Volume 67 | Number 6 Article 13

9-1-1989

St. Paul Mercury Insurance Co. v. Duke University: The Fourth Circuit Approves Insurance Coverage of Punitive Damages for International Misconduct in North Carolina

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St. Paul Mercury Insurance Co. v. Duke University: The Fourth Circuit Approves Insurance Coverage of Punitive Damages for Intentional Misconduct in North Carolina

Awards of punitive damages come in different sizes, are awarded on the basis of many types of conduct,[1] and may further more than one public policy.[2] In North Carolina punitive damages serve two narrow purposes: to punish aggravated misconduct and to deter such misconduct.[3] In determining the amount of a punitive damages award, jurors may consider the wealth of the defendant to ensure that punitive damages actually serve as punishment.[4]

Although commentators advance public policy arguments against the practice,[5] increasingly courts have allowed defendants to insure themselves against liability for punitive damages.[6] Since 1985 the North Carolina Supreme Court has expressly allowed insurance coverage for punitive damages based on grossly negligent or reckless conduct.[7] Whether this coverage extends to punitive damages based on intentional misconduct is a question that remains unanswered by the North Carolina judiciary.[8]

This Note will critique the conclusion of the United States Court of Appeals for the Fourth Circuit in *St. Paul Mercury Insurance Co. v. Duke University*[9] (*St. Paul*) that North Carolina public policy does not preclude insuring against punitive damages awards based on intentional misconduct. The Note begins with a discussion of the reasoning applied at both the district and appellate court levels. Next, the Note presents an overview of the role that punitive damages play throughout the United States and the relationship of insurance to that role. It then focuses on the development of the law of punitive damages in North Carolina leading up to the Fourth Circuit opinion in *St. Paul*. The Note concludes that the federal appellate court incorrectly assessed North Carolina law and public policy in determining that insurance policies can cover punitive damages resulting from intentional misconduct.

In *St. Paul* the issue of insuring against punitive damages for intentional misconduct came before the federal court in a declaratory judgment action brought by St. Paul Mercury Insurance Company.[10] The declaratory judgment

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1. Ervin, *Postscript: Punitive Damages in North Carolina*, 59 N.C.L. REV. 1255, 1257-59 (1981).

2. *See* Ervin, *supra* note 1, at 1255.

3. *See infra* note 91 and accompanying text.

4. W. PROSSER & P. KEETON, PROSSER AND KEETON ON THE LAW OF TORTS § 2, at 15 (5th ed. 1984).

5. *See infra* notes 82-86 and accompanying text.

6. *See infra* note 74 and accompanying text.

7. *See* Mazza v. Medical Mut. Ins. Co., 311 N.C. 621, 319 S.E.2d 217 (1984); *infra* notes 97-103 and accompanying text (discussion of *Mazza*).

8. *See infra* text accompanying note 104.

9. 849 F.2d 133 (4th Cir. 1988).

10. 670 F. Supp. 630, 631 (M.D.N.C. 1987), *aff'd in part, rev'd in part*, 849 F.2d 133 (4th Cir. 1988).

was to determine St. Paul's contractual liability to pay punitive damages under an insurance policy issued to Duke University.[11] The punitive damages in question were awarded in a North Carolina state court action against Duke and one of its employees for certain intentional acts.[12]

The district court used a two-step analysis to determine whether the terms of the policy obligated St. Paul to pay Duke's punitive damages claims.[13] The first step required the court to determine whether the policy provided coverage of punitive damages awards.[14] The court relied on a "well established rul[e] of construction"[15] that requires the court to "construe the [insurance] contract before it liberally in favor of the insured and against the insurer."[16] Applying this rule of construction, the court concluded that the punitive damages assessed against Duke were covered under the policy because the policy language was "general and broad, with no specific exclusionary clause" for punitive damages.[17]

Having determined that the policy covered punitive damages, the court proceeded to the second step in its analysis: deciding whether North Carolina public policy precludes insurance coverage of punitive damages awarded for intentional torts.[18] The district court recognized that public policy questions are best left for legislative determination.[19] Because North Carolina lawmakers had not addressed the issue, however, the federal court was forced to do so.[20]

To resolve this issue, the district court looked to the public policy analysis used by the North Carolina Supreme Court in *Mazza v. Medical Mutual Insurance Co.*,[21] a decision expressly allowing insurance coverage of punitive damages

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11. *Id.* at 630.

12. *Id.* at 631. The events leading up to the declaratory judgment action began with a dispute between two medical doctors employed by Duke University, Dr. Raymond U and Dr. Leonard R. Prosnitz. The dispute centered on the ownership of, access to, and control of a Thermotron, a machine used for experimental cancer research and treatment. In order to prevent access to the machine, Dr. U removed parts and equipment from the machine in late March or early April 1984. On April 4, 1984, the university obtained a temporary restraining order that required Dr. U to return the parts of the machine that he had taken. A few months later, the parties reached a consent agreement as to future ownership, use, and control of the machine and Duke voluntarily dismissed the state court action on July 18, 1984. *Id.*

On October 3, 1984, Dr. U filed a state court action in the Superior Court of Durham County, North Carolina. The complaint alleged several causes of action against Duke and Dr. Prosnitz relating to the use of the Thermotron. On September 19, 1986, the jury awarded compensatory and punitive damages to Dr. U for his malicious prosecution claim against Duke University and for his libel and slander claims against Dr. Prosnitz. The punitive damages award included $1,000,000 against Duke for malicious prosecution and $50,000 against Dr. Prosnitz for libel and slander. *Id.*

13. *Id.* at 631-32. The court also held that the terms of the policy did not cover Dr. Prosnitz as a Duke employee. *Id.* at 632-33. This Note will not address the court's discussion of that issue.

14. *Id.* at 633.

15. *Id.*

16. *Id.* (citing Mazza v. Medical Mut. Ins. Co., 311 N.C. 621, 631, 319 S.E.2d 217, 223 (1984)).

17. *Id.* at 634.

18. *Id.*

19. *Id.* at 635 (citing Gardner v. N.C. State Bar, 316 N.C. 285, 293, 341 S.E.2d 517, 522 (1986)).

20. "[I]n the case before the Court, the North Carolina General Assembly has provided *no* guidance for the resolution of a question the Court can *not* avoid." *Id.*

21. 311 N.C. 621, 319 S.E.2d 217 (1984).

awarded for gross negligence.[22] As a starting point, the court recognized that contract law requires enforcing contracts as written, absent compelling policy considerations.[23] By contrast, the state's competing punitive damages policy is to "*punish* intentional wrongdoing and to *deter* others from similar behavior."[24]

Following the *Mazza* analysis, the court balanced the public policy interest in enforcing insurance contract obligations against the competing interest in precluding coverage of punitive damages.[25] The court distinguished authority such as *Mazza*, which permits insurance coverage of punitive damages for gross negligence,[26] by stating that these cases "involve totally different concerns and provide little persuasive guidance in this case."[27] Instead, the court relied on authority that would preclude coverage for punitive damages on policy grounds.[28] It concluded that insurance coverage of punitive damages for intentional acts, as opposed to reckless or negligent acts, would "defea[t] the dual purpose of punitive damages to punish the wrongdoer and to deter similar conduct in the future."[29] According to the court: "The ground for 'interference' [with freedom of contract] in a case involving insurance coverage for punitive damages arising from intentional torts is . . . *compelling* in that the purposes served by insurance and punitive damages are diametrically opposed."[30]

The United States Court of Appeals for the Fourth Circuit reversed the district court.[31] The appellate court agreed with the lower court that the issue centered on the tension between the public policy that enforces contracts as written to ensure commercial stability and the public policy against allowing individuals to insure themselves against penalties for their misconduct.[32] The Fourth Circuit panel reversed the district court, however, relying on two flaws it saw in the district court's analysis.[33]

The panel ruled that the district court had exceeded its authority in assessing undetermined state policy. It held that the role of the federal courts to determine state public policy barring enforcement of contractual obligations was limited to policy that is "well defined and dominant, and [which] is to be ascer-

22. *St. Paul*, 670 F. Supp. at 634-35. The district court limited its reliance on *Mazza* to the form of its analysis. Because the *Mazza* court expressly reserved the question of insurance coverage for punitive damages claims involving intentional acts, the conclusions of the case did not bear directly on the issue before the court. *Id.* at 635.

23. *Id.*

24. *Id.* at 635-36 (quoting Newton v. Standard Fire Ins. Co., 291 N.C. 105, 113, 229 S.E.2d 297, 302 (1976)).

25. *Id.*

26. *See supra* notes 21-22 and accompanying text.

27. The court distinguished the gross negligence cases, stating that "[t]he notion of spreading the risk of punitive damages through insurance is more palatable in the arena of negligent conduct than in the arena of intentionally tortious conduct, which by definition requires the intent to cause the tortiously proscribed result with its concomitant heightened level of culpability." *St. Paul*, 670 F. Supp. at 636.

28. *Id.* at 636 n.16 (citing 14 state law cases).

29. *Id.* at 637.

30. *Id.*

31. St. Paul Mercury Ins. Co. v. Duke Univ., 849 F.2d 133, 134-35 (4th Cir. 1988).

32. *Id.* at 135-36.

33. *Id.* at 136-37.

tained 'by reference to the laws and legal precedents and not from general considerations of supposed public interests.' "[34] Using this standard, the Fourth Circuit concluded that the district court had overstepped its authority in predicting North Carolina state policy. According to the court, "having found no [existent state policy] the district court was bound to enforce the bargain as made by the parties."[35]

Having determined that the district court erred in predicting North Carolina public policy, the appellate court held that the lower court also made an incorrect assessment of existing North Carolina policy.[36] The court then proceeded to make its own policy assessment.[37] This portion of the panel's analysis focused on case law holding that "[refusal] to enforce a contract covering punitive damages for intentional acts would allow insurers to avoid an obligation for which they bargained, and to be enriched unjustly."[38] Based on this authority, the court concluded that if Duke fulfilled its obligations under the contract by paying premiums, St. Paul was required to pay Duke's punitive damages claim. According to the court, a holding to the contrary "would . . . destroy to a large extent the certainty on which our commercial system depends."[39]

Although modern jury awards often include them, the concept of punitive damages developed late in the history of the English common law.[40] Awards of punitive damages, sometimes called exemplary damages or smart money, began in England during the mid-eighteenth century to compensate the injured plaintiff for nonphysical injuries and to punish the wrongdoer.[41] Toward the end of the eighteenth century, courts in the United States began to recognize the concept of punitive damages as developed in England.[42] At the beginning of the nineteenth century, United States courts broadened the concept of compensatory damages to include intangibles such as mental anguish and pain and suffering.[43] As a result, punitive damages were no longer necessary to compensate for nonphysical injuries.[44] By the 1830s, the increasing number of jury awards for

34. *Id.* at 135 (quoting United Paperworkers Int'l Union v. Misco, Inc., 108 S. Ct. 364, 373 (1987)).

35. *Id.* at 136 (focusing on the district court's reference to the *Mazza* opinion, which expressly reserved the issue of insuring against punitive damages resulting from intentional acts). The appellate court believed that the district court had inferred from the *Mazza* court's express reservation of the issue a de facto public policy rule against insuring against punitive damages arising from intentional conduct. *Id.* While by no means the only possible construction of the district court's language, this interpretation likely was reinforced by St. Paul's argument that the express reservation of the issue by the *Mazza* court "indicates that that court would decide the question differently" for intentional acts than it had with respect to negligent acts. *Id.*

36. *Id.*

37. *See id.*

38. *Id.* (citing Koehring Co. v. American Mut. Liab. Ins. Co., 564 F. Supp. 303, 312 (E.D. Wis. 1983) and First Nat'l Bank of St. Mary's v. Fidelity and Deposit Co., 283 Md. 228, 232-43, 389 A.2d 359, 361-67 (1978)).

39. *Id.* at 137.

40. Bell & Pearce, *Punitive Damages and the Tort System*, 22 U. RICH. L. REV. 1, 3 (1987).

41. *Id.*

42. Carruthers v. Tillman, 2 N.C. 501 (1 Hayw.) (1797); Coryell v. Colbaugh, 1 N.J.L. 90 (Sup. Ct. 1791).

43. *See* Bell & Pearce, *supra* note 40, at 4.

44. Bell & Pearce, *supra* note 40, at 4.

mental anguish shifted the focus of punitive damages away from compensation to punishment and deterrence.[45]

The function of punitive damages to punish and deter has survived and exists in most American jurisdictions today.[46] This role, however, has been attacked in two ways. First, punitive damages in a civil action go against the basic aim of the civil court system: to compensate an injured plaintiff, not to punish a defendant for his wrongdoing.[47] Following this reasoning, the only appropriate forum to punish citizen misconduct is the criminal court system.[48] Second, both commentators and case law express doubt as to the efficacy of punitive damages as a deterrent. At least eight jurisdictions have noted the ineffectiveness of punitive damages in deterring misconduct.[49] A task force for the American College of Trial Lawyers concluded that punitive awards "usually reflect the jury's dissatisfaction with a defendant and their desire to punish him, without regard to the true harm caused by the defendant's conduct."[50]

In response to these arguments, some jurisdictions have redefined the role of punitive damages to encompass a compensatory function.[51] These jurisdictions view punitive damages as a necessary evil offsetting the deficiencies of a system that does not compensate plaintiffs for the cost of litigation.[52] At least one jurisdiction expressly limits punitive damages awards to the cost of litiga-

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45. Bell & Pearce, *supra* note 40, at 4.

46. Note, *Corporate Insurability of Punitive Damages Arising from Employee Acts*, 11 J. CORP. L. 99, 100-01 (1985).

47. Editorial Comment and Annotations, *Punitive Damages—Justifications, Criticisms and Limitations*, 30 DEF. L. J. 189, 202 (1981); *see also* Note, *Insurance for Punitive Damages: A Reevaluation*, 28 HASTINGS L.J. 431, 434 (1976) (noting the distinction between civil and criminal law). These challenges can be traced back as far as 1851. *See* Day v. Woodworth, 54 U.S. (13 How.) 363, 371 (1851) (upholding the validity of punitive damages).

48. As stated by one commentator: "If conduct or practice is so inimical to public interest as to deserve punishment, it should be discouraged by fines or other penalties as felonies, misdemeanors and other statutory violations are punished." Editorial Comment and Annotations, *supra* note 47, at 202. At least one state, Indiana, will not allow a punitive damages award when the defendant may be held criminally liable. *See* Skufakiss v. Duray, 85 Ind. App. 426, 154 N.E. 289 (1926). Punitive damages frequently are awarded against defendants not subject to criminal liability. In this situation, the question becomes whether a jury's determination that defendant has committed a wrong is sufficient basis for punishment, absent legislative determination that the wrong merits a criminal penalty.

49. These jurisdictions include Arizona, Georgia, Idaho, Kentucky, Maryland, Oregon, Tennessee and Vermont. Sprentall, *Insurance Coverage of Punitive Damages*, 84 DICK. L. REV. 221, 229 & n.60 (1979); *see also infra* note 70 and accompanying text (discussion of case law expressing doubt about the deterrent effect of punitive damages).

50. Bell & Pearce, *supra* note 40, at 14; *see also* Note, *supra* note 47, at 434 (suggesting that the punitive damages system would work more effectively if the awards were paid to the state).

51. Zuger, *Insurance Coverage of Punitive Damages*, 53 N.D.L. REV. 239, 257-58 (1976); *see, e.g.*, Pennsylvania Threshermen & Farmers' Mut. Casualty Ins. Co. v. Thornton, 244 F.2d 823, 827 (4th Cir. 1957) (barring insurance coverage for punitive damages is contrary to purpose and spirit of liability policies to protect the public); New Amsterdam Casualty Co. v. Jones, 135 F.2d 191, 196 (6th Cir. 1943) (noting that punitive damages claimants benefit from liability insurance).

52. *See* Editorial Comment and Annotations, *supra* note 47, at 202; Zuger, *supra* note 51, at 258. Such a view indicates dissatisfaction with the doctrine of compensatory damages. If the compensatory system in fact is inadequate, it should be liberalized. The tort system should not use punitive damages to serve a purpose for which they were not intended. *See* Note, *supra* note 47, at 435.

tion.[53] Other jurisdictions take a more subtle approach to plaintiff compensation through punitive damages, stating that they serve a dual role of punishment and compensation.[54]

Not only do jurisdictions differ on the function of punitive damages, they also split on whether public policy allows individuals to insure themselves against punitive damages. Historically, the question was deemed a matter of simple contract interpretation.[55] In the 1960s, however, courts moved beyond simple contract interpretation to add a second step to the analysis.[56] Once a court found that the insurance policy covered punitive damages, the second step then determined whether public policy prohibited such coverage.[57] Because courts typically construe ambiguous contract language in favor of punitive damages coverage,[58] modern courts tend to focus on the second step in the analysis.[59]

Emphasizing this second step, two leading cases reached opposite conclusions regarding insurance for punitive damages.[60] *Northwestern National Casu-*

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53. *See* Tedesco v. Maryland Casualty Co., 127 Conn. 533, 536-37, 18 A.2d 357, 359 (1941) (Connecticut limits punitive damages awards to the cost of litigation).

54. *See, e.g.*, Hicks v. Herring, 246 S.C. 429, 437-38, 144 S.E.2d 151, 155 (1965) ("[Punitive] damages are awarded . . . as punishment and as a deterrent. . . . [They also] involve a compensatory aspect."); Pan Am. Petroleum Corp. v. Hardy, 370 S.W.2d 904, 908 (Tex. Ct. App. 1963) ("Exemplary damages may be awarded . . . [as] punishment . . . and may also include compensation for inconvenience, reasonable attorney's fees, and other losses too remote to be considered under actual damages.").

55. Brogdon, *Insuring Punitive Damages: A Closer Look at Public Policy Analysis*, 37 F.I.C.C. Q. 369, 373-74 (1987). Using this simple contract interpretation, sufficiently broad contract language covered punitive damages. *Id.*

56. Brogdon, *supra* note 55, at 377-79; *see* Lazenby v. Universal Underwriters Ins. Co., 214 Tenn. 639, 648-49, 383 S.W.2d 1, 4-5 (1964) (court uses a two-step analysis). Although this approach gained momentum in the 1960s, as early as 1935 the Colorado Supreme Court applied a public policy analysis. *See* Universal Indem. Ins. Co. v. Tenery, 96 Colo. 10, 17, 39 P.2d 776, 779 (1934) ("The injured will not be allowed to collect from a nonparticipating party for a wrong against the public.").

57. Brogdon, *supra* note 55, at 377-79.

58. *See, e.g.*, Stipcich v. Metropolitan Life Ins. Co., 277 U.S. 311, 322 (1928) (ambiguous contract language construed in favor of the insured because the policy was prepared by the insurer); Carroway v. Johnson, 245 S.C. 200, 203, 139 S.E.2d 908, 909 (1965) (ambiguous language construed in favor of insured); *but see* Tedesco v. Maryland Casualty Co., 127 Conn. 533, 538, 18 A.2d 357, 359 (1941) (policy coverage for "liability imposed upon [the insured] . . . because of bodily injury" construed not to include coverage for punitive damages); Aetna Casualty & Sur. Co. v. Wackenhut Corp., 442 So. 2d 192, 193 (Fla. 1984) (policy coverage of "damages because of bodily injury" does not encompass coverage for punitive damages); Caspersen v. Webber, 298 Minn. 93, 99-100, 213 N.W.2d 327, 331 (1973) (policy coverage of "damages because of bodily injury" construed not to include punitive damages against man who pushed hatcheck girl).

59. *See, e.g.*, Whalen v. On-Deck, Inc., 514 A.2d 1072, 1073-74 (Del. 1986) (Delaware public policy does not prohibit insuring against punitive damages); Baker v. Armstrong, 106 N.M. 395, 396-98, 744 P.2d 170, 171-73 (1987) (insuring punitive damages does not violate public policy); Esmond v. Liscio, 209 Pa. Sup. 200, 212-14, 224 A.2d 793, 800 (1966) (Pennsylvania public policy prohibits insuring against punitive damages for wanton misconduct); Sinclair Oil Corp. v. Columbia Casualty Co., 682 P.2d 975, 979-81 (Wyo. 1984) (Wyoming public policy allows insuring against punitive damages).

60. *See* Northwestern Nat'l Casualty Co. v. McNulty, 307 F.2d 432 (5th Cir. 1962) (holding that insuring against punitive damages would offend public policy); Lazenby v. Universal Underwriters Ins. Co., 214 Tenn. 639, 647-49, 383 S.W.2d 1, 4-5 (1964) (holding that public policy would not bar insuring punitive damages).

alty Co. v. McNulty[61] heads the line of cases barring insurance for punitive damages as an affront to public policy. In *McNulty* the United States Court of Appeals for the Fifth Circuit examined public policy relating to insurance coverage for punitive damages assessed against a drunken driver.[62] The court began its public policy analysis by defining the role of punitive damages in Florida.[63] The court concluded that in Florida punitive damages served to punish and deter misconduct, not to compensate the injured party.[64] In light of this function, public policy "would seem to require that the damages rest ultimately as well [as] nominally on the party actually responsible for the wrong."[65] The court further explained this policy:

> Where a person is able to insure himself against punishment he gains a freedom of misconduct inconsistent with the establishment of sanctions against such misconduct. It is not disputed that insurance against criminal fines or penalties would be void as violations of public policy. The same public policy should invalidate any contract of insurance against the civil punishment that punitive damages represent.[66]

This reasoning established the court's view that insurance should not cover punitive damages.

Two years after the Fifth Circuit decided *McNulty*, the Tennessee Supreme Court addressed the identical issue in *Lazenby v. Universal Underwriters Insurance Co.*[67] Like the *McNulty* court, the Tennessee court began its public policy analysis by determining that in Tennessee punitive damages served to punish and deter certain aggravated misconduct.[68] Unlike the *McNulty* court, however, the *Lazenby* court held that such policy concerns did not require voiding insurance coverage for punitive damages.[69]

The court based its conclusion on three factors. First, the court doubted whether prohibiting insurance for punitive damages would actually further the

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61. 307 F.2d 432 (5th Cir. 1962).

62. The claims in *McNulty* resulted from an automobile accident involving the defendant, a drunken driver, who fled the accident scene. The plaintiff suffered severe injuries including permanent brain damage. *Id.* at 433.

63. The court's choice of applicable state law is confusing. First, the court stated that Virginia public policy would control because the contract was made and issued in that forum. The court, however, quickly shifted its focus to Florida public policy because it was Florida law that imposed the punitive damages. The court stated, "[Florida is] where the action was brought and the damages awarded, and where the punitory and deterrent effects of the punitive damages awarded in this case would have their greatest impact." *Id.* at 435.

64. *Id.* at 436. The court concluded further that the Florida courts' characterization of punitive damages "conforms with the most widely accepted basis for punitive damages in other American jurisdictions." *Id.*

65. *Id.* at 440.

66. *Id.* The court expressly limited its holding to damages awarded with a view to punish and deter individuals from "intentional or malicious wrongdoing, or, action or inaction having such a conscious disregard of others that a jury might fairly infer from the circumstances of aggravation that the wrong partakes of a criminal character, whether or not it is punishable as an offense against the state." *Id.* at 442.

67. 214 Tenn. 639, 383 S.W.2d 1 (1964).

68. In Tennessee punitive "damages are allowed . . . in negligence cases when there has been some willful misconduct, or entire want of care which would raise the presumption of a conscious indifference to consequences." *Id.* at 646, 383 S.W.2d at 4.

69. *Id.* at 649, 383 S.W.2d at 5.

deterrent goal of punitive damages.[70] Second, the court recognized that, under prevailing legal standards, consumers had a reasonable expectation that insurance would cover punitive damages.[71] Finally, the court noted that, in the face of conflicting public policy considerations, insurance contracts should be enforced except in a clear case.[72] The court concluded that in light of these arguments, the facts of *Lazenby* did not present a sufficiently clear case.[73]

More than twenty years later, opinion remains split on whether *Lazenby* or *McNulty* presents the more compelling argument. The majority of jurisdictions, however, follow *Lazenby* and allow insurance coverage for punitive damages.[74] Commentators and later case law following this majority rule have noted at least one additional argument in support of insuring punitive damages. This argument recognizes that punitive damages may serve a compensatory purpose.[75] Because of this compensatory function, no compelling policy outweighs freedom of contract.[76]

Some jurisdictions have modified the *Lazenby* rule by distinguishing between punitive awards for unintentional and intentional conduct.[77] This distinction facilitates a compelling public policy argument against insuring punitive damages resulting from intentional conduct.[78] Using this argument, a defendant's culpability increases with the degree of control he has over his action, with

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70. "[T]o say the closing of the insurance market, in the payment of punitive damages, would act to deter guilty drivers would in our opinion contain some element of speculation." *Id.* at 647, 383 S.W.2d at 5. Later courts also have expressed skepticism as to the deterrent effect of punitive damages. *See, e.g.*, Harrell v. Travelers Indem. Co., 279 Or. 199, 207-08, 567 P.2d 1013, 1017 (1977) (finding no substantial relationship between insuring for punitive damages and the tendency of aggravated misconduct); *but see* Price v. Hartford Accident and Ins. Co., 108 Ariz. 485, 487, 502 P.2d 522, 524 (1972) (holding that punitive damages will continue to deter misconduct because insurance policies will not cover them completely).

71. *Lazenby*, 214 Tenn. at 648, 383 S.W.2d at 5.

72. *Id.* at 648-49, 383 S.W.2d at 5. This reasoning sustains numerous subsequent opinions. Brogdon, *supra* note 55, at 383-89; *see, e.g.*, *Price*, 108 Ariz. at 487, 502 P.2d at 524 (noting that insurance companies must honor their obligations); Baker v. Armstrong, 106 N.M. 395, 396, 744 P.2d 170, 173-74 (1987) (using a consumer expectation analysis); Sinclair Oil Corp. v. Columbia Casualty Co., 682 P.2d 975, 981 (Wyo. 1984) (noting that public policy against insuring punitive damages is not compelling).

73. *Lazenby*, 214 Tenn. at 649, 383 S.W.2d at 5.

74. 1986 figures show that 22 jurisdictions allow insurance for punitive damages. Another six jurisdictions allow insuring against punitive damages in cases of vicarious liability. Only eight jurisdictions disallow insuring against punitive damages under any circumstances. Schumaier & McKinsey, *The Insurability of Punitive Damages*, 72 A.B.A. J. 68, 68-69 (March 1, 1986).

75. Note, *supra* note 47, at 444. Under similar reasoning, if a punitive award is based on vicarious liability, there may be no policy argument against insurance coverage. *See* Note, *Insurance Coverage of Punitive Damages*, 10 IDAHO L. REV. 263, 266 (1974); Schumaier and McKinsey, *supra* note 74, at 70-72.

76. The leading case in support of this argument is Tedesco v. Maryland Casualty Co., 127 Conn. 533, 538-39, 18 A.2d 357, 359 (1941). *Tedesco* permitted insurance coverage of punitive damages because the purpose of awarding punitive damages is " 'not to punish the defendant for his offense but to compensate the plaintiff for his injuries.' " *Id.* at 538, 18 A.2d at 359 (quoting Doroszka v. Lavine, 111 Conn. 575, 578, 150 A.2d 692, 692-93 (1930)).

77. Morrison, *Punitive Damages and Why the Reinsurer Cares*, 20 FORUM 73, 74 (1984). *See, e.g.*, Southern Farm Bureau Casualty Ins. Co. v. Daniel, 440 S.W.2d 582, 584 (Ark. 1969) (driver insured against punitive damages, assessed in part by analogy to allowance of employers to ensure against punitive lability on basis of *respondeat superior*); Abbie Uriguen Oldsmobile Buick, Inc. v. United States Fire Ins. Co., 95 Idaho 501, 504, 511 P.2d 783, 789 (1973) (negligent driver insured).

78. Indeed, insurance policies may not even cover compensatory damages if the insured's ac-

culpability lowest for mere negligence and highest for intentional conduct.[79] As defendants' culpability increases, so must his personal responsibility for the consequences of his action.[80] Jurisdictions making this distinction allow insurance coverage of punitive damages for negligent or reckless misconduct but bar coverage if the underlying misconduct is intentional.[81]

Although *Lazenby* represents the majority rule, a strong line of case law and commentary has developed in support of *McNulty*.[82] Criticisms of *Lazenby* include a fear that allowing insurance coverage of punitive damages will promote wasteful awards,[83] will allow insurers to control the public policy behind punitive damages,[84] and will spread punitive liability among faultless policy holders.[85] One commentator suggests that the argument at the heart of *Lazenby* does not concern insurance or freedom of contract at all, but rather stems from a deep dissatisfaction with the system of punitive damages itself.[86]

North Carolina follows the *Lazenby* approach to insuring punitive damages,[87] allowing insurance coverage for grossly negligent misconduct,[88] while the question whether punitive damages stemming from intentional misconduct are insurable remains unresolved by the North Carolina judiciary. In North Carolina punitive damages are available to plaintiffs, not as a matter of right, but only when the tort contains elements of aggravated or outrageous misconduct.[89] To incur punitive damages liability, defendant must inflict injury in a " 'malicious, wanton, and reckless manner.' "[90] In addition to reserving punitive dam-

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tions were intentional. *See* 1B APPLEMAN, INSURANCE LAW AND PRACTICE § 462, at 305-07 (1981).

79. *See generally* PROSSER & KEETON, *supra* note 4, § 34, at 208-14 (explaining civil liability distinctions based on different levels of culpable conduct).

80. *See* PROSSER & KEETON, *supra* note 4, § 34, at 208-14.

81. As of 1984, 11 of the 22 jurisdictions prohibiting insurance coverage of punitive damages did so only if the punitive damages award derived from intentional conduct. Morrison, *supra* note 77, at 79-80.

82. *See, e.g.*, American Sur. Co. v. Gold, 375 F.2d 523, 527 (10th Cir. 1966) ("Permitting the penalty for the misdeed to be levied on one other than he who committed it cannot possibly implement [public] policy."); City Prod. Corp. v. Globe Indem. Co., 88 Cal. App. 3d 31, 42, 151 Cal. Rptr. 494, 501 (1979) ("public policy of [California] prohibits insurance covering punitive damages"); Nicholson v. American Fire and Casualty Ins. Co., 177 So. 2d 52, 54 (Fla. 1965) ("a person has no right to expect the law to allow him to place responsibility for his reckless and wanton actions on someone else"); Crull v. Gleb, 382 S.W.2d 17, 23 (Mo. App. 1964) ("public policy should invalidate any insurance contract against civil punishment that punitive damages represent").

83. Sprentall, *supra* note 49, at 231.

84. Note, *supra* note 75, at 270-71. Insurers obtain this control because they have the power to insert clauses in insurance contracts exempting them from covering punitive damages. *Id.*

85. Zuger, *supra* note 51, at 251-52.

86. Sprentall, *supra* note 49, at 231-33. *See* American Sur. Co. v. Gold, 375 F.2d 523, 527 (10th Cir. 1966) ("The question is not so much the efficacy of the policy underlying punitive damages; rather it is a question of the implementation of that policy."). Restructuring or abolishing the punitive damages system would better address this dissatisfaction than would abrogating its purpose. A review of the commentary that would abolish the system is beyond the scope of this Note. For a good summary of the arguments, see 16A APPLEMAN, *supra* note 78, § 8879, at 464-70.

87. *See supra* notes 67-69 and accompanying text.

88. *See* Mazza v. Medical Mut. Ins. Co., 311 N.C. 621, 626, 319 S.E.2d 217, 220 (1985).

89. Ervin, *supra* note 1, at 1259 n.23 (listing various causes of action for which North Carolina juries have assessed punitive damages).

90. Bryant v. Reedy, 214 N.C. 748, 759, 200 S.E.2d 896, 902 (1938) (quoting Ford v. McAnally, 182 N.C. 419, 421, 109 S.E. 91, 92 (1921)).

ages for aggravated misconduct, the North Carolina courts have defined their purpose narrowly. The North Carolina Supreme Court has described this purpose:

> Although some jurisdictions do allow punitive damages to compensate the plaintiff for non-quantifiable compensatory damages, . . . North Carolina has consistently allowed punitive damages solely on the basis of its policy to *punish intentional wrongdoing and to deter others from similar behavior.*[91]

This description leaves no room for the compensatory role recognized in other jurisdictions.[92]

Consistent with the narrow purpose of punitive damages to punish and deter, in *Cavin's, Inc. v. Atlantic Mutual Insurance Co.*[93] the North Carolina Court of Appeals held that an insurance contract covering awards against the insured for "personal injury" did not cover an award of punitive damages based on intentional conduct.[94] In *Cavin's*, however, the court of appeals expressly reserved the question whether public policy bars insurance coverage of punitive damages in any event.[95] The North Carolina Supreme Court addressed this issue more than eight years later in *Mazza v. Medical Mutual Insurance Co.*[96]

In *Mazza* the court determined that North Carolina public policy did not prohibit insuring against punitive damages arising from wanton or grossly negligent conduct.[97] The court began by looking at the competing public policy doctrines of contract and tort, stating that "the right of parties to enter into contracts is a valid and important public interest to consider in balancing the competing interests involved."[98] The court further noted the lack of legislative restriction or regulation of the right to sell insurance which covers punitive damages.[99] Finally, the court made an analogy to the doctrine of *respondeat supe-*

91. Newton v. Standard Fire Ins. Co., 291 N.C. 105, 113, 229 S.E.2d 297, 302 (1976) (emphasis added). Punitive damages punish and deter through economic sanctions. To ensure that a punitive damages award punishes a particular plaintiff, the jury may consider evidence of defendant's wealth in determining the amount. *Bryant*, 214 N.C. at 759, 200 S.E. at 902; PROSSER & KEETON, *supra* note 4, § 2, at 15.

Other areas of the law utilize similar theories of punishment and deterrence through economic sanctions. *See* 12 U.S.C. § 93(b) (1982) (allowing civil penalties against banks of up to $1,000 per day for banking violations); 15 U.S.C. § 15(a) (1982) (allowing treble damages recovery for antitrust violations); 42 U.S.C. § 1988 (1982) (allowing attorneys' fees assessment against government in civil rights action).

92. *See supra* notes 75-76 and accompanying text.

93. 27 N.C. App. 698, 220 S.E.2d 403 (1975).

94. *Id.* at 704, 220 S.E.2d at 406; *see also* Nationwide Mut. Ins. Co. v. Knight, 34 N.C. App. 96, 100, 237 S.E.2d 341, 345 (1977) (insurance policy use of the term "damages" deemed not to include punitive damages).

95. *Cavin's*, 27 N.C. App. at 704, 220 S.E.2d at 407-08.

96. 311 N.C. 621, 319 S.E.2d 217 (1984).

97. *Id.* at 623, 319 S.E.2d at 219. The claim was based on a punitive damages award for medical malpractice. *Id.* at 621, 319 S.E.2d at 218.

98. *Id.* at 627, 319 S.E.2d at 221.

99. *Id.* The court relied on N.C. GEN. STAT. § 58-72 (1982). While this statute does not explicitly condone insuring against punitive damages, it does not expressly prohibit the practice either. Further review of North Carolina insurance regulation reveals language expressly allowing an insurer to exclude coverage for punitive damages. *See* N.C. GEN. STAT. § 58-480 (1987). Implicit in this language is the inference that, absent an exclusion, such coverage may be allowed.

rior, which holds a master liable for his servant's punitive damages.[100] According to the court, allowing vicarious liability for punitive damages "refutes the . . . contention that public policy prohibits anyone other than the actual wrongdoer or tortfeasor from paying punitive damages."[101]

While the court concluded that North Carolina public policy does not preclude insurance coverage for wanton or grossly negligent conduct,[102] the *Mazza* decision did not completely resolve the issue in *St. Paul*. In *Mazza* the court distinguished between punitive damages awards for intentional and unintentional conduct.[103] Based on this distinction, the court expressly declined to determine whether public policy would prohibit a party from insuring herself against the consequences of intentional acts.[104]

Although the North Carolina judiciary has not determined whether insurance can cover punitive damages awarded in civil actions for intentional misconduct, it has ruled on an analogous issue, insurance coverage of criminal penalties. Under North Carolina law, the general rule regarding insurance against penalties for criminal acts is as follows:

> [A]n insurance policy is void as against public policy if its intent is to indemnify the insured against liability for his own criminal acts. . . . The general rule prohibiting insurance against liability for criminal acts advances a legitimate public policy interest against relieving a wrongdoer from responsibility for his own wilful and wrongful act, in order that the commission of such acts not be encouraged.[105]

In *Shew v. Southern Fire & Casualty Co.*[106] the North Carolina Supreme Court applied this general policy to restitution payments made by criminal defendants to crime victims. The court held that insurance could not cover these payments on public policy grounds.[107] In support of this conclusion, the court held that "it is a basic proposition of public policy, requiring no citation of supporting authority, that an insured is not allowed to profit from his own wrongdoing. . . . [Allowing insurance of criminal restitution payments would be] tantamount to condoning insurance against the results and penalties of one's own criminal

100. *Mazza*, 311 N.C. at 627, 319 S.E.2d at 221. The court relied on Hairston v. Atlantic Greyhound Corp., 220 N.C. 642, 18 S.E.2d 166 (1942), which held a master responsible for the punitive damages of his servant if the servant's misconduct occurred in the course and scope of the master's business. *Id.* at 645, 18 S.E.2d at 168.

101. *Mazza*, 311 N.C. at 627-28, 319 S.E.2d at 221. The court failed to draw a clear distinction between third party punitive damages liability through *respondeat superior* and punitive damages liability through insurance coverage. An employer's ability to control employee conduct, in part, justifies the doctrine of *respondeat superior*. Under the control theory, the employer is, to some extent, at fault if an employee commits intentional or grossly negligent acts in the course of employment. Therefore, vicarious liability for punitive damages encourages the employer to hire carefully and to oversee employee activity. PROSSER & KEETON, *supra* note 4, § 69, at 500-01.

102. *Mazza*, 311 N.C. at 631, 319 S.E.2d at 223.

103. *Id.* at 626, 319 S.E.2d at 220.

104. *Id.*

105. Graham v. James F. Jackson Assoc., Inc., 84 N.C. App. 427, 432, 352 S.E.2d 878, 881 (1987) (insurance policy covers policeman convicted of involuntary manslaughter because conviction could be based on negligent misconduct).

106. 307 N.C. 438, 298 S.E.2d 380 (1983).

107. *Id.* at 444, 298 S.E.2d at 384.

acts."[108]

In summary, the North Carolina judiciary has determined that punitive damages are not available as a matter of right[109] and serve only to punish and deter aggravated misconduct.[110] Although the state courts have held that insurance can cover punitive damages for grossly negligent conduct[111] and cannot cover restitution payments resulting from a criminal penalty,[112] neither the judiciary nor the general assembly has ruled on whether insurance can cover punitive damages resulting from *intentional* misconduct.[113]

The Fourth Circuit's determination in *St. Paul Mercury Insurance Co. v. Duke University*[114] that North Carolina public policy allows insuring against punitive liability[115] is erroneous in light of North Carolina law in this area. The appellate court first argued that the lower court overstepped its authority by applying nonexistent state policy.[116] This argument lacks merit. Although no North Carolina law directly on point exists,[117] the district court did not create its analysis with smoke and mirrors.

Initially, the appellate court misconstrued the trial court's reference to *Mazza v. Medical Mutual Insurance Co.*[118] The appellate court's argument began by stating that the North Carolina Supreme Court had not made a de facto determination of the issue in question by expressly leaving the issue open in *Mazza*.[119] The district court did not, however, rely on a de facto determination of the issue left open in *Mazza*. The lower court referred to *Mazza* only to verify that the issue was undetermined.[120] The court stated that "cases such as *Mazza* dealing with negligence cases involve totally different concerns and provide little persuasive guidance in [determining state public policy]."[121]

Rather than finding a de facto ruling, the district court looked at the policy of punishment and deterrence behind punitive damages articulated by the North Carolina Supreme Court in *Mazza*.[122] Continuing its analysis, the court further noted the significant distinction between punitive damages resulting from negli-

108. *Id.* Although the court pointedly distinguished criminal restitution payments from civil liability, this distinction should not weaken this particular analogy because the *Shew* court referred to compensatory rather than punitive damages in making this distinction. *Id.* at 442-43, 298 S.E.2d at 382-83.

109. *See supra* text accompanying notes 89-90.

110. *See supra* note 91 and accompanying text.

111. *See supra* notes 97-101 and accompanying text.

112. *See supra* notes 105-08 and accompanying text.

113. *See supra* notes 20 & 22 and accompanying text.

114. 849 F.2d 133 (4th Cir. 1988).

115. *Id.* at 137; *see supra* notes 32-39 and accompanying text.

116. *St. Paul*, 849 F.2d at 136; *see supra* notes 34-35 and accompanying text.

117. *See supra* text accompanying note 104.

118. *St. Paul*, 849 F.2d at 136; *see supra* notes 25-30 and accompanying text (discussion of the trial court's reference to *Mazza*); *supra* note 35 (discussion of the court of appeals ruling on this reference).

119. *St. Paul*, 849 F.2d at 136.

120. *Id.*

121. St. Paul Mercury Ins. Co. v. Duke Univ., 670 F. Supp. 630, 634 (M.D.N.C. 1987), *aff'd in part, rev'd in part*, 849 F.2d 130 (4th Cir. 1988).

122. *Id.* at 635-36.

gence and those resulting from intentional misconduct.[123] The district court clearly did not rely on an inferred holding in the *Mazza* opinion to determine North Carolina public policy.[124]

A related factor, not considered by the district court, is North Carolina's analogous policy toward insuring oneself against criminal sanctions.[125] The North Carolina Supreme Court clearly and unequivocally has barred such coverage, noting that public policy does not "[condone insuring oneself] against the *results and penalties of one's own criminal acts.*"[126] A policy designed to punish and deter *intentional* misconduct is more closely related to the policy behind criminal sanctions such as restitution than to civil penalties for negligent conduct. Therefore, if the policy interests supporting criminal sanctions outweigh the policy interests favoring freedom of contract, the policy interests behind punitive damages resulting from intentional misconduct should lead to the same result.

In its second line of attack, the appellate court criticized the district court's analysis of the conclusions of other jurisdictions with regard to insuring punitive damages,[127] thus making the very same analysis for which it chastised the district court earlier in its opinion. This criticism is not compelling. The Fourth Circuit argued that although the district court cited numerous examples of jurisdictions that preclude insuring against punitive damages for intentional acts, other jurisdictions allow such coverage on the basis of "strong public policy favoring enforcement of contracts."[128] It appears that the district court did not err by making a policy assessment, but rather by making an assessment with which the appellate court did not agree.

As noted by the appellate court, *some* jurisdictions would allow insurance coverage on these facts. This fact does not make the district court's conclusion necessarily erroneous[129] because jurisdictions remain split in their analysis of this issue.[130] Furthermore, of the states that allow insurance coverage of punitive damages arising from intentional acts, more than half interpret their availa-

123. *Id.* at 636; *see supra* note 27. The argument in favor of this distinction making a difference, as regards insuring against punitive damages, is that intentional conduct is more culpable than negligent conduct, and therefore warrants a higher degree of punishment. *See supra* notes 79-80 and accompanying text. This argument, however, may be better addressed by completely disallowing punitive damages for negligent conduct.

124. In addition to the compelling state law arguments, the policy of substantial appellate court deference to district court predictions in matters of state law weighs against the court of appeals decision in *St. Paul. See* Caspary v. Louisiana Land & Exploration Co., 707 F.2d 785, 788 n.5 (4th Cir. 1983). This deference is based on the premise that a district court is more familiar with the law and the prevalent judicial climate of the state in which it sits. *Id.*

125. *See supra* notes 105-08 and accompanying text.

126. Shew v. Southern Fire & Casualty Co., 307 N.C. 438, 444, 298 S.E.2d 380, 384 (1983) (emphasis added).

127. The appellate court could not "accept the district court's reliance on the 'persuasive weight of authority' from other jurisdictions in determining that North Carolina's public policy would prohibit insurance coverage of punitive damages arising from intentional acts." *St. Paul*, 849 F.2d at 136 (4th Cir. 1988); *see supra* notes 36-39 and accompanying text.

128. *St. Paul*, 849 F.2d at 136.

129. This is true particularly in light of the policy of deference to district court predictions of state law.

130. *See supra* note 74.

bility and scope more broadly than does North Carolina.[131] The district court's conclusion disallowing coverage for punitive damages follows logically from the narrow focus of punitive damages in this state.[132]

The Fourth Circuit Court of Appeals should not have reversed the district court's determination that insuring against punitive damages liability resulting from intentional misconduct violates North Carolina public policy. An analysis of both North Carolina punitive damages law and the law on this issue in other jurisdictions weighs heavily in favor of prohibiting such insurance on public policy grounds. In order to mitigate further misinterpretation of North Carolina public policy in this area, the North Carolina Supreme Court or the general assembly must speak to this issue quickly and clearly.[133] Once either body has spoken, it will be clear to the federal judiciary that insuring oneself against punitive damages resulting from intentional acts offends both the letter and the spirit of North Carolina law and public policy.

MELINDA C. BURROWS

131. *See supra* note 74.

132. *See supra* notes 87-92 and accompanying text.

133. A recent administrative report indicates that the executive branch of North Carolina government agrees with this analysis. *See* OFFICE OF POLICY AND PLANNING, N.C. DEPT. OF ADMIN., REPORT ON THE NORTH CAROLINA TORT SYSTEM, 27 (1988) (on file at the North Carolina Law Review).