, at *7 (quoting Missouri, K. & T. Ry. v. Carter, 68 S.W. 159, 164 (1902)). Texas also has a strong public policy of enforcing its insurance contracts:

> Texas has a strong public policy of enforcing its insurance policies and requiring insurers to step up to the plate with respect to their insureds and properly pay.... We have very strong public policies about not letting insurance companies back off of their obligations.

Westchester, 2003 WL 21475423, at *7 (quoting American Int'l Specialty Lines Ins. Co. v. Triton Energy Ltd., 52 S.W.3d 337, 341-42 (Tex. App. - Dallas 2001). In fact, Texas courts have concluded that public policy would best be served by requiring the insurance company to honor its obligation. Safway Steel, 743 S.W.2d 693.

5. Upholding the Reasonable Expectations of the Policyholder Is In the Public Interest.

The nature of insurance contracts require that the reasonable expectations of policyholders are upheld in interpreting the terms of the contract. Insurance contracts are aleatory, meaning that the policyholder performs first, by paying premium while the insurance company performs later, but only if a loss occurs that arises out of a "fortuitous" event. Aleatory contracts differ ordinary contracts, where both parties perform simultaneously, a difference that provides the insurance company with the future advantage of economic leverage.

As the Illinois Supreme Court recognized when addressing the same argument:

> The insurance industry is powerful and closely knit. As evidenced by the CGL policies in the instant case, most policies are standard-form, are worded very similarly (see Zurich Insurance v. Raymark Industries, Inc. (1987), 118 Ill.2d 23, 33, 112 Ill. Dec. 684, 514 N.E.2d 150), and are offered on a take-it-or-leave-it basis (Aetna Casualty & Surety Co. v. Condict (S.D. Miss. 1976), 417 F.Supp.

> 63, 73). Any insured, whether large and sophisticated or not, must enter into a contract with the insurer which is written according to the insurer's pleasure by the insurer. (See AIU Insurance Co. v. Superior Court (1990), 51 Cal.3d 807, 822, 799 P.2d 1253, 1264-65, 274 Cal.Rptr. 820, 831-32; Broadwell Realty Services, Inc. v. Fidelity & Surety Co. (1987), 218 N.J. Super. 516, 524, 528 A.2d 76, 80.) Generally, since little or no negotiation occurs in this process, the insurer has total control of the terms and the drafting of the contract.

Outboard Marine Corp. v. Liberty Mut. Ins Co., 607 N.E.2d 1204, 1218 (Ill. 1992).

Protection of the policyholder's reasonable expectations levels the playing field, to some extent, and provides the policyholder with the insurance coverage it paid for. In most cases, "the language of the insurance policy will provide the best indication of the content of the parties' reasonable expectations." See Bensalem Twp. v. International Surplus Lines Ins. Co., 38 F.3d 1303, 1309 (3d Cir. 1994).

In this case, Stephens Paving paid premiums and contracted for the "all sums" protection provided by its liability policy and reasonably expected to be covered for punitive damages. The insurance industry regularly charges premiums for "all sums" coverage. It would be unfair to policyholders who pay these premiums to relieve the insurance companies of the costs associated with this business decision. Courts have adopted this position as well:

> In our view, it is naïve at least, if not pure fiction, to hold that an insurance contract against liability for punitive damages is invalid as contrary to public policy because such a contract would 'shift the burden' to an insurance company so as to either 'punish' it or have it pass that burden 'on [to] the public,' so at 'punish society.'
>
> On the contrary, an insurance company which deliberately enters into a contract to provide coverage against liability for punitive damages is free to charge either a separate or additional premium for that risk.

Harrell v. Travelers Indem. Co., 567 P.2d 1013, 1019 (Or. 1977) (emphasis added).

The United States Court of Appeals for the Fourth Circuit found this argument persuasive and held that a public policy against the insurability of punitive damages "would unjustly enrich the insurer, which collected premiums on the basis of a promise to absorb a risk it now seeks to avoid. It would also destroy to a large extent the certainty on which our commercial system depends." St. Paul Mercury Ins. Co. v. Duke Univ., 849 F.2d 133, 137 (4th Cir. 1988).

The Arizona Supreme Court in Price also found that the insurance company had voluntarily covered its insured's liability for punitive damages. Because the insurance companies' premiums had been based on its exposure, "it may be presumed that holding it liable for what it has promised to pay would not result in additional burdens on the . . . public." Price, 502 P.2d at 524.

Public policy can be best served by requiring insurance companies to honor their contractual obligations. Based on the language of most standard-form insurance policies and the premiums paid in exchange for the protection afforded under that language, most policyholders likely expect to receive insurance coverage for an award of punitive damages. Courts have ruled that the reasonable expectations of the policyholder coupled with public policy of freedom of contract outweigh other public policy considerations against insuring punitive damages. See Lazenby, 383 S.W.2d 1. The insurance industry which sold liability insurance intending to cover punitive damages, should not now be permitted to renege on its promise, while benefiting from the premiums it collected, by hiding behind a shield of "public policy."

IV. CONCLUSION

For the foregoing reasons, United Policyholders urges that Texas public policy permits insurance coverage for punitive damages in gross negligence cases, and therefore, this Court should answer the question certified in the negative.

Respectfully submitted,

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