

# Counterclaims Filed as "Defensive Strategy" Are Covered Defense Costs

---

January 2005

In an unreported decision, a federal magistrate judge in Oregon, applying Oregon law, has issued a recommended opinion holding that an employment practices liability (EPL) policy does not afford coverage for monies paid to settle a claim filed by a former officer alleging fraud, breach of contract, negligent misrepresentation and unjust enrichment. *Acradyne, Inc. v. Travelers Cas. & Sur. Co.*, 2004 WL 2997572 (D. Or. Nov. 18, 2004). However, the court also found that the costs incurred by the company in prosecuting a counterclaim against the officer were covered defense costs.

The insurer issued an EPL policy to a company. The policy provided that the insurer would pay the company all damages on account of claims made for "wrongful employment practices," which was defined to include "wrongful termination," "breach of oral, implied or written employment agreement" and "employment-related misrepresentation." The policy's definition of "damages" excluded "liquidated damages" and "severance pay or penalties under an employment contract, or any agreement, policy or procedure providing for payment in the event of separation from employment or sums sought solely on the basis of a claim for unpaid services under an express or implied agreement."

The former officer sued the company after it terminated the officer's employment agreement prior to the expiration of its fixed term. The agreement provided for a term of six years, and the company agreed to pay the officer a salary of \$250,000 per year, plus an incentive stock option plan. The agreement also provided that the company would continue to pay the officer's salary for the full six years should it terminate him without cause. Three years into the agreement, the company reduced the officer's salary. A year later, the officer attempted unsuccessfully to purchase stock by exercising his options. The company terminated his employment shortly thereafter, characterizing the termination as "with cause." The company did not continue to pay the officer his salary. At a case evaluation session, a panel recommended that the case be settled for \$310,000. The insurer agreed to pay \$90,000, and the company paid the former officer \$220,000. The company then sued the insurer to recover the \$220,000 it paid to settle the suit.

The court ruled in favor of the insurer as to payments made by the company to the former officer. The court found that the former officer's breach of contract and fraud allegations did not constitute "employment-related misrepresentation" claims. The court based this finding on three conclusions. First, the court explained that "a misrepresentation is not 'employment-related' if there is no employment at the time they (sic) are made." The

court stated that the alleged misrepresentation underlying the former officer's complaint occurred in April 1998, at the time when the company was attempting to induce the officer to sign the employment agreement and join the company, not when the company subsequently failed to fulfill its promises. Second, the court found that most of the former officer's fraud allegations related to the offered incentive stock option plan, and it reasoned that breach of an incentive stock plan was not included within the insurance policy's definition of Wrongful Employment Practice. Third, the court found that the fraud allegations were excluded from coverage because they were claims that existed at the time the policy was issued. The court imputed constructive knowledge on the part of unnamed "partners, principals, officers or directors" at the company regarding the claims' existence as of April 1998, the time period during which the officer was recruited to join the company under allegedly false pretenses.

The court found that the officer's breach of contract count fell within the severance payment exclusion. "Severance pay" was not defined in the policy, but, based upon surrounding language in the policy, the court interpreted that term to "include any monies payable to [a] terminated employee pursuant to an agreement, policy or procedure." The court also concluded the officer's allegations did not constitute a "wrongful termination" claim, noting that the parties' employment agreement had given the company the right to terminate the officer with or without cause.

The court did hold, however, that the company was entitled to recover \$8,000 in legal expenses incurred in pursuing its counterclaim against the former officer for breach of fiduciary duties, misappropriation of trade secrets, conversion and unfair trade practices. The court rejected the insurer's argument that these were not defense costs, reasoning that the "filing of such counterclaims is properly characterized as a defensive strategy." The court noted that the amounts prayed for in the counterclaim "were minimal" and would have offset the amounts due to the company. According to the court, "[t]his is not a case where an insured acted in the offensive in the hopes of recovering a significant amount of money."

For more information, please contact us at 202.719.7130.