

I v. I and Breach of Contract Exclusions Do Not Preclude Coverage for Former CEO

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In an unreported decision, the United States District Court for the Southern District of California, applying California law, has held that the insured v. insured and breach of contract exclusions in a D&O policy do not apply to preclude coverage for a default judgment for negligent misrepresentations entered in a suit brought by the former president and CEO of the policyholder in connection with his termination. *Norsworthy v. Clarendon Nat'l Ins. Co.*, Civil No. 03cv2483 J (POR) (S.D. Cal. Apr. 14, 2005). The court also held that damages in the form of severance pay are wages that do not constitute "Loss" under the policy but that deferred compensation and accrued vacation are forms of back pay that fall within an exception to the wages exclusion in the policy definition of "Loss" and are thus covered.

The insurer issued a directors, officers and organization liability policy to the policyholder company. The policy contained an insured v. insured exclusion, which precluded coverage for any loss in connection with a claim "by or on behalf of, in the name or right of, the Insured Organization, whether directly or derivatively or any Insured Person, unless such Claim is . . . for an actual or alleged Employment Practices Wrongful Act." The policy had a breach of contract exclusion, which also contained an exception for "Employment Practices Wrongful Acts." The policy defined "Employment Practices Wrongful Act" to include "any actual or alleged Workplace Tort" and further defined "Workplace Tort" to include "misrepresentation, defamation (including libel and slander), invasion of privacy, false imprisonment, negligent evaluation, negligent training or supervision, wrongful discipline or wrongful deprivation of career opportunity, if actually or allegedly related to the claimant's employment by the Insured Organization."

The plaintiff filed the underlying action in California state court against the company and one of its officers "alleging that defendants wrongfully induced him to accept a demotion from President and Chief Executive Officer . . . to Chief Operating Officer in exchange for promises of severance pay, then failed to pay him severance pay, wages and vacation pay following his separation" from the company. The company tendered defense of the action to the insurer, which apparently relied on the insured v. insured and breach of contract exclusions to deny coverage. The policyholder then failed to defend the action, and the state court entered a default judgment for negligent misrepresentation. As an assignee of the defendants' rights under the policy, the underlying plaintiff then filed the instant action seeking coverage for the judgment under the policy.

The court held that the consent to assignment clause in the policy did not preclude the assignment in this case. The court noted that, although California law generally permits enforcement of consent clauses, the clause did not apply in this case because the assignment in no way expanded the insurer's obligations under the policy and because the default judgment had fixed the monetary value of the claim prior to the assignment.

The court noted, however, that the underlying state court proceedings did not in any way decide the question of coverage and observed that "[w]hether Plaintiff's claim is covered under the Policy ultimately turns on whether the negligent misrepresentation found by the Superior Court constitutes a Workplace Tort." In this regard, the court first rejected the plaintiff's contention that the insurer's claims counsel conceded that the claim was an "Employment Practices Wrongful Act." The court noted that the asserted concession by claims counsel was equivocal because it was accompanied by a reservation of rights. Moreover, the court held that it is well established that "California law does not bind insurers to their employees' statements regarding coverage, since coverage is a question of law."

The court, however, rejected the insurer's argument that negligent misrepresentation was not a "Workplace Tort" because it involved contractual liability. The court noted that the negligent misrepresentation claim was a contract claim under California law. The court explained, however, that both the insured v. insured and breach of contract exclusions in the policy contained exceptions for Employment Practices Wrongful Act claims, which included Workplace Torts. It stated that "the Court finds it compelling that the Policy carves out EPWA's from the breach of contract exclusion, such that a misrepresentation that relates to a contract would still be covered by the Policy." Based on this interpretation, the court held that the policy provided coverage for the negligent misrepresentation claims and that neither the insured v. insured nor breach of contract exclusions precluded coverage.

The insurer further argued that the severance, accrued vacation and deferred compensation awarded to the plaintiff in the default judgment constituted "wages," which were expressly excluded from the definition of Loss in the policy. The court held that the term "wages" was not ambiguous and referred to all compensation due to an employee. The court noted, however, that the policy excepted "back pay awards and front pay awards" from the wages exclusion and would thus provide coverage for the severance, accrued vacation and deferred compensation if such amounts were determined to be back pay or front pay. Relying on dictionary definitions and judicial constructions, the court held that severance is not back or front pay (and thus not covered) but that accrued vacation and deferred compensation are covered forms of back pay. The court also rejected the plaintiff's argument that the "wages exclusion" was unenforceable, holding that the exclusion was conspicuous and unambiguous.

Finally, the court granted the insurer's motion for summary judgment as to the plaintiff's bad faith cause of action. The court noted that "[t]he mere fact that [the insurer] denied coverage for a portion of the judgment this Court now finds to be covered is insufficient to establish bad faith" and that "to be liable in tort for violating the covenant of good faith and fair dealing, an insurer must be found to have acted unreasonably." The court held that the insurer's arguments were not wholly unsupported, that the plaintiff failed to adduce any evidence that the insurer acted unreasonably and that the plaintiff therefore could not satisfy his burden

of proof as to the bad faith cause of action.

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