Overlooked Fundamentals of Buying Stand-Alone EPLI Policies

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There are two fundamental issues that must be considered when purchasing any stand-alone EPLI product. Preferably, these issues will be evaluated *before* the insurance broker goes to market and begins negotiating more specific coverage terms. First, the policyholder should decide whether it wants a "working layer" program (i.e., a policy with relatively low limits combined with low deductibles/self-insured retentions) or a "catastrophic" program (i.e., a policy with relatively high limits combined with high deductibles/self-insured retentions). Second, the policyholder must determine whether it seeks a "duty to defend" policy (i.e., a policy under which the insurer is obligated to defend any claim alleging something that is covered under the policy) or a policy in which the insurer has "no-duty to defend" (also called a "duty to pay" program) and is obligated to pay defense costs only when the insured orchestrates the defense of a claim.

The EPLI market today provides for any combination of the foregoing. The most common combinations are either a working layer/duty to defend program or a catastrophic/duty to pay program. However, one just as easily can buy a working layer/duty to pay program or a catastrophic/duty to defend program. Failure to address these fundamental issues can cause a range of problems for the policyholder, from the mere nuisance of increasing EPL claim handling costs to something much more ominous creation of a claims handling "reputation" that is out of alignment with the policyholder's EPL claims resolution philosophy. If the policyholder is confronted with these problems, the insurance broker who placed the program will suffer as well.

> ***Policyholders attempting to determine the appropriate level of risk to retain under their EPLI program must understand* why *they are choosing a specific deductible or self-insured retention.***

This article examines these two fundamental questions in detail. The goal is to provide practical information that can be used to address these two key areas when structuring an EPLI program.

Catastrophic versus Working Layer Coverage

In the early days of the EPLI market, most policies were written on a working layer basis (i.e., relatively low limits combined with low deductibles/self-insured retentions). Shortly thereafter, several carriers began offering catastrophic coverage (i.e., relatively high limits combined with high deductibles/self-insured retentions). Today, however, policyholders have a range of working layer or catastrophic EPLI program choices. Nearly any blend of high/low limits *and* high/low deductibles (or self-insured retentions) currently is available. Understanding the differences between the two types of programs and focusing on the key issues associated with buying either program are important for both policyholder **and** insurance broker alike.

Catastrophic and Working Layer Mean Different Things to Different People

EPLI programs can be written with deductibles (or self-insured retentions (S.I.R.)) of any size, from as low as $5,000 per claim to any amount the policyholder desires. For example, a $1 million or $2 million S.I.R. is not uncommon for a large policyholder with thousands or tens of thousands of employees. In contrast, for a small firm a program involving a $100,000 S.I.R. could be considered a catastrophic program, while a company with thousands of employees might classify it as a working layer program. Accordingly, there is no ironclad point at which a self-insured amount whether deductible or self-insured retention--automatically becomes a working layer program or catastrophic program.

Insureds might consider selecting a higher deductible or self-insured retention and investing the resulting premium savings in loss control measures, such as an in-depth human resources audit.

In most instances, however, an EPLI program subject to a $5,000 or $10,000 deductible (or S.I.R.) is considered a working layer program. This means the insurer will be involved in handling and adjusting the vast majority of the insured's EPL claims regardless of whether the program is written on a duty to defend or duty to pay basis.

Similarly, an EPLI program subject to a deductible or S.I.R. of $1 million or more almost always will be classified as a catastrophic program. This means that ultimately the insurer will have no responsibility for paying the defense and indemnity costs associated with virtually all of the insured's EPL claims. Rather, in the final analysis the insurer will be paying defense and/or indemnity costs under only two circumstances: (1) for the truly "big hit," single plaintiff claim or (2) for claims involving multiple plaintiffs (e.g., a class-action lawsuit), which can result in damage exposures in the millions of dollars and tens of millions of dollars for companies with thousands of employees.

In between the $10,000 to $1 million parameters is the "gray area." Depending on a number of variables most notably the insured's EPL claims frequency coupled with its ability to retain risk an EPLI program containing a deductible or self-insured retention with an amount between these numbers could be deemed a working layer program for one insured but a catastrophic program for another insured. For example, many of the author's clients have considered a $50,000 deductible or S.I.R. as creating a catastrophic program. Only midway into the policy term **did** such clients learn that they had actually purchased a working layer program, given their insurer's involvement in most of the EPL claims brought against them.

Trading Dollars or Catastrophic Protection?

Policyholders attempting to determine the appropriate level of risk to retain under their EPLI program must understand *why* they are choosing a specific deductible or self-insured retention. Unless an organization seeks to merely "trade dollars" with its insurance carrier, the firm should select a deductible or self-insured retention amount that will trigger payments for only the "big hit" single-plaintiff claims and for multiple-plaintiff/class-action claims. In making this decision, companies must analyze their EPL claims experience. Organizations having little or no previous claim history should discuss their EPL exposure with local labor and employment lawyers.

After several years, a firm often finds its EPL policy has made no payments. This is because all of the claims have involved combined defense and indemnity costs that are below the deductible or S.I.R.. Consequently, the efficacy of continuing the coverage is often challenged and the question arises as to whether or not the EPLI program should even be renewed. At this point, however, insureds should recognize that the purpose of the program is to protect against catastrophic liability not to insure each and every run of the mill EPL claim.

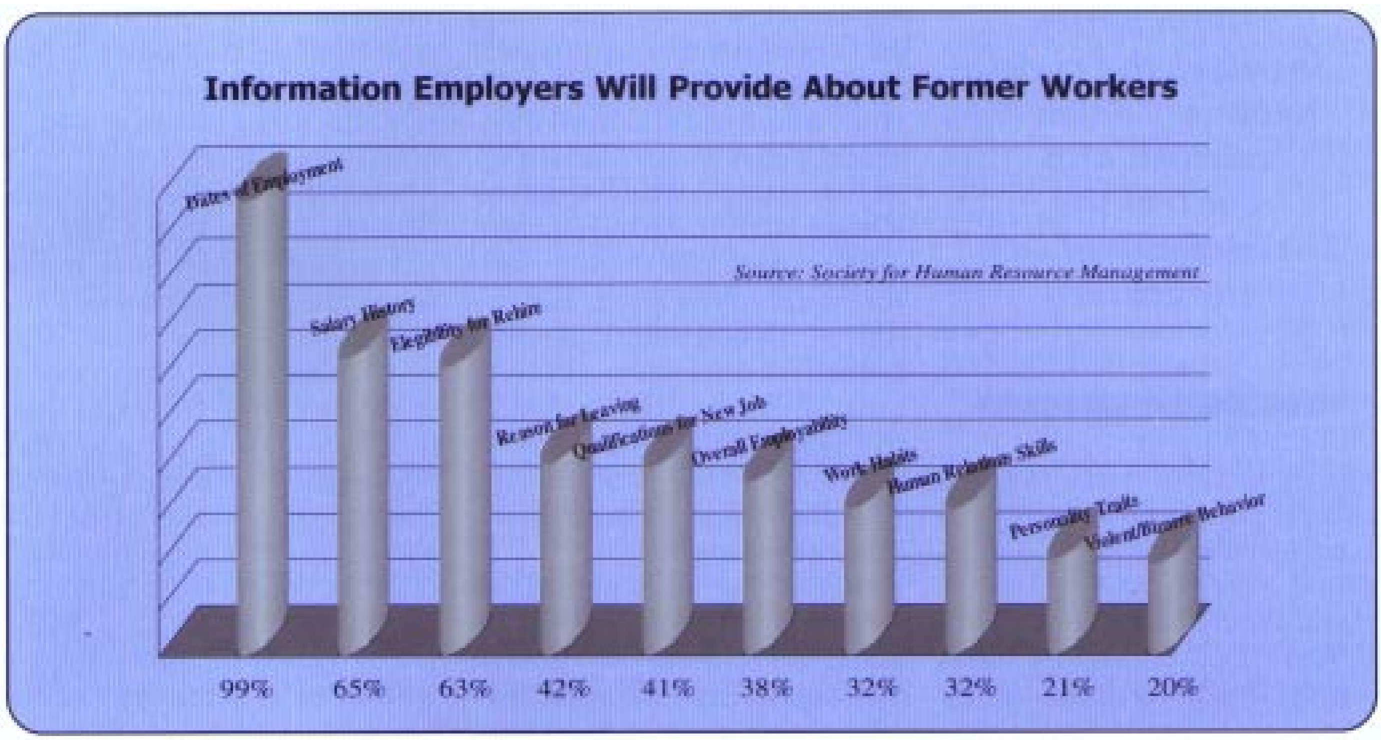
An organization content to "trade dollars" with its insurer should consider selecting a low deductible or self-insured retention. Nevertheless, if such firms continue to experience high claims frequency, they eventually can expect to pay additional premium upon renewal so the account will remain profitable for the insurer. Absent such an increase, these insureds should not be surprised to receive a notice that the insurer intends to nonrenew the program. Ultimately, organizations must determine if this type of cost/benefit methodology truly is the best risk financing approach for the company. As an alternative to this approach, insureds might consider selecting a higher deductible or self-insured retention and investing the resulting premium savings in loss control measures, such as an in-depth human resources audit.

The Classic Mismatch

When buying a catastrophic program on a duty to pay (i.e., non-duty to defend) basis (see below for a discussion of this type of coverage), it is not sufficient to merely ensure that the self-insured retention is high enough to avoid "trading dollars" with the insurer. In addition, it is imperative that the notice and cooperation provisions of the policy be written in a manner that facilitates one of the main goals of a duty to pay catastrophic program: allowing the *insured* to handle all run of the mill claims, thereby avoiding the transactional costs that would otherwise accrue if the *insurer* were to adjust such claims. Examples of such costs include continuously providing the insurer with copies of all pleadings and discovery associated with the claim, sending the insurer regular status reports, and giving the insurer access to the insured's defense counsel, which in turn, would require the attorney to provide periodic liability and damages analyses.

Yet, unless this issue is addressed correctly within the policy, insureds might be forced to incur such costs even when there is no possibility that a claim will approach, let alone reach or exceed, the self-insured retention. Unfortunately, the author has continually witnessed this scenario when advising clients with catastrophic programs. These insureds regularly agonize over the amount of time and money they expend on such activities-- even for run of the mill claims involving less than $100,000 in defense and indemnity costs. This is despite the fact that the programs were written with self-insured retentions of $500,000, $1 million, or more.

Notice Requirements. There are ways to avoid such mismatches. First, the insured, insurance broker, and underwriter must discuss such questions at policy placement. At that time, a specific claims ban-



dling protocol should be devised that provides both the insured and underwriter with a comfort level, while addressing both the insured's and the insurer's needs. Specific amendments can then be made to the policy that facilitate such requirements. For example, the policy's notice provisions can be changed so notice of claims is required for all claims on a bordereau (a periodic report providing loss data regarding specific risks) compiled on a regular basis (e.g., quarterly, semiannually, or just before each renewal); and for any particular claim, whether or not reported on the bordereau, when either defense and indemnity costs reach a certain percentage of the self-insured retention (and, importantly, a corresponding amendment should be obtained that defense and indemnity costs within this percentage can be incurred by the insured without the consent of the insurer) or the claim is in the nature of a class action.

One of the important differences between a duty to pay and duty to defend policy involves the right to choose defense counsel and control the defense of the claim.

Cooperation Provisions. In addition to notice requirements, the cooperation provisions of the policy must be examined. Otherwise, the insurer could demand a multitude of information on each and every EPL claim notice the insured receives regardless of the likelihood that the claim will reach or exceed the self-insured retention. The cooperation provisions, just like the notice requirements, can be modified in a variety of ways. In line with the changes previously suggested for notice requirements, the cooperation provisions can be revised to provide that the insurer is not entitled to any information about a claim (other than the notice of the claim on the bordereau) until a certain percentage of the self-insured retention is reached by the expenditure of defense costs or the expenditure of defense costs and anticipated expenditure of indemnity costs. Only at that point would the standard cooperation provisions become effective. Alternatively, it can be agreed that the insured need only provide the insurer with the notice of the claim and the copy of the complaint, demand letter, or other form of claim until a certain percentage of the self-insured retention is reached. At that juncture, the standard cooperation provisions would apply.

Again, the main point is to structure the policy so the insured can be allowed to handle and adjust EPL claims within the retention but without having to expend unnecessary, **time** and money to keep the insurer informed of claims on which the insurer will never be called upon to make a payment. There are many ways to articulate these issues, but one result is certain failure to address them in a duty to pay catastrophic program can lead to headaches, or worse, for the policyholder.

Finally, if the insured intends to devise an EPLI program so the insured, not the insurer, will handle and adjust most claims, the question should be asked as to whether that insured would be better off buying duty to pay (i.e., non-duty to defend) coverage rather than duty to defend coverage. Even with a choice of counsel endorsement on a duty to defend program, the author has encountered several situations in which insurers were permitted to exercise considerable control over the claim handling process despite the fact that the insured had purchased a catastrophic EPLI program with a high deductible/S.I.R.

One simple way to address this issue is to buy a duty to pay policy (or non-duty to defend policy). Directors and Officers Liability insurance policies are commonly structured in this manner. Nevertheless, it is interesting to note that while most insureds insist on buying "duty to pay" D&O insurance even when purchasing EPL coverage by means of an endorsement to a D&O policy, rarely do they consider whether the same type of defense coverage provisions should apply within their stand-alone EPLI policy.

Duty To Defend versus Duty To Pay Coverage

When EPLI coverage emerged in the early 1990's, most of the policies (at least ones written on a working layer basis) were offered on duty to defend forms. Today, however, the EPLI market has evolved to the point where, as noted previously, the policyholder can easily choose between a duty to defend or duty to pay form. Policyholders should not squander this choice. Rather, they must make an informed decision as to which form of program will be more beneficial.

Figure 1
Representative"Duty To Pay" and "Duty To Defend" EPLI Policy Language

Duty To Defend

We have the right and duty to defend and appoint an attorney to defend any "Claim" brought against any "Insured" for a "Wrongful Employment Act" to which this insurance applies even if the "Claim" is groundless or fraudulent.

Source: Kemper Insurance Company; Employment Practices Liability Insurance Policy; KEP 90 00 (5/99)

Duty To Pay

The Insured retains the responsibility to defend any Claim. The Insurer has no duty to provide a defense to any Claim.

Source: XL Insurance LTD., Broad Form Employment Practices Liability Insurance; EPL-005 1998

What Do the PhrasesMean?

The phrase "duty to defend" in a liability insurance policy expressly states that the insurer has the duty to defend any claim alleging something that is covered under the policy (whether it is covered damages, a covered wrongful act, or something else).

The phrase "duty to pay" (or "non-duty to defend") in a liability insurance policy expressly states that the insurer does *not* have the duty to defend claims; rather, it is the duty of the insured to defend claims. Such forms compel the *insurer* to pay the defense costs only in connection with the *insured's* executing the defense of claims.

Representative EPLI policy wording of both duty to defend and duty to pay provisions appears in Figure 1.

Who Controlsthe Defense?

One of the important differences between a duty to pay and duty to defend policy involves the right to choose defense counsel and control the defense of the claim 9Under a duty to defend policy, unless specifically negotiated otherwise in the policy, the insurer has the right to choose defense counsel. The one exception is where the insurer agrees to defend the policyholder subject to a reservation of rights letter. In these circumstances, an insurer has the right to investigate and defend a claim to determine if coverage applies without waiving its right to later deny coverage. If such reservation creates a conflict of interest for the defense counsel chosen by the insurer, the policyholder has the right to select counsel of its choice, paid by the insurer subject to certain restrictions. Under this rule, which applies in many but not all jurisdictions, such counsel are commonly referred to as independent counsel (or *Cumis* counsel in California).

Counsel Selection Issues. Other than cases in which the insurer is obligated to provide independent counsel, under a duty to defend form the lawyer handling the policyholder's delense can be any lawyer chosen by the insurer, even if the policyholder does not know, like, or even want the lawyer. It also means that, regardless of whether the insurer uses a lawyer recommendedby the policyholder, the insurer has the right to remove that lawyer from the defense of the claim at any time and substitute any other lawyer of the insurer's choosing. In contrast, under a correctly worded duty to pay policy, the policyholder is able to use any lawyer of its choosing.

Claim Settlement Issues. Under a duty to defend policy, the insurer typically has the absolute, unfettered right to control the defense of the claim if the insured wants the coverage afforded by the policy. Therefore, the insurer can settle a claim at any time even if the policyholder does not want to settle the claim. Moreover, duty to defend policies permit the insurer to refuse to settle a claim and take it to trial despite the policyholder's desire to settle the claim. Conversely, under duty to pay policies, the policyholder has the right to control the defense of the claim, thereby conferring upon the policyholder the option of settling a claim or taking it to trial.

Claim Handling "Reputation" Issues. There is yet another key advantage inherent in a duty to pay EPLI approach compared to a duty to defend EPLI program. Duty to pay arrangements allow the policyholder not the insurer to create the "reputation" the policyholder seeks to project. This is because duty to pay policies allow the policyholder rather than the insurer to handle claims. Perhaps a policyholder "throws money" at all claims, regardless of merit; "vigorously resists" frivolous claims by taking all such claims to trial while settling meritorious claims only after thorough investigation and discovery; or takes all claims to trial irrespective of merit and despite possible adverse consequences. Regardless of its preferred approach, policyholders generally favor the opportunity to make this determination rather than conferring it upon an insurance company. Typically, insureds want be in a position allowing them to formulate, implement, and monitor their own EPL claims handling strategy and in the process, create the specific "reputation" the policyholder seeks to promote.

Conflict of Interest Issues. There is a final, crucial advantage of a duty to pay liability insurance program over a duty to defend liability insurance program. Duty to pay policies assure that the attorneys handling the defense are not typical insurance defense lawyers, some of whom may have divided loyalties between the policyholder and insurer. A number of those divided loyalties are actually imposed by law upon defense lawyers under a duty to defend program. This is because some states' laws provide that the defense lawyer under a duty to defend policy has two clients the insurer and the policyholder and owes fiduciary duties to each. In contrast, under duty to pay policies, the defense counsel has only one client the policyholder.

Conclusion

Although EPLI is a maturing market, many policyholders as well as insurance brokers are still mastering the details of the coverage. While it is true that there are many details to learn, it is also true that there are two fundamental issues that must first be thoroughly considered when structuring any EPLI program: (1) does the policyholder want a working layer or catastrophic program? and (2) does the policyholder want a duty to defend or duty to pay (non-duty to defend) program?

Policyholders should ask themselves and insurance brokers should ask their clients these questions when structuring an EPLI program. Even if all of the more detailed issues are addressed correctly, failure to examine these two fundamental areas is likely to produce a problematic, if not disastrous, EPLI program for both the policyholder that purchased it and for the insurance broker that sold it.

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