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PRINCIPLES OF INSURANCE COVERAGE: A GUIDE FOR THE EMPLOYMENT LAWYER

FRANCIS J. MOOTZ*

INTRODUCTION

Employment lawyers have witnessed a virtual revolution in the law of employment relations during the past thirty years. Although the federal government intervened substantially in private employment relationships in response to the economic catastrophe of the Great Depression,¹ employers remained largely free of regulation until the explosion of statutes and common law developments that commenced in the 1960s and continues today.² Recent developments in common law tort and contract principles are particularly troubling for defense counsel in employment matters, since the resulting doctrinal uncertainty renders it difficult to assess the client's exposure with any assurance until the appeals in the case have been exhausted.

* © 1995, Francis J. Mootz, III, Professor of Law, Western New England College School of Law. This article is a revised version of a paper presented on August, 8, 1995 at the 1995 Annual Meeting of the American Bar Association in Chicago, Illinois. Professor Mootz gratefully acknowledges the assistance and insight provided by Larry Weidemier (Class of '97). Mr. Weidemier formerly served as Manager, Commercial Lines Underwriting Training, at Hanover Insurance Company, Worcester, Massachusetts.

1. *See, e.g.*, National Labor Relations Act of 1935, 29 U.S.C.A. §§ 151-69 (1988); Federal Old-Age, Survivors, and Disability Insurance Benefits Act (Social Security Act) of 1935, 42 U.S.C.A. §§ 401-33 (1988); and Fair Labor Standards Act of 1938, 29 U.S.C.A. §§ 201-19 (1988).

2. Federal statutes affording protections to employees address a wide range of issues and often are supplemented by state legislation. Much of the legislation defines the civil rights of applicants and employees. *See, e.g.*, Civil Rights Act of 1964 (Title VII), 42 U.S.C.A. §§ 2000e-2000e-17 (1988), Civil Rights Act of 1991, Pub. L. No. 102-106, 105 Stat. 1071 (codified as amended at 42 U.S.C. §§ 19871, 2000e (1991)); Age Discrimination in Employment Act, 29 U.S.C.A. §§ 621-34; Americans With Disabilities Act, 42 U.S.C.A. §§ 12101-213 (1990). Increasingly, however, legislation regulates the terms and conditions of employment. *See, e.g.*, Employee Polygraph Protection Act, 29 U.S.C.A. §§ 2001-09 (1988); Family and Medical Leave Act, 29 U.S.C.A. §§ 2601-54 (1993). Common law developments include expanded recognition of implied-in-fact contracts premised on oral statements or employee handbooks, promissory estoppel, defamation, and wrongful discharge in contravention of public policy.

Consider the uncomfortable position of the lawyer representing Mobil Coal Producing, Inc. ("MCP"). In 1985, the Wyoming Supreme Court held that MCP's employee handbook constituted part of the employment contract between MCP and its workers, and therefore that the handbook provisions were binding on the company.³ MCP immediately added a provision to its employee handbook which expressly disclaimed any intent that the handbook be contractually binding, and MCP amended the applications signed by all prospective employees to include a clause acknowledging that the employment relationship would be terminable at the will of either party. An employee hired after MCP began using these disclaimers later sued MCP for breach of contract for failing to adhere to the disciplinary procedures outlined in the employee handbook. MCP obtained summary judgment, but the Wyoming Supreme Court reversed and remanded the case for trial.⁴ The court initially found that the language of the handbook was sufficient to connote a promise giving rise to potential liability under a theory of promissory estoppel, notwithstanding the legal effectiveness of the disclaimers to negate full contractual obligation.⁵ On rehearing, the court changed tack and held that MCP might be subject to contractual liability because the disclaimers were insufficiently conspicuous to be binding on McDonald.⁶ Justice Thomas, dissenting from both majority opinions, expressed his confusion and concern:

I fear that corporate America, as it lives in the state of Wyoming, will be forced to conclude that the court is toying with it in some cruel and peculiar game of cat and mouse. In my judgment, we offered guidance in the earlier employee at will cases and, now, when confronted with an employer who followed that advice, we should not say that we really did not mean to adhere to our earlier guidance.⁷

This statement most likely captures the sentiment of many defense lawyers in employment matters.

3. *Mobil Coal Producing, Inc. v. Parks*, 704 P.2d 702, 706-07 (Wyo. 1985).

4. *McDonald v. Mobil Coal Producing, Inc.*, 789 P.2d 866 (Wyo. 1990), *reaff'd*, 820 P.2d 986 (1991).

5. *Id.* at 869.

6. *McDonald*, 820 P.2d at 989. Subsequently, the Wyoming Supreme Court reaffirmed and explained this latter rationale. See *Lincoln v. Wackenhut Corp.*, 867 P.2d 701, 703-04 (Wyo. 1994) (courts will enforce a "conspicuous and unambiguous disclaimer" in an employee handbook, as measured by the clarity and prominence of the disclaimer language, as well as the placement of the disclaimer in the handbook).

7. *McDonald*, 789 P.2d at 872 (Thomas, J., dissenting).

The increasing plasticity of tort and contract doctrines in employment litigation is not an isolated development, but rather is part of a broader trend that represents the legacy of the Legal Realism movement earlier this century. This trend may be summarized as a rejection of abstract doctrinal formalism in favor of paying much greater attention to the reasonable expectations of the parties to the transaction and also to the disparities in their bargaining power. These same concerns driving current developments in employment law have inspired similar and more longstanding developments in the law governing the relationship between an insurance carrier and its insured. Ironically, then, an employment lawyer will find that the doctrinal shifts magnifying her client's exposure to its employees are paralleled by doctrinal shifts in insurance law that greatly increase her client's ability to demand coverage under its insurance contracts for these legal expenses and judgments. Even the mouse gets to play the cat on occasion.

In this Article, I will discuss basic insurance law principles that come into play when employers assert that their liability insurance provides coverage for employment disputes. Although the examples I use to explain these concepts pertain to coverage disputes in connection with employment litigation, I will focus on the basic principles and leave the detailed legal analysis of the coverage issues to the other participants in the symposium.⁸

8. Joseph P. Monteleone, *Coverage Issues Under Commercial General Liability and Directors' and Officers' Liability Policies*, 18 W. NEW ENG. L. REV. 47 (1996); James E. Scheuermann & John K. Baillie, *Employer's Liability and Errors and Omissions Insurance Coverage for Employment-Related Claims*, 18 W. NEW ENG. L. REV. 71 (1996); Larry M. Golub, *A Checklist for Insurance Coverage in the Employment Litigation Context*, 18 W. NEW ENG. L. REV. 99 (1996); Steven R. Gilford & Robert M. Fogler, *Insurance Coverage Actions: Who, Where, and When to Sue*, 18 W. NEW ENG. L. REV. 123 (1996); Joseph P. Monteleone, *Employment Practices Liability Insurance (EPLI) Policies: Who Controls Selection of Defense Counsel*, 18 W. NEW ENG. L. REV. 159 (1996); Wayne E. Borgeest, Anthony J. Fowler, & Michael M. Santocki, *Employment Law Claims: Triggering Coverage Under "Claims Made" Policies*, 18 W. NEW ENG. L. REV. 179 (1996); Calum Anderson, *Insurance Coverage for Employment-Related Litigation: Connecticut Law*, 18 W. NEW ENG. L. REV. 199 (1996); Marylou Fabbo, Audrey J. Samit, & Richard U. Stubbs, Jr., *Insurance Coverage for Employment Claims in Massachusetts*, 18 W. NEW ENG. L. REV. 255 (1996).

Previously published articles providing specific legal analysis of insurance coverage for employment litigation include: WAYNE E. BORGEEST & PATRICK M. KELLY, *EMPLOYMENT LAW LIABILITY CLAIMS: WHAT YOU NEED TO KNOW ABOUT INSURANCE COVERAGE* (eds., Practising Law Institute 1995); Irene A. Sullivan & Adam C. Rosenberg, *Insurance Coverage for Wrongful Termination and Employment Discrimination Claims*, in *INSURANCE COVERAGE LITIGATION: 1994* (Practising Law Institute); Robert A. Machson & Joseph P. Monteleone, *Insurance Coverage for Wrongful Employment Practices Claims Under Various Liability Policies*, 49 BUS. LAW. 689 (1994); James E.

At the outset, it is important to emphasize that insurance coverage is not and should not be the only technique an employer uses to manage the risk arising out of employment-related practices. For several reasons, insurance may not even be the most desirable technique. First, coverage often will be a disputed matter, leading to uncertainty and perhaps to increased transaction costs in dealing with employment claims. Additionally, insurance defense counsel retained by the insurance carrier may conduct the litigation in a manner that conflicts with the employer's broader human resources strategy for dealing with employee grievances. Finally, an insurer's underwriters may refuse to continue coverage for a reasonable price if the employer submits an inordinate number of employment-related claims within a particular period.

On the other hand, insurance coverage might afford far more in terms of risk management than simply defending claims and paying losses. Depending on the importance to the insurer of the employer's account, the employer may be able to secure the insurer's agreement to establish a loss prevention and claim settlement procedure that would allow the employer to participate actively in risk management at every stage. Needless to say, the employer's counsel should work together with the insurer in this regard; if possible, the employer might insist that an on-going risk management committee composed of counsel, claims, and loss control personnel from the insurer and the employer's human resource managers coordinate the risk management strategies relating to employment practices. Such coordination would involve the employer rather than subjecting it to an insurer that reacts according to its own interests when problems arise.

I. RELEVANT LIABILITY INSURANCE POLICIES

Litigation asserting that the employer's liability insurance provides coverage for employment disputes has become increasingly common as a result of the tremendous increase in employment litigation. It is by no means unusual that employers would seek insurance coverage of these claims, given that the "first liability

Scheuermann, *Insurance Coverage for Employment-Related Claims*, 28 TORT & INS. L.J. 778 (1993); Kearney W. Kilens, *Employer Insurance Coverage for Employment Litigation*, 79 ILL. BAR J. 32 (1991); David M. Spector & David B. Ritter, *Insurance Coverage of Employee Claims Against Employers*, 5 LAB. LAW. 615 (1989); John E. Peer & Ronald E. Mallen, *Insurance Coverage of Employment Discrimination and Wrongful Termination Actions*, (pts. 1 & 2) 54 DEF. COUNS. J. 464-81 (1987) and 55 DEF. COUNS. J. 12-25 (1988).

insurance policies . . . were purchased by employers as protection against tort liability to employees resulting from work injuries” prior to the adoption of workers’ compensation legislation.⁹ Defense counsel—whether in-house counsel supervising litigation or outside counsel retained by the employer to defend the suit—play an important role in assisting clients to identify potential insurance coverage for employment disputes. It is not possible to examine the potential for insurance coverage competently without drawing upon a detailed understanding of substantive employment law and the specifics of the claims being asserted against the employer. Reviewing the relevant policies is complicated by the fact that a number of common liability policies might provide coverage when an employer faces an employment-related claim.¹⁰ In this part of the Article, I briefly describe the liability policies that potentially afford coverage for typical employment-related claims.

In order to identify relevant liability insurance policies, employment lawyers must understand the three-dimensional model of insurance coverage that is operative in many cases. First, the employer’s liability insurance program has a “width,” defined by the various policies that provide primary insurance coverage. Second, the liability program has a “height,” defined by the different economic levels of coverage provided by various insurance products. Finally, the liability program has a “length,” defined by an historical succession of policies owned by the employer during the time period implicated by the allegations in the complaint. Only by examining fully the “three dimensions” of the employer’s insurance portfolio can the lawyer ensure that no potential coverage is overlooked. I discuss each of these dimensions in turn.

A. *Primary Liability Coverage: The Width of the Client’s Insurance*

The *Commercial General Liability (“CGL”) Policy* provides basic liability insurance coverage for various business entities and governmental units. A CGL policy serves as a general-purpose

9. ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW* § 4.8(a) (student ed. 1988). See C. ARTHUR WILLIAMS, JR., *INSURANCE ARRANGEMENTS UNDER WORKER’S COMPENSATION* 3-4 (1969) (asserting that an 1886 employer’s tort liability policy was the first instance of liability insurance in America).

10. The general problem in the insurance market of the “heavy reliance on so many different forms of insurance and of the relatively disorganized way in which all this coverage has come into being” is analyzed by Professor Abraham in KENNETH S. ABRAHAM, *DISTRIBUTING RISK* 133-72 (1986).

foundation for the insured's liability coverage, much as the typical homeowner's policy provides individuals with their basic liability coverage. For purposes of employment-related claims, the CGL policy is fairly described as promising to pay, on behalf of the employer, the liabilities associated with bodily injuries and personal injuries caused by accidents. Certain risks, such as liability incurred by a business on account of the negligent operation of its automobiles, are covered by separate policies premised on different underwriting and pricing.¹¹ The most important example of a policy that provides additional primary coverage is the *Workers' Compensation and Employer's Liability Policy*, which in fact provides two distinct types of coverage for an employer's potential liability to employees.¹² The workers' compensation coverage under the policy promises to pay all benefits due from the employer pursuant to the governing workers' compensation scheme. Workers' compensation statutes vary from state to state, sometimes to a significant degree.¹³ Generally, these statutory schemes impose no-fault liability on employers to pay death benefits, medical and rehabilitation expenses, and/or lost wages to employees suffering injuries that arise out of and occur during the course of their employment; in exchange, the statutes insulate the employer from what would often

11. In the early stages of this project, my research assistant, Larry Weidemier, suggested that it was only a matter of time before an industrious lawyer sought coverage for employment-related liabilities under the business auto policy. While updating my research in January, 1996, I was only mildly surprised to find an example of just such a claim. See *Edquist v. Insurance Co. of N. Am.*, No. C6-95-1111, 1995 WL 635179 (Minn. App. Oct. 31, 1995) (unpublished opinion) (rejecting the insured's argument that coverage under its business auto policy was triggered by a claim that its area manager sexually assaulted and harassed a female subordinate while in a company car, given that there was no "occurrence" as required by the policy).

12. As one court recently summarized:

[E]mployers' liability insurance is traditionally written in conjunction with workers' compensation policies, and is intended to serve as a "gap-filler," providing protection to the employer in those situations where the employee has a right to bring a tort action despite the provisions of the workers' compensation statute or the employee is not subject to the workers' compensation law. Generally, these two kinds of coverage are mutually exclusive.

Producers Dairy Delivery Co. v. Sentry Ins., 718 P.2d 920, 927 (Cal. 1986) (citations omitted). See also *Ottumwa Hous. Auth. v. State Farm Fire & Casualty Co.*, 495 N.W.2d 723, 729 (Iowa 1993) ("Employers' liability insurance protects an employer against common-law liabilities for injuries resulting to employees. In contrast, workers' compensation insurance protects the employer against liability imposed by the worker's compensation acts.").

13. Several states still make the workers' compensation scheme elective for both employer and employee, a carryover from the necessity to avoid constitutional challenge earlier this century. ARTHUR LARSON, *WORKMEN'S COMPENSATION* § 5.20 (desk ed. 1988).

be more expansive tort liability.¹⁴ The employer's liability coverage, in contrast, promises to pay on behalf of employers certain liabilities incurred to employees that fall outside the scope of the workers' compensation statutes. Unless and until *Employment-Related Practices Liability* endorsements or policies become widely available to employers, the CGL policy and Workers' Compensation and Employers' Liability Policy will continue to be the most pertinent primary coverages implicated by employment related claims.

Another liability policy that may provide coverage for an employment claim is *Directors & Officers ("D&O") Liability Insurance*. In many cases, claims made against a business by a disgruntled or former employee will also include separate claims against individual corporate officials. A D&O policy generally indemnifies a company for any settlements, judgments, and expenses that it incurs as a result of claims premised on wrongful acts committed by its directors and officers acting in their official capacity. D&O policies may also insure the directors and officers personally. Even more specific is *Pension and Welfare Fund Fiduciary Liability Insurance*, which insures pension and welfare benefit plans, administrators, and trustees against suits alleging wrongful acts in connection with the operation of such plans. Given the broad preemptive effect of ERISA,¹⁵ many employment-related claims in fact amount to claimed rights under ERISA.¹⁶

14. See, e.g., *Suckow v. NEOWA FS, Inc.*, 445 N.W.2d 776, 779 (Iowa 1989) ("[an] employer's immunity is the quid pro quo by which the employer gives up his normal defenses and assumes automatic liability, while the employee gives up his right to common law verdicts"). See generally LARSON, *supra* note 13, at §1.10; Richard A. Epstein, *The Historical Origins and Economic Structure of Workers' Compensation Law*, 16 GA. L. REV. 775, 800-03 (1982) (offering an economic justification of the quid pro quo embodied in workers' compensation acts).

15. Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001-1461 (1988). ERISA's broad preemption provision is found at 29 U.S.C. § 1144 (1988).

16. See, e.g., *Ingersoll-Rand Co. v. McClendon*, 498 U.S. 133 (1990); *Sanson v. General Motors Corp.*, 966 F.2d 618, 621 (11th Cir. 1992), *cert. denied*, 113 S. Ct. 1578 (1993) (holding that the plaintiff employee's state law claims were preempted by ERISA, even though ERISA afforded no relief for the alleged wrongdoing). Because the remedies afforded by ERISA have been construed very narrowly by the courts, it is unlikely that a fiduciary responsibility policy will provide coverage in an employment-related claim since the employee often will only be awarded wrongfully withheld benefits, which are outside the scope of covered losses. See *Massachusetts Mut. Life Ins. Co. v. Russell*, 473 U.S. 134 (1985) and its developing progeny. However, if the developing federal common law cause of action of equitable estoppel survives Supreme Court scrutiny, it may well be that a suit for promised benefits that admittedly are outside the

In summary, several policies or endorsements providing primary liability insurance potentially will provide coverage for employment disputes. Counsel assisting an employer to review its liability coverage must fully review the applicable "width" of the employer's primary insurance protection.

B. Excess Liability Coverage: The "Height" of the Client's Insurance

Many businesses purchase one or more levels of coverage to supplement their primary liability coverages. "Follow Form" *Excess Liability Policies* generally provide coverage under the same terms as the primary policy for liability in excess of those policy limits. Typically, excess policies supplement an underlying primary program of liability coverage consisting of CGL, Workers' Compensation and Employers' Liability, and Business Auto Liability coverages. In comparison, *Umbrella Excess Liability Policies* combine excess coverage with supplemental coverage intended to fill certain "gaps" in the primary insurance coverage.¹⁷ Because the insurance carriers participating in this market have developed their own policy forms, any umbrella policy must be reviewed carefully, especially if no potential coverage exists under the employer's primary liability insurance policies.¹⁸

These levels of coverages and their inter-relationship are illustrated in the following example. Assume that a company has purchased a CGL policy that includes a \$25,000 deductible and a policy limit of \$500,000, excess coverage for liability between \$500,000 and \$1 million, and umbrella coverage up to a limit of \$10 million. If an employee recovers a \$2 million verdict, all of which is covered under these liability policies, the employer would pay the \$25,000 deductible, the CGL carrier would pay \$475,000, the excess

scope of unambiguous plan language will trigger coverage. *See, e.g.* Black v. TIC Inv. Corp., 900 F.2d 112, 114-15 (7th Cir. 1990).

17. A court recently described the "unique and special coverage" afforded by an umbrella policy by noting that "under certain circumstances, the policy acts as primary insurance, where there is coverage under the [umbrella] policy but not under any other regular primary policy issued" to the employer. *Dixon Distrib. Co. v. Hanover Ins. Co.*, 612 N.E.2d 846, 849-50 (Ill. App. Ct. 1993), *aff'd*, 641 N.E.2d 395 (Ill. 1994).

18. Thus, in a number of cases employers have sought coverage for employment disputes from their umbrella carrier. *See, e.g.*, *Jostens Inc. v. Northfield Ins. Co.*, 527 N.W.2d 116 (Minn. Ct. App. 1995), *Dixon Distrib. Co. v. Hanover Ins. Co.*, 641 N.E.2d 395 (Ill. 1994), *Teague Motor Co. v. Federated Serv. Ins. Co.*, 869 P.2d 1130 (Wash. Ct. App. 1994); *Clark-Peterson Co. v. Independent Ins. Assoc. Ltd.*, 492 N.W.2d 675 (Iowa 1992).

carrier would pay \$500,000, and the umbrella carrier would pay \$1 million. Because employment claims may result in large verdicts, it is important to investigate the full "height" of the employer's insurance coverage. Moreover, even in the absence of coverage at the primary level of insurance, in some cases an umbrella policy may provide coverage for the claim. An umbrella policy providing coverage for an event not covered by the underlying primary policies generally will do so only over a "retained limit," which is equivalent to a deductible.

C. *Liability Coverage over Time: The "Length" of the Client's Insurance*

Collecting and reviewing the relevant policies that potentially provide coverage for employment litigation may be further complicated if the employee alleges continuing wrongful acts by the employer over a period of several years. Under standard *Occurrence Coverage* policies, each and every policy in force at the time of the alleged wrongful acts by the employer potentially provides coverage for the claim. Therefore, it is important to identify the time periods during which the alleged injuries occurred and to review all liability policies in force during this period, regardless of whether the policies continue in force at the time that the claim for coverage is asserted. In response to the long "tail" of liability facing carriers utilizing occurrence coverage, some insurers recently have begun to issue liability policies that provide only *Claims Made Coverage*.¹⁹ In its pure form, the coverage "trigger" for this more restrictive policy is a claim made against the insured during the policy term for an occurrence taking place during the policy term. Generally, however, coverage is expanded to include claims arising out of occurrences taking place on or after the "retroactive date" specified in

19. See KEETON & WIDISS, *supra* note 9, at § 5.10(d)(3) (noting that in recent years "most liability insurers have sought to expand dramatically the use of 'claims made' policies to liability risks beyond the professional liability areas in which these coverages came to be used extensively in the 1970s" but also noting the resistance to this move expected in the market). In fact, CGL "occurrence" policies continue to dominate the standard market, notwithstanding the availability, since 1985, of an Insurance Services Office "claims made" CGL policy. However, specialty products such as fiduciary insurance for pension plan administrators are more likely to be written on a "claims made" basis. See, e.g., *Gulf Resources & Chem. Corp. v. Gavine*, 763 F. Supp. 1073 (D. Idaho 1991). Although Employment Practices Liability Insurance policies are still relatively new to the market and therefore, still developing in response to consumer demand, it is apparent that these policies will be written almost exclusively on a "claims made" basis.

the policy. Additionally, many policies provide coverage for claims made during an "extended reporting period," which follows the normal expiration of the policy.

A simple example illustrates the distinction between Occurrence and Claims Made coverage. Assume that an employer is sued in 1994 for invasions of privacy that allegedly occurred during 1992, as might be the case if the employer's former practice of clandestinely searching through personal effects in employee lockers is only later discovered. The employer should investigate potential coverage under any occurrence policies in effect during 1992, as well as under any claims made policies in effect during 1994.

D. *An Example of the Three-Dimensional Model*

The following hypothetical scenario demonstrates the significance of the three-dimensional model of insurance protection. Assume that an employee files a workers' compensation claim for a job-related injury on December 1, 1987. The employee subsequently resigns in February, 1990, and promptly files a lawsuit consisting of a number of causes of action. In her complaint, the employee alleges that the employer immediately responded to her workers' compensation filing by mounting a three year retaliatory campaign that consisted of slandering the employee in front of other employees and defaming her in performance appraisals, leading her to quit her employment in order to escape intolerable working conditions. Upon her resignation, the employee requested severance payments on the ground that her employment had been terminated, but her request was denied by the administrators of the employer's benefits plan. The employee claims that she was constructively discharged and is now suing for wrongful discharge, intentional and negligent infliction of emotional distress, defamation, and an arbitrary and capricious denial of benefits due under an ER-ISA-governed plan.²⁰

20. These allegations state a viable claim in tort for wrongful discharge on account of the employer's violation of the clear public policy in favor of workers exercising their statutory right to obtain workers' compensation benefits. *See, e.g., Kelsay v. Motorola, Inc.*, 384 N.E.2d 353 (Ill. 1978). Although courts have been reluctant to permit plaintiffs to recover on emotional distress theories merely because they were terminated in a brusque manner, the plaintiff might state a cause of action if she alleges that the employer drove her to resign by outrageous conduct that inflicted severe emotional distress. *See, e.g., Wilson v. Monarch Paper Co.*, 939 F.2d 1138 (5th Cir. 1991). Moreover, the employee states a viable claim for slander with regard to the statements made to fellow employees and also might state a claim for defamation with respect to the performance appraisals under a theory of self-publication. *See, e.g., Lewis v. Equitable*

In response to this claim, the employer will need to review a number of liability policies to determine whether insurance coverage is available. If the employer purchased a CGL occurrence coverage policy from Company A for two successive years beginning January 1, 1987, a CGL occurrence coverage policy from Company B for the policy year beginning January 1, 1989, and a CGL claims made policy from Company C each year since January 1, 1990, it will be necessary to review both policies issued by Company A, the policy issued by Company B, and the policy issued by Company C for the year 1990. Moreover, the employer's Workers' Compensation and Employers' Liability Policy might provide coverage to the extent that the employer seeks a dismissal of part of the civil action by asserting the exclusivity of the workers' compensation remedy for the employee's emotional distress injuries. Additionally, liability policies covering the actions of officers, directors, and plan fiduciaries may be implicated, given the probability that the plaintiff would sue such individuals personally in her complaint. Finally, excess and umbrella policies may provide coverage in the event of a large plaintiff's verdict. Consequently, in this hypothetical case it is necessary to review a number of insurance policies to assess potential coverage for the claims asserted by the plaintiff.²¹

II. BASIC PRINCIPLES OF INSURANCE COVERAGE

With the relevant liability insurance policies in hand, the employment lawyer will be in a position to assist with her client's assessment of whether coverage potentially exists. Coverage is a contractual undertaking by the insurance carrier to accept the risk of certain losses that may be incurred by the insured party in the future. Liability policies provide what is known as third-party in-

Life Assurance Soc'y, 389 N.W.2d 876 (Minn. 1986). A plan participant may bring an action under ERISA to compel payment of benefits due them under the plan, 29 U.S.C. § 1132(a)(1)(B) (1988), but if the plan accords discretionary powers to the administrator to determine eligibility for benefits, the court may reverse an administrator's denial of benefits only if it is found to be arbitrary or capricious. *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989).

21. Cf. *Lumbermen's Mut. Casualty Co. v. S-W Indus., Inc.*, 39 F.3d 1324 (6th Cir. 1994) (claims for coverage against seven insurers who provided a variety of policies during the relevant period that the employee allegedly suffered injury); *Fidelity & Guar. Ins. Underwriters, Inc. v. Everett I. Brown Co.*, 25 F.3d 484 (7th Cir. 1994) (claims for coverage under a liability package which included a primary liability policy, an excess policy, and a workers' compensation and employers' liability policy); *Dixon Distrib. Co.*, 641 N.E.2d 395 (claims for coverage under four policies comprising a comprehensive commercial insurance package, including a primary liability policy, an umbrella policy, and a workers' compensation and employers' liability policy).

insurance, since they afford coverage to the insured for legal liabilities to third persons that may arise in the future. The scope of coverage is defined by the written contract (the policy), which must be read carefully and in its entirety. Although I use the language of the CGL policy to provide examples of the concepts and principles that I will be discussing, liability policies generally follow the same basic format.

The Insurance Services Office's ("ISO")²² CGL policy (10/93 edition) follows a straightforward format. Section I sets forth the Coverages provided by the policy. Each coverage is stated in terms of an Insuring Agreement that defines the grant of coverage and Exclusions that limit the scope of the Insuring Agreement. Section II defines the persons and entities who are insured under the policy. Section III defines the limits of insurance, as expressed in the dollar amounts set forth on the Declarations page of the policy. Section IV sets forth conditions of the insurance contract, including rights and duties of both the insurer and the insured. Finally, and of great importance, Section V provides definitions of the key terms used throughout the policy. In the subsections that follow, I discuss basic legal principles that govern the interpretation of a liability policy. I will focus on selected topics that arise when considering the four general questions raised by coverage litigation: (1) is the claim within the scope of coverage, (2) do any exclusions eliminate or restrict such coverage, (3) has the insured complied with its duties under the policy, and (4) has the insurer complied with its duty to provide a defense of the action and to pay losses for a covered event?

One important caveat is in order. The ISO regularly amends its standard policy forms and regularly creates optional endorsements. Additionally, insurance carriers may draft their own policies or endorsements that differ from the current ISO forms. Although the foundational legal principles discussed in this section are unlikely to change in the near future, the specific policy language used as examples may very well differ from the terms contained in a particular CGL policy. Thus, the growing body of case law interpreting the availability of coverage for employment related disputes must be reviewed carefully, since the decisions in many of these cases—even cases only several years old—are predicated on policy lan-

22. Insurance Services Office, Inc. is a national insurance industry service organization that develops and files coverage forms, promulgates advisory loss costs, and performs other services for and on behalf of its member companies.

guage no longer used by many insurance carriers. As is always the case in analyzing a contract, painstaking attention must be paid to the precise terms of the contract before researching applicable legal precedent.

A. Coverage

The CGL policy is not an “all risks” policy that insures against any and all claims and losses suffered by the employer. Instead, the CGL policy obligates the insurer to assume only certain specified risks. Consequently, the Insuring Agreement simultaneously grants coverage and also limits coverage. The CGL policy consists of three separate grants of coverage, the first two of which are pertinent to employment related claims. The Insuring Agreement of Coverage A provides coverage for damages resulting from “‘bodily injury’ or ‘property damage’” and “caused by an ‘occurrence’.” In the employment litigation context, the requirement of “bodily injury” is crucial because an employee may allege only economic or reputational injury. Moreover, the definition of “occurrence” as an “accident” is also important because it would appear to preclude coverage of claims when the employee alleges that her injuries resulted from actions—such as termination of employment—intended by her employer.

The Insuring Agreement of Coverage B provides coverage for damages resulting from “‘personal injury’ or ‘advertising injury,’” without a limitation to accidental occurrences. The policy definition of “personal injury” makes clear that Coverage B provides coverage for non-bodily injuries arising out of one or more of the listed torts, including libel and slander. Given the increasing frequency of defamation claims being added to employment claims, many employers rely upon Coverage B to demand coverage.

Courts employ basic insurance law principles to determine whether the employee’s complaint potentially asserts that she has suffered a bodily injury caused by an accident, a personal injury, or both. Courts uniformly read Insuring Agreements broadly, reasoning that the insurance company has unilaterally drafted the policy from a position of far greater sophistication and understanding of the underwriting process than the average insured. The following quote is representative of the boilerplate analysis used by courts in assessing coverage: “Contract terms should be read as a reasonable person in the insured’s position would have understood them. . . . The insurer has an affirmative duty to define coverage limitations in

clear and explicit terms. . . . An insurance contract is generally liberally construed against the insurer.”²³ The principle coverage battles under the CGL policy in the context of employment related suits, then, generally concern how broadly the courts will read the terms “bodily injury,” “occurrence,” and “personal injury” in favor of the employer. These specific coverage issues under the CGL policy, and similar coverage issues under other liability policies, are analyzed by the articles in this symposium.

B. *Exclusions*

If coverage is afforded by the Insuring Agreement, it then is necessary to determine whether the policy excludes the particular risk from coverage. Insurers regularly define the scope of coverage in relatively inclusive terms, and then set forth specific limitations on this broad grant of coverage to tailor the risk assumed under the policy. Exclusions may be classified generally as serving one or more of the following interests: (1) designating certain risks as better covered elsewhere, i.e., with a different insurance product, (2) designating certain risks as insurable only upon the payment of an additional premium, and (3) designating certain risks as uninsurable in the standard market, or in some cases uninsurable in the insurance market as a whole. Because an exclusion works to “take back” a grant of coverage, courts narrowly construe the language of the exclusion and may shift the burden of proof to the insurer to prove that the otherwise covered risk has been excluded.²⁴

Coverage A (“bodily injury” caused by an “occurrence”) includes fourteen exclusions, at least three of which may affect coverage for employment related claims. The “Expected or Intended Injury” exclusion excludes a class of uninsurable risks, such as an insured committing an unprovoked battery with the intent to cause bodily injury; additionally, the exclusion removes certain insurable intentional torts from coverage that are better covered elsewhere, namely under Coverage B. The “Workers’ Compensation” and

23. *Lapeka, Inc. v. Security Nat’l Ins. Co.*, 814 F. Supp. 1540, 1544-45 (D. Kan. 1993) (determining that unintentional discrimination may be an “occurrence,” but that the plaintiffs did not suffer “bodily injury” as a result) (citations omitted).

24. *Western Heritage Ins. Co. v. Magic Years Learning Ctrs. and Child Care, Inc.*, 45 F.3d 85, 88 (5th Cir. 1995) (noting that under Texas law exclusions are construed even more strictly against the insurer than coverage provisions); *Lapeka, Inc.*, 814 F. Supp. at 1545 (noting that the distinction between coverage and exclusionary provisions is determinative of the burden of proof under Kansas law); *Motor Panels, Inc. v. Birmingham Fire Ins. Co.*, No. 3:91CV7198, 1991 WL 516545, at *2 (N.D. Ohio Nov. 27, 1991).

“Employers’ Liability” exclusions in Coverage A both serve to remove coverage on the basis that the risks are better covered elsewhere, namely the Workers’ Compensation and Employers’ Liability Policy. However, the broad language excluding “bodily injury to an employee . . . arising out of and in the course of employment” likely will exclude some risks that are not within the plain meaning of the Workers’ Compensation and Employers’ Liability coverage, thereby rendering certain claims uninsurable in the standard market.²⁵

The exclusions in Coverage B are less pertinent to employment litigation generally, but the exclusion of personal injury “arising out of the willful violation of a penal statute or ordinance committed by or with the consent of the insured” designates an uninsurable risk that may be relevant to some employment claims.²⁶ Finally, the ISO “Employment-Related Practices Exclusion” endorsement (10/93 edition), designed to amend both Coverage A and Coverage B, represents an attempt by insurers to remove most employment litigation from the scope of basic coverage provided by the CGL policy. If this exclusion is used by an insurer in conjunction with the emerging optional endorsement for “Employment Practices Liability” coverage, it would represent the insurer’s decision that the risk of employment-related claims will be assumed only for an additional premium. At present, however, several insurers have responded to the tremendous increase in coverage litigation brought by employers by amending their policies to include various forms of employment practices related exclusions, leaving these risks uninsurable except under “surplus lines” insurance products in the specialty market.²⁷ Insurers have been successful in enforcing these exclusions, and so it should be expected that liability policies will include such clauses with increasing frequency.²⁸

25. *Ottumwa Hous. Auth. v. State Farm Fire & Casualty Co.*, 495 N.W.2d 723, 727 (Iowa 1993).

26. *See, e.g., MGM, Inc. v. Liberty Mut. Ins. Co.*, 855 P.2d 77, 80 (Kan. 1993) (enforcing exclusion by denying coverage to an employer that subjected its employees to wiretaps that were illegal under the federal criminal code).

27. *Machson & Monteleone*, *supra* note 8, at 711-13.

28. *See, e.g., Transamerica Ins. Co. v. Superior Court*, 35 Cal. Rptr. 2d 259 (1994) (exclusions in Workers’ Compensation and Employers’ Liability Policy), *reh’g denied*, 40 Cal. Rptr. 2d 808 (1995); *Teague Motor Co. v. Federated Serv. Ins. Co.*, 869 P.2d 1130 (Wash. Ct. App. 1994) (exclusion of employment discrimination from umbrella policy); *Old Republic Ins. Co. v. Comprehensive Health Care Assoc., Inc.*, 2 F.3d 105 (5th Cir. 1993) (enforcing “sexual abuse” exclusion and “employment-related claim” exclusion in CGL policy and enforcing an “employment” exclusion in umbrella policy);

C. *Insured's Duties: Notice and Cooperation*

The conditions section of the CGL policy is designed to create a claim settlement process that ensures effective protection under the policy for the employer, while also affording the insurer the information it needs to settle the employer's claim properly. The employer's principal duties under the policy are to provide timely notice of the potentially covered occurrence and to cooperate with the insurer's investigation and defense of the action. The notification requirement provides that the employer must notify the insurer "as soon as practicable of an occurrence or an offense which may result in a claim" by providing the known details of the occurrence. Additionally, the employer must notify the insurer as soon as practicable of any claim or suit to which the policy applies by immediately sending "copies of any demands, notices, summonses or legal papers." This latter duty is particularly important, since the insurer is under the obligation to defend the insured in the suit and is entitled to conduct the litigation.

The employer's failure to comply with its obligations under the contract certainly will impair the settlement process and may establish a defense to enforcement of the policy in favor of the insurer. Generally, courts are hesitant to deprive the third party claimant of a source of funds to satisfy a judgment solely on the basis of the insured's failure to comply with the notice provisions of the policy. In many jurisdictions, therefore, the insurer is excused from performance under the policy only if the delay in notice has prejudiced its efforts to investigate and defend the claim.²⁹ However, the insurer's duty to provide a defense to the employer does not benefit the third-party claimant directly. Consequently, courts may be more willing to preclude an employer from obtaining reimburse-

Reliable Springs Co. v. St. Paul Fire & Marine Ins. Co., 869 F.2d 993 (6th Cir. 1989) (enforcing "discrimination and unfair employment practices" exclusion).

29. KEETON & WIDISS, *supra* note 9, at § 7.2(e) (describing the balancing test employed by many courts to determine whether a failure to provide notice prejudices the insured sufficiently to warrant denying a source of funds to the third party claimant by excusing the insurer of its duty to pay damages on behalf of the insured); ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 404-07 (1987) ("The approach requiring the insurer to demonstrate it was prejudiced is obtaining an increasing following."). See, e.g., Twin City Fire Ins. Co. v. King County, 749 F. Supp. 230 (W.D. Wash. 1990) (employer was denied coverage under policy because insurer was prejudiced when the employer failed to notify the insurer of the suit until three years after it was filed, four months after the plaintiff's verdict at trial, and only one day prior to a court-arranged conference to settle the appeal, despite the employer's claim that it reasonably believed that its exposure in the case would not exceed the applicable deductible), *aff'd*, 942 F.2d 794 (1991).

ment of its defense costs when it unreasonably delays providing notice of the suit to the insurance carrier.³⁰ Therefore, it is vital that the employment lawyer assist the employer in identifying any and all liability policies that potentially provide coverage for an occurrence or claim as soon as possible, thus enabling the employer to provide prompt notice to the pertinent carriers in order to facilitate the claim processing and to preserve its right to secure reimbursement for any defense costs incurred until such time as the insurer assumes the defense.

D. *Insurer's Duties: Defense and Indemnification*

The principal obligation of the insurer is to pay covered losses. The CGL policy provides that the insurer "will pay those sums that the insured becomes legally obligated to pay as damages" for covered losses. This obligation is straightforward. Although complex disputes may arise over whether the losses are covered under the policy, the insurer's duty to pay damages on behalf of the insured usually is not controversial once these matters have been adjudicated.³¹ An important exception is the line of "bad faith" cases that involve an insurer refusing to settle a pending claim within the pol-

30. See, e.g., *SL Indus., Inc. v. American Motorists Ins. Co.*, 607 A.2d 1266, 1272-73 (N.J. 1992). In *SL Industries*, the employee had sued for age discrimination, and the carrier had denied coverage on the ground that no "bodily injury" or "personal injury," as those terms were defined in the policy, had occurred. Discovery revealed that the employee was seeking recovery for emotional pain and suffering, for which he had received treatment. The insured did not disclose this information to the insurer for another two years. The court stated that the duty to defend is inextricably linked with the insurer's right to control the litigation, a right which could no longer be enforced with respect to the prior two years of litigation. Consequently, the court held that "when the insured's delay in providing relevant information prevents the insurer from assuming control of the defense, the insurance company is liable only for that portion of the defense costs arising after it was informed of the facts triggering the duty to defend." *Id.*

31. Refusing to indemnify the employer after the litigation has ended with a verdict that falls within the coverage of the policy will likely render the insurer subject to a tort action for bad faith. See, e.g., *Bugni v. Employer's Ins. of Wausau*, 405 N.W.2d 84 (Wis. Ct. App. 1987). In *Bugni*, the insured employer sued for bad faith breach when the primary and excess carriers refused to indemnify him for his defense expenditures and the jury verdict entered in favor of the employee. The court held that the jury verdict—finding a wrongful discharge but no bad faith on the part of the employer—eliminated the insurer's arguments that the allegations concerned intentional actions excluded by the policy. "[W]e conclude that, once the federal verdict was rendered, none of the defenses the [insurer] asserted had a reasonable basis in the law. None of the propositions upon which [the insurer] founded its refusal to pay was fairly debatable." *Id.* The case was remanded for further fact-finding regarding the bad faith claim.

icy limits, thereby exposing the insured to excess liability.³²

In contrast to the duty to pay damages, the insurer's "right and duty" to defend the employer in suits seeking such damages raises more complex issues. The Insuring Agreements for Coverages A and B provide that the insurance company "will have the right and duty to defend any suit seeking" damages that fall within the coverage provisions. Employment-related litigation often involves fact-specific claims arising in an unsettled or contested area of law. The resulting extensive discovery and motion practice means that defense costs often are as substantial as the ultimate recovery or settlement obtained by the employee. Thus, the insured's obligation to provide a defense is an extremely important part of the Insuring Agreement. Although many states continue to measure the insurer's duty to defend solely against the allegations of the underlying complaint, other states have more broadly interpreted the clause to require that the duty to defend be assessed in light of all

32. The landmark case establishing the modern cause of action for "bad faith" in insurance claims settlement involved an insurer that failed to take account of its insured's interests when it declined to settle the case within the policy limits, thereby subjecting the insured to liability in the amount that the judgment exceeded the policy limits. *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198 (Cal. 1958). Although premised on the general duty of good faith and fair dealing implied in every contract, *id.* at 200, insurance carriers are subjected to tort damages when they breach this contractual duty. *Cf. Foley v. Interactive Data Corp.*, 765 P.2d 373 (Cal. 1988) (refusing to extend tort damages beyond the insurance context, holding that only contract damages are available to an employee suing his employer for a breach of the implied covenant of good faith and fair dealing). The unique "bad faith" cause of action in the insurance context "evolved as a means of imposing sanctions on insurers whose negligence or intentional misconduct frustrate the smooth functioning of the insurance mechanism." STEPHEN S. ASHLEY, *BAD FAITH ACTIONS: LIABILITY AND DAMAGES* § 1.11 (1994). If not subjected to tort damages, insurers would be free to withhold a reasonable settlement offer in an effort to obtain a defendant's verdict at trial, knowing that their exposure for this calculated risk is "capped" by the policy limits. *Id.* at § 2.03.

The "bad faith" doctrine was raised in an interesting manner by an employer in *Ottumwa Hous. Auth. v. State Farm Fire & Casualty Co.*, 495 N.W.2d 723 (Iowa 1993). In *Ottumwa*, the employee had sued for sex discrimination and filed a claim for workers' compensation benefits. The insurer defended the workers' compensation claim but refused to defend the discrimination suit under either the Workers' Compensation policy or the CGL policy. The employee eventually withdrew her claim for workers' compensation benefits in the face of a vigorous defense and pursued only her civil claims. The employer claimed in later litigation against the insurer that the insurer had acted in bad faith by refusing to settle the workers' compensation claim, on the theory that settlement of the workers' compensation claim would have assisted with the disposition of the civil claim. The court made short work of responding to this assertion: "Because there was no basis for [the employee's] workers' compensation claim, State Farm—under the duty to defend provision—had every right to defend the claim in the way it did." *Id.* at 730.

relevant extrinsic facts.³³ As one court recently explained, the liberal rule is warranted because employers “expect their coverage and defense benefits to be determined by the nature of the claim against them, not by the fortuity of how the plaintiff, a third party chooses to phrase the complaint.”³⁴ Even when judged only against the allegations in the complaint, the general rule is that the duty to defend is triggered when the potential exists for the employee to prevail against an insured on the basis of a covered occurrence or claim.³⁵

33. See generally 7C JOHN A. APPLEMAN, *INSURANCE LAW AND PRACTICE* § 4683 (Berdal ed., 1979, West Supp.). For example, Texas and Indiana have held to the “four corners” rule in the face of change, limiting the duty of defense to cases in which the complaint pleads a covered injury. *Old Republic Ins. Co. v. Comprehensive Health Care Ass’n, Inc.*, 2 F.3d 105, 107 (5th Cir. 1993); *Transamerica Ins. Servs. v. Kopko*, 570 N.E.2d 1283, 1285 (Ind. 1991) (rejecting the liberal test adopted by the court of appeals). In contrast, California has adopted the more liberal test, construing the duty to defend to be implicated when either the facts alleged in the complaint or extrinsic facts raise the potential that the complaint might later be amended to seek recovery for a covered injury. *Gray v. Zurich Ins. Co.*, 419 P.2d 168, 177 (Cal. 1966) (The duty to defend is based on the “facts which the insurer learns from the complaint, the insured, or other sources. An insurer, therefore bears a duty to defend its insured whenever it ascertains facts which give rise to the potential of liability under the policy.”).

34. *SL Indus., Inc. v. American Motorists Ins. Co.*, 607 A.2d 1266, 1272 (N.J. 1992). One commentator notes that this rule “is sensible: an insurer should not be allowed to escape its obligations by ignoring true facts, simply because the plaintiff failed to allege them.” JERRY, *supra* note 29, at 563. See, e.g., *American Guar. and Liab. Ins. Co. v. Vista Medical Supply*, 699 F. Supp. 787, 794 (N.D. Cal. 1988) (duty to defend is triggered when employee alleges in her declaration in support of the complaint that the employer made false statements to humiliate her, although the complaint does not allege facts giving rise to potential liability for defamation). The liberal rule is required in states that have adopted notice pleading, since the complaint in these jurisdictions is an unreliable gauge of the facts forming the basis of the plaintiff’s claims. *Great Am. Ins. Co. v. Hartford Ins. Co.*, 621 N.E.2d 796, 798 (Ohio Ct. App. 1993). Of course, the “liberal” rule might work in the insurer’s favor if the complaint potentially triggers coverage, but the facts surrounding the matter establish that no coverage under the policy in fact is triggered. See, e.g., *Northern Ins. Co. of New York v. Morgan*, Nos. 1 CA-CV 92-0020, 1 CA-CV 92-0553, 1995 WL 564722 at *2 (Ariz. Ct. App. Sept. 26, 1995) (holding that the insurer had no duty to defend because the sexual conduct in question either was intentional and excluded from coverage or was consensual and therefore nonactionable, regardless of the phrasing of the allegations in the complaint).

35. Compare *Ellis v. Transcontinental Ins. Co.*, 619 So. 2d 1130 (La. Ct. App. 1993) (wrongful discharge claim premised on retaliation for assertion of FLSA rights triggered the duty to defend because the retaliatory actions pleaded in the complaint included invasions of privacy, humiliation and discrimination) with *French Cleaners, Inc. v. Aetna Casualty & Sur. Co.*, No. CV 92-0518285, 1995 WL 91423, at *4 (Conn. Super. Ct. Feb. 17, 1995) (no coverage for age discrimination claim that alleged no defamatory statements by the employer that caused injury: “A different question might have been presented if [the employee] had sought damages for injury to her professional reputation as a result of [the employer’s] allegedly discriminatory treatment of her on account of her age.”).

It is universally acknowledged that the duty to defend is broader than the duty to pay losses under the policy. This is true in a very obvious sense, given that the insurer promises to defend any suit alleging damages covered by the policy, whereas the insurer will not have to pay any sums if the employer prevails in the litigation.³⁶ The breadth of the duty to defend is more expansive than the duty to pay in other important respects as well. First, the general rule is that a complaint that raises one claim within the policy coverage generally triggers a duty to defend the insured against all claims asserted in the complaint, due to the difficulty of bifurcating control over the litigation or of later apportioning the costs when the case involves a number of interlocking and overlapping claims.³⁷ Moreover, the policy provides that the duty to defend ter-

36. In California, which has adopted the extrinsic facts test of the duty to defend, the rule is summarized as follows:

The duty to defend arises as long as the facts (either expressed or implied in the third party's complaint, or as learned from other sources) give rise to a potentially covered claim, even though the insurer's investigation produces facts showing the claim is baseless. It is the insurer's duty to prove the allegations false.

Devin v. United Serv. Auto. Ass'n, 8 Cal. Rptr. 2d 263, 268 (Cal. Ct. App. 1992) (citations omitted). See also *City of Old Town v. American Employers Ins. Co.*, 858 F. Supp. 264, 269 (D. Me. 1994); *Intermountain Gas Co. v. Industrial Indemn. Co.*, 868 P.2d 510, 513 (Idaho Ct. App. 1994).

37. See, e.g., *Vienna Family Medical Assoc., Inc. v. Allstate Ins. Co.*, 872 F. Supp. 1509 (S.D. W. Va. 1995) (insurer had duty to defend seven count complaint brought by former employee, although many of the asserted claims did not fall within the coverage provisions); *Wong v. State Compensation Ins. Fund*, 16 Cal. Rptr. 2d 1 (Cal. Ct. App. 1993) ("If a complaint states several possible theories of recovery, the insurer must defend the entire claim unless and until the insurer is able to limit the complaint to theories for which it has provided no insurance."); *Great Am. Ins. Co. v. Hartford Ins. Co.*, 621 N.E.2d 796, 800 (Ohio Ct. App. 1993). But see *Great American*, 621 N.E.2d at 801-02 (Ford, P.J., dissenting) (arguing that the court should more strictly assess whether covered and non-covered claims arise from the same occurrence); *SL Industries*, 607 A.2d at 1280 (holding that the duty to defend arises only with respect to covered claims and rejecting the majority rule presuming that these costs cannot be apportioned between insurer and insured).

A collateral effect of broadly construing the duty to defend in this way is to raise a significant conflict of interest between the insurer conducting the litigation and the employer/defendant. Because the insurer will only be obliged to pay covered damages awarded in the suit, it has a financial interest in ensuring that a verdict will be more heavily weighted toward non-covered claims. Given this conflict, states adopt a variety of responses, including: allowing the insured to select the defense counsel, requiring the insurer to reimburse the employer's counsel to monitor the litigation, or simply ignoring the potential for conflict altogether. Eric M. Holmes, *A Conflicts-of-Interest Roadmap for Insurance Defense Counsel: Walking an Ethical Tightrope Without a Net*, 26 WILAMETTE L. REV. 1 (1989); Todd R. Smyth, Annotation, *Duty of Insured to Pay for Independent Counsel When Conflict of Interest Exists Between Insured and Insurer*, 50 A.L.R. 4TH 932 (1986 & Supp. 1994).

minates when the policy limit has been exhausted “in the payment of judgments or settlements,” and so many courts hold that the insurer cannot refuse to provide a defense in ongoing litigation even if it has agreed to pay the policy limits into court to be applied against the eventual judgment or settlement.³⁸ Finally, as analyzed in the next section of this article, courts have employed the doctrine of reasonable expectations to expand the duty to defend.

Wrongfully refusing to provide a defense is a breach of contract by the insurer. In subsequent coverage litigation, the employer is entitled to reimbursement of its defense expenditures, in addition to indemnification for covered judgments or settlements. Additionally, the employer may be entitled to recover the attorneys’ fees and costs incurred in securing this reimbursement.³⁹ Many jurisdictions hold that an insurer that wrongfully refuses to provide a defense will be “estopped from raising noncoverage as a defense under the indemnity provisions of the policy.”⁴⁰ This remedy potentially is significant, since the duty to defend is broader than the duty to indemnify. Consequently, if an insurer has a duty to defend an employer, but the litigation ultimately establishes that the employer is liable only for non-covered events, an insurer that fails to provide the defense will be required to reimburse the employer notwithstanding the absence of a covered occurrence. Additionally, if the employer resolves the matter by settlement, this same logic leads some courts to preclude the insurer from challenging the amount of the settlement or attempting to allocate it among covered and non-covered claims.⁴¹ Consequently, a prudent insurer will either assume the defense under a reservation of rights to later deny coverage and seek reimbursement or will seek a declaratory judgment of its obligations immediately.⁴² Finally, some courts have extended the “bad faith” analysis to apply to the insurer’s re-

38. JERRY, *supra* note 29 at 574-75. Cf. *Ellis*, 619 So. 2d 1130 (holding that CGL and umbrella carriers who refused to defend an action where some of the allegations potentially came within the policy coverage were liable for the attorney fees expended by the insured and the settlement paid to the employee, subject to the trial court’s assessment of the reasonableness of those sums).

39. See, e.g., *Jostens, Inc. v. Mission Ins. Co.*, 387 N.W.2d 161, 168 (Minn. 1986).

40. *Society of Mount Carmel v. National Ben Franklin Ins. Co.*, 643 N.E.2d 1280, 1292 (Ill. App. Ct. 1994) (noting the congruity of Illinois and California law on this point).

41. JERRY, *supra* note 29, at 579-84.

42. For an example of a case where the insurance company gambled and won, see *Zack Co. v. Liberty Mut. Ins. Co.*, No. 93-7015, 1995 WL 33135, at *2 (N.D. Ill. Jan. 25, 1995) (insured argued that failure of insurer to seek declaratory judgment or to provide a defense under a reservation of rights estopped the insurer from denying coverage;

fusal to provide a defense, presumably on the ground that even the foregoing remedies may be insufficient to prevent the insurance company from strategically refusing to expend large amounts in defense costs until forced to do so by an employer who brings suit.⁴³

The burden of the duty to defend is accepted by insurers in order to obtain the extremely valuable right to control the litigation and disposition of the underlying claim. This control is crucial in the employment litigation setting, since emotions often run high. Recently, the United States Court of Appeals for the Third Circuit held that a law firm could not prevent its liability insurer from settling a hostile environment and sexual harassment suit.⁴⁴ Although the firm argued that the litigation was groundless and that settling the suit would injure its reputation, and also that the settlement would preclude it from pursuing a later suit for malicious prosecution, the court permitted the insurer to settle with the plaintiff based on the clear provisions in the policy.⁴⁵ As the court noted, an employer wishing to retain control over settlement of cases (as many professionals choose to do in their malpractice policies) must purchase a policy that affords this right.⁴⁶

however, the court found that complaint filed by insured's employee did not trigger the duty to defend, thereby relieving insurer of any obligations).

43. See, e.g., *Tibbs v. Great Am. Ins. Co.*, 755 F.2d 1370 (9th Cir. 1985) (affirming an award of \$600,000 punitive damages for breach of the duty to defend); *State Farm Fire & Casualty Co. v. Price*, 684 P.2d 524, 532 (N.M. Ct. App. 1984) (remanding case to determine whether the insurer's breach of the duty to defend amounted to closing its eyes to the facts and acting in bad faith).

In the employment setting, it appears likely that an insurer's denial of coverage will be premised on a good faith objection to the insured's reading of the policy, given the sharply contested legal issues involved. See, e.g., *Vienna Family Medical Assoc., Inc. v. Allstate Ins. Co.*, 872 F. Supp. 1509, 1514 (S.D.W. Va. 1995); *Clark-Peterson Co. Inc. v. Independent Ins. Assoc., Ltd.*, 514 N.W.2d 912, 916 (Iowa 1994):

Defendants were not overly litigious, they merely believed no coverage existed under the policy, a contention with which we initially agreed. Once a final determination was made, the defendants promptly paid the entire claim. Even prior to this, [the insurer] paid attorney fees in the underlying defense and paid half the judgment at the termination of trial, reserving the right to reclaim the fees and portion of the judgment paid. With this degree of cooperation it cannot be said that defendants were overly litigious. . . . The coverage was reasonably debatable in view of our final determination.

Id. (citation omitted).

44. *Caplan v. Fellheimer Eichen Braverman & Kaskey*, 68 F.3d 828 (3d Cir. 1995).

45. *Id.* at 839.

46. *Id.* at 839-40 ("It is not appropriate for us to amend the policy here in order to give [the insured] a type of coverage for which it didn't contract.").

III. INTERPRETING THE INSURANCE CONTRACT

Coverage is determined not only by interpreting the terms of the insurance contract as written, but also by applying judicially-created doctrines that may expand the insured's rights beyond a strict reading of the policy language. As one leading commentator has summarized, "[j]udges in insurance cases not only make insurance law; sometimes they also make insurance."⁴⁷ Conversely, courts will refuse to enforce an insured's rights under even an unambiguous insurance policy if such enforcement would violate public policy. In such a case, it is appropriate to say that sometimes judges also "unmake" insurance. In this section of the Article, I provide a basic overview of these two key principles that govern interpretation of the terms of an insurance contract.

A. *From Contra Proferentem to Reasonable Expectations: Judge-Made Insurance*

If a written contract contains an ambiguity, it is a well-settled maxim that the courts generally will prefer the interpretation favoring the party who did not draft the language in question.⁴⁸ Although not limited to cases involving adhesion contracts, the maxim *contra proferentem* is followed more rigorously when a significant disparity of bargaining power exists between the parties, and the stronger party supplies all of the terms of the written contract. This, of course, is the situation in the typical insurance transaction, even in the case when a business entity is purchasing commercial insurance.⁴⁹ Consequently, an employer asserting coverage should prevail if it is able to demonstrate that *one* reasonable reading of the policy provides coverage, even if the employer's interpretation is not the only, or even the most, reasonable manner in which to construe the policy language.⁵⁰ This rule of interpretation

47. ABRAHAM, *supra* note 10, at 101.

48. The maxim, *omnia praesumuntur contra proferentem*, is widely cited and is embodied in RESTATEMENT (SECOND) OF CONTRACTS § 206 (1981).

49. Of course, very large commercial entities (including, of course, insurance companies) are sometimes able to negotiate insurance coverage in a manner that more closely resembles contract negotiation between two parties having equal competence, expertise, and bargaining power. See, e.g., *Falmouth Nat'l Bank v. Ticor Title Ins. Co.*, 920 F.2d 1058, 1061-62 (1st Cir. 1990) (general rules of construction regarding insurance policies do not apply to a case involving a sophisticated insured that had negotiated specific terms in the policy tailored to a particular lawsuit).

50. "There are literally thousands of judicial opinions resolving insurance coverage disputes in favor of claimants on the basis that a provision of the insurance policy at issue was ambiguous and therefore should be construed against the insurer." KEETON

provides one of the justifications for the universal judicial practice of reading coverage provisions broadly and exclusions narrowly.

Twenty-five years ago, however, commentators began to recognize that the courts were interpreting insurance contracts in a manner that could not be explained solely by the maxim *contra proferentem*. In a path breaking article, then Professor Robert Keeton articulated the “doctrine of reasonable expectations” to explain the interpretive approach increasingly taken by courts since the early 1960s.⁵¹ Judge Keeton summarizes the doctrine in his treatise as follows: “In general, courts will protect the reasonable expectations of applicants, insureds, and intended beneficiaries regarding the coverage afforded by insurance contracts even though a careful examination of the policy provisions indicates that such expectations are contrary to the expressed intention of the insurer.”⁵²

& WIDISS, *supra* note 9, at § 6.3(a)(2). See, e.g., *Western Heritage Ins. Co. v. Magic Years Learning Ctr. and Child Care, Inc.*, 45 F.3d 85, 88 (5th Cir. 1995) (holding that a policy provides coverage for a claim of sexual harassment when a “physical abuse” coverage endorsement renders later exclusions ambiguous, since the court must adopt the construction of the policy urged by the insured so long as it is not unreasonable); *Trustees, Missoula County Sch. Dist. No. 1 v. Pacific Employer’s Ins. Co.*, 866 P.2d 1118, 1124 (Mont. 1993) (holding that a policy exclusion of damages paid for sums owed pursuant to a contract was ambiguous with regard to the employee’s statutory claims for bad faith termination and recovery of lost wages and must be read in favor of the employer).

51. Robert Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970).

52. KEETON & WIDISS, *supra* note 9, § 6.3(a)(3). For commentary on the doctrine, see Laurie Kindel Fett, Note, *The Reasonable Expectations Doctrine: An Alternative to Bending and Stretching Traditional Tools of Contract Interpretation*, 18 WM. MITCHELL L. REV. 1113 (1992) (student note exploring the doctrine under Minnesota law); Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823 (1990) (providing a detailed historical account of the doctrine and asserting that the doctrine is principled and can be applied within justiciable guidelines); Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461 (1989) (student note providing a “law and economics” critique of the doctrine); Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 392 (1986) (arguing for refinements to the doctrine in response to the fading appeal that the doctrine holds for courts and commentators and contending that courts should “discard their unfortunate tendency to speak the platitudes of reasonable expectations without undertaking a careful and systematic analysis”); William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267, 287-96 (1986) (formulating standards for applying the doctrine); Scott B. Krider, *The Reconstruction of Insurance Contracts Under the Doctrine of Reasonable Expectations*, 18 J. MARSHALL L. REV. 155 (1984) (student note arguing that regulatory efforts address the underlying problems in the insurance industry in a manner superior to judicial use of reasonable expectations); William Mark Lashner, *A Common Law Alternative to the Doctrine of Reasonable Expectations in the Construction of Insurance Contracts*, 57 N.Y.U. L. REV. 1175, 1208 (1982) (student note arguing that “any provision which undercuts the bargained-for insurance coverage must [be] specifically ex-

In other words, even when the policy language unambiguously precludes coverage, under certain circumstances courts will hold that coverage exists.⁵³

Professor Abraham has organized the “reasonable expectations” line of cases in a persuasive manner by suggesting that there are two distinct applications of the doctrine.⁵⁴ In “misleading impression” cases, the courts find that the insurer has in some manner influenced the insured to believe that coverage exists despite the precise terms of the policy. These cases represent a logical extension of the maxim *contra proferentem* by acknowledging that in some instances it may be unjust to enforce even unambiguous policy terms, given the nature of the bargaining process and relative bargaining strength of the parties.⁵⁵ In “mandated coverage” cases, by contrast, the courts determine that coverage is desirable and will be imposed despite the policy terms in order to effectuate a general goal of broader risk spreading. These latter cases stand “as criticism of the insurance market as a whole,” rather than an indictment of the insurer for misleading behavior and are best regarded as judi-

plained to the insured” to be enforceable); Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151 (1981) (article that served as the basis for the book chapter discussed in the text accompanying *infra* notes 54-56).

53. Courts traditionally invoke *contra proferentem* with the caveat that the doctrine is not a license for courts to rewrite the insurance contract between the parties. *See, e.g.*, *Lapeka, Inc. v. Security Nat'l. Ins. Co.*, 814 F. Supp. 1540, 1545 (D. Kan. 1993) (A court may not “torture words in order to import ambiguity” into the policy, nor may the court “make another contract for the parties. Its function is to enforce the contract as made.”). The doctrine of reasonable expectations breaks with this traditional limitation on the scope of contract interpretation. As Professor Henderson correctly states, decisions that rely on the doctrine of reasonable expectations “solely to construe policy language do not support a new principle at all. . . . The doctrine of reasonable expectations, if it involves a new principle at all, may apply without regard to any ambiguity. It may affect the substantive provisions of the policy, regardless of how the policy is drafted.” Henderson, *supra* note 52, at 827.

54. ABRAHAM, *supra* note 10, at 104.

55. Judge Keeton lists five “pragmatic reasons why coverage limitations that conflict with reasonable expectations ought not to be enforced even when the limitations are both explicit and unambiguous in policy forms,” all of which support the “misleading impression” cases. KEETON & WIDISS, *supra* note 9, at § 6.3(a)(4). The reasons offered are: (1) insurance contracts are complex documents that the average insured finds difficult to understand, (2) the insured receives a copy of the policy only after purchasing it, when the motivation to read the policy is minimal, (3) the insurer is able to exercise its expertise and superior bargaining power by inserting specific limitations in the policy that work an unconscionable advantage over the insured, (4) general marketing techniques engender expectations of comprehensive coverage, and (5) the insurance policy is titled and structured to emphasize coverage and downplay exclusions. *Id.*

cial creation of insurance.⁵⁶

1. "Misleading Impression" Cases

*Clark-Peterson Co., Inc. v. Independent Insurance Associates, Ltd.*⁵⁷ provides a good example of a court using the "misleading impression" application of the doctrine of reasonable expectations. Clark-Peterson suffered a substantial judgment in a suit brought by an employee alleging a discriminatory termination on the basis of his alcoholism. The policy provided coverage for "[p]ersonal [i]njury," defined to include "[d]iscrimination or humiliation;" however, the policy also limited this coverage to accidents which unintentionally cause such injury and later in the policy excluded liability for discrimination "committed by or at [Clark-Peterson's] direction."⁵⁸ The Iowa Supreme Court agreed with the trial court's finding that the employee's suit was "not covered under the precise wording of the policy," since the discriminatory termination in this case was an intentional act committed by Clark-Peterson.⁵⁹ Nevertheless, the court found that the insurer must provide coverage on the basis of the reasonable expectations doctrine.

In order to invoke the reasonable expectations doctrine under Iowa law, an employer must first demonstrate either that the policy is "such that an ordinary layperson would misunderstand its coverage" or that the employer's coverage expectations were fostered by "circumstances attributable to the insurer."⁶⁰ The court found that the ordinary layperson could reasonably expect coverage for such "an unusual and controversial liability, liability which no doubt came as a shock" to Clark-Peterson, given that the policy provided coverage for personal injury resulting from discrimination.⁶¹ The court distinguished intentional racial or sexual discrimination—conduct as to which no reasonable employer could expect coverage—from intentional discrimination on the basis of alcoholism, the conduct giving rise to liability in this case.⁶²

Nevertheless, the court emphasized that the doctrine is limited

56. ABRAHAM, *supra* note 10, at 109.

57. 492 N.W.2d 675 (Iowa 1992) (*en banc*).

58. *Id.* at 676 n.3.

59. *Id.* at 677.

60. *Id.*

61. *Id.* at 678.

62. The court expressed some sympathy for an employer who may have bona fide business reasons to fire an alcoholic employee, albeit illegal and discriminatory reasons. *Id.* at 678 n.6.

in scope, to the extent that bare reasonable expectations of coverage are not sufficient in themselves to override policy terms. Although acknowledging that the reasonable expectations doctrine "has become a vital part of our law interpreting insurance policies," the court stressed that the doctrine "does not contemplate the expansion of insurance coverage on a general equitable basis. The doctrine is carefully circumscribed; it can only be invoked where an exclusion '(1) is bizarre or oppressive, (2) eviscerates terms explicitly agreed to, or (3) eliminates the dominant purpose of the transaction.'"⁶³ The court held that the clear grant of coverage for claims relating to injuries resulting from discrimination was later eviscerated, even if not eliminated entirely, by other sections of the policy. Thus, *Clark-Peterson* was able to satisfy the second test. The court's rationale unambiguously was premised on the quasi-deceptive (even if benign) structure of the policy and the difference in expertise and bargaining power between the parties.

To deny discrimination coverage in the present case would be to withdraw with the policy's left hand what is given with its right. In a fundamental sense, of course, this is the proper function of any exclusion clause in an insurance policy. The reasonable expectations doctrine does no violence to this proper function by its limited intrusion into it. The doctrine means only that when, within its metes and bounds definition, an exclusion acts in technical ways to withdraw a promised coverage, it must do so forthrightly, with words that are, if not flashing, at least sufficient to assure that a reasonable policy purchaser will not be caught unawares.

The reasonable expectations doctrine is a recognition that insurance policies are sold on the basis of the coverage they

63. *Id.* at 677 (quoting *Aid (Mutual) Ins. v. Steffen*, 423 N.W.2d 189, 192 (1988)). The "misleading impression" cases probably encompass the more extreme cases in which an insured argues that the policy is "unconscionable" or provides "illusory coverage" for the premium charged. In *Clark-Peterson*, the court applied a test that sensibly combined the interest in upholding reasonable expectations with the interest in precluding the insurer from obtaining unconscionable advantages. Professor Keeton suggests that in order to avoid

claims based on either reasonable expectations or unconscionability, the insurer should be required to adopt measures which guarantee (1) either that the purchaser has actual expectations consistent with described coverage because the purchaser was made aware of the limitations during the marketing transaction, or that it would be unreasonable for an insured to have expectations that are not consistent with the insurance policy provisions, and (2) that the premium charged appropriately reflects the actual scope of risk that the policy provisions define.

KEETON & WIDISS, *supra* note 9, at 641-42.

promise. When later exclusions work to eat up all, or even substantially all, of a vital coverage, they cannot rest on technical wording, obscure to the average insurance purchaser. At some point fairness demands that the coverage clause itself be self-limiting.⁶⁴

Although the court rejected a purely equitable approach, the “fairness” of extending coverage beyond the policy terms was premised on the court’s belief that the insurer engendered reasonable expectations with its policy format.

It is useful to compare *Clark-Peterson* with *Jostens, Inc. v. Northfield Insurance Co.*⁶⁵ In *Jostens*, the Minnesota Court of Appeals rejected the employer’s argument that coverage should be afforded under the doctrine of reasonable expectations, based on its finding that the discrimination “coverage” provided by the umbrella policy was effectively negated immediately in the insuring agreement itself. The *Jostens* court held that the employer could have no reasonable expectation of coverage for discriminatory employment practices arising from the insurance market generally, nor from the terms of the policy, since the exclusionary language was included as part of the definition of “discrimination” in the insuring provision.⁶⁶ In short, the court refused to create insurance since the insurer did not contribute to any mistaken beliefs that an employer

64. *Clark-Peterson*, 492 N.W.2d at 679.

65. 527 N.W.2d 116 (Minn. Ct. App. 1995).

66. [W]e believe that the policy’s “except for” language immediately negated any legitimate expectation engendered. *Jostens* could not have been under more than a momentary delusion that the policy afforded coverage for the costs at issue, given the juxtaposition of the exclusions to the policy’s mention of discrimination; thus, the reasonable expectations doctrine does not provide coverage.

Id. at 118. The court also rejected the separate claim by the employer that the policy provided only illusory coverage for discrimination, holding that “the doctrine of illusory coverage is best applied . . . where part of the premium is specifically allocated to a particular type or period of coverage and that coverage turns out to be functionally nonexistent,” or where the employer reasonably believes that “some specific part of its premium was allocated to discrimination coverage.” *Id.* at 119. Because *Jostens* did not pay a separate premium for the extremely limited discrimination coverage and because the limited nature of the coverage was expressed in a manner that defeated any reasonable expectations that *Jostens* might hold to the contrary, the policy terms were enforced as written. *Cf. Fidelity and Guar. Ins. Underwriters, Inc. v. Everett I. Brown Co.*, 25 F.3d 484, 490 (7th Cir. 1994) (finding that the Indiana law of “illusory coverage”—limited to cases where a premium was paid for coverage that will not provide benefits under any set of reasonably expected circumstances—is inapplicable when the employer is covered for many potential claims under the terms of the policy); *Wayne Township Bd. of School Comm. v. Indiana Ins. Co.*, 650 N.E.2d 1205, 1212 (Ind. Ct. App. 1995).

reasonably could have held about the scope of coverage under the umbrella policy.

The “misleading impression” application of the reasonable expectations doctrine provides employers with a powerful tool to avoid a strict reading of the policy terms, but this theory is not unbounded. If the policy language and marketing techniques employed by the insurer scrupulously avoid engendering expectations on the part of the reasonable employer that the dispute in question is covered by the policy, then the insurance contract most likely will be enforced as written.

2. Mandated Coverage Cases

A more dramatic application of the reasonable expectations doctrine occurs when the court finds coverage despite the absence of any misleading conduct attributable to the insurer. Professor Abraham contends that the tremendous expansion of the insurer’s duty to provide a legal defense to the insured is an example of the “mandated coverage” application of the doctrine of reasonable expectations.⁶⁷ The California courts recently struggled with the “mandated coverage” application of the reasonable expectations doctrine in a series of cases that determined the scope of the duty to defend provision in workers’ compensation policies. In recent years, the California Supreme Court has held that civil claims for injuries resulting from the termination of employment, including emotional distress that does not result in a physical disability, are preempted by the exclusive remedy provided under workers’ compensation law.⁶⁸ On the basis of these cases, the California Court of Appeal decided that when an employee sues for wrongful discharge and claims damages for emotional distress caused by the termination, the employer is entitled to a defense of the civil action by its workers’ compensation carrier. The court reasoned that the employer “could reasonably have expected [the insurer] to assert the bar of workers’ compensation as an affirmative defense in the underlying case.”⁶⁹ Because it is questionable that a reasonable employer would expect its workers’ compensation carrier to defend a

67. Abraham discusses the seminal case in this area, *Gray v. Zurich Ins. Co.*, 419 P.2d 168 (Cal. 1966). ABRAHAM, *supra* note 10, at 110-12.

68. *Livitsanos v. Superior Court*, 828 P.2d 1195 (Cal. 1992); *Shoemaker v. Myers*, 801 P.2d 1054 (Cal. 1990).

69. *Wong v. State Compensation Ins. Fund*, 16 Cal. Rptr. 2d 1, 6 (Cal. Ct. App. 1993), *overruled by* *La Jolla Beach and Tennis Club, Inc. v. Industrial Indemnity Co.*, 36 Cal. Rptr. 2d 100, 884 P.2d 1048 (Cal. 1995) (en banc).

civil suit in which the employee makes no claim for benefits under the workers' compensation laws, this case is best understood as mandating a specific kind of coverage not otherwise available in the insurance market: protection against the costs of defending claims in civil suits that seek recovery for injuries compensable only under the workers' compensation statutes.⁷⁰ Needless to say, this case represented a dramatic expansion of the duty to defend provision in the Workers' Compensation Policy.

The scope of the duty to defend under a workers' compensation policy was finally resolved by the California Supreme Court in *La Jolla Beach and Tennis Club, Inc. v. Industrial Indemnity Co.*⁷¹ An employee of La Jolla filed suit alleging a racially discriminatory termination that also amounted to an intentional infliction of emotional distress. La Jolla tendered defense of the case to its workers' compensation carrier, which refused to defend the action. La Jolla pleaded the exclusivity of the workers' compensation remedy as an affirmative defense, settled the lawsuit with its employee before the issues were adjudicated, and then sought recovery from its insurer for breach of its duty to defend and for indemnification. The trial court entered summary judgment for the insurer, but the court of appeal reversed this judgment and found that the employer was entitled to a defense.⁷² The court expressed its reluctance to impose additional burdens on the workers' compensation system, but nevertheless found that the "wide-ranging obligation" of the duty to defend compelled the result it reached since the claimed injury of emotional distress "had the potential of coming within the scope of the Workers' Compensation Act [and] this potential would in turn give rise to a duty to defend."⁷³ The court reasoned that if the employer successfully established that it did not discriminate against its employee, but the employee nevertheless established that he suffered emotional distress as a result of the termination, the employee's suit eventually would be reduced to a claim for benefits under the workers' compensation statutes. Thus, the civil action raised the potential that the employee ultimately would be asserting a claim for benefits that would be covered under the workers' compensation insurance policy.⁷⁴

70. Cf. ABRAHAM, *supra* note 10, at 111.

71. 23 Cal. Rptr. 2d 656 (Cal. Ct. App. 1994), *rev'd*, 36 Cal. Rptr. 2d 100, 884 P.2d 1048 (Cal. 1995) (en banc).

72. *Id.*

73. *La Jolla*, 23 Cal. Rptr. 2d at 659, 661 (relying on *Wong*, 16 Cal. Rptr. 2d at 1.).

74. *Id.* at 662.

The California Supreme Court, en banc, reversed the court of appeal and found that no duty to defend existed on these facts. In its opinion the court quite clearly distinguished the different applications of the reasonable expectations doctrine regarding an insurer's duty to defend. First, the court acknowledged as a general matter that the reasonable expectations of the insured will be respected when the policy is "ambiguous" due to the language used or its placement in the policy.⁷⁵ The court found that the policy unambiguously promised only to defend any claim, proceeding, or suit for benefits under the workers' compensation law and that the underlying suit did not seek such benefits.⁷⁶ In short, the court found that the case did not fall within the "misleading impression" application of the doctrine of reasonable expectations.

However, the employer explicitly urged the court to employ a broader test of reasonable expectations by arguing that employers who purchase liability insurance packages (including CGL and workers' compensation policies) are entitled to receive the "seamless insurance protection" that they reasonably expect.⁷⁷ This more expansive claim amounts to a request that the courts mandate coverage to "fill the gaps" in the insurance package, an invitation that the supreme court refused in this case. The court found that the employer could not reasonably expect seamless coverage, especially since, by purchasing several different policies, the employer manifested its understanding that each policy was limited in scope.⁷⁸ The court further found that the underlying suit raised no potential for a covered judgment, since workers' compensation benefits may be awarded only through the administrative process established by the workers' compensation law. To hold otherwise, the court reasoned, would amount to converting the duty to defend in a workers' compensation policy into an unlimited litigation insurance policy.

There is always some possibility that facts alleged in one forum could, in the future, form the basis for a covered claim in a different action. Were this the test, however, *any* judicial or administrative action involving an employer-employee relationship could be characterized as a "predecessor" claim for workers' compensation benefits.

....

75. *La Jolla Beach and Tennis Club, Inc. v. Industrial Indem. Co.*, 36 Cal. Rptr. 2d 100, 106, 884 P.2d 1048, 1054 (Cal. 1995).

76. *Id.* at 108-09, 884 P.2d at 1056-57.

77. *Id.* at 109, 884 P.2d at 1057.

78. *Id.*

Rather, the test is whether the *underlying action for which defense and indemnity is sought* potentially seeks relief within the coverage of the policy. . . . Thus, the Court of Appeal fundamentally misconstrued the kind of potential coverage that gives rise to a duty to defend when it concluded that [the insurer] had a duty to defend the civil action merely because [the employee] might, at some indeterminate time in the future, file a workers' compensation claim that did fall within [the insurer's] coverage.⁷⁹

In short, the supreme court rejected the "mandated coverage" application of the reasonable expectations doctrine on the facts of the *La Jolla* case.

Nevertheless, it remains the case that the broad duty to defend under California law is premised on precisely the rationale that the supreme court rejected in *La Jolla*: that the substance of the claims, and not a third party claimant's erroneous pleading, should determine the scope of the duty.⁸⁰ The opinion of the court of appeal in *La Jolla*, then, appears to apply the reasonable expectations doctrine more consistently with the precedents and might be followed in other jurisdictions willing to accept the far-reaching ramifications of the "mandated coverage" application of the doctrine of reasonable expectations. The supreme court reversal probably represents the judgment that the harsh reality of the business and insurance environment in California should override the extension of reasonable expectations doctrine, which is to say that the court declined to mandate litigation coverage in a situation where to do so would

79. *Id.* at 110, 884 P.2d at 1058.

80. The court claimed to follow the analysis set out in the seminal duty to defend case, *Gray v. Zurich Ins. Co.*, 419 P.2d 168 (Cal. 1966), but there is no easy reconciliation of the two cases. In *Gray*, the insured was sued for maliciously and intentionally assaulting the plaintiff, and eventually suffered a plaintiff's jury verdict and an award of damages. Injuries to third persons resulting from the insured's intentional acts were not within the scope of coverage of the liability policy. However, the court held that the insurer breached its duty to defend, since the plaintiff "could have amended his complaint to allege merely negligent conduct," thereby triggering potential coverage under the policy. *Id.* at 177. There seems to be no principled basis for distinguishing between the possibility that a plaintiff might amend a civil claim in light of the insured's anticipated defense and the possibility that a plaintiff might withdraw a civil claim and refile it as a claim for workers' compensation benefits in light of the employer's defense to the claim. More importantly, if the employer's claim is *in fact* subject to the exclusive jurisdiction of the workers' compensation system, it appears only reasonable for an employer to expect its insurance carrier to secure a dismissal of the improperly filed civil action (or certain counts in the complaint) and to protect the employer's interests in the worker's compensation forum with respect to such claims. For this reason, *La Jolla* is perhaps best read as a decision by the court that it will not mandate litigation coverage when to do so would place enormous strains on the already overburdened workers' compensation system.

cause more harm than good. Despite this apparent resolution, there most certainly will be additional litigation in California regarding an employer's ability to secure a defense from its liability carriers for employment litigation, especially since the *La Jolla* court was careful to limit its analysis to the duty to defend under the workers' compensation portion of the policy and was also careful not to decide the scope of the duty to defend under the employer's liability portion of the policy.⁸¹

The doctrine of reasonable expectations is vitally important to employers seeking coverage for employment litigation, since a painstaking review of the specific language of many liability policies will suggest that coverage is not afforded for many liabilities arising out of employment-related practices. However, it would be a mistake to conclude that courts will lightly disregard policy terms, and so it is important for the employment lawyer to determine which application of the reasonable expectations doctrine fits with the facts of the case, thereby serving her client's needs, and to assist the client in developing a strategy for invoking the doctrine persuasively.

B. *Public Policy as a Limitation on Promised Coverage*

It is well established that courts will not enforce contracts that are contrary to public policy, regardless of the clarity with which the parties have expressed their intentions to be bound.⁸² Insurance contracts are subject to this general rule no less than other contracts.⁸³ This limitation on the parties' freedom to contract is premised on the fact that a contract is never entirely a private matter, especially if the contract is a liability insurance policy. By definition, a contract of liability insurance affects the injured third party seeking compensation from the insured by providing a source of funds to satisfy a judgment. Obviously, there is a strong public policy in favor of ensuring that injured parties are compensated to the fullest extent possible. The contract might also affect other persons, however, if the existence of insurance encourages the insured to

81. *La Jolla*, 36 Cal. Rptr. 2d at 103, 884 P.2d at 1048. If *Gray* remains good law, these arguments should prove persuasive, since the result in *La Jolla* is premised on the forum in which the complaint was filed. Liability policies other than the workers' compensation policy, of course, provide coverage for damages awarded in civil suits within the terms of the policy.

82. RESTATEMENT (SECOND) OF CONTRACTS § 178 (1979); E. ALLEN FARNSWORTH, CONTRACTS §§ 5.1-5.9 (2d ed. 1990).

83. COUCH ON INSURANCE 2D (rev. ed.) § 39:14 (Mark S. Rhodes, ed. 1985).

harm others intentionally by absolving the insured of financial accountability.⁸⁴ It is equally obvious that there is a strong public policy in favor of reducing injurious behavior and requiring that certain wrongdoers bear the full consequences of their actions.

The public policy defense, when used as a limitation on promised coverage in an insurance policy, amounts to a decision that the former public policy is outweighed by the latter on the facts of a particular case. Thus, courts deem certain claims to be uninsurable, despite the fact that this has the undesirable effect of eliminating a source of funds to satisfy any judgment obtained by an injured third party claimant. The general rule in this regard, known as the principle of "fortuity," is that "a contract of insurance to indemnify a person for damages resulting from his own intentional misconduct is void as against public policy and courts will not enforce such a contract."⁸⁵ If courts "make insurance" with the doctrine of reasonable expectations, then they also "unmake insurance" with the public policy limitation on enforcement.

One of the earliest and most important developments in modern employment law was judicial recognition of the tort of wrongful discharge in violation of public policy.⁸⁶ As stated in a leading case, "when an employer's discharge of an employee violates fundamental principles of public policy, the discharged employee may maintain a tort action and recover damages traditionally available in such actions."⁸⁷ One might expect courts to prohibit an employer from enforcing any insurance coverage available for a wrongful discharge claim, given that the underlying liability necessarily implicates public policy. In *Dixon Distribution Co. v. Hanover Insurance Co.*,⁸⁸ the Illinois courts recently addressed this issue in a manner that clarifies the public policy defense to enforcement of insurance contracts and distinguishes this defense from the use of public pol-

84. *Ranger Ins. Co. v. Bal Harbour Club Inc.*, 549 So. 2d 1005, 1007 (Fla. 1989) ("The rationale underlying [the public policy doctrine] is that the availability of insurance will directly stimulate the intentional wrongdoer to violate the law."). Based upon this rationale, for example, courts will not permit a party to insure against liabilities it incurs by engaging in criminal conduct. *See, e.g., State Farm Fire & Casualty Co. v. Baer*, 745 F. Supp. 595 (N.D. Cal. 1990), *aff'd*, 956 F.2d 275 (9th Cir. 1992).

85. *Dixon Distrib. Co. v. Hanover Ins. Co.*, 641 N.E.2d 395, 401 (Ill. 1994). This public policy doctrine may be judicially acknowledged, or in some cases it is directly stated in legislation. *See, e.g., CAL. INS. CODE* § 533 (West 1993) and *MASS. GEN. L. ch. 175, § 47* (1994).

86. MARK A. ROTHSTEIN, ET. AL., *EMPLOYMENT LAW* §§ 9.9-9.14 (1994).

87. *Tameny v. Atlantic Richfield Co.*, 164 Cal. Rptr. 839, 840, 610 P.2d 1330 (Cal. 1980).

88. 612 N.E.2d 846 (Ill. App. Ct. 1993), *aff'd*, 641 N.E.2d 395 (Ill. 1994).

icy as the gravamen of an employment tort. As explained in *Dixon*, although in some instances termination of employment will contravene public policy, it is not necessarily the case that permitting the employer to utilize available insurance coverage will also violate public policy.

In *Dixon*, the employer had been sued for willfully, intentionally, and wrongfully terminating an employee in retaliation for having filed two workers' compensation claims. These allegations state a classic case of wrongful discharge, since public policy strongly disfavors permitting employers to use their economic power to inhibit employees from exercising their statutory rights. The trial court determined that coverage for wrongful termination suits is precluded in the interests of public policy. Nevertheless, the appellate court reversed the summary judgment entered in favor of the insurer, holding that the tort claim fell within the coverage provision of the policy and that public policy did not bar enforcement of the insurance contract.⁸⁹ The appellate court reasoned that the availability of insurance coverage for wrongful discharge claims would benefit all parties and would not induce wrongful behavior.

It may be more in the public's interest to allow businesses to protect themselves by insurance coverage against all the various forms of claims for discrimination, sexual harassment, and retaliatory discharge than to allow businesses to become bankrupt in defending against several catastrophic suits.

. . . .

If insurance coverage somehow insulated employers from liability and thereby made them more likely to fire employees in retaliation for asserting protected rights, then the public policy may favor a restriction of insurance on that basis. However . . . [i]nsurance companies have the right to refuse to insure or to increase their premiums, both of which may act as deterrents against retaliatory discharges by impetuous employers.

. . . .

89. The appellate court held that the tort of wrongful discharge was within the policy definition of "occurrence" because it did not necessarily involve an act committed with "actual malice." *Dixon*, 612 N.E.2d at 853 (contending that terminations in violation of public policy may be premised on business decisions rather than animus). The supreme court affirmed, noting that the tort of wrongful discharge required only a causal connection between the worker's compensation filings and the discharge, not actual malice against the employee. *Dixon*, 641 N.E.2d at 399. Moreover, the court noted that although punitive damages are available as a remedy in a suit for wrongful discharge upon a showing of actual malice, punitive damages are not a "necessary consequence of the tort." *Id.* at 400.

Having a third party, with an economic interest to protect, oversee the actions of the employer could be very beneficial to the employee and society.⁹⁰

The supreme court reinforced this balancing test by emphasizing that public policy is implicated only when an employer seeks indemnification for injuries that it intended to inflict, and not when an employer seeks coverage for intentional actions that have resulted in injuries.⁹¹

The analysis in *Dixon* is persuasive, and should provide guidance to other courts. The public policy against enforcing insurance contracts should be triggered only when an insurance policy will indemnify an employer who *intended* to harm its employees with impunity in light of available coverage. Otherwise, the public policy in favor of making resources available to injured persons supports enforcement of coverage. In contrast, the tort of wrongful discharge is premised on the bare intentional action of discharging an employee, under circumstances where the public interest is harmed as a *result* of this action. There appears to be no sound reason to preclude the insurability of wrongful discharge claims *per se*, although certain wrongful discharge claims may involve the kind of intentional behavior that, if not outside the policy coverage, would be deemed uninsurable for reasons of public policy.⁹²

The circumstances under which courts will void coverage on the grounds of public policy have been carefully considered in a

90. *Dixon*, 612 N.E.2d at 857.

91. *Dixon*, 641 N.E.2d at 401-02. This distinction is expressed in *Lumbermens Mut. Casualty Co. v. S-W Indus., Inc.*, 39 F.3d 1324, 1331 (6th Cir. 1994), where the court interpreted the policy language defining a covered occurrence as being neither "expected nor intended" as preserving "the element of 'fortuity'" by preventing insureds from using liability coverage as a shield for the consequences of their anticipated intentional conduct. The court distinguished this narrow limit on coverage from the "broader range of losses" constituting intentional torts and held that the employer's insurer must indemnify the employer for compensatory damages paid to an employee after suffering a jury verdict for an intentional tort.

92. *But see* *Coit Drapery Cleaners, Inc. v. Sequoia Ins. Co.*, 18 Cal. Rptr. 2d 692, 698 (Cal. Ct. App. 1993) (interpreting a legislatively enunciated public policy against insuring willful acts to "bar the attempt to shift liability for intentional sexual harassment and associated employment-related torts [claims of wrongful discharge, infliction of emotional distress, battery, and sexual assault] to an insurer"). However, *Coit* primarily was a sexual harassment case involving particularly egregious behavior by the defendant and therefore probably should not be read as necessarily precluding coverage for all wrongful discharge claims. *Cf.* *U.S. Fire Ins. Co. v. Beltmann North Am. Co.*, 883 F.2d 564, 568-69 (7th Cir. 1989) (applying Illinois law and holding that wrongful discharge allegations will necessarily fall within the "actual malice" policy exclusion; subsequently disapproved in *Dixon*, 641 N.E.2d at 400).

number of cases involving discriminatory employment practices. In these cases the same dynamic is at work: on one hand courts are reluctant to leave third party plaintiffs without recourse to funds contractually owed the defendant employer, but on the other hand courts are hesitant to permit an employer to purchase insurance against prospective liability for discriminating against employees and applicants for employment. Title VII of the Civil Rights Act of 1964, which prohibits employment discrimination, is similar to the tort of wrongful discharge in that liability may exist even in the absence of a specific intent to cause harm.⁹³ In such cases of “disparate impact” discrimination, courts generally find that the existence of liability insurance does not undermine public policy.⁹⁴

In contrast, a claim by an employee that she has suffered “disparate treatment” on discriminatory grounds necessarily includes an allegation that the employer intended to discriminate.⁹⁵ Some courts have concluded that insurance coverage for intentional discrimination would undermine the strong public policy against discrimination.⁹⁶ However, this position has been challenged by other

93. Title VII is codified at 42 U.S.C.A. §§ 2000e-2000h(6) (1988 & Supp. 1993). In *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971), the United States Supreme Court held that Title VII was directed against discriminatory effects in the workplace as well as intentionally discriminatory actions by employers. In the lexicon of discrimination law, the former cases involve “disparate impact,” whereas “disparate treatment” is involved in the latter cases.

94. See, e.g., *Solo Cup Co. v. Federal Ins. Co.*, 619 F.2d 1178, 1187-88 (7th Cir.), cert. denied, 449 U.S. 1033 (1980); *Save Mart Supermarkets v. Underwriters at Lloyd's London*, 843 F. Supp. 597, 606 (N.D. Cal. 1994); *Union Camp Corp. v. Continental Casualty Co.*, 452 F. Supp. 565, 568 (S.D. Ga. 1978).

95. When claiming “disparate treatment,” the employee has an affirmative burden of production and the ultimate burden of proof regarding the employer’s discriminatory intent. *Texas Dep’t of Community Affairs v. Burdine*, 450 U.S. 248, 253 (1981).

96. See, e.g., *Foxon Packaging Corp. v. Aetna Casualty and Sur. Co.*, 905 F. Supp. 1139 (1995). After holding that the racial discrimination charge was excluded from coverage, the court continued by declaring (in dicta) that insurance coverage for intentional discrimination is void as against public policy.

Aetna argues, and this court agrees, that the public policy of the State of Rhode Island as articulated in the Fair Labor Practices Act, militates against judicial creation of a safe harbor within which Foxon may presumably violate the law at will with impunity. Such a result would do violence to the public policy of the state and eviscerate the statute’s intended guarantee of a workplace free of discrimination.

....
Foxon comes before this court to seek, in essence, insulation from its own wrongdoing . . . It would be a clear violation of public policy if businesses and individuals could insure themselves against liability for committing intentional acts of discrimination. This result would promote, rather than deter discriminatory behavior Foxon’s knowing failure to address the blatantly discrim-

courts that enforce coverage even for intentional “disparate treatment” of employees, finding such coverage not to be contrary to public policy.⁹⁷ The different results in these cases are not ex-

inatory acts of its employees should not be condoned by shifting the burden of satisfying Hernandez’s damage awards to Aetna.

Id. at 1146.

See also Coit, 18 Cal. Rptr. 2d 692 (interpreting state statute precluding insurance for willful acts with regard to a case involving egregious, predatory, and intentional sexual harassment and discrimination); *Boston Hous. Auth. v. Atlanta Int’l Ins. Co.*, 781 F. Supp. 80, 83 (D. Mass. 1992) (interpreting state statute precluding insurance for deliberate or intentional wrongdoing to preclude coverage in light allegations that the insured flagrantly and deliberately violated anti-discrimination provisions and government orders); *Legg Mason Wood Walker, Inc. v. Insurance Co. of N. Am.*, 23 Fair Empl. Prac. Cas. 778 (D.D.C. 1980) (BNA); *Continental Ins. Co. v. McDaniel*, 772 P.2d 6, 9 (Ariz. Ct. App. 1988) (concluding that “there is no coverage for an insured’s intentional acts, wrongful under the law of torts, because contractual intent and public policy coincide to prevent an insured from acting wrongfully knowing his insurance company will pay the damages”); *Ranger Ins. Co. v. Bal Harbour Club, Inc.*, 549 So. 2d 1005, 1009 (Fla. 1989) (holding that permitting parties to insure against claims of intentional religious discrimination would encourage such discrimination).

97. *See, e.g., Union Camp*, 452 F. Supp. at 567-68 (S.D. Ga. 1978) (“The proposition that insurance taken out by an employer to protect against liability under Title VII will encourage violations of the Act is based on an assumption that is speculative and erroneous. . . . Where a class of employees is entitled to back pay under a court order and the employer is financially unable to comply with the same, insurance would provide the mandated compensation.” The court noted that the insurer remains free to exclude such liabilities from coverage.); *Clark-Peterson Co. v. Independent Ins. Assocs.*, 492 N.W.2d 675 (Iowa 1992) (utilizing the doctrine of reasonable expectations to extend coverage beyond the precise terms of the policy).

These cases often involve variations of D&O or E&O policies written for public school districts. These products insure against liabilities arising out of “wrongful acts” and generally do not exclude intentional wrongs. In fact, the very purpose of these policies is to protect an entity, usually a public school, from the substantial losses that it may incur vicariously and also for defending and indemnifying its employees for their wrongful acts, whether committed intentionally or negligently. Consequently, insurers must rely on public policy arguments in an effort to avoid coverage. *See, e.g. School Dist. for the City of Royal Oak v. Continental Casualty Co.*, 912 F.2d 844, 847-50 (6th Cir. 1990); *New Madrid County Reorg. Sch. Dist. No. 1 v. Continental Casualty Co.*, 904 F.2d 1236 (8th Cir. 1990); *University of Ill. v. Continental Casualty Co.*, 599 N.E.2d 1338, 1351 (Ill. Ct. App. 1992), *appeal denied* 606 N.E.2d 1235 (Ill. 1992) (“[W]e find there is no Illinois public policy prohibiting insuring for damages caused by one’s intentional acts except to the extent that the insured wrongdoer may not be the person who recovers the policy proceeds. The fact that many insurance policies contain an exclusion for intentional conduct demonstrates insurers have not relied on any broad public policy. Defendant could have included such an exclusion in its BEL policy, but did not. This court will not rewrite the BEL policy to create an exclusion.”); *Independent Sch. Dist. No. 697, Eveleth v. St. Paul Fire and Marine Ins. Co.*, 515 N.W.2d 576, 580 (Minn. 1994) (“We do not believe that a school district will discriminate against its employees simply because it carries wrongful act insurance coverage; nor do we believe that school districts carrying this type of insurance coverage have a license to commit intentional wrongs. Accordingly, we enforce the contract as it is written.”); *Cf. Continental Casualty Co. v. Canadian Universal Ins. Co.*, 924 F.2d 370 (1st Cir. 1991) (finding that cover-

plained by the use of different tests but rather in the application of an agreed balancing test: weighing the benefit to the plaintiff of permitting insurance coverage against the harm to society of encouraging future intentional wrongdoing.⁹⁸ Courts permitting coverage reject the hypothesis that discrimination will be reduced by denying coverage.

In short, then, public policy does not prohibit an employer sued for discrimination or wrongful discharge from ever obtaining a defense and indemnification under liability insurance. In fact, recent court decisions evidence a willingness to permit insurance coverage even for intentional acts by the employer. However, if the wrongful act amounts to a purposeful effort by the employer to cause injury to the employee, courts generally still will refuse to enforce otherwise available insurance for reasons of public policy. In such cases, though, it often is the case that the insurance policy will preclude coverage in unambiguous terms in either the insuring agreement or the exclusions, and so the public policy doctrine

age for sexual harassment is unambiguous under the "wrongful acts" trigger and offering no discussion of any potential public policy bar to enforcement).

The *Royal Oak* court cited an article by Professor Willborn with approval, concluding that the presumption that liability insurance might "stimulate" future discriminatory conduct is unfounded. See Steven L. Willborn, *Insurance, Public Policy, and Employment Discrimination*, 66 MINN. L. REV. 1003 (1982). Professor Willborn argues that insurance coverage generally should be enforced to effectuate the public policy favoring compensation unless the insured displays a "calculating intent" to engage in discrimination based on the existence of insurance. *Id.* at 1027-30.

Of course, if the policy limits coverage to negligent acts, then "disparate treatment" discrimination will fall outside the coverage even if public policy would permit coverage. See, e.g., *Golf Course Super. Ass'n of Am. v. Underwriters at Lloyd's*, London, 761 F. Supp. 1485, 1491 (D. Kan. 1991) (no coverage under policy language, although Kansas law permits coverage even for punitive damages awarded as a result of intentional acts for which the insured is vicariously liable); *School Dist. No. 1 v. Mission Ins. Co.*, 650 P.2d 929 (Or. Ct. App. 1982). Similarly, when the plaintiff is suing only for bodily injuries, then an educational liability policy (which excludes such injuries from coverage) will not be triggered, although coverage under the insured's CGL policy may well be triggered. *Wayne Township Bd. of Sch. Comm'rs v. Indiana Ins. Co.*, 650 N.E.2d 1205, 1211-12 (Ind. Ct. App. 1995) (holding CGL coverage was triggered, but not coverage under an Educational Errors and Omissions Policy in a suit for injuries caused when a school principal sexually molested a student).

98. Thus, in *Ranger* the court explicitly found that anti-discrimination legislation primarily is intended to deter wrongdoing rather than compensate victims, thereby tilting the balance toward prohibiting coverage. *Ranger*, 549 So. 2d at 1006-09. In contrast, in *Royal Oak* the court rejected the idea that insurance coverage would promote discriminatory practices, finding that "the prospect of escalating insurance costs and the trauma of litigation, to say nothing of the risk of uninsurable punitive damages, would normally neutralize any stimulative tendency the insurance might have"; thus, the court found little to counterbalance the public interest in providing a source of funds to the injured plaintiff. *Royal Oak*, 912 F.2d at 848.

should only rarely place an additional limitation on the scope of coverage.⁹⁹

99. In most cases, the intentional nature of the conduct will remove the case from coverage under the terms of the policy, and so the public policy issue need not be reached. *See, e.g.*, *American Guar. and Liability Ins. Co. v. Vista Medical Supply*, 699 F. Supp. 787, 789-90 (N.D. Cal. 1988) (holding that California law permits insurance coverage unless there is a "preconceived design to inflict injury," but that the policy restricts coverage of intentional act to a much greater degree); *Intermountain Gas Co. v. Industrial Indem. Co.*, 868 P.2d 510, 515 (Idaho Ct. App. 1994) (holding that intentional discrimination is excluded under the policy); *Daly Ditches Irrigation Dist. v. National Sur. Corp.*, 764 P.2d 1276, 1278 (Mont. 1988).

A recent Massachusetts case underscores the importance of policy exclusions in this regard. Shortly after being ordered to pay claimants who alleged "disparate treatment" sex discrimination, the employer ceased operations. The claimants brought a direct action against the employer's CGL carrier to recover their judgment, but summary judgment was entered for the insurer on the ground that the policy excluded coverage for intentional acts. The Massachusetts Supreme Judicial Court affirmed on this ground, not reaching the question whether coverage would be precluded under the statutorily defined public policy against insuring intentional harm. *Rideout v. Crum & Forster Commercial Ins.*, 633 N.E.2d 376 (Mass. 1994). It is conceivable that the public policy balancing under these particular facts, involving injured claimants with no other means to satisfy the judgment and a now defunct employer, might not void coverage had it been available. Although the existence of a statute defining the public policy of Massachusetts might be deemed to afford less leeway to courts, there still is room for judicial interpretation of what a finding of "willfulness" means as a matter of substantive employment law. *See, e.g.*, *Andover Newton Technological Sch., Inc. v. Continental Casualty Co.*, 930 F.2d 89, 93 (1st Cir. 1991) (finding that coverage for a "willful" violation of federal age discrimination law is not subject to the statutory bar, since "willfulness" includes the "reckless disregard" of whether the conduct is prohibited). Moreover, even if the statute is deemed to preclude indemnification, it may not preclude enforcement of the insurer's duty to defend. *Id.* at 95. *See also* *Republic Indem. Co. v. Superior Court*, 273 Cal. Rptr. 331, 334 (Cal. Ct. App. 1990) (interpreting CAL. INS. CODE §533 (West 1994)). *But see* *Boston Housing Authority*, 781 F. Supp. at 83-84. *Cf.* *Horace Mann Ins. Co. v. Barbara B.*, 846 P.2d 792 (Cal. 1993) (statutory bar applies only to indemnification for the intentional conduct, and not to the duty to defend in a case that may involve some non-intentional acts giving rise to liability).

A similar issue arises when an insured seeks indemnification for the punitive damages component of an otherwise covered loss. There has been a great deal of litigation regarding the insurability of punitive damages.

The debate is a vigorous one. Not surprisingly, courts are split on the question of whether punitive damages liability for reckless, wanton, or grossly negligent conduct is uninsurable. Roughly two-thirds of the states that have considered the question have held that punitive damages are insurable, and the remaining states have held that punitive damages are not insurable. Where punitive damages are insurable, however, all states that have considered the matter recognize an exception when the insured's conduct is intentional.

JERRY, *supra* note 29, at 352. *See also* Alan I. Widiss, *Liability Insurance Coverage for Punitive Damages? Discerning Answers to the Conundrum Created by Disputes Involving Conflicting Public Policies, Pragmatic Considerations and Political Actions*, 39 VILL. L. REV. 455, 493 (1994) (surveying the current state of the law and arguing that punitive damages ought to be insurable in many instances) and George L. Priest, *Insurability and Punitive Damages*, 40 ALA. L. REV. 1009 (1989) ("Our courts conflict sharply: some

CONCLUSION

Employment lawyers acting as defense counsel have grown weary of the willingness of courts in recent years to develop flexible common law responses to employee claims. However, this same judicial attitude works to the benefit of employers when they demand a defense and seek indemnification under a liability insurance policy for employment-related claims. In both situations, the contemporary approach is to place less emphasis on the technical wording of adhesion documents connected with the relationship in favor of upholding reasonable expectations.¹⁰⁰ For the employer seeking insurance coverage of an employment-related claim, the maxim

deny coverage on grounds of public policy; the majority allow coverage.”). As Professor Priest notes, the increasing willingness to permit coverage of punitive damages is directly related to the substantial expansion of the availability of the remedy, to the extent that the traditional “requisite level of moral depravity to justify punitive liability” that raises the public policy question in the first place may be lacking. *Id.* at 1034.

Given the availability of punitive damages for many employment related claims, this question is of significant concern for employers and insurers. See, e.g., *Lumbermens Mut. Casualty Co. v. S-W Indus., Inc.*, 39 F.3d 1324, 1329 (6th Cir. 1994), which held that an employer was not entitled to indemnification for a \$2.5 million punitive damage award, although the employer was entitled to indemnification for compensatory damages incurred as a result of an intentional tort. The *Lumbermens* court noted that, because punitive damages are designed to punish and deter, public policy weighs much more heavily against insurability than it does with respect to compensatory damages for intentional torts. *Cf. Wojciak v. Northern Package Corp.*, 310 N.W.2d 675, 680 (Minn. 1981) (permitting employer to recover discretionary treble damages under statute prohibiting retaliatory discharge, since “the statute reflects as much concern for the employees’ welfare as it does a desire to punish employers,” in contrast to common law punitive damages).

100. Despite this parallel at a very general level, however, it would be a mistake to conclude that substantive developments in employment law will translate directly to substantive changes in the interpretation of insurance policies. Employers will be subjected to new forms of liability that are held not to be within the scope of their liability coverage, despite the (reasonable?) expectation that their liability policies would cover such unanticipated exposure. See, e.g., *SL Indus., Inc. v. American Motorists Ins. Co.*, 607 A.2d 1266, 1275 (N.J. 1992), which stated:

Now that tort law has expanded to recognize claims for emotional distress, both with and without physical manifestations, the argument is that an insured would reasonably expect coverage to be extended to those suits. We disagree. Tort law and insurance law are not coextensive. . . . Regardless of changes in tort law, an insured does not reasonably expect the policy to be interpreted in ways that contravene the contract’s language.

Id.

On the other hand, employers have not been held to the same remedial standards as insurers for breaches of the covenant of good faith and fair dealing, just one example of the fact that their exposure to their employees is in some important respects more narrow than their insurer’s exposure to them. See *Foley v. Interactive Data Corp.*, 765 P.2d 373 (Cal. 1988) (distinguishing employers and insurers, holding that only insurers are subject to tort damages for a bad faith breach).

contra proferentem and the doctrine of reasonable expectations work to transform insurance policies into valuable economic resources for managing the employer's exposure and losses.

The flexibility evidenced in the court decisions is not unprincipled, however. As in the employment context, at some point the courts respect the ability of insurers to define the scope of the risks that they are assuming. Insurers are most likely to be able to enforce limitations on coverage for employment litigation if: (1) they limit their risks plainly and clearly and in accordance with the policy premiums being charged and (2) the limitations are either consistent with the employer's reasonable expectations or are marketed in a manner designed to eliminate such expectations.¹⁰¹ The recent efforts by insurers to amend their policies to exclude coverage for liability related to employment practices, if they prove successful in the market, likely will continue to pass judicial muster. If so, in many cases employers may be precluded from asserting potential coverage under the policy and thereby triggering the insurer's duty to defend. The law governing employment relations continues to change daily, though, and so the battles between employers and their insurers are far from over.

101. Cf. KEETON & WIDISS, *supra* note 9.