

**THE PECULIAR MORAL HAZARD OF EMPLOYMENT
PRACTICES LIABILITY INSURANCE:
REALIGNMENT OF THE INCENTIVE TO
TRANSFER RISK WITH THE INCENTIVE
TO PREVENT DISCRIMINATION**

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INTRODUCTION

Human beings, as risk averse creatures, generally prefer to transfer risk rather than bear that risk personally.¹ However, such risk transference can create a phenomenon known as moral hazard.² Moral hazard occurs when the existence of insurance alters the incentives to prevent losses, and in most cases, actually increases the probability of loss.³ If a party is disinclined to act as he/she should and is insured, he/she knows that the insurance

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1. For the intellectual foundations of theories of risk aversion, see JOHN VON NEUMANN & OSKAR MORGENSTERN, *THEORY OF GAMES AND ECONOMIC BEHAVIOR* (Princeton Univ. Press, 60th Anniversary ed. 2004). For more recent empirical evidence of the influence of risk aversion on decision making, see *CHOICES, VALUES, AND FRAMES* (Daniel Kahneman & Amos Tversky eds., 2000); *JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES* (Daniel Kahneman et al. eds., 1982).

2. See Christopher Parsons, *Moral Hazard in Liability Insurance*, 28 *GENEVA PAPERS ON RISK & INS.* 448, 451 (2003). While "moral hazard" is a term of art for economists and the risk management industry, this article considers it in the ethical context of perverse incentives and unintended consequences.

3. ROBERT H. JERRY, II, *UNDERSTANDING INSURANCE LAW* § 10[c][2], at 13 (1987) ("[T]he existence of insurance could have the perverse effect of increasing the probability of loss. . . . This phenomenon is called moral hazard.").

will cover any harm he/she causes, and the incentive to avoid the harm is reduced.⁴

One loss, namely employment liability, has raised new moral hazard challenges. Major changes in employment discrimination law in the early 1990s brought about a dramatic increase in employment litigation,⁵ creating high levels of risk for employers that were quickly addressed by a new form of insurance known as Employment Practices Liability Insurance (“EPLI”).⁶ While previous forms of business insurance explicitly excluded coverage for liability arising out of employment practices, EPLI filled this gap by providing employers with the means to manage the increasing litigation risk associated with discrimination, sexual harassment, and other breaches of employment law.⁷ EPLI almost immediately enjoyed astonishing success, with rapidly expanding markets.⁸

Despite the success of EPLI markets, risk transfer of employment practices liability may create moral hazard by reducing employers’ incentive to engage in activities that help prevent illegal and wrongful acts. Such moral hazard associated with risk transference is not unique to EPLI and has been discussed in the context of third-party liability at length.⁹ This article proposes,

4. For example, risk transfer in the form of insurance can reduce investment in loss prevention. Indeed, automobile insurance has been shown to increase the number of car accidents, fire insurance to provide the incentive to commit arson, and disability insurance to create an upsurge in dismemberment. See Robert Schenk, *CyberEconomics: An Analysis of Unintended Consequences* (Dec. 2004), <http://ingrimayne.saintjoe.edu/econ/RiskExclusion/Risk.html> (citing Hal Lancaster, *Insurance Companies, Cheated for Centuries, Are Still Being Taken*, WALL ST. J., Dec. 23, 1974, at A1).

5. See Gregory Todd Jones, Note, *Testing for Structural Change in Legal Doctrine: An Empirical Look at the Plaintiff’s Decision to Litigate Employment Disputes a Decade After the Civil Rights Act of 1991*, 18 GA. ST. U. L. REV. 997 (2002); Marie Leone, *Buying Bias Coverage: Risk Doesn’t Discriminate*, CFO.COM, Mar. 31, 2005, <http://www.cfo.com/printable/article.cfm/3809890?f=options>.

6. Karen Callanan & Gerald L. Maatman, Jr., *Employment Practices Liability Insurance: Yesterday, Today, and Tomorrow*, 2 J. EMP. DISCRIMINATION L. 223, 223 (2000) (“EPLI is an insurance policy dedicated to protecting employers against suits alleging wrongful termination, sexual harassment, discrimination, and workplace torts like defamation, invasion of privacy, and infliction of emotional distress.”).

7. Joan Gabel et al., *Evolving Conflict Between Standards for Employment Discrimination Liability and the Delegation of that Liability: Does Employment Practices Liability Insurance Offer Appropriate Risk Transference?*, 4 U. PA. J. LAB. & EMP. L. 1, 28–30 (2001).

8. *Id.*

9. See, e.g., Parsons, *supra* note 2, at 452 (citing J. David Cummins & Sharon Tennyson, *Moral Hazard in Insurance Claiming: Evidence from Automobile Insurance*, 12 J. RISK & UNCERTAINTY 29 (1996)).

however, that when the injured third party is an employee, EPLI creates a peculiar and particularly troubling moral hazard. In areas other than those insured by EPLI, moral hazard is offset by the risk the wrongdoer bears regardless of the presence of insurance—the auto accident can still harm the driver, the arson can still burn the homeowner, etc. As a result, even without insurance, there is some incentive to behave legally.¹⁰

With discrimination and harassment, however, we do not have that extra incentive because the wrongdoer bears no risk of personal harm. If an employer is inclined to engage in wrongful employment practices or fails to prevent such practices, the employer only injures the employee, thereby making the wrongdoer's incentive to behave legally exist solely within the risk of damages and a finding of liability. EPLI allows the employer to transfer the risk of those damages, creating a peculiar moral hazard because the incentive to behave legally is arguably reduced in the process. The reduced incentive is particularly troubling given the way in which the law has come to specifically protect employees by emphasizing that employers actively engage in prevention.¹¹ This Article will posit that this legal construct relies on prevention and has evolved into a moral framework. The Article then examines whether the incentive to transfer risk harms employees by undermining this legal/moral framework in the workplace.

Section I considers the connection between employment law, the damages it imposes, and the ethical standards for encouraging appropriate behavior in order to determine the role of the law as a tool for creating a just workplace. Section II explores whether the availability of EPLI as a means of transferring an employer's risk of liability creates a peculiar moral hazard that undermines the incentives created by employment law. Finally, this Article examines other means of realigning these incentives, including incentives within the insurance industry that sells EPLI, to facilitate the co-existence of employees' legal protection and employers' desire to transfer risk.

I. THE CONNECTION BETWEEN LAW AND ETHICS IN THE WORKPLACE

This Article considers how the incentive to reduce the cost of employment practices liability affects the relationship between employer and employee. The employment relationship is highly

10. Parsons, *supra* note 2, at 456 (noting that in most cases, the victim, wrongdoer, and insurer are one in the same).

11. See Gabel et al., *supra* note 7, at 26–27.

regulated,¹² but also carries an ethical component fostered by efforts to level the inherent imbalance of power that favors employer over employee.¹³ Employment law builds a framework that marries legal requirements with ethical norms to create an incentive to maintain a balance in the workplace.¹⁴ If this balance is upset by the cost benefits offered by risk transference via an insurance product that is less expensive than the damages imposed, employment law no longer functions to impose a workplace norm. Before analyzing whether the balance is, in fact, upset, we will begin by establishing employment law as a guide for moral conduct at work.

A. *Law in General as a Moral Imperative*

The article proffers an argument, most closely captured in a more general work by Larry Alexander and Emily Sherwin, that anti-discrimination law, specifically with respect to its intent to right an untenable power imbalance in the workplace, is driven by a broad range of moral theories.¹⁵ Like Alexander and Sherwin, we acknowledge that the translation of moral imperative into law is not a perfect one.¹⁶ In fact, philosophical reflection

12. See, e.g., Equal Pay Act of 1963, 29 U.S.C. § 206(d) (2000); Age Discrimination in Employment Act of 1967, 29 U.S.C. § 621 (2000); Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e (2000); Americans with Disabilities Act of 1990, 42 U.S.C. § 12182 (2000).

13. See CAROL GILLIGAN, IN A DIFFERENT VOICE 168 (1982); ROSEMARIE SKAINE, POWER AND GENDER: ISSUES IN SEXUAL DOMINANCE AND HARASSMENT 65–74 (1996).

14. See *contra* JOHN AUSTIN, THE PROVINCE OF JURISPRUDENCE DETERMINED 157 (Wilfrid E. Rumble ed., Cambridge Univ. Press 1995) (1832) (“The existence of law is one thing; its merit or demerit is another. Whether it be or be not is one enquiry; whether it be or be not conformable to an assumed standard, is a different enquiry.”).

15. See LARRY ALEXANDER & EMILY SHERWIN, THE RULE OF RULES: MORALITY, RULES, AND THE DILEMMAS OF LAW 2 (2001) (“We find it unnecessary to adopt a position on the content of morality because we believe that the observations we make about the nature, role, and importance of rules are pertinent to all or nearly all moral theories.”); Peter A. Alces, *The Unruliness of Rules*, 101 MICH. L. REV. 2037, 2046 (2003) (reviewing ALEXANDER & SHERWIN, *supra*, with regard to the interplay between rules and morality); see also Joan T.A. Gabel & Nancy R. Mansfield, *Sexual Harassment in the Eye of the Beholder: On the Dissolution of Predictability in the Ellerth/Faragher Matrix Created by Suders for Cases Involving Employee Perception*, 12 DUKE J. GENDER L. & POL’Y 81 (2005).

16. Alexander and Sherwin acknowledge “the bluntness of rules, their over- and underinclusiveness.” ALEXANDER & SHERWIN, *supra* note 15, at 3. They say that “[b]ecause moral principles can never be perfectly captured in application by the general categories of facts that rules pick out, general rules that perform their settlement function will always be morally imperfect in application.” *Id.*

about the moral force of law has a long history with antecedents at least as early as Plato's dialogues.¹⁷ Fortunately, the present analysis need not resolve millennia-old questions about the essential nature of the connection between law and morality.¹⁸ For the purposes of this paper, we need only accept that a connection between law and morality *can* exist in specific circumstances,¹⁹ and that this connection has merit as a normative means for evaluating the extent to which law achieves society's ethical imperatives. Specifically, this article relies on an idea central to the development of Bernard Gert's public rule morality.²⁰ Gert maintains that morality can drive a system of public rules or

17. In the famous dialogue *Crito*, Socrates has been condemned to death for teaching that has allegedly corrupted the youth. When his friends suggest an escape from prison to save his life, Socrates is willing to do so only if his friends can convince him that this violation of the law would be just. As is well known, Socrates ultimately refuses to disobey the law and is put to death. PLATO, *CRITO*, in *READINGS IN THE PHILOSOPHY OF LAW* 56–63 (John Arthur & William H. Shaw eds., 3d ed. 2001). Arthur and Shaw comment that “‘Crito’ thus sets the stage for centuries of debate over the nature and extent of a citizen’s legal obligation.” *Id.* at 56–57. In contrast to the classical tradition of natural law presented by Aquinas and rooted in classical Greek philosophical thought, particularly that of Aristotle, the conventionalist political philosophies of Hobbes and Hume gave rise to the early ideas of legal positivism, first elaborated by Jeremy Bentham and subsequently popularized by John Austin. *See id.* at 111–23. Early emphasis on Austin’s command theory of law in which law was defined by the power of a sovereign legislative institution gave way to the revised positivism of Hans Kelsen and H.L.A. Hart, which placed more emphasis on the systematic and normative character of the law. *See generally* H.L.A. HART, *THE CONCEPT OF LAW* (1961); H.L.A. HART, *ESSAYS IN JURISPRUDENCE AND PHILOSOPHY* (1983); HANS KELSEN, *GENERAL THEORY OF LAW AND STATE* (Anders Wedberg trans., 1961); H.L.A. Hart, *Are There Any Natural Rights?*, 64 *PHIL. REV.* 175 (1955); H.L.A. Hart, *Positivism and the Separation of Law and Morals*, 71 *HARV. L. REV.* 593 (1958). Kelsen viewed the law as a normative system. KELSEN, *supra*, at 3 (“Law is not, as it is sometimes said, a rule. It is a set of rules having the kind of unity we understand by a system.”). This emphasis set the stage for the contemporary debate between Hart and his student (and natural law advocate) Ronald Dworkin. *See generally* RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* (1978); Ronald A. Dworkin, “*Natural*” *Law Revisited*, 34 *U. FLA. L. REV.* 165 (1982).

18. For an excellent collection of works framed in the context of legal obligation, see *THE DUTY TO OBEY THE LAW* (William A. Edmundson ed., 1999).

19. This is surely a notion to which both Hart and Dworkin would subscribe. One formal operationalization of this idea is found in the work of Bernard Gert where he offers the maxim “obey the law” as one of the ten justified general rules of a society’s moral system. BERNARD GERT, *MORALITY: ITS NATURE AND JUSTIFICATION* 201–02 (1998). “Adopting the moral attitude toward the rule ‘Obey the law’ only commits one to holding that, unless an impartial rational person can publicly allow the law to be ignored or broken, one should obey it.” *Id.* at 202.

20. *Id.*

laws and that such moral underpinnings provide the authority that creates not only the duty to obey these rules, but a benefit that can accrue to society when they are obeyed.²¹ Bernard Gert, Ronald Green, and K. Donner Clouser state that “at the core of our view is the claim that morality involves a public system of rules and ideas that all impartial rational persons would put forward as a public guide to everyone’s conduct.”²² Such views have been broadly adopted, with some variation, by contemporary neo-positivists, including Joseph Raz and Matthew Kramer.²³

The extent to which these views overlap specifically with employment law is seen in the way in which employment law creates incentives for moral conduct. In order to evaluate this incentive, we will explore the evolution and status of the relevant laws.

B. *The Deterrent Effect of Employment Liability Damages as an Incentive-Creating Moral Imperative at Work*

With its “superiors” and “subordinates,” the workplace inherently features an imbalance of power favoring employers. All too often employers abuse their power, producing unacceptable conduct, which can “assume a moral dimension.”²⁴ Employment law’s evolution as a tool to “create limits on . . . [employers’] acquisition and exercise of power”²⁵ fulfills many aspects of that moral dimension by righting the imbalance of power to make the workplace equitable and fulfill the social interest of protecting the worker.

Employers have long held the tools to dominate the workplace environment, including the right to hire, fire (with or without cause), determine work assignments, and decide upon

21. *Id.*

22. Ronald M. Green, Bernard Gert & K. Danner Clouser, *The Method of Public Morality Versus the Method of Principlism*, 18 J. MED. & PHIL. 477, 481 (1993).

23. See generally Matthew H. Kramer, *Requirements, Reasons, and Raz: Legal Positivism and Legal Duties*, 109 ETHICS 375 (1999). For a less formal application of legal positivism to contemporary U.S. business practices, see Bruce D. Fisher, *Positive Law as the Ethic of our Time*, BUS. HORIZONS, Sept.–Oct. 1990, at 28; Ellwood F. Oakley, III & Patricia Lynch, *Promise-keeping: A Low Priority in a Hierarchy of Workplace Values*, 27 J. BUS. ETHICS 377 (2000); Ellwood Oakley, III & Patricia L. Smith, *Commercial Law and Neo-Positivism: A Viable Framework for Analyzing Contemporary Business Ethics*, 19 LEGAL STUD. F. 195 (1995). At the very least, the school of contemporary philosophers working in the field of public rule morality accords jurisprudence a legitimate place at the table of the morality debate.

24. See GILLIGAN, *supra* note 13.

25. Burton Brody, *One Potato[e], Two Potato[e], Three Potato[e], Four Power, Power, We Want More: A Thought on “Overlawyering”*, 71 DENV. U. L. REV. 151, 152 (1993).

economic rewards, including pay and promotion.²⁶ Economists have similarly described subordinates' work as "[the sale of promises] to obey commands."²⁷ Applied appropriately, employer power encourages positive results, including productivity, employee advancement and an efficient firm.²⁸ Problems can nonetheless arise when the rights of superiors conflict with the individual rights of the subordinates.²⁹ Such individual rights include, of course, the right to insulation from wrongful employment practices and discrimination.

Employment law began at the federal level in an effort to right this imbalance, as Congress created labor relations acts to protect the activities of organized employee associations, workers' compensation and safety acts to provide minimum wage levels and to protect employees from occupational hazards and injuries, and, ultimately, anti-discrimination legislation to protect civil rights in the workplace.³⁰ During the past forty years, Title VII and other anti-discrimination statutes have evolved to a guideline for moral behavior by introducing incentives to eliminate employer power abuse and encourage nondiscriminatory conduct.

The moral incentive is found within the damages provision of Title VII, which serves two functions. First, the Supreme Court noted Title VII's purpose was "to make persons whole for injuries suffered on account of unlawful employment discrimination."³¹ Second, it is via the deterrent effect of damages that Title VII

26. See RICHARD T. DEGEORGE, *BUSINESS ETHICS* 398 (4th ed. 1995); CHARLES SPENCER, *BLUE COLLAR: AN INTERNAL EXAMINATION OF THE WORKPLACE* 92 (1977) (stating that "[t]he right to discipline its employees has been broadly conceded as an inalienable right of management, . . . a basic property of the productive process . . ."); Sid L. Moller, *The Revolution that Wasn't: On the Business as Usual Aspects of Employment at Will*, 27 U. RICH. L. REV. 441, 443 (1993).

27. See JOHN R. COMMONS, *LEGAL FOUNDATIONS OF CAPITALISM* 284 (1932), quoted in Moller, *supra* note 26, at 445.

28. See Moller, *supra* note 26, at 443-44 (citing RALF DAHRENDORF, *CLASS & CONFLICT IN INDUSTRIAL SOCIETY* 71 (1959)).

29. See *id.* at 443.

30. See, e.g., Federal Employees Compensation Act, 5 U.S.C. §§ 8101-8193 (2000); National Labor Relations Act (Wagner Act of 1935), 29 U.S.C. §§ 151-169 (2000); Age Discrimination in Employment Act of 1967 (ADEA), 29 U.S.C. §§ 621-634 (2000); Occupational Safety and Health Act (OSHA), 29 U.S.C. §§ 651-678 (2000); Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e to 2000e-15 (2000); Americans with Disabilities Act of 1990 (ADA), 42 U.S.C. §§ 12101-12213 (2000); see also Andrew Altman, *Making Sense of Sexual Harassment Law*, 25 PHIL. & PUB. AFFAIRS 36 (1996).

31. *Albemarle Paper Co. v. Moody*, 422 U.S. 405, 418 (1975).

creates a preventive nondiscriminatory workplace atmosphere.³² When Congress included backpay as a remedy, it created the monetary motivation to comply with the law.³³ The Supreme Court has stated, “If employers faced only the prospect of an injunctive order, they would have little incentive to shun practices of dubious legality.”³⁴ The Court explained clearly Title VII’s role in motivating employers to eliminate workplace discrimination: “It is the reasonably certain prospect of a backpay award that ‘provide[s] the spur or catalyst which causes employers and unions to self-examine and to self-evaluate their employment practices and to endeavor to eliminate . . . the last vestiges of an unfortunate and ignominious page in this country’s history.’”³⁵

The deterrent effect of damages under Title VII evolved when Congress further empowered employees by passing the Civil Rights Act of 1991, which guaranteed jury trials and provided compensatory and punitive damages for discrimination lawsuits.³⁶ Congress evinced a particular focus by addressing intentional discrimination. Not only did it amend the damage provisions, it stated that the Act’s primary purpose was “to confirm that the principle of anti-discrimination is as important as the principle that prohibits assaults, batteries and other intentional injuries to people.”³⁷ Congress noted that

32. See *id.* at 417–21 (quoting the Conference Committee Report accompanying the 1972 Amendments to Title VII and affirming the right to backpay). Discussing Congress’ inclusion of a backpay remedy, the Court noted that “[i]f employers faced only the prospect of an injunctive order, they would have little incentive to shun practices of dubious legality.” *Id.* at 417. The backpay provision of Title VII provides that when the court has found “an unlawful employment practice, the court may enjoin the respondent from engaging in such unlawful employment practice, and order such affirmative action as may be appropriate, which may include, but is not limited to, reinstatement or hiring of employees, with or without back pay . . .” 42 U.S.C. § 2000e-5(g) (2000). See also H.R. REP. NO. 88-914, pt. 1, at 18 (1963), cited in *United Steelworkers of Am. v. Weber*, 443 U.S. 193, 204 (1979).

33. *Albemarle Paper Co.*, 422 U.S. at 405.

34. *Id.* at 417.

35. *Id.* at 417–18 (quoting *United States v. N.L. Indus.*, 479 F.2d 354, 379 (8th Cir. 1973)).

36. Pub. L. No. 102-166, 105 Stat. 1071 (1991) (codified at 42 U.S.C. § 1981(a) (2000)).

37. H.R. REP. NO. 102-40(I), pt. 1, at 15 (1991). Congress did not ignore, however, intentional discrimination’s often subliminal nature:

Employment discrimination, as we know today, is a far more complex and pervasive phenomenon. Experts familiar with the subject generally describe the problem in terms of ‘systems’ and ‘effects’ rather than simply intentional wrongs. The literature on the subject is replete with discussions of the mechanics of seniority and lines of pro-

“[s]trengthening Title VII’s remedial scheme to provide monetary damages for intentional gender and religious discrimination [was] necessary Monetary damages simply raise the cost of an employer’s engaging in intentional discrimination, thereby providing employers with additional incentives to *prevent* intentional discrimination in the workplace before it happens.”³⁸ Congress explained that employer liability deters specific employers and the employer community as a whole from future discriminatory conduct.³⁹ In 1998, the Supreme Court agreed by holding that employment discrimination is a fundamental abuse of employer power.⁴⁰ They renewed their view of Title VII’s deterrent purpose in 2004.⁴¹ In the next section, we address whether EPLI undermines employment law’s deterrent effect and, as a result, undermines the moral framework the law creates.

II. DOES EPLI UNDERMINE THE MORAL FRAMEWORK OFFERED BY EMPLOYMENT LAW?

The overarching goal of employment law is to deter wrongful employment practices.⁴² To synthesize the evolution of

gression, perpetuation of the present effects of earlier discriminatory practices through various institutional devices, and testing and validation requirements.

Id. at 24.

38. *Id.* at 64–65.

39. H.R. REP. NO. 102-40(I), pt. 1, at 64–70 (1991). Dr. Freada Klein, described as one of the foremost experts on sexual harassment in the workplace and a consultant to leading corporations, echoed that view:

Allowing full compensatory and punitive damages . . . would provide a stronger incentive for employers to implement effective remedies for intervention and prevention, which I think is the real goal. Data suggests that employers do indeed implement measures to interrupt and prevent employment discrimination when they perceive that there is increased liability.

Id. at 70.

40. See *Oncale v. Sundowner Offshore Servs., Inc.*, 523 U.S. 75 (1998). The Supreme Court decided two similar sexual harassment cases during the same year as the *Oncale* holding. In *Burlington Indus., Inc. v. Ellerth*, 524 U.S. 742 (1998), and *Faragher v. City of Boca Raton*, 524 U.S. 775 (1998), the Court expanded employer liability for sexual harassment by holding employers responsible for certain actions of its managers even where the employer was unaware that the conduct occurred. The *Oncale*, *Ellerth*, and *Faragher* decisions are referred to as the “trilogy” because together they have significantly altered the employment law liability landscape.

41. See *Pa. State Police v. Suders*, 542 U.S. 129, 134 (2004).

42. See Gabel et al., *supra* note 7, at 26 (maintaining that by inflicting punitive damages on employers who are vicariously liable, the Court is emphasizing employers’ duty to prevent).

employment law and its deterrent effect into a framework where people are encouraged to engage in the most rational moral behavior, one must recognize that the law represents a rule system that guides the public to a rational standard of conduct in the workplace.⁴³ The rule, as we surmise it, is that discrimination is unacceptable conduct for which the wrongdoer should be held responsible, with that responsibility increasing for a failure to prevent the discrimination. That discrimination is unacceptable is difficult to dispute. That the wrongdoer must personally bear the liability is debatable given the cost such liability can create and the resulting desire for an employer to transfer the risk of that liability.

Despite employers' desire to limit their risk, the legal rule remains and builds a moral framework at the workplace for employers who might otherwise engage in or fail to prevent wrongful employment practices. Admittedly, EPLI would not affect the incentives of an employer who would provide a moral and nondiscriminatory workplace regardless of legal standards. This paper, however, does not address the nondiscriminatory employer. Analysis of moral hazard focuses upon those who seek to do wrong or fail to prevent wrongful behavior and need an incentive to do right.⁴⁴ We similarly address employers who would otherwise treat their employees in an immoral way and need an incentive to treat them properly.

Employment law has evolved to create this incentive through the deterrent effect of damages with corresponding reductions in liability for prevention. When the Supreme Court decisions of 1998 made employers responsible under circumstances where they "knew or should have known" about discriminatory conduct, it also established rather clear affirmative defenses available to insulate employers from imputed liability.⁴⁵ To establish an effective affirmative defense, employers must: (1) exercise reasonable care to prevent and promptly correct supervisor discrimi-

43. See generally GERT, *supra* note 19.

44. See Parsons, *supra* note 2, at 451 ("[Moral hazard] is essentially an incentive problem, arising from asymmetric information of agents and the difficulty that insurers have in discriminating between the actions of the insured on the one hand, and exogenous uncertainty on the other.") (citing R.A. LITTON, CHARTERED INS. INST., MORAL HAZARD AND INSURANCE FRAUD 3 (1988) ("Moral hazards are those conditions that increase or decrease the probability, frequency or severity of loss because of the attitude and character of either an insured person or some other person."); A.E.B ALPORT, CHARTERED INS. INST., RISK AND BEHAVIOUR: SOME NOTES TOWARDS A DEFINITION OF MORAL HAZARD 79 (1988) ("Moral hazard is an expression of the influence of human activity and its impact on insurance, either by its presence or its absence.")).

45. See *Ellerth*, 524 U.S. at 765; *Faragher*, 524 U.S. at 794–95.

nation (including dissemination of an effective anti-discrimination policy); (2) demonstrate that the harassed employee fails to take advantage of the system in place.⁴⁶ The Supreme Court reiterated its position in the 2004 case of *Suders* when it specifically noted Congress' intent to connect Title VII's deterrent effect with prevention, with a reduction in liability when that prevention was sufficient.⁴⁷

Transferring the risk of damages via EPLI creates a moral hazard by undermining this deterrent effect.⁴⁸ Other types of liability insurance, such as automobile insurance, address this moral hazard by relying heavily on the wrongdoer's other incentives—namely, the wrongdoer's incentive to avoid their own injury.⁴⁹ One is less likely to drive dangerously knowing that such behavior could result in personal harm. Employment practices, however, are peculiar in that the wrongdoer has no risk of personal injury.⁵⁰ Unlike the automobile-driver who may injure him/herself when causing an accident, the employer who would discriminate is halted only by the threat of damages. If those damages are paid by a third party, what then halts the employer?

46. *Ellerth*, 524 U.S. at 765; *Faragher*, 524 U.S. at 807; see also Marc R. Engel, *Millennium Resolution: Reduce Your Risk of Employment-Related Litigation*, EMP. L. STRATEGIST, Aug. 1999, at 1.

47. *Suders*, 542 U.S. at 134.

48. See Sean W. Gallagher, *The Public Policy Exclusion and Insurance for Intentional Employment Discrimination*, 92 MICH. L. REV. 1256, 1266–74 (1994) (quoting Steven L. Willborn, *Insurance, Public Policy, and Employment Discrimination*, 66 MINN. L. REV. 1003, 1009 (1982), who states, “Insurance [for intentional discrimination] would undermine the deterrent effect of damages. Hence, to preserve the deterrent effect, [public policy] prohibits insurance for such liability.” *Gallagher, supra*, at 1270 n.60).

49. See Parsons, *supra* note 2, at 455 (citing *Delanoy v. Robson*, 5 Taunt. 605 (1814), as the oldest case referring to liability insurance that describes that most insureds and insurers share the incentive to restrain loss); see also Ind. Sch. Dist. No. 697, *Eveleth v. St. Paul Fire & Marine Ins. Co.*, 515 N.W.2d 576 (Minn. 1994) (discussing coverage for intentional discrimination); Steven R. Goldstein & Amy R. Stein, *Is Employment Policy Liability Insurance Against Public Policy?*, 51 CPCU J. 138, 138 (1998) (noting that “[s]ince there have been few, if any, judicial decisions interpreting the terms and conditions of EPLI policies, it is unclear whether or not the courts will find certain provisions . . . against public policy”); Rosemary A. Macero & Lucy Halatyn, *Employer Beware: Do You Have Insurance Coverage for Employment Claims?*, in INSURANCE LAW 1999: UNDERSTANDING THE ABCs 399, 425 (PLI Litig. & Admin. Practice, Course Handbook Series No. 602, 1999) (noting that “public policy goals seem to conflict with the scope of available coverage under EPLI which, by its terms, defines actions which have previously been determined by various courts to constitute intentional conduct”).

50. Parsons, *supra* note 2, at 455 (Interestingly, the judge in the *Delanoy* case as cited by Parsons refers to the lack of shared incentive as “peculiar.”).

The urgency in answering this question is growing to the extent that claims are increasing and the damages awarded are rising.⁵¹ We infer from these increases that there is more need than ever to enforce the incentives offered by employment law. With regard to damages, a Marsh, Inc., study shows that the median compensatory jury award for 2003 was \$250,000, compared with \$133,691 in 1997.⁵² Approximately eighteen percent of the awards were for one million dollars or more whereas in 1997, seven percent were for that amount.⁵³ Further, the same study finds that discrimination cases are heading towards state courts where federal damages caps do not apply.⁵⁴ With regard to frequency of claims, the Marsh study finds only a twelve percent increase from 1993 to 2003, but explains that claims settled out of court do not appear in the study.⁵⁵ Marsh analysts also describe a seventy percent win-rate for plaintiffs filing wrongful discharge and/or discrimination suits.⁵⁶

Along with the inference we draw that increasing damages implies an increasing need to enforce the moral framework's incentive to prevent, we also infer that increasing damages raises the employer's desire to transfer risk. The insurance market has responded.⁵⁷ EPLI dates only to the early 1980s, but it began to sell well in the early 1990s when carriers introduced their EPLI products in greater numbers. Industry analysts report EPLI sales are growing and that, while in 1994 fewer than ten insurance companies offered EPLI policies, by the summer of 2004 forty-four companies were in the market.⁵⁸

With increased market competition in recent years, significant product differentiation arose. "Enhanced" EPLI policies emerged covering various forms of discrimination, sexual harassment, wrongful discharge, defamation, and negligent hiring.⁵⁹

51. See Leone, *supra* note 5.

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. Paul Walther, Seaview 2002—IRU Fall Conference—A Recap, http://www.irua.com/event_fa2002.php (last visited July 15, 2005) [hereinafter Seaview 2002] (citing Gina Higgins, Managing Director for Marsh, Inc.).

57. See generally *The EPL Insurance Market: Where It Is, Where It's Going*, 19 RISK MGMT. LETTER 1 (1998) [hereinafter *The EPL Insurance Market*].

58. See *id.*; *Employment Practices Liability (EPL) Markets*, EMP. PRACTICES LIABILITY CONSULTANT, Summer 2004, at 22; Jon Enscoe, *Insurance for Employment-Related Claims*, S.F. ATT'Y, Oct./Nov. 1998, at 32; Simon J. Nadel, *Employment Practices Liability Insurance Makes Some Headway with Employers*, 66 U.S. L. WK., Nov. 11, 1997, at 2275.

59. See *The EPL Insurance Market*, *supra* note 57.

EPLI carriers offered higher coverage limits, and some carriers offered coverage for punitive damages where state law allowed.⁶⁰ Despite product differentiation, the one similarity all EPLI policies share is payment of employment liability damages, even, in some cases, for punitive damages.⁶¹

Payment of damages either removes or significantly reduces the risk of a judgment for employers who fail to uphold employment law in their workplace. While insurance does retain and allocate the funds necessary to guarantee that injured employees are paid, the availability of such funds, however, does not restore the imbalance of power which exists when an employer fails to prevent wrongful employment practices. Employment law's moral framework presupposes that the statutory purpose is to "reduce and mitigate the unfair disadvantage . . . from which persons suffer on account of their race or gender."⁶² This moral framework is tied to prevention, with money in place primarily to create an incentive for that prevention. While damages compensate for injuries, EPLI coverage for damages can never restore employment law's moral framework which relies on prevention. Transferring the risk of those damages removes the incentive to prevent the wrongful act from ever occurring, particularly since the employer risks no personal harm. If employment law's primary purpose is to "provide the spur or catalyst which causes employers . . . to self-examine and to self-evaluate their employment practices and to endeavor to eliminate [discrimination],"⁶³ then removing the framework employment law creates sets up a peculiar and troubling moral hazard.

III. POTENTIAL REALIGNMENT OF INCENTIVES, MORAL FRAMEWORKS, AND EMPLOYMENT LAW

Despite the moral hazard EPLI creates, it exists and operates within a growing market. EPLI can, however, exist within employment law's moral framework if the market responds to realign the incentive to prevent wrongful employment practices with the incentive to transfer risk.

These two incentives may appear mutually exclusive in that the incentive to prevent lies in the moral framework and the

60. David M. Katz, *\$100M Suits Fuel Market for Bias, Harassment Coverage*, NAT'L UNDERWRITER, PROP. & CASUALTY/RISK & BENEFITS MGMT. ED., Apr. 8, 1996, at 1, 1.

61. See CLARENCE E. HAGGLUND ET AL., *EPL EMPLOYMENT PRACTICES LIABILITY GUIDE TO RISK EXPOSURES AND COVERAGE* 65-74, 83-86 (1998).

62. Altman, *supra* note 30, at 45.

63. *Albermarle Paper Co. v. Moody*, 422 U.S. 405, 417-18 (1975) (quoting *United States v. N.L. Indus.*, 479 F.2d 354, 379 (8th Cir. 1973)).

incentive to transfer risk is economic. In examining moral hazard in EPLI, there is hesitation in looking to economic factors for a solution. The risk is that the moral framework employment law builds could become, in practice, an economic framework built on concepts such as rational behavior and cost-benefit analysis.

Such concerns are not unfounded. In 1957, Gary Becker wrote *The Economics of Discrimination*, considered a seminal work,⁶⁴ in which he posits “that a person with a ‘taste for discrimination’ will act ‘as if he were willing to pay something, either directly or in the form of a reduced income, to be associated with some persons instead of others.’”⁶⁵ Becker’s analysis assumes that the employer decides to discriminate based on the presence or absence of financial incentive. Many scholars build upon Becker’s framework, either directly or indirectly, by analyzing wrongful employment practices as a form of rational or irrational behavior, as opposed to moral or immoral behavior.⁶⁶

While there are rational and irrational aspects of discrimination, such analysis ignores that the emphasis of employment law is not just on the financial consequences of wrongful behavior, but also on the imbalance of power between employer and employee and the injustice this imbalance causes when abused. Employment law, therefore, emphasizes damages aimed at prevention and not just damages aimed at compensation.⁶⁷ On the other hand, using a pure moral framework ignores that there is a market for EPLI and that the market is growing. We therefore propose that the solution may lie in an effort to align the moral framework with the economics in examining pricing and selling of EPLI in a way that restores the incentive to prevent and is not limited to an assurance that funds are available once an injury has occurred.

In order to realign the incentives to both prevent wrongful practices and to transfer risk, markets must respond to more than what makes the product sellable. To some degree, the insurance industry has begun this journey by raising the price of

64. See George R. Boyer & Robert S. Smith, *The Development of the Neoclassical Tradition in Labor Economics*, 54 *INDUS. & LAB. REL. REV.* 199, 209 (2001).

65. *Id.* (citing GARY BECKER, *THE ECONOMICS OF DISCRIMINATION* 14 (1957)).

66. See, e.g., Orley Ashenfelter & Ronald Oaxaca, *The Economics of Discrimination: Economists Enter the Courtroom*, 77 *AM. ECON. REV. (PAPERS & PROC.)* 321, 321 (1987); Samuel R. Bagenstos, “Rational Discrimination,” *Accommodation, and the Politics of (Disability) Civil Rights*, 89 *VA. L. REV.* 825 (2003); Boyer & Smith, *supra* note 64.

67. See generally SKAINE, *supra* note 13, at 377.

EPLI—in some cases, up to four-hundred percent.⁶⁸ The industry maintains that the higher premiums are in place because during EPLI's short life, better loss history data⁶⁹ has become available and that data has facilitated more accurate underwriting and pricing.⁷⁰ Higher premiums relate solely to costs and not prevention. Higher premiums create an incentive in that the filing of a claim may make premiums go up—but higher premiums do not create the incentive employment law builds to prevent wrongful practices.

To realign incentives, there must be more than a higher premium. There must be a barrier to the incentive to transfer risk that arises, unless the employer retains the incentive to prevent the wrongful practices. When underwriting EPLI coverage, insurers can add to the data traditionally relied on for pricing and look also to the atmosphere the employer creates. Most employers who seek coverage have never had a claim filed against them. To an insurer evaluating whether to provide coverage, such an employer would be desirable. An insurer, however, could go further to mandate that this employer have in place appropriate efforts at prevention of wrongful employment practices before approving coverage. If such a requirement is too onerous, insurers could, in the alternative, offer discounts or reduced premiums for employers who actively seek to provide a nondiscriminatory workplace, much like employers who receive group health discounts for no-smoking policies or workers compensation discounts for safe workplaces.⁷¹

Many EPLI carriers have employed an intersection of underwriting with the encouragement of prevention. Some insurers require applicants to examine their anti-discrimination policies and procedures and often insist on a full-scale audit of the company's human resources practices. Other insurers offering EPLI have denied coverage to applicants who do not have in place adequate anti-discrimination preventive procedures.⁷² Still, some insurers provide internet guidance on appropriate human resource practices with thirty minutes of free telephone counsel

68. Seaview 2002, *supra* note 56.

69. Insurers capture information about the losses, or payouts, for which they are responsible over a period of time in order to determine how much premium to charge in the future. See ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW § 8.4(a)(2)–(3) (Student Ed. 1988).

70. See Phil Zinkewicz, *EPLI Comes of Age*, ROUGH NOTES, Mar. 2004, at 52.

71. See Kenneth E. Warner & Hillary A. Murt, *Economic Incentives for Health*, 5 ANN. REV. PUB. HEALTH 107 (1984).

72. Nadel, *supra* note 58, at 2276.

per month and a reduction in the deductible if they use the counseling.⁷³

Such market enforcement by insurers to prevent discrimination aligns the moral framework and the Supreme Court's efforts in offering the "affirmative defense" while still allowing options for those employers seeking to transfer risk. So long as an appropriate preventive program is in place (i.e., an employer cannot transfer risk without proactively seeking to prevent discrimination before it happens) the moral framework of employment law can co-exist with the incentive to transfer risk, making EPLI's moral hazard less troubling.

CONCLUSION

Morality includes a public rule system that offers a rational guide to positive conduct. In their efforts to regulate discrimination, Congress and the courts have created an evolving rule system that sets the legal and moral standard for appropriate conduct at work. This standard of conduct reflects that discrimination is both immoral and illegal and results in employer liability for damages. The sting of damages is the law's primary means of motivating compliant, preventive, non-discriminatory work environments. Employment Practices Liability Insurance allows employers to transfer the law's economic motivator to a third party insurer. EPLI, therefore, potentially creates a moral hazard that employers will engage in conduct, or fail to prevent it, because any resulting liability belongs to the insurer.

This moral hazard is particularly troubling in light of the peculiar character of employment law. Unlike other areas of liability, a wrongdoer employer bears no personal risk of harm. Compared to the wrongdoer driver who risks injury in an accident or the wrongdoer arsonist who risks a burn, the employer has an incentive to avoid discrimination primarily by the damages imposed if it fails. The Supreme Court upholds the preventive force of employment law's moral framework by giving employers an affirmative defense if they use "preventive medicine" and make a good faith effort to stop discrimination before it starts. If EPLI coverage is contingent on similar proactive measures, the moral hazard disappears, thereby realigning the incentives created by employment law's moral framework and the incentives of employers to manage their risk.

73. Larry G. France, *Employment Practices Liability*, ROUGH NOTES, June 2003, at 96, 96-97.