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Punitive Damages/Insurability

TEXAS PUBLIC POLICY DID NOT PROHIBIT
INSURANCE COVERAGE FOR PUNITIVE
DAMAGES AWARDED AGAINST A NURSING
HOME IN 1995

*Jury Decides Whether Underlying Plaintiff Made
Policy Limit Settlement Demand Where Policy
Limits Were Uncertain Because Defense Costs
Were Included within Policy Limits*

*Westchester Fire Insurance Company v. Admiral
Insurance Company*, 152 S.W.3d 172 (Tex.
App.-Fort Worth 2004)

Quinn

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Case at a Glance

An excess carrier that has paid punitive damages in a judgment against an insured may be subrogated to the insured's rights against a primary carrier that failed to settle within policy limits.

When a defending primary carrier has an offer to settle within policy limits, that sum includes punitive damages, and the applicable statute does not exclude punitive damages from insurability, Texas public policy does not exclude punitive damages from insurability, and the primary carrier may have been negligent in failing to accept the

settlement offer.

The jury resolves factual questions about whether settlement demands were within policy limits where the insured's on-going defense costs eroded policy limits.

Summary of Decision

An excess insurer (Westchester) brought this equitable **subrogation** action against a primary insurer (Admiral) to recover costs the excess insurer incurred as a result of the primary insurer's failure to settle a lawsuit against a nursing home they both insured. Very few facts about the misconduct of the nursing home were set forth in this opinion. Apparently, among other things, its personnel had the elderly plaintiff in the underlying case lie for long periods in a urine soaked bed. Nor was anything said about the actual conduct of the underlying trial. One significant fact was that mistreatment of the patient occurred in 1994 and the trial of the patient's lawsuit occurred in 1995, before the Texas legislature amended a statute governing the punitive damage liability of for-profit nursing homes.

There was, however, a great deal of discussion of legal principles, legislative history, and jurisprudence pertaining to the primary insurer's obligation to pay punitive damages awarded against the nursing home and the excess insurer's right to recover punitive damages paid on behalf of the nursing from the primary insurer. There is also some discussion of evidence with regard to attempts to settle the underlying case.

Subrogation. Under Texas law, some cases say that one party (*A*) is subrogated to the rights that a second (*B*) might have against a third (*C*) only if *A* made one or more payments on behalf of *B* which it had a legal obligation to make. In other words, *A*'s making of the payments was in some sense involuntary—at least from the point of view of legal

rights. Not all Texas courts hold this exact view. In the case of excess insurers, payment is involuntary, or at least not purely voluntary, if the excess insurer has a reasonable belief that it owes the money. *Keck Mahin & Cate v. National Union Fire Insurance Company, Pa.*, 20 S.W.3d 692, 702-03 (Tex. 2000). Under this doctrine, "if Westchester in good faith reasonably believed at the time of settlement that its payment was necessary for its protection, then its settlement was not voluntary, and it was entitled to equitable subrogation[.]" However, this analysis only pertains to the right of subrogation. It pertains only to whether the insurer has *standing* to bring the subrogation case. It does not pertain to whether the primary carrier, under the situations of a case like this one, *actually owes* money. That liability is not determined by whether the excess carrier was reasonable in making its payment. It is determined by whether the primary carrier acted unreasonably in failing to settle the underlying case.

Settlement Obligations. Under Texas law, if an insurer is defending a lawsuit on behalf of a policyholder because of its right and duty to defend, as specified in the insurance contract, he has a duty to settle the case under certain circumstances. *G.A. Stowers Furniture Co. v. Ham Indem. Co.*, 15 S.W.2d 544 (Tex. Comm'n. App. 1929, holding approved). For many years, this has been called the "Stowers Doctrine." Here is how the *Westchester/Admiral* court describes the rule:

The *Stowers* duty to settle is not activated unless three prerequisites are met: (1) the claim against the insured is within the scope or coverage, (2) the claimant has made a settlement demand that is within the policy limits, and (3) the terms of the demand are such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's potential exposure to an excess judgment.

If (1)-(3) are met, the *Stowers* doctrine" is triggered. The major question in this case was whether Admiral failed to discharge its *Stowers* duty. If it did, then the excess carrier may have every right to recovery on a subrogation claim.

Insurance Coverage for Exemplary (or Punitive) Damages? The major purely legal question in the case was whether there was insurance coverage at any relevant time in Texas for

exemplary/punitive damages. Admiral argued that there were not.

Insurance Policy. Significantly, it was not merely a CGL policy. That was one component, to be sure. There was another section to the policy, however. The policy also contained a part entitled "Coverage O-Hospital Professional Liability." Significantly, Coverage O covered liability "arising out of the rendering or failure to render during the policy.... [n]ursing treatment to [a relevant] person[.]" Coverage O was not restricted to accidents or occurrences. In the underlying case, the nursing home was found to have been grossly negligent in the treatment of the plaintiff. Further, Admiral never issued a reservation of rights letter.

Public Policy. Admiral argued that insurance of exemplary-punitive damages was contrary to public policy. The court of appeals rejected this view. Contracts which are against public policy are void. However, contracts are against public policy, only if they are illegal or otherwise injurious to public good. Public good, however, is to be found in the actions of the legislature: no statute; no public leave likely, at least from the judicial point of view. See RESTATEMENT (SECOND) OF CONTRACTS § 178(1) (1981). To be sure, said the court, the federal district judge in Fort Worth, [who-while quite a difficult individual-is brilliantly knowledgeable about insurance] stated in 1988 that punitive damages were not insurable. *Hartford Cas. Ins. Co. v. Powell*, 19 F.Supp.2d (N. D. Tex. 1998). This was nothing but an "Erie guess," however said the court of appeals. In addition, implied the court of appeals, the case before that judge eventually turned on the idea of an *accident* and the definition of that word.

Thus, although state appellate courts may consider decisions of Texas federal courts, they need not be bound by them. They may reject their reasoning, as this court of appeals did. In *Powell* the federal judge was concerned about the utilization of insurance as an economic device which would severely cut down on the extent to which awards of punitive damages would prevent vicious conduct. The court of appeals rejected this view for several reasons. Most important is that the net worth of the defendant is admissible when amounts of punitive or exemplary damages are being determined. Another important consideration is that freedom of

contract is an important public policy. It is also an important public policy in Texas forbidding insurance companies from backing off their obligations.

Statutory Change. To be sure, there are statutes in place, some of them nearly a quarter of a century old pertaining to punitive damages and medical malpractice cases. Those statutes, however, did not apply under the circumstances of this case. The defendant was a for-profit nursing home, and neither physician nor a not-for-profit nursing home, which relevant statutes at the time did address. Furthermore, although there have been several changes in state statutes regarding exemplary-punitive damages, statutes passed after 1994 could not apply to this case: the policy was originally issued in 1993; the events triggering coverage occurred in 1994; and there was a suit and a settlement in 1995. Legislative changes to definitions-including the definition of exemplary damages-do not reach backwards, especially if the statute says that they don't.

Interestingly, both insurers agreed that exemplary-punitive damages were no longer coverable by liability insurance. Apparently, they together (at least impliedly) asked the court to rule on the "present liability of insured punitive damages[.]" The court declined to do so. The question was not really before it so anything it said would be no more than an advisory opinion, and the court held that it had no jurisdiction to render any such opinion. Thus, in effect, the court held that there was coverage under the policy at issue for punitive damages in 1994-1995.

Settlement Offers. Based on *Stowers* Doctrine, Admiral contended there was no settlement demand within policy limits. Westchester took the opposite position. The evidence was that plaintiffs' counsel several times told the lawyers defending the case that the plaintiffs would settle within policy limits. The insurance policy limits were, of course, eroding. This was not a policy, like a CGL policy, with a fixed amount available to pay claims. It was more like a malpractice policy where there are policy limits, but they are devoted both the defense and claims. In at least one letter, the defendant nursing home indicated the insurer that the plaintiffs were willing to settle for "full policy limits," whatever they were.

At the same time, the plaintiff was not following the usual, recognized, excepted procedure for making *Stowers* demands. The reason for this, no doubt, was that the policy at issue was an eroding policy. It is very difficult to know how to make a *Stowers* demand when such policies are all there is. At the same time, there was some evidence that the nursing home believed, at least, that the entire aggregate limits were available to pay the claim. (Of course, that proposition cannot be true if the policy was generally an eroding policy.)

At the trial itself, counsel for the plaintiff testified that he had made a demand for settlement within policy limits. He said that he made a *Stowers* demand. The probative evidence, but it was not entirely unambiguous. Plaintiff's counsel testified as follows with respect to his demand letter:

What I'm setting out is basically that we are willing to settle for the primary insurance limits, [and the next phrase of the letter] sets out what they have been represented to us to be, \$1,000,000.

In other words, the issue is whether counsel offered to settle for \$1 million or whether he offered to settle for whatever was left, though he has been told that there might be as much as \$1 million left. Obviously, these are distinct ideas.

As with many policies related to delivery of professional services, the insured has to agree to any settlement. The nursing home did agree to any settlement within policy limits. Subsequently to communications already described, there was a mediation; there were further communications; some of the settlement demands were higher than policy limits; and the insurer claimed that it attended to the subsequent demands to be sure, communications on the topic of settlement were not absolutely clear as time wore on.

Holding. The court of appeals held that "viewed under the proper standard, there is more than a scintilla of evidence to raise a fact issue regarding whether the [plaintiffs] made a settlement demand within policy limits." Thus, if there is a *Stowers* demand which is rejected, and subsequent demands are higher than policy limits, *Stowers* has still been triggered, and the existence of the earlier demand may extend the carrier's obligations beyond its policy limits.

Prudent Insurer Behavior. Item #1 of the *Stowers* criteria was never in controversy, or it was in controversy only to the extent that the insurability of exemplary-punitive damages was an issue. Item #2 of the criteria was just discussed. Item #3 of *Stowers* indicates that the primary carrier will be liable beyond policy limits only if a reasonable or prudent insurer would have accepted the plaintiffs' within-limits offer to settle. Admiral took the position that no prudent carrier would have accepted the plaintiffs' settlement offer which was within policy limits, if there was one. Certainly, contended Admiral, "an ordinarily prudent insurer would not have accepted an opening demand for its full policy limits without first attempting to negotiate a lower settlement amount." But it was precisely these negotiations that cut it off from any demand within policy limits. According to the court of appeals, however, an expert witness testified that that wasn't true. Hence there was evidence before the court so that there were fact issues as to "whether an ordinarily reasonable person would accept the offer," made within policy limits (assuming there was one).

Comment

(1) This is a long opinion. It is worth remembering that it is an en banc opinion. It is also worth remembering that the issue of coverage for punitive (or, exemplary) damages is a hot issue. In a number of states, most particularly Texas. See Michael Sean Quinn, *Punitive Damages and Liability Insurance*, 18 INS. LITIG. RPTR 121 (1996).

(2) Probably the most significant issue here is the evidentiary question over whether any of the demands made by the plaintiffs' counsel were within policy limits. Since this case is tried to a jury, it will be a complex and most interesting case.

(3) One of the most serious problems facing the *Stowers* Doctrine is the problem of liability policies with declining limits. How can one tell whether one is making a demand within policy limits, unless one knows how much money is left? Frequently, however, the insurance company itself doesn't know how much money is left, because the lawyers aren't

submitting current bills. Even if the lawyers are submitting current bills, the accounting may not be completed, or even started. Moreover, even if the lawyers have submitted bills, the bills may involve portions which the carrier should not pay.

It looks like there is a simple way out of this problem. The plaintiff should make a demand for policy limits, whatever's left. But that number might be too low, especially if the defendant has some money to pay a judgment. Or that the amount might be lower than anyone can anticipate. Or it might be indeterminable, which-in effect-is (or is related to) one of the positions Admiral was taking.

This is a problem, of course, not only in professional malpractice policies, such as medical or legal policies. It is also a problem in D&O policies. Furthermore, several years ago, liability insurers tried to switch the CGL policy from a fixed-limit type policy to an eroding policy. If the insurance industry ever succeeds in that endeavor, *Stowers* (and similar) settlement demands and negotiations will become more complicated.

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