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**SEXUAL HARASSMENT LITIGATION: WORKERS' COMPENSATION AND EMPLOYERS LIABILITY
CARRIERS BEWARE**

Kevin G. Fitzgerald, Esq.
(414) 297-5841
Ethan D. Lenz, Esq.
(414) 297-5567

Overview

Background.

The New Jersey Superior Court has issued a decision affording an employer coverage against a claim based on the employer's vicarious liability for "hostile work environment sexual harassment." *Schmidt v. Smith*, 684 A.2d 66 (N.J. Sup. Ct. App. Div. 1996).¹ The court found such coverage pursuant to the provisions of Part Two of the employer's Workers' Compensation insurance policy. *Id.* As a result of this decision, insurers selling workers' compensation insurance ("Insurers") pursuant to the National Council on Compensation Insurance Workers' Compensation and Employers' Liability Insurance Policy (the "NCCI Policy Form") face potential exposure to coverage for similar claims in New Jersey and other Jurisdictions.

Issues Raised by the Schmidt Decision.

1. Does the analysis set forth in the *Schmidt* decision potentially expose Insurers to liability for coverage of an employer's vicarious liability, arising from "hostile work environment sexual harassment" claims, asserted in a New Jersey forum?
2. Does the analysis set forth in the *Schmidt* decision potentially expose Insurers to liability for coverage of an employer's vicarious liability, arising from "hostile work environment sexual harassment" claims, asserted in United States forums outside New Jersey?

Conclusions.

1. Insurers are exposed to coverage, in a New Jersey forum, pursuant to coverage afforded under the NCCI Policy Form because that form fails to specifically exclude coverage for an employer's vicarious liability resulting from "hostile work environment sexual harassment."
2. Although the plaintiff in *Schmidt* based the allegations of her complaint on New Jersey's Law Against Discrimination ("LAD"), the decision largely relies on common law and general principles of Workers' Compensation insurance law. Therefore, other forums can easily adopt the rationale and holding of the case (although other forums may hesitate to do so given the suspect reasoning and rationale employed by the New Jersey court in reaching the decision). Accordingly, Insurers are exposed to coverage for an employer's vicarious liability, arising from "hostile work environment sexual harassment" claims, in forums outside New Jersey.

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Analysis of the Schmidt Decision

Facts Underlying the Case.

The plaintiff in *Schmidt* filed suit against her employer, Personalized Audio Visual, Inc. ("PAV") and PAV's president, Dennis Smith ("Smith"). 684 A.2d at 68. Her Complaint alleged several causes of action including a claim of "hostile work environment sexual harassment", brought under New Jersey's Law Against Discrimination (the "LAD"). *Id.* The case revolved around the Plaintiff's allegations that Smith hired her as an office manager in January 1991, and subsequently sexually harassed her until she resigned in February of that same year. *Id.* She further alleged that as a result of Smith's conduct she suffered severe emotional distress, along with various physical manifestations of this condition. *Id.* at 69. PAV and Smith sought coverage for defense costs and indemnification for any damages arising from the claims, pursuant to Workers' Compensation and Commercial General Liability ("CGL") policies issued by United States Fidelity and Guaranty Co. ("USFG"). *Id.* at 68.

USFG denied coverage and refused PAV's and Smith's tender of the defense. *Id.* Therefore, PAV and Smith instituted a third-party action for declaratory judgment, seeking an order that USFG defend and indemnify them. *Id.* Prior to deciding the declaratory judgment action, however, the trial court tried the Plaintiff's action against Smith and PAV. *Id.* Following that trial, the jury returned an \$80,000 verdict for the Plaintiff. *Id.* at 69. The jury made specific findings, including that the Plaintiff "was the victim of a hostile work environment and sexual harassment."² *Id.* Pursuant to this finding, the Plaintiff moved for an order granting attorney's fees under the provisions of the LAD. The court granted the motion, awarding her over \$180,000 in attorneys' fees. *Id.*

Following the verdict and motion decision, the trial court found that USFG's Workers' Compensation and CGL policies afforded coverage for "plaintiff's damages, all taxed costs (including plaintiff's counsel fees), and for defense counsel fees and costs." *Id.* USFG appealed this ruling to the Superior Court.

The Superior Court's Decision.

The Superior Court upheld the trial court's decision on two significant points, as concerns Insurers selling workers' compensation insurance pursuant to the NCCI Policy Form. It found the USFG policy afforded:

1. Indemnification coverage for all damages arising from the claim against PAV for its vicarious liability resulting from Smith's hostile work environment sexual harassment; and
2. Defense cost coverage for PAV, based on this same claim.

Rationale Underlying the Decision, as it Applies to Coverage Afforded to the Employer.

The Superior Court first determined that all of PAV's liability, based on the theory of "hostile work environment sexual harassment," arose due to PAV's vicarious liability for the actions of Smith. *Id.* at 69-71. The court applied general principles of agency law and New Jersey common law to reach this conclusion. *Id.* Specifically, they found that:

3. PAV delegated authority to Smith to control the work environment;
4. Smith exercised that authority;
5. The exercise of that authority resulted in a violation of the LAD; and
6. The delegation of the authority by PAV aided Smith in injuring the plaintiff.

Id. at 71.

The court then analyzed the coverage afforded to PAV by the CGL policy. It found the policy excluded coverage because this claim arose "out of and in the course of" the Plaintiff's employment with PAV. *Id.* at 71-72.

this claim arose "out of and in the course of" the Plaintiff's employment with PAV. *Id.* at 71-72.

After discussing the CGL exclusion, the court turned to the coverage afforded by the Workers' Compensation policy. It noted the general principle that "(e)mloyer's liability coverage" is meant to provide "protection to the employer in those situations where the employee has a right to bring a tort action despite the provisions of the workers' compensation statute..." *Id.* at 72 citing *Producers Dairy Delivery Co., Inc. v. Sentry Ins. Co.*, 718 P.2d 920, 927 (Cal. 1986). Relying on this principle, the court began an in-depth analysis of the policy.

The policy's insuring agreement afforded coverage for PAV's liability for "bodily injury by accident or bodily injury by disease" arising "out of and in the course of the injured employee's employment." *Id.* at 72. However, the policy also excluded coverage for:

5. Bodily injury intentionally caused or aggravated by (PAV); ("Exclusion 5")

7. 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. ("Exclusion 7")

*Id.*³

The court first addressed Exclusion 7 as it applied to the claim asserted against PAV. *Id.* It noted that PAV's liability for the "hostile work environment sexual harassment" rested on the jury's determination that Smith committed intentional acts of assault, battery and intentional infliction of emotional distress. *Id.* Specifically, it recognized that PAV had no intent to harass the Plaintiff. *Id.* However, as previously noted, PAV became vicariously liable to the Plaintiff by delegating control over the work environment to Smith, who used the control to harass her and cause injury. *Id.*

Regarding the policy language, the court noted that Exclusion 7 failed to specifically exclude coverage for "vicarious liability resulting from hostile workplace sexual harassment."⁴ *Id.* at 73. Further, it determined that PAV, could harbor "reasonable expectations" of coverage for Smith's acts. *Id.* It based this determination on New Jersey law requiring employers to "make sufficient provision for the complete payment of any obligation" it might incur to an injured employee. *Id.* Since the employer's liability section of the policy affords coverage for liability arising outside the workers' compensation coverage, PAV reasonably expected coverage "for its vicarious liability resulting from the intentional torts of an employee." *Id.* Accordingly, the court refused to apply Exclusion 7 to preclude coverage for PAV.

Next, the court analyzed the application of Exclusion 5 to the claim asserted against PAV. *Id.* at 74. USFG urged that the "exclusivity provision" of New Jersey's Workers' Compensation Act, required the Plaintiff to allege an intentional wrong by PAV, to maintain her suit. *Id.* However, the court rejected this argument. *Id.* Instead, it found no evidence showing PAV acted intentionally in producing the Plaintiff's injuries. Further, it found that the LAD contained no language mandating the Workers' Compensation Act as the sole remedy for violation of that law. *Id.* Therefore, the court held Exclusion 5 inapplicable, and granted PAV coverage for the Plaintiff's damages.⁵

Rationale Underlying the Decision as it Applies to the Employee/"Harasser."

In addition to coverage for PAV, the court considered whether the Workers' Compensation policy afforded coverage to Smith. *Id.* at 75. However, it concluded the policy excluded coverage for his actions, due to their intentional nature. *Id.*

Rationale Underlying the Decision Finding a Duty to Defend the Employer.

Finally, the court addressed USFG's duty to defend both PAV and Smith. An Amended Complaint alleged that PAV negligently breached a duty to Plaintiff by failing to properly hire, train and supervise its supervisors. The court found such allegations, if proven, covered under the Workers' Compensation policy, giving rise to a duty to defend. Regarding Smith, however, the Court only addressed coverage under the CGL and ignored any duty of defense arising pursuant to the Workers' Compensation policy.

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Analysis of Schmidt as it Applies to the NCCI Policy Form

1. Insurers are exposed to coverage in a New Jersey forum, pursuant to insurance sold under the NCCI Policy Form because that form fails to specifically exclude coverage for an employer's vicarious liability resulting from "hostile work environment sexual harassment."

It appears that the USFG policy was written largely in accord with the NCCI Policy Form. The NCCI Policy Form insuring agreement, like the *Schmidt* form, affords coverage for "bodily injury by accident or bodily injury by disease." NCCI Policy Form, p. 2 of 6. It further provides that such bodily injury must "arise out of and in the course of the employee's employment . . ." *Id.*

Beyond the insuring agreement, the NCCI Policy Form exclusions are almost identical to those in the USFG policy. It excludes:

...

5. bodily injury intentionally caused or aggravated by (the employer);

...

7. damages arising out of coercion, criticism, demotion, evaluation, reassignment, discipline, defamation, harassment, humiliation, discrimination against or termination of any employee, or any personnel practices, policies, acts or omissions . . .

NCCI Policy Form, p. 3 of 6.

Like the USFG policy, the NCCI Policy Form Exclusion 7 fails to specifically exclude coverage for an employer's vicarious liability resulting from "hostile work environment sexual harassment." Accordingly, Insurers providing workers' compensation coverage pursuant to the NCCI Policy Form face an exposure from such claims when asserted against insured employers, in a New Jersey forum. Further, because the policy actually affords coverage for these claims, the Insurers are exposed to defense costs, when the claims are alleged against insured employers.⁶

2. Insurers are exposed to coverage in forums outside New Jersey, because *Schmidt* is largely based on common law agency principles and general principles of Workers' Compensation law, making it easy for other jurisdictions to adopt the rationale and holding of the decision.

Schmidt obviously sets no direct precedent for a jurisdiction outside New Jersey. However, other jurisdictions could easily adopt the underlying rationale of the decision, and find coverage for similar "sexual harassment" claims pursuant to the employers' liability coverage of a Workers' Compensation policy.⁷ While New Jersey's LAD statute underlies the claim against Smith, the court uses general principles of agency law to find the employer vicariously liable for the "hostile work environment sexual harassment." Therefore, it is entirely possible for a court in another jurisdiction to use this same rationale to hold an employer vicariously liable for violations of a similar statute, or for any common law claim the jurisdiction recognizes for "sexual harassment."

Beyond general agency principles, *Schmidt* also relies on general principles of Workers' Compensation insurance to provide a further basis for its decision. It begins with the principle that employers' liability coverage is meant to cover exposures created when an employee brings a tort action against the employer outside the state's workers' compensation statute. Further, the decision relies on the fact that the state requires employers to make provision for the payment of obligations incurred to employees for injuries suffered in the course of employment. Finally, the court builds on this, using a general principle of insurance coverage interpretation, when it focuses on the employer's "reasonable expectations." Once

insurance coverage interpretation, when it focuses on the employer's "reasonable expectations." Once again, the use of such general legal principles make this decision easy to adopt in any jurisdiction employing the same or similar principles. Accordingly, Insurers face a potential exposure to similar claims in any United States jurisdiction where they sell workers' compensation insurance pursuant to an NCCI Policy Form.

Conclusion

The USFG policy in *Schmidt* and the NCCI Policy Form employ nearly identical insuring agreements and exclusions. Most significantly, both the USFG policy in *Schmidt* and the NCCI Policy Form fail to specifically exclude coverage for an employer's vicarious liability for "hostile work environment sexual harassment." Thus, pursuant to the holding and rationale expressed in *Schmidt*, Insurers providing workers' compensation insurance coverage pursuant to the NCCI Policy Form face potential exposure, in New Jersey, from claims asserting vicarious liability of an insured employer resulting from such claims. Further, other jurisdictions could easily adopt the *Schmidt* decision, exposing Insurers to coverage of similar claims, outside New Jersey. Consequently, it would be wise for all Insurers to consider revising the NCCI Policy Form to specifically exclude such claims. Alternatively, Insurers might consider the viability of adding an endorsement to the NCCI Policy Form to exclude the claims.

Endnotes

2. The New Jersey Supreme Court has granted a "Petition for Certification," therefore, the decision is subject to review. *Schmidt v. Smith*, 690 A.2d 608 (1997).
3. It appears that the court is referring to the jury's individual findings that: (1) Smith sexually harassed the Plaintiff, and (2) the sexual harassment created a hostile work environment. As more fully explained, *infra*, these combined claims translate into a finding that PAV was vicariously liable for "hostile work environment sexual harassment."
4. Smith and PAV contended that the court should refuse to consider Exclusion 7 because USFG had amended it and failed to properly raise the amended version at trial. *Id.* Therefore, they urged the court to only consider the pre-amendment exclusion, which excluded coverage for:

"(d)amages arising out of the discharge of, coercion of, or discrimination against any employee in violation of law."

Id. However, the court summarily refused this request, and analyzed the exclusion, as amended. *Id.*

5. The court uses the terms "hostile work environment sexual harassment" and "hostile workplace sexual harassment" interchangeably when referring to the Plaintiff's claim.
6. The court never directly addressed which damages were covered by the USFG policy. Therefore, it appears that, like the trial court, they allowed coverage for all damages assessed against PAV (i.e., plaintiff's direct damages and all taxed costs (including plaintiff's counsel fees).
7. The NCCI Policy Form contains the following defense provision, regarding its Employers Liability insurance coverage:

We have the right and duty to defend, at our expense, any claim, proceeding or suit against you for damages payable by this insurance

NCCI Policy Form, p. 3 of 6.

Although the decision's rationale makes it easy to adopt in other jurisdictions, this risk is tempered by the fact that other jurisdictions may be hesitant to adopt the suspect reasoning employed by the New Jersey court in reaching the decision. Further, this seems to be borne out by the fact that no other courts have followed the decision, as it relates to an Insurer's liability for coverage of an employer's vicarious liability, arising from "hostile work environment sexual harassment."

