THE INSURABILITY OF PUNITIVE DAMAGES – A PRIMER

Few things stoke greater fear in risk managers, outrage in C-Suite executives or wrath in Boards of Directors than runaway punitive damages jury verdicts. The fear is well founded, especially when you consider the difficulty in insuring such exposures. To be sure, recent headlines underscore the very real potential for impairment of a company’s balance sheet by an uninsured punitive damages verdict. Below, we present some of the risk transfer products available and touch on the advantages and/or disadvantages of each in mitigating this exposure.

A. THE BERMUDA “OCCURRENCES REPORTED” FORM

Punitive damages have historically been included in the “Damages” definition of the Bermuda “Occurrences Reported” form and, thus, historically have been considered indemnifiable under the form. Such “automatic” punitive damages coverage has long been considered a true advantage of purchasing coverage under the Bermuda Form. These programs have traditionally attached at higher levels, but the sustained soft marketplace has driven those attachments down. Indeed, several companies across diverse industries have taken advantage of these lower attachment points to purchase the broad coverage available under the Bermuda “Occurrences Reported” form in both traditional and multi-year programs.

B. THE “PUNI-WRAP” POLICY

Since the early 90s, Bermuda-based carriers have also offered policyholders a separate stand-alone policy to protect against awards
for punitive damages where the domestic “wrapped” policy is otherwise prohibited from providing punitive damages coverage due to public policy, statutory, or regulatory considerations. This policy, commonly referred to as the “puni-wrap” policy, is offered on an indemnification basis and is triggered by a judgment in a court of law. Payments made under the domestic wrapped policy erode the limits of the puni-wrap policy; therefore, the puni-wrap policy does not provide an insured with additional limits or coverage per se. Nevertheless, a puni-wrap policy provides “gap” coverage for punitive damages verdicts in those 20+ states in which punitive damages are otherwise deemed uninsurable.

While the insurance industry has long recognized this “gap” protection as the perceived value of the puni-wrap policy, perhaps its greater value lies in the alignment of interests puni-wrap coverage creates between an insured and its insurer in the context of litigation. Indeed, the determination of whether and when a case should be settled and the commensurate value of a case often turn on the merits of the allegations related to the punitive damages demand. Alignment of interests between insurer and insured regarding defense strategy, whether to settle or take a case to trial and case outcome is critical to secure the right result. An insurer, obligated to defend and/or reimburse an insured for defense costs regardless of venue, with exposure for both the compensatory and punitive elements of a case, provides an insured relative certainty that its interests and that of the insurer are aligned for purposes of case outcome. However, where an insurer has an obligation to an insured to defend or reimburse the insured for defense costs but has no obligation to reimburse the insured for the punitive damages part of a verdict (or settlement), differences as to case value inherently exist and may force an insured to contribute the “punitive” component to a settlement or face the potential for a runaway verdict in an undesirable trial.

This puni-wrap alternative is offered by various excess insurance carriers’ Bermuda facilities, such as ACE (ACE Bermuda), Chubb (Chubb Atlantic), Chartis (Chartis Bermuda), XL (XL Bermuda), and others.

While large numbers of payments have not been made to date under the Bermuda puni-wrap policies, no evidence indicates that a Bermuda-based insurer has been unable to indemnify an insured for punitive damages due to some regulatory or legal prohibition. Nevertheless, given this lack of precedent and the recent heightened regulatory scrutiny placed upon the insurance industry, policyholders and carriers alike have looked to alternative ways to insure against the runaway punitive damages verdict.

C. THE MOST FAVORABLE VENUE ENDORSEMENT

The Most Favorable Venue (MFV) Endorsement, touted by domestic carriers as an alternative to a puni-wrap policy, has become a popular coverage enhancement intended to require the contracting parties to apply the law of the jurisdiction most favorable for purposes of determining the insurability of punitive damages. Domestic carriers have been largely successful in securing regulatory approval of such endorsements and offer them in a bold attempt to compete for business from insureds otherwise forced to go “off-shore” to secure affirmative punitive damages coverage. The question often raised about these endorsements is: can two parties, otherwise subject to the laws and regulations of the U.S., contract to apply the law of a specific jurisdiction simply for purposes of avoiding the prohibition against the insurability of such damages by whichever court they find themselves in? Only time will tell. Whatever the outcome, as with the puni-wrap alternative discussed above, perhaps the true value of the MFV endorsement lies in its ability to create an alignment of interests between an insured and an insurer in the defense of a case where such alignment would otherwise not exist absent an insurer’s exposure to punitive damages.

While different insurers take different approaches to this endorsement and offer differing language, generally speaking the endorsements include language such as “the definition of a claim includes punitive and exemplary damages, and the enforceability of this provision shall be governed by such applicable law that most favors coverage for such punitive or exemplary damages.” The cost for this endorsement can vary depending on the risk, operating locations, and the insurer’s view of the punitive exposure specific to a particular insured.
While the endorsement demonstrates a legitimate intent by insurers to provide relative contract certainty as to coverage for punitive damages, the question remains: what is meant by “the laws of any jurisdiction that is most favorable to the insurability of such damages?” While regulators have approved it, the endorsement has yet to meet heightened scrutiny by the courts and therefore remains a mystery as to whether it will actually work.

CONCLUSION

As brokers and consultants to our risk management clients, we are tasked with assessing risk and finding viable insurance solutions for them. While the likelihood of being hit with a punitive damages payment, which cannot be appealed away or reduced, is very small, the risk remains. Indeed, absent explicit punitive damages coverage, the policyholder has an inherent and identifiable gap in coverage. Moreover, there is undoubtedly value in securing alignment of interests between insured and insurer in the defense and outcome of litigation. To those risk managers who ask: Is there value in purchasing a “puni-wrap” policy? we say simply that in the unlikely, but possible, event your company gets hit with a punitive damages verdict not otherwise insurable, we would not want to be in the shoes of the one advising the board that “well...we have a $20M verdict against us for which we’re not insured.” If I’m a board member, the first question that comes to mind is, “Could we have been? Is there insurance for such a thing?” The answer is “yes” and the ramifications of such a situation would likely be uncomfortable for the messenger.

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