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# California Appellate Court Rejects Automatic Attorneys' Fees to an Employee who Successfully Defends Against Lawsuit by Employer

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California Labor Code section 2802 generally requires employers to indemnify their employees for losses the employee incurs within the scope of employment. As one common example, section 2802 requires an employer to indemnify an employee for attorneys' fees if the employee is sued by a third party, such as a customer, concerning conduct that falls within the scope of employment. But what about legal fees incurred by an employee in defending against a lawsuit by the employer itself, such as for unfair competition or misappropriation of trade secrets?

Resolving an issue of first impression, in *Nicholas Laboratories, LLC v. Chen*,[1] published on October 12, 2011, a California Court of Appeal held that section 2802 does not require an employer to indemnify an employee for attorneys' fees incurred in defending a lawsuit brought by the employer against the employee, even if the employee prevails. In that case, Nicholas Labs filed an action against its own director of information technology, Christopher Chen, alleging that Chen engaged in a side-business that competed with the company, diverted business opportunities away from Nicholas Labs, stole certain computers and printers, and misused a company credit card, among other things. Nicholas Labs alleged claims against Chen including breach of contract, breach of the implied covenant of good faith and fair dealing, conversion, negligence, money had and received, unjust enrichment, and constructive trust. Chen responded by filing a cross-complaint against Nicholas Labs, seeking indemnification of his attorneys' fees. On the verge of trial, Nicholas Labs agreed to dismiss its claims against Chen provided that Chen's cross-complaint would be submitted to the judge.

Chen alleged that Nicholas Labs was required to pay his attorneys' fees of about $90,000 by virtue of: (1) an indemnification clause in a certain operating agreement; (2) California Corporations Code section 317; and (3) California Labor Code section 2802. Both the trial court and Court of Appeal rejected all three theories.

First, the operating agreement did not apply because Chen did not work for the entity that was a party to the operating agreement—instead, he worked for a related entity, Nicholas Labs, that had no operating agreement with an indemnification clause.

Second, Corporations Code section 317, which requires a corporation to indemnify legal expenses incurred by its agents under some circumstances, did not apply because Nicholas Labs is a limited liability company, which was not covered under that section of the Corporations Code.

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Finally, the court addressed Labor Code section 2802. Section 2802 requires an employer to "indemnify his or her employee for all necessary expenditures or losses incurred by the employee in direct consequence of the discharge of his or her duties." Generally, the court explained, the word "indemnify" implies an employer's obligation to pay the employee's defense fees if the employee is sued by a *third party* for acts taken by the employee in the course of his or her job. However, that observation was not dispositive (for instance, Corporations Code section 317 uses the word "indemnify" and expressly includes reimbursement of attorneys' fees for certain lawsuits brought by the corporation against the corporation's agent).

The court found little guidance in prior case law, but the court's consideration of the "more expansive fabric of the law suggests that any interpretation of section 2802 that would allow the statute to become a unilateral attorney fee statute in litigation between employees and employers would be incompatible with that larger body of law." For example, the California Uniform Trade Secrets Act only allows a successful party to be awarded attorneys' fees under limited circumstances, such as where the employer's suit against the employee for misappropriation of trade secrets was made in "bad faith." Cal. Civ. Code § 3426.4. Construing Labor Code section 2802 to automatically award attorneys' fees to an employee who successfully defends any suit by his/her employer would contradict the California Uniform Trade Secrets Act. The *Nicholas Labs* court also cited other examples of rules governing attorneys' fees that would be undermined or rendered superfluous if section 2802 applied to complaints filed by employers against employees, including: (1) the "default" rule in California that each side pay its own attorneys' fees unless specifically otherwise provided by statute; (2) Code of Civil Procedure section 128.7, which permits courts to award fees under some circumstances; and (3) Corporations Code section 317, "which demonstrates that the Legislature can make it plain it intends to depart from the ordinary meaning of 'indemnify' to include a first party claim." Although employers sometimes file lawsuits against employees for purposes of ""arassment or intimidation," the *Nicholas Labs* court held that "this concern is true of every lawsuit."

In a footnote, the court addressed another significant issue and commented that an employee does not need to win an employment-related lawsuit brought by a third party in order to be entitled to indemnification by the employer under section 2802 for defending against such a lawsuit. The *Nicholas Labs* court rejected the argument that there is a "prevailing party" prerequisite to section 2802 indemnification, even though other courts had suggested that was the case.[2] Instead, as long as the employee was acting within the scope of his or her employment, or in obedience to the employer's direction, the employer is obligated to pay the employee's legal fees—even if the employee ends up losing the lawsuit. Likewise, it is well-established that if an employer refuses to indemnify under section 2802 when obligated to do so, the employer will also be forced to pay the legal fees run up by an employee who subsequently is required to sue the employer to obtain the proper reimbursement.

In general, the *Nicholas Laboratories* decision reinforces the so-called "American Rule" of attorneys' fees—unless a specific law or contract provides otherwise, each party to a lawsuit shoulders its own attorneys' fees. As a result, *Nicholas Laboratories* provides some protection for employers who sue their employees in California for wrongful conduct, such as misappropriation of trade secrets or other unfair competition, while still providing protection for employees who are sued by third parties for acts committed in the scope of their employment.

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[1] Case No. G044105, California Courts of Appeal, Fourth Appellate District.

[2] *See O'Hara v. Teamsters Union Local #856*, 151 F.3d 1152, 1158 (9th Cir. 1998) ("Although there are very few California decisions that discuss § 2802 in the indemnification context, those California courts that have dealt with it have held that in order to be acting in 'discharge of (his) duties' the employee must have acted 'within the course and scope of . . . employment' *and* the action against the employee must be 'unfounded.'").