EPLI: Hot Coverage Loaded with E&O Traps for the Unwary

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Employment-practices liability insurance ("EPLI") — everyone is talking about it; policyholders everywhere are looking into it; brokers are eager to sell it and cash in on the fervor.

But with policyholders' haste to buy EPLI policies, and with the money to be made by brokers and agents in selling such policies, are there any issues that might be overlooked that could turn this boon into a boondoggle? From this coverage lawyer's perspective, you better believe it.

After following the EPLI market for about two years, my humble opinion is there are at least two important issues that frequently are overlooked by brokers when placing EPLI policies that could prove to be the source of errors-&-omissions claims: (1) under what circumstances will an employee accused of willful conduct be defended and/or indemnified under the EPLI policy; and (2) whether the client should have a "duty-to-defend" or "duty-to-pay" policy, what are the practical differences between the two, and how to explain those differences to a client looking to buy an EPLI policy.

Convicted Criminal As Insured

Dateline 1990. A preschool in Alaska purchases a policy akin to EPLI in that it provides coverage for sexual molestation. A child accuses a teacher of sexual molestation. The accused is convicted and sentenced to jail. The child then files a civil suit against the convicted criminal and his employer for tort damages.

The convicted criminal tenders the lawsuit to his former employer's insurer. The carrier denies coverage, saying the criminal is not an insured under the "Who Is An Insured" provisions of the policy. The insurer argues in the alternative that, even if the criminal is an insured, the criminal cannot possibly be entitled to coverage for willful acts of sexual molestation.

Not so, said the 9th U.S. Circuit Court of Appeals in a 1995 decision. The convicted criminal was entitled to coverage, the claim was paid, and the policy was depleted, thereby exposing the employer to other claims that would have been covered by the policy. The court reasoned that Alaska's public policy in favor of compensating victims outweighed its public policy against insuring willful acts.

This is the type of court ruling that should make anybody purchasing EPLI sit up and take notice.

How do you address this issue? First, the policyholder should determine under what circumstances, if any, an employee accused of willful conduct may be covered under the EPLI policy. Will the person be entitled to a defense, but not indemnity coverage? Will the person have to refund defense costs if found liable "in fact" for willful conduct? Will the person be covered for defense and indemnity if a claim of willful conduct is settled?

Second, once the policyholder determines the parameters of coverage to be afforded employees for allegations of willful conduct, the policy must spell out those parameters.

Duty to Payor Defend

In addition to dealing with the matter of whether, and under what circumstances, an employee's willful conduct is to be insured under an EPLI policy, one of the other issues that needs to be addressed with the client *before* filling out applications and going to the market for an EPLI policy is whether the client wants "duty-to-defend" or "duty-to-pay" coverage.

The former obligates the insurer to defend any claim potentially covered by the policy. The latter does *not* obligate the insurer to defend potentially covered claims. Rather, under a duty-to-pay policy, the insured controls the defense of the claim and the insurer pays the defense costs.

Some policyholders prefer to control the defense of claims that fall within the scope of coverage provided by EPLI policies. They think of such claims in the same way they think of directors-&-officers claims. (Note that the majority of D&O policies are written on a duty-to-pay form.) For such policyholders, duty-to-defend forms are not favored because, unless the insurer reserves rights with respect to the underlying claim, thereby allowing the insured to claim a right to independent counsel paid by the insurer, the insurer usually has an unfettered right to control the defense of the underlying claim.

The insurer could, for example, settle a claim that should be defended, thereby opening the floodgates to copycat claims. Because defense costs erode EPLI policy limits, the cost of defending those claims alone can exhaust the coverage. If that happens, the insured would have to pay the remaining defense and indemnity costs for such copycat claims and any other valid claims that should have been covered under the policy.

Alternatively, the insurer could refuse to settle a claim that rightfully should be settled, and thereby exhaust policy limits with a needless and expensive defense. The result could be premature exhaustion of the policy so that the insured is left to pay for any settlement or judgment in the claim, or is left holding the bag on other claims that apply to the policy.

Covered, Non-Covered Claims

Do duty-to-defend and duty-to-pay policies provide differing coverage when the underlying claim contains both covered and non-covered claims? It depends on what state's law applies to the insurance policy for the particular claim at issue.

In some circumstances, the two types of policies ultimately should pay the same amount of defense and indemnity costs on an underlying claim that contains both covered and non-covered claims. In other circumstances, the duty-to-defend policy may pay a little more of the defense costs in such an underlying claim.

Brokers should understand these nuances and be able to explain them to clients and prospective clients rather than merely stating the pat, not-always-correct phrase, "Duty-to-defend policies are much better than duty-to-pay policies when it comes to covering defense costs." This is a sure-fire way for brokers to expose themselves to E&O claims.

The rules of allocation under duty-to-pay policies are less well-known than the rules applicable to duty-to-defend policies. Practically everybody knows

that an insurer issuing a duty-to-defend policy must defend the entire underlying claim as long as one claim is potentially covered, even if other claims are not covered. However, a duty-to-pay policy can provide just as much coverage.

'Reasonably Related' Costs

With respect to allocation of defense costs, courts have held that any cost "reasonably related" to the defense of a covered claim is covered by a duty-to-pay policy, even if such cost also benefits the defense of a non-covered claim. Such courts rule that, in order for the insurer to be relieved of its obligation to pay any particular defense costs, it must show that such costs are not at all related to the defense of a covered claim. This is a very difficult burden to meet, with the result being that many times all of an insured's defense costs can be paid under a duty-to-pay policy.

With respect to indemnity costs for settlements and/or judgments, some courts have ruled that if the settlement or judgment at issue was not made larger because of the existence of any non-covered claims, then no allocation is allowed under a duty-to-pay policy. ill other words, some courts have ruled that, unless the insurer can show by what amount the settlement or judgment would have been smaller in the absence of the non-covered claims, no allocation is allowed under a duty-to-pay policy.

Most courts hold that the duty-to-defend insurer must provide a full defense of the entire underlying claim as long as part of the underlying claim is potentially covered, with no allocation allowed. However, some courts do allow for allocation between covered and non-covered claims under duty-to-defend policies. These courts have ruled that the insurer has the burden of showing what particular defense costs were not in any way related to the defense of covered claims. This standard appears indistinguishable from the "reasonably related" standard used by some courts with respect to duty-to-pay policies.

It is also not well-established what allocation rules apply to settlements and/or judgments under duty-to-defend policies when the settlement and/or judgment is comprised of covered and non-covered claims. The policyholder should be able to successively argue that the "larger-settlement" rule developed in the duty-to-pay policy context also applies in a duty-to-defend context as well.

Sharing Privileged Info

One issue often overlooked by lawyers, insureds and brokers alike concerns the insured's obligation to share privileged information with the insurer, and whether such disclosed information is discoverable by the underlying claimant. Most states recognize the rule that disclosure of confidential and privileged information by policyholders to their duty-to-defend liability insurers does not act as a waiver of the privileges and protections that attach to that information.

The two most common protections sought to be preserved are the attorney-client privilege and attorney work-product doctrine. Courts recognize that waiver of such protections would not make sense when the liability insurer's policy contains a duty to defend that obligates the insurer to appoint counsel to protect and defend the interests of its insured.

However, whether disclosure of privileged and otherwise protected information to a duty-to-pay liability insurer whose policy does not contain a duty to defend acts to waive such privilege and protection is a serious question addressed by only a handful of courts.

Some courts have squarely addressed the issue, holding that such a disclosure would waive the protections and that, therefore, the policyholder is not required by the cooperation clause of the duty-to-pay policy or any other reason to disclose privileged or protected information to its insurer. Other courts, however, have held that the policyholder is required to disclose such information to its duty-to-pay insurer.

This issue is a problematic one that almost always rears its ugly head when adjusting claims under duty-to-pay liability policies. What happens is that the duty-to-pay insurer asks for privileged information. The insured refuses to disclose the information, fearing that the claimant might be entitled to anything disclosed. The insurer claims that the insured has breached the cooperation clause and may not be entitled to coverage.

Such tangential disputes obviously are not conducive to a smooth adjustment of an underlying claim. Policyholders looking to purchase duty-to-pay EPLI policies should be made aware of this issue beforehand so that they know what to expect if they decide to purchase such a form.

Accept No Substitutes

If the client decides to buy a duty-to-pay EPLI policy, no substitutes should be accepted. The policy must be written in a way — either by its form alone, or as modified by endorsement and/or letters of intent — that makes it clear the insured has the sole and exclusive right to control the defense of the underlying claim.

The insurer should not have any right to assume control of the defense of the claim or revoke the insured's choice of defense counsel. The insurer also should not have the right to make a request to the insured to settle an underlying claim in order to cap the insurer's liability. The insurer must pay defense costs as they are billed to the insured, not after the insured pays the bills, and not after the underlying claim has been resolved.

That means that the insurer must pay defense costs for even "potentially" covered claims, even if it ultimately turns out that it does not have to pay any indemnity costs for such claims (either because the insured wins the underlying claim so there is no liability, or it ultimately is shown that the underlying claim is excluded from coverage).

In the final analysis, EPLI policies are hot - risk managers are eager to buy them, and brokers are eager to sell them. This coverage is only going to get hotter in the months and years ahead. My advice to all brokers and agents is to know the two issues discussed in this article so that they can avoid getting burned by an E&O claim on an EPLI placement.

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