

INSURING UNINSURABLE PUNITIVE DAMAGES

For the first time in history, many U.S. insurers today are willing to afford coverage under various types of insurance policies for punitive and exemplary damages under certain circumstances. This coverage is typically referenced in the definition of “Loss” with a provision which states that Loss includes punitive or exemplary damages. Such a provision does not, though, afford blanket coverage for any punitive or exemplary damage award since all of the exclusions in the policy would still apply. In addition, absent special provisions or arrangements, such coverage would be available only if punitive and exemplary damages are deemed insurable under the law pursuant to which the policy is construed.

In an attempt to maximize the circumstances under which a punitive or exemplary damage award is deemed insurable, insureds generally have two options: 1) purchase the coverage from a U.S. insurer and include in the policy a “most favorable jurisdiction” provision, or 2) purchase the coverage in Bermuda either within a standard Bermuda insurance policy form (which typically includes punitive damage coverage) or in a relatively new type of Bermuda “wrap around” punitive damage policy which supplements the insured’s policy purchased in the U.S.

This paper analyzes the effects to an insured from purchasing coverage for punitive or exemplary damages either in the U.S. or in Bermuda. When evaluating this coverage, three separate issues must be considered. First, are punitive damages insurable under the applicable jurisdiction? Second, what is the applicable jurisdiction to determine whether the punitive damages are insurable? Third, who decides what is the applicable jurisdiction to determine the insurability of the punitive damages? Each of those questions are discussed below under both U.S. and United Kingdom legal authorities.

I. ARE PUNITIVE DAMAGES INSURABLE?

A. United States Law

Courts in many states have ruled that it is against the public policy of that state to allow insurance coverage for a punitive damage award since such coverage would tend to defeat the purpose of the punitive damage award (i.e. punish the defendant for committing egregious wrongdoing). Courts in approximately 20 states have either ruled that punitive damages are uninsurable for public policy reasons or have not addressed the issue. However, if the punitive damages are based upon the defendant’s vicarious liability rather than the defendant’s own conduct, virtually all courts in the U.S. which have addressed the issue have found such punitive damages to be insurable.

For large corporations with facilities, employees or conduct in many states, there is a substantial risk that a punitive damage award could be awarded in a jurisdiction which considers such an award uninsurable even though the insurance policy expressly affords coverage for punitive damages. In essence, courts adopting that view conclude that the public policy justification for a punitive damage award outweighs the freedom of two parties to contractually agree upon the terms of insurance coverage. Although shared by many courts, that view has not been universally adopted by all courts in the U.S. For example, the North Dakota Supreme Court ruled that punitive damages were covered under a professional liability policy even though the applicable public policy prohibited the insurability of punitive damages. The court in essence held that the insured's freedom to contract with its insurer outweighed the public policy prohibition against insuring punitive damages. Since the insurance policy specifically covered punitive damages, the court ruled the insured should be entitled to that coverage notwithstanding public policy concerns for such coverage. Continental Casualty Co. v. Kinsey, 499 N.W.2d 574 (N.D. 1993). Such a ruling, though, is very much the minority view among U.S. courts.

B. United Kingdom Law

The general rule under English law is that an insured is deprived of the right to payment of a claim otherwise covered under an insurance policy's terms only if (i) the insured has committed an act with deliberate intention of bringing about the insured event, or (ii) the loss flows from a criminal act. See, e.g. Euro-Diam Ltd. v. Brathurst [1988] 2 AER 23; Tinsley v. Milligan [1993] 3 AER 65; St. John Shipping Corp. v. Joseph Rank Ltd. [1957] 1 QB 267. Only limited authority exists with respect to applying this general rule to the insurability of punitive damages since generally such damages are not available under English law.

A recent Court of Appeal decision applies this general rule to the insurability of punitive damages under English law. In Lancashire County Council v. Municipal Mutual Insurance Limited [1996] 140 SJLB 108, the English court considered whether public policy should prohibit the insurability of punitive damages which are otherwise covered under an insurance policy. In that case, the defendant was found liable for punitive damages based upon the defendant's vicarious liability of its agents. The court ruled that it was not against public policy to enforce the insurance policy provision covering punitive or exemplary damages under the circumstances. The court noted the following reasons for its ruling:

1. Allowing insurance for punitive damages afforded to the plaintiff a far better chance of recovering on the award;
2. A punitive damage award, if insurable, would still likely create a punitive effect because (i) the punitive damage exposure could exceed the policy's limits of liability, (ii) sufficiently egregious conduct is uninsurable, and (iii) the insured would likely realize an increase in future insurance premiums as a result of such a claim;

3. There is a public policy recognizing the need to hold the parties to their contractual obligation, and therefore if the insurer had taken a premium for insuring against punitive damages, such coverage should be afforded; and
4. Contracts should be unenforceable based upon public policy only in plain cases.

In summary, it appears that unlike many states in the U.S., there is no per se prohibition against insuring punitive damages under United Kingdom law, although a public policy prohibition exists if the insured's wrongdoing rises to a sufficient level of malice or intentional misconduct. Existing authority, though, does not clearly define when that threshold for uninsurability is crossed. In other words, punitive damages will be more likely insurable under United Kingdom law than under the law of many states in the U.S.

II. IS A CHOICE-OF-LAW PROVISION ENFORCEABLE?

Because the law of the United Kingdom and some states in the U.S. appears more favorable to the insurability of punitive damages than other states in the U.S., a logical insurance response would be to state in the insurance policy that the law of a particularly favorable jurisdiction will apply with respect to enforcing the punitive damage coverage expressly afforded by the insurance policy. This type of "choice of law" provision raises an important question as to whether such a provision is enforceable. As explained below, this type of provision is more likely to be enforceable under United Kingdom law than under U.S. law.

A. United Kingdom Law

If an insurance policy expressly selects United Kingdom law, English courts will most likely enforce that agreement and will apply English law in determining whether the punitive damage award is insurable. A 1997 Queen's Bench decision broadly enforced a choice of law provision in an insurance policy which selected English law even though the policy was formed in Australia and insured Australian risks:

It is clear that the parties to the insurance policy bargained for English law. This Court should therefore give effect to that intention, unless it would be contrary to English public policy (which includes international public policy) to give effect to the enforcement of the jurisdiction clause which is otherwise valid....Although the insurance policy has a very close connection with Australia, that is not a decisive factor in considering the particular question of public policy before the Court....This is not to say that in an appropriate case the Court will not take into account in relation to an insurance contract public policy of a jurisdiction with which the insurance has a close connection [citation omitted]...In this case, however, the Court is concerned with the enforceability of the parties'

freely chosen choice of law and jurisdiction in a credit insurance policy. In contracts of this kind between commercial enterprises, there is no equivalent restriction in English law or in Community law on the parties' choice of law....In my judgment therefore, this Court should give effect to the bargain of the parties and their freely negotiated choice of law and jurisdiction.

Akai v. Peoples Insurance Co., Ltd., [1998] 1 Lloyd's Rep. 90. Thus, it appears quite likely that a provision selecting United Kingdom law would be enforced by an English court under United Kingdom authority.

B. United States Law

Unfortunately, the choice-of-law rules in the U.S. are more complex and less predictable than in the United Kingdom. If the issue of enforcing the choice-of-law provision is submitted to a U.S. court, it is unclear whether the U.S. court would enforce that choice-of-law provision.

The general rule regarding the enforceability of choice-of-law provisions under U.S. law is summarized in Section 187 of the Restatement of the Law, Second, Conflict of Laws:

(ii) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either:

(a) The chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or

(b) Application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of §188, would be the state of the applicable law in the absence of an effective choice of law by the parties.

The official comments for this section of the Restatement includes the following explanatory discussion:

The chosen law should not be applied without regard for the interests of the state which would be the state of the applicable law with respect to the particular issue involved in the absence of an effective choice by the parties. The forum will not refrain from applying the chosen law merely because this would lead to a different result than would be obtained

under the local law of the state of the otherwise applicable law. Application of the chosen law will be refused only (i) to protect a fundamental policy of the state which, under the rule of §188, would be the state of the otherwise applicable law, provided (ii) that this state has a materially greater interest than the state of the chosen law in the determination of the particular issue. The forum will apply its own legal principles in determining whether a given policy is a fundamental one within the meaning of the present rule and whether the other state has a materially greater interest than the state of the chosen law in the determination of the particular issue. The parties' power to choose the applicable law is subject to least restriction in situations where the significant contacts are so widely dispersed that determination of the state of the applicable law without regard to the parties' choice would present real difficulties.

No detailed statement can be made of the situations where a 'fundamental' policy of the state of the otherwise applicable law will be found to exist. An important consideration is the extent to which the significant contacts are grouped in this state. For the forum will be more inclined to defer to the policy of the state which is closely related to the contract and the parties than to the policy of a state where few contacts are grouped but which, because of the wide dispersion of contacts among several states, would be the state of the applicable law if effect were to be denied the choice-of-law provision. Another important consideration is the extent to which the significant contacts are grouped in the state of the chosen law. The more closely this state is related to the contract and to the parties, the more likely it is that the choice-of-law provision will be given effect. The more closely the state of the chosen law is related to the contract and the parties, the more fundamental must be the policy of the state of the otherwise applicable law to justify denying effect to the choice-of-law provision.

U.S. courts have generally followed the rule set forth in the Restatement and have enforced choice-of-law provisions in insurance policies and other contracts unless enforcement of such a provision would conflict with a fundamental policy of the state whose laws would otherwise apply in the absence of the choice-of-law provision. See, e.g. Independent Petrochem Corp. v. Aetna Cas. & Sur., 654 F. Supp. 1334, 1357, aff'd in part and rev. in part 944 F.2d 940 (D.C. Cir. 1991) (choice-of-law provision in an insurance policy controls unless the choice was unreasonable or a fundamental conflict existed between the policies of the chosen state and those of the otherwise applicable state); Warm Springs Forest Products Industries v. Ebico., 300 Or. 617, 716 P.2d 740, 743 (1986) (choice-of-law provision in an insurance contract is enforceable since the plaintiff failed to show a "fundamental public policy" for invalidating that agreement); Fine v. Property Damage Appraisers, Inc., 393 F. Supp. 1304, 1308 (E.D. La. 1975)

(parties are permitted to select in the insurance policy the applicable law applying to the insurance policy so long as such selection comported with the public good).

At least one court has applied this general rule in the context of the insurability of punitive damages. In International Surplus Lines v. Pioneer Life, 209 Ill. App. 3d 144 (1990), the subject insurance policy expressly covered punitive damages, but “only where permitted by law.” The court ruled that the phrase “where permitted by law” was a choice-of-law provision referring to the jurisdiction in which the claim arose. More importantly, the court further held that the public policy of the state where the insured and insurer were located was not so strong or fundamental as to override the choice-of-law provision. Thus, this case suggests that if punitive damages are insurable under the selected law, but uninsurable under the otherwise applicable law, the selected law will still apply and the punitive damages will still be insurable.

To maximize the chances of punitive damages being insurable under a policy issued in the U.S. and to conform to this Restatement rule, many policies contain a “most favorable jurisdiction” clause which states that the insurability of punitive damages will be determined under the law of any jurisdiction which allows the insurability of punitive damages if that jurisdiction has a substantial relationship to the insurer, the insureds, the policy or the underlying claim. If such a provision is enforced, it is likely in most cases that a jurisdiction favoring the insurability of punitive damages will apply.

However, the enforceability of a choice-of-law provision is not a certainty under U.S. law. Numerous courts have refused to apply an express choice-of-law provision in an insurance policy or other contract because enforcing such a provision would conflict with a fundamental policy of the state whose laws would otherwise apply or because there was not a sufficient relationship between the selected jurisdiction and the parties to the contract. See, e.g. Nedlloyd v. Superior Court, 234 Cal. App. 3d 550 (Cal. App. 1991) (choice-of-law provision not enforced because the selected jurisdiction had no substantial relationship to the parties or the disputed transaction); Rutter v. BX of Tri-Cities, Inc., 60 Wash. App. 743 (Wash. App. 1991) (choice-of-law provision was invalid because application of the selected law was contrary to a fundamental policy of the forum state); Electrical and Magneto Service v. AMBAC Int., 941 F.2d 660 (8th Cir. 1991) (choice-of-law provision not enforced because a fundamental policy of Missouri would be violated); Greenwood Trust Co. v. Mass., 776 F. Supp. 21 (D. Mass. 1991) (choice-of-law provision not enforced because it would violate a fundamental policy of the forum state).

In summary, if the enforceability of a choice-of-law provision is determined under U.S. law, there is substantial uncertainty whether such a provision would be enforced if, by doing so, otherwise uninsurable punitive damages become insurable. Because in many U.S. jurisdictions punitive damages are considered uninsurable based upon public policy considerations, it appears likely that at least some courts will determine that by enforcing a choice-of-law provision, a fundamental policy of the forum state has been violated and therefore the choice-

of-law provision will not be enforced. On the other hand, such a provision is more likely to be enforced if challenged under United Kingdom law.

III. WHO DETERMINES WHETHER A CHOICE-OF-LAW PROVISION IS ENFORCEABLE?

Because different courts apply different rules in determining whether a choice-of-law provision is enforceable, another important question is what court will determine the validity of the choice-of-law provision. Absent a special dispute resolution provision in the insurance policy, the coverage dispute will likely be decided in whatever court the insurance dispute is submitted. Frequently, this will be a court which the party filing the coverage action believes will be most sympathetic to that party's coverage position. However, if the insurance policy contains a mandatory United Kingdom arbitration provision, it is quite unlikely a U.S. court will address the enforceability of the choice-of-law provision. Stated differently, to maximize the likelihood that punitive damages would be covered, the insurance policy should not only select United Kingdom law for determining the insurability of punitive damages, but should also include a mandatory U.K. arbitration provision to prevent U.S. courts from deciding whether the choice-of-law provision is enforceable. For this reason, covering punitive damages through a Bermuda insurance policy which applies United Kingdom law and which contains a mandatory United Kingdom arbitration provision, appears more likely to survive judicial attack than any type of punitive damage coverage provision in a policy issued in the United States. By both applying United Kingdom law and requiring a United Kingdom tribunal to determine the coverage issue, the insureds are most likely to obtain the intended punitive damage coverage.

This type of off-shore coverage also removes the punitive damage coverage issue from insurance regulators in the U.S. As a practical matter, insurance regulators may be the party most likely to challenge the insurability issue. Insureds obviously will contend that coverage exists. Similarly, an insurer that expressly covers punitive damages and touts that coverage in its marketing efforts will likely acknowledge the existence of that coverage, except perhaps where the insured's conduct is quite egregious. An insurance regulator in the U.S., though, may have sufficient regulatory concerns about such coverage that the regulator may seek to prevent a U.S. insurer from paying punitive damage awards under the policy. By obtaining this coverage through an off-shore insurance company over which the U.S. insurance regulator has no control, the parties have further enhanced the likelihood that the coverage terms in the policy will be enforced as written.

IV. SUMMARY

A "most favorable jurisdiction" provision in a U.S. insurance policy will, like a Bermuda policy, usually adopt the law of a jurisdiction which allows the insurability of punitive damages. However, there is a greater risk under a U.S. insurance policy that a court in the U.S. will not enforce the "most favorable jurisdiction" provision if by doing so punitive damages which are uninsurable in the forum state become insurable. Bermuda/U.K. law will more likely view punitive damages as insurable and will more likely enforce the parties' selection of U.K. law to determine the insurability of punitive damages. Therefore, it is more advantageous to

purchase this coverage in Bermuda in a policy that (i) expressly grants such coverage, (ii) selects U.K. law to determine the insurability of punitive damages, and (iii) requires disputes under the policy to be determined in an arbitration or legal proceeding in the U.K.

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