

An Employer's Duty To Indemnify An Employee for Costs of Defending Criminal Actions

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INTRODUCTION

Most approaches to the indemnification of employee's legal expenses incurred in defending criminal actions focus on the corporate indemnification statutes. *E.g.*, Cal. Corp. Code § 317; Del. Code tit. 8, § 145. Unfortunately, in many situations those statutes do not provide for mandatory indemnification.

However, at least in California, an employee has an independent right to indemnification pursuant to a Labor Code statute governing employees' expenses. Cal. Lab. Code section 2802. While the Labor Code section has never been expressly interpreted as requiring indemnification of legal fees incurred in defending criminal charges, the purpose of the statute, its reference to unlawful activities and the logic of the case law construing the statute in the context of civil legal expenses strongly supports such an interpretation. This statute has the advantage of being mandatory, and provides additional leverage in obtaining funding for employees who become criminal defendants or investigative subjects or targets.

I. STATUTORY OVERVIEW

A. California Law

California Labor Code section 2802 states:

An employer shall indemnify his employee for all that the employee necessarily expends or losses in direct consequence of the discharge of his duties as such, or of his obedience to the directions of the employer, even though unlawful, unless the employee, at the time of obeying such directions, believed them to be unlawful.

The statute's scope is very broad, encompassing such items as diverse as the cost of replacing an employee's stolen tools, *Machinists Automotive Trades Dist. Lodge v. Utility Trailer Sales Co.*, 141 Cal. App. 3d 80, 190 Cal. Rptr. 98 (1983), as well as (in certain contexts) the employee's legal expenses. *Douglas v. Los Angeles Herald-Examiner*, 50 Cal. App. 3d 449, 123 Cal. Rptr. 690 (1975).

B. Similar Statutes

The California statute, evidently derived from a Field Code section, has analogs in some of the other states. *See, e.g.*, Mont. Code § 39-2-701; N.D. Cent. Code § 34-02-01; S.D. Codified Laws § 60-2-1. California, however, appears to have the most decisional law interpreting employer indemnification.

C. Restatement (Second) of Agency

The Restatement also obligates an employer to indemnify an employee for

"expenses of defending actions by third persons brought because of the agent's authorized conduct, such actions being unfounded but not brought in bad faith" Restatement (Second) of Agency § 439(d).

D. Other Indemnification Authority

A corporate employer may have similar indemnification obligations under the various corporate indemnification statutes. See, e.g., Cal. Corp. Code § 317; Del. Code tit. 8 § 145. See generally Block, Barton & Radin, *Indemnification and Insurance of Corporate Directors*. In addition, a government employee may have a right to a government supplied defense of civil or criminal actions arising out of acts performed in the scope of government employment. See, e.g., Cal. Gov't Code § 825 *et. seq.*

II. FACTORS BEARING ON AN EMPLOYER'S INDEMNIFICATION OF AN EMPLOYEE

A. Civil v. Criminal Actions

The California cases interpreting Labor Code section 2802 as requiring indemnification of legal expenses have done so in the context of underlying civil actions asserting claims against the employee. *Grissom v. Vons Companies, Inc.*, 1 Cal. App. 4th 52, 1 Cal. Rptr. 2d 808 (1991); *Douglas v. Los Angeles Herald-Examiner*, 50 Cal. App. 3d 449, 123 Cal. Rptr. 683 (1975). No reported case has held that section 2802 requires indemnification of the costs of defending a criminal action—but there is no reason why section 2802 should not be so interpreted. Indeed, it could be argued that the statute's reference to the indemnification of an employee's expenses stemming from activities "even though unlawful" is evidence that the Legislature contemplated that the defense

of criminal actions would be encompassed by section 2802.

The Restatement could also require the indemnification of the costs of defending a criminal action, but the language there is somewhat more equivocal: The Restatement refers only to "defending actions by third persons." Restatement (Second) of Agency § 439(d). Furthermore, Comment a to the Restatement states: "Thus, it cannot be stated whether the principal has a duty to indemnify an agent. . . for the expenses of defending unsuccessful criminal prosecutions based on authorized acts." *Id.*, Comment a.

B. Employee Status

By its terms, section 2802 applies only to employees. Independent contractors and other agents thus may not have the same rights to indemnification. Under California law, the existence of an employer-employee relationship usually turns on whether, or to what extent, the employer has control over the manner and means of accomplishing the employee's tasks. See *City of Los Angeles v. Vaughn*, 55 Cal. 2d 198, 201, 10 Cal. Rptr. 457 (1961). Moreover, the existence of an employer's right to terminate the employee, without cause, is strong evidence of an employer-employee relationship. *Id.*

C. In the Discharge of the Employer's Duties

Section 2802 requires indemnification only for those expenses incurred "in direct consequence of the discharge of [the employee's] duties as such, or of this obedience to the directions of the employer . . ." Indeed, this requirement is at the heart of all obligations owed by a principal to its agent. See Restatement (Second) of Agency section 438, Comment a. For this reason, an employer's duty of indemnification does not arise when an employee is sued or is charged with crimes "solely because he

was off on a frolic of his own not within the scope of his employment” *Douglas*, 50 Cal. App. 3d at 464.

Importantly, it does not appear to matter whether the charging instrument alleges that the employee was acting or not acting in the course and scope of his employment. The right to indemnification hinges on the actual “state of fact,” not on the way the charges are alleged. *Douglas*, 50 Cal. App. 3d at 464.

D. Success or Failure in the Underlying Action

There is no explicit language in section 2802 requiring that the underlying action be successfully defended by the employee before a duty to indemnify exists. Indeed, the focus of inquiry under section 2802, *i.e.*, whether the employee’s costs of defense were necessarily expended in direct consequence in the discharge of duties, has nothing to do with whether the employee’s defense is successful or unsuccessful.

No case has squarely reached this issue. In *Douglas*, however, the court noted that the Restatement requires indemnification only if the underlying lawsuit is “unfounded.” In the case underlying *Douglas*, the employee had secured from the plaintiff a “release with prejudice.” The *Douglas* held that the disposition constituted a successful defense; even if the Restatement rule were California law, the disposition of the underlying lawsuit was sufficient to conclude that the lawsuit was “unfounded.” The court thus stated that “[a]lthough the Restatement makes a distinction between actions which are ‘unfounded’ and actions which are meritorious, we need not concern ourselves with that distinction here.” *Douglas*, 50 Cal. App. 3d at 461.

Thus, based on the language of the statute and the absence of any case law, it would appear that so long as the employee’s

legal fees were necessarily expended as a direct consequence of the employee’s duties, the employer has a duty to indemnify. This contrasts with the corporate indemnification statutes, which require at least some success by the corporate officer or director before the corporation is required to indemnify.

For a discussion of how an employee’s belief that his actions are unlawful may work to the same effect as requiring success on the merits in some cases, see Subsection E below.

E. Employee’s Belief in the Illegality of his Acts

Another requirement in section 2802 may foreclose indemnification in some criminal cases where the defense is unsuccessful: The statute does not require indemnification where “the employee, at the time of obeying [the employer’s] directions, believed them to be unlawful.” Indemnification is therefore not required where an employee knows or believes that her acts constitute crimes. Consequently, it would appear that in any criminal action where knowledge of illegality is an element of the crime, a conviction or guilty plea would, in effect, absolve the employer from its duty to indemnify. Conviction of a crime which does not require proof of knowledge of illegality, however, would not appear to foreclose indemnification under section 2802—especially in light of the statute’s language covering acts committed by the employee “even though unlawful.”

F. Underlying Litigation Brought “In Bad Faith”

The Restatement exempts an employer from indemnification of legal expenses if the underlying lawsuit was brought “in bad faith.” Restatement (Second) of Agency § 439(d). No further explanation is offered by the Restatement.

The *Douglas* court rejected this requirement:

We cannot endorse the requirement of the Restatement that the action by the third person (for which the employee is entitled to indemnity) must be one that was "not brought in bad faith" since no such distinction appears in Labor Code section 2802. The employee who is sued for authorized acts in the scope of his employment is as much in need of and deserving of indemnity if the third person acts in bad faith as the employee is if the third person acts in good faith. The needs and rights of the employees should not be measured by the state of mind of the third person plaintiff. If the term "bad faith" is intended to exclude actions brought as a result of collusion between the third person and the employee, then we have no quarrel with the term.

At any rate, even if the bad faith exception applied, it is unclear that it would have any meaning in the context of underlying criminal proceedings.

G. Interplay Between Section 2802 and the Corporate Indemnification Statutes

Despite arguably contradictory or conflicting language, there is no reason to assume that the corporate indemnification statutes trump or otherwise interfere with an employee's rights under section 2803. Corporate indemnification statutes *do* usually refer to employees as well as directors and officers; nonetheless, the corporate indemnification statutes contain language making any indemnification rights thereunder nonexclusive. See, e.g., Cal. Corp. Code § 317(g); Del. Code tit. 8, § 145(5). The interaction between the corporate indemnification statutes and section 2802 has not

been directly engaged by the courts. See *Douglas*, 50 Cal. App. 3d at 466.

One additional difference between section 2802 and the corporate indemnification statutes is that section 2802 applies to all employers, whether incorporated or not. Furthermore, section 2802 would appear to govern employers who are incorporated outside the state of California, so long as California law applies to the employer-employee relationship. See *Douglas*, 50 Cal. App. 3d at 466.

III. DUTY TO DEFEND AND CONTROL OF COUNSEL

A. Employer's Duty to Defend

The *Douglas* court implied that section 2802 carried some duty to defend. The recent *Grissom* case, however, has put that idea to rest:

Section 2802 does not say that employee must "defend" an employee. The word "defend" does not appear in section 2802. The statute merely requires the employer to *indemnify* the employee for all that the *employee necessarily expends* in direct consequence of the discharge of the employee's duties. The focus of the actual words of the statute is on the *employee's* expenditure. If *that* expenditure is necessarily in direct consequence of the discharge of the employee's duties, then the employer must "indemnify" (i.e., reimburse) the employee.

Grissom, 1 Cal. App. 4th at 57-68 (emphasis in original) (footnote omitted).

B. Option to Defend

In certain cases, however, an employer may elect to hire competent counsel for its

employee, thereby relieving itself of a duty to reimburse the employee for the costs expended by the employee. This is because the employer need only indemnify those expenses which are necessarily incurred by the employee. In some cases, the employer's hiring of competent counsel will obviate the need for any legal expenditures by the employee:

It may be, of course, that an employee's expenditure of money on legal costs would be totally unnecessary if his or her employer timely provided competent counsel to defend the employee under circumstances where the counsel is not subject to any conflict of interest between the employer and employee. In such a situation, for the employee to select and then hire his or her own counsel *in addition* to counsel already being provided free of charge might, depending on all the facts involved, be a gross waste of resources and highly unreasonable.

Grissom, 1 Cal. App. 4th at 58 (emphasis in original).

C. Conflicts of Interest

An employer who opts to hire an attorney for the employee risks a conflict of interest, if the same counsel also represents the employer in the same or related proceedings. In *Grissom*, the employer chose to hire a law firm to represent the truck driver employee (rather than simply indemnify the employee) in a lawsuit over a vehicular accident. The same law firm, however, was retained to represent the employer in a workers compensation proceeding initiated by the employee. The employee promptly retained independent counsel to defend against the accident lawsuit, and thereafter sued his employee for

indemnification. In the indemnification lawsuit, the employer argued that its offer of defense absolved it from its duty to indemnify.

The court held that the obligation under section 2802 is to indemnify, not to defend. Therefore, an offer to defend only relieves the duty to indemnify to the extent that independent counsel is rendered unnecessary:

[J]ust because an employer selects and pays for an attorney to defend an employee does not mean that the employee might not find it reasonably necessary to select and hire additional counsel. Counsel selected by the employer may be incompetent or, as the initial law firm selected by the employer in this case, possibly caught in a conflict of interest between the employer and the employee. Additionally, the sheer press of time may make it "necessary" for an employee to select and hire his or her own counsel. If an employer dithers on an employee's request for counsel while time to respond to a complaint or some discovery request is running out, the employee is practically forced to go out and hire an attorney to take the appropriate action—even if the employer *later* decides to provide counsel free of charge.

Grissom, 1 Cal. App. 4th at 58 (emphasis in original).

Furthermore, whether independent counsel is "necessary" was held by the Court to be a question of fact. The factors that bear on whether an employee needs independent counsel include:

- (1) whether the employer has already agreed to provide counsel;

- (2) the competency and experience of counsel provided by the employer;
- (3) any time constraints requiring the employee to take unilateral action in selecting and hiring counsel;
- (4) the complexity and difficulty of the litigation against the employee in relation to the ability and capacity of the employer-provided counsel;
- (5) whether there are any conflicts between the employer and the employee;
- (6) the past history of the relationship between the employer and the employee; and
- (7) the nature of any problems arising in the attorney-client relationship and the reasons behind those problems.

Grissom, 1 Cal. App. 4th at 58 n.4.

Thus, whether an employer may take up the defense of an employee rather than straightforwardly indemnify the employee's costs of defense will depend on the circumstances. Where it is clear that the employee is charged with a single crime in which the employer is not even arguably involved, it is very possible that an employer may retain its choice of competent counsel for the employee. If, on the other hand, the employer is implicated, or

might be implicated, in the same criminal prosecution, or aware the employer faces civil exposure on the same set of facts as the criminal action, an employee's right to reimbursement for his or her independent counsel's fees should rarely be denied.

CONCLUSION

While no reported case has yet ordered the indemnification of an employee's criminal defense costs pursuant to California Labor Code section 2802, that section appears to provide an excellent complement to any employee's rights under the corporate indemnification statutes. Provided that the employee was acting in the course or scope of employment and lacked knowledge that he or she was committing unlawful acts, legal fees incurred by the employee and defense of criminal charges appear to be indemnifiable expenses.

Furthermore, in some cases an employer may be able to escape its duty to indemnify by hiring competent counsel for its employee. However, such an assumption of the employee's defense is fraught with potential conflicts, and therefore may be inadequate in a number of cases.