IN THE SUPREME COURT OF TEXAS

NO. 04-0728

FAIRFIELD INSURANCE COMPANY, APPELLANT,

v.

STEPHENS MARTIN PAVING, LP; CARRIE BENNETT, INDIVIDUALLY AND AS REPRESENTATIVE OF THE ESTATE OF ROY EDWARD BENNETT, DECEASED, AND AS NEXT FRIEND OF LANE EDWARD BENNETT, CODY LEE BENNETT, AND APRIL ANNE BENNETT, MINORS, APPELLEES

ON CERTIFIED QUESTION FROM THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Argued November 9, 2004

JUSTICE WAINWRIGHT delivered the opinion of the Court, joined by CHIEF JUSTICE JEFFERSON, JUSTICE HECHT, JUSTICE O'NEILL, JUSTICE BRISTER, JUSTICE MEDINA, JUSTICE GREEN, and JUSTICE WILLETT, and by JUSTICE JOHNSON as to sections I, II, and IV only.

JUSTICE HECHT filed a concurring opinion, joined by JUSTICE BRISTER, JUSTICE MEDINA, and JUSTICE WILLETT.

JUSTICE JOHNSON filed a concurring opinion.

This case is before the Court on a certified question from the United States Court of Appeals for the Fifth Circuit: "Does Texas public policy prohibit a liability insurance provider from indemnifying an award for punitive damages imposed on its insured because of gross negligence?" *Fairfield Ins. Co. v. Stephens Martin Paving, LP,* 381 F.3d 435, 437 (5th Cir. 2004). Pursuant to

article V, section 3-c of the Texas Constitution and rule 58.1 of the Texas Rules of Appellate Procedure, we answer that Texas public policy does not prohibit coverage under the type of workers' compensation and employer's liability insurance policy at issue in this case.

I. FACTUAL AND PROCEDURAL BACKGROUND

Stephens Martin Paving, a highway paving company, employed Roy Edward Bennett as a brooming machine operator. On December 20, 2002, Bennett died as a result of injuries that occurred when a brooming machine rolled over. Stephens Martin Paving carried a workers' compensation and employer's liability insurance policy, issued by Fairfield Insurance Company. Fairfield paid workers' compensation benefits to Bennett's wife and children under the policy in accordance with Texas workers' compensation law.

On January 24, 2003, Bennett's survivors sued Stephens Martin Paving for gross negligence, seeking exemplary damages because Stephens Martin Paving allegedly failed to provide a safe place to work, failed to follow and enforce OSHA safety rules and regulations, and failed to properly train and supervise its employees. Having received workers' compensation benefits, Bennett's survivors are barred by statute from recovering actual damages and seek only exemplary damages in the suit.[1]

On February 24, 2003, Fairfield sued Stephens Martin Paving and Bennett's survivors in federal district court, seeking a declaratory judgment that Fairfield owed no duty to defend or indemnify Stephens Martin Paving in the suit for exemplary damages. Relying on *Ridgway v. Gulf*

[1] Generally, an employer who purchases workers' compensation insurance is protected from an employee's common law claims for injuries occurring during the course and scope of the employee's work responsibilities. TEX. LAB. CODE § 408.001. However, this exclusive remedy doctrine does not prohibit recovery of exemplary damages if the employee's death is caused by the employer's gross negligence. *Id.* § 408.001(b)–(c).

Life Insurance Co., 578 F.2d 1026, 1029 (5th Cir. 1978), the federal district court concluded that the language in Fairfield's policy covers exemplary damages and that Texas public policy does not prohibit insurance coverage of those damages. The court denied Fairfield's motion for summary judgment and entered a judgment declaring that Fairfield has a duty to defend Stephens Martin Paving and a duty to indemnify Stephens Martin Paving as provided by the policy if Stephens Martin Paving is adjudicated responsible for the damages sought in the underlying suit brought by Bennett's survivors (either by judgment or settlement). Fairfield appealed, and the Fifth Circuit certified to this Court the question of the insurability of exemplary damages for gross negligence. *Fairfield Ins. Co.,* 381 F.3d at 437; TEX. R. APP. P. 58.1.

II. COVERAGE OF EXEMPLARY DAMAGES FOR GROSS NEGLIGENCE

Determining whether exemplary damages for gross negligence are insurable requires a two-step analysis. *See, e.g.*, *Grinnell Mut. Reinsurance Co. v. Jungling*, 654 N.W.2d 530, 535–37 (Iowa 2002); *Fluke Corp. v. Hartford Accident & Indem. Co.*, 34 P.3d 809, 814 (Wash. 2001); *Brown v. Maxey*, 369 N.W.2d 677, 685 (Wis. 1985). First, we decide whether the plain language of the policy covers the exemplary damages sought in the underlying suit against the insured.

Second, if we conclude that the policy provides coverage, we determine whether the public policy of Texas allows or prohibits coverage in the circumstances of the underlying suit. We first look to express statutory provisions regarding the insurability of exemplary damages to determine whether the Legislature has made a policy decision. *See Town of Flower Mound v. Stafford Estates Ltd. P'ship*, 135 S.W.3d 620, 628 (Tex. 2004) ("Generally, 'the State's public policy is reflected in its statutes.'") (quoting *Tex. Commerce Bank, N.A. v. Grizzle*, 96 S.W.3d 240, 250 (Tex. 2002)); *FM*

Props. Operating Co. v. City of Austin, 22 S.W.3d 868, 873 (Tex. 2000). If the Legislature has not made an explicit policy decision, we then consider the general public policies of Texas.

A. POLICY LANGUAGE

The policy Fairfield issued to Stephens Martin Paving contains two types of insurance: workers' compensation insurance and employer's liability insurance. Under the workers' compensation part of the policy, Fairfield agrees to pay the benefits that Stephens Martin Paving is required to pay by Texas workers' compensation law and other enumerated costs. In this case, the parties agree that the policy covers the workers' compensation benefits paid to the Bennetts. The workers' compensation part of the policy makes the employer responsible for "any payments in excess of the benefits regularly provided by the workers compensation law including those required because: 1. of your serious and willful misconduct; . . . 3. you fail to comply with a health or safety law or regulation."

Under the employer's liability part of the policy, Fairfield agrees to pay "all sums [Stephens Martin Paving] legally must pay as damages because of bodily injury to [its] employees, provided the bodily injury is covered by this Employers Liability Insurance" and other specific costs. It excludes coverage of "punitive or exemplary damages because of bodily injury to an employee employed in violation of law." An endorsement to the policy adds that "[t]his exclusion does not apply unless the violation of law caused or contributed to the bodily injury." The policy also excludes damages arising from injuries caused by intentional acts.

The Bennetts' claim against Stephens Martin Paving seeks only exemplary damages for gross negligence. Therefore, the coverage issue in this case concerns only the employer's liability part of

the policy and not the part of the policy regarding workers' compensation benefits. 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.

B. TEXAS STATUTORY PROHIBITIONS

When considering whether public policy should prohibit the coverage of exemplary damages in a particular case, courts should study the contexts in which the Legislature has spoken. In a few instances, the Legislature has expressly prohibited or otherwise limited the availability of such insurance.

Health Care Providers: Article 5.15-1, section 8 of the Texas Insurance Code prohibits insurance coverage of exemplary damages assessed against health care providers and physicians, creating an exception for a subset of healthcare providers including hospitals, nursing homes, and assisted living facilities:

> No policy of medical professional liability insurance issued to or renewed for a health care provider or physician in this state may include coverage for exemplary damages that may be assessed against the health care provider or physician; provided, however, that the commissioner may approve an endorsement form that provides for coverage for exemplary damages to be used on a policy of medical professional liability insurance issued to a hospital, as the term "hospital" is defined in this article, or to a for-profit or not-for-profit nursing home or assisted living facility.

TEX. INS. CODE art. 5.15-1, § 8.[2]

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[2] As part of the Medical Liability Insurance Improvement Act of Texas, passed in 1977, the Legislature prohibited "health care providers" from obtaining insurance coverage of exemplary damages in Texas. Act of May 30, 1977, 65th Leg., R.S., ch. 817, Part 3, § 8, 1977 Tex. Gen. Laws 2039, 2055–56. "Health care provider" was defined as:

> any person, partnership, professional association, corporation, facility, or institution licensed or chartered by the State of Texas to provide health care as a registered nurse, hospital, dentist, podiatrist, chiropractor, optometrist, blood bank that is a nonprofit corporation chartered to operate a blood bank

Guaranty Funds and Excess Liability Pools: The Legislature has explicitly excluded risk management and excess insurance pools for various public entities[3] from paying exemplary damages.[4] In 1989, the Legislature amended the Texas Property and Casualty Insurance Guaranty Act to exclude from the definition of "covered claims" against insolvent insurers "any punitive, exemplary, extracontractual, or bad faith damages awarded in a court judgment against an insured or insurer."[5] The Legislature has included the same prohibition for several other such entities

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> and which is accredited by the American Association of Blood Banks, or not-for-profit nursing home, or an officer, employee, or agent of any of them acting in the course and scope of his employment.

Act of May 30, 1977, 65th Leg., R.S., ch. 817, Part 3, § 2(2), 1977 Tex. Gen. Laws 2039, 2055. Later amendments redefined health care providers and expressly allowed providers to obtain insurance coverage of exemplary damages through an approved policy endorsement. Act of June 3, 1987, 70th Leg., 1st C.S., ch. 1, § 7.01, 1987 Tex. Gen. Laws 1, 35–36 (allowing an endorsement for hospitals); Act of May 21, 1997, 75th Leg., R.S., ch. 746, § 1, 1997 Tex. Gen. Laws 2451, 2451 (allowing an endorsement for not-for-profit nursing homes); Act of May 27, 2001, 77th Leg., R.S., ch. 1284, § 5.02, 2001 Tex. Gen. Laws 3083, 3085 (requiring an endorsement for for-profit nursing homes); Act of May 14, 2003, 78th Leg., R.S., ch. 141, § 2, 2003 Tex. Gen. Laws 195, 195 (allowing an endorsement for assisted living facilities).

[3] Act of June 3, 1987, 70th Leg., 1st C.S., ch. 1, § 5.08, 1987 Tex. Gen. Laws 1, 26 (current version at TEX. INS. CODE §§ 2207.001–.409) (Excess Liability Pool for Counties and Certain Educational Entities); Act of June 3, 1987, 70th Leg., 1st C.S., ch. 1, § 5.09, 1987 Tex. Gen. Laws 1, 31 (current version at TEX. INS. CODE §§ 2208.001–.309) (Texas Public Entity Excess Insurance Pool).

[4] TEX. INS. CODE § 2207.353(c) ("Money in the [Excess Liability Fund for Counties and Certain Educational Entities] may not be used to pay: (1)punitive damages . . . ."); *id.* § 2208.252(b) ("Money in the [Texas Public Entity Excess Insurance Fund] may not be used to pay: (1) punitive damages . . . ."); *id.* § 2208.303 ("Excess insurance coverage provided by the [Texas Public Entity Excess Insurance Pool] may not include coverage for punitive damages.").

[5] Act of May 29, 1989, 71st Leg., R.S., ch. 1082, § 6.13, 1989 Tex. Gen. Laws 4370, 4395–96 (current version at TEX. INS. CODE § 462.210). *See also* Act of May 30, 2003, 78th Leg., R.S., ch. 1218, § 2, 2003 Tex. Gen. Laws 3458, 3459 (current version at TEX. INS. CODE § 462.302(c)(2)) ("The [Texas Property and Casualty Insurance Guaranty Association] has no liability for . . . claims for . . . exemplary damages . . . ."). That Act was first passed in 1971 to protect insolvent property and casualty insurers' policyholders and third-party claimants by authorizing assessments against other Texas insurers to pay "covered claims" against insurers that had become insolvent. Act of May 12, 1971, 62d Leg., R.S., ch. 360, § 1, 1971 Tex. Gen. Laws 1362 (current version at TEX. INS. CODE §§ 462.001–.351).

covering exceptional risks.[6] In each instance the Legislature's concern appears to have been for the financial impact on these entities of insurance for exemplary damages.[7]

The Legislature is aware of and sensitive to issues of insurance coverage of exemplary damages. It has made the policy decision to prohibit insurance coverage of those damages in selected circumstances.

C. WORKERS' COMPENSATION

This Court has recognized that "the administration of the workers' compensation system is heavily imbued with public policy concerns." *Lawrence v. CDB Servs., Inc.*, 44 S.W.3d 544, 553 (Tex. 2001), *superseded by statute*, TEX. LAB. CODE § 406.003(e), *as explained in Storage & Processors, Inc. v. Reyes*, 134 S.W.3d 190, 192 (Tex. 2004). Because this case arises from a claim for exemplary damages under the Texas Workers' Compensation Act, we review the applicable statutory scheme and accompanying insurance regulation of that field.

In Texas, participation in the workers' compensation system is optional for employers and employees. However, if the employer purchases workers' compensation insurance, the employer

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[6] TEX. INS. CODE § 463.204 (9) (stating that the Life, Accident, Health, and Hospital Service Insurance Guaranty Association cannot pay punitive or exemplary damages); *id.* § 2203.154 ("The [Medical Liability Insurance Joint Underwriting Association] may not issue or renew a medical liability insurance policy for a physician or health care provider under this chapter that includes coverage for punitive damages assessed against the physician or health care provider."); *id.* § 2205.253(b) (Money in the [Texas Child-Care Facility Liability Fund] may not be used to pay: (1) punitive damages . . . ."); *id.* § 2209.253(b) ("Money in the [Texas Nonprofit Organizations Liability Fund] may not be used to pay: (1) punitive damages . . . ."); *id.* § 2209.303 ("Liability insurance coverage provided by the [Texas Nonprofit Organizations Liability Pool] may not include coverage for punitive damages."); *id.* § 2602.255(4) (excluding "exemplary, extracontractual, or bad faith damages awarded against an insured or title insurance company by a court judgment" from "covered claims" against the Texas Title Insurance Guaranty Association).

[7] The Legislature also requires commercial liability insurers to file closed claim reports including, among much other information, "amounts paid for punitive damages." TEX. INS. CODE § 38.154(a)(3)(C)(x). At a minimum, this suggests that the Legislature is aware that insurers are making some payments for punitive damages and has not broadly prohibited those payments.

must adhere to the statutory and regulatory guidelines of the Workers' Compensation Act. Among these requirements is the legislative directive that only workers' compensation policies approved by the Texas Department of Insurance are available in Texas.[8] TEX. INS. CODE art. 5.56.[9] These policies provide broad coverage for an employee's injuries. In exchange for fulfilling the Act's requirements, the Act protects an employer from an employee's common law claims for injuries or death occurring during the course and scope of the employee's work responsibilities, except those claims involving the death of an employee caused by an employer's intentional or grossly negligent conduct. TEX. LAB. CODE § 408.001. An employee who does not "opt out" of the workers' compensation system waives claims not provided by the Act. *Id.* § 406.034. Thus, workers' compensation insurance provides the exclusive remedy for the injury or death of a participating employee in most cases.

This exclusive remedy does not prohibit recovery of exemplary damages if the employee's death is caused by the employer's gross negligence. *Id.* § 408.001(b)–(c). Section 408 states:

> (a) Recovery of workers' compensation benefits is the exclusive remedy of an employee covered by workers' compensation insurance coverage or a legal beneficiary against the employer or an agent or employee of the employer for the death of or a work-related injury sustained by the employee.

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[8] Before 1991, the Texas Department of Insurance (TDI) was known as the State Board of Insurance. Act of May 27, 1991, 72d Leg., R.S., ch. 242, § 1.01, 1991 Tex. Gen. Laws 939, 939; *see also* Act of May 30, 1993, 73rd Leg., R.S., ch. 685, § 1.01, 1993 Tex. Gen. Laws 2559, 2559 (specifying that "a reference in [all statutes involving insurance] to the State Board of Insurance means [TDI]").

[9] In 2005, the Legislature renumbered and codified Article 5.56 and other articles into sections of the Texas Insurance Code. Act of May 24, 2005, 79th Leg. R.S., ch. 727, §§ 2, 18(a)(4). We cite to the version applicable to the underlying suit in this case. TEX. INS. CODE art. 5.56 (*added by* Act of June 7, 1951, 52d Leg., R.S., ch. 491, 1951 Tex. Gen. Laws 868, 945).

> (b) This section does not prohibit the recovery of exemplary damages by the surviving spouse or heirs of the body of a deceased employee whose death was caused by an intentional act or omission of the employer or by the employer's gross negligence.
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> (c) In this section, "gross negligence" has the meaning assigned by Section 41.001, Civil Practice and Remedies Code.

The Bennetts bring this claim for exemplary damages only under Subsections 408(b) and (c), arguing that Stephens Martin Paving's gross negligence caused Bennett's death.

TDI is authorized to adopt rules "governing hearings and other proceedings necessary for the promulgation or approval of rates[,] . . . policy forms[,] or policy form endorsements." TEX. INS. CODE art. 1.33C. Article 5.56 of the Insurance Code provides that TDI "shall prescribe standard policy forms to be used by all companies or associations writing workmen's compensation insurance in this State" and prohibits organizations from using policy forms "other than those made, established and promulgated and prescribed by [TDI]," except as specifically provided by the statute.[10] By Article 5.62, the Legislature "empowered [TDI] to make and enforce all such reasonable rules and regulations not inconsistent with the provisions of this subchapter as are necessary to carry out its provisions." TEX. INS. CODE art. 5.62.

Under the authority delegated to TDI from the Legislature, TDI approves standard workers' compensation insurance policies and endorsements. *See* Texas Workers' Compensation Commission and Employers' Liability Manual, available at http://www.tdi.state.tx.us/wc/regulation/index.html#manual. As previously discussed, the policy

[10] Organizations may "use any form of endorsement appropriate to its plan of operation, if such endorsement [is] first submitted to and approved by the Board." TEX. INS. CODE art. 5.57.

provides two types of insurance coverage—workers' compensation insurance and employers' liability insurance. The workers' compensation part of the policy only provides coverage for benefits required by workers' compensation law and other enumerated costs, excluding punitive damages. If, under Section 408.001, workers' compensation insurance provides the exclusive remedy for an injured employee who is participating in the system, then why would the TDI-approved, standard policy—the only policy workers' compensation insurers may use—provide any additional liability insurance to employers? The statutory scheme and TDI's execution of the scheme reveal an intent to provide additional insurance coverage—coverage for an employer's gross negligence.[11] Although Section 408.001 allows an employee to pursue a claim for exemplary damages against an employer for intentional acts, the insurance policy here excludes coverage for such intentional acts. Thus, the "all sums" language in the employer's liability part of this TDI-approved, dual coverage policy covers some of the common law claims excluded from the workers' compensation part of the policy, but it does not cover claims based on intentional acts. 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.

[11] The TDI policy does not provide coverage of "punitive or exemplary damages because of bodily injury to an employee employed in violation of law," nor does it cover these damages arising from injuries caused by intentional acts. An endorsement to the policy adds that "[t]his exclusion does not apply unless the violation of law caused or contributed to the bodily injury." We note that Bennett's petition alleges that Stephens Martin Paving failed to follow and enforce safety rules and regulations and OSHA rules and regulations. Because we do not have a complete record and we limit our discussion to the Fifth Circuit's certified question, we do not address whether these allegations trigger the exclusion.

III. PUBLIC POLICY CONSIDERATIONS

Although the Legislature's expressed direction ends our inquiry in the present case, we recognize that the Fifth Circuit framed its certified question as a broad inquiry about Texas public policy and the coverage of exemplary damages. We hesitate to opine on policy language and fact situations not before us, but also recognize the import of this issue and therefore discuss some of the considerations relevant to determining whether Texas public policy prohibits insurance coverage of exemplary damages in other contexts in the absence of a clear legislative policy decision.

A. SUMMARY OF THE DEBATE

Although determining whether public policy prohibits the insurance coverage of exemplary damages for gross negligence in Texas is a novel question for this Court, the issue is no stranger to the United States' legal community. Christopher A. Wilson, Lazenby *after* Hodges—*Insurability of Punitive Damage Awards in Tennessee: A Continuing Question of Public Policy*, 36 U. MEM. L. REV. 463 (2006); Stephanie L. Grassia, *The Insurability of Punitive Damages in Washington: Should Insureds Who Engage in Intentional Misconduct Reap the Benefit of Their "Bargains?,"* 26 SEATTLE U. L. REV. 627 (2003); Lorelie S. Masters, *Punitive Damages: Covered or Not?*, 55 BUS. LAW. 283 (1999); Michael A. Rosenhouse, Annotation, *Liability Insurance Coverage as Extending to Liability for Punitive or Exemplary Damages*, 16 A.L.R.4th 11 (1982).

For over forty years, courts, legislatures, and scholars nationwide have struggled with this issue. Of the forty-five states in which the highest court of the state or the legislature has addressed the insurability of exemplary damages in some fashion, twenty-five have established generally that their public policy does not prohibit coverage, sometimes including or excluding the uninsured

motorist or vicarious liability contexts.[12] Eight states have adopted a broad prohibition against insuring exemplary damages.[13] Seven states allow insurance coverage of exemplary damages only

[12] HAW. REV. STAT. § 431:10-240 (2007) ("Coverage under any policy of insurance issued in this State shall not be construed to provide coverage for punitive or exemplary damages unless specifically included."); MONT. CODE ANN. § 33-15-317 (2007) ("Insurance coverage does not extend to punitive or exemplary damages unless expressly included by the contract of insurance."); NEV. REV. STAT. § 681A.095 (2007) ("An insurer may insure against legal liability for exemplary damages or punitive damages that do not arise from a wrongful act of the insured committed with the intent to cause injury to another."); VA. CODE ANN. § 38.2-227 (2007) ("It is not against the public policy of the Commonwealth for any person to purchase insurance providing coverage for punitive damages arising out of the death or injury of any person as the result of negligence, including willful and wanton negligence, but excluding intentional acts."); *Montgomery Health Care Facility, Inc. v. Ballard*, 565 So.2d 221, 226 (Ala. 1990) (wrongful death case); *State Farm Mut. Auto. Ins. Co. v. Lawrence*, 26 P.3d 1074, 1080 (Alaska 2001); *State Farm Mut. Auto. Ins. Co. v. Wilson*, 782 P.2d 727, 729–36 (Ariz. 1989); *Cal. Union Ins. Co. v. Ark. La. Gas Co.*, 572 S.W.2d 393, 453 (Ark. 1978) (citing *So. Farm Bureau Cas. Ins. Co. v. Daniel*, 440 S.W.2d 582 (Ark. 1969)); *Jones v. State Farm Mut. Auto. Ins. Co.*, 610 A.2d 1352, 1354 (Del. 1992); *Roman v. Terrell*, 393 S.E.2d 83, 86 (Ga. Ct. App. 1990), *aff'd by*, *State Farm Mut. Auto Ins. Co. v. Weathers*, 392 S.E.2d 1 (Ga. 1990); *Abbie Uriguen Oldsmobile Buick, Inc. v. U.S. Fire Ins. Co.*, 511 P.2d 783, 789–91 (Idaho 1973); *Grinnell*, 654 N.W.2d at 540–41 (citing *Skyline Harvestore Sys., Inc. v. Centennial Ins. Co.*, 331 N.W.2d 106, 109 (Iowa 1983)); *Ky. Cent. Ins. Co. v. Schneider*, 15 S.W.3d 373, 376 (Ky. 2000) (citing *Cont'l Ins. Cos. v. Hancock*, 507 S.W.2d 146 (Ky. 1973)); *First Nat'l Bank of St. Mary's v. Fid. & Deposit Co.*, 389 A.2d 359, 364–67 (Md. 1978); *Shelter Mut. Ins. Co. v. Dale*, 914 So. 2d 698, 703 (Miss. 2005); *Mazza v. Med. Mut. Ins. Co. of N.C.*, 319 S.E.2d 217, 220–22 (N.C. 1984) (negligent medical malpractice); *MacKinnon v. Hanover Ins. Co.*, 471 A.2d 1166, 1168 (N.H. 1984) (holding that public policy does not prohibit homeowner's insurance policy from covering liability arising from intentional tort of battery and negligent infliction of emotional distress); *Cont'l Cas. Co. v. Kinsey*, 499 N.W.2d 574, 581 (N.D. 1993) (requiring insurer to indemnify insured for punitive damages award according to insurance policy, but allowing insurer to seek reimbursement from insured because contracting away responsibility for "willful fraud and deceit" violated state statute); *Harrell v. Travelers Indem. Co.*, 567 P.2d 1013, 1021 (Or. 1977); *S.C. State Budget & Control Bd. v. Prince*, 403 S.E.2d 643, 648 (S.C. 1991) (holding insurer could not deny coverage for punitive damages "in the name of the public policy when the language of its own policy specifically provides such coverage," but failing to explain why); *State v. Glens Falls Ins. Co.*, 404 A.2d 101, 105 (Vt. 1979); *Fluke*, 34 P.3d at 815; *Loveridge v. Chartier*, 468 N.W.2d 146, 159 (Wis. 1991); *State ex rel. State Auto Ins. Co. v. Risovich*, 511 S.E.2d 498, 505 (W. Va. 1998); *Sinclair Oil Corp. v. Columbia Cas. Co.*, 682 P.2d 975, 981 (Wyo. 1984).

[13] OHIO REV. CODE ANN. § 3937.182(B) (2008) (prohibiting coverage for punitive and exemplary damages in automobile policies and certain types of casualty and liability policies); UTAH CODE ANN. § 31A-20-101(4) (2007) ("No insurer may insure or attempt to insure against . . . punitive damages."); *PPG Indus. v. Transamerica Ins. Co.*, 975 P.2d 652, 657 (Cal. 1999); *Lira v. Shelter Ins. Co.*, 913 P.2d 514, 517 (Colo. 1996); *Bernier v. Burris*, 497 N.E.2d 763, 776 (Ill. 1986) (citing *Beaver v. Country Mut. Ins. Co.*, 420 N.E.2d 1058, 1060–61 (Ill. App. Ct. 1981)) (in dicta); *Biondi v. Beekman Hill House Apartment Corp.*, 731 N.E.2d 577, 579 (N.Y. 2000); *Town of Cumberland v. R.I. Interlocal Risk Mgmt. Trust, Inc.*, 860 A.2d 1210, 1219 n.14 (R.I. 2004); *City of Fort Pierre v. United Fire & Cas. Co.*, 463 N.W.2d 845, 848 (S.D. 1990).

in the vicarious liability context, prohibiting the practice otherwise.[14] Three states allow insurance coverage of exemplary damages in the uninsured motorist context, but have not directly spoken outside this context.[15] Two other states have precluded insurance coverage of exemplary damages in the uninsured motorist context, but have not otherwise directly spoken on the issue.[16] Finally, the insurability of exemplary damages resulting from acts akin to gross negligence has not been addressed by the highest court or legislature in Indiana, Michigan, Missouri, and Texas.[17] Thus, the majority of states that have considered whether public policy prohibits insurance coverage of exemplary damages for gross negligence, either by legislation or under the common law, have decided that it does not.

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[14] KAN. STAT. ANN. § 40-2,115(a) (2006) ("It is not against the public policy of this state for a person or entity to obtain insurance covering liability for punitive or exemplary damages assessed against such insured as the result of acts or omissions, intentional or otherwise, of such insured's employees, agents or servants, or of any other person or entity for whose acts such insured shall be vicariously liable, without the actual prior knowledge of such insured."); *Bodner v. United Servs. Auto. Ass'n*, 610 A.2d 1212, 1221–22 (Conn. 1992); *U.S. Concrete Pipe Co. v. Bould*, 437 So. 2d 1061, 1064 (Fla. 1983); *Perl v. St. Paul Fire & Marine Ins. Co.*, 345 N.W.2d 209, 216 (Minn. 1984); ; *Malanga v. Mfgs. Cas. Ins. Co.*, 146 A.2d 105, 108–10 (N.J. 1958); *Aetna Cas. & Sur. Co. v. Craig*, 771 P.2d 212, 215–16 (Okla. 1989); *Esmond v. Liscio*, 224 A.2d 793, 800 (Pa. 1966).

[15] *Sharp v. Daigre*, 555 So. 2d 1361, 1364 (La. 1990) (mentioning but not applying broad rule to general liability insurance); *Jaramillo v. Providence Wash. Ins. Co.*, 871 P.2d 1343, 1351–52 (N.M. 1994); *Carr v. Ford*, 833 S.W.2d 68, 71 (Tenn. 1992) (holding uninsured motorist statute permits but does not require coverage for punitive damages); *Lazenby v. Universal Underwriters Ins. Co.*, 383 S.W.2d 1 (Tenn. 1964). *But see West v. Pratt*, 871 S.W.2d 477, 479 (Tenn. 1994) (stating in dicta that a "clear public policy exists in Tennessee that strongly disfavors the payment of punitive damages by uninsured motorist carriers to their insureds").

[16] *Tuttle v. Raymond*, 494 A.2d 1353, 1360 n.20, 1362 & n.25 (Me. 1985) (citing *Braley v. Berkshire Mut. Ins. Co.*, 440 A.2d 359, 361–62 (Me. 1982)); *Santos v. Lumbermens Mut. Cas. Co.*, 556 N.E.2d 983, 990, 991 n.17 (Mass. 1990).

[17] Nebraska does not allow recovery of exemplary damages. *Distinctive Printing & Packaging Co. v. Cox*, 232 Neb. 846, 857 (Neb. 1989) (citing NEB. CONST. art. VII, § 5; *Miller v. Kingsley*, 230 N.W.2d 472, 474 (Neb. 1975) ("It is a fundamental rule of law in this state that punitive, vindictive, or exemplary damages are not allowed.")).

Two key cases, decided over forty years ago, continue to illustrate the opposing viewpoints on the insurability of exemplary damages: *Northwestern National Insurance Co. v. McNulty*, 307 F.2d 432 (5th Cir. 1962), and *Lazenby v. Universal Underwriters Insurance Co.*, 383 S.W.2d 1 (Tenn. 1964). In *McNulty*, a drunk driver seriously injured another motorist in Florida. 307 F.2d at 433. The injured motorist sued for compensatory and punitive damages, securing a verdict for $57,500: $37,500 in compensatory damages and $20,000 in punitive damages. *Id.* The drunk driver's insurance policy provided $50,000 in coverage. *Id.* The insurer argued that only the compensatory part of the verdict was covered by the policy. *Id.* The court agreed, holding that Florida public policy prohibited the insurability of punitive damages. *Id.* at 434.

Key to the court's reasoning was its conclusion that Florida law characterized "punitive damages as a penalty, imposed as a means of punishing the defendant in order to deter him and others from antisocial conduct, and to no significant extent compensation." *Id.* at 436. The court relied heavily on the different functions of punitive and compensatory damages in different states' schemes:

> The crucial distinction . . . is the different function served by compensatory and punitive damages. In a system of law basing recovery of damages on the defendant's culpability, compensatory liability, while it may discourage negligent conduct as a side effect, is primarily designed to shift a loss from a wholly innocent party to one whose fault is responsible for causing the loss, although in many cases the fault of the responsible party may not have been so blameworthy that he would have been punished criminally if the fault had not caused an accident. The rationale of compensatory damages is not so much a policy that the responsible party should pay; it is more a policy that the wholly innocent party should not pay. Insurance against compensatory liability therefore does not frustrate the reason for imposing the liability. But in a case involving the determination that punitive damages are insurable the public policy considerations are broader and more important.

Id. at 438. The court concluded that allowing a wrongdoer "to insure himself against punishment" would result in "a freedom of misconduct inconsistent with the establishment of sanctions against such conduct." *Id.* at 440. However, even the *McNulty* court recognized some exceptions to this rule, suggesting that public policy would not prohibit an employer from obtaining insurance to cover exemplary damage awards arising from the acts of employees. *Id.*

The Supreme Court of Tennessee decided the lead case in support of the insurability of exemplary damages only a few years after the *McNulty* decision. *Lazenby*, 383 S.W.2d 1. Again, the case involved an insurance company's refusal to pay the punitive damages portion of a verdict against a drunk driver. *Id.* at 2. The court recognized that the dominant purpose of exemplary damages in Tennessee was similar to that discussed in *McNulty*: "the interest of society and of the agreed [sic] individual are blended and such damages are allowed as punishment for such conduct and as an example or warning to the one so guilty, and others, in order to deter them from committing like offenses in the future." *Id.* at 4. Despite the similarity of the two courts' characterizations of the purpose of exemplary damages, the Tennessee Supreme Court held that the exemplary damages in that case were insurable. *Id.* at 5.

First, the *Lazenby* court explained that if criminal sanctions "apparently have not deterred this slaughter on our highways and streets," then "the closing of the insurance market, in the payment of punitive damages" would be unlikely to deter such wrongful conduct. *Id.* Second, the expectations of the insured, upon reading the plain language of the insurance policy, was that exemplary damages would be covered absent intentional conduct to injure. *Id.* The court also concluded that the line between "simple negligence and negligence upon which an award of punitive

damages can be made" did not justify a public policy exception for acts otherwise covered by the insurance policy. *Id.* Finally, the court observed that using public policy arguments to partially void a contract that, if construed as written, would protect the insured from both compensatory and punitive damages should not be done "except in a clear case" and concluded that "the reasons advanced do not make such a clear case." *Id.*

These cases outline the primary arguments advanced by the parties in this case and the arguments considered by courts nationwide. We now consider these arguments in light of Texas law.

B. TEXAS PUBLIC POLICY

In the absence of expressed direction from the Legislature, whether a promise or agreement will be unenforceable on public policy grounds will be determined by weighing the interest in enforcing agreements versus the public policy interest against such enforcement. *See* RESTATEMENT (SECOND) OF CONTRACTS § 178(1) ("A promise or other term of an agreement is unenforceable on grounds of public policy if legislation provides that it is unenforceable or the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms."). On one side of the scale is Texas' general policy favoring freedom of contract. *Lawrence*, 44 S.W.3d at 553. Courts weighing this interest should consider the reasonable expectations of the parties and the value of certainty in enforcement of contracts generally. *See*

RESTATEMENT (SECOND) OF CONTRACTS § 178(2).[18] On the other side of the scale is the extent to which the agreement frustrates important public policy.[19] *Id.* § 178 cmts. (b)–(d).

1. FREEDOM OF CONTRACT

We find applicable here our observations in *Lawrence*, in which this Court affirmed the enforceability of an agreement related to the Workers' Compensation Act and considered public policies relevant at that time:

> Undoubtedly, the issue we face raises critical and complex public policy issues. And the administration of the workers' compensation system is heavily imbued with public policy concerns. At the same time, we have long recognized a strong public policy in favor of preserving the freedom of contract. Courts must exercise judicial restraint in deciding whether to hold arm's-length contracts void on public policy grounds:
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> . . . .
>
> Given the lack of any clear legislative intent to prohibit agreements like the ones before us, and absent any claim by the petitioners of fraud, duress, accident, mistake, or failure or inadequacy of consideration, we decline to declare them void on public policy grounds. We believe the factually-intensive, competing public policy concerns raised by the parties and by amici in these cases are not clearly resolved by the statute and are best resolved by the Legislature, not the judiciary.

Lawrence, 44 S.W.3d at 553. This Court has long recognized Texas' strong public policy in favor of preserving the freedom of contract. TEX. CONST. art. I, § 16 ("No bill of attainder, ex post facto law, retroactive law, or any law impairing the obligation of contracts, shall be made."); *see also*

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[18] "In weighing the interest in the enforcement of a term, account is taken of (a) the parties' justified expectations, (b) any forfeiture that would result if enforcement were denied, and (c) any special public interest in the enforcement of the particular term." RESTATEMENT (SECOND) OF CONTRACTS § 178(2).

[19] "In weighing a public policy against enforcement of a term, account is taken of (a) the strength of that policy as manifested by legislation or judicial decisions, (b) the likelihood that a refusal to enforce the term will further that policy, (c) the seriousness of any misconduct involved and the extent to which it was deliberate, and (d) the directness of the connection between that misconduct and the term." RESTATEMENT (SECOND) OF CONTRACTS § 178(3).

Churchill Forge, Inc. v. Brown, 61 S.W.3d 368, 371 (Tex. 2001); *Lawrence*, 44 S.W.3d at 553 (citations omitted); *Wood Motor Co. v. Nebel*, 238 S.W.2d 181, 185 (Tex. 1951).

> [I]f there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice. Therefore, you have this paramount public policy to consider–that you are not lightly to interfere with this freedom of contract.

Nebel, 238 S.W.2d at 185 (quoting *Printing & Numerical Registering Co. v. Sampson*, 19 L.R.Eq. 462, 465 (1875)). We also recognize the importance of the "indispensable partner" to the freedom of contract: contract enforcement. *Chesapeake Operating, Inc. v. Nabors Drilling USA, Inc.*, 94 S.W.3d 163, 176 (Tex. App.—Houston [14th Dist.] 2002, no pet.) (en banc). Importantly, freedom of contract is not unbounded. "As 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." *In re Prudential Ins. Co. of Am.*, 148 S.W.3d 124, 129 & n.11 (Tex. 2004); *see Sonny Arnold, Inc. v. Sentry Sav. Ass'n*, 633 S.W.2d 811, 815 (Tex. 1982) (recognizing "the parties' right to contract with regard to their property as they see fit, so long as the contract does not offend public policy and is not illegal"). Absent strong public policy reasons for holding otherwise, however, the preservation of contractual freedom and enforcement is no less applicable to the relationship between an insured and insurer. *See Fortis Benefits v. Cantu*, 234 S.W.3d 642, 648, 649 (Tex. 2007).

The Legislature determines public policy through the statutes it passes. *Stafford Estates Ltd. P'ship*, 135 S.W.3d at 628; *Grizzle*, 96 S.W.3d at 250 (Texas' public policy is reflected in its statutes); *FM Props. Operating Co.*, 22 S.W.3d at 873. The Legislature has passed many laws

declaring certain agreements illegal and, therefore, against public policy. *See*, *e.g.*, TEX. BUS. & COM. CODE § 2.302 (unconscionable contracts); *Id.* § 15.05 (contracts in restraint of trade or commerce); TEX. FIN. CODE § 302.001 (contracts for usurious interest); TEX. CIV. PRAC. & REM. CODE §§ 127.002–.003 (certain mineral agreements that provide for indemnification of a negligent indemnitee).

In other cases, the Legislature has decided that public policy requires certain conditions be met before an agreement may be enforceable. *See*, *e.g.*, TEX. BUS. & COM. CODE § 17.42 (A consumer's waiver of DTPA remedies is against public policy unless specific requirements are met.); TEX. GOV'T CODE § 2254.005 (Contracts for professional services not obtained in compliance with the Professional Services Procurement Act are void as against public policy.); TEX. LAB. CODE § 406.035 (Except as provided by statute, an agreement waiving an employee's right to workers' compensation is void.).

Also, this Court has held in a number of cases over the years that public policy clearly disfavors certain types of agreements.[20] In these circumstances, the Court has exercised its authority to determine and enforce public policy.

2. PURPOSE OF EXEMPLARY DAMAGES

In situations where the Legislature has not spoken directly on whether public policy prohibits insurance coverage of exemplary damages for gross negligence, a court should consider the purpose of exemplary damages. The common law and legislative development of exemplary damages in Texas informs this analysis.

For over 150 years, this Court has held that exemplary damage awards serve to punish the wrongdoer and set "a public example to prevent the repetition of the act." *Cole v. Tucker*, 6 Tex. 266, 268 (1851); *Graham v. Roder*, 5 Tex. 141, 149 (1849); *see also Cavnar v. Quality Control Parking, Inc.*, 696 S.W.2d 549, 555 (Tex. 1985). We confirmed that dual purpose in *Transportation*

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[20] *See, e.g.*, *Hoover Slovacek LLP v. Walton*, 206 S.W.3d 557, 559 (Tex. 2006) (holding that agreement between lawyer and client providing for termination fee was against public policy); *PPG Indus., Inc. v. JMB/Houston Ctrs. Partners Ltd. P'ship*, 146 S.W.3d 79, 82, 87 (Tex. 2004) (holding that assignment of claims for violations of the Texas Deceptive Trade Practices–Consumer Protection Act was against public policy); *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 205 (Tex. 2002) (holding that lawyer fee-sharing agreement was against public policy); *State Farm Fire and Cas. Co. v. Gandy*, 925 S.W.2d 696, 698, 705 (Tex. 1996) (holding that insured's prejudgment assignment of claims against liability insurer was against public policy); *Zuniga v. Groce, Locke & Hebdon*, 878 S.W.2d 313, 316 (Tex. App. —San Antonio 1994, writ ref'd) (holding that assignment of legal malpractice claims was against public policy); *Elbaor v. Smith*, 845 S.W.2d 240, 241 (Tex. 1992) (holding that Mary Carter agreements, in which the defendant receives assignment of part of plaintiff's claim and both remain parties at trial were against public policy); *Desantis v. Wackenhut Corp.*, 793 S.W.2d 670, 681 (Tex. 1990) (holding that unreasonable non-competition agreement was against public policy); *Juliette Fowler Homes, Inc. v. Welch Assocs.*, 793 S.W.2d 660, 663 (Tex. 1990) (same); *Int'l Proteins Corp. v. Ralston-Purina Co.*, 744 S.W.2d 932, 934 (Tex. 1988) (holding that assignment of plaintiff's claims against one tortfeasor to another tortfeasor was against public policy); *Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987) (holding that indemnity against one's own negligence was against public policy without express language); *Trevino v. Turcotte*, 564 S.W.2d 682, 690 (Tex. 1978) (holding that assignment of right to challenge will to one who had taken under will was against public policy); *Crowell v. Housing Auth. of Dallas*, 495 S.W.2d 887, 889 (Tex. 1973) (holding that lease provision exempting landlord from tort liability to tenants was against public policy); *Hooks v. Bridgewater*, 229 S.W. 1114, 1118 (Tex. 1921) (holding that contract transferring custody of a child in exchange for permitting the child to inherit from the transferee was against public policy).

Insurance Co. v. Moriel, citing the Legislature's definition of exemplary damages in force at the time of the opinion: "'Exemplary damages'" means "any damages awarded as an example to others, as a penalty, or by way of punishment." 879 S.W.2d 10, 16 (Tex. 1994). Although some pre-*Moriel* decisions recognized that exemplary damages "also exist to reimburse for losses too remote to be considered as elements of strict compensation" or to compensate a plaintiff for inconvenience and attorneys fees, these cases do not undermine the longstanding *primary* purpose of exemplary damages: to punish and deter. *See Hofer v. Lavender*, 679 S.W.3d 470, 474 (Tex. 1984) (citing *Mayer v. Duke*, 10 S.W. 565 (1889)); *Allison v. Simmons*, 306 S.W.2d 206, 211 (Tex. Civ. App.—Waco 1957, writ ref'd n.r.e.); *Foster v. Bourgeois*, 253 S.W. 880 (Tex. Civ. App.—Austin 1923), *aff'd*, 259 S.W. 917 (Tex. 1924).

Legislative enactments of the last decade clarify compensatory recovery is not a component of exemplary damages in Texas today, and the most recent enactments downplay the role of deterrence and focus squarely on the punitive aspect. Act of April 11, 1995, 74th Leg., R.S., ch. 19, § 1, 1995 Tex. Gen. Laws 108, 109 (deleting "as an example to others" from the definition and instead defining exemplary damages as "any damages awarded as a penalty or by way of punishment"), *amended by* Act of June 2, 2003, 78th Leg., ch. 204, § 13.02, 2003 Tex. Gen. Laws 847, 887 (current version at TEX. CIV. PRAC. & REM. CODE § 41.001(5)) ("'Exemplary damages' means any damages awarded as a penalty or by way of punishment but not for compensatory purposes. Exemplary damages are neither economic nor noneconomic damages.").[21]

[21] Many of the other "remote" categories of damages reflected in previous exemplary damage awards are now available, or explicitly unavailable, by Legislative enactment rather than as a component of exemplary damages. *See, e.g.*, TEX. BUS. & COM. CODE § 17.50(d) (prevailing consumers "shall" recover attorney's fees under the Texas

Chapter 41 of the Texas Civil Practice and Remedies Code also makes clear that the punishment imposed through exemplary damages is to be directed at the wrongdoer. Section 41.006 provides that "[i]n any action in which there are two or more defendants, an award of exemplary damages must be specific as to a defendant, and each defendant is liable only for the amount of the award made against that defendant." A defendant's liability for exemplary damages based on the conduct of employees, agents, and associates is also limited. Section 41.005 provides that "a court may not award exemplary damages against a defendant because of the criminal act of another" unless:

> (1) the criminal act was committed by an employee of the defendant;
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> (2) the defendant is criminally responsible as a party to the criminal act under the provisions of Chapter 7, Penal Code;
>
> (3) the criminal act occurred at a location where, at the time of the criminal act, the defendant was maintaining a common nuisance under the provisions of Chapter 125, Civil Practice and Remedies Code, and had not made reasonable attempts to abate the nuisance; or
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> (4) the criminal act resulted from the defendant's intentional or knowing violation of a statutory duty under Subchapter D, Chapter 92, Property Code, and the criminal act occurred after the statutory deadline for compliance with that duty.

Deceptive Trade Practices Act); TEX. CIV. PRAC. & REM. CODE § 41.001(4) ("'Economic damages' means compensatory damages intended to compensate a claimant for actual economic or pecuniary loss; *the term does not include exemplary damages* or noneconomic damages.") (emphasis added); *id.* § 41.001(12) ("'Noneconomic damages' means damages awarded for the purpose of compensating a claimant for physical pain and suffering, mental or emotional pain or anguish, loss of consortium, disfigurement, physical impairment, loss of companionship and society, inconvenience, loss of enjoyment of life, injury to reputation, and all other nonpecuniary losses of any kind *other than exemplary damages*.") (emphasis added); *see also New Amsterdam Cas. Co. v. Tex. Indus. Inc.*, 414 S.W.2d 914, 915 (Tex. 1967) (restating "the rule that statutory provisions for the recovery of attorney's fees are in derogation of the common law"). These Legislative enactments demonstrate the punitive nature of exemplary damages.

TEX. CIV. PRAC. & REM. CODE § 41.005(a)–(b). Even when the actor is the defendant's employee, the defendant is not liable for exemplary damages unless:

> (1) the principal authorized the doing and the manner of the act;
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> (2) the agent was unfit and the principal acted with malice in employing or retaining him;
>
> (3) the agent was employed in a managerial capacity and was acting in the scope of employment; or
>
> (4) the employer or a manager of the employer ratified or approved the act.

Id. § 41.005(c). Chapter 41 provides that exemplary damages can be awarded for fraud, malice, gross negligence, or certain statutory violations. *Id.* § 41.003(a), (c). "Fraud" does not include constructive fraud. *Id.* § 41.001(6). "Malice" requires specific intent to cause substantial injury. *Id.* § 41.001(7). "Gross negligence " is defined as:

> an act or omission:
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> (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
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> (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.

Id. § 41.001(11). Other statutory actions may prescribe a different culpable mental state for exemplary damages. *Id.* § 41.003(c). With these basic standards in mind, Section 41.011(a) provides:

> In determining the amount of exemplary damages, the trier of fact shall consider evidence, if any, relating to:

(1) the nature of the wrong;

(2) the character of the conduct involved;

(3) the degree of culpability of the wrongdoer;

(4) the situation and sensibilities of the parties concerned;

(5) the extent to which such conduct offends a public sense of justice and propriety; and

(6) the net worth of the defendant.

Id. § 41.011(a).

The first, second, and fifth evidentiary factors raise concerns of an objective nature. How did the conduct of the defendant, viewed in the abstract, irrespective of the parties, depart from broad norms or expectations? It does not matter whether the defendant was a conglomerate or an individual; the nature of the conduct is what matters. On the other hand, the third, fourth, and sixth factors focus subjectively—because the issue is punishment—on the individual parties. What will it take to punish the defendant?

There is some inherent tension between the policies recognized by freedom of contract and the policy behind awarding exemplary damages. Spreading the risk of, and obligation for, exemplary damages through insurance does not affect the objective factors. They may be evaluated without regard for individual personalities. The issue is this: What penalty should this conduct, in the abstract, bear? But the subjective factors are relevant to a determination of the amount of exemplary damages only if the *defendant* must pay it to the *plaintiff*. If exemplary damages are to be paid by

insurance, it is less relevant to set the amount based on whether the plaintiff was trusting or the defendant calculating or wealthy.

A few cases applying Texas law have considered whether insurance for exemplary damages is against public policy in light of the purpose behind exemplary damages. Their reasoning regarding the interplay of these competing policies is instructive.

Texas appellate courts have uniformly rejected as against public policy coverage under uninsured or underinsured motorist policies when the insured seeks to recover from his own insurer exemplary damages assessed against a third-party tortfeasor.[22] In that situation, the burden of the exemplary damages would fall entirely on the insurer and its policyholders, not on the tortfeasor, thereby entirely defeating the purpose of such damages. In one case, *State Farm Mutual Automobile Insurance Co. v. Shaffer*, Shaffer was injured in an automobile accident with Torres. 888 S.W.2d at 147. The court of appeals held that it was against public policy to require State Farm, Shaffer's insurer, to pay exemplary damages assessed against Torres. *Id.* at 149. Citing Chapter 41 as establishing the basis and manner for assessing exemplary damages, the court explained that "neither deterrence of wrongful conduct nor punishment of Torres, the wrongdoer, is achieved by imposing exemplary damages upon Shaffer's insurance carrier for Torres' wrongful act." *Id.* (citations omitted).

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[22] *Milligan v. State Farm Mut. Auto. Ins. Co.*, 940 S.W.2d 228, 232 (Tex. App.—Houston [14th Dist.] 1997, writ denied), *overruling Home Indemnity Co. v. Tyler*, 522 S.W.2d 594 (Tex. Civ. App.—Houston [14th Dist.] 1975, writ ref'd n.r.e.); *State Farm Mut. Auto. Ins. Co. v. Shaffer*, 888 S.W.2d 146, 149 (Tex. App.—Houston [1st Dist.] 1994, writ denied); *Vanderlinden v. USAA Prop. & Cas. Ins. Co.*, 885 S.W.2d 239, 242 (Tex. App.—Texarkana 1994, writ denied); *Gov't Employees Ins. Co. v. Lichte*, 792 S.W.2d 546, 549 (Tex. App.—El Paso 1990), *writ denied*, 825 S.W.2d 431 (Tex. 1991) (per curiam).

Other Texas courts of appeals have noted that the policy considerations regarding exemplary damages coverage depend on whether the basis for the damages is the conduct of the insured's employees or agents. In *American Home Assurance Co. v. Safway Steel Products Co.*, the insurers appealed a declaratory judgment in favor of the insureds for coverage of exemplary damages. 743 S.W.2d 693, 695–96 (Tex. App.—Austin 1987, writ denied). Exemplary damages of $750,000 and $1 million had been assessed against the insureds, respectively, in one case for gross negligence in failing to warn about the limitations of a football helmet the insured manufactured and in the other case for gross negligence in the design and marketing of a scaffold. *Id.*

The court of appeals observed that while allowing exemplary damages coverage shifts the burden of the punishment to "the innocent members of society who purchase insurance," contrary to the purpose of such damages, disallowing coverage for a large corporation means that exemplary damages for the misconduct of perhaps one or only a few employees will "inevitably be passed on to the consumers of its products—who are also innocent," also contrary to the damages' purpose. *Id.* at 704.

In *DaimlerChrysler Insurance Co. v. Apple*, an employee claimed that three of his employer's managers had defamed him. No. 01-05-01115-CV, 2007 WL 3105899, at *1–2 (Tex. App.—Houston [1st Dist.], Oct. 25, 2007, reh'g filed). The trial court confirmed in part the arbitration panel's assessment of exemplary damages of $500,000 against the employer, $500,000 against its owner and CEO, and $50,000 each against the three managers, all of whom were

determined to be vice-principals. *Id.* at *3 & n.4.[23] Following an appeal, the employer settled with the employee, but the employer's insurer under both a CGL policy and an umbrella policy refused coverage of the exemplary damage awards, arguing in part that such coverage was against public policy. *Id.* at *3–4. The court of appeals disagreed but limited its holding to circumstances "where a corporation is held liable for conduct by vice-principals; the conduct was done without the participation or knowledge of the CEO, officers or shareholders of the corporation." *Id.* at *18 (citations omitted). The court explained that under these circumstances "the agreement . . . serves the public good because [the employer], its CEO, its officers, and its shareholders did not commit the wrongful acts and should be allowed to have their insurance policy, for which they paid, indemnify them for the punitive damages." *Id.* (citations omitted).[24]

These courts of appeals cases highlight the general considerations that are important when determining whether the policy behind exemplary damages should limit parties' ability to contract for coverage of those damages. In the uninsured and underinsured motorist context, it may be

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[23] *See also Hammerly Oaks, Inc. v. Edwards*, 958 S.W.2d 387, 391 (Tex. 1997) (stating that "the general rule in Texas" is set out in RESTATEMENT OF TORTS § 909 (1939): "Punitive damages can properly be awarded against a master or other principal because of an act by an agent if, but only if, (a) the principal authorized the doing and the manner of the act, or (b) the agent was unfit and the principal was reckless in employing him, or (c) the agent was employed in a managerial capacity and was acting in the scope of employment, or (d) the employer or a manager of the employer ratified or approved the act.").

[24] Similarly, the court of appeals in *Westchester Fire Insurance Co. v. Admiral Insurance Co.*, made a limited holding that exemplary damages in a case involving grossly negligent treatment of a nursing home resident were, under the applicable statute in effect when the underlying suit against the insured was settled, insurable. 152 S.W.3d 172, 176 (Tex. App.—Fort Worth 2004, pet. filed). The primary carrier filed a motion for partial summary judgment, arguing that Texas public policy prohibits insurance coverage of exemplary damages. The trial court concluded that any coverage for exemplary damages under the policy was void. The court of appeals reversed, deciding that Texas public policy *at the times relevant* to the underlying case did not preclude coverage for exemplary damages under the primary carrier's policy. *Id.* at 189–90.

appropriate for policyholders to share in the burden of injuries caused by underinsured motorists, but not their punishment. In other words, the 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.

The considerations may weigh differently when the insured is a corporation or business that must pay exemplary damages for the conduct of one or more of its employees. Where 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. When a party seeks damages in these circumstances, courts should consider valid arguments that businesses be permitted to insure against them.

Extreme circumstances may prompt a different analysis. The 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. For example, liability policies themselves normally bar insurance for damages caused by intentional conduct, as did the liability policy in this case. The fact that insurance coverage for exemplary damages may encourage reckless conduct likewise gives us pause. Were the existence of insurance coverage to completely eviscerate the punitive purpose behind awarding exemplary damages, it could defeat not only an explicit legislative policy but also the court's traditional role in deterring conscious indifference. *See* RESTATEMENT (SECOND) OF CONTRACTS § 178(3). However, JUSTICE HECHT's concurrence would go further and more fully address these circumstances.

IV. CONCLUSION

The Legislature authorized the Texas Department of Insurance to create a policy that provides insurance coverage for exemplary damages in workers' compensation cases. Thus, we decline to invalidate the parties' workers' compensation contract to enforce a public policy urged by Fairfield but not adopted by the Legislature. In response to the certified question, we answer that the public policy of Texas does not prohibit insurance coverage of exemplary damages for gross negligence in the workers' compensation context. However, without clear legislative intent to generally prohibit or allow the insurance of exemplary damages arising from gross negligence, we decline to make a broad proclamation of public policy here but instead offer some considerations applicable to the analysis in other cases. Of course, how our answer is applied in the case before the Fifth Circuit is solely the province of that certifying court. *Amberboy v. Societe de Banque Privee*, 831 S.W.2d 793, 798 (Tex. 1992).

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J. Dale Wainwright
Justice

OPINION DELIVERED: February 15, 2008