ROUTE TO:

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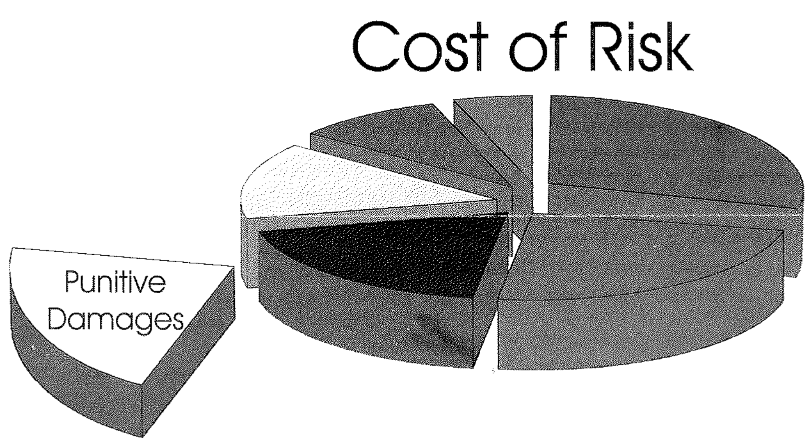
Punitive Damages and the Risk Manager

By Joseph J. Launie, Ph.D., CPCU, FACFE

What, Me Worry?

Punitive damages awarded for various examples of corporate malfeasance or misfeasance have been a part of the American corporate scene for a long time. Inclusion of estimates of the cost of punitive damages or the risk cost of the potential of punitive damages seems to be missing from most corporations' estimates of the cost of risk. This indicates that either corporate risk managers have found a magic silver bullet to insulate them from this exposure or that the risk is so nebulous and difficult to estimate that it is ignored on an ex ante basis and only dealt with ex post. The second approach certainly does remove the uncertainty, since it is relatively easy to read the numbers on the jury's findings. Of course, if no forecast has been made and no reserving done, then any punitive-damages award that does arrive must by definition be unbudgeted. I suppose one can always send a junior staff member up to inform the CFO.

Since risk managers as a class are pretty bright people with ever-improving analytic tools, there must be a reason for this state of affairs. It can be found in the nature of the punitive damages exposure itself. Although it is difficult enough for a firm operating in a single state such as Texas to deal with this problem, the difficulty increases exponentially for a national firm. The states have widely varying approaches to this area, and solutions that work in one state may be proscribed by statute in another.



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The Standards

A national firm would like a single set of rules and a level playing field in all jurisdictions. In such a situation, the corporate counsel could provide uniform advice nationwide. This is far from the case with respect to punitive damages. Courts across the country have taken positions on all sides of virtually every issue concerning exemplary damages. For example, one judge seemed to take a dim view of the entire concept, observing acidly, "The idea is wrong. It is a monstrous heresy. It is an unsightly and unhealthy excrescence, deforming the symmetry of the body of law" *(Fay v. Parker, 53 N.H. 342, 382)(1873).*

This sentiment was expressed by a justice of the New Hampshire Supreme Court in 1873, even though the United States Supreme Court had declared 22 years before: "We are aware that the propriety of this doctrine (of punitive damages) has been questioned by some writers; but if the repeated judicial decisions for more than a century are to be received as the best exposition of what the law is, the question will not admit of argument" *(Day v. Woodworth, 54 U.S. 363, 371)(1851).*

The United States Supreme Court did not end the arguments over punitive damages in 1851. There appears to be little evidence of universal agreement among the courts of the states on these issues today. Several punitive damage cases

(**Punitive**, continued inside)

Update to Last Quarter's Newsletter

Many of you may remember that last quarter's *RHA Review* featured an article about California's third-party bad-faith statute, better known as Civil Code Sections 2870 – 2871. The article mentioned that as of January 1, 2000, this code would be new law in California. What we didn't expect at the time was the power of the people. The issue was put on the ballot as a proposition in elections held after we went to press. At the urging of the insurance industry, the electorate rejected the bill, so California is staying put with regard to third-party bad faith.

(**Punitive**, continued from cover)

have been ruled on by the United States Supreme Court in recent years.

One area that differs from state to state is the threshold for the imposition of punitive damages themselves. Nebraska, New Hampshire and Washington shorten this discussion by refusing to recognize punitive damages at all. Louisiana and Massachusetts permit the imposition of punitive damages only when established by statutes. In 31 states, the minimum standard of conduct required for the imposition of punitive damages is less than malice. Ten states require malice as the minimum standard of conduct for the imposition of punitive damages. The states legally define *malice* in a variety of ways, with some including the concepts of fraud and oppression.

The Insurance of Punitive Damages

The use of the insurance mechanism to fund punitive damages losses is proscribed in several states. Once again, uniformity in this area is a chimera. In many cases, those courts that have prohibited the insurance of punitive damages have cited public policy considerations such as the belief that it is improper to permit the wrongdoer to shift the burden of the award to another. This argument is examined in detail in a subsequent section.

Eighteen states, including Texas, permit the insurance of punitive damages when liability is direct. Four additional states permit insurance when liability is direct, except for intentional torts. Thirty-one states, including Texas, permit insurance for punitive damages when liability is vicarious. The question of insurance for punitive damages when liability is direct is undecided in Colorado and South Dakota. Insurance for punitive damages when liability is vicarious is also undecided in New York, Rhode Island and Utah.

Following the public policy argument, it seems logical that those states with the higher malice standard might prohibit insurance, whereas those with the lower standard would permit it. Although the majority of the states follow this pattern, there are important exceptions. New York has a less-than-malice standard but prohibits the insurance of directly imposed punitive damages.

Shifting the Burden

Review of the case law in those states prohibiting the insurance of punitive damages reveals a common thread of a public policy concern. If the purpose of the imposition of the exemplary damages is to punish, the argument goes, then the wrong-doer should not be allowed to shift the burden of the damage award to others.

Although this is a worthy and lofty goal, it seems to ignore several aspects of the reality of punitive damages. First, the punitive-damages award is not a surgical strike slicing through the complexities of the corporate form and striking only the target officers and owners. Although there is no question that a large punitive-damages award will get the attention of the board of directors and the corporate officers, they and the stockholders will not be the only ones affected. A large damage award against a corporation imposes an initial burden on the entire corporation. At a minimum, to the extent that the corporate structure consists of debt and equity, the bondholders are impacted. Rarely, if ever, have the bondholders been implicated in whatever the activity was that occasioned the punitive-damages award. Perhaps the impact on the bondholders could be viewed as a collateral damage. Second, the location of the ultimate burden of the award may be different because of shifting. Depending on the economic realities of the product market on the one side and the labor and vendor market on the other, part of the burden may be shifted to the consumers or to the employees and vendors.

To the extent that the burden falls on those other than the intended target through shifting or the fundamental imprecision of the process, the public policy argument against shifting through insurance is weakened. There is ample evidence that, at least in some cases, significant amounts of the ultimate burden of particular punitive-damages awards are shifted to the consumers. The tobacco companies have been hit with some large punitive-damages awards recently and have publicly discussed the fact that they plan to shift the burden of these awards on to their customers, the smokers, through price increases. In fact, concern has arisen recently that excessive awards may overburden the tobacco companies to the point that they themselves become

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bankrupt. The case law in several states, speaking to the size of the award, indicates that it should be large enough to sting and to deter harmful conduct. No useful public policy purpose is served by destroying the targeted firm.

Finally, a prohibition against the shifting of punitive-damages awards through insurance seems to assume that the offending corporation can unload its damage award upon some unsuspecting insurer and escape unscathed. Most underwriters would be offended by such a view of the world. Though insurance is a transfer mechanism, it is not costless.

The Role of the Risk Manager

The uncertainty of the imposition of punitive damages imposes a risk cost on the corporation, whether or not the insurance transfer mechanism is chosen. Low-frequency, high-severity loss distributions such as punitive damages are the most difficult to estimate. Some studies of the punitive damages' severity distribution have found it to be a chaos process, making estimation unusually difficult.

With a few exceptions, a punitive-damages award against a corporation occurs because of a breakdown somewhere within the corporate chain of command. Rarely is the action or inaction which caught the jury's attention the result of a corporate policy approved and sanctioned by the board of directors. Although the risk manager may be comforted by this thought to a certain degree, the fact that breakdowns happen means that the threat of future punitive-damages awards is there for all corporations.

The initial step in the risk management process is risk identification and measurement. The possibility of a future punitive-damages award imposed upon their corporation is certainly on most risk managers' radar screens. For the reasons given above, measurement of the probability and likely risk cost of that threat is extremely difficult.

The techniques available to the risk manager to deal with the punitive-damages problem are somewhat limited. As previously indicated, shifting through insurance is proscribed in many jurisdictions. Even when it is not, most underwriters' enthusiasm for this type of risk is tepid at best. Underwriters and risk managers alike are uncomfortable with loss distributions that are difficult to estimate. At the end of the day, the insurance transfer mechanism requires a price. The price level that makes the underwriter willing to bind may well give the risk manager acute indigestion.

Most risk managers may well end up assuming the punitive-damages risk. Since the risk manager is unlikely to be able to estimate the future cost any better than the underwriter, there is often no explicit reserve created. There should at least be a realization that this lingering unresolved uncertainty means that the cost of risk of the rest of the company's risk management program is probably understated. Unresolved, unreserved uncertainty imposes a cost, and that is perhaps the ultimate burden of punitive damages.

References

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FROM NEAR AND FAR

On the evening of March 28, our Metroplex sibling, Fort Worth, was dealt a direct hit when a tornado tore through its downtown area just after quitting time. Many high-rise buildings were severely damaged, including the Cash America Building, Bank One Tower and UPR Plaza. According to the *Fort Worth Star Telegram*, total damages were expected to be close to $500 million.

According to *National Underwriter*, seven catastrophic events so far this year have produced more than $1.7 billion in insured property losses; $990 million of this was in Texas alone.

In mid-April an Air Philippines 737 crashed shortly before it was due to land at Davao in the Philippines. All 131 passengers and crew were killed. At press time the cause of the crash had not been determined.

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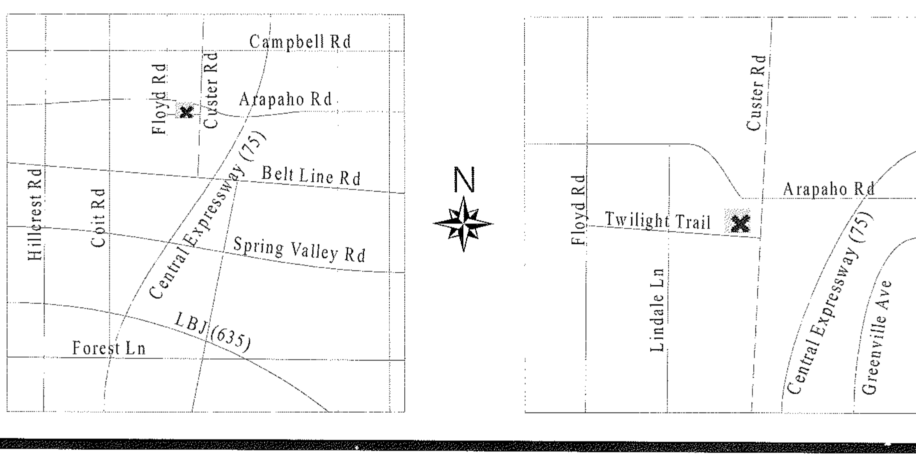
MOVING ON DOWN THE ROAD

As most of you read this, the staff at Robert Hughes Associates will be packing up and trying to organize their stuff into boxes marked "move" and "trash." As some of you may already know, we are moving our offices to a new larger location a few miles down the road. As of **June 23**, our new address will be **508 Twilight Trail, Suite 200**, **Richardson, Texas 75080**.

Our unique new space is in a complex called Twilight Plaza, which is just north of Dallas and less than one mile from U.S. Highway 75 (Central Expressway). The new location puts us within minutes of downtown Dallas and gives us easy access to LBJ Freeway and DFW Airport. The additional breathing room will give us the opportunity to continue to expand our library and give us the flexibility to begin work on some exciting new projects. The map below will give you a good idea of where we will be and also lessen your number of available excuses for not coming to visit us. If you are out this way, please drop by and say hello.



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