

Employment Litigation And Insurance Coverage

Law360, New York (August 2, 2011) -- For employers, protecting against unfair competition or enforcing a restrictive covenant or a nondisclosure, confidentiality, or separation agreement sometimes requires pursuing litigation against a former employee or their new employer. Affirmative litigation of this type can be protracted and expensive, and it is typically not covered by insurance.

But, when a defendant asserts a counterclaim — such as tortious interference, defamation, misrepresentation or invasion of privacy — a plaintiff-employer is placed in a defensive posture, and the counterclaims may trigger insurance coverage.

Companies with the right counsel and an understanding of their insurance program can convert a counterclaim into an entitlement to coverage and obtain valuable assistance from their insurance company in the form of defense dollars. This article discusses critical steps to take when a counterclaim is asserted and how to effectively make the case for coverage based on case law examples that involve counterclaims commonly asserted in the employment context.

The Right to a Defense

Counterclaims typically arise when a plaintiff is engaged in — and focused on — prosecuting its claims. As a result, a plaintiff-employer might not automatically view a defendant's counterclaim as an opportunity. A savvy company, however, can convert a counterclaim into a “covered claim” and obtain insurance dollars for amounts expended to defend these claims by seeking coverage from their insurer.

An insurer's duty to defend or obligation to reimburse defense costs can be the most valuable aspects of an insurance policy, particularly because, in employment-related litigation, defense costs often exceed indemnity payments.

Depending on the nature of the counterclaim and the type of coverage available, a company that notifies its insurer of a counterclaim as soon as it is asserted may be able to offset some of the high costs of litigation. The key is for companies to think about insurance as a valuable asset, and to give immediate notice to all potentially impacted insurers.

Employers should also closely review their insurance policies in light of the allegations in a defendant's counterclaim. Jurisdictions vary on how to determine whether allegations are covered by insurance, but in many jurisdictions the duty to defend is broader than the duty to indemnify — meaning that if even one allegation is potentially covered under a policy, the insurer must fund a company's entire defense of the counterclaims (but not its costs for pursuing its affirmative claims).

Of course, not all claims are covered, and insurers frequently attempt to rely on policy exclusions to

deny coverage. But in most jurisdictions, insurers bear the burden to prove that a particular exclusion applies. And because exclusions are often interpreted narrowly and in favor of coverage, this can be a heavy burden for an insurer. Additionally, if a policyholder demonstrates that exclusionary language is ambiguous, courts almost universally interpret the policy against the insurance company and in favor of coverage.

For example, a policy exclusion that precludes coverage for claims arising out of a breach of contract might only exclude claims arising out of “express contracts.” Thus, coverage could be available for a counterclaim that alleges breach of an implied contract, quantum meruit or unjust enrichment.

Additionally, if the allegations in a breach of contract counterclaim are vague, an insurer might have to defend because a defendant could potentially prove that an implied contract existed. Further, the standard exclusion for alleged violations of the Fair Labor Standards Act does not preclude tort-based claims for front and back pay. Accordingly, if an employee seeks to recover more than earned wages, coverage could exist for a counterclaim alleging a FLSA violation.

Common Counterclaims That Can Be Covered By Insurance

The spectrum of claims asserted in employment litigation is a broad, and counterclaims by employees and new employers take many forms. Former employees can allege counterclaims sounding in tort, contract and statutory violations, and a single case can involve an array of claims. But each case, and the insurance issues presented, turns on its individual facts and liability theories.

For example, in *Pure Power Boot Camp Inc. v. Warrior Fitness Boot Camp LLC*, No. No. 08 Civ. 4810, 2010 (S.D.N.Y. Dec. 22, 2010), an employer filed suit in New York to enforce a noncompete agreement against former employees who were preparing to open a fitness center in competition with their current employer. After terminating an employee, the employer accessed email from the employees’ personal email accounts.

The employees asserted counterclaims against their former employer alleging violations of the New York Labor Law, violations of the Stored Communications Act and the Electronic Communications Privacy Act, attempted sabotage of defendants business, and unauthorized use of images in violation of New York privacy law.

There is no public record of whether the former employer obtained coverage for the defense of these claims. But it is clear that the employees’ claims ran the spectrum — from statutory violations to common law — making it more likely that coverage could have been available under different types of insurance policies.

Additionally, in *eBusinessware Inc. v. Technology Services Group Wealth Mgmt. Solutions LLC*, 2009 U.S. Dist. (S.D.N.Y. Dec. 29, 2009), an employer sued its former employees (and other defendants) claiming that the employees breached noncompetition agreements, misappropriated trade secrets and committed other unlawful acts against the employer.

In response, the employees filed 16 counterclaims against the employer for, among other things, breach of fiduciary duty, breach of contract, breach of stock option plans, breach of implied contract, breach of the covenant of good faith and fair dealing, unjust enrichment, fraudulent inducement, negligent misrepresentation and racketeering.

Again, the variety of counterclaims by the defendants presents multiple bases to examine whether

insurance coverage would be triggered under various types of policies — employment-related liability coverage and general liability, to name a few.

Making the Case for Coverage

From an insurance coverage perspective, each counterclaim — and the allegations that comprise it — should be examined closely, and viewed as an opportunity for coverage. Insurers frequently deny coverage without thoroughly understanding the claim or the allegations in the case.

Policyholders should not simply accept their insurer's coverage denial. Rather, policyholders should carefully review their coverage, the allegations in the counterclaim, the insurer's bases for denial and the law, and make a case for coverage. The employers in the following cases did just that and prevailed.

Link Snacks Inc. v. Federal Insurance Company, 664 F. Supp. 2d 944 (W.D. Wis. 2009), is a good example. *Link Snacks* involved a case by affiliated snack food companies against a former chief operating officer seeking a declaration of rights regarding the COO's interest in the company.

The COO counterclaimed for, among other things, breach of fiduciary duty (premised on the allegation that he was wrongfully terminated), defamation, misrepresentation, and invalidity of a noncompete provision. After the companies' D&O insurer, Federal Insurance Company, refused to defend the action, the companies litigated against the COO, which culminated in a mixed verdict. *Id.* 945.

The companies then filed suit against Federal, alleging it had a duty to defend against the counterclaims. In declining to defend, Federal asserted that the COO did not sue for wrongful termination, which was the only kind of claim covered under the policy when a company executive sued the company or other executives.

In ruling for the companies, the court found that the counterclaim triggered Federal's duty to defend because the COO's breach of fiduciary duty claim was premised on allegations that he was wrongfully terminated from his position in the companies — the policy did not limit coverage for a particular type of wrongful termination claim, as alleged by Federal. Additionally, Federal was estopped from challenging coverage since the court found that it had breached its duty to defend.

In another case in which an employer-policyholder emerged victorious against their insurer, *AXA Marine & Aviation Ins. Co. v. Podaras*, No. 93-2581, 1994 U.S. Dist. (E.D. La. July 12, 1994), a former employee brought a wrongful discharge and defamation lawsuit against his former employer.

The employee claimed that the employer engaged in a "smear campaign" against him and defamed him after his employment was terminated. The employer's insurers filed a declaratory judgment action, claiming they had no duty to defend the employer.

The relevant policy excluded coverage for any liability of the employer to any of its employees. The insurers claimed that the exclusion barred coverage, and sought a declaratory judgment that they had no duty to defend the employer. The court denied the insurers' motion for summary judgment and granted the employer's cross-motion for summary judgment, ruling that, as to the defamation claim, the court could not find that the policies unambiguously excluded coverage because the defamation took place after the employment relationship ended.

Conclusion

Counterclaims by former employees in response to claims by former employers are virtually inevitable. In employment actions, such counterclaims often include allegations that a former employer: (1) made false statements about a former employee, (2) infringed a former employee's statutory rights, (3) breached an explicit or implied contract, or (4) was unjustly enriched.

The allegations may not be clearly stated or labeled but might instead appear within employment-statute type claims, as well as common law causes of action such as intentional infliction of emotional distress, libel, slander, defamation or disparagement. Some of these claims might be covered by insurance; however counterclaims are denominated, they can contain potentially covered allegations that trigger a duty to defend.

Policy language is important. Some policies expressly exclude breach of contract but nonetheless cover alleged breach of implied contract; some might cover only defamation claims, while others cover libel, slander or defamation. Whatever the policy, insurers will point to specific language to argue that counterclaims do not trigger a defense obligations.

Employers should examine allegations carefully and seek advice from coverage and employment counsel about noticing and seeking defense for these counterclaims. Prompt and careful evaluation of counterclaims in connection with insurance policies can unearth an extremely valuable asset in the form of insurance coverage.

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