

Fifth Circuit Allocates Between Covered and Uncovered Amounts and Finds Punitive Damages Uninsurable under Texas Law

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The United States Court of Appeals for the Fifth Circuit, applying Texas law, has affirmed a district court's judgment that allocated \$5 million of a \$9 million settlement of an underlying claim to punitive damages and concluded that Texas public policy would not permit insurance coverage for punitive damages based on the extreme facts of the case. *Am. Int'l Specialty Lines Ins. Co. v. Res-Care, Inc.*, 2008 WL 2232089 (5th Cir. Jun. 2, 2008).

The insured sought coverage for a wrongful death suit filed by the estate of a former resident of a group home operated by the insured, who died after an employee poured bleach on the resident. For several days following the incident, other employees at the home failed to care for her injuries. She died from severe complications from the bleach burns, which covered more than 40% of her body. The resident's estate filed a wrongful death and survival suit seeking compensatory and punitive damages.

The insured sought coverage under two policies: a professional liability and commercial general liability policy with a \$1 million limit and a commercial umbrella policy with a \$15 million limit. The umbrella policy excluded coverage for punitive damages, but the primary policy did not.

The insurer and insured executed a non-waiver agreement that authorized the insurer to seek a settlement of the lawsuit. The agreement recognized that the insurer did not believe the policies covered punitive damages and provided that in the event of a settlement, the insurer would have the right to recoup from the insured any sums not covered by the policies.

The insurer settled with the underlying plaintiff for \$9 million and sued the insured to recover the portion of the settlement attributable to punitive damages. The district court held a bench trial to allocate the settlement between punitive and compensatory damages. The court found that \$5 million of the \$9 million settlement was attributable to punitive damages and entered judgment in favor of the insurer for \$5 million.

The insured argued on appeal that the district court erred by considering evidence in the allocation trial that would not have been admissible during trial of the underlying suit. The Fifth Circuit explained that the goal of

an allocation trial is not to retry the merits of the case but to determine what portion of the settlement was reasonably intended to be allocated to covered amounts. Observing that district courts have considerable leeway in determining what evidence is relevant to that inquiry, the Fifth Circuit held that the district court properly decided the allocation issue and thus rejected the insured's argument.

The insured also argued that the district court erred in refusing to permit coverage for punitive damages under the primary policy, which was silent as to the issue of insurability of punitive damages. The Fifth Circuit noted that, in *Fairfield Insurance Co. v. Stephens Martin Paving, LP*, 246 S.W.3d 653 (Tex. 2008), the Texas Supreme Court established a two-step process for courts to determine whether punitive damages are insurable. The court first asks whether the plain language of the policy covers the punitive damages. "Second, if the court determines that the policy provides coverage, it determines whether Texas public policy allows or prohibits such coverage." The Fifth Circuit found that the primary policy covered punitive damages, but "conclude[d] that the circumstances of [the resident's] injury and death, occurring while living in a facility with documented systemic problems of care, were so extreme that the purposes of punishment and deterrence of conscious indifference outweigh the normally strong public policy of permitting the right to contract between insurer and insured." Accordingly, the Fifth Circuit affirmed the district court's judgment that the insured must repay the \$5 million allocated to punitive damages.