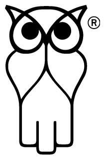

EPLiC™

**Employment Practices Liability Consultant**

*"Your quarterly guide to exposures, coverage, and loss control"*

# Post-*Clackamas* and Employment Practices Liability Claims: Are You a Covered "Employee" or a Barred Insured?

***By Raymond T. Mak, Esq.***

When is an employee *really* an employee? For purposes of determining coverage under the Americans With Disabilities Act (ADA), that was the question addressed by the United States Supreme Court last term in *Clackamas Gastroenterology Associates v Wells,* 123 S. Ct. 1673 (2003).

The *Clackamas* decision is known for the Court's ruling that an ownership interest in a company or partnership does not preclude an individual from being considered an "employee" in determining coverage under the ADA. However, its implications are far more reaching than the narrow question presented.

The Court's decision undoubtedly impacts the vast number of smaller professional service companies, including law firms, medical practices, and accounting offices. Moreover, the decision not only resolved a long-standing split among the federal circuit courts of appeals that utilized different tests for determining employee status under the ADA but has also extended to other federal antidiscrimination laws, such as the Pregnancy Discrimination Act, Title VII of the Civil Rights of 1964, and the Age Discrimination in Employment Act. To be sure, courts have also applied *Clackamas* to Employee Retirement Income Security Act (ERISA) actions and even those filed under state antidiscrimination laws. Finally, of lesser notoriety—but certainly not importance—the *Clackamas* decision also has a significant impact on the coverage of employment practices liability claims under insurance policies.

This article discusses the significance of the determination of employee status, the *Clackamas* decision and its impact, and the policy coverage implications for employment practices liability claims under insurance policies.

## Background: The "Employee" Count

The distinction between employees, partners, and owners is critical to the applicability of the array of federal employment laws. Generally, the various employment statutes are applicable only to employers with a certain threshold of "employees." Many federal statutes, such as the

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## From the Editors ...

Welcome to the Fall 2004 edition of *EPLiC*. Our purpose is to supply our readers with the most innovative, practical, state-of-the-art strategies and tools to help you lower your company's or your clients' exposure to employment-related claims and to buy the most expansive, cost-effective employment practices liability (EPL) insurance coverage possible.

In this issue's lead article, "Post-*Clackamas* and Employment Practices Liability Claims: Are You a Covered 'Employee' or a Barred Insured?," Raymond T. Mak, an attorney with the law firm of Epstein Becker & Green, P.C., examines a decision by the United States Supreme Court addressing the issue of whether partners and principals in law, medical, accounting, and insurance agency offices have "employee status." The decision has significant implications as respects both liability under the major employment laws and the applicability of coverage under employment practices liability insurance policies.

In "The United States Supreme Court Expands Employee Rights," Brad Adler, an attorney with the law firm of Freeman Mathis & Gary, LLP, analyzes the effects of two more U.S. Supreme Court decisions, both of which appear to have had the effect of expanding employee rights. The first case addresses the statute of limitations applicable to a § 1981 claim, while the second attempts to resolve a conflict that had developed within the circuit courts as to whether a constructive discharge constitutes a tangible employment action in a hostile work environment claim.

"EPL Policy Conditions: Frequently Overlooked, Always Important," by Bob Bregman, demonstrates how and why the conditions sections of EPL policies can have a significant effect on both the insured's and the insurer's rights under the policy.

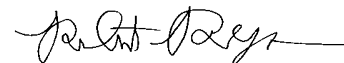
In "Guns at the Workplace: Liability Challenges," attorney Mark Lies analyzes the potential employment and general liability exposures that result when employees bring guns to the workplace. His article provides a set of useful guidelines and procedures for minimizing these liabilities.

The final article in this issue is a counterpoint by coeditor Don Phin to Bob Bregman's Summer 2004 *EPLiC* editorial regarding the proliferation of class action employment litigation. Don presents a completely different "take" on this issue and proposes a solution to the abuses these lawsuits have produced recently.

Please let us know what you think about these articles, and advise us of additional topics you would like to see addressed in future issues.

May all of your risks
be profitable,

Donald A. Phin, Esq.



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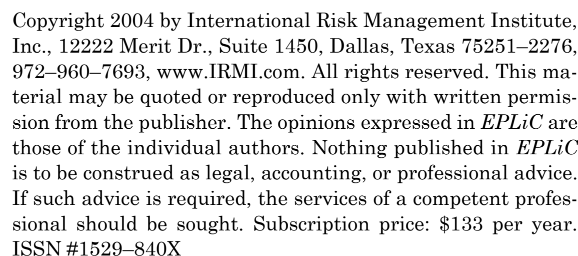

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Civil Rights Act of 1964, the Age Discrimination in Employment Act of 1967, and the Americans With Disabilities Act of 1990, do not apply to employers with fewer than 15 "employees." Congress created this exemption "to spare very small firms from the potentially crushing expense of mastering the intricacies of the antidiscrimination laws, establishing procedures to assure compliance, and defending against suits when efforts at compliance fail."

Often, small companies doing business as partnerships and professional corporations have only a few employees, apart from the partners, owners, or shareholders. However, many businesses reach the conclusion that they have only "a few employees" based on an assumption that persons with particular titles such as shareholder, director, or vice president, or those who occupy other similar high-level positions, are not "employees" under the federal employment laws by virtue of the fact that they are the owners of the business and/or comprise its board of directors. These businesses therefore presume that as officers and directors of a company, they are more analogous to partners in a partnership than to shareholders in a corporation, and consequently they are not employees and should not be counted as such for purposes of the numerical thresholds set forth by the various employment statutes.

Prior to the *Clackamas* decision, there was support for such reasoning. However, in *Clackamas,* the United States Supreme Court expressly rejected this rationale by specifically explaining that determining whether a shareholder/director is an employee cannot be answered by asking whether such an individual appears to be the functional equivalent of a partner. It noted that there are many partnerships today that include hundreds of partners, some of whom may well qualify as "employees" because control is concentrated in a small number of managing partners.

Determining whether partners, owners, or shareholders are "employees" for purposes of the federal employment statutes is therefore a critical issue. The determination, however, is complicated by the fact that not all the statutes set forth a meaningful definition of the term. For example, Title I of the ADA—the statute that is the subject of the *Clackamas* decision—defines an "employer" as "a person engaged in an industry affecting commerce who has 15 or more employees for each working day in each of the 20 or more calendar weeks in the current or preceding calendar year ...." The statute, however, defines "employee" simply as "an individual employed by an employer." As described by the Supreme Court in its decision, this is a nominal definition that "explains nothing." Indeed, prior to *Clackamas*, courts have previously articulated different tests for determining who is an "employee" under the ADA, because the statute itself provides no guidance.

## The Circuit Court Split

The Seventh Circuit Court of Appeals, for example, by using an economic-realities test, had concluded that shareholders acted more like partners than as shareholders of a general corporation and therefore were not employees under the ADA. See *EEOC v Dowd & Dowd, Ltd.*, 736 F2d 1177 (7th Cir 1984). The Eighth and Eleventh Circuits have similarly followed the economic-realities approach in cases involving shareholders. See, e.g., *Devine v Stone, Leyton & Gershman,* 100 F3d 78 (8th Cir 1996); *Fountain v Metcalf, Zima, & Co., P.A.,* 925 F2d 1398 (11th Cir 1991).

On the other hand, under a similar factual scenario, the Second Circuit specifically rejected the economic-realities test and concluded that whether the shareholder acted as a partner was irrelevant. See *Hyland v New Haven Radiology Associates, P.C.,* 794 F2d 793 (2nd Cir 1986). In that case, the Second Circuit focused not on the shareholder's role as owner and manager but on the "contractual employment relationship voluntarily entered into by [the plaintiff] and the corporation." *Id.* at 797. In *Clackamas,* the Supreme Court eliminated the circuit split and resulting confusion by articulating a test for determining whether an individual is an employee under the ADA.

## The *Clackamas* Case and the Court's Ruling

Deborah Wells was a bookkeeper for her employer, a medical clinic. She suffered from a tissue disorder and made several requests for

reasonable accommodations to permit her to perform her job. Shortly before her termination, the clinic demoted her to a receptionist position in an office location several miles farther from her home. Ms. Wells maintained that her employer assigned her to the position knowing and expecting that she would be unable to do the job and intending to cause her to quit. The clinic maintained that it transferred her because she was unable to satisfactorily do her job as a bookkeeper. It considered the receptionist position to be a less demanding one. Ms. Wells's medical condition worsened to a point where she was unable to work. As a result, she obtained medical authorizations for leave. However, the clinic, applying its unexcused absence policy, had already mailed her a termination letter.

Ms. Wells sued under the ADA asserting that the clinic unlawfully discriminated against her by refusing to accommodate her alleged disability and by terminating her employment. The clinic moved for summary judgment, asserting that it was not a "covered employer" under the ADA because it did not have 15 or more employees. The clinic met this statutory requirement only if its four physician-shareholders were counted as employees. The clinic argued that they were not. According to the clinic, dismissal of the lawsuit was required because the physicians were shareholders and directors, not employees. The district court, relying on the economic-realities test, agreed and entered summary judgment for the clinic.

On appeal, the Ninth Circuit Court of Appeals reversed. The court reasoned that a professional corporation should not be permitted to have "the best of both worlds"—using its corporate label to receive favorable tax, employee benefit, and civil liability advantages and then arguing that it is like a partnership to insulate itself from liability for employment discrimination. Additionally, the court focused on the broad purpose of the statute—to eliminate illegal discrimination—and found that the term "employee" should be interpreted liberally. Accordingly, the Ninth Circuit held the physician-shareholders were employees, and therefore, the clinic, having 15 or more employees, was subject to the ADA.

The Supreme Court refused to adopt either the economic-realities test or the "broad purpose of the ADA" standard. Instead, the court held that the common law element of control in the master–servant relationship is the most significant guidepost for determining whether one is an employee. Consequently, the court adopted the approach advocated by the Equal Employment Opportunity Commission (EEOC): "if the shareholder-directors operate independently and manage the business, they are proprietors and not employees; if they are subject to the firm's control, they are employees." Further, the court endorsed EEOC guidance for making this determination. Specifically, the EEOC compliance manual lists six factors that are relevant to deciding whether a shareholder-director is an employee:

1. Whether the organization can hire or fire the individual or set the rules and regulations of the individual's work

2. Whether and, if so, to what extent the organization supervises the individual's work

3. Whether the individual reports to someone higher in the organization

4. Whether and, if so, to what extent the individual is able to influence the organization

5. Whether the parties intended that the individual be an employee as expressed in written agreements or contracts

6. Whether the individual shares in the profits, losses, and liabilities of the organization

The court stressed that no one factor should be considered decisive—deciding whether a shareholder is an employee must be based on "all the incidents of the relationship." The court's ruling emphasized this point with two illustrations: "The mere fact that a person has a particular title—such as partner, director, or vice-president—should not necessarily be used to determine whether he or she is an employee or proprietor. Nor should the mere existence of a document styled 'employment agreement' lead inexorably to the conclusion that either party is

an employee." In light of this new standard for determining employee status, the court reversed the Ninth Circuit's ruling and returned the case to the district court for further proceedings.

## Significance of the Decision

This ruling certainly impacts professional corporations and some smaller employers in assessing their obligations and potential liability under federal employment laws. Almost any statute that has an "employee size" requirement would be affected by the court's decision. In addition to the ADA, for example, the ruling could require currently exempt professional corporations to comply with the following.

- Title VII of the Civil Rights Act of 1964, which prohibits discrimination based on race, religion, sex, and national origin by employers with 15 or more employees
- The Age Discrimination in Employment Act (ADEA), which protects employees over age 40 working at employers with at least 20 employees
- The Family and Medical Leave Act, which applies to companies with 50 or more employees

Indeed, courts have recently applied the *Clackamas* factors as determinative to the employee status issue in Title VII cases. See, e.g, *Bhanukumar C. Shah v Deaconess Hospital,* 355 F3d 496 (6th Cir 2004); *Alexandra Kakides v King Davis Agency, Inc.,* 283 F Supp 2d 411 (D Mass 2003). But see *Colangelo v Motion Picture Projectionists, Operators & Video Technicians, Local 110* (ND Ill 2004), holding that *Clackamas* does not apply to Title VII cases; ADEA cases, see, e.g, *Bhanukumar C. Shah v Deaconess Hospital, supra;* Pregnancy Discrimination Act cases, see, e.g., *Heather Bragg v The Technology Group, et al.,* 303 F Supp 2d 1181 (D Co 2004); and denial of benefit cases under ERISA, see, e.g., *Pearl v Monarch Life Insurance Company, et al.,* 289 F Supp 2d 324 (EDNY 2003).

Moreover, even if it is determined that an employer is exempt from statutory coverage of a federal employment law under the *Clackamas* standards, businesses must be mindful of the state and local statutes—many of which have lower employee size thresholds—that cover similar liabilities.

As mentioned, the implications of the *Clackamas* decision stretch far beyond the ADA and the determination of whether an employer has the minimum number of employees. In this sense, the ruling may be perceived as a positive result for employers, in part because the court provided a relatively clear test to be applied in determining who is entitled to protection under the federal employment statutes. Lawyers for plaintiff employees may have to undertake additional inquiries to identify who are the "true" employees. Viewed from another perspective, however, the ruling also affects whether director-shareholders themselves can sue; protection under the various employment laws will be afforded them if it can be established that they are truly employees under the *Clackamas* criteria. Under either perspective, small corporations and partnerships should reconsider their previous conclusions concerning their exposure to claims.

## Impact on Employment Practices Liability Claims

Finally, the decision impacts insurance coverage considerations. Employment practices liability insurance (EPLI), directors and officers (D&O) insurance, and other professional/specialty liability policies with employment practices coverage insure against specified claims by employees. Aside from the continuance or dismissal of a lawsuit due to statutory employee counts, insurance policy coverage issues are implicated when it has been determined that, under the *Clackamas* decision, a plaintiff is not an employee but rather a shareholder-director or true owner of a professional corporation, and there is an "insured versus insured" policy exclusion that is applicable.

Some EPLI policies and most D&O and other professional liability policies contain an "insured versus insured" exclusion to policy coverage of claims made by one insured under the policy against another insured. The intent of such an exclusion is to bar coverage for claims that do not truly involve claims for which the policy was purchased (for example, alleged errors or omissions

of a professional), such as "infighting" or internal business disputes. The exclusion is also intended to eliminate coverage for collusive claims where, for example, one corporate director sues another solely for the purpose of sharing the proceeds of the lawsuit. As many policies today contain EPLI extensions or endorsements, the insured versus insured exclusion would preclude coverage for employment claims made by one insured against another—i.e., a shareholder who sues another shareholder for alleged discriminatory personnel practices—even if the employment practices endorsement or extension in and of itself does not contain the specific exclusion.

Accordingly, notwithstanding the inclusion of an EPLI endorsement to a policy, the exclusion will still control coverage determinations. Typical exclusionary language in such provisions would state that the policy does not apply "… to any claim made by a present, former, or prospective partner, officer, director, stockholder employee, or employee of the Insured …." Other versions of the exclusion may bar coverage "by or on behalf of" or "by, on behalf of, or in the name or right of" any other insured.

When it is properly applied by insurers, numerous court decisions have upheld the insured versus insured exclusion. See, e.g., *American Medical Int'l, Inc. v National Union Fire Ins. Co.,* 244 F3d 715 (9th Cir 2001) (upholding the exclusion to apply in claims against directors and officers); *Stratton v National Union Fire Ins. Co.,* No. 03-CV-12018, 2004 U.S. Dist LEXIS 17613, at *17 (D Mass Sept. 23, 2004) (agreeing that the purpose of the insured versus insured exclusion "is to protect insurers from collusive lawsuits by corporations trying to recoup corporate losses by attributing them to the wrongdoing of directors and officers who, if insured, have nothing to lose by taking the blame …").

In articulating the proper test for determining who is really an "employee" for purposes of the federal employment law thresholds, the *Clackamas* decision is therefore significant to policy coverage of employment practice claims. Application of the six-factor test directly relates to the determination of whether the insured versus insured exclusion would apply to bar insurance policy coverage of employment claims. The decision in essence determines who can be sued and, at the same time, who can sue. So, too, from an insurance policy perspective, does *Clackamas* determine policy coverage for employment practices claims: such a determination depends on a finding of whether the individual claimant is a true "employee"—and therefore triggering policy coverage; or whether the claim was made under the policy by an individual who is an owner—and consequently invoking the insured versus insured exclusion to bar policy coverage. Insurers' claims examiners, therefore, should bear in mind the potential coverage implications of the court's ruling.

## Conclusion

The *Clackamas* decision has been hailed as a victory for both plaintiffs and businesses. From a plaintiff's perspective, the ruling enables the piercing of barriers such as titles and positions as obstacles in establishing employee status and, consequently, satisfying the requisite numerical jurisdictional thresholds in employment statutes. On the other hand, businesses maintain that they finally have clearer standards and parameters by which they may govern themselves to achieve or sustain true ownership status. The merits of either viewpoint may be debated indefinitely. One observation on the ruling may be indisputable: the process in attempting to establish one's status will engender additional litigation; fact-specific inquiries relating to one's authority to hire and fire, extent of supervisory capacity, reporting and compensation structures, and other *Clackamas* criteria will all be the subjects of battles among litigants. However, lest *Clackamas* is perceived as a decision that is litigation-significant only, its impact on policy coverage of employment practices claims under insurance policies is undoubtedly equally as important. *EPLiC*

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