

THE WORLD IS CHANGING—AND EMPLOYMENT PRACTICES LIABILITY INSURANCE IS FOLLOWING SUIT

By

Joanne Blackburn
Garvey Schubert Barer
1191 Second Avenue, Eighteenth Floor
Seattle, Washington 98101-2939

Sandi Dale
Swiss Reinsurance Company
Mythenquai 50/60
8022 Zürich
Switzerland

Todd A. Roberts
Ropers, Majeski, Kohn & Bentley
1001 Marshall Street
Redwood City, California 94063

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Employment litigation is the one area of law least affected by tort reform efforts, and providing perhaps the greatest underwriting and claims handling challenge to insurers. While the courts and state legislatures have been far more willing to implement measures capping damages available to uninsured motorists, against doctors in medical malpractice suits, and curtailing punitive damages, employers remain broadly exposed to liability despite typically being subject to “at-will” statutes allowing employees to be terminated for any reason that is not otherwise illegal.

As will be discussed in this paper, traditional insurance products were never intended to provide the liability protections required by employers to protect against claims of wrongful termination, sexual harassment, discrimination, wage and hour claims, or related companion causes of action. Even under Employment Practices Liability Insurance (“EPLI” or “EPL”) policies, complex and novel coverage questions arise given the broad variety of innovative employment compensation and incentive plans that have been devised by employers through the years. To complicate matters further, depending on the public policy of the state in question, indemnity coverage may be unavailable despite the express coverage grant in the EPLI policy.

Background and History of EPL Policies

EPL insurance first came into existence in the early 1990s, perhaps inspired by the Anita Hill-Clarence Thomas hearings, which increased the public awareness of appropriate conduct in the workplace, but most certainly as a result of the major gap in uninsured employer exposure left by commercial general liability policies. EPL insurance has also taken off since Supreme Court’s decisions in *Burlington Industry v. Ellerth*, 524 U.S. 742, 118 S. Ct. 2257, 141 L. Ed.2d 633 (1998) and *Faragher v. City of Boca Raton*, 524 U.S. 775, 118 S. Ct. 2275, 141 L. Ed.2d 662 (1998) reaffirmed and expanded employer’s liability for actions by their employees.

The existence of EPL insurance has also benefited Directors & Officer (“D & O”), commercial general liability (“CGL”) and other insurers faced with employment claims. There have been several cases that are not EPLI coverage cases, but that do examine other coverages and reference EPL policies to support their findings that coverage did not exist under a CGL or D&O policy. A recent example is *Miller v. ACE USA*, 261 F. Supp. 2d 1130, 2003 U.S. Dist. Lexis 8009, 91 Fair Empl. Prac. Cas. (BNA) 1521; (D.C. Minn. 2003). The court found the existence and offering of a separate EPLI policy supported the notion that the parties would not reasonably expect the D&O policy purchased to extend to employment-based actions.

In recent years, there has been an increase in both the demand and market competition for EPL policies, which has resulted in EPLI policies emerging to cover various forms of discrimination, sexual harassment, wrongful discharge, defamation, and negligent hiring. In fact, by its very nature, EPL is steeped in legal and legislative issues,

complicating the underwriting and claims processes. The following represents the major federal enactments that affect employer/employee relationships:

- Civil Rights Act of 1964 – Title VII
- Age Discrimination Enforcement Act of 1988 (ADEA)
- Americans with Disabilities Act of 1990 (ADA)
- Civil Rights Act of 1991
- Family Medical Leave Act of 1993 (FMLA)

More recent federal legislation regarding privacy, drug testing and AIDS in the workplace; the Equal Pay Act which amends the Fair Labor Standards Act to prevent wage differentials that are based solely on gender; National Labor Relations Act; compliance with affirmative action regulations; the Workers Adjustment and Retraining Notification Act (which requires certain employers to provide 60 days notice in advance of plant closing and mass layoffs); not to mention common law tort claims and a whole host of state laws prohibiting employment discrimination, has greatly expanded potential employer liability.

Some Facts and Figures

Over the last 10 years, claims stemming from sexual harassment, discrimination, ADA, FMLA, wrongful termination and the like have been filed in record numbers. More than 450 employment lawsuits are filed in the United States every day. The number of employment discrimination cases filed in federal court has doubled since 1992. As a result, the EEOC currently has a 12 to 18 month backlog for resolution of discrimination cases.

The fastest growing categories of workplace discrimination claims are those of retaliation, sexual harassment and disability law violations. Texas has the distinction of having the most employee lawsuits filed of any state, while the largest number of employment lawsuits per employee population are filed in New Mexico. Washington, DC, Nevada, Alaska and Colorado follow closely behind. The Dakotas, New Hampshire and Vermont have the distinction of being the least litigious states per employee population.

The average plaintiff's verdict in employment law cases exceeds \$250,000, with 15% of all verdicts exceeding \$1 million. Almost one-third of all wrongful termination verdicts contain a punitive damage award equal to or exceeding the compensatory award. Of all cases tried, 56% result in verdicts for the employee. A survey conducted by the California Chamber of Commerce found that half of the companies that were sued spent in excess of \$50,000, and one-third spent more than \$100,000 defending these claims--- these amounts don't include the cost of settlement or verdict.

Changes in Insurance Products

EPL insurance is becoming more important in the increasingly litigious business environment. Prior to the increase in frequency, severity and magnitude of employment suits, exposure to EPL perils was considered a “small-ticket” item involving back pay or a severance package. Some traditional insurance policies did historically provide some limited protection against EPL-related exposure such as claims of defamation, invasion of privacy and, less frequently, some forms of employer discrimination. However, insurance companies have modified the wording of these policies to clarify their intent to comprehensively exclude all employment related exposures. These modifications have taken place in various insurance products, including directors and officers liability, commercial general liability, professional liability, homeowner’s insurance and worker’s compensation insurance.

With close to one hundred companies now providing EPL coverage, an insured has a wide-range of products from which to choose. While some insureds are modifying their existing insurance by endorsements to *include* EPLI coverage with special sublimits, others are going to a “stand alone” EPL product. But regardless of which product is chosen, because of the change in the litigation environment and the hardening of the market, an insured is most likely to see some of the following trends:

- Annual rather than multi year policies;
- Increased premium;
- Reduction in limits;
- Increase in deductible or self-insured retention;
- Change from claims-made form to a claims-made and reported form;
- Varying retention levels/ higher retentions established for class-action litigation claims;
- More stringent due diligence requirements.

While insureds are seeing changes in their policy provisions, they are also being presented with more useful risk management advice, newsletters, publications and loss control recommendations from insurers. More and more insurer-insureds are also working together in co-insurance situations, developing integrated policies for specific needs and forming strategic alliances.

EPL Coverage Promise and Basic Features

EPL policies share language common to E & O and D & O policies, extending coverage for specifically enumerated “**Wrongful Acts**” or “**Wrongful Employment Practices**,” but then tailor those covered acts to the employment setting to include wrongful termination, wrongful failure to hire or promote, wrongful failure to create or enforce any employment practice or policy, and unlawful discrimination of all types. The EPL coverage promise also extends coverage to those “**personal injury**” offenses typically within the basic scope of commercial liability policies, but excluded under

various “employment exclusions” defeating coverage for “employment-related”: defamation, invasion of privacy, discrimination and infliction of emotional distress. *Frank and Freedus v. Allstate Insurance Company*, 45 Cal. App.4th 461(1996) [no duty to defend suit for wrongful termination, discrimination and “post-employment” defamation]; *Parish of Christ Church v. Church Ins. Co.*, 166 F.3d 419 (1st Cir. 1999). Remarkably, many EPL policies also expressly cover the mere breach of a written or oral employment contract, leaving financially strapped employers little incentive to fulfill their contractual obligations to employees.

Most EPLI policies are “wasting” or “self-depleting” policies, meaning that the applicable policy limit is reduced by defense costs including attorney’s fees, expert costs and other claim expenses. Given the extraordinarily high cost of defending wrongful termination and other employment cases, the defense promise is nearly always the most important feature of the policy. Unlike defenses extended under most general liability policies, where attorney’s fees and litigation expenses are a supplemental benefit and the liability limit relates solely to the indemnification promise, employment defense attorneys and insureds have a greater incentive to expend their limited defense dollars judiciously.

The “damages” covered by the policy broadly include front pay, back pay, damages for loss of future earnings, prevailing party attorney fees and pre and post-judgment interest. Expressly excepted from the definition of “damages” are taxes, civil or criminal fines or penalties, punitive damages, liquidated damages, multiplied damages over the base award, the cost of complying with equitable and injunctive relief, *and damages deemed uninsurable under the law under which the policy is interpreted*. This latter restriction is especially significant given the conflict arising from the promise, for instance, to cover “unlawful discrimination” and “unlawful retaliation.” Not mentioned are other benefits of employment such as 401(k) contributions, pensions, stock options, disability and health benefits, overtime pay for non-exempt employees, car allowances and the like.

Defenses to Claims Under EPLI Policies

Insurers have compelling arguments in many cases that the claims asserted against employers do not seek to recover “damages” of the type covered under even the most broadly worded EPLI policies or that they are otherwise excluded. Given the inherently wrongful nature of many employment claims, public policy defenses are also available in those states prohibiting insurance coverage for wrongful acts and punitive damages despite conflicting language in the EPLI policy to the contrary.

The “No Damages” Argument

Most EPL Policies expressly exclude coverage for costs and expenses incurred to comply with an award of injunctive or other equitable relief of any kind and for

liquidated damages. The phrase “damages” in this context is also frequently associated with compensatory damages as opposed to restitutionary type relief.

Frequently, claims by software and other engineers for wrongful termination are accompanied by novel claims of “unjust enrichment” and claims for injunctive relief associated with the use of their inventions. Such claims are commonly regarded as equitable claims of the type falling outside the scope of the insuring agreement. (See, *Jacqua v. Nike, Inc.* (Or.App. 294, 298.) It is also settled that claims of complying with injunctive relief and other types of non-damage relief do not qualify as “damages.” (See, *Cutler-Orosi Unified School District v. Tulare County School District Authority*, 31 Cal.App.4th 617, 632-33 (1994).)

Additionally, EPL insurers may argue, by analogy, that some employment-related claims, including those for wrongfully withheld overtime wages are restitutionary in nature and do not qualify as “damages” for insurance purposes. In *Bank of the West v. Superior Court*, 2 Cal.4th 1254, 1266 (1996), the California Supreme Court held that a claim under California’s Unfair Business Practices Act did not give rise to a duty to defend under the “advertising injury” provisions of a liability policy because, among other reasons, the only monetary relief available under the Act was for restitution. The California Supreme Court reasoned that the term “damages” as commonly used in general liability policies extended to compensatory damages only, but not damages that were restitutionary in nature.

In *Cortez v. Purolator Air Filtration Products* ((2000) 23 Cal.4th 161), the Supreme Court held that a claim for failure to pay overtime wages in violation of Labor Code section 1194 could be stated as one for violation of the Unfair Business Practices Act since, once earned, the unpaid wages became property to which the plaintiff was entitled. Therefore, the court ruled overtime wages could be “disgorged” from the employer since they were wrongfully retained. Read in conjunction with *Bank of the West*, it is unmistakable that overtime wages are considered a form of “restitution” in this context and should not qualify as covered “damages” under EPLI policies.

Despite the expansive nature of many EPL coverage promises, substantial restrictions exist in the definition of “damages.” The nature of the damages claimed may be restitutionary or limited solely to injunctive or equitable relief of the policy.

Breach of Contract, Fringe Benefit, Stock Options and Liquidated Damages

Many older EPLI policy forms expressly extend coverage to liabilities arising out of the breach of an oral or written employment agreement. This broad coverage left insurers on the hook for claims against employers who refused to pay employees because they pay lacked the ability to pay or otherwise refused to abide by the contract terms. For obvious reasons, many insurers now exclude from coverage: (1) damages determined to be owing under a written or express contract of employment; (2) losses in form of the

commissions, bonuses, profit sharing or benefits pursuant to a contract of employment; (3) the cost of any fringe benefits; and (4) liquidated damages.

These limitations have been upheld and applied by the courts. One typical case is *TVN Entertainment Corp. v. General Star Indemnity Co.* 59 Fed. Appx. 211, U.S. App. Lexis 3976 (9th Cir. 2003 unpublished) in which General Star issued TVN an EPLI policy that provided coverage for losses TVN suffered because of “wrongful employment acts” such as discrimination, defamation, harassment and breach of an implied employment contract. The policy excluded from coverage: (1) damages determined to be owing under a *written or express* contract of employment; and (2) losses in the form of commissions, bonuses, profit sharing or benefits pursuant to a contract of employment. While the policy was in effect TVN terminated one of its employees, who was awarded \$13,218,588 in arbitration. The arbitrator ruled TVN had “materially breached the express and implied terms of [the] Employment Agreement and the covenant of good faith in fair dealing” and that the damages were proximately caused by the breach. TVN filed suit after General Star disclaimed coverage under the EPLI policy.

The court held that this policy language was clear and explicit and therefore would govern. The court affirmed the lower court’s finding that the stock options, which were granted to the employee through his employment agreement in a paragraph separate from that describing his annual salary, fell within the policy’s exclusionary language. The court went on to state that the other policy language excluding coverage for “damages determined to be owing under a written or express contract of employment” was also clear and unambiguous and could be applied to the arbitrator’s ruling and holding

In addition, the court determined that stock options fall in the same category as fringe benefits and profit-sharing arrangements. (*Id.*, citing Webster’s New World College Dictionary at p. 568, (4th Ed. 2000) [defining “fringe benefit” as “any form of employee compensation provided in addition to wages or base salary, such as a pension, insurance, coverage, vacation...”].) The court also concluded that “stock options” were properly regarded as an excluded “bonus” in the context of the case.

Some policies more narrowly exclude coverage for “medical, pension, disability, life or other similar employee benefits.” Whether incentive bonuses and “stock options” fall within the scope of such exclusion remains an open question.

Finally, many express contracts of employment also provide for “continuation pay” or for a “severance payment.” Such payments are regarded as a “liquidated damages.” (See, e.g., *Cross v. Gardner Printing Company*, 285 F.3d 1106, 1110 (8th Cir. 2002) [termination without cause entitling employee to payment of all compensation under an employment contract is a “liquidated damages”]; *Bramhall v. ICN Medical Laboratories, Inc.*, 284 Ore.279 (1978).) Severance payment and liquidated damages of this type do not fall within the basic scope of most EPL policies.

The Public Policy – Insurability Issue

Many states such as California, New York, Kansas and Oregon prohibit insurance coverage for liabilities for willful acts or inherently wrongful conduct in violation of public policy. These restrictions are typically statutory and extend only to the insurer's duty to indemnify and not to the defense obligation. In many instances, therefore, the insurer's obligation is strictly limited to the defense of the suit and *may not* extend to the duty to indemnify.

Nearly all EPLI policies except from coverage relief "deemed uninsurable under applicable law" either as part of the definition of "damages" or by express policy exclusion. Other related restrictions apply to the multiplied portion of any damage award, punitive damages, and civil or criminal fines or sanctions.

Even in those states prohibiting insurance coverage for judgments based on intentional acts or inherently wrongful conduct, the cases uniformly draw distinction between discrimination claims for "disparate impact" and "disparate treatment." A disparate impact claim is based on the application of a facially neutral employment policy that has substantial disparate impact upon members of the affected class. Courts have held that some claims for discrimination in employment may be prosecuted on a "disparate impact" theory that requires proof only of unintentional or negligent conduct for which coverage may exist. (See, *Solo Cup Company v. Federal Insurance Company*, 619 F.2d 1178, 1186-1187 (7th Cir. 1980); *Ranger Ins. Co. v. Bal Harbor Club, Inc.*, 549 So.2d 1005 (Fla. 1989).)

Thus, in *Melugin v. Zurich Canada*, 50 Cal.App.4th 658 (1996), the court held that a business liability insurer was required to provide a defense to a suit alleging sexual discrimination in employment under a policy extending coverage for "discrimination...violation of civil rights [and] sexual discrimination" unless the indemnification for "damages based on the above offenses...is not prohibited by law." Relying on *Solo Cup*, the court held that Zurich Canada, at minimum, had an obligation to defend. (See also, *Save Mart Supermarkets v. Underwriters at Lloyd's London*, 843 F.Supp. 597 (N.D.Cal. 1994) [California Insurance Code section 533 did not prohibit defense of class action suit alleging claims of disparate impact discrimination].)

"Disparate treatment" claims, on the other hand, necessarily require proof of "intentional" discrimination (*Griggs v. Duke Power Co.*, 401 U.S. 424 (1970)) of the type for which no insurance coverage is available. (*B&E Convalescent Center v. State Compensation Insurance Fund*, 8 Cal.App.4th 78 (1992); *Hubel v. Madison Mut. Ins. Co.*, 2003 NY Slip OP 51026V(unpublished); see also, *E-Z Loader Boat Trailers, Inc. v. The Travelers Indemnity Company*, 726 P.2d 439 (Wa. 1986).) The courts reason that disparate treatment discrimination necessarily implicates an intent to injure. (See, *Groshong v. Mutual of Enumclaw Ins. Co.*, 923 P.2d 1280 (Or. 1996, aff'd 985 P.2d 1284). Whether stated as knowing discrimination or a violation of a fundamental public policy, the result is the same - - no indemnity coverage exists for disparate treatment discrimination as a matter of law.

The Defense Dilemma

Faced with claims that necessarily require proof of intentional discrimination or other employer misconduct, insurers must reconcile the conflict between the express terms of the policy promising a defense and the fundamental rule that an insurer has no obligation to defend unless there exists some possible claim upon which a duty to indemnify rests. The California court has provided a workable solution that protects both insurers and insureds alike.

In *Downey Venture v. LMI Insurance Company* ((1988) 66 Cal.App.4th 478), the court faced this same dilemma in the context of a claim for “malicious prosecution,” for which LMI’s policy expressly provided coverage as part of the “personal injury” coverage. LMI defended the suit, contributed toward settlement of the malicious prosecution case, and reserved its right to seek reimbursement on the basis that California Insurance Code section 533 prohibited coverage for “willful acts” even in the face of the express policy language. Downey Venture, in turn, contended that LMI was guilty of fraud by promising to provide insurance coverage for malicious prosecution and then claiming such coverage was unavailable by law.

In summary, the court concluded that LMI was correct and was entitled to reimbursement of its settlement contribution. The court differentiated between an agreement to defend an insured upon mere accusation of a willful tort, on the one hand, and the actual commission of such willful tort on the other. Thus, the court drew an important distinction between the defense promise and the indemnification promise. Inasmuch as section 533 precluded only indemnification coverage based on willful conduct and not the defense of an action in which such conduct was alleged, the insurer was entitled to provide benefits in the form of a defense. The court also held there could be no fraud in light of the territorial provisions in the policy because coverage could be provided in those other jurisdictions, which had no similar public policy prohibition. Finally, the court of appeal correctly noted that substantial policy benefits were provided in the form of defense payments under the supplementary payments section of the policy even though indemnification coverage was unavailable by law.

Claims- Made Restriction

Most EPL policies are written on a “claims-made” or “claims-made and reported” basis. This serves as another significant coverage restriction that will be enforced by the courts.

In *Pantropic Power Products, Inc. v. Fireman’s Fund Ins. Co.*, 141 F. Supp. 2d 1366 (S.D. Fla. 2001), the insured brought a declaratory relief action seeking coverage under an EPLI policy effective July 1, 1998, with a retroactive date of July 1, 1993. This was a “claims made” policy, which limited coverage to claims first made against the insured during the policy period and reported to the insurer “as soon as practicable after the claim

is made (but in no event more than 60 days following the end of the policy period).” The policy was thereafter renewed for an additional year.

On November 12, 1998, an employee of Pantropic filed an administrative charge of sexual harassment against the company. Following the investigation, and a dismissal by the Florida Commission on Human Rights, the plaintiff filed a civil complaint against Pantropic on September 3, 1999. The complaint accused Pantropic of retaliation and negligent retention in addition to the prior allegations of sexual harassment raised in the administrative charge. Pantropic reported the Florida lawsuit to Fireman’s Fund on September 17, 1999. After an investigation of the claim, Fireman’s Fund denied coverage based on the insured’s failure to report the claim within 60 days of the expiration of the policy period in which the claim was “first made.”

Defendant argued that the Flores claim was first made against the insured on November 12, 1998, when Flores filed his administrative charge and, as such, the claim would only be covered if it were reported to the insurer within 60 days of the end of the first policy period. Since the plaintiff first reported the claim on September 17, 1999, 16 days too late, the claim was not covered. In contrast, plaintiff argued that because the two claims for retaliation and negligent intention were first made in September of 1999 and promptly reported within the same policy period, the claims were covered.

The court examined the policies to determine whether they were each a separate contract that clearly contemplated that each policy ran for a separate and finite period, running from the date of inception to the date of expiration. The court held that “the two policies did provide for continuous coverage, so that claims raised between July 1, 1998 and July 1, 2000, would be covered, provided that Pantropic timely notified the carrier of the claim. The policy unambiguously limits the insurers exposure to those claims reported ‘as soon as practicable . . . but in no event more than 60 days following the end of the policy period.’ The underlying claim did not fall into cracks between the two policies, nor was the coverage ‘illusory.’ Therefore, in examining the timing of the claims the court held that the claims asserted by the plaintiff in his administrative hearing were not covered by the first policy.

The court then turned its attention to whether the two additional allegations asserted in the civil suit were covered by the “renewal” policy. The insured argued that the two additional claims were first made on September 3, 1999, upon the filing of the complaint. In contrast, the insurer argued that the claims arose from the same wrongful practice, or series of wrongful practices and therefore were a single claim that were made when Flores initially filed his underlying administrative charge. The court found that the factual circumstances giving rise to the underlying allegations shared temporal proximity and involved the same individuals. Also, the alleged acts of retaliation negligence occurred not in a vacuum but as a consequence of the prior acts of harassment. Therefore, the court concluded that the factual circumstances alleged were sufficiently related for purposes of the notice provision of the policy. Based upon this analysis, the court found in favor of the insurer defendants.

Conclusion

Given the explosion in employee lawsuits throughout the United States, EPLI policies have become increasingly important to employers and pose major underwriting and claims handling challenges to insurers. Policy forms have evolved slowly to restrict coverage where none was originally intended. Current EPL forms better reflect that many employee claims such as those for the denial of stock options, severance payments, and other benefits constitute major employer exposures not contemplated by earlier policy forms.

To date, there are surprisingly few reported decisions interpreting EPLI policies, although a substantial body of law has formed relating to employment claims tendered under general liability policies. With the increasing popularity of EPLI policies and proliferation of employment suits, one can reasonably anticipate an increase in coverage litigation in this area to follow suit.