BY WAYNE BERNSTEIN

Sexual Harassment: Not Covered in California?

A California law that has been used by insurers to deny claims under commercial general liability policies for willful or intentional acts could be used to deny sexual harassment claims as well.

Insureds and brokers in California may face new challenges ahead with some insurers possibly denying indemnification payments for sexual harassment claims made under employment practices liability (EPL) policies for domiciled California risks.

The word 'intent' has reared its ugly head, and now a few insurers who sold policies for this specific purpose may try to shield themselves from making indemnity payments by invoking a long-standing California Insurance Code statute that goes back to 1935. It prohibits them from making indemnification payments for such claims.

California Statute Code Section 533 states: "An insurer is not liable for a loss caused by the willful act of the insured; but he is exonerated by the negligence of the insured, or of the insured's agents or others."

Sound familiar? It should, since this is the very statute argued in the courts many times suggesting that "willful or intentional acts" committed by insureds are not indemnifiable under commercial general liability policies.

The original objective of the statute was to prohibit insurers from providing insurance coverage for willful wrongs and discourage willful torts. The rationale being that as a matter of public policy, wrongdoers should not profit from their own wrongdoing or be indemnified from the effects of the wrongdoing. The statute was also implemented to bar indemnification for false or fraudulent claims activity, which were also considered "intentional acts," under the statute. But acts deemed to be reckless or negligent are not subject to the statute's restrictions.

Within the last decade, the interpretation of the statute has been the focal point of many bad faith lawsuits filed by policyholders. Policyholders sued their insurance companies for bad faith and breach of contract, because of the insurer's unwillingness to provide either a defense and/or indemnification. But it is important to understand that these lawsuits involved insurers providing commercial general liability insurance policies, not employment practices liability policies.

The California statute was initiated long before EPL policies were developed in 1991, and Section 533 is certainly not without gray areas. While the statute in its raw form prohibits insurers—those contending they are abiding by the law—from making indemnity payments for sexual harassment claims, it does not preclude insurers from providing defense coverage or the reimbursement of legal expenses. This is a very important aspect of coverage because of the substantial defense costs associated with EPL claims.

But one provision of Section 533 states that the same exclusionary language is to apply to all insurance contracts in California, wherein lies the problem with EPL policies for California risks.

Intentional or Not?

So you may ask, why buy an EPL policy if sexual harassment indemnification is prohibited? After all, isn't this one of the very reasons that employment practices liability policies were drafted in the first place?

Jeff Tanenbaum of Littler Mendelson in San Francisco, an employment law firm, notes that this would be a major shortcoming in any EPLI policy, but that while some insurers are interpreting acts of sexual harassment as an intentional act, the news is not all bad. The claimant's litigation is usually structured to include multiple causes of action, so if insurance coverage exists, the coverage of the policy may be triggered by at least one or another cause of action. Some of the more common causes of action include infliction of emotional distress, discrimination, hostile work environment, and wrongful termination.

But if the complaint were to only allege acts of sexual harassment, indemnification from the EPL policy might be barred under the statute's present wording. Another noteworthy point is that, just because the claimant construed the acts to be sexual harassment, does not necessarily mean that is how the insurer and/or the courts will interpret the claim.

Wrongful acts committed vicariously are precluded from the statute. Thus, if an employer entity is sued due to alleged wrongful acts committed by its employees, the statute does not prohibit indemnification. The logic being that if the employer entity was unaware or did not know of these wrongful acts, then they could not be considered intentional.

Conversely, the situation changes when the alleged perpetrator of such conduct

is an executive officer of a corporation or a principal of the insured entity. As was the case in *Coit Drapery Cleaners Inc. v. Sequoia Insurance Co.*

In this bad-faith lawsuit, the president and major shareholder of the insured corporation was known for sexually harassing its female employees. One of the employees sued for sexual discrimination and wrongful termination. The insured corporation submitted the claim to its insurance company, who subsequently declined the claim. The insured corporation settled with the employee, but sued the insurance company for bad faith and breach of contract, claiming that the insurer had at least a duty to defend.

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Both the trial and appellate courts found that the corporation and its management had tolerated this behavior for some time.

Therefore, the court ruled in favor of the insurance company, agreeing that the acts of sexual harassment and wrongful termination were, in fact, willful and intentional, and found that the corporation approved the conduct of the president, so Section 533 would bar any coverage. Again, this precedent-setting case involved the CGL policy and not an EPL policy.

No Court Tests

As a practical matter, when there is a question of coverage under a particular policy, insurers will generally tender the claim under a reservation of rights, until all the facts of the claim can be sorted out.

This way, the insurance company is acting in good faith on behalf of the insured, while at the same time not eliminating the possibility of denying or not paying the claim.

Nevertheless, not all insurers are approaching the interpretation of Section 533 indemnification payments in the same manner, when it comes to EPL policies. Therefore, knowing which insurers will respond positively to this type of claim is important. The application of the statute should be another factor to consider when comparing one company with another.

Because employment practices liability insurance is a relatively new coverage, Section 533 and its effects have not been fully tested by the courts. To date, the courts have not agreed on any one significant ruling relating to the barring of indemnification for EPL claims.

The courts' past legal opinions were derived from decisions based on the language of the CGL policy, so there may be a strong likelihood that these same interpretations may be applied in the future.

In the meanwhile, Littler Mendelson reminds employers that it is important that they be careful consumers of employment practices liability insurance and look for the best available products for their needs, while still remembering that EPLI does not solve all risk concerns.

As noted by Tanenbaum, "no matter how good your policy, it will always be critically important to follow good human resource policies and procedures to stay out of court in the first place."

Stay tuned.

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