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EXPERT ANALYSIS

A Handy Guide for Choosing And Using Employment Practices Liability Insurance Coverage

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Like many employers, you may have been down this road before: Bright and early one morning, you receive notification that a lawsuit has been filed against your company and its executives, alleging some form of employment discrimination, harassment or other workplace wrongdoing.

You swiftly reach out to your favorite employment lawyer — the one who knows you, your business and perhaps even this particular situation best. You then recall (or are soon reminded) that your company has insurance that may cover this dispute. End of problem? Not really.

While the existence of insurance may answer some of your most pressing questions, such as who is going to pay to defend the company and who will cover the cost of some or all of any judgment or settlement, it may create a host of unanticipated questions as well.

If, for example, your company has an employment practices liability insurance, or EPLI, policy, the very first thing you will find out is that unless you have a "duty to reimburse" policy (described below), you most likely will be required to bid a fond farewell to your preferred employment lawyer and will be introduced (courtesy of your insurance company) to your "new" employment lawyer — whom you most likely do not know and probably have never met.

It should come as no surprise that insurers strongly prefer to select their own panel counsel, with whom they have most likely negotiated significantly lower hourly rates (usually in exchange for case volume). Because panel counsel rates rise slowly or not at all, there is an ever-widening gap between panel rates — which are comparable to the rates paid to workers' compensation lawyers — and the rates charged by independent law firms.

However, the difference between a workers' compensation case (where liability and damages are strictly limited by statute) and a typical employment case pending before a jury is, of course, enormous.

There have been recent single-plaintiff cases in California and elsewhere, for example, that have resulted in jury verdicts in the $20 million to $30 million range. One fairly recent blockbuster verdict in a discrimination case against AutoZone exceeded $185 million.[1]

Panel counsel, of course, will be looking to the insurer and not the employer for their next case. For that reason, they typically consider the insurer to be their "client" at least as much as your company is.

At the very least, this situation may present a loyalty dilemma for panel counsel. This is because the insurance company will likely be much less interested in funding a defense based on "principle" — and, therefore, more interested in settling — than the employer may prefer.

Although insurers have always pressed their policyholders to choose lawyers listed on their panel, in the past most carriers would reluctantly let the policyholders pick their own lawyers (i.e., lawyers who are not on the panel).

Under those circumstances, the insurer would pay the lower rates charged by panel counsel, leaving it to the policyholder to pay the difference between panel rates and the rates charged by the policyholder's preferred counsel.

Most employers were more or less content with this solution.

Recently, however, in an effort to further control the selection of defense counsel (and presumably to drive more volume to their panel counsel), a number of large insurers have gone so far as to prohibit the insured from paying the difference between panel rates and the rates charged by the insured's preferred attorney, thereby forcing the insured to either use panel counsel or forfeit benefits under their EPLI policy.

Employment practices liability insurance policies typically provide coverage for both the company and its employees for certain defined "wrongful employment acts," such as discrimination, illegal harassment, retaliation and wrongful termination.

Under some policies, this is an absolutely non-negotiable point — and unless you are careful, you may not realize how limited your options are until it is too late.

The surprises do not end there. This analysis is designed to assist employer policyholders in the situation described above so they can procure the type and amount of EPLI coverage their company needs.

BASICS OF AN EPLI POLICY

EPLI policies typically provide coverage for both the company and its employees for certain defined "wrongful employment acts," such as discrimination based on a protected characteristic (such as age, race, religion, national origin, disability, gender, sex, marital status, etc.), as well as claims alleging illegal harassment, retaliation or wrongful termination.

Because EPLI coverage can be all-encompassing and, in fact, the Insurance Services Office has approved a form EPLI policy, these policies are often sold as "form" policies. They often have vastly different coverage terms and exclusions, as endorsements are added to the "form" policy due in part because they are a relatively new product in the insurance market.

For instance, EPLI policies, via their endorsements, often exclude claims for intentional acts and/or punitive damages, as well as claims arising under the National Labor Relations Act, the Worker Adjustment and Retraining Notification Act, the Fair Labor Standards Act, state wage-and-hour laws, the Employee Retirement Income Security Act, the Occupational Safety and Health Act, and workers' compensation laws.

EPLI policies are usually either "claims made" or "occurrence based," though claims-made policies are far more common.

EPLI claims-made policies require an insurer to cover claims or incidents that occur and are reported while the relevant policy is in force, regardless of whether the incident giving rise to the claim occurred during the policy period.

An occurrence-based policy, on the other hand, requires the insurer to cover claims arising out of an "occurrence" (as defined by the policy) that took place during the policy period, regardless of whether the claim was reported during that period.

Finally, it is very important to understand that in stark contrast to many other types of policies, defense costs generally count toward the total liability limit of an EPLI policy. In other words, as defense costs and expenses grow, they erode the indemnity coverage available to pay for, among other things, a settlement or adverse judgment.

WHAT 'COVERAGE' DOES AN EPLI POLICY PROVIDE?

The duty to defend vs. the duty to reimburse vs. the duty to indemnify

EPLI policies generally require the insurer to defend (or reimburse) and indemnify the policyholder, but one must pay special attention to the terms of the policy, because these are significantly different concepts in insurance law.

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The duty to defend relates to an insurer's obligation to defend a policyholder against a suit or claim brought against it. A duty-to-defend provision in an EPLI policy generally contains language like the following:

> The [insurer] shall have the right and duty to defend any claim covered by this coverage section. Defense counsel shall be selected by the [insurer] from the [insurer's] list of approved employment defense firms.[2]

Note that "the duty to defend is broader than the duty to indemnify; an insurer may owe a duty to defend its insured in an action in which no damages ultimately are awarded."[3]

Generally speaking, any action that contains claims that may potentially fall within the coverage of the EPLI policy gives rise to the insurer's duty to defend. This "potentially covered" standard is construed liberally and in favor of the policyholder.

The duty to "reimburse" is similar to the duty to defend. However, under a typical duty-to-reimburse policy, the insured may select its own counsel, with such selection usually being subject to the insurer's acceptance or approval.

A duty-to-reimburse policy typically reads as follows:

> The insureds have the right and duty to retain qualified counsel of their choosing to represent them in the defense or appeal of claims, but no defense expenses may be incurred without the [insurer's] consent, such consent not to be unreasonably withheld.[4]

Both the duty to defend and the duty to reimburse are typically accompanied by a separate duty to indemnify: to provide actual payment/reimbursement for adverse judgments or settlements.

This duty to indemnify is more limited than a duty to defend or a duty to reimburse, as an insurer has the duty to indemnify a policyholder only for claims that are actually covered by the relevant EPLI policy.

For instance, an EPLI policy often will provide that the insurer "shall" pay on behalf of the policyholder the amount that it becomes "legally obligated" to pay for a "wrongful employment act," as defined by the policy.

To trigger this duty, there must be no dispute (often due to a court determination or an insurer-approved settlement) that the amount the policyholder became "legally obligated" to pay arose from a covered "wrongful employment act."

The right to select counsel based on a conflict of interest

As stated above, insurers generally want to exercise control over the selection of defense counsel, particularly in the EPLI context. However, when there is a conflict of interest between the insurer and policyholder, independent counsel should be appointed to represent the policyholder.

In California this is commonly referred to as *Cumis* counsel, which takes its name from a 1984 state appeals court decision,[5] though courts in other states have come to similar conclusions.

In *Cumis* the court held that in the event of a conflict of interest between a policyholder and its insurer, the insurer is obligated to pay for the policyholder's independent counsel. It further held that the mere potential of a conflict of interest is enough to trigger the right to independent counsel.

Specifically, the *Cumis* court held that:

> Where there are divergent interests of the insured and the insurer brought about by the insurer's reservation of rights based on possible noncoverage under the insurance policy, the insurer must pay the reasonable cost of hiring independent counsel by the insured. The insurer may not compel the insured to surrender control of the litigation.

This situation often arises in the employment context when the damages are caused by conduct of the insured that may either be covered or not based on whether it was "negligent" or "intentional" conduct, or accidental or not.

While some courts hold an insurer liable if it refuses in bad faith to settle a claim within policy limits and a jury issues a verdict against the insured above the policy limits, this scenario can be avoided at the outset when negotiating the policy terms.

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Basically, counsel has a conflict because in the underlying litigation, it would be more advantageous from the insurer's standpoint for the conduct to have been intentional — as there would be no coverage — but this position obviously would be problematic for the employer policyholder.

A LESSON TO BE LEARNED

A policyholder's misunderstanding of its coverage under an EPLI policy can indeed lead to disastrous consequences.

Consider the following example: An employer has been sued by several of its employees who allege workplace discrimination. In the midst of the litigation, the employee-plaintiffs make a settlement demand for the limits then available under the applicable policy, but the insurer-appointed counsel advises the client to reject the demand. As a result, the litigation continues and the available policy limits erode as the defense costs and fees incurred on the employer's behalf mount.

It is vitally important to find out which insurers offer duty-to-defend policies and which offer duty-to-reimburse policies and then compare coverage, counsel selection options and, of course, premiums.

A later attempt to settle the case becomes futile because the employee-plaintiffs are by then unwilling to settle for the (diminished) amount of coverage remaining under the policy. As a result, the case ultimately goes to trial, and there is a significant award in favor of the employee-plaintiffs that exceeds the eroded limits of the EPLI policy, leaving the employer to cover the difference.

While some courts hold an insurer liable if it refuses in bad faith to settle a claim within policy limits and the insured subsequently suffers a verdict in excess of limits, this scenario may be avoided at the outset when negotiating the terms of the policy.

WHAT TO DO — AND WHEN TO DO IT

First, if you do not already have EPLI coverage, carefully consider whether your company will be better off remaining uninsured (i.e., "self-insured").

Many clients have analyzed their experience with EPLI and panel counsel and have determined that the premiums and deductibles (the "self-insured retention" amounts) are just too high when stacked up against the limited benefits and representation provided under the policy.

If you are in the market for an EPLI policy for the first time, make sure you identify the kinds of "wrongful employment acts" you would like covered and, if possible, look at historical costs associated with defending against and paying for these types of claims on your own.

Furthermore, your bargaining power is at its greatest during negotiations over the new EPLI policy, so this is the best time to request that you be allowed to select defense counsel (possibly at agreed-upon hourly rates). A potential compromise is that the insurer will add your preferred counsel to the insurer's list of panel counsel from which you can select in the event of a claim.

Second, if you already have coverage under an EPLI policy, now is the time to become familiar with its terms.

Specifically, you will want to be sure to understand whether your policy provides defense/ reimbursement or indemnity coverage (or both). If defense coverage is provided, you should determine whether the policy allows you as the policyholder to select counsel of your choice.

As explained above, if the policy provides a duty to defend, then the insurer is most likely going to limit your selection to panel counsel. Conversely, if the policy provides a duty to reimburse, then you most likely will be permitted to select your own counsel.

Therefore, it is vitally important to find out which insurers offer duty-to-defend policies and which offer duty-to-reimburse policies and then compare coverage, counsel selection options and, of course, premiums.

If your current policy does not give you the right to select defense counsel, you can look to other insurers to provide you with this important right. Once that insurance is effective, cancel the

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original policy in accordance with its terms and obtain reimbursement from the first carrier of any paid but unused premiums.

Third, another option you may want to consider is to obtain similar coverage via an endorsement to another one of your company's already existing policies (such as a directors and officers liability policy).

In addition to saving you the time and effort of procuring an entirely new policy, this option probably will be less costly, as insurers usually charge a substantially lower amount for the endorsement than for procuring an EPLI policy.

Conversely, taking this route may carry with it some disadvantages, as the limits applicable to the relevant policy may not be sufficient to address employment practices-related disputes. If that is the case, the policy may be exhausted sooner than anticipated.

Furthermore, the EPLI policy is likely to provide a larger breadth of coverage for employment practices-related disputes.[6]

Finally, if your insurer is refusing to allow you to pay the difference between the panel counsel rates in the policy and the amount charged by your preferred lawyer and you received a reservation of rights letter, you should carefully review the letter to see if independent *Cumis* counsel is warranted based on a conflict of interest.

If you still have questions, Proskauer's employment and insurance coverage attorneys are standing by to assist. They have vast experience in advocating on behalf of employer-policyholders and negotiating with insurers so that EPLI-related restless nights will be few and far between.

NOTES

[1] *Juarez v. AutoZone Stores Inc.,* No. 08-cv-417, *verdict returned* (S.D. Cal. Nov. 17, 2014).

[2] Fed. Ins. Co., Executive Protection Portfolio (Form 14-02-7304) at 18, available at http://bit.ly/2n840Cs (emphasis added).

[3] *Montrose Chem. Corp. v. Super. Ct.,* 6 Cal. 4th 287, 295 (1993).

[4] Exec. Risk Indem. Inc., ABA Employers Edge at 10, available at http://bit.ly/2mujEGI (emphasis added).

[5] *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y Inc.,* 162 Cal. App. 3d 358 (Cal. Ct. App., 4th Dist. 1984), codified at Cal. Civ. Code § 2860.

[6] See, e.g., Robert A. Bregman, Int'l Risk Mgmt. Inst., *Key Coverage Options under Employment Practices Liability Policies, available at* http://bit.ly/2m9dCIb.

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