

PUBLIC POLICY AND COVERAGE FOR EXEMPLARY DAMAGES

FAIRFIELD INSURANCE COMPANY V. STEPHENS MARTIN PAVING, LP

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PUBLIC POLICY AND COVERAGE FOR EXEMPLARY DAMAGES

I. INTRODUCTION

Legislatures and scholars have struggled with the issue of whether the insurability of exemplary or punitive damages violates public policy for over forty years.¹ Of the forty-five states in which the highest court of the state or the legislature has addressed the issue in some fashion, twenty-five states have established generally that their public policy does not prohibit coverage.² Eight states have adopted a broad prohibition against insuring exemplary damages.³ Seven states allow insurance coverage of exemplary damages only in the vicarious liability context, prohibiting the practice otherwise.⁴ Three states allow insurance coverage of exemplary damages in the uninsured motorist context, but have not directly spoken outside this context.⁵ Two other states have precluded insurance coverage of exemplary damages in the uninsured motorist context, but have not otherwise directly spoken on the issue.⁶ Finally, the insurability of exemplary damages resulting from acts akin to gross negligence has not been addressed by the highest court or legislature in Texas and three other states.⁷ Thus, the majority of states considering whether public policy prohibits insurance coverage of exemplary damages for gross negligence, either by legislation or under the common law, have concluded that it does not.⁸

The Texas Supreme Court has recently issued its opinion in *Fairfield Insurance Company v. Stephens Martin Paving, L.P.*,⁹ holding that Texas public policy does not prohibit coverage under a workers' compensation and employer's liability insurance policy. In reaching its conclusion, the court examined statutes bearing on public policy, and recognized that the Legislature authorized the Texas Department of Insurance to create a policy that provided coverage for exemplary damages in a worker's compensation case.¹⁰ The court explained that without clear

legislative intent to generally prohibit or allow the insurance of exemplary damages arising from gross negligence, it could not make a broad proclamation of public policy, and offered some considerations applicable to the analysis in other cases.¹¹ This paper will explore the *Stephens Martin Paving* public policy analysis.

II. PUBLIC POLICY AND PUNITIVE OR EXEMPLARY DAMAGES: THE MAJORITY'S FOCUS

The majority opinion provided guidance as to the considerations future courts may employ in determining coverage for exemplary damages, and whether such coverage violates public policy.¹²

A. Public Policy

"Public policy has been described as 'that principle of the law which holds that no subject can lawfully do that which has a tendency to be injurious to the public or against the public good, the principle under which the freedom to contract or private dealings are restricted by law for the good of the community.'" ¹³ In the absence of express direction from the Legislature, whether a promise or agreement will be unenforceable on public policy grounds will be determined by weighing the interest in enforcing agreements versus the public policy interest against such enforcement.¹⁴ On one side of the scale is Texas' general policy favoring freedom of contract, while the other side of the scale involves the extent to which the agreement frustrates public policy.¹⁵

Texas has a strong public policy in favor of preserving the freedom of contract. Freedom of contract is not unbounded. Absent strong public policy reasons for holding otherwise, the preservation of contractual freedom and enforcement is no less applicable to the relationship between an insured and insurer.¹⁶

¹ *Fairfield Insurance Company v. Stephens Martin Paving, L.P.*, 2008 Tex. LEXIS 123, *19, 51 Tex. Sup. Ct. J. 491 (Feb. 15, 2008).

² *Id.* & n.12 (citations omitted).

³ *Id.* & n.13 (noting Ohio, Utah, California, Colorado, Illinois, New York, Rhode Island, and South Dakota).

⁴ *Id.* at 20 & n.14 (noting Kansas, Connecticut, Florida, Minnesota, New Jersey, Oklahoma, and Pennsylvania).

⁵ *Id.* & n.15 (noting Louisiana, New Mexico, and Tennessee).

⁶ *Id.* & n.16 (noting Maine and Massachusetts).

⁷ *Id.* at 20 (referencing Indiana, Michigan, and Missouri).

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* at *50.

¹¹ *Id.* at *50-51.

¹² The court explained that the coverage analysis involves a two-step analysis: (1) whether the plain language of the policy covers the exemplary damages sought in the underlying suit against the insured; and (2) if the policy provides coverage, whether the public policy of Texas allows or prohibits coverage in the circumstances of the underlying suit. *Id.* at *4.

¹³ See 4-23 Appleman on Ins. § 23.2 (quoting *Ploen v. Union Ins. Co.*, 253 Neb. 867, 573 N.W.2d 436 (1998)).

¹⁴ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *29 (citing RESTATEMENT (SECOND) OF CONTRACTS § 178(1)).

¹⁵ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *30.

¹⁶ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *33.

The Texas Legislature determines public policy through the statutes it passes, and it has passed many laws declaring certain agreements illegal and, therefore, against public policy.¹⁷ The Legislature has also decided that public policy requires certain conditions be met before an agreement may be enforceable.¹⁸

The Texas Supreme Court has also held that public policy disfavors certain types of agreements, exercising its authority to determine and enforce public policy.¹⁹

B. Punitive or Exemplary Damages

For over 150 years, the Texas Supreme Court has held that exemplary damage awards serve to punish the wrongdoer and set “a public example to prevent the repetition of the act.”²⁰ As the court recognized, since 1995, the Legislature has downplayed the role of deterrence and focused squarely on the punitive aspect.²¹

Texas law statutorily defines “exemplary damages”:

"Exemplary damages" means any damages awarded as a penalty or by way of punishment but not for compensatory purposes. Exemplary damages are neither economic nor

noneconomic damages. Exemplary damages includes punitive damages.²²

Exemplary damages may be awarded only if the claimant proves by clear and convincing evidence that the harm with respect to which the claimant seeks recovery of exemplary damages results from: (1) fraud, (2) malice, or (3) gross negligence.²³ “Malice” means a specific intent by the defendant to cause substantial injury or harm to the claimant.²⁴ “Gross negligence” means an act or omission: (a) which when viewed objectively from the standpoint of the actor at the time of its occurrence involves an extreme degree of risk, considering the probability and magnitude of the potential harm to others; and (b) of which the actor has actual, subjective awareness of the risk involved, but nevertheless proceeds with conscious indifference to the rights, safety, or welfare of others.²⁵ The claimant must prove by clear and convincing evidence the elements of exemplary damages; this burden of proof may not be shifted to the defendant or satisfied by evidence of ordinary negligence, bad faith, or a deceptive trade practice.²⁶ Exemplary damages may be awarded only if the jury was unanimous in regard to finding liability for and the amount of exemplary damages.²⁷

An award of exemplary damages must be specific as to a defendant, and each defendant is liable only for the amount of the award made against that defendant.²⁸ A defendant may not be exposed to liability for punitive damages the result of criminal acts of another; and except in certain circumstances, the conduct of employees will not result in punitive liability for the employer.²⁹

Under Texas law, an award of exemplary damages must be determined separately from compensatory damages.³⁰ Exemplary damages are “capped,” utilizing a formula set by the Legislature in an attempt to comport with federal due process requirements: an amount not to exceed the greater of (1)(A) two times the amount of economic damages; plus (B) an amount equal to any noneconomic damages found by the jury, not to exceed \$750,000; or (2) \$200,000.³¹

¹⁷ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *33-34 (referencing unconscionable contracts, contracts in restraint of trade or commerce, contracts for usurious interest, and certain mineral agreements).

¹⁸ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *34 (referencing waiver of DTPA remedies; contracts for professional services; and waiver of employee’s right to workers’ compensation).

¹⁹ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *34-35 (referencing agreement between lawyer and client providing for termination fee; assignment of claims for violation of DTPA; lawyer fee-shifting agreement, insured’s prejudgment assignment of claims against liability insurer; assignment of legal malpractice claims; Mary Carter agreements; unreasonable noncompetition agreements; assignment of plaintiff’s claims against one tortfeasor to another tortfeasor; indemnity against one’s own negligence [without certain language]; assignment of right to challenge will to one who had taken under will; lease provision exempting landlord from tort liability to tenants; and contract transferring custody of child in exchange for permitting child to inherit from the transferee).

²⁰ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *37.

²¹ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *38.

²² TEX. CIV. PRAC. & REM. CODE ANN. § 41.001(5) (Vernon Pamph. 2007).

²³ TEX. CIV. PRAC. & REM. CODE ANN. § 41.003(a).

²⁴ TEX. CIV. PRAC. & REM. CODE ANN. § 41.001(7).

²⁵ TEX. CIV. PRAC. & REM. CODE ANN. § 41.001(11).

²⁶ TEX. CIV. PRAC. & REM. CODE ANN. § 41.003(b).

²⁷ TEX. CIV. PRAC. & REM. CODE ANN. § 41.003(d).

²⁸ TEX. CIV. PRAC. & REM. CODE ANN. § 41.006.

²⁹ TEX. CIV. PRAC. & REM. CODE ANN. § 41.005.

³⁰ TEX. CIV. PRAC. & REM. CODE ANN. § 41.008(a).

³¹ TEX. CIV. PRAC. & REM. CODE ANN. § 41.008(b).

In determining the amount of exemplary damages to be imposed against a defendant, the jury is instructed that it may consider certain factors: (1) the nature of the wrong; (2) the character of the conduct involved; (3) the degree of culpability of the wrongdoer; (4) the situation and sensibilities of the parties concerned; (5) the extent to which such conduct offends a public sense of justice and propriety; and (6) the net worth of the defendant.³²

C. Who is Punished?

In *Stephens Martin Paving*, the court recognized that the section 41.011 factors to be considered by the jury in setting the amount of exemplary damages, in part, require an objective consideration of how the conduct of the defendant departed from broad norms and expectations, without consideration of the individual defendant. Others require a subjective focus – what will it take to punish this defendant? Thus, an inherent tension arises between the policies of freedom of contract and awarding exemplary damages.³³

Spreading the risk of, and obligation for, exemplary damages through insurance does not affect the objective factors, while the subjective factors bear directly on the determination against the individual defendant.³⁴ If exemplary damages are to be paid by insurance, it is less relevant to set the amount based on the section 41.011 factors.

D. Texas Courts' Historical Treatment of the Coverage Issue Provides Considerations for Future Analysis

Texas intermediate appellate courts have, for over thirty years, addressed the issue of coverage for exemplary damages, and whether coverage violates public policy. The courts focus on whether coverage is against public policy in light of the purpose underlying exemplary damages.

For example, court have uniformly rejected as against public policy coverage under uninsured or underinsured motorists policies when the insured seeks to recover from his own insurer exemplary damages assessed against a third-party tortfeasor.³⁵ In that situation, the burden of the exemplary damages would fall entirely on the insurer and its policyholders, not on the tortfeasor, defeating the purpose of such damages. Thus, the purpose may not

be achieved by penalizing those who obtain the insurance required by law for the wrongful acts of those who do not.³⁶

When the conduct involves the insured's employees, courts recognize that while allowing exemplary damages coverage shifts the burden of the punishment to the innocent members of society who purchase insurance contrary to the purpose of exemplary damages, disallowing coverage for a large corporation means that exemplary damages for misconduct of perhaps one or only a few employees will inevitably be passed on to the consumers of its products who are also innocent – also contrary to the purpose of those damages.³⁷ Thus, where the corporation must pay exemplary damages for the conduct of one or more of its employees, and where other employees or management are not involved in or aware of the wrongful conduct, the purpose of exemplary damages may be achieved by permitting coverage so as not to penalize many for the wrongful act of one.³⁸

The court recognized that extreme circumstances may prompt a different analysis. While the touchstone is freedom of contract, the court emphasized that strong public policies may compel a serious analysis into whether a court may legitimately bar contracts of insurance for extreme and avoidable conduct that causes injury. Liability policies, for example, normally bar coverage for damages caused by intentional conduct. Insurance coverage for exemplary damages may encourage reckless conduct, and if the existence of insurance eviscerates the purpose of exemplary damages, it defeats explicit legislative policy and the court's traditional role in deterring conscious indifference.

III. ADDITIONAL CONSIDERTIONS: JUSTICE HECHT'S CONCURRENCE

A. Deducing Public Policy

Justice Hecht's concurring opinion expanded on the analysis required in determining whether coverage for exemplary damages violates public policy. He began with general thoughts. Texas law recognizes and protects a broad freedom of contract, but that freedom is not unbounded. As a rule, parties have the right to contract as they see fit, so long as their agreement does not violate the law or public policy.

³² TEX. CIV. PRAC. & REM. CODE ANN. § 41.011.

³³ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *42-43.

³⁴ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *43.

³⁵ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *44 & n.22 (citations omitted).

³⁶ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *48-49.

³⁷ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *45-46 (citations omitted).

³⁸ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *49.

A state's public policy must be carefully deduced from its constitution, laws, and judicial decisions. The requirement of deduction is critical and circumscribes judicial authority. Courts must derive public policy from existing law, and must not create it. Court must recognize that public policy, just like *stare decisis*, may change over time.³⁹

Justice Hecht discussed the evolution of the public policy considerations at issue when insureds seek coverage under various policies, concluding that "the business of insurance is affected with a public interest" that is neither simple nor static and that supersedes the parties' freedom to contract for the shifting of risks in some instances and not in others.⁴⁰

In addressing the issue of coverage presented by the Fifth Circuit in *Stephens Martin Paving*, Justice Hecht looked to the sources of public policy considerations – the statutes stating the purpose of exemplary damages and prescribing the manner in which they are assessed, other statutes allowing and disallowing insurance for punitive damages, administrative regulations of insurance, Texas caselaw, and caselaw in other American jurisdictions.⁴¹

B. Statutory Review

The first public policy consideration, and most important of them, is that the purpose of punitive damages is to punish. Explaining the codification of chapter 41 of the Texas Civil Practice and Remedies Code, Justice Hecht concluded that if punitive damages are covered by insurance and paid from policyholders' premiums, so that the wrongdoer suffers no more than a sliver of the sanction, the sting of punishment is dissipated.⁴² Regardless of whether the insured's premiums increase, or insurance may be cancelled, or whether it may be forced out of business and stigmatized as a wrongdoer, insurance would indisputably spread consequences among many who

deserve no punishment at all, which contravenes the policy reflected in Chapter 41. Thus, insuring against punitive damages impairs their purpose.⁴³ Further, the objective and subjective factors the jury considers in determining an amount of punitive damages require the specific circumstances of a plaintiff and a defendant be taken into account; insurance coverage makes this impossible. The amount an insured pays is dependent on coverage and any deductible; thus, insuring against punitive damages conflicts with the way in which such damages must be assessed under Chapter 41.⁴⁴

Further, the Legislature has restricted the availability of punitive damages coverage to health care providers. In 1977, when it adopted the Medical Liability Insurance Improvement Act, the Legislature provided that professional liability policies issued for physicians and certain health care providers could not include punitive damages coverage. In 1987, 1997, 2001, and 2003, the statute was amended to allow the Board of Insurance, and later the Commission, to approve a policy endorsement providing punitive damages coverage first for hospitals, then for-profit nursing homes, and finally assisted living facilities. Justice Hecht concluded that the history underlying the Legislature's enactment and amendment of the Act made it difficult to discern any policy or policies whatsoever regarding coverage for punitive damages.⁴⁵

Justice Hecht also examined legislation concerning guaranty funds and excess liability pools, recognizing that modifications prohibiting them from paying punitive damages entirely or in part, shows a legislative concern for the economic impact on the entities of insurance for punitive damages.⁴⁶

The Legislature also required commercial liability insurers to file closed claim reports including, among much other information, amounts paid for punitive damages. The reports, still required, show "that punitive damages factor only very slightly into the settlement of commercial liability claims."⁴⁷

Justice Hecht concluded that from the legislative activity he examined, only a few inferences could be drawn. First, liability insurance for health care providers offered by Texas insurers should not be made

³⁹ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *55 & nn. 10-11 (Hecht, J., concurring).

⁴⁰ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *64-66 & nn. 17-23 (Hecht, J., concurring).

⁴¹ Commentators explain that public policy of a state is found in its constitution, statutes, and court decisions, with the acts of the legislature being superior to judicial opinions as determinants of public policy. A court construing an insurance policy must ensure its conformity to public policy and principles of fairness. A court should not decide the question of public policy without first discussing the contract rights of the parties. See 4-23 Holmes' Appleman on Ins. § 23.2 Supp. (2007) (discussing public policy and contract formation issues).

⁴² *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *74 (Hecht, J., concurring).

⁴³ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *76 (Hecht, J., concurring).

⁴⁴ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *79 (Hecht, J., concurring).

⁴⁵ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *80-81 & nn.49-53(Hecht, J., concurring).

⁴⁶ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *84 & n.55 (Hecht, J., concurring).

⁴⁷ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *85 & nn.56-58 (Hecht, J., concurring).

more costly by coverage for punitive damages. Further, the concern for guaranty funds and excess liability pools is that they not be burdened by payments for punitive damages. The Legislature's concern appears to be economic. Yet, if this is the predominant concern, why hasn't the Legislature taken more action through other legislation? In sum, Justice Hecht could discern little concerning public policy in the legislative limitations on and express approvals of punitive damages coverage.⁴⁸

C. Administrative Regulation of Insurance

Justice Hecht then examined the administrative regulation of insurance, explaining first that insurance is thoroughly regulated in Texas. Policy forms, for the most part, must be approved by the Commissioner of Insurance, and this approval of policy forms including and excluding various types of coverage is also some reflection of public policy.

- Standard form personal auto policies do not state specifically whether punitive damages are covered;
- Standard form homeowners' policies do not appear to cover punitive damages
- Other policies have been held to cover punitive damages in the absence of a provision specifically excluding such coverage:
 - CGL and Umbrella;
 - Professional liability for-profit nursing home;
 - Umbrella policy; and
 - Commercial vehicle policy.⁴⁹

In sum, it is impossible to determine the factors that influence the Commissioner of Insurance in deciding whether to approve or disapprove of punitive damages coverage, but the Commissioner's decision must be taken into account in considering whether coverage is against public cases.

D. Texas Caselaw

⁴⁸ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *89-90 (Hecht, J., concurring).

⁴⁹ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *91-92 & nn. 62-64 (Hecht, J., concurring).

Justice Hecht also examined Texas authority. The cases involve three categories in which punitive damages are assessed against (1) someone other than the insured; (2) an individual insured based on his own conduct, and (3) a corporate insured based on the conduct of its employees.

Coverage under uninsured and underinsured motorists insurance, the first category, has been rejected as against public policy because the burden of the punitive damages would fall entirely on the insurer and its innocent investors and policyholders, and not on the tortfeasor. The second category involves personal automobile insurance, and the courts have concluded punitive damages coverage is not against public policy because it has been approved by the state regulatory agency. The third category involves commercial vehicle and general liability policies. The commercial vehicle cases split – concluding that coverage was and was not against public policy – while the general liability policies cases concluded that coverage was not against public policy. The cases were considered both before and following the enactment of Chapter 41. Thus, Texas courts have uniformly held that in the uninsured or underinsured motorist context, coverage of punitive damages is against public policy, but in other contexts have not so concluded.

E. Other Jurisdictions

Finally, Justice Hecht examined other jurisdictions, and reported:

- 19 states generally permit coverage of punitive damages⁵⁰;
- 8 states would permit coverage of punitive damages for grossly negligent conduct, but not for more serious conduct⁵¹;
- 11 states would permit coverage of punitive damages for vicariously-assessed liability, but not directly-assessed liability⁵²;

⁵⁰ *Stephens Martin Paving*, 2008 Tex. LEXIS 123, *106-07 & n. 92 (Hecht, J., concurring) (enumerating Alabama, Alaska, Arizona, Delaware, Georgia, Hawaii, Idaho, Maryland, Mississippi, Montana, New Hampshire, New Mexico, North Carolina, South Carolina, Tennessee, Vermont, Washington, Wisconsin, and Wyoming).

⁵¹ *Id.* at n.93 (Hecht, J., concurring) (enumerating Arkansas, Kentucky, Iowa, Louisiana, Nevada, Oregon, Virginia, and West Virginia).

⁵² *Id.* at n.94 (Hecht, J., concurring) (enumerating California, Connecticut, Florida, Illinois, Indiana, Kansas, Kentucky, Minnesota, New Jersey, Oklahoma, and Pennsylvania).

- 7 states generally prohibit an insured from indemnifying himself against punitive damages⁵³; and
- Remainder of states has silent, unclear, or otherwise inapplicable law.⁵⁴

punitive damages would violate Texas public policy unless these considerations are outweighed by factors, such as expressions of legislative will, or regulatory approval of the coverage, or the attenuation of the burden of liability from the misconduct. The public policy analysis must answer why punitive damages for such egregious behavior should be avoided by insurance.

F. Conclusion: Considerations for Determining Coverage

Justice Hecht provided several considerations for determining the broad question of whether coverage for punitive damages violates Texas public policy:

- Contracts must be respected, and the right to contract freely should not be restricted without compelling reasons;
- Punitive damages may be assessed only as punishment and not for any other purpose, and thus they must be directed at the specific conduct of an individual defendant and must be based on his particular circumstances, including his net worth;
- Punitive damages coverage may pose an undesirable cost to insureds and to the public;
- Insurance is highly regulated, and the Commissioner of Insurance must have broad discretion to determine when punitive damages coverage may be offered.

Thus, even if public policy considerations do not preclude punitive damages coverage for the business, they counsel against extending the coverage to wrongdoer himself. Taking into account the policy favoring freedom of contract, Justice Hecht would hold that Chapter 41's punitive purpose would be significantly impaired, and a defendant's net worth could not be meaningfully incorporated in the assessment, as Chapter 41 requires, insurance against

⁵³ *Id.* at n.95 (Hecht, J., concurring) (enumerating Colorado, New York, North Dakota, Ohio, Rhode Island, South Dakota, and Utah).

⁵⁴ *Id.* at n.96 (Hecht, J., concurring) (enumerating Maine, Massachusetts, Michigan, Missouri, and Nebraska). Jurisdictions which prohibit insurance coverage for punitive damages are now in the minority. *See* 18-126 Appleman on Ins. § 126.2 (2007) (discussing public policy of punishment and liability insurance).