RECENT DEVELOPMENTS IN EMPLOYMENT PRACTICES LIABILITY INSURANCE LAW AND PRODUCTS IN THE UNITED STATES

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In the last several years, employment practices liability claims have continued to proliferate in the United States. The term "employment practices liability" or "EPL" here refers to risks associated with wrongful termination, sexual harassment, discrimination and a variety of employment - related practices, procedures and conduct, not only by the corporate employer but also by the corporation's employees. As many insureds were successful in getting such claims covered under their commercial general liability ("CGL") policies in the late 1980s and early 1990s, many CGL insurers responded by placing broad-form EPL exclusions on their policies and advising their insureds to seek cover for such claims elsewhere. Some insurers were happy to begin selling new products to insure EPL risks.

Policyholders in the United States today have many insurance options from which to choose when deciding how to insure EPL exposures. This article attempts to address some of the more salient points regarding the developments in EPL insurance law and products in the United States and to discuss some of the issues that are being considered when purchasing such products. It is hoped that a discussion of this subject is not only of interest to lawyers practising outside of the United States, but also proves useful to such lawyers who might be advising their clients on insuring EPL exposures at home and/or abroad.

HOW WERE EPL CLAIMS COVERED BY CGL POLICIES?

To appreciate some of the issues that exist with respect to certain EPL insurance products, it is important to understand how EPL claims used to be covered under CGL policies. Before CGL carriers began placing broad-form EPL exclusions on their CGL policies, many insureds were successful in arguing that a variety of EPL claims were covered under CGL policies. Insureds typically looked to either or both the "bodily injury" and "personal injury" coverages provided by CGL policies.[1]

As for "bodily injury" coverage, many corporate insureds argued that allegations of the corporation's negligent super - vision of the employee or group of employees committing wrongful conduct and/or the corporation's vicarious liability for that conduct satisfied the CGL policy's requirement of an "accident" or "occurrence" that causes the "bodily injury".[2]

As for "personal injury" coverage, many insureds also successfully argued that EPL claims fell within one or more of the offences enumerated in the definition of "personal injury" in a CGL policy. For example, many sexual harassment claims contain allegations of false imprisonment or detention, which is a covered "personal injury" offence.[3] Similarly, many EPL claims contain allegations of libel, slander or other forms of disparagement, all of which are covered "personal injury"

1 Under CGL policies, "personal injury" coverage is separate from "bodily injury" coverage. "Bodily injury" coverage insures claims of damages because of "bodily injury, sickness or disease, and death resulting therefrom". "Personal injury" coverage provides coverage for certain enumerated "offences", such as malicious prosecution; false imprisonment or detention; wrongful entry, eviction or invasion of the right of private occupancy; libel, slander or the publication of disparaging material; and invasion of the right of privacy. "Personal injury" coverage typically is not subject to an "accident" or "occurrence" requirement. Such coverage also typically is *not* subject to an "employee injury" exclusion. The "employee injury" exclusion purports to bar coverage for a claim for damages because of "bodily injury" sustained by an employee of the insured. The "employee injury" exclusion has barred coverage for many EPL claims that otherwise would be covered under the "bodily injury" coverage afforded by CGL policies. It should be noted, however, that a handful of courts have concluded that the "employee injury" exclusion does not bar "bodily injury" coverage for EPL claims. See, *e.g. Save Mart Supermarkets v. Underwriters at Lloyd's London* (N.D. Cal. 1994) 843 F. Supp. 597 (court refused to apply "employee injury" exclusion to discrimination claims, reasoning that the exclusion bars coverage only for injuries that are compensable under workers' compensation).

2 See, *e.g. Castle & Cooke, Inc. v. Great American Ins. Co.* (1986) 42 Wash. App. 508 (claim for "disparate impact" can constitute an "occurrence" because a policy causing disparate impact - as opposed to a policy of "disparate treatment" - is not intended to discriminate against a particular class of persons); *Save Mart Supermarkets v. Underwriters at Lloyd's London* (N.D. Cal. 1994) 843 F. Supp. 597 (same); *State Form Fire & Cas. Co. v. Westchester Ins.* Co. (C.D. Cal. 1989) 721 F. Supp. 1165 (negligent supervision causing discrimination can constitute an "occurrence'").

3 See, *e.g. David Kleis, Inc. v. Superior Court* (1995) 37 Cal. App. 4th 1035.

offences.[4] The corporate employer can be held liable for such conduct either because of its vicarious liability based on the acts of one or more employees committing such offences, or because of its direct liability for failing to properly supervise such individuals, failing to follow up with complaints regarding such individuals or just failing to maintain a work environment free of such offences.

When reviewing any EPL insurance product, these two bases of liability must be kept in mind. A corporate employer can be held directly liable for its own acts-such as for negligent supervision, negligent failure to follow up, negligent failure to maintain a work place free from harassment and discrimination, etc. In addition, and very importantly, a corporate employer can be held vicariously liable for the acts of an employee. It is this issue of vicarious liability that arguably has not been addressed correctly by many EPL insurance products.

LEGAL VIABILITY OF EPL INSURANCE

When EPL insurance products began receiving much publicity about two years ago, many questioned whether such insurance violates public policy against insuring intentional acts. This question might go unanswered in many courts for some time-no EPL insurer in its right mind would sell EPL insurance and then reject coverage for an EPL claim based on the argument that what it sold violates public policy. So it is not likely that much case law will develop on this issue.

Fortunately, case law existed before the advent of EPL insurance products to explain why the answer to this question is that such coverage is viable. For example, in *Republic indemnity Co. v. Superior Court*,[5] the court expressly addressed the issue of the insurability of wrongful termination and discrimination claims under California law. California Insurance Code section 533, which must be read into every insurance policy sold in the state, precludes indemnifying an insured for his own wilful acts. The insurer in *Republic* argued that wrongful termination and employment discrimination are always intentional and, therefore, always wilful. The court disagreed and ruled in favour of coverage for claims of wrongful termination and discrimination.

Even more fortunately, at least one insurer who expressly provided one form of EPL coverage to an insured did, amazingly, run for cover when EPL claims were tendered under the policy. In *Melugin v. Zurich Canada*,[6] the court analysed a CGL policy that contained an endorsement that amended the "personal injury" coverage to expressly include "discrimination." The insurer disputed coverage for a discrimination claim that the insured tendered to the insurer. The insurer argued that in California discrimination is not insurable, because it is a wilful act, and therefore excluded as a matter of public policy by reason of California Insurance Code section 533. The court rejected the insurer's position. The court correctly noted that claims for discrimination can be based on intentional acts that cause unintended harm, insurance coverage for which is not barred as a matter of public policy.[7] The court also correctly noted that even if public policy barred coverage for the insured person who committed the acts of discrimination, such public policy does not also bar coverage for the corporate employer who is held vicariously liable for the acts of an employee who committed a wilful act, as long as the corporation did not ratify the wilful act at issue.[8]

EXPRESS COVERAGE FOR EPL RISKS

The insurance industry has responded to the growing publicity of EPL claims with a variety of products. Some CGL insurers offer an EPL endorsement to their CGL policies for an extra premium. This endorsement is cumbersome because it is written on a claims-made basis, even when the CGL policy is written on an occurrence basis. Some Directors' and Officers' Liability ("D&O") insurers began offering an EPL endorsement on their policies, which extended coverage not only to EPL claims, but also to employees who were not directors and officers. Such an extension of coverage is, in my opinion, problematic, for the reasons discussed below, because the D&O policy should be used for directors and officers, not employees who are not directors and officers. Other insurers decided to introduce into the market an altogether new product, stand-alone Employment Practices Liability Insurance ("EPLI"). In the last couple of years, the EPL endorsement to a D&O policy and the EPLI policy, alone or used in conjunction, have become the most popular options for companies in the United States. The EPL endorsement to a CGL policy is rarely used, and its continued viability is questionable.

EPL ENDORSEMENT ON A D&O POLICY VS. STAND-ALONE EPLI POLICY

Many companies in the United States are asking themselves: should we buy an EPL endorsement for our D&O policy in lieu of an EPLI policy, or should we just buy an EPLI policy, or should we buy both? There is no one right answer to this question. However, the present author offers some thoughts

4 See, *e.g. American Guar. & Liability v. Vista Medical Supply* (N.D. Cal. 1988) 699 F. Supp. 787; *Loyola Marymount University v. Hartford Accident & Indemnity Co.* (1990) 219 Cal. App. 3d 1217 (insured and insurer agreed with this analysis, but coverage was barred by a unique "employee injury" exclusion that expressly applied to "personal injury" as well as "bodily injury").

5 (1990) 224 Cal. App. 3d 492.

6 (1996) 50 Cal. App. 4th 658.

7 *ibid.*, at 665 to 666.

8 *ibid.*, at 666. It also should be noted that some courts have ruled that the public policy in favour of compensating victims outweighs the public policy against insuring someone for his wilful acts. See, *e.g. St. Paul Fire & Marine Ins. Co. v. F. H.* (9th Cir. 1995) 55 F.3d 1420 (corporate employee was convicted of criminal sexual abuse and sentenced to jail; subsequent civil lawsuit for compensatory damages was brought against the employee while in jail, was tendered to the insurer that issued a policy covering sexual abuse, and court forced insurer to provide coverage).

on the subject and observations as to how most companies in the United States appear to be addressing this question.

Most EPL endorsements to D&O policies extend coverage not only to directors and officers but also to employees who are not directors and officers. The reasonableness of exposing a D&O insurance programme to claims against employees who are not directors and officers is open to question. In the author's opinion, the D&O programme is intended to protect directors and officers, not non-director and non-officer employees. This issue is even more relevant with respect to EPL risks, because it does not seem efficient to expose a D&O insurance programme to EPL loss experience (which could mean not only premature exhaustion of the programme but also higher premiums for renewal policies) when there is a ready alternative in the market to pick up that exposure - EPLI policies.

But the EPL endorsement to a D&O policy can be a valuable coverage enhancement for protecting directors and officers. Accordingly, it makes sense for companies to purchase *both* a stand-alone EPLI policy and the EPL endorsement to a D&O policy, where the EPL endorsement is amended to extend coverage *only* to the directors and officers. However, priority issues should be expressly addressed in either or both policies so that it is understood which policy, *vis-à-vis* each other, is primary, and which is excess, for EPL claims.

VARIOUS DIFFERENT EPLI PROGRAMMES ARE AVAILABLE

There are several distinct types of EPLI programmes that are offered in the United States. Those types can be referred to as follows:

* Catastrophic
* Working layer duty to defend
* Working layer duty to pay
* Working layer hybrid duty to defend/duty to pay

A catastrophic EPLI programme is intended to work as the name suggests. It typically contains substantial limits (such as $25 million, $50 million or more) and substantial retentions (often anywhere between $250,000 and $5 million). Such a programme has been favoured by large corporations seeking to insure the one large single-claim hit, or large exposures than can arise with multiple related claims or class actions. Such catastrophic policies, like most D&O policies, are "duty to pay" policies where the insured, not the insurer, has the right to control the defence of claims.

Working layer EPLI programmes on the other hand are intended to provide insurance not only for the large single claim hit, multiple related claim and class action, but also the run-of-the-mill EPL claim that typically results in defence and settlement costs under $100,000. They typically carry limits of $1 million, $3 million or $5 million and deductibles anywhere between $5,000 and $50,000. There are three types of working layer EPLI policies currently offered in the U.S. market: "duty to defend", "duty to pay", and a hybrid "duty to defend/duty to pay". A "duty to defend" policy provides that the insurer has the right and duty to defend any claim potentially covered by the policy. A "duty to pay" policy provides that the insured has the right to control the defence of the claim and the insurer has to pay the defence costs. A hybrid "duty to defend/duty to pay" policy provides that, for any particular claim, the insured is allowed to choose whether the EPLI policy responds on a "duty to defend" or "duty to pay" basis.

SPECIFIC ISSUES TO ADDRESS IN ANY EPL INSURANCE PRODUCT

Regardless of whether an EPL endorsement to a D&O policy or EPLI policy is purchased, there are many specific issues that must be addressed when reviewing the terms and conditions of the form being used. The following list of issues is *not* intended to be an exhaustive list of all that must be addressed. Rather, it is intended to be demonstrative of some of the issues that should be addressed, and are being addressed, by companies in the United States.

WHETHER "DAMAGES" MUST BE SOUGHT IN ORDER TO HAVE A "CLAIM"

Some EPL insurance forms expressly provide that "damages" need not be sought in order for a covered "claim" to be at issue. Other policies expressly provide than "damages" must be sought. Still other policies are ambiguous on the issue. Why is a prerequisite of "damages" being sought before a claim is considered a covered "claim" a problem? It is most evident on working layer EPLI policies. Many types of EPL claims begin with a charge of wrongful conduct with the Equal Employment Opportunity Commission ("EEOC"). Many times, such EEOC complaints do *not* seek damages, but rather seek a ruling that will allow the aggrieved employee or prospective employee to sue in a civil court for damages and other relief. When an EPLI policy provides that a claim, in order to be covered, must seek damages, EPLI insurers typically refuse to cover EEOC claims that do not seek damages. Defending an EEOC claim can run into tens of thousands of dollars. Other types of claims like EEOC proceedings could also fall outside of the definition of "claim" that requires as a prerequisite that damages be sought. Accordingly, the requirement of "damages" being sought in order for coverage to be triggered should be removed.

BATCH CLAUSE WORDING

Virtually all EPL insurance forms are subject to some form of deductible or self-insured retention. Working layer EPLI policies typically contain deductibles in the range of $5,000 to $50,000 (depending on what premium the insured is willing to pay for the policy). Catastrophic EPLI policies typically contain self-insured retentions in the range of $250,000 to $5 million (again, depending on the premium paid for the policy). D&O policies with EPL endorsements are almost always subject to substantial deductibles or self-insured retentions for corporate indemnification coverage. Because such deductibles and self-insured retentions typically apply per "claim" or per "each insured event" it is very important, if not vital, that the policies contain a correctly worded "batch" clause that aggregates multiple claims arising

out of similar or related facts, circumstances, wrongful acts, etc. Otherwise, coverage that an insured would expect could be functionally eviscerated by the application of myriad deductibles and/or self-insured retentions.

ASSUMPTION OF DEFENCE CLAUSE

There are a few issues that are relevant only to "duty to pay" or hybrid "duty to defend/duty to pay" EPL insurance products. One issue is the "assumption of defence" clause. Some "duty to pay" and hybrid "duty to defend/duty to pay" EPLI policies and D&O policies with an EPL endorsement contain a clause that allows the insurer, in its absolute discretion, to assume the control of the defence of any claim after the insured has already been defending the claim. Such a clause functionally eliminates the purpose of having a "duty to pay" or hybrid "duty to defend/duty to pay" policy - to give the insured the right to control the defence of the EPL claim. Accordingly, such a clause should be deleted from any "duty to pay" or hybrid "duty to defend/duty to pay" EPLI policy or D&O policy.

CONSENT TO COUNSEL AND REVOCATION OF CONSENT CLAUSES

Another issue that is relevant only to "duty to pay" or hybrid "duty to defend/duty to pay" EPLI policies and D&O policies with an EPL endorsement is the "consent to counsel" and "revocation of consent" clauses. The consent to counsel clause provides that, although the insured gets to choose which lawyer will defend the insured, the insurer must consent to the insured's choice. Such a clause, if it has to be in the policy, should also provide that the insurer's consent shall not unreasonably be withheld. Otherwise, it might be helpful to delineate the specific grounds on which consent can be withheld (such as the chosen lawyer must (a) have experience of so many years handling EPL claims, (b) charge a commercially reasonable rate, etc.). The revocation of consent clause provides that the insurer may, in its absolute discretion, revoke its consent to the insured's choice of defence counsel at any time, even after the insured's counsel has spent much time on the claim. Such a clause should be deleted, lest the insurer cause havoc by invoking this right in the midst of the defence of a claim, after the insured's counsel had already spent much time, effort, and partial policy limits defending the claim.

PRIOR ACTS EXCLUSION

Most, if not all, EPL insurance products are issued on a claims-made form. Some EPL insurance products do not provide prior acts coverage. Many EPL insurance products do, however, provide prior acts coverage and many insurers will provide prior acts coverage if asked. Prior acts coverage should, therefore, be insisted on and obtained.

PRIOR KNOWLEDGE EXCLUSION

For those EPL insurance products that do provide prior acts coverage, they often are subject to a prior knowledge exclusion. However, not all prior knowledge exclusions are worded the same way. A properly worded prior knowledge exclusion contains language to the effect that the insured must not merely have knowledge prior to policy inception of a fact or circumstance that serves as the basis of a claim during the policy period. Rather, a properly worded exclusion provides that it must be reasonably foreseeable that the facts or circumstances known could give rise to an EPL claim during the policy period. An incorrectly worded prior knowledge exclusion does not contain such reasonably foreseeable language. The problem with such a prior knowledge exclusion is that claims of discrimination based on policies and procedures that exist prior to policy inception and known to everyone and thought by everyone to be lawful and nondiscriminatory might always be excluded under it, if the language were given a literal interpretation. In addition to adding such reasonably foreseeable language, the exclusion also should be amended so that only the knowledge of management-level and higher level employees is subject to the exclusion, rather than the knowledge of all employees. This amendment narrows the scope of the exclusion.

INTENTIONAL INJURY EXCLUSION

Although from the standpoint of corporate vicarious liability it is not advisable to include an intentional injury exclusion on an EPL insurance product, such an exclusion should be included to avoid the unfortunate incident of having an employee who actually committed an intentionally injurious act successfully make a claim on the corporate insured's EPL insurance programme (which could prematurely erode or exhaust limits and result in a higher premium for renewals). That unfortunate scenario already has been the subject of litigation in the United States on a policy form analogous to an EPL form.[9] To avoid this type of result, an EPL insurance product should have some form of intentional injury or wilful conduct exclusion. Such an exclusion should expressly state that it applies only if the employee in fact committed an act with the intent to cause injury.

SEVERABILITY AS TO EXCLUSIONS

Most EPL insurance products do not provide severability as to all exclusions. However, at a minimum, an EPL insurance product should provide severability as to the intentional injury exclusion and prior knowledge exclusion. In other words, if any insured is found liable for committing an intentional injury, that insured's acts should not automatically be imputed to any other insured. Obviously, with respect to the possibility of an employee being found liable for intentionally sexually harassing another employee, this type of severability is very important. Also, just because one insured has knowledge prior to policy inception of facts or circumstances that reasonably could be foreseen to be the basis of a claim made during the policy period, that knowledge should not be imputed to all other insureds. In the U.S. EPL insurance market, most carriers will provide severability as to the intentional injury exclusion but *not* the prior knowledge exclusion.

9 See n. 8 above.

SEVERABILITY AS TO THE APPLICATION FOR INSURANCE

Some EPL insurance forms provide severability as to the application for insurance. Many do not. Such severability is important so that the corporation and other insureds are not barred from coverage merely because of a false representation or statement in, or omission from, the application for insurance by one insured. In addition, some insurers will entertain severability not only as to insureds, but also as to facts. In other words, it is possible to have the severability provisions worded so that if a material mis-statement or omission is discovered, coverage is barred only as to the person responsible for the mis-statement or omission and only as to the claim for which the mis-statement or omission is relevant.

CONCLUDING THOUGHTS

Stand-alone EPLI policies and D&O policies with EPL endorsement are a welcome sight to the list of insurance products that can help a company operating in the United States finance its liability risks. However, because or the mad rush of many insurers and insurance brokers attempting to capitalise on the publicity of these two insurance products, EPLI policies and D&O policies providing EPL coverage often are placed without the necessary analysis that should take place. Hopefully, this article is of interest to lawyers practising outside of the United States whose clients may be facing these EPL risks at home and/or abroad.