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NEWSLETTER

Insurer Cannot Breach Duty to Defend for Rescinded Policy Unless Court Holds Rescission Was Improper

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In an unreported decision, a California federal court, applying California law, has held that an insurer that rescinds an insurance policy cannot be deemed to have violated its duty to defend unless a court determines that the rescission was improper. *Atmel Corp. v. St. Paul Fire & Marine Ins. Co.*, 2005 WL 2562626 (N.D. Cal. Oct. 11, 2005).

The policyholder company made computer chips. Before it completed an insurance application for an E&O policy, a client informed the company that some of its computer chips were defective. The company then responded "no" to the following question on the insurance application: "Does anyone in your organization have knowledge or information of any act, error or omission which might reasonably be expected to result in an Errors and Omissions claim?"

The client sued the company and the case settled. The company submitted the claim to the insurer for coverage. The insurer and the company disputed whether coverage existed for the underlying lawsuit, and the company filed a declaratory judgment action. Immediately thereafter, the insurer rescinded the policy.

The court rejected the company's argument that the insurer is relieved of its duty to defend only when a court rules that rescission is allowed. Under California law, rescission is appropriate "if the insurer has concealed or misrepresented material facts in its application for insurance." The court explained that "the rescission effectively renders the policy totally unenforceable from the outset so that there never was any coverage, and therefore, no benefits are payable." The court found that "[u]nless and until the court concludes that defendant's rescission was proper, it is premature to evaluate whether defendant breached any obligations under the policy." According to the court, unilateral rescission does not encourage insurers to avoid or delay defense obligations when there are no grounds for rescission because a company would have causes of action for bad faith and unfair claims settlement practices under California Insurance Code Section 790.03(h).

The court then held that California Civil Section 2860 does not limit a company's recoverable damages when the insurer breaches its duty to defend. Section 2860 requires insurers to pay the company selected independent counsel "rates which are actually paid by the insurer to attorneys retained by it in the ordinary

course of business in the defense of similar actions in the community where the claim arose or is being defended." The court explained that the damages are limited to reasonable fees only when an insurer has defended, even under a reservation of rights. Here, the insurer did not defend the underlying case.

Last, the court rejected the company's argument that under the policy terms, an insurer can rescind only for intentional fraud. The policy included a fraud and misrepresentation clause providing that the policy is void if the company "mislead[s] us, or attempt[s] to defraud or lie to us about any matter concerning this insurance—either before or after a loss," but excluded unintentional errors. The court found that this clause did not waive the insurer's statutory "right to material information" on the application. The court agreed with the insurer that "common sense dictates that the fraud and misrepresentation clause, which is contained in the policy issued after the application has been approved, does not apply to misrepresentation or concealment in an insurance application."

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