VIII. UNDERSTANDING EPL POLICY EXCLUSIONS.

41.22 Consider Exclusions Both Related to, and Unrelated to, Employment Laws. Exclusions in EPL policies fall into two broad categories. First, EPL policies include employment-law related exclusions that limit the types of EPL risks insured under the policy. Employment-law related exclusions bar coverage for a variety of claims under federal employment acts and similar state legislation. The remaining exclusions — those that are not related to employment laws — generally reinforce the claims-made nature of EPL policies and the avoidance of moral hazards. Examples of the latter include provisions barring coverage for:

- Illegal profits;
- Criminal acts; or
- Claims about which the insured previously has provided notice to the insurer.

Very few cases exist which address exclusions under EPL policies. This chapter part examines the few decisions that have considered exclusions under EPL policies. This chapter part also discusses cases that have analyzed similar exclusions under other types of coverages, such as CGL policies.

41.23 Consider Exclusions Related to Employment Laws.

41.23[1] Most EPL Policies Bar Coverage for Claims Made Under a Variety of Federal and State Laws That Provide Special Rights to Employees. One such exclusion provides:

> [A]ny actual or alleged violation of the Fair Labor Standards Act (except the Equal Pay Act), the National Labor Relations Act, the Worker Adjustment and Retraining Notification Act, the Consolidated Omnibus Reconciliation Act of 1983, the Occupational Safety and Health Act, any workers' compensation, unemployment insurance, social security, or disability benefits law, other similar provisions of any federal state or local statutory or common law or any rules or regulations promulgated under any of the foregoing [Farmers Auto. Ins. Ass'n v. St. Paul Mercury Ins. Co., 482 F.3d 976, 977 (7th Cir. 2007)].

Some policies set out a separate exclusion for each statute. The following is a brief explanation of the laws that underlie the employment-law related exclusions:

- **The Fair Labor Standards Act ("FLSA")** [29 U.S.C. § 201, *et seq.*] applies to all employers. Among other things, it sets a minimum wage for all employees and requires overtime pay for work in excess of 40 hours in a work week. Most states have their own statutes modeled on the FLSA.
- **The National Labor Relations Act ("NLRA")** [29 U.S.C. § 167, *et seq.*] applies to most private employers except airlines, railroads and farmers. Among other things, the NLRA guarantees employ-

ees the right to organize and bargain collectively. The Act further protects employees from unfair labor practices, including interference with the right of employees to engage in protected concerted activity. "Protected concerted activity" includes action by two or more employees protesting wages, hours or working conditions.

- **The Worker Adjustment and Retraining Notification Act ("WARN")** [29 U.S.C. § 2101 *et seq.*] requires certain employers to notify affected workers of any plant closings 60 days before the shutdown would take effect. WARN also mandates that certain employers provide 60-days' notice to affected employees in the event of a layoff involving more than one-third of the organization's employees (totaling 50 or more employees), or whenever the employer will lay off 500 or more employees. The statute applies to employers with 100 or more full-time employees.
- **The Consolidated Omnibus Budget Reconciliation Act of 1983 ("COBRA")** [29 U.S.C. § 1161, *et seq.*] requires employers to provide terminated employees with the option to continue group health coverage at their own expense for a period of time after the employee's termination. Employees may also elect to continue to insure their covered spouses and dependent children. COBRA applies to private employers who employ 20 or more people.
- **The Occupational Safety and Health Act ("OSHA")** [29 U.S.C. § 651, *et seq.*] requires that employers provide a workplace free from recognized hazards that are likely to cause harm, and the Act provides regulations for both employers and employees to this end. The Act also prohibits discrimination against workers who assert OSHA rights or participate in an OSHA proceeding.
- **Workers' compensation laws** provide workers with an exclusive remedy for injuries based on the negligence of their employer. Under most states' laws intentional acts, including discrimination claims, fall outside of the workers' compensation system.
- **Unemployment insurance, social security or disability benefits laws** include any legislation to supplement income or provide monetary benefits due to employees who have been laid-off or otherwise unable to work.

41.23[2] Understand FLSA Exclusions.

41.23[2][a] The Key Issue Is Whether the FLSA Exclusions Bar State Counterparts to the FLSA. Only a handful of cases have interpreted these employment-law related exclusions. These cases have focused on whether FLSA exclusions applied to state law counterparts to the FLSA. When an EPL policy bars coverage for federal legislation, the insurer will also attempt to exclude claims arising from any state law counterparts to the federal legislation. EPL policies rarely name specific

state legislation, however. Instead, insurers set out specific federal acts under the exclusion and try to include state laws by using a catch-all phrase for "similar" state laws.

> ⊠ **Strategic Point:** Because other employment-law related exclusions use like wording, the cases concerning the FLSA exclusions should bear on whether claims made under other state employment laws fall within exclusions for their corresponding federal acts.

41.23[2][b] ***Farmers Auto. Ins. Ass'n v. St. Paul Mercury Ins. Co.*** The leading case concerning the FLSA exclusion is *Farmers* [482 F.3d 976 (7th Cir. 2007)]. This decision also warrants examination because of the court's unique analysis of the policy language. In *Farmers*, the Seventh Circuit affirmed the lower court's finding that an FLSA exclusion was clear and unambiguous [482 F.3d at 979].

Claims adjusters working for Farmers brought suit against their employer for failing to pay them overtime in violation of the Illinois Minimum Wage Law. Farmers sought coverage from its EPL insurer, St. Paul, which denied coverage based on the exclusion for actual or alleged violations of the FLSA and similar state law provisions [482 F.3d at 976].

Farmers sued St. Paul under the EPL policy, but St. Paul sought and obtained summary judgment based on the FLSA exclusion. The Seventh Circuit affirmed. In doing so, the court rejected Farmers' argument that St. Paul's use of the term "similar," to describe state statutes akin to the FLSA, was "hopelessly vague" [*id.* at 978].

Examining the FLSA and the Illinois Minimum Wage Act, the court found both laws imposed identical requirements on employers to pay time and a half for any work in excess of 40 hours a week [*id.*]. Farmers pointed out two notable differences between the Illinois and federal statutes: (1) the Illinois statute applied only to Illinois workers; and (2) the Illinois statute included no limitation to employers engaged in interstate commerce. Farmers argued that these differences made the statutes dissimilar, and therefore the FLSA exclusion did not apply.

The Seventh Circuit disagreed. The court explained that the difference in scope of the state and federal statutes did not bear on the issue whether the two acts were similar. Instead, the court focused on the FLSA exclusion's purpose, which was to avoid the moral hazard of tempting employers to refuse paying their employees, and then passing this cost on to their EPL insurers. In this regard, the court observed that the purpose of the exclusion applied equally to both statutes [*id.*].

The court also rejected Farmers' argument that the term "similar" should be interpreted with reference to the average person's under-

standing of the term. This is a common rule of contract interpretation [*see, e.g.*, Kvaerner Metals Div. of Kvaerner United States, Inc. v. Commercial Union Ins. Co., 908 A.2d 888, 897 (Pa. 2006)]. Instead, the *Farmers'* court stated:

> But that is a blind guide in the present case because the average person has no understanding of the exclusion of claims based on the Fair Labor Standards Act and similar statutes. The language is not addressed to the average person, but to employers, and they know what the Fair Labor Standards Act is, know there are state counterparts, and could not think they'd bought insurance that would enable them to disregard the state overtime provisions. The interpretation of a document is relative to the understanding of the intended readership. . . [482 F.3d at 979].

41.23[2][c] ***Payless Shoesource, Inc. v. Travelers Cos.*** In *Payless Shoesource* [2008 U.S. Dist. LEXIS 59746 (D. Kan. 2008)] the court considered an identical exclusion as it applied to a claim under California's wage and hour laws. The insured argued that the court should apply the last antecedent rule, which provides:

> [Q]ualifying words, phrases, and clauses are ordinarily confined to the last antecedent, or to the words and phrases immediately preceding. The last antecedent, within the meaning of this rule, has been regarded as the last word which can be made an antecedent without impairing the meaning of the sentence [*id.* at *15].

The insured agued that under the last antecedent rule the phrase "other similar provisions of any federal, state, or local statutory or common law . . ." modified only the final law listed in the exclusion, that is, disability benefits laws. Accordingly, the insured concluded that the modifier did not apply to the FLSA. Thus, the exclusion should bar coverage only under the FLSA and not the California wage and hour laws.

The court rejected the insured's argument. The court reasoned that the antecedent rule applied only when an ambiguity existed, and the court found no ambiguity in the exclusion. The court also overruled the insured's argument that differences between the FLSA and the California wage and hour laws made the two laws dissimilar. In this regard, the court found the Seventh Circuit's arguments in *Farmers* persuasive.

> **Warning:** It is debatable whether a state court would have reached the same decision as in *Farmers* and *Payless Shoesource*. Under the canons of interpretation in many states, courts strictly construe exclusions against the insurer [*see, e.g.*, Seaboard Sur. Co. v. Gillette Co., 486 N.Y.S.2d 873, 876 (N.Y. 1984) (noting courts will construe policy exclusions against insurers unless the insurer drafts the exclusion in "clear and unmistakable language"). The court in *Farmers* failed to address this point of law. On the other hand, St. Paul undoubtedly had other coverage defenses; for example, the

illegal profit exclusion, discussed below, would potentially bar coverage for unpaid wages. Likewise, many policies bar coverage for amounts deemed uninsurable at law, which would have probably saved St. Paul from having to indemnify Farmers for any amounts it had to disgorge. Disgorgement is also discussed below in connection with the illegal profit exclusion.

41.23[2][d] ***SWH Corp. v. Select Ins. Co.*** In contrast, an unreported California Court of Appeals decision found ambiguous a differently worded exclusion of the same type [*SWH Corp.*, 2006 Cal. App. Unpub. LEXIS 8694 (Cal. Ct. App. 2006)]. In the underlying matter, employees of SWH brought suit under California's wage and labor laws for unpaid wages. Select had issued SWH a directors' and officers' liability policy that expressly afforded coverage for "employment claims." Select denied coverage because of, among other reasons, an exclusion that barred coverage:

> [F]or an actual or alleged violation of, responsibilities, obligations or duties imposed by (1) any law governing workers' compensation, unemployment insurance, social security, disability benefits or similar law, (2) the Fair Labor Standards Act (except the Equal Pay Act), (3) the National Labor Relations Act, (4) the Worker Adjustment and Retraining Notification Act, (5) the Consolidated Omnibus Budget Reconciliation Act of 1985, (6) the Occupational Safety and Health Act, (7) rules or regulations promulgated thereunder, amendments thereto or similar provisions of any federal, state or local statutory law or common law, (8) the Employee Retirement Income Security Act of 1974 or (9) any common law applicable to fiduciaries of any pension, profit sharing, health and welfare or other employee benefit plan or trust established or maintained for the purpose of providing Benefits to employees of the Insured Company; however, this exclusion shall not apply to any Employment Claim for any actual or alleged Retaliatory Treatment [*id.* at *6].

SWH sued Select. Select moved for and obtained summary judgment based in part upon the exclusion. Select argued that the exclusion barred not only FLSA claims, but also applied to the California wage and labor laws. The court of appeals, however, reversed. The court found the exclusion was ambiguous, remarking that each of the categories in the exclusion, one through six, stood on their own. The court reasoned, "If the parties intended the state law modifier to modify all the previous categories of laws, they presumably would have placed category seven at the very end of the paragraph, or would have explicitly identified the categories subject to the modification" [*id.* at *38]. The court found that the exclusion failed to meet the standard of "conspicuous, plain and clear" and therefore construed the exclusion against Select [*id.* at 14].

41.23[2][e] ***Noxubee County Sch. Dist. v. United Nat'l Ins. Co.*** Wage claims may also fall within other exclusions. For example, over 100

employees and former employees of Noxubee County School District sued their employer for failing to pay them overtime in violation of the Fair Labor Standards Act [*Noxubee County Sch. Dist.*, 883 So. 2d 1159 (Miss. 2004)]. The school district sought coverage under a School Board Legal Liability policy, which included coverage for "wrongful employment acts." The insurer denied coverage, and the school board sought declaratory relief.

The insurer moved for summary judgment, arguing that the FLSA count did not constitute a wrongful employment act. The insurer also argued that the claim fell within an exclusion for "back wages, overtime, or future wages (even if designated as liquidated damages); or arising from collective bargaining agreements" [*id.* at 1161]. The Mississippi Supreme Court agreed the claim did not constitute a wrongful employment act, as the school board's insurance policy defined the term. With respect to the exclusion for wages, the court observed: "even if Noxubee County's failure to comply with FLSA would constitute a "wrongful act" or a "wrongful employment act" under the language of the policy, coverage would nevertheless be denied due to the specific exclusion of claims for back wages, overtime, or future wages as set forth in Exclusion 12" [*id.* at 1164].

41.23[3] Consider Workers' Compensation Exclusions. It appears that no courts have interpreted EPL policy exclusions for claims based on violations of workers' compensation, social security or disability benefits laws. CGL policies, as well as many other types of liability policies, bar coverage for workers' compensation claims. For the most part, courts have upheld workers' compensation exclusions [*see, e.g.*, Luikart v. Valley Brook Concrete & Supply, Inc., 613 S.E.2d 896, 901 (W. Va. 2005)]. The exclusion applies to claims that should fall within the workers' compensation act, even if the insured lacks workers' compensation insurance [Brown v. Ind. Ins. Co., 184 S.W.3d 528, 535 (Ky. 2005)]. In addition, most workers' compensation claims should also fall within a bodily injury exclusion, if applicable. [The bodily injury exclusion receives further discussion below.]

41.23[4] Consider Exclusions for ADA Claims. Most EPL policies bar coverage for claims made under the Americans with Disabilities Act ("ADA"). The ADA applies to all employers with 15 or more employees. It prohibits discrimination against qualified individuals with disabilities. A *qualified individual with a disability* is an employee who can perform the essential functions of the job with or without reasonable accommodation. Employers subject to the ADA are generally required to make reasonable accommodations, unless to do so would prove to be an undue hardship or would pose a direct threat of immediate harm to the employee or others.

It appears that no cases exist that interpret an ADA exclusion under an

EPL policy, although one court has upheld an ADA exclusion found in a CGL policy [*see* Aardvark Child Care & Learning Ctr., Inc. v. Markel Ins. Co., 2003 U.S. Dist. LEXIS 12197 (E.D. Pa. 2003)]. In that case, the underlying matter involved a state-court action brought by a three-year-old child and his mother. The plaintiffs alleged that the insured child-care facility had violated the ADA by failing to accommodate the child's disabilities. The plaintiffs further claimed that the insured had retaliated against the child by declining to provide further services.

The insured sought a defense and indemnification under its CGL policy. The insurer refused to defend its insured, relying upon an exclusion (added by endorsement) that barred claims for "Any loss or claim based upon or arising out of discrimination by the 'Teacher' on the basis of age, color, race, sex, creed, religion, national origin, or marital status or violation of any civil rights act or the Americans with Disabilities Act" [*id. at* *2]. The insured filed a breach of contract and bad faith action and the insurer filed a motion for summary judgment. With little analysis, the court found the exclusion relieved the insurer of any duty to defend, and that the insurer had not acted in bad faith by refusing to defend [*id.* at *2-3].

Strategic Point: Most of the above employment-law related exclusions have exceptions for retaliation claims. For example, a claim made by an employee for workers' compensation falls outside of an EPL policy's coverage. If, however, the employee brings a claim asserting that the employer retaliated against him or her for making the workers' compensation claim, then the EPL policy should respond to the retaliation claim.

For an insured, coverage for potential retaliation claims brings a potential dilemma with respect to providing notice of the claim to the insurer. At least one EPL decision suggested that an allegation of retaliation relates to the underlying claim which formed the grounds for the retaliation [*see* Pantropic Power Prods. v. Fireman's Fund Ins. Co., 141 F. Supp. 2d 1366, 1368 (S.D. Fla. 2001), (discussed in § 41.11[3] above). In *Pantropic Power*, the court found that the insured should have provided notice of the underlying claim during the policy period and could not obtain coverage for the retaliation claim in a subsequent policy period [*id.*]. It appears doubtful, however, that a court would require an insured to provide notice of a claim clearly excluded under the policy, out of fear that an event within the policy's coverage might occur later.

Nevertheless, insureds should consider providing notice of an excluded claim to their insurers as a "circumstance that may lead to a claim." Many EPL policies provide that if an insured gives notice of circumstances that may lead to a claim, and a claim later arises from

those circumstances, the insurer will treat the claim as if it were made within the policy period when the insured notified the insurer of the circumstances. If the insured's policy includes such a term, it should weigh providing notice of circumstances related to an excluded claim if there is a potential for a retaliation claim by the employee.

Timing: There are reasons not to provide notice of the circumstances that might lead to a claim, however. If the claim is inconsequential, the insured must consider what notice of a potential claim will do to its premiums. On the other hand, if the insured reasonably expects a retaliation claim, prior knowledge and/or prior notice exclusions [discussed in § 41.24[1] below] may bar coverage for the matter in subsequent policy periods. Providing notice of circumstances that may lead to a claim may be the best way for the insured to protect its rights.

Providing notice of a potential claim could also have an impact on the defense of the case. Communications with a party's insurer may be subject to discovery. Counsel should consider whether providing potential notice of a retaliation claim, before the claim is made, will have a harmful effect on the client's defense, and perhaps become a self-fulfilling prophecy.

41.23[5] Considering Exclusions for Non-Monetary Relief.

41.23[5][a] Exclusion for Claims for Non-Monetary Relief Is Sometimes Combined with Exclusion for ADA Claims. Most EPL policies bar coverage for claims seeking non-monetary relief. The discussion of this exclusion is included within the subsection on employment-law related exclusions because underwriters sometimes combine the exclusion for ADA claims with the exclusion for non-monetary relief exclusion. Injunctive relief is the typical remedy for ADA claims.

The non-monetary relief exclusions typically specify claims for:

- injunctive relief;
- declaratory relief;
- disgorgement;
- job reinstatement;
- education/sensitivity programs related to wrongful employment acts; or
- any other equitable remedy, including the costs incurred to comply with an equitable remedy.

Only a few cases appear to have addressed this type of exclusion, and none of these cases involve EPL policies.

41.23[5][b] D&O Insurance. In *Hatfield v. 96-100 Prince St.* [1997 U.S. Dist. LEXIS 3804 (S.D.N.Y. 1997)], the director of a cooperative corpo-

ration sought to compel his directors' and officers' liability insurer to defend him in two actions. The first involved a dispute over a sublease, in which the plaintiff sought compensatory damages, punitive damages and attorney's fees. The second case sought equitable relief in connection with a disputed director's election. The policy included the following exclusion:

> PSM [the insurer] shall not be liable to make payment for Loss or defend any claim made against the Insured alleging, based upon or arising out of any one or more of the following:
>
> * * * * *
>
> (d)(1) claims, demands or actions seeking relief, or redress, in any form other than money damages,
>
> (2) For fees or expenses relating to claims, demands or actions seeking relief, redress, in any form other than money damages [*id.* at *7].

The court determined that this exclusion applied to the suit for equitable relief and granted the insurer summary judgment [*id.* at *8].

41.23[5][c] E&O Insurance. At least one court upheld a non-monetary relief exclusion in an errors and omissions ("E&O") insurance policy, to bar coverage for the cost of complying with certain non-monetary aspects of a settlement [*see* Am. Med. Sec., Inc. v. Executive Risk Specialty Ins. Co., 393 F. Supp. 2d 693, 709 (E.D. Wis. 2005)]. American Medical Security ("AMS") provided health insurance on a nationwide basis. A number of AMS policyholders filed a class-action against AMS, accusing AMS of replacing their policies at renewal with inferior coverages. AMS reached a settlement with its insureds. As part of the settlement, AMS agreed, in effect, to sell certain health insurance policies at a discount to class members.

AMS purchased a managed care errors and omissions liability policy from Executive Risk. The policy's definition of Loss excluded coverage for "non-monetary relief or redress in any form, including without limitation the cost of complying with any injunctive, declaratory or administrative relief" [*id.* at 708]. AMS's insurer denied liability for the cost incurred by AMS in providing policies to the plaintiff class at an advantageous rate. AMS countered that the exclusion for non-monetary relief applied only to equitable relief. The court resolved the dispute in the insurer's favor, explaining that the exclusion was not limited to injunctive relief, but barred coverage for all non-monetary relief [*id.* at 709].

41.23[6] Consider Breach of Contract Exclusions. As discussed in § 41.16[1] above, EPL underwriters differ in their approach to providing coverage for breach of employment contracts. Some insurers choose to exclude coverage outright for claims arising out of an employment contract. Only one case appears to have considered the exclusion in the

EPL context, and the court found for the insurer and enforced the exclusion [*see* TVN Entertainment Corp. v. General Star Indem. Co., 59 Fed. Appx. 211 (9th Cir. 2003)]. In that case, TVN fired one of its employees, who had entered an employment contract with TVN. The ex-employee pursued an arbitration action against TVN for breach of the contract and prevailed [*id.* at 212].

TVN sought coverage under an EPL policy issued by General Star. The policy afforded coverage for "wrongful employment acts," which included breach of an implied employment contract. The policy, however, excluded "damages determined to be owing under a written or express contract of employment" [*id.*].

General Star declined to indemnify TVN for the arbitration award based on the contractual exclusions, and coverage litigation ensued. The district court granted General Star's motion for summary judgment based on the contract exclusions, and TVN appealed. The Ninth Circuit affirmed, rejecting TVN's arguments that the contract exclusions contained ambiguous language. The court ruled the exclusions were clear and explicit and found that the arbitration award fell squarely within the exclusion for damages owing under a written or express contract of employment [*id.* at 213, *citing* Bank of the West v. Superior Court, 833 P.2d 545 (Cal. 1992)].

The court also ruled that an award of stock options to the employee, provided for under the employment contract, fell within the exclusion for "commissions, bonuses, profit sharing or benefits pursuant to a contract of employment." The court observed that the stock options were a form of employment benefit, and therefore fell within the benefits exclusion [*id.*].

41.24 Consider Exclusions Not Related to Employment Laws.

41.24[1] Consider Prior Knowledge/Prior Notice Exclusions. Similar to other claims-made coverages, most EPL policies exclude claims if the insured had knowledge of circumstances that, prior to the policy period, the insured should have reasonably foreseen would result in a claim. Similarly, EPL policies exclude coverage for a claim if, during a preceding policy period, the insured provided notice of the same or similar wrongful employment acts that underlie the current claim. These two exclusions are generally referred to as prior knowledge and prior notice exclusions. Both of these exclusions serve to reinforce the claims-made aspect of EPL policies.

> ⊠ **Strategic Point:** Whether an insured *should have known* that an event, circumstance or situation would result in a claim under the EPL policy typically will be an issue of fact. If there is evidence that the insured should have known that a claim would result but failed to report the claim, the insurer may also have a basis to deny coverage because of a misrepresentation in the application for insurance.

One court found a prior notice exclusion in an EPL policy inapplicable to the second of two suits filed against a hospital by a patient [Methodist Healthcare v. Am. Int'l Specialty Line Ins. Co. [AISLIC], 310 F. Supp. 2d 976 (W.D. Tenn. 2004)]. In the initial suit, a mother filed a malpractice action on behalf of her infant for injuries the child allegedly suffered during delivery. The mother named her obstetrician and the insured hospital as defendants. The hospital obtained a dismissal from this action. Later, the mother sued the hospital alleging that it had negligently credentialed the obstetrician, which led to the child's injuries.

AISLIC had issued the hospital a not-for-profit individual and organization insurance policy. The hospital also had liability coverage with Professional Underwriters Insurance Company. The claimant had filed the first suit within Professional Underwriter's policy period but filed the second suit after that policy expired. Nevertheless, Professional Underwriters agreed to defend the second suit, accepting the allegations in the second suit as interrelated to the first suit.

The claimant had filed both suits within AISLIC's policy period, but the hospital tendered the second suit to AISLIC. AISLIC denied coverage citing several exclusions, including one that barred coverage for conduct:

> [A]lleging, arising out of . . . or to the same or Related Wrongful Act alleged or contained, in any Claim which has been reported, or in any circumstances of which notice has been given, under any policy of which . . . it may succeed in time [*id.* at 980].

AISLIC argued that this exclusion applied because the AISLIC policy was the successor to the Professional Underwriters' policy and the exclusion barred claims for which AISLIC was a successor insurer. AISLIC relied, in part, upon Professional Underwriters' determination that the first and second claims were interrelated wrongful acts.

The hospital sought a declaratory judgment as to AISLIC's duty to defend and indemnify it. AISLIC moved for summary judgment, which the court denied. First, the court rejected AISLIC's argument that Professional Underwriter's coverage determination had any bearing on AISLIC's coverage obligation. Further, the court observed that the AISLIC and Professional Underwriters' policy periods had some overlap, and therefore were concurrent, not consecutive insurers. Finally, the court ruled that the claimant's first and second suits constituted two distinct actions because of the different theories of recovery advanced in each case. Based on these findings, the court ruled that the related wrongful act exclusion was inapplicable to the claimant's second suit [*id.* at 981].

41.24[2] Consider Bodily Injury and Property Damage Exclusions. Although less common, some EPL policies have exclusions for bodily injury and property damage claims. In addition to barring coverage for injury an employee might receive in connection with an employment decision (a scuffle following a termination comes to mind), the underwriters also

intended to delineate between the coverage afforded under EPL and other types of liability policies.

> **Consider:** Typically, little overlap should exist between an EPL policy and Coverage A of a CGL policy. Coverage A of a CGL policy insures against "bodily injury" and "property damage" caused by an "occurrence." Most CGL policies, however, bar bodily injury claims brought by employees. If an EPL policy affords coverage for defamation claims, then some overlap may exist between the EPL policy and Coverage B of a CGL policy. Coverage B of CGL policies typically includes coverage for defamation and does not usually exclude coverage when an employee brings a defamation claim.

Bodily injury exclusions in EPL policies may also bar coverage for claims involving professional malpractice. In one case, *Methodist Healthcare v. Am. Int'l Speciality Line Ins. Co.* [310 F. Supp. 2d 976 (W.D. Tenn. 2004) (discussed in the previous subsection)], the court ruled that a bodily injury exclusion in an EPL policy was ambiguous as applied to a claim alleging that a hospital negligently credentialed an obstetrician, leading to the injury of an infant. The exclusion at issue provided that: "[AISLIC] would not be liable to make any payment for Loss in connection with a Claim made against the Insured . . . for bodily injury, sickness, disease, death of any person . . ." [*id.* at 979]. Because the underlying claim sought recovery for injuries to a child, the court agreed that read alone, the exclusion would defeat coverage [*id.* at 980].

The court observed, however, that the policy added another exclusion by endorsement, which stated:

> The following exclusion, 4(n), is added to the policy: 4(n) alleging, arising out of, based upon, or attributable to the Organization or an individual Insured's performance or rendering of or failure to perform or render medical or other professional services or treatments for others, provided however, that this exclusion shall not operate to limit coverage for Employment Practices Claims or Non Employment Discrimination Claims, or to matters arising out of peer review or credentialing processes [*id.*].

The court found this exclusion rendered the bodily injury exclusion ambiguous. The court read the peer review and credentialing exception to the professional services exclusion as affording affirmative coverage for claims involving defects in credentialing. The court reasoned that the bodily injury exclusion may or may not apply to the exception to the exclusion. Thus, the court deemed the bodily injury exclusion ambiguous. The court therefore applied an interpretation that favored the insured, and ruled the bodily injury exclusion did not apply.

> ⊠ **Strategic Point:** Arguably, the court could have harmonized the bodily injury exclusion with the exception to the professional services exclusion. As observed in the previous subsection, AISLIC had made

a weak argument that the prior claim exclusion also barred coverage. By raising this argument, AISLIC may have hurt its credibility with the judge. Only the judge knows for sure, but it is possible AISLIC's weak argument on the prior act exclusion influenced the court's decision with respect to the stronger bodily injury exclusion.

The lesson is that a policyholder should seize upon weak arguments raised by an insurer and argue that they are evidence of the insurer's unreasonable [and if applicable, bad faith] conduct.

41.24[3] Consider Moral Hazard Exclusions – Illegal Profit, Dishonest, Criminal and Fraudulent Conduct Exclusions.

41.24[3][a] These Exclusions Bar Coverage for Conduct That Many Courts Already Have Deemed Uninsurable. Most EPL policies include a number of exclusions that bar coverage for potential moral hazards, such as obtaining an illegal profit, or engaging in conduct that is dishonest, criminal or fraudulent. It appears that only one decision has interpreted these exclusions under EPL policies [Coleman v. Sch. Bd. of Richland Parish, 418 F.3d 511, 518 (5th Cir. 2005)]. Thus, this subsection examines similar exclusions found in other policies. As discussed below, these exclusions bar coverage for conduct that many courts already have deemed uninsurable.

41.24[3][b] Consider the Common EPL Policy Illegal Profit Exclusion. This type of exclusion typically bars coverage for gaining of any profit or advantage to which an insured was not legally entitled. A black letter concept of insurance law is that insurance does not include the restoration of an ill-gotten gain" [*see, e.g.*, Level 3 Communications Inc. v. Fed. Ins. Co., 272 F.3d 908, 910 (7th Cir. 2001); Cent. Dauphin Sch. Dist. v. Am. Cas. Co., 426 A.2d 94, 97-98 (Pa. 1981)].

Example: In a leading case specifically addressing disgorgement of ill-gotten profit, the California Supreme Court held: "It is well established that one may not insure against the risk of being ordered to return money or property that has been wrongfully acquired. Such orders do not award 'damages' as that term is used in insurance policies." [Bank of the West v. Superior Court, 833 P.2d 545, 553 (Cal. 1992); *see also* Executive Risk Indem., Inc. v. Pac. Educational Servs., 451 F. Supp. 2d 1147 (D. Haw. 2006) (ruling that D&O carrier had no obligation to indemnify insured college for damages that were in effect rebates of tuition; the court found that the relief sought was restitutionary and therefore not damages).] The illegal profit exclusion merely expresses the black-letter rule.

Example: An illegal profit exclusion in an E&O policy was upheld in *Am. Med. Sec., Inc. v. Executive Risk Specialty Ins. Co.* [393 F. Supp. 2d 693 (E.D. Wis. 2005) (discussed in § 41.23[5][c] above in connection with a non-monetary relief exclusion)]. In *Am. Med.*, the

policyholder, itself a health insurer, faced a suit by a group of policyholders claiming that AMS had overcharged for health insurance premiums. Some of the class plaintiffs also claimed that AMS had reduced their benefits, requiring them to pay for medical care out-of-pocket. AMS settled with its policyholders and agreed to repay part of the premiums it had collected, as well as pay for medical care that AMS would have covered had it not reduced benefits. AMS then sought to recover the cost of refunds and medical care from its E&O insurer. The E&O insurer, however, argued that these payments fell within an exclusion for "profit, remuneration or advantage to which such insured was not legally entitled" [*id.* at 710]. The court found that the profit or advantage exclusion unambiguously excluded these costs, and granted summary judgment for the E&O insurer.

Claims for compensation may not always fall within the illegal profit exclusion, however.

Example: In *Int'l Ins. Co. v. Johns* [874 F.2d 1447 (11th Cir. 1989)], the Eleventh Circuit affirmed a lower court's finding that the illegal profit exclusion did not bar coverage when a shareholder sued a corporation and its directors and officers for waste. In *Johns*, certain directors and officers received compensation under a golden parachute agreement after the sale of their company. The former chairman of the company also received a five-year consulting contract with the new company. A dissident shareholder filed a derivative action alleging these transactions constituted corporate waste. The directors and officers settled the derivative action by returning part of the compensation they received under the golden parachute; the former chairman agreed to shorten his contract. The directors and officers sought coverage for the compensation they returned pursuant to the settlement agreement. Their D&O insurer denied coverage, citing the illegal profit exclusion, among other reasons. The directors and officers sued the D&O insurer. The insurer had argued that the golden parachute provisions constituted an illegal profit because the benefits paid under the contract represented corporate waste. However, the Eleventh Circuit determined that the board had properly granted the golden parachutes under Florida corporate law and exercised its business judgment. Because the board had properly granted the compensation, the court determined that the golden parachute provisions were not illegal [*id.* at 1469-1470]. As the directors and officers had to return legally obtained compensation, they suffered an insurable loss under the policy [*id.* at 1454-1455, 1470].

41.24[3][c] Consider the Common EPL Policy Exclusion for Dishonest, Criminal or Fraudulent Acts.

41.24[3][c][i] Most Include a Non-Imputation Clause. A typical exclusion bars coverage for any claim in which a final adjudication has established that an insured committed a dishonest, fraudulent or criminal act or omission, or committed a wrongful employment act with actual knowledge of its wrongful nature or with intent to cause damage. Most intentional act exclusions also include a non-imputation clause, which provides that the insurer will not impute the acts of one insured to any of the other insureds for determining the application of the dishonesty exclusion [*see, e.g.*, MDL Capital Mgmt. v. Fed. Ins. Co., 2008 U.S. Dist. LEXIS 57089, at *54 (W.D. Pa. 2008) (refusing to apply dishonesty exclusion to insured co-defendant although insured's principal was convicted of fraud, conspiracy and obtaining an illegal profit); *but see* TIG Specialty Ins. Co v. Pinkmonkey.com, Inc., 375 F.3d 365, 371 (5th Cir. 2004) (finding personal profit exclusion barred coverage under a D&O policy when wording of exclusion provided the insurance did not apply to "any Claim made against *any Insured*" arising out of an illegal personal profit)].

41.24[3][c][ii] Most Have Been Narrowly Applied.

> **Consider:** In the employment context, the criminal acts exclusion is likely to apply only to the most egregious situations, such as violence directed against an employee based on race. Such an attack may result in criminal charges under statutes prohibiting racially motivated violence.

Courts have typically interpreted the criminal, dishonest and fraudulent acts exclusion restrictively [*see, e.g.*, Jefferson-Pilot Fire & Cas. Co. v. Boothe, Prichard & Dudley, 638 F.2d 670 (4th Cir. 1980) (under Virginia law, the criminal act exclusion did not apply to claims alleging antitrust violations against law firm); St. Paul Fire & Marine Ins. Co., v. Icard, Merrill, Cullis & Timm, P.A., 196 So. 2d 219 (Fla. Dist. Ct. App. 1967) (under Florida law, unsupported allegations in complaint filed by a *pro se* plaintiff against law firm did not fall within dishonest/fraudulent/criminal act exclusion and thus liability insurer had a duty to defend firm).

41.24[3][c][iii] Consider the Exclusion for "Intentional Acts." Some insurers exclude coverage under EPL policies for "intentional acts," and these exclusions bar coverage for claims that arise from acts that were intended to cause harm or committed with knowledge of their wrongful nature. Because many employment-related claims arise from conduct that is inherently intentional, some insurers no longer include such exclusions in their policies.

Some policyholders have argued that these exclusions are not enforceable because the exclusion swallows the policy's grant of coverage. A federal court of appeals, however, recently enforced an

intentional act exclusion in an EPL policy and held that the exclusion meant that the policy provided coverage for "acts of racial discrimination or harassment only if they are committed by an insured without actual knowledge of their wrongful nature or intent to cause damage" [Coleman v. Sch. Bd. of Richland Parish, 418 F.3d 511, 518 (5th Cir. 2005)]. In that matter, the intentional acts exclusion barred coverage for any claim, "brought about or contributed to in fact by any dishonest, fraudulent or criminal Wrongful Act or by any Wrongful Act committed with actual knowledge of its wrongful nature or with intent to cause damage" [*id*. at 515]. This court rejected the insured's argument that limiting the coverage to only "unintentional" acts would render the policy's coverage "illusory and meaningless" [*id.* at 518].

In some jurisdictions, in order for an intentional acts exclusion to apply, the insurer must establish that the insured either had a desire to bring about the particular consequences of his act or that the consequences are substantially certain to result from the act [West Am. Ins. Co. v. Merritt, 456 S.E.2d 225 (Ga. Ct. App. 1995) ("[M]ere knowledge and appreciation of a risk, short of a substantial certainty, is not the equivalent of intent"); Brown v. St. Paul Fire & Marine Ins. Co., 338 S.E.2d 721, 723 (Ga. Ct. App. 1985)].

41.24[3][c][iv] Consider the Exclusion for Dishonesty. If the policy provides that the dishonesty exclusion applies only if a final adjudication establishes the insured acted dishonestly or fraudulently, then an insurer typically may not bring an ancillary action to establish its insured's dishonesty [*see* Nat'l Union Fire Ins. Co. v. Continental Ill. Corp., 666 F. Supp. 1180 (N.D. Ill. 1987)]. In the *Nat'l Union Fire Ins.* case, the dishonesty exclusion applied only if a judgment or other final adjudication established the insured's dishonesty [*id.* at 1197]. The insured settled a suit against it in which the plaintiffs had alleged the insured had acted dishonestly. After the settlement, the insurer sought to decline coverage on the basis that its insured had in fact acted dishonestly. Because the settlements did not establish the insured's dishonesty, the exclusion did not apply and the court refused to allow the insurer to proceed with a collateral action to establish whether the insured acted dishonestly [*id.; see also* PepsiCo v. Continental Cas. Co., 640 F. Supp. 656, 660 (S.D.N.Y. 1986)].

41.24[3][c][v] Consider the Exclusion for Criminal Acts. With respect to criminal convictions, typically an insured may not contest the circumstances of his or her conviction following a trial.

> **Example:** In *Cretens v. State Farm Fire & Cas. Co.* [60 F. Supp. 2d 987, 993 (D. Ariz. 1999), *aff'd*, 11 Fed. Appx. 860 (9th Cir. 2001)], the court barred an insured from arguing he acted unintention-

ally after a jury convicted him of voluntary manslaughter.

State laws differ, however, concerning the preclusive effect of a guilty plea. For example, Arizona law is less than categorical on the subject. It precludes a defendant in a civil action from denying the essential allegations of a criminal offense to which the defendant has pled guilty, but only in actions brought by the victim or the state [Ariz. Rev. Stat. Ann. § 13-807].

Cross Reference: For a discussion of the judicial construction of intentional injury exclusions, Eric Mills Holmes, Appleman on Insurance 2d § 118.3.

41.24[3][d] Retaliation Actions Are Generally Covered by EPL Policies.

Warning: Some federal and state laws criminalize retaliation:

1. 18 U.S.C. § 15(e) enacted as part of Sarbanes-Oxley, criminalizes "knowingly, with the intent to retaliate, take . . . any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense";

   La. Rev. Stat. Ann. § 23:964 criminalizes retaliation against employees for cooperating in any investigation or enforcement action to enforce Louisiana labor laws;

   Among other jurisdictions, Colorado, Hawaii, Illinois, Minnesota, New Jersey and Oklahoma have enacted similar laws [*see* Colo. Rev. Stat. § 8-4-120; Haw. Rev. Stat. § 387-12(a); 820 Ill. Rev. Stat. § 115/14(c); Minn. Stat. Ann. § 177.32; N.J. Stat. Ann. § 34:11-56a; 24 Okla. Stat. § 199].

Some EPL policies affirmatively cover retaliation claims, and most EPL policy exclusions have an exception for retaliation claims. However, if an employer's alleged retaliation resulted in a criminal charge, such a charge would probably fall within a criminal acts exclusion, subject to the final adjudication clause.

41.24[4] Consider "Mixed Actions" Where the Claimant Asserts Both Intentional and Negligent Conduct. The moral hazard exclusions are unlikely to bar the insurer's obligations with respect to mixed actions, for example, when the claimant asserts both criminal, intentional and negligent conduct [*see, e.g.*, Durham City Bd. of Educ. v. Nat'l Union Fire Ins. Co., 426 S.E.2d 451 (N.C. Ct. App. 1993) (holding that negligence claims do not fall within a criminal act exclusion, even when the damages to the injured party resulted from a criminal act)].

In situations in which a claimant has asserted mixed allegations of both

intentional and negligent conduct, the exclusion would not afford the insurer a basis to decline to defend its insured. Again, most moral hazard exclusions usually require an adjudication that the insured committed a dishonest, fraudulent or illegal act. Further, most state's laws require an insurer that has accepted a duty to defend to defend the entire action [*see, e.g.*, Maryland Cas. Co. v. Peppers, 355 N.E.2d 24 (Ill. 1976) (if a complaint alleges several theories of recovery, the duty to defend arises even if only one theory is potentially covered)].

41.24[5] Consider Defense Costs Incurred for Uncovered Claims.

Warning: In the event an insured is adjudicated to have engaged in dishonest, fraudulent or criminal conduct, or obtained an illegal profit, some policies include language permitting the insurer to recover defense costs incurred for the uncovered claim. Similarly, some state's laws permit insurers to recover defense costs in connection with uninsured counts, if the insurer has reserved its rights on this coverage defense [*see e.g.*, Buss v. Superior Court, 939 P.2d 766 (Cal. 1997); Matagorda County v. Texas Ass'n of Counties County Gov't Risk Mgmt. Pool, 975 S.W.2d 782 (Tex. App. 1998), *aff'd*, 52 S.W.3d 128 (Tex. 2000)].

Warning: If the policy does not provide that the insurer has a duty to defend, the insurer will likely have a duty to either indemnify or advance defense costs incurred by the insured's counsel.

Insurer's Perspective: Where an insurer has no duty to defend, however, many states permit the insurer to allocate defense costs between insured and uninsured claims and to pay only those costs associated with covered claims [*see* Safeway Stores v. Nat'l Union Fire Ins. Co., 64 F.3d 1282, 1289 (9th Cir. 1995)]. Accordingly, insurers may seek to impose an allocation agreement upon its insured, under which the insured pays some fraction of defense costs.

Insured's Perspective: Insureds should be aware that many states have limited an insurer's ability to allocate defense costs and should require indemnification for any defense fees that are reasonably related to the defense of the claim [*see, e.g.*, Pan Pac. Retail Props., v. Gulf Ins. Co., 471 F.3d 961, 971 (9th Cir. 2006); Safeway Stores v. Nat'l Union Fire Ins. Co., 64 F.3d 1282, 1289 (9th Cir. 1995)].

Cross Reference: For a discussion of defense and allocation issues in the absence of a duty to defend, *see* Robert H. Shulman, Andrew M. Reidy, Christine Davis, Averitt Buttry, *Hot Issues In D&O Insurance*, 719 PLI/Lit 205 (2005).

41.25 Consider the EPL Pollution Exclusion. A few EPL policies include an exclusion for pollution claims. Such an exclusion bars coverage for claims based upon, arising from, or in consequence of pollution. Of those policies that

include a pollution exclusion, most appear to have an absolute pollution exclusion with a single exception for retaliation claims.

It does not appear that any courts have considered the pollution exclusion in an EPL policy, although countless decisions exist under CGL policies. EPL policies generally exclude coverage for workers' compensation claims and may also exclude bodily injury claims. These exclusions would likely bar coverage for most claims by employees arising out of pollution. It is difficult to imagine a pollution claim intersecting with an employment practices liability claim, except in the context of a whistle-blower retaliation claim.

41.26 Consider Contractual Liability (Indemnification) Exclusions. Similar to CGL policies, EPL policies often include an exclusion for any amount any insured is obligated to pay by reason of the assumption of another's liability for a wrongful employment practice under a contract or agreement. This exclusion operates to deny coverage when the insured assumes responsibility for the conduct of a third party [*see* Federated Mut. Ins. Co. v. Grapevine Excavation, Inc., 197 F.3d 720, 726 (5th Cir. 1999)]. Unlike the CGL exclusion, the EPL policy does not have an exception for "insured contracts."

Parties often confuse the contractual indemnification exclusion with a breach of contract exclusion [*see* Am. Family Mut. Ins. Co. v. Am. Girl, Inc., 673 N.W.2d 65, 81 (Wis. 2004) (stating "We conclude that the contractually-assumed liability exclusion applies where the insured has contractually assumed the liability of a third party, as in an indemnification or hold harmless agreement; it does not operate to exclude coverage for any and all liabilities to which the insured is exposed under the terms of the contracts it makes generally"); Olympic, Inc. v. Providence Wash. Ins. Co., 648 P.2d 1008, 1011 (Alaska 1982) (explaining that assumption of liability in a contract "refers to liability incurred when one promises to indemnify or hold harmless another, and does not refer to the liability that results from breach of contract.")]. The contractual indemnification exclusion prevents insureds from extending coverage to a third party through an indemnification agreement.

◗ **Cross Reference:** Appleman, Insurance Law and Practice § 4497.02 (J. Appppleman ed.)