Judge-Made Insurance That Was Not on the Menu: Schmidt v. Smith and the Confluence of Text, Expectation, and Public Policy in the Realm of Employment Practices Liability

Jeffrey W. Stempel
University of Nevada, Las Vegas -- William S. Boyd School of Law

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JUDGE-MADE INSURANCE THAT WAS NOT ON THE MENU: SCHMIDT v. SMITH AND THE CONFLUENCE OF TEXT, EXPECTATION, AND PUBLIC POLICY IN THE REALM OF EMPLOYMENT PRACTICES LIABILITY

JEFFREY W. STEMPPEL*

INTRODUCTION

In Schmidt v. Smith,1 the New Jersey Supreme Court caught more than a few observers by surprise.2 New Jersey courts have generally issued opinions regarded as pro-claimant and pro-policyholders.3 But everyone’s taste for recompense and coverage has

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* Professor of Law, William S. Boyd School of Law, University of Nevada, Las Vegas. This commentary is in part an outgrowth of a presentation on “Emerging Coverage Issues” delivered at the Professional Liability Underwriters Symposium, EPLI and the Changing Workplace (Mar. 2, 1999 in New York) and other writings on employment claims. See JEFFREY W. STEMPPEL, LAW OF INSURANCE CONTRACT DISPUTES Ch. 21 (2d ed. 1999); JEFFREY W. STEMPPEL, Recent Case Developments, 5 CONN. INS. L.J. 489 (1998). Special thanks to Jeff Klenk, Jay Mootz, and other Symposium participants, Mara Levy for research assistance, as well as to Ann McGinley, Ken Vinson, and Dean Dick Morgan.

2. See, e.g., David F. McGonigle, Recent Developments: Employment Discrimination/Harassment Claims Under EL Policies: Schmidt v. Smith, J. INS. COVERAGE, vol. 1, no. 1, at 94 (1998) (discussing the case without overt criticism but clearly treating the decision as important and suggesting it represents a new and unexpected development for insurance coverage law); Susanne SalaFane, N.J. Harassment Ruling Roils WC Market, NAT’L UNDERWRITER PROP. & CAS. RISK & BENEFITS MGMT., Apr. 5, 1999, at 16 (noting that after the decision there was an “initial outcry by insurers” that it “would send workers’ compensation premiums soaring” and treating the decision as surprising and a major fissure in the structure of insurance coverage packages typically offered for commercial risks, but quoting industry sources that the impact of the decision may be slower and less drastic than first envisioned by insurers); Daniel Hays, N.J. WC Rocked by Sex Ruling, NAT’L UNDERWRITER PROP. & CAS. RISK & BENEFITS MGMT., June 29, 1998, at 4 (same); Comp Policy Covers Harassment Defense, BUS. INS., July 13, 1998, at 10 (treating the ruling as surprising and threatening to existing combination of workers’ compensation and employers’ liability claims).
3. See, e.g., Morton Int’l, Inc. v. General Accident Ins. Co. of Am., 629 A.2d 831 (N.J. 1993) (finding that, linguistically, the qualified pollution exclusion bars coverage for pollution claims against policyholder, but that representations of insurers to regulators made in connection with approval of the exclusion require insurer to provide cov-
limits.

In Schmidt, the court exceeded those limits for many observers by holding that despite what it regarded as clear contract language in an exclusion, an insurer providing Employers’ Liability ("EL") coverage along with Workers’ Compensation ("WC") insurance for the employer was required to provide coverage in a case of blatant sexual harassment bordering on criminal assault. In doing so, the Schmidt court, however laudable its motives, pushed doctrines of reasonable expectations of coverage, public policy, and statutory interpretation further than was necessary or wise.

Although the net result of the decision may be salutary to the degree it provides greater recompense for victims of sexual harassment and other discriminatory injury in the workplace, Schmidt v. Smith remains a troubling episode of judicial enthusiasm for mandated coverage. Although the workers’ compensation realm of law imposes more coverage responsibilities upon employers and insurers, the nature of the underlying claim and the clarity of the exclusion should have received greater attention by the court. Notwithstanding the statutory framework of the workers’ compensation law, the Schmidt v. Smith decision was not as compelled as the court suggests. Certainly, traditional means of contract and statutory construction do not support mandating coverage and it is

4. The term is Professor Kenneth Abraham’s, taken from his article, Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured, 67 Va. L. Rev. 1151, 1162–63 (1981), from which the term “judge-made insurance” is also borrowed. Professor Abraham used both terms to refer to a category of insurance coverage decisions where despite little textual guidance—or even clear contrary language—courts found coverage for policyholders out of a belief that the insurance policy in question should provide such coverage in light of the nature of the policy and the context of the claim.
by no means clear that mandated coverage is the public policy “answer” to the dilemma faced by the Schmidt court.\textsuperscript{5}

In addition, the court’s approach on behalf of policyholders and claimants borrows from the suspect jurisprudential approach of reading policy language with great literalism and making sweeping pronouncements regarding wrongdoing and public values.\textsuperscript{6} In recent years, insurers have often been the litigants advocating this extreme form of contract or statutory construction. Take perhaps the most extreme recent example: general liability insurers have frequently (and with more success than they deserve) invoked the linguistic breadth of the “absolute pollution exclusion” to deny coverage for claims involving lead paint poisoning, carbon monoxide poisoning, and workplace accidents that incidentally involve chemicals, even though such denials extend well beyond the understanding of the exclusion held by reasonable persons with the most fervent commitment to hyperliteralism.\textsuperscript{7} In addition, these insurers frequently seek to make a morality play of insurance coverage litigation: policyholders (the same policyholders to whom the insurer owes a near fiduciary relationship) are demagogically deemed “polluters,” obvious bad guys who should be stripped of the insurance

\begin{itemize}
\item \textsuperscript{5} See infra notes 45-74 and accompanying text (discussing reasons for lack of compelling case for mandating Employers’ Liability Insurance (“ELI”) coverage of sexual harassment claims). Regarding the mandatory nature of WC insurance coverage and its differences from conventional liability insurance, see Arthur Larson & Lex K. Larson, 9 Larson’s Workers’ Compensation § 92 (1999).
\item \textsuperscript{6} See Jeffrey W. Stempel, Unmet Expectations: Undue Restriction of the Reasonable Expectations Approach and the Misleading Mythology of Judicial Role, 5 Conn. Ins. L.J. 181, 245-77 (1998) (criticizing textual literalism as a school of contract interpretation and advocating a reasonable role for factors of intent, purpose, and expectation in construing contracts); Jeffrey W. Stempel, Reason and Pollution: Correctly Construing the “Absolute” Exclusion in Context and in Accord with its Purpose and Party Expectations, 34 Tort & Ins. L.J. 1, 7-17, 33-35, 58-59 (1998) (reviewing basic contract principles and concluding that mainstream contract construction is not literalist or restricted solely to dictionary analysis of text; criticizing certain insurers for attempting to turn contract litigation into a “morality play” about whether policyholder is a bad “polluter”); see also Jeffrey W. Stempel, Unreason in Action: A Case Study of the Wrong Approach to Construing the Liability Insurance Pollution Exclusion, 50 Fla. L. Rev. 463 (1998) (criticizing Florida Supreme Court’s formal and hyperliteral application of pollution exclusion to bar coverage for claims against an architectural firm when a blueprint machine overturned and spilled ammonia).
\item \textsuperscript{7} See Stempel, Reason and Pollution, supra note 6, at 1-5; William P. Shelley & Richard C. Mason, Application of the Absolute Pollution Exclusion to Toxic Tort Claims: Will Courts Choose Policy Construction or Deconstruction?, 33 Tort & Ins. L.J. 749-50 n.1 (listing cases where pollution exclusion defense was not successful for toxic tort claims) & n.2 (listing cases where pollution exclusion was held to bar such “toxic tort” claims, or claims where chemicals were involved).
\end{itemize}
coverage they thought they were buying.³

Despite the different nature of the coverage disputes, the Schmidt v. Smith decision mirrors, to a significant degree, the errors of insurers and sympathetic courts that have over-applied the pollution exclusion. In both types of coverage disputes, the courts have made an overbroad application of the exclusion. Specifically, in Schmidt v. Smith:

- Language is read hyperliterally rather than with sufficient appreciation of background, context, and purpose of the insuring agreement;
- Public policy preferences are turned into mandates that override other indicia of contract meaning; and
- An unanticipated result obtains, one at odds with the expectations of at least several interested parties, in this instance the insurer, the industry, and probably the employer and regulators as well.

Compared to the toxic tort cases, which deny coverage because of the pollution exclusion, Schmidt v. Smith at least has the redeeming value of extending rather than constricting coverage, enhancing the prospects for compensation of harassment and discrimination victims, and imposing burdens on actors well suited to risk-bearing and risk-spreading for profit. On the other hand, contract enforcement and reliance interests take something of a beating in Schmidt. Methodologically, the decision follows an interpretative fork that one hopes is not a harbinger of future judicial action even though the net impact of the decision may not be negative.⁹

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³ See Stempel, Reason and Pollution, supra note 6, at 33-35, 58-59 (criticizing certain insurers for attempting to turn contract litigation into a “morality play” about whether policyholder is a bad “polluter”).

⁹ By contrast, I find no such silver lining in the decisions that construe the pollution exclusion too broadly. See generally Stempel, Reason and Pollution, supra note 6; Stempel, Unreason in Action, supra note 6. In the cases erroneously treating commonplace liability claims as excluded “pollution,” the policyholder is deprived of coverage on which it relied, but the insurance industry, risk managers, and the public register no comparable gain through the development of more affordable insurance or sounder risk pools. Rather, a few insurers at certain fortuitous junctures obtain episodic relief from their contract obligations, leading to modestly greater profits for the insurer that are diluted and circulated to shareholders or consumed by constituents of the corporate entity. In short, there is, to use the Supreme Court’s memorable phrase from Ginzburg v. United States, 383 U.S. 463, 478 n.2 (1966) (Black, J., dissenting) and other cases involving regulation of sexually explicit materials, “no redeeming social value” to the overly broad and literal application of the pollution exclusion. By contrast, there may be some positive aspects of Schmidt v. Smith despite the current dread it induces in WC/EL insurers. See infra notes 43-58 and accompanying text.
I. The Schmidt v. Smith Litigation

Lisa Schmidt filed a complaint against her employer, Personalized Audio Visual, Inc. ("PAV"), and its president, Dennis Smith, alleging hostile work environment sexual harassment in violation of the New Jersey Law Against Discrimination ("LAD"), assault, battery, invasion of privacy, and intentional infliction of emotional distress. In an amended complaint, she also alleged liability for negligent infliction of emotional distress against Smith and negligent failure to train supervisors against PAV.

PAV and Smith sought defense and indemnity coverage from United States Fidelity & Guaranty ("USF&G") under a Comprehensive General Liability ("CGL") policy and later under an Employer's Liability ("EL") policy. USF&G denied coverage under both policies. The trial of the discrimination action preceded the trial of the coverage dispute. USF&G had the opportunity to participate in the defense, but refused. At trial, the jury found Smith liable for hostile work environment, sexual harassment, assault, battery, and intentional infliction of emotional distress. The jury found PAV liable only for hostile work environment sexual harassment. The verdict form did not ask whether the employer's liability was direct or vicarious or whether the employer might be vicariously liable for the intentional torts committed by Smith.

After the jury verdict, the trial court found that USF&G was responsible for coverage. The intermediate appellate court affirmed the trial court's verdict and found that PAV's EL policy provided coverage even though its CGL policy did not. The New Jersey Supreme Court affirmed this result, but rejected in part the reasoning of the appellate court.

11. See id. at 1015-16.
12. See id. at 1016.
13. See id.
14. See id.
15. See id.
16. See id.
17. See id.
18. See id.
19. See id.
20. See id.
21. See id. (stating that the exclusion in the employer's liability coverage of the WC policy was not applicable to sexual harassment claims when liability for those claims was imposed vicariously); see also Smith v. United States Fidelity & Guar. Co., 684 A.2d 66, 73-74 (N.J. Super. App. Div. 1996).
22. See Schmidt, 713 A.2d at 1018.
that the language of the CGL policy did in fact operate to exclude employment discrimination claims, but also held that such coverage was statutorily required by state law requiring employers to make arrangements for coverage of any bodily injury incurred by workers.\textsuperscript{23}

The EL policy in question stated that it covered damages accruing to the employer for occurrences of "bodily injury by accident or bodily injury by disease," which arises 'out of and in the course of the injured employee's employment' by the insured."\textsuperscript{24}

However, the EL policy also contained an exclusion for damages "arising out of coercion, demotion, evaluation, reassignment, discipline, defamation, harassment, humiliation, discrimination against or termination of any employee, or any personnel practices, policies, acts or omissions."\textsuperscript{25}

The court found the broad language of this exclusion was textually applicable in the Schmidt claim because the damages for which PAV was liable were damages "arising out of" harassment.\textsuperscript{26} However, the court also found that the exclusion could not be enforced against PAV or Smith because the exclusion was inconsistent with New Jersey law that requires employers to "make sufficient provision for the complete payment of any obligation [the employer] may incur to an injured employee."\textsuperscript{27}

Specifically, the supreme court held that because Schmidt's claim was based in part on a finding of negligence by the employer and supervisor,\textsuperscript{28} her injuries were of the type for which bodily injury coverage for workplace mishaps was mandated by state statute.\textsuperscript{29} Consequently, application of the harassment exclusion in the EL policy to Schmidt's injuries resulting from negligence violated New Jersey law and was unenforceable (even though the negligent injury was related to or resulted in claims of harassment).

\begin{itemize}
  \item \textsuperscript{23} See id.
  \item \textsuperscript{24} Id. at 1017 (citation omitted).
  \item \textsuperscript{25} Id.
  \item \textsuperscript{26} See id. at 1018.
  \item \textsuperscript{27} Id. at 1015 (quoting N.J. STAT. ANN. § 34:15-71 (West 1988)).
  \item \textsuperscript{28} Although the jury did not specifically make a finding of negligence or vicarious liability against the employer, neither did it foreclose negligence, which was pleaded by the plaintiff and on which evidence was presumably presented at trial. See id. at 1016. Although the court did not elaborate on this point, it implicitly concluded that the jury verdict must be viewed in the light most favorable to the employer policyholder, which argued that the verdict, although arguably ambiguous, was one based on negligence rather than intentional wrongdoing.
  \item \textsuperscript{29} See id. at 1018.
\end{itemize}
However, according to the supreme court, the harassment exclusion would be enforceable to bar coverage for claims that did not fall within the statutorily mandated coverage for "accidental bodily injury" (bodily injury not intended by the employer even though other workers may have acted with intent to do harm). According to the Schmidt court, state law does not require the employer to provide coverage for claims that do not result in "bodily injury."30 Thus, an insurer's use of an exclusion to bar coverage for the financial or reputational injury usually associated with "criticism, demolition, evaluation, and defamation," would normally be enforceable since a policyholder "would not expect to be covered" in such cases, making the exclusion "valid as long as the liability arising from those discomforts is not related to bodily injury."31

The Schmidt court held that in the instant case, the employer's liability was "primarily related to the personal injuries [the employee plaintiff] suffered as a result of [the supervisor's] conduct."32 New Jersey law regards emotional injury accompanied by physical manifestation as "bodily injury" under liability insurance policies.33 The New Jersey Supreme Court did not disturb the intermediate appellate holding that the employer's CGL policy, which included an employment-related injury exclusion, did not provide coverage.

In another case decided the same day, American Motorists Insurance Co. v. L-C-A Sales Co.,34 the court also excluded coverage for harassment and wrongful termination claims under a standard CGL policy. That decision makes clear that Schmidt was based not on the specific language of the EL policy at issue, but on state law and public policy mandating minimum insurance coverage for bodily injury to workers. American Motorists did not present these statutory and public policy considerations. In American Motorists, the New Jersey Supreme Court was faced with age discrimination and harassment claims made by a former employee of the policyholder.35 According to the court, the CGL's employment exclusion

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30. See id.
31. Id.
32. Id.
34. 713 A.2d 1007 (N.J. 1998).
35. In American Motorists, John Picciolo had worked as a salesman for L-C-A Sales for more than thirty years, until his termination in 1991 at age 67. See id. at 1008. He sued, charging that he had been harassed into involuntary retirement because of his age. See id. L-C-A sought coverage for the Picciolo suit under its CGL. See id. The CGL contained the typical insuring agreement covering bodily injury claims against the
language barred coverage for the employee’s age discrimination and harassment claims.

The *American Motorists* court found the employment claims exclusion in the CGL to be broad, clear, and enforceable despite the general rule that it is the insurer’s burden to demonstrate the applicability of the exclusion. A unanimous court found that this burden was met because the exclusion was “clear and unambiguous,” particularly given its location in the policy adjacent to an exclusion for workers’ compensation claims. According to the court, the plain language of the employment exclusion and its placement in the policy demonstrates that the objective of the CGL policy was to exclude from coverage all claims—whether falling within or beyond the workers’ compensation system—“arising out of and in the course of” [Plaintiff’s] employment. Were the employee exclusion interpreted only to bar coverage for workers’ compensation claims, the workers’ compensation exclusion in LCA’s CGL policy would be redundant.

In addition, the court applied an expansive meaning to the exclusion’s “arising out of” language, and equated the term with “originating from,” “growing out of,” or “having a ‘substantial nexus’ with the activity for which coverage is provided.” Consequently, plaintiff’s claim that he was harassed by telephone calls at home, as well as by actions at work, did not bring the claim within the CGL coverage.

As evidenced by the juxtaposition of *American Motorists* and *Schmidt*, the *Schmidt* court recognized that the EL insurer had utilized compellingly clear language excluding harassment and discrimination coverage, but refused to enforce that clear language favoring the *insurer* because New Jersey state law requires the employer to provide coverage for any workplace-related bodily injury claims. In other words, the supreme court “rewrote” the insuring agreement to require the EL insurer to provide broader coverage to the employer. Effectively, the court created a new insuring agreement of “judge-made insurance.”

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policyholder and also contained the typical exclusionary language that there would be no coverage for bodily injury to “[a]n employee of the insured arising out of and in the course of employment by the insured.” *Id.*

36. *See id.* at 1013.
37. *See id.*
38. *Id.*
39. *Id.* at 1010.
II. INTERPRETATIVE FACTORS IN CONSTRUING INSURANCE POLICIES AND STATUTES

Insurance policies are contracts and the ordinary rules of contract interpretation apply to insurance coverage disputes. In addition, because of the technical nature of insurance, the structure of the insuring process, and the control over contract language typically exercised by insurers, conventional contract doctrines have been fine tuned under insurance law. Although courts and commentators frequently refer to a divergence between "regular" contract law and insurance law, insurance coverage litigation, like contract litigation, ordinarily turns on questions of textual interpretation conducted in light of the intent of the parties, the purpose of the insurance policy at issue, the expectations of the parties, particularly the reasonable expectations of the policyholder, and the impact of regulatory law and questions of public policy. Many of these same rules apply for interpreting legislative enactments or administrative regulations.

A. Text

The text of the policy is the primary basis for construction of the policy and for decisions regarding coverage disputes. Where the text of an insurance policy is clear, admits of only one reasonable meaning, and does not render an absurd result, a court ordinarily applies the text as written to decide the coverage question. Where policy language is unclear, courts ordinarily consider other factors in determining meaning. However, under the long-standing contract principle of contra proferentem ("against the drafter"), ambiguous language is construed against the author of the policy, which is nearly always the insurer. Some courts invoke the contra proferentem principle against the insurer as soon as the court determines that the language at issue is ambiguous, but this is a minority view. Most courts first consider extrinsic evidence of meaning

40. For general principles of contract interpretation and construction of insurance policies, see Jeffrey W. Stempel, Law of Insurance Contract Disputes § 4.04 (2d ed. 1999).
42. See Stempel, supra note 38, § 4.04, at 4-15.
43. See id. § 4.08, at 4-57.
44. See id. at 4-59 to 4-60.
before applying the \textit{contra proferentem} tiebreaker.\textsuperscript{45}

B. \textit{Intent and Purpose}

The principal determinant of meaning, other than the policy text, is the intent of the parties. Many courts state that ascertaining the intent of the parties and construing the policy accordingly is the chief judicial task. Therefore, the policy language has importance not because of its status as the content of the instrument, but because of its status as the most accurate embodiment of the intent of the parties.\textsuperscript{46} However, even courts that treat intent as the primary factor in contract interpretation usually will not consider extrinsic evidence of intent where the policy language is seemingly clear and sensible.\textsuperscript{47}

The purpose of the insurance policy\textsuperscript{48} combines with the intent of the parties\textsuperscript{49} to provide extrinsic evidence for resolving ambiguous language and to guide the court in its determination of the meaning of the text of the insurance policy.\textsuperscript{50} Because intent and purpose are so closely related, there is a tendency among courts and commentators to collapse the two. This Article uses “intent” to connotate the specific intent of the contracting parties in situations where the parties in fact had relatively specific expectations regarding the meaning of certain terms and the resolution of potential claims thought likely to result. In contrast, the “purpose” of the insurance policy refers to the general function of the instrument and its role in the risk management of the policyholder. For example, a policyholder may obtain CGL insurance to protect it from the third-party claims normally levied against businesses of that type. Thus, a restauranteur policyholder may not have a specific intent that her CGL will cover claims for illness caused by an exotic bacteria or legionnaire’s disease carried in the restaurant’s ventilation system, but views the purpose of the CGL as providing coverage for claims if patrons allege that they became sick from eating in the restaurant.

\textsuperscript{45} See \textit{id.} at 4-60.


\textsuperscript{48} See \textit{Stemple, supra} note 38, § 4.05.

\textsuperscript{49} See \textit{id.} § 4.04.

C. Reasonable Expectations

Related to both purpose and intent is the concept of reasonable expectations. As a consideration in contract interpretation, reasonable expectations have long played a role. For example, when policy language is unclear, courts normally give the language the construction that would be accorded it by a reasonable policyholder reader.\(^{51}\) During the past 30 years, the reasonable expectations concept in insurance law has been associated with the writings of Judge Robert Keeton who, as a Harvard Law School professor, enunciated in his scholarly writings a “reasonable expectations doctrine” that not only employed the reasonable expectations concept to construe doubtful policy language, but also posited that insurance policies should be construed to effect the objectively reasonable expectations of the policyholder, even in cases where “painstaking” analysis of the text of the policy would have negated those expectations.\(^{52}\)

The expectations of policyholders as an interpretative tool has been utilized most often when clear contract language excluding coverage exists in the policy but is “hidden” or “confusing” or “deceptive” because of its location in the policy. On relatively rare occasions the reasonable expectations concept has been invoked to overcome clear contract language that is not hidden or “sneaky,” but would operate to negate an essential coverage function of the policy.

D. Interpretative Groundrules of Statutory Construction

Although a substantial commentary on statutory interpretation lies well beyond the scope of this Article, some comment on this body of law is required to appreciate the bold breadth of Schmidt v. Smith.\(^{53}\) Although courts and commentators have tended to treat the construction of statutes and insurance policies as two separate realms, there are many interpretative similarities.

\(^{51}\) See Stempel, supra note 38, ¶ 4.04 (discussing role of reasonable construction under traditional ground rules for contract construction); ¶ 4.09 (discussing the reasonable expectation doctrine applied as a specific school of insurance contract interpretation). See, e.g., Claussen v. Aetna Cas. & Sur. Co., 676 F. Supp. 1571 (S.D. Ga. 1987), rev’d, 888 F.2d 747, 749 (11th Cir. 1989). For a further discussion of the reasonable expectations approach as a theory of insurance policy interpretation, see Stempel, Unmet Expectations, supra note 6, at 181 and Abraham, supra note 4, at 1151.


\(^{53}\) 713 A.2d 1014 (N.J. 1998).
Statutory interpretation of insurance law, while an area of greater debate and less doctrinal consistency than exists for contracts, nonetheless resembles contract jurisprudence a great deal. The statutory text is very important, but is not interpreted literally or with excessive formalism and brittleness. Statutory language is the most important factor, but questions of specific legislative intent and general legislative purpose are also frequently utilized by courts to decide cases.\(^{54}\)

E. Comprehensive Approaches to Construction of Statutes and Insurance Policies

To a degree, intent, purpose, and expectation overlap considerably and commingle in influencing judicial interpretation of insurance policy text. Although expectations analysis is typically viewed as focusing on the understanding of the policyholder, many coverage doctrines tending to favor insurers can be seen as part of the broader principle that the scope of policy coverage must be consistent with the objectively reasonable expectations of both insurer and policyholder. For example, the principles that only "fortuitous" losses are covered\(^{55}\) and that a policyholder may not recover more than it has lost (the "indemnity" principle)\(^{56}\) need not be codified in the policy to be utilized to deny coverage to a policyholder who intentionally brought about a loss or who is seeking a duplicative recovery exceeding his own losses. In addition, the rule that a policyholder must have an insurable interest in the object of the insurance\(^{57}\) could be regarded as another extension of the reasonable expectations doctrine favoring insurers.

F. Statutes, Regulation, and Public Policy

Insurable interest and other aspects of insurance law may be

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55. See *Stempel*, supra note 38, § 1.05[a] for a more detailed discussion of the fortuity principle.

56. See *id.* § 1.03 for a more detailed discussion of the indemnity principle.

57. See *id.* § 1.04. The insurable interest doctrine provides that a policyholder cannot reasonably expect to obtain money for the loss of something in which he has no insurable interest.
substantially regulated by statute.\textsuperscript{58} Much of the regulatory apparatus surrounding insurance is addressed to the solvency of insurers, their investment behavior and financial strength, and to issues of marketing, consumer protection, and remedies for insurer misbehavior. Some state insurance regulation also involves construction of the insurance contract itself. In addition, courts may consult the overall regulatory scheme of insurance in deciding coverage questions and fashioning remedies. Courts may determine insurance coverage disputes based on public policy considerations drawn from the court's interpretation of the statutory scheme or derived from other statutes or the common law.\textsuperscript{59}

Judicial restriction of the reach of "unconscionable" contract terms can be seen as judicial decision-making decision based on public policy. Coupled with the statutory system of regulating insurance, each state has a department of insurance charged with applying the state insurance laws and empowered to promulgate and enforce regulations in that mission. Courts often take cognizance of the position of the insurance regulators on issues of public policy and construction of state statutes.

III. \textit{Schmidt v. Smith}: Exceeding Reasonable Expectations and Overmandating Insurance

The array of insurance policy interpretive factors discussed above form a considerable arsenal for courts attempting to decide insurance coverage disputes. However, within this universe policy text is the first among equals regarding contract meaning and legal effect. Close behind is any specific understanding of each party's intent.\textsuperscript{60} The purpose of the policy and the expectations of the parties are less overtly invoked as a basis of decision, but hold significant importance in determining insurance disputes. Notions of public policy are generally used only in rare cases unless there is an express statutory or regulatory directive compelling a particular result. The restricted role of such public policy considerations stems

\textsuperscript{58} See generally \textit{id.}, Ch. 2 (regarding government regulation of the insurance business and insurance product).

\textsuperscript{59} See \textit{id.}

\textsuperscript{60} I also include much of the law of equitable estoppel and waiver (and even promissory estoppel) in this category. These doctrines, to a considerable degree, decide insurance disputes based on some notion of intent of at least one of the parties, usually the insurer, which has reflected an intent to do something for the policyholder, or to refrain from invoking a defense. For further discussion of waiver and estoppel, see \textit{Stempel}, \textit{supra} note 38, Ch. 5.
from the traditional Anglo-American view that courts should decide cases by applying law and refrain from activity that smacks too much of "making" law or "judicial activism" based on the court's own notions of what is good or just. 61

The Schmidt v. Smith 62 decision comes as a surprising and disorienting decision in large part because, despite clothing itself in the language of a statutory "command," it creates coverage extending considerably beyond what appears to have been actually contemplated by either insurers or others involved in the relevant market. 63 Schmidt v. Smith is one of those rare cases that (at least to date) has been discussed far more in the secondary literature than it has been cited by other courts. In fact, despite the pathbreaking nature of Schmidt, it has been cited by only one other court, 64 although future Schmidt-like decisions may be in the metaphorical pipeline of pending litigation. 65

To appreciate the degree to which mandatory employment discrimination coverage expands the concept of WC and EL insurance, one needs to recall the circumstance that bore the workers' compensation system. Prior to the advent of workers' compensation laws, workers worked, quite literally, at their own risk. An employee who was injured on the job had recourse in the courts, but could obtain compensation only if he or she successfully shouldered the burden of proving negligence by the employer. In addition to the practical logistical barriers established by the common law

61. See Stempel, Unmet Expectations, supra note 6, at 265-72.
63. See Scalfane, supra note 2, at 16; Hays, supra note 2, at 4.
64. As of the date of publication of this Article, there was only one case citing Schmidt v. Smith in the LEXIS-NEXIS "Mega" database, which includes all state and federal cases recorded by LEXIS: American Motorists Ins. Co. v. L-C-A Sales Co., 713 A.2d 1007 (N.J. 1998). Although this would ordinarily not be unusual for such a recent case, it appears to me most significant because Schmidt was widely reported in the insurance trade press and even in the legal trade press. As noted above, supra note 3, the New Jersey Supreme Court is well-known and traditionally closely watched in matters of insurance law. In addition, most state workers' compensation laws have language very similar to, if not identical with, the New Jersey language held by the Schmidt court to compel coverage. One would have expected at least the first salvo by claimants in other states seeking expanded coverage and compensation.
65. See Scalfane, supra note 2, at 16 (noting that after Schmidt, "[I]nsurers are sifting through options for dealing with the ruling and some attorneys agree that old cases might be reopened. One carrier has already logged a jump in such claims"). According to sources at New Jersey Manufacturers Insurance Company, "125-150 discrimination cases have already come in" since Schmidt, a number characterized as "a lot of activity" in that the insurer, which claims 20 percent of the New Jersey market, had not seen "any" such claims prior to Schmidt. See id. at 17.
method (e.g., was the injury severe enough to warrant a claim; did the worker even know a lawyer or how to find one; would a lawyer take the matter on contingency; if not, could the worker afford legal representation), employers could avail themselves to an array of common law defenses, such as the "fellow servant rule," which provided that the employer was not legally liable for worker injuries brought about by the negligence of co-workers. In its most extreme form, the fellow servant rule barred recovery where the employer was negligent but the co-worker was more negligent or exhibited negligence that was an intervening and superseding cause of the worker's injury. Assumption of risk also provided a powerful defense to employers, as did contributory negligence. In short, recompense for an injured worker, like work itself, was no bed of roses for laborers during the late 19th and early 20th centuries.

The advent of workers' compensation legislation changed much of the legal landscape in favor of the worker.66 Employers were made strictly liable for workplace injuries taking place in the ordinary course of employment, and the fellow servant defense was abolished.67 Defenses such as assumption of risk were also abolished, although employers could still defeat claims if the injured worker engaged in "willful misconduct" or was outside the scope of employment at the time of injury.68 In return, employers did not face jury trials over the injuries and injured workers were compensated according to a schedule of benefits.69

While the average worker did not fare as well from the early 20th century reforms as did railroad workers (who could sue under favorable circumstances provided under the Federal Employers Liability Act ("FELA")),70 the conventional wisdom is that even with

66. Regarding the pre-existing common law and the changes made by workers' compensation statutes, see Larson & Larson, supra note 5, §§ 1.02, 1.03, 2.01-05, 2.06-08. New Jersey's statute, first enacted in part in 1911, is representative. See National Grange Mut. Ins. Co. v. Schneider, 392 A.2d 641, 642 (N.J. 1978).

67. See Larson & Larson, supra note 5, §§ 1.01-03, 2.03-05.

68. See id. §§ 30.01-38.06. The willful misconduct defense of the employer, although hardly toothless, is substantially less powerful than the common law doctrines such as contributory negligence and assumption of risk. For example, benign but foolish horseplay does not bar recovery under the workers' compensation law, but would frequently be claim-barred negligence by the employee at common law.

69. See id. §§ 2.07-08.

70. The Federal Employers Liability Act, 45 U.S.C. §§ 51-60 (1994), was enacted in 1908. It permits railroad workers to sue over work-related injuries in either state or federal court, but does not allow defendants to remove state court actions to federal court. See id. § 56. The worker plaintiff need only prove some negligence on the part of the railroad (not the preponderance normally required to prevail in tort litigation),
political compromise, workers' compensation reforms generally improved the situations of employees. Today, there remains significant debate about the efficacy of the workers' compensation system. Employers consistently complain about high benefit levels, high premiums, and significant fraud and abuse in the system. Workers, their attorneys, and labor advocates argue that the benefit schedules are too low, resulting in undercompensation for many injuries.

At the time of enactment of workers' compensation legislation during the early 20th century, there was, of course, no state or federal antidiscrimination law. At common law, employers were given an absolute right to discriminate against workers based on race, creed, color, ethnicity, or gender. Nothing short of physical violence against the worker was actionable, and even that appears to have been widely permitted as a practical matter under certain circumstances.\textsuperscript{71} Although the post-Civil War civil rights statutes had been enacted, the greatest potential aid to workers, 42 U.S.C. § 1981, which provides a cause of action to one who is discriminated against in the making of a contract because of race, was not given full effect and enforcement until the Supreme Court decided \textit{Runyon v. McCrory}.\textsuperscript{72} Furthermore, § 1981 is limited to cases of racial discrimination, and while it may also protect ethnic groups, it clearly does not outlaw gender discrimination.

To perhaps belabor the obvious, the overarching theme of workers' compensation law was not to attack invidious discriminat-

\textsuperscript{71} Regarding the history of employment discrimination law and the absence of significant prohibitions on job discrimination prior to the 1960's, see MICHAEL J. ZIMMER, ET AL., CASES AND MATERIALS ON EMPLOYMENT DISCRIMINATION 3-32 (4th ed. 1997).

\textsuperscript{72} 427 U.S. 160, 172-74 (1976) (holding that plaintiffs alleging race discrimination in seeking to gain admission of child to private school stated a claim for race discrimination under the statute). The force of \textit{Runyon v. McCrory} was significantly curtailed in \textit{Patterson v. McLean Credit Union}, 491 U.S. 164, 171 (1989), which held that a bank teller harassed on the basis of her race did not state a claim under § 1981 since the harassment did not involve prohibition on contracting per se because of race. \textit{See also} ZIMMER ET AL., supra note 69, at 95 (noting that the \textit{Patterson} holding was legislatively overruled by the Civil Rights Act of 1991).
tion in the workplace, but to give workers monetary relief for the sort of physical injury that occurred as an ordinary consequence of work, particularly physical labor. Workers’ compensation law was originally intended to apply to flesh-and-blood workplace injury and was so structured.73 Over the years, interpretation of the statute has evolved and the concept of physical injury has expanded to encompass stress-related ulcers, carpal tunnel syndrome, job-induced phobia, and the like.74

Without a doubt, workers’ compensation was not intended to be a job discrimination compensation system. Laws against discrimination did not arrive until the 1964 Civil Rights Act.75 The New Jersey statute relied upon by the Schmidt court was enacted in 1917. Although the 1964 Act prohibited gender discrimination,76 it was not widely construed to prohibit sexual harassment (as opposed to outright refusal to hire or promote women) until the Supreme Court’s 1986 Meritor Savings Bank, FSB v. Vinson77 decision. For decades, workers’ compensation legislation was referred to as workmen’s compensation law—nomenclature that persists even today among the less socially enlightened. Making workers’ compensation law into antidiscrimination law engrains onto the statutory scheme a good deal more than was historically envisioned.

Against this historical backdrop, it is more than fair to argue that the web of American antidiscrimination law is not part of the fabric of workers’ compensation law, but is instead a separate section of the law of civil liability. This is reflected not only by the presence of separate statutory schemes, case law, and doctrines governing both bodies of law, but in the organization of the legal profession as well. For example, the workers’ compensation bar is distinct from the employment discrimination bar, with relatively little overlap. Workers’ compensation and job discrimination have

73. See Larson & Larson, supra note 5, §§ 1.01-.04.
74. See id. §§ 50.01-.07, 51.01-.05, 52.01-.53.05, 56.01-.06.
76. See id. § 2000e-2(a)(1). Ironically, but fortunately, gender discrimination was added to the Act by its opponents, who were erroneously confident that a law barring gender discrimination would fail even if one outlawing race discrimination would not. But to the surprise of the smug sexists of Congress, other leaders and the public reacted positively to the addition of gender to the bill and sex discrimination remained prohibited in the enacted final version of the law. See William N. Eskridge, Jr. & Philip P. Frickey, Legislation: Statutes and the Creation of Public Policy 15-16 (2d ed. 1995). See generally Charles Whalen & Barbara Whalen, The Longest Debate: A Legislative History of the 1964 Civil Rights Act (1985).
77. 477 U.S. 57 (1986) (construing sexual harassment to be a form of gender discrimination under Title VII of the 1964 Civil Rights Act).
traditionally been two separate spheres of law and largely continue in that vein.

Because workers’ compensation legislation is broadly worded to apply to any “bodily injury,” one can make a substantial case that workers’ compensation and related legislation applies to bodily injury caused at the workplace, regardless of whether its source is discrimination or sexual harassment. *Schmidt v. Smith*\(^7^8\) presents a particularly compelling case for construing the law broadly. Lisa Schmidt was not merely upset over workplace sexism. She testified that she was physically assaulted by her boss on repeated occasions, and that as a result, she experienced anorexia, bulimia, and attempted suicide on four occasions.\(^7^9\) Clearly, Lisa Schmidt’s injuries were bodily injuries for which the perpetrator and the employer should be held legally responsible. But this determination begs the question of whether the employer’s WC/EL carrier should pick up the tab for this liability when the insurance policy contained an irrefutably clear exclusion of such claims.

Recall that WC insurance is marketed in tandem with EL insurance. As the *Schmidt* court itself observed, EL coverage is “traditionally written in conjunction with workers’ compensation 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 provisions of the workers’ compensation statute.”\(^8^0\) The typical WC policy (and statute) exempts from coverage the employer’s “serious and willful misconduct, the knowing employment of a worker in violation of the law . . . and failure to comply with health and safety laws.”\(^8^1\) To fill the normal gaps existing between its WC coverage and its CGL coverage, the employer policyholder normally purchases EL coverage, which is “designed to protect the employer against liability from traditional physical injury torts that may be brought by an employee.”\(^8^2\) Thus, under New Jersey law, as elsewhere, an employer’s WC policy does not cover the intentional torts committed by one co-worker against another. However, such acts are ordinarily covered under EL poli-

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\(^7^8\) 713 A.2d 1014 (N.J. 1998).


\(^8^0\) *Schmidt*, 713 A.2d at 1017 (quoting Producers Dairy Delivery Co. v. Sentry Ins. Co., 718 P.2d 920, 927 (Cal. 1986)).

\(^8^1\) *Stempel*, *supra* note 38, § 21.01[a], at 21-6 to 21-7.

\(^8^2\) *Id.* § 21.03, at 21-11.
cies, as long as the intentional injury was committed by the co-worker, rather than the employer as an entity.

Writing prior to the *Schmidt v. Smith* decision, this author ventured that EL policies without language excluding coverage for employment claims could prove to be a crossroads of litigation over coverage:

Notwithstanding that the drafters of the EL probably did not intend to cover discharge and job discrimination claims (although they probably did not have a specific intent to exclude them either), the language of an EL may permit a policyholder to claim coverage that is denied in the CGL.\textsuperscript{83}

Policyholders without language in their EL policies that specifically addresses the issue of discrimination liability can make a good case for coverage, although case law is divided.\textsuperscript{84} However, "a well-drafted exclusion for employment-related harassment or discrimination claims should be enforceable . . . ."\textsuperscript{85}

In *Schmidt*, the USF&G EL policy at issue stated straightforwardly that the EL insurance did not cover "[d]amages arising out of coercion . . . harassment . . . discrimination . . . any personnel practices, policies, acts or omissions."\textsuperscript{86} As the *Schmidt* court observed, this exclusion is sufficiently understandable that a reasonable policyholder would realize that discrimination and harassment claims are not covered; and clearly, the damages for which PAV (the employer) was liable in *Schmidt* were damages stemming from sexual harassment.\textsuperscript{87}

\textsuperscript{83} Id.
\textsuperscript{84} See id. at 21-14.
\textsuperscript{85} Id. (noting that recently issued EL policies "tend to include such exclusionary language").
\textsuperscript{86} Schmidt v. Smith, 713 A.2d 1014, 1017 (N.J. 1998).
\textsuperscript{87} See id. at 1018. The New Jersey Supreme Court reversed the intermediate appellate court, which had engaged in considerable contortion to find that the insurer's harassment exclusion was ambiguous, in order to invoke the *contra proferentem* principle and construe the policy against the insurer and in favor of coverage. *See* Schmidt v. Smith, 684 A.2d 66, 73 (N.J. Super. Ct. App. Div. 1996), aff'd, 713 A.2d 1014 (N.J. 1998).

The New Jersey Supreme Court's rhetoric is perhaps a bit lukewarm in finding the harassment exclusion sufficiently clear to merit enforcement absent public policy concerns. The court stated that "the phrasing of the exclusion is not 'so confusing that the average policyholder cannot make out the boundaries of coverage.'" *Schmidt*, 713 A.2d at 1018 (quoting *Weedo v. Stone-E-Brick*, Inc., 405 A.2d 788 (N.J. 1979)). But read fairly, the *Schmidt* exclusion is better than merely "non-confusing." It admits only one reasonable understanding: the EL policy in question and the issuing insurer did not contract to undertake coverage for sexual harassment or employment discrimination claims against PAV.
Under these circumstances it is clear that as a matter of contract interpretation the insurer did not need to cover the Schmidt claim. Nearly every standard indicia of contract meaning points in this direction: clear text; seeming intent of the parties; the purpose of the WC/EL policies and the exclusion, which is particularly compelling in light of the history of WC and EL coverage; as well as the reasonable expectations of the parties. The insurer clearly did not intend to provide such coverage. The average policyholder reading this exclusion could not form a reasonable belief that it had coverage, since both the language of the policy and the traditional function of EL policies does not provide such coverage.

Arrayed against this veritable deck of interpretative factors favoring the insurer, the Schmidt court invoked essentially one trump card: New Jersey law requires employers to obtain insurance coverage for all work-related bodily injuries suffered by workers. According to the court:

In order to assure that this statutory remedy given in lieu of a common law remedy is not illusory, the Legislature has required that every employer carry Workers' Compensation insurance. Those policies must cover not only claims for compensation prosecuted in the Workers' Compensation court, but also claims for work-related injuries asserted in a common law court... In short, the terms of a policy cannot conflict with the statutory mandate that there be coverage provided for all occupational injuries.

Although this is an important statutory mandate required of employers, it hardly follows that insurers violate the law by selling employers an insurance product subsequently found by a court to be insufficiently comprehensive in its bodily injury coverage. Despite the "semi-public" nature of WC/EL insurance, the court effected an expansion of the insurance status quo not envisioned (much less commanded) by the legislature when it held not only that the insurer and employer are subject to the statutory mandate, but that remedy for failing to provide this coverage is court-mandated coverage.

The language in Schmidt quoted above is grounded in precedent which holds that insurance sold to fulfill an employer's WC and EL insurance needs must be as broad as the statutory mandate

88. See Schmidt, 713 A.2d at 1018.
89. Id. at 1016-17.
90. See Larson & Larson, supra note 5, § 92.
imposed on employers. But this approach may impose unnecessary burdens on WC/EL insurers in relation to other commercial actors such as the employers themselves. Even if under New Jersey law an employer’s mandate must be the insurer’s mandate, it remains unclear as to whether harassment and discrimination fall within that mandate, in view of the distinctions between discrimination claims and traditional workers’ compensation claims. Unfortunately, the *Schmidt* court did not linger over these questions; instead, it leapt to a broad, compulsive reading of the statute in order to override a clear contract exclusion.

As noted above, insurance sold to employers to fulfill their workers’ compensation obligations is more public than the average insurer-policyholder contract. In defense of the *Schmidt* court, it can be said that the leading treatise on workers’ compensation, as a matter of black letter law, emphasizes the requirements imposed on WC/EL insurers by courts pursuant to the statutes:

Since compensation insurance is for the benefit of the employee as well as of the employer, some of the usual incidents of insurance are modified for the employee’s protection. Defenses, such as nonpayment of premiums or breach of policy conditions, which the insurer might have against the employer, are not available against the employee. Moreover, under many statutes, a policy cannot be canceled merely by action of the insurer, the employer or both; notice to the compensation commission is ordinarily required, followed by an interval in which replacement of the insurance can be effected. The compensation commission has jurisdiction to pass upon questions of compensation insurance when they affect the rights of the employee, while questions purely between the insurer and insured may remain within the jurisdiction of the courts.91

The distinctive feature of compensation insurance is that, although it arises from a contract between the employer and the carrier, it creates a sort of insured status in the employee that comes to have virtually an independent existence. The insurance carrier therefore stands in two relations: to the employer, to protect it from the burden of its compensation liability, and to the employee, to ensure that he or she gets the benefits called for by the statute. The former relation is governed largely by the insurance contract; the latter is governed by the statute.92

Thus, a significant number of insurer defenses that are other-

91. *Id.* § 92, at 17-1 (emphasis removed).
92. *Id.* § 92.21, at 17-14 to 17-16.
wise available against the employer are not permitted to defeat an employee's claim for coverage under the policy. These include misrepresentation, concealment, failure to report compensation, failure to give proper notice, unauthorized assignment, and other arguable breaches of a policyholder's duty of cooperation and good faith. Furthermore, "[T]he law has undertaken to compel a certain minimum coverage in insurance contracts, regardless of any narrower agreement between insurer and employer." Accordingly, there is conventional wisdom that may be cited for support by the Schmidt court: "[I]f a compensation policy is written at all, the insurer will frequently find that the scope of its liability to employees is taken completely out of the hands of the parties to the insurance contract and dictated by the law of the state." However, the treatise writers making this statement say mandated insurance under the statute is designed mainly to prevent insurers from "cherry picking" the best risks while refusing others. Their overall discussion of required coverage focuses on the presumed legislative intent of having WC/EL insurance cover all aspects of the employer's operations. However, there appears to be no clear mandate to require particular forms of coverage outside of the traditional core of coverage provided for typical workplace physical injury.

Therefore, despite the differences between WC/EL insurance and CGL insurance, the Schmidt court clearly could have been more flexible and fair with the insurer regarding the case remedy. Notwithstanding previous cases construing employer mandates to be insurer mandates, the court could have also recognized that in this case inadequate insurance was the employer's problem and not the insurer's problem. For example, the court could have made its decision prospective only. Prior to Schmidt, most casual observers would have reasonably expected that clear exclusionary language in an insurance policy would have been enforced when the nature of the exclusion was consistent with the general grant of coverage.

In addition, the court could easily have held the employer re-

93. See id. at 17-17.
94. Id. § 93.10, at 17-99.
95. Id.
96. See id. §§ 93.10, 93.20-.30, at 17-99, 17-106, 17-108. Consequently, when it is said that New Jersey has "one of the stiffest types" of "full-coverage" workers' compensation statutes, it must be emphasized that the treatise authors refer to a requirement that there be coverage of the full range of the employer's operations, not that there must be coverage (even if clearly excluded) for all manner of the employer's liability-creating activities and consequences. See id. § 93.20, at 17-104.
sponsible for deficiencies in such newly minted mandatory coverage. It is the employer to whom the statutory mandate is directed. Even if the insurer was contributing to the delinquency of the employer by issuing an EL policy that did not include full coverage for all manner of work-related bodily injuries, it is by no means clear that the appropriate remedy is to force the insurer into providing the coverage it thought it had excluded and which the court concluded was excluded by the clear language of the insurance policy at issue. Furthermore, it does not appear that state regulators in any way disapproved of the exclusion for discrimination or harassment found in the policy at issue in *Schmidt*. Although the more express exclusion at issue in the case is relatively new, it was hardly secret and may even be commonplace in most WC/EL policies.97

Statutory mandates of employer financial responsibility are important in the law. So, too, is judicial enforcement of contracts. If the court was determined to give its decision retroactive effect, a better means of mediating any tension between these two legal values (if the insurer is to be blamed at all) would have been to levy an appropriate administrative fine upon the insurer for writing non-conforming coverage (albeit unintentionally in view of the path-breaking nature of the *Schmidt* decision). It is unlikely that even a serious fine would have equaled the more than $181,000 for which the insurer was held liable by the court (for insurance coverage that the court found was expressly disclaimed).98

Beyond this seemingly excessive punishment, the New Jersey Supreme Court's primary error remains its unduly broad reading of the employer mandates of the statute. As noted above, WC/EL coverage historically and functionally has been applied to physical injuries that come from working under normal conditions gone awry (e.g., a crushed finger in a punch press), even where the coverage is under the EL policy for an intentional tort (e.g., a brawl between co-workers arguing over respective responsibilities for curing a defect in construction) rather than the WC policy for accidental injuries. Traditionally, the expected scope of EL coverage has not

97. The initial policy issued to PAV excluded coverage for "[d]amages arising out of the discharge of, coercion of, or discrimination against any employee in violation of the law," language that when properly read would exclude the claim in *Schmidt*. Prior to the *Schmidt* incidents, the exclusion was amended to its more exclusionary form. The new exclusion barred coverage not only for discrimination, but also for "harassment," "humiliation," as well as for "any personnel practices, policies, acts or omissions." See *Schmidt*, 713 A.2d at 1017.

98. See *id.* at 1016 (noting the total award of $181,730.36 to plaintiff Schmidt against PAV and Smith).
included discrimination and harassment claims, at least not with sufficient force to create an expectation that would override clear exclusionary language. This is the case notwithstanding that the basic state statute requires that the employer, not the insurer, have sufficient means to satisfy bodily injury claims by workers.

To justify its abrupt and counterintuitive break in the law, the Schmidt court did invoke precedent to buttress its view that insurers are equally bound by the statute that commands that employers be capable of satisfying work-related claims by employees. According to the Schmidt court, “USF&G must indemnify PAV, however, for the same reason that New Jersey Manufacturers Insurance Company had to indemnify Variety Farms for its obligations to the underage employee injured in that case.”99 Although citing the 1980 Variety Farms decision assists the Schmidt court’s campaign to suggest it is not engaging in the manufacture of new forms of mandated EL coverage, Variety Farms is a relatively weak reed on which to hang the substantial obligations imposed on EL carriers under Schmidt.

In Variety Farms, Inc. v. New Jersey Manufacturers Insurance Co.,100 the employer hired a 15-year-old worker, underage by state law, who was seriously injured at work. The youth worker sued for workers’ compensation benefits but the EL carrier refused, citing an exclusion from coverage where the claim involved “any employee employed in violation of law with the knowledge or acquiescence of the insured or any executive officer thereof.”101 The Variety Farms court found the exclusion unenforceable because the EL policy had implicitly been issued to the employer to comply with the statutory workers’ compensation and employer liability coverage mandate. The court reasoned that the statutory goal of adequate coverage for workers would be unreasonably defeated if the insurer was permitted to enforce the exclusion.102

Unlike Schmidt, however, the Variety Farms court grounded its decision in the historical context of the movement toward workers’ compensation legislation and the traditional function of WC and EL insurance,103 invoking precedent from National Grange Mutual

101. Id. at 698.
102. See id. at 699-700.
103. See id. at 700.
Insurance Co. v. Schneider.\textsuperscript{104} Quoting National Grange, the Variety Farms court focused on the core function of the workers' compensation system.

[T]he minor's suit ... [must be] fitted consciously and appropriately into a complex and balanced system of compensation for work injuries.

... The statutes we deal with were necessary legislative reactions to 19th Century industrial excesses. The reformers who created workmen's compensation and factory law remedies for injured workers and industrially abused minors simply would not purposely deprive an illegally employed 13-year-old, who claims injury by the negligence of his employer, insurance protection granted routinely to almost everyone else.\textsuperscript{105}

Both courts in Variety Farms and National Grange based their decisions mandating coverage on the original intent of the legislature enacting the workers' compensation system. Both decisions also relied on the historical context of the statute and the nature of the instant claims, tragic but all-too-common physical injuries to underage employees operating dangerous machinery at work as part of their ordinary workplace duties. In short, both decisions viewed the coverage at issue as reasonably expected by the participants in the workers' compensation system, including the WC and EL insurers, in light of the totality of the circumstances.

By contrast, Schmidt v. Smith\textsuperscript{106} involved a type of claim far removed from the original legislation and customary employer-insurer expectations. Without in any way diminishing the seriousness and wrongfulness of sexual harassment, it is clear that coverage for sexual harassment and job discrimination is not what legislators, employers, or insurers had in mind prior to the modern era of employment litigation. In New Jersey, the statutory provision read so broadly by the Schmidt court predates the sexual harassment cause of action by more than 60 years.\textsuperscript{107}

Where the EL policy is silent on the topic, it is still appropriate

\textsuperscript{104} 392 A.2d 641 (N.J. Super. Ct. Law Div. 1978). In National Grange, a 13-year-old meat market employee lost his right arm in a meat grinder accident. When the youth sought benefits the insurer rejected coverage, citing the policy's illegal employment exclusion. Both the National Grange and Variety Farms courts rejected this defense. See id. at 644.

\textsuperscript{105} Variety Farms, 410 A.2d at 701 (quoting National Grange, 392 A.2d at 644).

\textsuperscript{106} 713 A.2d 1014 (N.J. 1998).

\textsuperscript{107} See Meritor Sav. Bank, FSB v. Vinson, 477 U.S. 57, 65 (1986) (stating that "Title VII affords employees the right to work in an environment free from discriminatory intimidation, ridicule and insult").
to find coverage for job discrimination and sexual harassment and to reject insurer arguments that the harassment was not an "accident," that emotional trauma suffered by the victim was not sufficient "bodily injury," or that certain relief for the victim does not qualify as "damages." But where the insurer in most certain terms excludes coverage for harassment, discrimination, and coercion on the face of an EL policy issued to a commercial policyholder, any statutory or public policy case for coverage seems to lack the force required to overcome such a clear exclusion.

Put another way, child labor and workers left incapacitated by machines have long been part-and-parcel to the system of workers' compensation and employer liability. Coverage for such claims is justified even when policy language is substantially to the contrary. Discrimination and harassment should not, in view of their relative recency and disturbance of prior expectations, similarly override contrary language in the policy.

*Schmidt* thus represents an exercise in judicial activism and court-created insurance coverage that is not justified in view of the circumstances of the claim, the language and purpose of the policy at issue, the historical context and expectations of the parties, and the availability of more apt remedies and means of fostering greater EL coverage in the future. Despite its sympathetic factual situation, *Schmidt* exceeds the bounds of legitimate judicial law-making and contract reformation.

**IV. CONTINUING TENSION ON THE EMPLOYMENT CLAIMS FRONT: COMPENSATION, DETERRENCE, FAIRNESS, AND EQUALITY**

Beyond the suspect methodology of *Schmidt*, however, there remains the harder question: even if *Schmidt* is bad law, is it good policy? After decades of being the dirty little secret of the American workplace, employee injuries for discrimination and harassment have finally received the serious attention they deserve. Title VII is less than 35 years old, but has had, and continues to have, a profound impact in the workplace. The sexual harassment component of Title VII protection accorded workers is barely a decade old and has, during the 1990's alone, become a wellspring of litigation and a source of employer concern and action. In 1998, the United States Supreme Court decided four sexual harassment cases,\(^{109}\) sub-

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108. *See generally* STEMPEL, supra note 38, § 21.03.
substantially clarifying the law in this area; an indication not only of the growing importance of gender discrimination law, but also its relative youth.

Without a doubt, the impact of discrimination law during the final third of the 20th century has been enormous. While many employers and social critics decry the trend, this author would like to disassociate himself from the seeming backlash against discrimination law. While surely there are weak and frivolous claims, the "boom" in employment discrimination claims has, for the most part, occurred because many employers or their agents have illegally engaged in discrimination and harassment grounded in gender, race, age, or ethnicity. Such conduct is illegal and its victims deserve legal recompense. Its perpetrators should be held responsible and in appropriate circumstances punished through exemplary damages (or even incarceration for extreme cases such as assault, battery, or rape).

Although critics may treat job discrimination, particularly sexual harassment claims, as the product of excessive political correctness or a new puritanism, this emerging area of litigation really represents the first stages of a statutory movement toward social equality. Protracted litigation, expense, and the occasional bogus claim by the malcontent worker are simply the prices that must be paid to apply this body of law, such that laudable social goals underlying the law are effected. Weak or frivolous contract claims are brought with significant frequency, often by well-heeled litigants who engage in costly wars of attrition. Yet no one suggests that the legal system's establishment of enforceable contract rights was a mistake that needs undoing. Rather, our legal system returns to the ongoing task of separating the bona fide claims from those that should not impose liability. Workers should have legal protection against race and gender discrimination just as contracting parties

defendant vicariously liable for sexual harassment by lifeguard supervisors in absence of effective city procedure permitting victims to report grievances); Burlington Indus., Inc. v. Ellerth, 118 S. Ct. 2257 (1998) (finding that Title VII permits sexual harassment claim even where plaintiff's refusal to submit to sexual advances did not result in discharge or lost promotion opportunities); Gebser v. Lago Vista Indep. Sch. Dist., 118 S. Ct. 1899 (1998) (finding school district not liable under Title IX where student plaintiff failed to report teacher's misconduct to responsible school officials); Oncale v. Sundowner Offshore Servs., Inc., 118 S. Ct. 998 (1998) (holding that Title VII applies to same-gender sexual harassment).

110. See, e.g., Walter B. Olsen, The Excuse Factory (1998) (criticizing the creation of antidiscrimination rights, including protection accorded to workers under the Americans with Disabilities Act, Title VII, and the ADEA, for fostering an atmosphere of employee opportunism and workplace inefficiency).
should have recourse to courts when contracts are breached, as investors should continue to enjoy protection under the securities laws, as victims of negligent injury should have the protection of tort law, and so on.

But, to say that Title VII and similar statutes are wise and deserve continued enforcement obviously does not answer the question of who should pick up the tab for defense, settlement, and judgments occasioned by such claims. One school of insurance and public policy thought argues that discrimination and harassment claims should not be insurable at all because much of the conduct at issue borders on the volitional. While one can certainly make a case for requiring employers to internalize all costs of such claims, it is an unconvincing case for several reasons.

- First, despite the "intentional act" sounding nomenclature of terms like "race discrimination" and "sexual harassment," a large amount of alleged workplace employment discrimination appears to be the result of unconscious prejudices (e.g., attitudes about whether women can understand machines or should be on the road 300 days a year, or whether a 60-year-old account representative still has the same zeal for his job), rather than an overt dislike of women, racial minorities, or older workers. 111 Although some oppose recovery in such situations, they are wrong. Discrimination, even if subconscious, nonetheless violates the law and injures the affected worker. Relief should be available, provided that the worker plaintiff can satisfy the pragmatically tougher burden of proving that the adverse employment decision really was the product of discrimination rather than serendipity or a merits-based decision with which the plaintiff merely disagrees.

- Second, even if the actor inflicting discriminatory treatment or harassment is acting with hateful racism or sexism, this hardly means that all defendants in the ensuing lawsuit are guilty of the same malice. The corporate employer defendant, which is often the deep pocket that will actually pay the resulting judgment or

settlement, frequently is not acting with malicious intent at all. The employer’s liability-creating “sin” may simply be that it failed to establish a system for monitoring discrimination by individual employees, was unable to recognize discrimination in its midst, or was unable to act forcefully enough to curb the individual perpetrator and assist the victim. Such failures of recognition or nerve, as the case may be, should not be condoned by the law, but neither should they make this very real risk of doing business uninsurable.

- Third, litigation claims may result in “false positives”: incorrect factfinder assessments that impose liability even when the defendant did not, in fact, discriminate, but simply treated the employee badly or was a less sympathetic litigant than the employee. Although these false positives do not occur with the frequency suggested by some critics of employment discrimination litigation (who, to paraphrase Will Rogers, never met a defendant they did not like), erroneous liability determinations in discrimination claims do occur. Similarly, factfinders at times impose liability for breach of contract or fraud when the defendant was merely a hard bargainer, or where a tort defendant manufactured a product that was safe if properly used, but the jury fails to appreciate the plaintiff’s misuse of the product. No one seriously suggests that insurance should be unavailable for tort claims (although the market may be difficult at times for such claims) or that contract rights are a bad thing, even though they can lead to controversial decisions like Pennzoil Co. v. Texaco Inc., 112 which imposed multibillion dollar liability on a company for what many regarded as permissible business behavior (attempting to beat a competitor by acquiring another company).

- Fourth, even if claims are properly characterized as marginal, they can be costly for defendants. Even marginal claims have some settlement value, particularly if the claimant has advantages of forum selection or natural sympathy from factfinders. Even where the defendant adopts a “millions for defense but not one cent for tribute” philosophy, the cost of defending such virtue may be high. Successful litigation is not cheap. It requires legal counsel and related expenses irrespective of the merits of the claim. While the frivolous claim may ordinarily be more eas-

112. 481 U.S. 1, 9 (1987) (reversing the federal court’s attempt to enjoin enforcement of a multibillion dollar state court judgment and describing the facts of the state court litigation).
ily defeated without trial than the marginal claim, neither can be eliminated for free. Certainly, strong but unsuccessful claims are expensive to defeat, even though a judgment is never obtained against the policyholder. To an extent, defendants lose even when they win.¹¹³

For all of these reasons, commercial actors should be able to obtain insurance coverage for job discrimination claims. But, reaching this conclusion still begs the question of how this risk should be managed and what insurance products should be deployed in the operation.

To a large extent, the market has answered this question. Private insurers, left to their own devices, have established insurance products dealing with employment-related claims. The primary vehicle, of course, is the WC policy in tandem with the EL policy. These policies provide coverage for employee claims under state workers' compensation law. This combined product addresses what has been, and continues to be, the major source of workplace claims: physical injury on the job that takes place in essentially the ordinary course of business because of the nature of the work.

The EL policy supplements the WC policy by providing coverage for similarly long-recognized physical injuries, resulting from essentially inherent workplace hazards. As discussed above, the EL policy was designed as a supplement to the WC policy and was probably never intended to apply to race and gender discrimination claims.

The CGL and other liability policies are designed to cover traditional risks of claims by third parties over the types of incidents that normally occasion third-party lawsuits. Such claims include conventional torts committed by workers or agents, claims arising out of defective products, or business competition, including commercial disparagement and defamation claims.

When third-party liability claims are new or out-of-the-ordinary, insurers often resist these claims as outside the scope of in-

¹¹³ Before anyone reaches for a handkerchief on behalf of litigation defendants, I should add that the same holds true for plaintiffs. They may obtain a judgment, but nonetheless have a net loss, because they were required to expend funds on counsel fees and related expenses due to a defendant's tort, breach of contract, or statutory violation. Sometimes the defendant seeks bankruptcy protection and the judgment debt is discharged for pennies on the dollar. In addition, commercial litigants have the advantage, in most cases, of deducting disputing costs from their income tax as a cost of doing business. Individual litigants, like employees claiming job discrimination, ordinarily have no such government subsidy for their claims.
tended coverage, notwithstanding the literal breadth of language in the liability policy. Take, for example, the emerging field of pollution coverage. Insurers sought not to provide coverage for pollution claims unless the pollution at issue was abrupt, since the policy required that the discharge be "sudden and accidental," notwithstanding that most dictionaries list the first meaning of "sudden" as "unexpected." In a related part of the pollution coverage saga, insurers also resisted coverage of pollution-related claims under the Personal Injury ("PI") section of the CGL, which provided coverage (without a pollution exclusion) for a claim of "wrongful entry" by the policyholder. Policyholders have argued (and have even had some success in litigation) that seepage of toxic waste onto adjoining property is a "wrongful entry" within the meaning of the CGL.

Although a thorough discussion of these coverage disputes lies well beyond the scope of this Article, this author merely observes that insurers resisting coverage in these cases argued against textual literalism and in favor of policy construction that accords with the purpose of the policies. Consider the stronger of the two previous examples. The "wrongful entry" aspect of the PI coverage of the CGL was aimed at conventional claims of trespass, and not at modern pollution claims arising well after the policies were contemplated and authored. Ordinarily, insurers should prevail in such litigation even though the literal language of the CGL favors policyholders on this point (a pollutant that seeps into the groundwater does, after all, "enter" property and cause damage).

Like pollution, employment discrimination claims are matters for which traditional liability insurers seek to avoid coverage. Some of this resistance may simply be fear of the new and unfamiliar. More of it is fear of the actuarially new and difficult to calculate. CGL insurers have long used language seeking to bar workplace-related claims. With the onset of discrimination claims, these insurers have steadily sought to strengthen this exclusionary language and avoid covering employment discrimination claims altogether.

114. See Stempel, supra note 38, § 14.11[b] (discussing the history, evolution, and current status of coverage litigation over the Qualified Pollution Exclusion).
115. See id. § 14.05[b] (discussing the history, evolution, and current status of litigation seeking coverage for pollution claims under the Personal Injury part of the CGL).
116. See id. (discussing how wrongful entry and trespass coverage provided under Personal Injury provisions of the CGL was designed to cover traditional entry and trespass claims, such as controversies between landlords and tenants, or property disputes among neighbors, rather than pollution claims).
Instead of having discrimination and harassment claims covered under the CGL, the insurance industry's own conduct has suggested that insurers do not want such claims subject to the CGL, but rather, that discrimination risks are better underwritten, priced, and administered through an Employment Practices Liability ("EPL") policy. EPL policies differ from CGL and other liability policies in a number of ways.\textsuperscript{117} The EPL policy is offered only in the claims-made form. It is relatively expensive in relation to the coverage limits provided. It contains a substantial deductible or self-insured retention ("SIR"). The policies typically have an aggregate limit as well as a per claim limit, and may also have "burning limits" where the costs of defending claims reduces the policy limits available for paying claims. Most importantly, EPL insurance is underwritten as a separate, specified risk. The insurer that offers EPL coverage investigates the employer applicant with a particular eye to the business in question, the workforce, and likely sources of claims, including discrimination, sexual harassment, and similar risks that have historically not been part of the underwriting investigation process for WC, EL, or CGL policies.\textsuperscript{118}

In short, insurers either want to avoid discrimination and harassment coverage altogether, via exclusions, or to monitor and control it very tightly through writing only the specified risk EPL policy for such coverage, so that they can better monitor loss experience and adjust their risk with some alacrity. This is the behavior of an insurance industry still getting its feet wet in EPL as an aspect of liability insurance. There are signs that the EPL segment of the insurance market is also showing the normal signs of development within the industry. For example, during the past few years EPL limits have gone up significantly while premium costs have gone down substantially. One is reminded of calculators and personal computers, where the cost of calculation or computation decreased dramatically as the industry's learning curve brought greater manufacturing efficiency.

\textsuperscript{117} See id. § 21.03 (describing EPL policy and its traits); see also Andrew Kaplan et al., The EPL Book: A Practical Guide to Employment Practices Liability and Insurance 110-96 (1997) (describing policy structure, defense and settlement provisions, exclusions, definitions, conditions, and operation of EPL policy).

Without being excessively sanguine about the mythical, all-knowing, all-responsive powers of the market (even the father of market theory, Adam Smith, was not so rabid a cheerleader),\textsuperscript{119} one can see the insurance industry responding to employment discrimination claims as a type of business liability that insurers are willing to insure—but only under certain conditions. Most importantly, insurers appear unwilling to insure discrimination claims as part of the package of traditional liability coverage for worker claims (under WC or EL coverage) or typical third party claims (insured under the CGL).

Rather, the insurance industry has attempted to treat discrimination claims like pollution claims (including government-ordered pollution cleanup).\textsuperscript{120} Insurers also want these claims out of the traditional bundle of liability coverage. Some insurers are willing to write this coverage (there is a growing market of Environmental Impairment ("EI") insurance just as there is a growing market of EPL insurance) but only as a separate product, more carefully tailored to the risk and more closely monitored and controlled by the insurer than is possible when the coverage is offered as part of an omnibus package of more traditional coverage with which the industry has more longstanding experience.

Although one should not worship markets too credulously,\textsuperscript{121} neither should one ignore them. Where a commercial market has spoken, one should ordinarily start with the proposition that this says something worth absorbing. One may, upon further analysis, conclude that the market has erred because of historical, social, political, or other factors, thus prompting one to favor government

\textsuperscript{119} See generally Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations (Knopf ed. 1991) (1776) (identifying market operation and generally praising its effects, but admitting the need for certain external government or social controls to permit markets to work well).

\textsuperscript{120} See Stempel, supra note 38, ¶ 14.12 (describing a split in the courts regarding coverage under older CGL language and the insurance industry's move to a more strongly worded exclusion barring coverage for government-mandated cleanup of polluted property).

\textsuperscript{121} As Anthony Kronman has observed: You want to know what a really free market looks like? Go to Moscow. That's a really free market. Market without law, without courts, where market grows from the barrel of a gun. And why shouldn't it? In a perfectly free market, when you begin to introduce the elements that distinguish our market from Moscow's, what you see growing is the realm of law.

Anthony T. Kronman, Legal Professionalism, 26 Fla. St. U. L. Rev. (forthcoming 1999) (arguing that to work well, markets require at least a critical minimum of regulation so that contracts are enforced and other rights protected to encourage investment and growth).
intervention. At least at the outset, regulators (executive, legislative, administrative, and judicial) should tread lightly before mandating or barring conduct by actors in the private market. Unless the market conduct in question implicates serious public health risks or similar matters of urgency, caution is advisable before mandating coverage.

Therein lies the core of my concern with the Schmidt v. Smith decision. As noted above, this author finds Schmidt troubling because of its overly broad approach to statutory construction (even the construction of a remedial statute) and its willingness to read a word with literal dictionary breadth and relatively little regard for the historical context and purpose of the statute. Literalism and extreme formalism are similarly troubling when applied to the reading of insurance policies or other contracts. Many courts, however, embrace such literalism and strict application of a seemingly "clear" facial meaning of contract or statutory text. Both sides of this hermeneutic debate would find common ground in holding that judicial overriding of contract language, on the basis of a general statutory framework or overarching notions of public policy, should take place only when necessary to override contract meaning in the service of compelling or mandated socio-legal goals.

One searches in vain for that justification in Schmidt. The court simply decided that because the workers’ compensation statutes of New Jersey require employers to be responsible for bodily injury claims by workers, any insurance purchased by an employer must necessarily provide coverage for bodily injury stemming from sexual harassment claims. Although it is good for claimants if defendants have insurance to pay claims, it is not socially required, except in select circumstances. Auto insurance is the best example outside workers’ compensation insurance, but most states require only minimal financial responsibility for those driving automobiles. Furthermore, the impetus behind these “financial responsibility laws” is that many drivers do not possess sufficient personal assets to be financially responsible absent insurance. In order to promote compensation for traffic accident victims, society mandates insurance for drivers, and the case law has tended to prevent such coverage from being defeated by insurer defenses.123

123. See, e.g., Nationwide Mut. Ins. Co. v. Roberts, 134 S.E.2d 654, 660 (N.C. 1964) (holding that under state mandated auto insurance, it makes no difference whether the policyholder’s acts were wilful, wanton, reckless, or negligent).
For employer policyholders, the social reasons for mandating coverage of discrimination claims are not as compelling.\textsuperscript{124} Most employers, even the corner grocer and newsstands, have some assets from which an employee's discrimination or harassment claim may be paid. Thus, the legislature's desire for adequate financial responsibility of employers for the victims of discrimination will ordinarily be satisfied without rewriting the insurance policy purchased by the employer, which did not provide for coverage of discrimination claims beyond the traditional core of workers' compensation and employers' liability claims.

The historical background here is important. Traditionally, WC and EL insurance coverage packages offered to the employer did not envision providing protection for discrimination claims, and in its modern form, contains clear and broad language designed to eliminate coverage for such claims. Furthermore, according to \textit{American Motorists Insurance Co. v. L-C-A Sales Co.},\textsuperscript{125} decided the same day, by the same New Jersey Supreme Court that issued the \textit{Schmidt} ruling, this language clearly and successfully excludes such coverage. For the CGL insurer (in \textit{L-C-A}), the exclusion is enforced, but for the EL insurer in \textit{Schmidt}, the same clear language was judicially nullified. Does the "semi-public" nature of WC and EL insurance really justify such disparate treatment of contracts?

All of this seeming judicial error is committed in the name of enhancing coverage, although the case for the judicial mandate is suspect. As noted above, the commercial actors likely to be discrimination defendants do have their own resources that are available to satisfy such claims. Furthermore, these same commercial actors purchased EL insurance that contained clear language excluding coverage for claims such as those brought by Lisa Schmidt. Where is the jurisprudential wisdom in providing such defendants

\textsuperscript{124} Even if it were as compelling as the auto insurance statutes' intent of fostering compensation for accident victims, this still would not support a wildly broad reading of the statute. As one court observed,

The entire [uninsured motorist] act is remedial in nature and is entitled to a liberal construction to effectuate the purpose thereof. But... it should not by judicial interpretation be extended beyond the plain intent of the statute.... Insurers may limit their liability and impose whatever conditions they please upon their obligations, provided such conditions are not in contravention of some statutory inhibition or public policy.


\textsuperscript{125} 713 A.2d 1007 (N.J. 1998).
with coverage which they implicitly declined and for which they never paid the requisite premium? Furthermore, despite the rather new and relatively thin market for EPL coverage, it appears that the insurance industry does provide coverage for defendants, such as Dennis Smith and PAV, should they not wish to risk their personal assets in the event of a discrimination claim.

Although broad-based insurance coverage is, in theory, a wonderful thing, whether it should be required is normally regarded as a question for the legislature. Although Schmidt arguably is premised on the notion that the New Jersey legislature has already made this determination, this author suspects that this comes as quite a revelation for the legislators who originally authored New Jersey Statute section 34:15-72 some 50 years before Title VII was enacted, and some 70 years before the Meritor Savings Bank, FSB v. Vinson\textsuperscript{126} decision declared that sexual harassment was actionable under Title VII.\textsuperscript{127}

At the risk of sounding like the quintessential jurisprudential fuddy-duddy, this author wishes that the New Jersey Supreme Court would have proceeded with more caution. At the very least, one would have expected a more sustained exploration of the intent of the enacting legislature rather than an opportunistic seizing upon the words of the statute when dealing with an insurance product (WC/EL coverage packages) historically identified with the bodily injury of smashed toes rather than the newer, more controversial bodily injury of physical manifestation of emotional trauma due to sexual harassment. Similarly, one might have hoped for a more sophisticated analysis of public policy than the abrupt conclusion that, because the purpose of the workers’ compensation statutory scheme was protection of workers from traditional bodily injury, latter-day developments in the law of employment claims must be subject to this same public policy regime.\textsuperscript{128}

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127. See id. at 65.
128. One can, of course, make a strong case that statutory meaning evolves over time and that courts should even embrace the task of “updating” legislation. See e.g., William N. Eskridge, Jr., Dynamic Statutory Interpretation (1994) (outlining such an approach, defending its legitimacy, and discussing its application). This view is of course controversial in many quarters. See, e.g., John Copeland Nagle, Newt Gingrich: Dynamic Statutory Interpreter, 143 U. Pa. L. Rev. 2209 (1995) (book review) (criticizing the author’s approach as too unsettling and creating the potential for partisan opportunism). I actually support so-called “dynamic” statutory interpretation if it is not excessive in degree. However, Schmidt v. Smith did not undertake a thorough and nuanced dynamic statutory analysis. It simply read the statutory language with formalistic literal breadth.
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Rather than making this leap, the New Jersey Supreme Court should have recognized that employment discrimination claims, particularly sexual harassment claims, are in an evolving state, as is the response of employers and insurers to such claims. As a result, some patience in allowing private actors to develop a market response and to permit the state’s legislative and executive officials to determine if, as a matter of policy, the market’s response to the problem is sufficient is in order. By imposing coverage as a matter of law, notwithstanding the insurer’s clear exclusionary language, the Schmidt court shifted the political landscape in favor of mandated coverage, and may have truncated the evolution of public policy in this area altogether. For example, had the Schmidt court refrained from imposing coverage, other actors in New Jersey government, politics, and society would have been required to address the issue, debating and deciding the question of whether to specifically include discrimination claims within required EL coverage. The legislature and executive branches may have established a special regime for discrimination coverage. They still might.

But because of Schmidt v. Smith,129 the status quo has been changed from one where the insuring agreement controls to one of mandated coverage. If the new mandated coverage status quo is to change, those seeking to change it will need to overcome the burdens of inertia. This means overcoming interest groups that have something to protect in the Schmidt ruling, as well as overcoming the ordinary inertia of placing workers’ compensation statutory reform on the legislative and regulatory agenda, processing it, educating political actors, persuading them, forcing a vote, and so on.

In effect, Schmidt has made the public policy “playing field” uneven. Those who think that discrimination risk management should be dealt with outside of ordinary workers’ compensation law now bear the burden of effecting political change. Because employers and insurers are powerful interest groups, they may well be able to shoulder the burden, although this is by no means clear. It is, of course, not at all apparent whether employers and insurers are sufficiently united to effect revision of the impact of Schmidt. For example, employers may regard the decision as one worth protecting, even at the expense of spending political capital to fend off insurance industry attempts to legislatively overrule Schmidt, which one certainly expects. However, if EL premiums increase substantially, employers may join insurers in seeking to decouple discrimination

coverage from EL insurance, unless desired discrimination coverage becomes more expensive when purchased through a separate EPL policy.\textsuperscript{130}

The one thing that seems safe to assume is that no one can even begin to predict the impact of \textit{Schmidt}. As discussed above, there is no certainty as to what New Jersey’s reaction to the decision will be. The statute may stand unchanged, or it may be modified in reaction to the decision. An overruling by the court itself is unlikely, at least in the foreseeable future, in view of the court’s unanimous decision. To date, despite the interest the decision has drawn in the insurance trade press and scholarly journals, there appears to be no concerted political activity in response to \textit{Schmidt}. Outside of New Jersey, there is no evidence that other courts are on the brink of either emulating or rejecting \textit{Schmidt}. There does not yet appear to be any cases pending in other states that would prompt other courts to consider the issue, even though most state workers’ compensation laws contain language similar to the New Jersey statute at issue in \textit{Schmidt}.\textsuperscript{131}

Because \textit{Schmidt} creates something of a \textit{tabula rasa} on the issue of whether bodily injury from discrimination is a mandated coverage under state workers’ compensation systems, the question remains: does an arguably incorrect interpretation and decision nonetheless create a better workers’ compensation insurance system? In the wake of \textit{Schmidt}, New Jersey EL carriers will presumably rewrite their policies to specifically include discrimination and harassment claims or will require that employers purchase EPL insurance as a condition of purchasing workers’ compensation and EL insurance. In any event, one expects insurers to collect a premium for providing this coverage, which now must be provided under state law if an insurer is to write EL coverage at all. Only by

\textsuperscript{130} At this juncture, the financial impact of \textit{Schmidt v. Smith} remains unclear. According to one regulator, “making predictions of skyrocketing premium rates [is] a matter of speculation.” \textit{See} Sclafane, \textit{supra} note 2, at 16. In fact, one insurer attorney, while admitting that he could not predict the number of discrimination claims in the offing, concluded that the average cost of each such claim was likely to be high, exerting upward pressure on WC/EL insurance rates. However, “’[g]iven what the Supreme Court decided, insurers can’t rewrite the exclusion,’” which suggests that any increased costs will inevitably be passed along to employers. \textit{See id.} (quoting insurer attorney Kevin Fitzgerald); \textit{see also} McGonigle, \textit{supra} note 2, at 100.

\textsuperscript{131} However, “[l]awyers who were interviewed felt the decision would not apply outside New Jersey.” Sclafane, \textit{supra} note 2, at 16. Presumably, counsel meant that the decision would not have extraterritorial effect on the non-New Jersey operations of New Jersey-based employers. They may also have meant that the \textit{Schmidt} decision, for the reasons discussed in this Article, is unlikely to be emulated in other states.
refusing to be an EL insurer can the carrier avoid the mandated discrimination coverage of \textit{Schmidt}.

In the wake of \textit{Schmidt}, however, insurers retain considerable latitude regarding insurance products and coverage. For example, an EL insurer could closely track the \textit{Schmidt} court’s interpretation of the statute and restrict its discrimination insurance to claims where bodily injury is alleged. In a similar fashion, the EL insurer could presumably place more stringent reporting requirements or triggering criteria on its EL policies. Also, more aggressive exclusions for discrimination claims could be utilized, but these would most likely be ineffective in light of the broad mandate for coverage the court found imposed by statute in \textit{Schmidt}. EL and related insurers may thus embrace \textit{Schmidt} and offer expansive coverage, but charge for it. In the alternative, EL insurers might attempt to limit their discrimination coverage to the extent permitted by \textit{Schmidt} and subsequent decisions enforcing \textit{Schmidt}.

This evolving world of WC/EL/EPL packages for employers will presumably be more expensive, but will also be more comprehensive, unless insurers adopt a very grudging reaction to \textit{Schmidt}. Employers will presumably desire to continue to purchase workplace liability insurance as before, but now they will need to pay for the discrimination coverage. Functionally, this expands the pool of policyholders in New Jersey holding employment discrimination insurance. With this larger risk pool, insurers may be able to more quickly acquire the underwriting and actuarial expertise to offer broad discrimination claims coverage at more reasonable rates.

If this occurs, \textit{Schmidt v. Smith} may prove to be a most satisfactory decision despite its analytic flaws and activist bent. The court may succeed to a degree in “technology forcing” by mandating this type of coverage for employers through the EL policy, just as pollution standards are viewed by many as helping to force industries to develop better technology for controlling air emissions and wastewater discharges.

It would be useful for society if discrimination claims were subjected to more widespread insurance coverage: employers would have greater protection; employees would have reduced risk of inadequate compensation due to employer insolvency or impoverishment; and insurers would make money, creating economic growth (so would lawyers, but that in itself is not a reason to oppose an otherwise useful development). Presumably, the incidence of discrimination and harassment over time will decline, not only because
of the deterrent value of discrimination litigation (which is present even without insurance), but also because of the presence of insurance underwriting.

Insurers, of course, hope to profit from writing coverage. Insurers that write discrimination coverage may prove adept at screening risks and counseling policyholders in order to reduce the incidence of discrimination claims. Applicants turned down for EPL coverage or the blended WC/EL/EPL coverage, which this author expects will emerge in the wake of Schmidt, must respond by improving personnel policies in order to qualify for coverage. Policyholders will presumably listen to insurer instructions for avoiding or minimizing claims.

In short, it is possible that Schmidt will prompt substantially expanded insurance coverage for discrimination claims, giving workers enhanced protection, and spurring growth in this segment of the insurance industry. It is also possible that the net impact of Schmidt will be to increase insurance premiums for employers or to force some insurers out of the New Jersey market with no significant expansion in the availability of discrimination coverage. Rather than hope for the best in the wake of a disruptive decision, this author suggests that the Schmidt court should have allowed the evolutionary process of the political system to take place without the judicial compulsion occasioned by the decision.

Conclusion

Close attention to text is a useful trait in the law, whether the text is a constitution, statute, or contract. Also important is attention to the intent of the contracting parties, the purpose of the instrument, the expectations of the parties, and the larger sphere of public policy goals attending legislation and governing private economic conduct. When courts embrace either textual or nontextual interpretative factors to the exclusion of the other, the resulting judicial analysis is suspect and potentially detrimental to both the legal system and to its participants. Ordinary contract construction methodology should be displaced by public policy fiat only in clear cases. Schmidt arguably breached this axiom. Although the eventual impact of Schmidt may well be positive, its methodology should not be emulated.