

Rescission Effective Upon Filing of Rescission Complaint

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In a decision not designated for publication, the United States District Court for the Northern District of California, applying California law, has held that an insurer's declaratory judgment complaint for rescission effectuated the rescission of the policy and that the subsequent coverage litigation confirmed the validity of the rescission. *In re Sonic Blue Inc.*, 2010 WL 2034798 (N.D. Cal. May 19, 2010). Because the rescission was proper, a bankruptcy plan administrator in the insured's bankruptcy proceeding was entitled to the return of the policy premium, less any benefits conferred on the insured under the policy prior to rescission.

A company purchased primary and excess D&O policies. Shortly thereafter, the insured company filed a petition for relief under chapter 11 of the Bankruptcy Code. A group of creditors filed a lawsuit against the company's directors and officers, alleging breach of fiduciary duty and fraud (the Underlying Action). The D&O insurers then filed a complaint against the insured company and the directors and officers seeking a declaration that the insurers had no obligation to provide coverage for the Underlying Action (the Coverage Action). The insurers included claims for rescission on the basis that the directors and officers had failed to disclose certain material communications in the policy applications. The insurers stated in the complaint that they were "ready, willing and able to return" to the insured company the policy premiums.

The creditors, the insurers and the directors and officers subsequently settled the Underlying Action. Pursuant to the settlement, consideration was to be paid contingent on the outcome of the Coverage Action, the creditors were substituted in the Coverage Action in place of the directors and officers, and the excess insurer dismissed its claims in the Coverage Action with prejudice. The court in the Coverage Action granted summary judgment in favor of the primary insurer, holding that it was entitled to rescind the policy.

After the confirmation of a bankruptcy plan, the plan administrator demanded the return of premiums paid for the primary and excess policies. The insurers refused to return the premiums, and the plan administrator initiated this litigation for the return of the premiums.

The court concluded that the excess insurer withdrew its rescission of the excess policy in the settlement of the Underlying Action. The excess insurer and the insured were therefore relieved of all obligations under the excess policy. The plan administrator argued, however, that the primary insurer could not retain the benefit of rescission by refusing to pay toward the settlement of the Underlying Action, while simultaneously refusing to return the premium.

The court held that the primary policy was deemed rescinded at the time the primary insurer filed the Coverage Action. The court agreed with the plan administrator that the later Coverage Action merely confirmed the rescission, which the court in the Coverage Action had the power to set aside if it determined there was no basis to rescind. The court also held that the bankruptcy stay did not alter the effective date of the rescission because the stay of the Coverage Action only resulted in a stay of the judicial confirmation of the rescission.

The court rejected the primary insurer's argument that the rescission was not effective because the insured directors and officers had independent contractual rights with respect to the policy. The insurer asserted that unilateral rescission effected by the filing of a declaratory judgment complaint would deprive the directors and officers of coverage without any remedy. The court noted that the directors and officers may pursue bad faith claims if insurers rescind without an adequate basis. In this case, however, the court in the Coverage Action had already concluded that the policy was properly rescinded based on the directors' and officers' misrepresentations.

The court determined that the doctrines of judicial estoppel and laches did not apply to bar the plan administrator from asserting that the policy was rescinded upon the filing of the complaint in the Coverage Action. Although the creditors and directors and officers had contested the validity of the rescission, those positions and the plan administrator's decision not to take a position in the Coverage Action did not affect the plan administrator's position in this litigation.

The court held that the plan administrator was entitled to the premiums the insured company paid for the primary policy. The insurer argued that it was similarly entitled to the return of payments it made under the policy on behalf of the directors and officers if the court required it to return the premium. The plan administrator contended, however, that the insurer was not entitled to a refund of those amounts paid after the rescission was effectuated because its duty to defend had terminated. The court stated that the insurer was entitled to recover the amounts paid on behalf of the insured under the policy but noted that the insurer cited no California law contrary to the case cited in support of the plan administrator's position that the insurer's obligation to pay defense expenses ended upon the rescission of the policy.

The court ultimately held that the plan administrator was entitled to the return of the primary policy premium, less the benefits conferred upon the insured under the policy. However, the court concluded that the parties were entitled to discovery as to the benefits conferred under the policy and when those benefits were conferred.