

ALERT

Insurer Entitled to Reimbursement of Defense Costs But Only for Amounts Advanced Prior to Rescission

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The United States District Court for the Northern District of California, applying California law, has granted summary judgment in favor of a bankruptcy plan administrator for the estate of an insured, holding that the plan administrator is entitled to recover premiums paid to an insurer after the insurer rescinded the policy. *In re SONICblue Inc.*, 2011 WL 839401 (N.D. Cal. Mar. 4, 2011). The court also held that the insurer is entitled to reimbursement for defense costs paid to the insured prior to the policy's rescission.

The insured was a consumer electronics company that filed for bankruptcy in 2003. In 2005, a group of the insured's creditors filed suit against the directors and officers of the insured seeking \$50 million in damages for alleged fraud and breach of fiduciary duty. The insurer issued a directors and officers policy to the insured and initially denied coverage before later agreeing to advance defense costs for the insured's directors and officers. In December 2005, the insurer filed a coverage action seeking a no coverage declaration and, in the alternative, to rescind the policy. The insurer continued to advance defense costs while the coverage action was pending until the insured's rights under the policy were assigned to the underlying plaintiffs in connection with the settlement of the underlying action. The court in the coverage action ultimately held that the insurer properly rescinded the policy. In a previous decision, the court had held that the rescission was effective as of the filing of the coverage action in December 2005. The plan administrator sought recovery of the premium payments made for the rescinded policy, and the insurer sought reimbursement of all defense costs, as well as costs it incurred

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in the coverage action. The plan administrator agreed that the insurer was entitled to defense costs paid prior to the rescission of the policy, but the parties disagreed over whether it was entitled to recover defense costs and costs incurred to pursue the coverage action after rescission of the policy.

The court held that the insurer was not entitled to reimbursement of any costs incurred after rescission of the policy. The court relied on *Atmel v. St. Paul Fire & Marine*, 426 F. Supp. 2d 1039, 1044 (N.D. Cal. 2005), stating that “there simply is ‘no duty to defend if an insurer has unilaterally rescinded a policy unless and until the rescission has been set aside.’” While the court noted that it “under[stood] the practical dilemma that [the insurer] faced, case law supports [the plan administrator]” because once the policy is rescinded, there is no contractual or legal obligation to pay for a defense. The court also commented that, under California law, the insurer had other available remedies, such as a claim against the insured for fraud. In addition, the court noted that the insurer had other incentives for defending the insureds in the underlying action. Moreover, the court recognized that the insurer “had to decide whether to refuse to advance defense costs in the Underlying Action, which would subject it to potential liability if the Court later found that it did not have proper grounds for rescission, or to continue to pay such costs despite having no legal obligation to do so,” but the court stated that “[l]itigation frequently involves balancing the risks and rewards of alternative courses of action and insurance companies are better positioned than most to evaluate such choices.”

Accordingly, the court held that the plan administrator was entitled to payment of the entire net premium received by the insurer and that the insurer was only entitled to reimbursement of defense costs advanced prior to the rescission of the policy. However, the court stayed enforcement of the judgment pending resolution of the appeal of the coverage action, noting that if the holding that rescission was appropriate is reversed, the insurer would have little chance of recovering amounts paid back to the estate.