William & Mary Business Law Review

Volume 2 (2011)
Issue 2

Article 5

April 2011

Texas Elective Workers' Compensation: A Model of Innovation?

Jason Ohana

NOTES

TEXAS ELECTIVE WORKERS' COMPENSATION: A MODEL OF INNOVATION?

ABSTRACT

Workers' Compensation is often described as a bargain between employers and employees. Employees give up the right to sue their employers in negligence for workplace injuries, and, in return, employers agree to pay predictable, statutorily mandated benefits to injured employees. Over time, this "bargain" became compulsory in every state but one. Texas is the only state in which employers and employees can decide whether or not to enter the workers' compensation bargain. This elective system has some fairly serious problems, and many have advocated its abandonment. This Note analyzes the system's history, compares the system to conventional compulsory systems, analyzes some of its weaknesses, and concludes that with some modifications, the system could be a useful model for other states interested in fostering innovation and cost reduction in their own occupational injury systems. This conclusion is based on the experience of a small but significant number of Texas employers that opt out of the workers' compensation system and yet provide, at a lower cost, substantially the same benefits to injured employees as would be available under workers' compensation. The existence of this parallel occupational injury system directly benefits those employers that are able to construct cost-saving alternative benefit programs. In addition, it has the potential to indirectly benefit even those employers that participate in the workers' compensation system as cost saving techniques innovated in the less regulated occupational injury benefits market trickle into the more highly-regulated workers' compensation market.

TABLE OF CONTENTS

INTRODUCTION

Texas is the only state that has an elective workers' compensation system.[1] The system has some fairly serious problems, and many have advocated its abandonment.[2] This Note analyzes the system's history, compares the system to the conventional compulsory systems that every other state has, analyzes some of the system's weaknesses, and concludes that with some modifications, the system could be a useful model for other states interested in fostering innovation and cost reduction in their own occupational injury systems. This conclusion is based on the experience of a small but significant number of Texas employers that opt out of the workers' compensation system, and yet provide, at a lower cost, substantially the same benefits to injured employees as would be available under workers' compensation.[3] The existence of this parallel benefit program presently benefits individual employers who can construct such programs and benefit from their cost savings. It also has the potential to benefit even those employers that participate in the workers' compensation system, as cost saving techniques innovated in the less regulated occupational injury benefits market trickle into the more highly regulated workers' compensation market.[4]

This Note is organized into five parts. Part I outlines the historical development of a no fault workers' compensation system in this country that came to replace common law employer's liability actions as the principal recourse for injured employees.[5] Part I also discusses how workers' compensation became compulsory in every state in the union except for Texas.[6] Part II explains Texas's unique workers' compensation system and includes a discussion of the different options Texas employers have for providing benefits to injured workers. Part II also chronicles a history of different types of abuses by non-subscribing employers and the Texas legislature's response to each type of abuse. Part II additionally discusses how non-subscribing employers are using the Federal Arbitration Act to preempt a Texas statute that forbids employers from

---

[1] *See infra* note 97 and accompanying text (comparing Texas's system to other states).

[2] *See* discussion *infra* Part II.C (describing the impact of waiver and arbitration provisions).

[3] *See infra* Part II (discussing Texas's workers' compensation system).

[4] *See* discussion *infra* Part III (detailing workers' compensation risk financing).

[5] *See infra* Part I.C.i-iii (chronicling the shift to a workers' compensation system).

[6] *See infra* note 97 and accompanying text (discussing Texas's workers' compensation system and its comparison to other states).

obtaining pre-injury claim waivers from their employees. Part III discusses the basic risk financing methods used in workers' compensation. Part IV explains the two basic ways employers can save money by opting out of the workers' compensation system, namely, assuming the risk of negligence claims and heading off negligence claims by providing an alternative benefit plan. Part V discusses the benefits of elective workers' compensation. It argues that an elective system of workers' compensation offers employers an opportunity to simultaneously save money and create new ways to provide benefits comparable to those of the workers' compensation system. The conclusion begins by noting that in order to expand Texas-style elective workers' compensation to other states, Congress must first amend the Federal Arbitration Act to prevent its preemption of state anti-waiver statutes in the employment contract context.[7] It proceeds to list some other more minor improvements that the system would require before any other states would consider adopting an elective system. Ultimately this Note concludes that with these modifications, and with Congressional action on the Federal Arbitration Act, elective workers' compensation would provide states and employers a competitive advantage.

I. HISTORY OF THE WORKERS' COMPENSATION SYSTEM IN THE UNITED STATES

A. The Negligence Liability System

Prior to the advent of modern workers' compensation statutes, employees injured on the job had no guaranteed benefits.[8] An injured employee's only recourse after an injury was to sue his employer under common law negligence.[9] Under the negligence regime, employers were required to exercise due care, which included hiring suitable and sufficient coworkers, establishing and enforcing proper rules of conduct, providing a safe workplace and safe equipment, and providing warnings and suitable instructions in dangerous working conditions.[10] An injured employee that could prove a breach of this duty of due care was entitled, at least in theory, to full compensation for his injuries, including medical expenses,

---

[7] See *infra* notes 150-54 for a discussion of the FAA's role in this context.

[8] *E.g.*, PRICE V. FISHBACK & SHAWN EVERETT KANTOR, A PRELUDE TO THE WELFARE STATE: THE ORIGINS OF WORKERS' COMPENSATION 28 (2000).

[9] *E.g.*, *id.* at 28-29; JACK B. HOOD ET AL., WORKERS' COMPENSATION AND EMPLOYEE PROTECTION LAWS 1-2 (3d ed. 1999).

[10] *See* FISHBACK & KANTOR, *supra* note 8, at 30; HOOD ET AL., *supra* note 9, at 1-2.

lost wages, and pain and suffering.[11] In addition to this post-injury remedy, employees in riskier jobs would theoretically earn higher wages than those employed in lower risk employments, a theoretical "risk premium."[12] Employees earning a risk premium could, in theory, use this extra money to purchase personal accident insurance.[13] As a practical matter, however, there is little evidence of correlation between riskier jobs and higher wages during the years preceding the workers' compensation era.[14]

Under the negligence liability system, employers had three defenses: the so-called "unholy trinity"[15] of assumption of risk, negligence of a fellow servant, and contributory negligence on the part of the injured employee.[16] The assumption of risk defense was far reaching; it provided a defense against negligence claims by an employee when an accident arose either from factors ordinary to the type of work the employee did or, in the case of an extraordinary risk, if such extraordinary risk was acceptable to the employee when he took the job.[17] The fellow servant defense barred recovery by an employee for injuries caused by the negligence of a co-employee.[18] Some suggest that this defense, which prevented liability of an employee to accrue to the employer despite the doctrine of *respondeat superior*, had as its justification an assumption of risk theory, whereby the employee assumed the risk of injury by a co-employee's negligence as one of the ordinary risks of employment in general.[19] The contributory negligence defense barred recovery by an employee whose injury was to any extent a result of his own negligence, even if the employer had been more negligent.[20] It is not hard to imagine how difficult it would be to

---

[11] FISHBACK & KANTOR, *supra* note 8, at 30.
[12] *Id.* at 31.
[13] *Id.*
[14] *Id.* at 49.
[15] PETER M. LENCSIS, WORKERS' COMPENSATION: A REFERENCE AND GUIDE 7 (1998).
[16] *E.g.*, FISHBACK & KANTOR, *supra* note 8, at 30; HOOD ET AL., *supra* note 9, at 2-5; 1 JAMES J. LORIMER ET AL., THE LEGAL ENVIRONMENT OF INSURANCE 322 (1st ed. 1978).
[17] *E.g.*, FISHBACK & KANTOR, *supra* note 8, at 30; HOOD ET AL., *supra* note 9, at 4-5; LORIMER ET AL., *supra* note 16.
[18] *E.g.*, FISHBACK & KANTOR, *supra* note 8, at 31; HOOD ET AL., *supra* note 9, at 2-3; LENCSIS, *supra* note 16, at 7.
[19] *E.g.*, HOOD ET AL., *supra* note 9, at 2-3; LENCSIS, *supra* note 15, at 7.
[20] *E.g.*, FISHBACK & KANTOR, *supra* note 8, at 31; HOOD ET AL., *supra* note 9, at 4; LENCSIS, *supra* note 15, at 7. The history described here predates the rise of comparative negligence as a replacement for contributory negligence. *See, e.g.*, McIntyre v. Balentine, 833 S.W.2d 52, 55 (Tenn. 1992).

prevail on a negligence claim with the foregoing defenses available to their fullest extent.

B. Workers' Compensation

Before proceeding to the transition in this country from a negligence liability system to a workers' compensation system, it is important to understand both what workers' compensation is and how it is different from the negligence liability system. The most fundamental difference between the two systems is that unlike the negligence system, injured employees are entitled to compensation under the workers' compensation system without respect to fault or negligence.[21] The threshold inquiry is not whether the employer was negligent but rather whether the employee's injury arose out of and in the course of employment.[22] The workers' compensation system is often described as a bargain,[23] or a quid pro quo,[24] between employers and employees.

Under a workers' compensation system, employers lose all of their common law defenses, and must pay benefits even when they were in no

> Between 1920 and 1969, a few states began utilizing the principles of comparative fault in all tort litigation. *See* C. Mutter, *Moving to Comparative Negligence in an Era of Tort Reform: Decisions for Tennessee*, 57 Tenn. L. Rev. [sic] 199, 227 n.127 (1990). Then, between 1969 and 1984, comparative fault replaced contributory negligence in 37 additional states. *Id.* at 228. In 1991, South Carolina became the 45th state to adopt comparative fault, *see Nelson v. Concrete Supply Co.* [sic], 303 S.C. 243, 399 S.E.2d 783 (1991), leaving Alabama, Maryland, North Carolina, Virginia, and Tennessee as the only remaining common law contributory negligence jurisdictions.

Id. (footnote omitted).

21 *E.g.*, LENCSIS, *supra* note 15, at 9.

22 *See, e.g.*, TEX. LAB. CODE ANN. § 401.011(10) (West 2009) ("'Compensable injury' means an injury that arises out of and *in the course and scope of employment* for which compensation is payable under this subtitle.") (emphasis added); 1-3 LEX K. LARSON, LARSON'S WORKERS' COMPENSATION LAW § 3.01 (2009); *see also* LENCSIS, *supra* note 15, at 35-40 (distinguishing and explaining "arising out of" and "in the course of"). *See generally* HOOD ET AL., *supra* note 9, at 60-69 (defining "in the course of employment" and discussing employment scenarios involving risk sufficient to satisfy "arose out of" criteria).

23 Richard A. Epstein, *The Historical Origins and Economic Structure of Workers' Compensation Law*, 16 GA. L. REV. 775, 800-01 (1982).

24 LENCSIS, *supra* note 15, at 9.

way at fault.[25] In exchange, employers benefit from the sole remedy doctrine, meaning that they are no longer liable in negligence for any injury that is compensable under the workers' compensation statute.[26] Additionally, the benefits employers must pay under workers' compensation statutes are predictable, as the statutes mandate them, and they are typically less than the amount for which employers would be liable in a successful negligence suit, at least with respect to lost wages and non-economic damages.[27] Employers remain liable under a workers' compensation system for all of an injured employee's medical expenses.[28] On the other hand, the amount employers must pay for lost wages is typically limited by either a dollar amount cap or a cap calculated as a percentage of the statewide average weekly wage.[29] Moreover, employers are typically not liable under workers' compensation statutes for so-called non-economic damages like pain and suffering and loss of consortium.[30]

On the employee side of the bargain, employees give up their right to sue,[31] and consequently their right to recover certain types of damages, such as lost wages over the statutory cap and non-economic damages like pain and suffering.[32] In return for giving up these two birds in the bush,

---

[25] HOOD ET AL., *supra* note 9, at 27.

[26] *Id.* at 26-27; LENCSIS, *supra* note 15, at 9-10; *see also* TEX. LAB. CODE ANN. § 408.001(a) (West 2009) (offering Texas's statutory articulation of the sole remedy doctrine); 1-1 LARSON, *supra* note 22, at § 1.01 (describing a "typical" workers' compensation act, including implementation of the sole remedy doctrine and accompanying elimination of negligence analysis).

[27] *See* LENCSIS, *supra* note 15, at 9-10, 52-53 (discussing the guarantee of compensation and the corresponding tradeoff of full recovery for the employee); 1-1 LARSON, *supra* note 22, at § 1.03 (describing the limitation of compensation under worker's compensation to "disability").

[28] *E.g.*, HOOD ET AL., *supra* note 9, at 93; LENCSIS, *supra* note 15, at 51. In Texas, "[a]n employee who sustains a compensable injury is entitled to *all health care reasonably required* by the nature of the injury as and when needed." TEX. LAB. CODE ANN. § 408.021(a) (West 2009) (emphasis added).

[29] *E.g.*, HOOD ET AL., *supra* note 9, at 97-98; LENCSIS, *supra* note 15, at 52-54. "A weekly temporary income benefit may not exceed 100 percent of the state average weekly wage." TEX. LAB. CODE ANN. § 408.061.

[30] *E.g.*, LARSON, *supra* note 22, at § 1.03.

[31] There are exceptions to this general rule, such as for injuries sustained outside of the employer/employee relationship and instances in which the employer commits an intentional tort. *See* LENCSIS, *supra* note 15, at 35-40, for a discussion of the "arising out of and in the course of employment" scope of workers' compensation.

[32] *See* LARSON, *supra* note 22, at § 1.03 (discussing the amount of compensation and limits on types of damages such as pain and suffering); LENCSIS, *supra* note 15, at 9 (describing the tradeoffs for guaranteed compensation under workers' compensation schemes, including loss of pain and suffering damages).

employees receive a statutory bird in the hand. This comes in the form of an entitlement to mandated benefits almost any time they suffer injury on the job, without the need to sue or prove negligence.[33] Finally, in theory, both sides benefit from the reduced need for litigation, at least as to the question of negligence.

C. The Shift to Workers' Compensation

Workers' Compensation systems began to appear in Europe in the 1880s.[34] The shift from negligence liability systems to workers' compensation systems occurred quickly in this country; in just one decade, from 1910 to 1920, forty-three states adopted workers' compensation statutes, including Texas in 1913.[35] Today, every state in the United States has a workers' compensation system.[36] Fishback and Kantor conclude that no single factor led to this rapid adoption, but rather that it arose due to a convergence of interests between employers, labor, and insurance companies.[37] In other words, workers' compensation was able to catch on so quickly because all of the major stakeholders in the workers' compensation debate wanted it, and there were essentially no major players remaining to oppose it.[38]

1. Employers

It may at first seem strange that employers would favor a move to workers' compensation. In order to understand this position, it is important to understand the shifting legal environment of the late 1800s and early

---

[33] LENCSIS, *supra* note 15, at 9.

[34] *See* Samuel B. Horovitz, *Worldwide Workmen's Compensation Trends*, 59 KY. L.J. 37, 40-41 (1970) (listing Germany in 1884, Austria in 1887, Norway in 1894, Finland in 1895, Denmark, France, and Italy in 1898, Greece in 1901, Belgium and Russia in 1903); *see also* Phil Hardberger, *Texas Workers' Compensation: A Ten Year Survey–Strengths, Weaknesses, and Recommendations*, 32 ST. MARY'S L.J. 1, 4 (2000) (denoting the adoption of the Workmen's Compensation Act of 1897 in Great Britain); Epstein, *supra* note 23, at 797 (describing the influence of the Workmen's Compensation Act of 1897 on the United States system); HOOD ET AL., *supra* note 9, at 7 (noting adoption of the Workmen's Compensation Act of 1897 in Great Britain).

[35] FISHBACK & KANTOR, *supra* note 8, at 58.

[36] LORIMER ET AL., *supra* note 16, at 322; Horovitz, *supra* note 34, at 41; *see also* LARSON, *supra* note 22, at § 2.08 (explaining that Hawaii was the final state to adopt a workers' compensation system in 1963).

[37] FISHBACK & KANTOR, *supra* note 8, at 113.

[38] *See id.* at 89, 112-13.

1900s. Labor's political strength was growing during this period.[39] With this increased clout, labor was successful in lobbying state legislatures to pass statutory reforms in employer's liability, including statutory limitations on employers' common law defenses.[40] For example, in 1887, the Massachusetts legislature limited the fellow-servant defense by making any supervisory workers vice-principals of the employer, meaning that a supervisor's negligence was no longer a defense to an employer's liability claim.[41] Massachusetts went even further in 1909 when it replaced contributory negligence with comparative negligence.[42] This meant that an employee's claim was no longer barred by his own contributory negligence, but was merely reduced by the amount of his own negligence.[43] Between 1900 and 1911, the number of states with employer's liability laws that restricted one or more of the common law defenses increased from seven to twenty-three.[44]

In addition to these statutory limitations, the courts in some states were also beginning to limit employers' common law defenses.[45] For example, in *Green v. Western American Co.*, the Washington Supreme Court limited the assumption of risk and contributory negligence defenses in cases involving a risk that the injured employee had previously brought to his employer's attention.[46] *Green* involved a mineworker who had requested timber to prop a section of a mine.[47] The plaintiff's supervisor informed him that there was no timber available and that he should return to work.[48] The court held that in light of the fact that the employer was statutorily required to have enough timber on hand for propping mines and that the plaintiff had advised his supervisor of the need for timber to prop

---

[39] *Id.* at 89.

[40] *See id*. at 94-95; *see also* J.E. Rhodes, *The Inception of Workmen's Compensation in the United States*, 11 ME. L. REV. 35, 37-38 (1917) (noting the passage and effect of the English Employer's Liability Act); LARSON, *supra* note 22, at § 2.05 (discussing Employer's Liability Acts starting with the English Employer's Liability Act of 1880); Epstein, *supra* note 23, at 787-97 (noting the English Employer's Liability Act that imposed a qualified form of negligence liability on employers).

[41] *E.g.*, FISHBACK & KANTOR, *supra* note 8, at 94.

[42] *Id*.

[43] *Id.*

[44] *Id.*

[45] *Id.* at 96-97.

[46] Green v. W. Am. Co., 70 P. 310, 320 (1902).

[47] *Id.* at 311.

[48] *Id.*

the mine, the plaintiff had not assumed the risk.[49] The court then proceeded to consider contributory negligence and observed:

> Assumption of risk and contributory negligence approximate where the danger is so obvious and imminent that no ordinarily prudent man would assume the risk of injury therefrom. But where the danger, though present and appreciated, is one which many men are in the habit of assuming, and which prudent men who must earn a living are willing to assume for extra compensation, one who assumes the risk cannot be said to be guilty of contributory negligence if, having in view the risk of danger assumed, he uses care reasonably commensurate with the risk to avoid injurious consequences.[50]

The court later remanded the case for trial because the jury had not considered the question of whether the plaintiff's care was commensurate with the risk.[51]

The legislative and judicial trend toward restricting the common law defenses available to employers led to uncertainty about the extent of employer's liability.[52] This uncertainty led to increased litigation.[53] In fact, the number of non-railroad employer's liability cases before state supreme courts jumped from 154 in 1900 to 490 in 1911.[54] This legal uncertainty, along with the concomitant increase in litigation, was one of the major reasons employers supported the move to a no-fault workers' compensation system.[55] The other major reason was that employers believed they could easily pass on this more predictable cost to their employees in the form of lower wages.[56]

2. Labor

Organized labor initially favored reforms to the negligence liability system over its wholesale replacement by a no-fault workers' compensation system, and it was instrumental in achieving the legislative reforms of the late nineteenth and early twentieth century that limited

---

[49] *Id.* at 318.
[50] *Id.* at 318 (citing Narromore v. Cleveland, C., C. & St. L. Ry. Co., 96 F. 298, 304-05 (6th Cir. 1899)).
[51] *Id.* at 318.
[52] FISHBACK & KANTOR, *supra* note 8, at 98.
[53] *Id.*
[54] *Id.* at 95, 98.
[55] *Id.* at 93-101.
[56] *Id.* at 90.

employers' common law defenses.[57] Organized labor's initial opposition to workers' compensation was part of a more general distrust of government regulation of the workplace, which unions feared would be unduly influenced by business interests.[58] As the labor-backed legislative reforms to the negligence liability system came on line, however, labor's position on workers' compensation began to shift.[59] In spite of these reforms, large numbers of workers were still left uncompensated.[60] Although certain employer defenses had been curtailed by the reforms, employees were still required to show negligence in order to prevail.[61] From a practical perspective, evidence of such negligence would likely often be in the hands of the employer or could only be obtained with the cooperation of fellow employees who were beholden to the employer for their livelihoods. As a result, in 1909, the American Federation of Laborers, through its federal and state branches, became a vocal proponent of workers' compensation statutes.[62]

3. The Insurance Industry

The insurance industry was a strong supporter of workers' compensation legislation, at least in states where no state monopoly was proposed.[63] From the industry's standpoint, such legislation would increase its customer base from those few workers that purchased personal accident policies to every employee of every employer covered by the statute.[64] Additionally, the workers' compensation system drastically reduced adverse selection problems because in most cases, individual employees would not be making the decision as to whether or not they should get coverage.[65] In a mandatory system, every employee in a job

---

57 *Id.* at 101.

58 *Id.*

59 *Id.*

60 *Id.*

61 *Id.*; *see also* Green v. W. Am. Co., 70 P. 310, 320 (1902) (describing alleged negligence causes of action in a worker personal injury case).

62 FISHBACK & KANTOR, *supra* note 8, at 101.

63 *Id.* at 109-12. In states with a monopolistic state fund, the state fund acts as the sole workers' compensation insurance carrier for the state. Private workers' compensation insurance is not allowed in such states. *E.g.*, LENCSIS, *supra* note 15, at 78. Thus, it is understandable why the insurance industry would be opposed to legislation mandating a monopolistic state fund.

64 FISHBACK & KANTOR, *supra* note 8, at 112.

65 *Id.* Adverse selection is a term of art in the risk management and insurance industry. It refers to a situation in which individuals with low levels of risk opt out of the

covered by the statute would be required to be covered, and thus the problem of only the riskiest employees entering the insurance market would be completely obviated.

D. Compulsory Workers' Compensation

Given that the interests of employers, labor, and the insurance industry became aligned in the early 1900s, workers' compensation statutes were quickly adopted in most states.[66] In stark contrast to modern statutes, of which nearly all are compulsory and cover all industries,[67] the majority of early state statutes was either elective, only applicable to certain hazardous industries, or had both of these features.[68] The key to understanding why the early statutes were not compulsory is to understand the constitutional challenges to and justifications for the early statutes.

Moving from the negligence liability system to a no-fault workers' compensation system was a shift that substantially affected the rights and responsibilities of both employers and employees. This move was challenged on several constitutional grounds, the most important of which were the Fourteenth Amendment's Due Process and Equal Protection Clauses.[69] Employers subject to compulsory compensation statutes argued that forcing an employer to pay benefits to injured employees in cases where the employer was not at fault was tantamount to depriving the employer of its property without due process of the law.[70] Employers could be forced to pay benefits without any proof of wrongdoing or

---

insurance market. With fewer "good risks" in the market, the average cost of risk for those that remain in the market increases. This is because the cost of the "bad risks" will be distributed across fewer premium payers. As this cost increases, more good risks may drop out fueling a cycle of increased costs and average losses. Mandatory participation obviates this danger by not allowing "good risks," or anyone else, to opt out.

[66] *Id.* at 113.

[67] U.S. CHAMBER OF COMMERCE, 2009 ANALYSIS OF WORKERS' COMPENSATION LAWS 10-13 (2009) [hereinafter CHAMBER OF COMMERCE ANALYSIS].

[68] FISHBACK & KANTOR, *supra* note 8, at 103-04 tbl.4.3; LENCSIS, *supra* note 15, at 11-13.

[69] LENCSIS, *supra* note 15, at 12.

[70] *See e.g.*, N.Y. Cent. R.R. Co. v. White, 243 U.S. 188 (1917) (holding the New York Workmen's Compensation Act does not violate the Due Process Clause); Hawkins v. Bleakly, 243 U.S. 210 (1917) (holding the Iowa elective Workmen's Compensation Act did not violate the Due Process Clause); Mountain Timber Co. v. Washington, 243 U.S. 219 (1917) (holding the Washington Workmen's Compensation Act does not violate the Due Process Clause).

negligence.[71] Furthermore, to the extent that statutes defined which employers were covered and which were not, covered employers raised equal protection challenges claiming that they were deprived of the common law defenses available to similarly situated employers that were not covered under the statutes.[72] Another constitutional challenge to workers' compensation statutes was that they interfered with the right of employers and employees to contract.[73]

State legislatures implemented two common measures, sometimes in combination, to protect their workers' compensation statutes from these constitutional challenges.[74] The first was to make their statutes elective, and the second was to restrict their scope to only certain hazardous industries.[75] Combinations of these two measures, such as a system that was compulsory as to certain hazardous industries but elective as to all others, were also enacted.[76] If a compensation system is elective, it cannot deprive an employer of its property without the employer electing to be bound by the system.[77] Elective systems are also non-disruptive of the right to contract, especially where both the employer and employee are permitted to elect whether or not to participate. The rationale for the limitation of the scope of compensation statutes to hazardous industries is different and proceeded as follows. Because states retain the power to regulate matters of public health, safety, and welfare as part of the police power, to the extent that compensation statutes applied only to hazardous industries, they could be viewed as public safety and welfare regulation, which is within the power reserved to the states.[78]

The United States Supreme Court confirmed that either of these approaches was sufficient to overcome constitutional objections. In 1917,

---

[71] *Hawkins*, 243 U.S. at 210; *N.Y. Cent. R.R. Co.*, 243 U.S. at 188; *Mountain Timber Co.*, 243 U.S. at 219.

[72] *See* Jeffrey Mfg. Co. v. Blagg, 235 U.S. 571, 571 (1915) (stating that employers do not waive common law defenses if they fail to comply with state workers' compensation statutes); *see also* FISHBACK & KANTOR, *supra* note 8 at 103-04 tbl.4.3; LENCSIS, *supra* note 15, at 11-13.

[73] *See N.Y. Cent. R.R. Co.*, 243 U.S. at 206 (explaining that freedom of contract is included in the right to liberty and the right to private property). Both of these rights are guaranteed by the Fifth and Fourteenth Amendments to the U.S. Constitution against deprivation by the federal or state governments respectively, without due process of law. U.S. CONST. amend. V & XIV.

[74] *E.g.*, LENCSIS, *supra* note 15, at 13.

[75] *Id.*

[76] *Id.*

[77] *Id.*

[78] *Id.*

the Supreme Court considered New York and Washington state compensation statutes, which were compulsory as to certain hazardous industries, as well as the Iowa compensation statute, which was elective.[79] The Court issued separate opinions upholding each of these statutes on the same day.[80] In upholding the New York statute, the Court held, "[i]t cannot be pronounced arbitrary and unreasonable for the State to impose upon the employer the absolute duty of making a moderate and definite compensation in money to every injured employee …."[81] Speaking directly to the police power justification, the Court further stated, "[t]he subject matter in respect of which freedom of contract is restricted is the matter of compensation for human life or limb lost or disability incurred in the course of hazardous employment, and the public has a direct interest in this as affecting the common welfare."[82]

For states that were inclined to extend compulsory coverage to the greatest number of workers possible, the question remained as to how far a state legislature could go in its definition of hazardous employments. The Supreme Court addressed this question in 1922 in the case of *Ward & Gow v. Krinsky*.[83] In *Ward*, the Court considered a provision in the New York compensation statute that classified any business employing more than four "workmen or operatives" as hazardous.[84] Workmen and operatives were terms of art that essentially meant manual laborers or machine operators.[85] The provision under consideration provided that a business with four or more manual laborers was compelled to provide workers' compensation insurance for all of its employees, not just those doing the hazardous work.[86] The Court, employing somewhat strained logic,[87] upheld the statute, holding that "[t]he Legislature, in the New York system, is justified in extending the benefits of the Compensation

[79] *Id.*

[80] *See* N.Y. Cent. R.R. Co. v. White, 243 U.S. 188, 188 (1917) (upholding the New York Workmen's Compensation statute); Hawkins v. Bleakly, 243 U.S. 210, 210 (1917) (upholding the Iowa elective Workmen's Compensation statute); Mountain Timber Co. v. Washington, 243 U.S. 219, 219 (1917) (upholding the Washington Workmen's Compensation statute).

[81] *N.Y. Cent. R.R. Co.*, 243 U.S. at 205.

[82] *Id.* at 206.

[83] Ward & Gow v. Krinsky, 259 U.S. 503 (1922).

[84] *Id.* at 506-07.

[85] *Id.* at 527 (McReynolds, J., dissenting).

[86] *Id.* at 506-07.

[87] *Id.* at 513 (reasoning "[t]hat there was inherent hazard in Krinsky's occupation is conclusively shown by the fact that in the course of it he received a serious and disabling personal injury arising out of it").

Law as far as it reasonably may determine occupational hazard to extend—to the 'vanishing point' as it were …."[88] Thus, the Court left the states with broad discretion to determine where hazard existed. States could extend their compensation systems to cover any employment that had even remote chances of causing injury rather than discarding hazard as a requirement for a valid exercise of the police power.[89]

In a case the following year, the Supreme Court considered "a compulsory compensation act establishing *in all except certain employments*, an exclusive system governing compensation for injuries to employees resulting in disability or death."[90] The issue before the Court in *Madera* was not the facial constitutionality of the statute, but whether the statute was constitutional, as applied, in requiring payment of death benefits to foreign national beneficiaries living in a foreign country.[91] Nevertheless, the Court began its analysis by affirming the facial constitutionality of the California statute, noting, "[t]his Court has in several cases sustained the constitutionality of workmen's compensation acts, from which the California Act in its constitutional aspects is not distinguishable."[92]

Madera illustrates how *Ward* essentially eliminated the hazard requirement. The Court in *Ward* granted state legislatures the power to define occupational hazard even to the "vanishing point."[93] California defined hazard in such a way that its compulsory compensation system extended to "all except certain employments."[94] Without pausing to analyze whether hazard existed in "all but certain employments," the Court summarily stated that California's Act was not distinguishable in any constitutional aspect from any of the compensation statutes it had previously upheld and that it was a valid exercise of the state's police power.[95] Thus, post *Ward*, states were unburdened by the hazard requirement and were free to extend their compulsory compensation systems to cover all, or at least nearly all, employees.

[88] *Id.* at 520.
[89] *Id.* at 520-21.
[90] Madera Sugar Pine Co. v. Indus. Accident Comm'n, 262 U.S. 499, 499 (1923) (emphasis added).
[91] *Id.* at 500-01.
[92] *Id.* at 501 (citing *Ward*, 259 U.S. 503).
[93] *Ward*, 259 U.S at 520.
[94] *Id*. at 499.
[95] *Madera*, 262 U.S. at 501.

Over the years, nearly every state amended its workers' compensation statutes to make coverage compulsory.[96] Today, workers' compensation is compulsory in all but one state—Texas.[97] Some states have exceptions to the general rule for narrow groups of specific employees like casual employees, domestic employees, and farm laborers, while others exempt employers with fewer than five employees.[98] But aside from these exceptions, workers' compensation is compulsory even in these states for the vast majority of employers and employees.[99]

The U.S. Chamber of Commerce, in its 2009 *Analysis of Workers' Compensation Laws*, states that only three states presently have an elective workers' compensation system: New Jersey, South Dakota, and Texas.[100] While New Jersey's statute is technically elective, it requires that opt-out employers carry liability insurance to cover their common law liability arising out of workplace injuries.[101] As such, insurance has never been available in New Jersey; the practical result is that opting out is not an option in that state.[102]

The classification of South Dakota as an elective state in table 1 of the 2009 *Analysis* may have been a clerical error.[103] South Dakota's statute is technically elective, but any employer that opts out is liable to action by injured employees who are permitted to proceed as if the employer had opted in. Injured employees still do not have to prove negligence even if

---

[96] LENCSIS, *supra* note 15, at 13.

[97] *Id.*; *see also* TEX. DEP'T OF INS. WORKERS' COMP. RESEARCH & EVALUATION GRP., COMPARISON OF STATE WORKERS' COMPENSATION SYSTEMS 5 tbl.1 (2008), *available at* http://www.tdi.state.tx.us/wc/regulation/documents/wc0904compare.zip [hereinafter COMPARISON OF SYSTEMS] (citing U.S. CHAMBER OF COMMERCE, 2003 ANALYSIS OF WORKERS' COMPENSATION LAWS (2003)) (comparing state workers' compensation systems); TEX. DEP'T OF INS. WORKERS' COMP. RESEARCH & EVALUATION GRP., EMPLOYER PARTICIPATION IN THE TEXAS WORKERS' COMPENSATION SYSTEM: 2008 ESTIMATES 2 (2008), *available at* http://www.tdi.state.tx.us/reports/wcreg/documents/2008_Employer_Partic.ppt [hereinafter EMPLOYER PARTICIPATION 2008] (discussing employer participation in the Texas worker's compensation system); CHAMBER OF COMMERCE ANALYSIS*, supra* note 67 (listing the characteristics of states' workers' compensation systems).

[98] LENCSIS, *supra* note 15, at 13; CHAMBER OF COMMERCE ANALYSIS, *supra* note 67.

[99] LENCSIS, *supra* note 15, at 13; COMPARISON OF SYSTEMS, *supra* note 97 at 5 tbl.1; EMPLOYER PARTICIPATION 2008, *supra* note 97, at 2; CHAMBER OF COMMERCE ANALYSIS, *supra* note 67.

[100] CHAMBER OF COMMERCE ANALYSIS, *supra* note 67.

[101] N.J. STAT. ANN. § 34:15-72 (West 2010); LENCSIS, *supra* note 15, at 111.

[102] LENCSIS, *supra* note 15, at 111.

[103] CHAMBER OF COMMERCE ANALYSIS, *supra* note 67, at 22. Table II of the same report states that workers' compensation in South Dakota is "[c]ompulsory as to all employment. Elective as to employer performing labor incidental to job." *Id*.

the employer opted out.[104] Moreover, the measure of damages in such a suit is 100 percent of the medical expense payments that would have been due under the workers' compensation statute plus two times the amount recoverable under other provisions of the statute, such as lost wages.[105]

In New Jersey and South Dakota, damages recoverable are greater if an employer "opts out" with no corresponding reduction in the employee's ability to obtain damages.[106] Thus, the only state that allows nearly all of its employers to elect whether to participate in the workers' compensation system is Texas.[107]

II. WORKERS' COMPENSATION IN TEXAS

A. Overview

Texas's workers' compensation system has been elective since it was first adopted in 1913.[108] Employers in the state can choose whether or not to subscribe to the workers' compensation system.[109] To opt out of the workers' compensation system, an employer need only notify the Workers' Compensation Division of the Texas Department of Insurance of its election to opt out[110] and notify its employees of this election upon hiring and via notices posted in conspicuous locations in the workplace.[111]

In 2008, 33 percent of Texas employers opted out of the workers' compensation system.[112] These employers employed 25 percent of the state's employees.[113] Twenty-six percent of the largest employers in Texas, those with more than 500 employees, opted out in 2008, and the smallest employers, those with four or fewer employees, opted out at a

---

[104] S.D. CODIFIED LAWS § 62-3-11 (2009).

[105] *Id.*

[106] N.J. STAT. ANN. § 34:15-72 (West 2010); S.D. CODIFIED LAWS § 62-3-11.

[107] LENCSIS, *supra* note 15, at 13*;* COMPARISON OF SYSTEMS, *supra* note 97; EMPLOYER PARTICIPATION 2008, *supra* note 97, at 2; CHAMBER OF COMMERCE ANALYSIS, *supra* note 67.

[108] EMPLOYER PARTICIPATION 2008, *supra* note 97, at 2, 4 (relying heavily on the data contained in this report). The report is based on a survey of 2,585 employers conducted by the Texas Department of Insurance and the Public Policy Research Institute at Texas A&M University. *Id.* The authors of the report estimate that their statistical findings have a 2.4 percent margin of error at the 95 percent confidence level. *Id.*

[109] TEX. LAB. CODE ANN. § 406.002(a) (West 2009).

[110] *Id.*

[111] *Id.*

[112] EMPLOYER PARTICIPATION 2008, *supra* note 97, at 6.

[113] *Id.* at 7.

rate of 40 percent.[114] The top reasons reported for opting out of the workers' compensation system in 2008 were: (1) workers' compensation premiums were too high (26 percent); (2) the employer had too few employees (26 percent); (3) the employer was not required to carry workers' compensation (11 percent); (4) the employer had few on-the-job injuries (9 percent); and (5) medical costs in the workers' compensation system were too high.[115] The top reasons reported by non-subscribing employers with greater than 500 employees were: (1) workers' compensation premiums were too high; (2) medical costs in the workers' compensation system were too high; and because (3) they had too few injuries.[116]

For subscribing employers, the workers' compensation system works much the same in Texas as it does in other states. The system for non-subscribers, the term of art used in Texas for employers that have opted out of the workers' compensation system, is quite different and warrants some explanation. Non-subscribing employers are subject essentially to the negligence liability system described *supra* in part I.A, with some modifications.[117] For an injured employee to recover damages from a non-subscribing employer, he must show that the employer was negligent.[118] In such a negligence case, the employer is barred by statute from raising the common law defenses of assumption of risk, contributory negligence, and negligence of a fellow employee.[119] Thus, once the employee has proven negligence, he is entitled to recover regardless of his own contributory negligence, the negligence of a fellow employee, or his assumption of the risk.[120]

Each individual employee in Texas is also permitted to opt out of the workers' compensation system if he works for an employer that has opted in.[121] To do so, an employee must provide his employer with written notice of his election within five days of either the day he began work or the day he received written notice that the employer participated in the workers' compensation system.[122] Unlike situations where the employer

[114] *Id.* at 8.
[115] *Id.* at 13.
[116] *Id.* at 14.
[117] *See* TEX. LAB. CODE ANN. § 406.033 (West 2009) (listing the defenses that are unavailable to employers).
[118] *See id.* (listing the defenses that are unavailable to employers); *see also* LENCSIS, *supra* note 15, at 111.
[119] TEX. LAB. CODE ANN. § 406.033(a).
[120] *Id.*
[121] *Id.* § 406.034(a).
[122] *Id.* § 406.034(b).

has opted out, the employer retains the defenses of assumption of risk, contributory negligence, and negligence of a fellow employee when the employee opts out and later brings suit.[123]

B. Alternative Benefit Plans

Although they have no obligation to do so, many non-subscribing employers provide benefits to their injured employees as part of their risk management and employee benefit programs.[124] These employers fund occupational injury benefits through various mechanisms, including self-funding and multiple forms of insurance, such as excess indemnity insurance, standard occupational accident insurance, and group health insurance.[125] In 2008, 52 percent of non-subscribing employers, covering 82 percent of employees of non-subscribers, provided occupational injury benefits.[126] Fifty-one percent of non-subscribing small employers, 89 percent of non-subscribing mid-size employers, and 83 percent of non-subscribing large employers provided some form of occupational injury benefits.[127] The stratified percentages of the non-subscriber workforce covered by occupational injury benefits were as follows: 62 percent of employees of small non-subscribers, 90 percent of medium sized non-subscribers, and 86 percent of large non-subscribers.[128]

Employers providing occupational injury benefits have no duty to provide a level of benefits equivalent to that provided by workers' compensation.[129] Of the 52 percent of non-subscribing employers that paid occupational injury benefits in 2008,[130] only 70 percent covered medical costs.[131] Of those that covered medical costs, 63 percent covered expenses for as long as they were medically necessary, while the remaining 37 percent capped medical expenses either with a dollar limit, a time limit, or both.[132] Applying these percentages to the larger universe of non-

[123] *Id*. § 406.034(d).

[124] Hardberger, *supra* note 34, at 7; EMPLOYER PARTICIPATION 2008, *supra* note 97, at 22-28.

[125] EMPLOYER PARTICIPATION 2008, *supra* note 97, at 26.

[126] *Id.* at 23.

[127] *Id.* at 24.

[128] *Id.* at 24.

[129] Hardberger, *supra* note 34, at 7; EMPLOYER PARTICIPATION 2008, *supra* note 97, at 22-28. Employers are not required to pay *any* benefits absent a showing of negligence. *Id.*

[130] EMPLOYER PARTICIPATION 2008, *supra* note 97, at 23.

[131] *Id.* at 27.

[132] *Id.*

subscribers, the total percentage of non-subscribers that provided a medical expense benefit to injured employees in 2008 was approximately 36 percent, with approximately 23 percent of non-subscribers providing benefits for as long as medically necessary and 13 percent providing benefits up to a time or dollar limit.[133] The numbers are similar for wage replacement benefits. Approximately 35 percent of all non-subscribers paid occupational injury benefits and 68 percent of those non-subscribers paid wage replacement benefits in 2008.[134] Of these, 57 percent paid wage replacement benefits for the entire duration of the employee's lost time; the remaining 43 percent paid wage replacement benefits subject to a durational or dollar limit.[135] Again, applying these percentages to the larger universe of non-subscribers, only about 20 percent of non-subscribers provided wage replacement benefits for the entire duration of their employees' lost time.

C. Waiver & Arbitration Provisions

Texas has worked hard to maintain a balance between maintaining a viable alternative to traditional workers' compensation on the one hand and protecting employees from employer overreaching on the other. For example, prior to 2001, non-subscribing employers could condition an employee's future receipt of occupational injury benefits on the employee waiving his rights to any common law negligence claims prior to suffering any injury, such as at the time of hire.[136] The benefit to the employer was that it could more easily calculate its exposure to occupational injury benefits claims and negligence claims because it would know *ex ante* which remedy was available to each employee.[137] Many, however, believed this was unfair because the employee was being asked to waive the rights normally waived under a full-fledged workers' compensation system in exchange for what was often an inferior package of benefits.[138] Moreover, the employee was being asked to do so before suffering an injury, when it was most unlikely that he would have the assistance of a lawyer to help him evaluate the bargain. The Texas Legislature responded to this concern

[133] *See id.* (detailing payments of medical benefits by non-subscriber employers).
[134] *Id.* at 28.
[135] *Id.*
[136] *See, e.g.*, Lawrence v. CDB Servs., Inc., 44 S.W.3d 544, 554 (Tex. 2001) (holding that the Texas statute did not clearly prohibit pre-injury waivers, and as such, the court lacked authority to read such a prohibition into the statute).
[137] Hardberger, *supra* note 34, at 10.
[138] *Id.* at 19.

in 2001 by amending the labor code to proscribe such pre-injury waivers.[139]

Another abuse of the waiver for alternative benefits bargain was the use of post-injury waivers that followed too closely in time to the injury. The concern was that employers could exact a waiver from the employee at the moment the employee was most vulnerable—right after an injury and while awaiting care.[140] In other words, an employer could show up at the hospital while the employee was awaiting treatment for his injury with an offer to pay for treatment in exchange for the employee's waiver of his right to any legal action against the employer. The Texas Legislature acted in 2005 to prohibit this practice by amending the labor code to prohibit certain post-injury waivers.[141] Post-injury waivers are now permitted only so long as they meet certain requirements.[142] These requirements are that: (1) the employee enters the waiver with knowledge of the waiver's effect; (2) the waiver is entered into not earlier than the tenth business day after the initial report of injury; (3) before signing the waiver, the employee has been evaluated by a non-emergency physician; and (4) the waiver is in a writing under which the true intent of the parties is specifically stated.[143] With pre-injury waivers abolished and post-injury waivers more strictly regulated, a new frontier has opened up in the continuing struggle to maintain the balance between preserving a viable alternative to workers' compensation and assuring fairness to employees.

A second tool non-subscribing employers use to protect against lawsuits in cases where they have provided or will provide occupational injury benefits is requiring the employee to sign an arbitration agreement.[144] In 2008, 14 percent of non-subscribers asked their employees to sign an agreement to resolve disputes through arbitration.[145] Of these, 95 percent

---

[139] TEX. LAB. CODE ANN. § 406.033(e) (West 2009).

[140] *See, e.g.*, Bison Bldg. Materials, Ltd. v. Sambrano, No. 01-07-00003, 2008 Tex. App. LEXIS 4844, at *8 (Tex. App. Houston 1st Dist. June 26, 2008) (involving the employer's delivery of a post-injury waiver to the employee, while the employee awaited treatment, stating "in electing to accept benefits under the PLAN, I understand and agree to give up the right to file a legal action against the Company … for any and all damages sustained by me because of my injury").

[141] *Id.* at *9 n.6.

[142] TEX. LAB. CODE ANN. § 406.033(f).

[143] *Id.*

[144] *See* Hardberger, *supra* note 34, at 12-15 (discussing the use of arbitration provisions to limit employee causes of action); EMPLOYER PARTICIPATION 2008, *supra* note 97, at 29-31 (quantifying the use of arbitration).

[145] EMPLOYER PARTICIPATION 2008, *supra* note 97, at 30.

asked their employees to sign the arbitration agreement pre-injury.[146] Among non-subscribing employers that utilized arbitration agreements, 36 percent stated they would not provide an employee medical or wage replacement benefits if the employee did not agree to arbitration.[147] One subtle way that arbitration agreements affect employee's rights is by the employer's selection of the arbiter. In 2008, 74 percent of non-subscribing employers that utilized arbitration reported knowing who served as the arbiter in arbitration proceedings.[148] Of these, more than half reported that the arbiter was either a single person who works for the employer and always serves as the employer's arbiter or a single person who works for the employer but is mutually agreed upon by the employer and the employee.[149]

In addition to this threat of bias, utilization of arbitration agreements affects employees' rights in a number of much more direct and serious ways. First, several courts of appeals in Texas have found that when a pre-injury waiver of common law claims is included in an arbitration agreement, the statutory prohibition against pre-injury waivers is preempted by the Federal Arbitration Act (FAA),[150] at least in cases involving an employer that in any way participates in interstate commerce.[151] Therefore, an employer, who would otherwise be prohibited by statute from requiring an employee to sign a pre-injury waiver of his right to sue the employer in exchange for participation in the employer's

[146] *Id.*
[147] *Id.*
[148] *Id.* at 31.
[149] *Id.*
[150] 9 U.S.C. § 1 (2009).
[151] *See* Bison Bldg. Materials, Ltd. v. Sambrano, No. 01-07-00003, 2008 Tex. App. LEXIS 4844, at *34 (Tex. App. Houston 1st Dist. June 26, 2008) ("[W]e … now hold that the FAA preempts any potential application of the Texas non-waiver provision stated in Labor Code section 406.033(e) to prevent enforcement of the arbitration clause stated in [the] Labor Code."); *In re* Border Steel, Inc., 229 S.W.3d 825, 832 (Tex. Ct. App. 2007) ("[T]he FAA preempts the application of the Texas non-waiver provision to prevent the enforcement of the Arbitration Agreement at issue here."); *In re* R & R Pers. Specialists of Tyler, Inc., 146 S.W.3d 699, 704 (Tex. Ct. App. 2004) ("We conclude that the FAA preempts the application of the nonwaiver provision to prevent or restrict enforcement of the arbitration provisions at issue here."). These holdings are consistent with the holdings of other courts on the preemption by the FAA of various non-waiver provisions. *See, e.g.*, Southland Corp. v. Keating, 465 U.S. 1 (1984) (holding that the FAA preempted a non-waiver provision in California's franchise statute); Jack B. Anglin Co. v. Tipps, 842 S.W.2d 266 (Tex. 1992) (holding that the FAA preempted a non-waiver provision in the Texas Deceptive Trade Practices–Consumer Protection Act); Commerce Park at DFW Freeport v. Mardian Constr. Co., 729 F.2d 334 (5th Cir. 1984).

occupational injury benefits program, can now do so indirectly by simply including the pre-injury waiver as part of an arbitration agreement.[152]

Still more troubling for employees is the practice of conditioning employment on acceptance of the waiver and arbitration agreement. This is possible because the FAA applies to employment contracts in general, with a small exception for employment contracts for transportation workers.[153] As the court in *Swift* pointed out, agreements regarding the relationship between employers and at-will employees are considered employment contracts in Texas for this and other purposes.[154] Thus, the court in *Bison*, for example, held that an employee was bound by an arbitration agreement as a matter of law by virtue of the employee continuing to work for the employer after having received notice of the agreement.[155] In reaching its conclusion, the court relied in part on *In re Halliburton*, an earlier decision by the Texas Supreme Court.[156] Conditioning employment on the acceptance of an arbitration and waiver agreement essentially immunizes an employer from a negligence lawsuit by its employees without subjecting it to the requirements of the workers' compensation system.[157] An employer can provide benefits that are inferior to those required under workers' compensation and still receive the principle benefit of the workers' compensation system by requiring employees to agree to waive their common law claims as part of an arbitration agreement.

It is unclear at this point whether and how the Texas Legislature can respond to this new threat to the careful balance it has struggled to maintain. Because the case law on FAA preemption of non-waiver provisions appears to be so well settled at the federal level,[158] federal

---

[152] *See supra* text accompanying note 151.

[153] 9 U.S.C. § 1 (2006); Circuit City Stores, Inc. v. Adams, 532 U.S. 105, 109 (2001); *see also In re* Swift Transp. Co., 311 S.W.3d 484, 488 (Tex. App. 2009) (holding that an arbitration agreement in a non-subscriber's occupational injury benefit plan was part of an employment contract since employees could not opt-out of participation and that since the employee in issue was involved in transportation, the arbitration agreement was not enforceable under the FAA).

[154] *See Swift Transp.*, 311 S.W.3d at 489 (citing Sterner v. Marathon Oil Co., 767 S.W.2d 686, 689 (Tex. 1989)).

[155] Bison Bldg. Materials, Ltd. v. Sambrano, No. 01-07-00003, 2008 Tex. App. LEXIS 4844, at *18 (Tex. App. Houston 1st Dist. June 26, 2008).

[156] *In re* Halliburton Co., 80 S.W.3d 566, 572-73 (2002) (holding that an at-will employee accepted an arbitration agreement after notice was provided and the employee continued working for the employer after the effective date of the agreement).

[157] *See id.*

[158] *See supra* text accompanying note 151.

legislative action may be required, such as amending the FAA to apply to employment contracts only to the extent that it does not interfere with the operation of non-waiver provisions in the labor and employment codes of the states. As there is no indication that such federal action is pending, FAA preemption remains a serious and potentially existential threat to Texas's non-mandatory workers' compensation system.

D. Retaliatory Discharge

Texas provides a statutory bar to employers discharging or in any other way discriminating against an employee because the employee has filed a workers' compensation claim.[159] In 1998, the Texas Supreme Court addressed the question of whether this non-discrimination provision in an earlier version of the statute applied to non-subscribing employers.[160] The court in *Bouchet* held that it did not.[161] This means that non-subscribing employers are not barred from taking adverse employment actions against their injured employees.[162] As a matter of public policy, this loophole should be closed. A right to a benefit is meaningless in the employment context if the employer can simply deter employees from exercising it through retaliation against those employees that do.

III. WORKERS' COMPENSATION RISK FINANCING

A. Overview

The top reason reported by non-subscribing employers in Texas for opting out of the workers' compensation system was that workers' compensation insurance premiums were too high.[163] In order to evaluate this justification, it is important to understand the various risk financing mechanisms utilized by employers under a workers' compensation system and to understand how these differ from opting out of the workers' compensation system altogether.

---

[159] TEX. LAB. CODE ANN. § 451.001 (West 2009).

[160] *See* Tex. Mexican Ry. v. Bouchet, 963 S.W.2d 52, 53 (Tex. 1998).

[161] *Id.*

[162] *See id.* at 56 (holding that an employee's action for retaliation cannot stand if not covered by the Texas Workers' Compensation Act).

[163] EMPLOYER PARTICIPATION 2008, *supra* note 97, at 13-14.

B. Guaranteed Cost Plans

Guaranteed cost workers' compensation insurance is the most basic form of risk financing.[164] The employer pays a premium to an insurance company, and the insurance company pays the employer's workers' compensation claims.[165] The insurance company bears the entire risk of paying the claims and thus the risk of inability to pay claims is minimal.[166] Most small to mid-size employers purchase guaranteed cost workers' com-pensation insurance.[167] Guaranteed cost workers' compensation premiums are calculated based on a number of factors. First, the insurer determines how to classify the predominant type of work done by the employer, what is known as the employer's governing classification.[168] Each insurance company that writes workers' compensation in a state files its rates with the state for each of these classifications, or class codes as they are known in the industry.[169] This filed rate is then multiplied by the employer's payroll to determine the premium.[170]

In addition to the filed rate and the payroll, insurers may add factors to adjust for the loss experience of the employer.[171] One such factor is called an experience modification factor, or "experience mod."[172] The experience mod for an employer is a comparison between the employer's historical loss experience and the historical loss experience of all employers in the same class code.[173] An experience mod of greater than one will result in an

---

164 The author of this Note spent six years working as a licensed commercial insurance broker for one of the two largest brokers in the world. Much of this section reflects general commercial insurance knowledge the author acquired working in the insurance industry. For additional information on risk financing, see generally RICHARD BERTHELSEN, ET AL., RISK FINANCING (4th ed. 2006), which provides a detailed treatment of risk financing.

165 BERTHELSEN, ET AL., *supra* note 164, at 2.3.

166 *Id.*

167 *Id.*

168 *See e.g.*, *Workers' Compensation Risk Classification*, WASHINGTON STATE DEPARTMENT OF LABOR AND INDUSTRIES, http://www.lni.wa.gov/ClaimsIns/Insurance /RatesRisk / How/RatesFaq/Default.asp (last visited Feb. 26, 2011) (Risk Classification).

169 *Id.*

170 *Id.*

171 *See generally* BERTHELSEN, ET AL., *supra* note 164, at 6.5.

172 *Id.* (an experience mod may fall under the category of experience rating).

173 *Id.* (explaining that an experience rating refers to a plan that "adjusts the premium for the current policy period to recognize the loss experience of the insured organization during *past* policy periods"). For detailed information on how to calculate an experience modification factor, see *Calculating a Firm's Experience Modification Factor*, WASHINGTON STATE DEPARTMENT OF LABOR AND INDUSTRIES, http://www.lni.wa.gov/

increased premium, and an experience mod of less than one will result in a reduced premium.[174] Insurance carriers may also apply other more discretionary credits to achieve a premium level that is acceptable to the client and profitable to the carrier.[175]

While experience mods and discretionary credits can substantially affect workers' compensation premiums, the carriers' filed rates, which form the basis of guaranteed cost premiums, are not discretionary.[176] These are subject to year over year fluctuation based not only on the combined loss experience in each class code, but also on conditions in the broader insurance market like the cost and availability of reinsurance, insured losses across all lines, and investment returns.[177] For these reasons, employers insured under guaranteed cost programs are the ones most susceptible to fluctuations in the insurance market and to paying premiums that are the most out of proportion to their losses.[178] In order to avoid this result, larger employers that have reached a critical mass and predictability of expected losses tend to favor loss sensitive plans.[179]

C. Loss Sensitive Plans

"Loss sensitive plans" is a term of art that describes any type of insurance plan in which the insured will pay more if losses are greater than expected and pay less if losses are less than expected.[180] There are a number of types of loss sensitive plans, including retrospective rating plans,[181] group captives,[182] self-insurance,[183] and large deductible plans.[184] This Note will provide a brief description of the latter two, as they are the simplest to understand and also the most common.

ClaimsIns/Insurance/RatesRisk/How/ExpFactor/ExpModFactor/Default.asp (last visited Feb. 26, 2011) (Washington State Department of Labor).

[174] *See Workers' Compensation Risk Classification*, *supra* note 168.

[175] *See e.g.*, BERTHELSEN, ET AL., *supra* note 164, at 3.27, 3.30 (explaining that insurers may choose to give the insured a lower premium if they accept a higher deductible and vice versa, and stating that larger deductible plans are more common with workers' compensation insurance).

[176] *Id.* at 2.31-2.32.

[177] *See generally id.* at 2.31-2.32 (referring to these fluctuations as the "underwriting cycle"). For a detailed explanation of reinsurance, see *id.* at 7.3-7.4.

[178] *See generally id.* at 2.31-2.32 (addressing fluctuations in premiums).

[179] *See generally id.* at 1.11-1.12.

[180] *Id.* at 13.11.

[181] *See generally id.* at ch. 6 (discussing retrospective rating plans).

[182] *See generally id.* at ch. 8 (discussing captive insurance plans).

[183] *See generally id.* at ch. 5 (discussing self-insurance plans).

[184] *See generally id.* at ch. 3 (discussing large deductible plans).

Self-insurance is permitted in nearly every state, including Texas.[185] A typical self-insurance program works as follows. First, an employer must qualify as a self-insurer with the state's insurance department.[186] Qualification typically involves an analysis of the employer's loss history and its financial statements over a certain period of time to ensure that the employer will have the financial wherewithal to pay its claims.[187] Other requirements often include the payment of a surcharge and the posting of a bond with the state to guaranty payment of claims.[188]

Once an employer has qualified, it will typically analyze its loss forecasts.[189] A loss forecast is an actuarial tool that calculates an employer's expected losses in each year at various loss limits.[190] A loss limit is simply a cap on the value of each loss.[191] Through the loss forecast analysis, an employer may, for example, determine that it expects to have \$7,500,000 in total workers' compensation claims with \$7,000,000 a year in losses under \$500,000; \$6,000,000 in losses under \$250,000, and \$5,000,000 in losses under \$100,000. With this data, the employer can seek excess workers' compensation insurance quotes with different self-insured retentions (SIRs).[192] Assuming that the actual losses exactly matched the predictions in the loss forecast, if the employer chose an SIR of \$100,000, it would pay \$5,000,000 in workers' compensation claims out of pocket, and its insurance company would pay the remaining \$2,500,000. Similarly, if the employer chose a \$500,000 SIR, it would pay \$7,000,000 in workers' compensation claims, and its insurance company would pay the remaining \$500,000.

In a world of perfect information, an employer would be best served by selecting the \$500,000 SIR. This is because the insurance company will charge any amount of loss forecast over the loss limit in premium. Thus, if the employer elected the \$100,000 SIR, the insurance company would start its premium calculations at \$2,500,000, the amount of losses expected over the SIR. To this number would be applied expense, profit,

---

[185] CHAMBER OF COMMERCE ANALYSIS, *supra* note 67, at 10-13.

[186] *See generally* BERTHELSEN, ET AL., *supra* note 164, at ch. 5 (discussing self-insurance plans).

[187] *See id.* (discussing self-insurance plans).

[188] *See generally id.* (discussing self-insurance plans).

[189] *See generally id.* at 4.34, 4.37 (describing the use of information provided by loss forecasts).

[190] *See generally id.* at 4.34 (describing the use of information provided by loss forecasts).

[191] *See generally id.* at 4.34, 4.37 (describing the use of information provided by loss forecasts).

[192] *See generally id.*

and risk factors. In contrast, at a $500,000 SIR, the insurance company would start at $500,000, and apply its expense, profit, and risk factors to this lower amount. Assuming that expenses beyond the expected losses ran at 15 percent,[193] and assuming the losses came in as expected, the expenses paid at the $100,000 SIR would be $375,000 while they would be only $75,000 at the $500,000 SIR. The total cost of risk to the employer, again based on the assumptions already laid out, would be the sum of the losses the employer retained, plus the premiums charged by the insurance company. At the $100,000 SIR, the total cost would be $5,000,000 in retained losses, plus a premium of $2,500,000 representing the insurer's expected losses, plus $375,000 representing the insurer's expense and profits, for a total of $7,875,000. At the $500,000 SIR, the total would be $7,000,000 in retained losses, plus $500,000 representing the insurer's expected losses, plus $75,000 representing the insurer's profit and expenses, for a total of $7,575,000. Of course, there is no such thing as perfect information, and many employers will trade the increased expense for a lower amount of risk. To understand how this works, assume there are two additional losses beyond what was predicted in the loss forecast. Assume both of these losses cost $500,000 each. The additional cost to the employer with the $100,000 SIR would be $200,000, two losses capped at $100,000 each. The additional cost of these losses to the employer with the $500,000 SIR, on the other hand, would be $1,000,000. In a year with these two "extra" losses, the employer with the $100,000 SIR would have a total cost of risk of $8,075,000 whereas the employer with the $500,000 SIR would have a total cost of risk of $8,575,000. Notice in each of these hypotheticals that far and away the largest component in the total cost of risk is the actual losses.

A similar concept to self-insurance is the large deductible program.[194] The fundamental difference between a large deductible program and self-insurance is the party ultimately liable to the injured worker.[195] In self-

[193] This figure is for illustrative purposes only. According to a survey of its clients, Marsh, Inc., one of the world's two largest commercial insurance brokers, puts the percentage of workers' compensation costs attributable directly to claims and related handling expenses at 91 percent for clients with loss sensitive plans. MARSH, INC., CASUALTY COST OF RISK 2008 2 (2009), *available at* http://global.marsh.com/documents/CasualtyCostofRisk_Report2008.pdf. The purpose of this section is not to estimate the exact expense ratio an employer can expect, but rather to demonstrate that even at a conservative 15 percent, the bulk of an employer's workers' compensation costs is directly attributable to its losses.

[194] *See* BERTHELSEN, ET AL., *supra* note 164, at 3.3 (discussing large deductible plans).

[195] *See id.* (discussing uses of large deductible plans).

insurance, the employer is directly liable to the employee, and the insurer's liability does not attach until the employer has paid the entire amount of the self-insured retention.[196] In a large deductible program, on the other hand, the insurer is directly liable to the injured employee and must recover deductible payments from the employer.[197] Thus, the risk that the employer will not pay rests with the employee in a self-insured plan and with the insurance company in a deductible plan. Accordingly, states, on behalf of employees, protect against this risk by analyzing employers' financial ability to pay claims and by taking other steps like requiring security and collecting surcharges to fund unpaid claims.[198] Insurance companies perform the same functions when they write large deductible plans.[199]

IV. How Employers Save Money by Opting Out

With this understanding of the more conventional risk financing structures for funding workplace injuries, it becomes apparent that there are essentially two ways that non-subscribers can reduce their workplace injury cost of risk. The first is for an employer to simply forgo providing any benefits and trust that its costs of defending and paying common law negligence claims will be lower than its cost of buying workers' compensation insurance. The second is for an employer to entice its employees to waive their common law negligence claims or agree to arbitrate their injury claims in exchange for occupational injury benefits that are less costly than those that would be provided under workers' compensation.

A. Assuming the Risk of Negligence Claims

Approximately 48 percent of non-subscribing Texas employers did not provide occupational injury benefits in 2008.[200] Employees of these employers accounted for 18 percent of the "non-subscriber" workforce.[201] The question that states considering elective workers' compensation need to answer is why nearly half of non-subscribing employers do not provide

---

[196] *See id.* at 5.3-4 (describing the purpose and operation of self-insurance plans).

[197] *See id.* at 3.30 (discussing the purpose and operation of large deductible plans).

[198] *See id.* at 5.10 (describing the processes of regulatory filing for employers).

[199] *See id.* at 3.30 (discussing insured organizations' obligations to provide security to insurers for large deductible plans).

[200] EMPLOYER PARTICIPATION 2008, *supra* note 97, at 23.

[201] *Id.*

occupational injury benefits. Part of the answer may be that over the years, partially through elimination of the common law defenses of assumption of risk, contributory negligence, and negligence of a fellow employee,[202] the Texas Legislature and courts have struck a balance: the negligence system is neither so favorable to employers that they all opt to take their chances in court nor so favorable to employees that no employer dares to opt out of the workers' compensation system. An imbalance would quickly lead to a mass shift to the more favorable position.

A look behind the numbers reveals, however, that there is something else going on. Small employers paid occupational benefits at a much lower rate than medium and large employers.[203] There may be perfectly valid reasons for this split. For example, it may be that a certain critical mass of employees, payroll, or losses is required to make some types of occupational injury benefits economical. Nevertheless, this raises a serious concern about the ability of these employers to pay claims. As discussed *supra* in Part III, the traditional workers' compensation risk financing mechanisms each account for the risk inability to pay claims.[204] Where the risk is transferred to insurance companies, as in guaranteed cost and large deductible plans, insurer solvency regulations and state guaranty funds provide protection against this risk.[205] Where the risk remains with the employer, as in self-insurance plans, the states protect against this risk by requiring financial reporting and collateral.[206] The Texas opt-out system, however, provides no such guarantees that negligence claims against an employer will be paid. The cost of such unpaid claims will be borne by the injured employees and potentially by society as a whole through social safety net programs like Social Security and Medicaid.

As a policy matter, this result should not be acceptable. Employers that retain the risk of negligence in lawsuits should not be any less accountable than those that retain the risk of workers' compensation claims through a self-insurance plan. Accordingly, states considering elective workers' compensation should subject non-subscribers to the same financial analysis and collateral requirements that they apply to self-insurers. Such requirements would likely preclude a large number of small employers from opting out, but they would ensure that those that are able to opt out are able to pay the negligence claims that ultimately arise.

---

[202] *See* TEX. LAB. CODE ANN. § 406.033 (West 2009) (listing the defenses that are unavailable to employers).

[203] EMPLOYER PARTICIPATION 2008, *supra* note 97, at 24.

[204] *See supra* Part III (discussing workers' compensation risk financing options).

[205] *See supra* Part III.

[206] *See supra* Part III.

Some would argue that the smallest employers, who are presently exempt from the workers' compensation system not only in Texas, but also in several other states,[207] should continue to be treated differently. The argument for this is that small employers, especially start-ups, often cannot afford large overhead expenses like a workers' compensation policy, and they should be allowed to forgo this until they reach a critical mass of employees.[208] While the premise that small businesses sometimes need extra help may be true, any such support should not be subsidized, as a matter of policy, by the injured worker or by the taxpayer when the worker exhausts his resources.

B. Exchanging a Waiver for Occupational Injury Benefits

As discussed *supra* in Part II, among non-subscribing employers only a relatively small percentage pay medical (23 percent)[209] and lost wage expenses (20 percent) for the entire duration of the employee's injury.[210] Thus, the remainder of non-subscribers that pay occupational injury benefits essentially receive waivers of negligence claims or agreements to arbitrate[211] in exchange for benefits that are inferior to those provided under the workers' compensation system. As noted above, this is an exceedingly difficult problem for a state to solve directly because it is preempted by ERISA from regulating the benefit plan and by the FAA from regulating the contents of arbitration agreements.[212] However, assuming a solution is found to the FAA preemption dilemma that would prevent employers from directly conditioning employment on acceptance of an arbitration and waiver agreement,[213] the fact that the benefits traded for are inferior to those provided by workers' compensation does not mean that such agreements would be either implicitly unfair or beyond the reach of the legislature. As long as an employer cannot condition employment on the execution of an arbitration agreement, the employee retains the power to forgo the occupational injury benefits offered by

[207] EMPLOYER PARTICIPATION 2008, *supra* note 97, at 2.
[208] *Id.* at 3.
[209] *See supra* Part II.B.
[210] *See supra* Part II.B.
[211] *See supra* Part II.C.
[212] *See supra* Part II.C.
[213] *See supra* Part II.C. Concededly, states will be powerless to regulate the fairness of the benefit programs because such concessions are "traded" for without first obtaining a change to the FAA that would preclude preemption of statutory non-waiver provisions in the states' labor and employment statutes.

refusing to sign the waiver or arbitration agreement. Such an employee would rely instead on the negligence remedy.

An informed employee's decision about whether to agree to this trade will depend on two factors: the generosity of the benefit plan and the employee's likelihood of prevailing in negligence claims. Thus, the legislature in a state with elective workers' compensation could indirectly regulate the contents of occupational injury plans by liberalizing or constricting the negligence remedy. If, for example, employers are providing skimpy benefits across the board, the legislature could respond by tweaking the employer's liability statute to make recovery by plaintiffs more likely. Granting employees beefed up litigation power would indirectly induce employers to provide richer benefits in order to secure waivers of this power. This, of course, assumes informed employees. The extent to which employees are or can become informed about their rights to refuse to sign waivers or arbitration agreements is an empirical matter beyond the scope of this Note. This Note assumes that it would be possible, through the plaintiff's bar, public service campaigns, and other means to make employees aware of their rights.

While it is possible to see how this could work, the problem of the burden of unpaid claims remains. The majority of Texas non-subscribers did not cover medical expenses or lost wages for the entire duration of the injury.[214] This means that claimants with injuries that outlast the durational or dollar limits of the employer's benefit plan will carry the burden of funding their continued medical care and lost wages. Informed employees should be capable of assessing this risk when determining whether to trade their rights to negligence claims. Furthermore, they should be capable of funding this risk through personal disability insurance. Thus, as long as two key conditions exist, namely a credible threat of successful negligence litigation and an informed workforce, this trade will be fair in most cases.

V. THE REAL BENEFIT OF ELECTIVE WORKERS' COMPENSATION

As noted above, there are fairly serious problems with the Texas elective workers' compensation system. This Note has addressed potential solutions to some of these problems, but the question remains: why should a state move to an elective system that, outside of Texas, no other state has adopted? The answer to this question lies in the 23 percent and 20 percent

[214] *See supra* Part II.B.

respectively of Texas non-subscribers that do pay medical expenses and wage replacement expenses for the entire duration of their employees' injuries.[215] These employers provide employees with substantially the same benefits as they would receive under workers' compensation, and yet, they presumably do so at a lower cost.[216] Benefits are strictly regulated for employers who opt into workers' compensation, but those who opt out have the opportunity to innovate and come up with ways to provide substantially the same benefits for less money. This innovation allows these employers to compete more effectively and could, down the road, lead to cost reductions even for opt in employers when the innovative ideas become adopted by the regulators.

CONCLUSION

Texas's elective workers' compensation system, while not ready for off the shelf roll-out to other states, does provide a blueprint for a system other states could adopt to foster innovation and cost reduction in their workers' compensation systems. States considering elective workers' compensation systems would do well to start with Texas's basic framework, with the following changes.

First and foremost, states considering elective workers' compensation would need to achieve a solution to the FAA preemption dilemma, most likely through lobbying for a change to the FAA to constrict the FAA's preemption of employment related non-waiver provisions. This would allow states to prevent employers from extracting pre-injury waivers from their employees. This is critical because if an employer can secure waivers from its employees before injuries, it can effectively neutralize the threat of negligence suits. It can thus secure the principal benefit of a workers' compensation system, namely near immunity from employer's liability lawsuits, while at the same time providing stingy or no benefits to the employees in return.

Second, states that do move forward with elective workers' compensation should require the same financial review and collateral requirements from non-subscribers as they do from self-insurers. This would ensure that workers who were injured through the negligence of their employers could count on their employers to have the financial

[215] *See supra* Part II.B.

[216] This Note makes this assumption on the following basis: an employer who could pay workers' compensation benefits for less than the cost of an alternative benefits plan would certainly do so because it would gain the additional benefit of being absolved from unpredictable negligence litigation.

wherewithal to make them whole. Such requirements would be likely to preclude a large number of small employers from opting out, but they would ensure that those who are able to opt out are able to pay the negligence claims that ultimately arise. Subscribers already guarantee their ability to pay claims either through their insurance companies or through collateral. There is no good reason that non-subscribers should be exempt from such a requirement.

Third, states considering elective workers' compensation should consider liberalization of the negligence remedy, at least to the extent Texas already has in eliminating the common law defenses of assumption of risk, contributory negligence, and negligence of a fellow employee. This will encourage non-subscribers to offer generous occupational injury benefits in exchange for waivers or arbitration agreements.

Finally, states considering elective workers' compensation should ensure that employees of non-subscribers are on the same footing as employees of subscribers with respect to retaliatory discrimination and discharge. Without protection from retaliation, employers could deter use of their benefit programs by taking adverse employment actions against employees that have availed themselves of their benefits.

Adopting an elective workers' compensation system, with these modifications, is likely to foster innovation and cost reduction in the field of occupational injuries. Employers would be empowered to develop occupational injury benefit plans that are both sufficiently generous as to make it worthwhile for their employees to trade their right to negligence claims for these plans and less costly because of a reduced need to comply with workers' compensation regulations. The cost savings employers could create would result in a competitive advantage for a state's employers and for the state itself in attracting employers.

Jason Ohana[*]

---

[*] Jason Ohana is a 2011 J.D. Candidate at the Marshall-Wythe School of Law at the College of William & Mary.