California Federal Court Examines Insurers' Right of Unilateral Rescission

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On October 11, 2005, a San Francisco federal district court held that insurers may rescind their insureds' policies without a prior judicial order, and may thereafter extinguish any defense obligations they might have had for a pending claim (*Atmel Corporation v. St. Paul Fire & Marine*, 2005 WL 2562626 finding [N.D. Cal.]). The decision emerges in contrast to authority rendered in other jurisdictions involving two high profile companies—Tyco International and Adelphia Communications Corporation. The courts in these matters required the insurers to fulfill their defense responsibilities unless and until a court was to affirm that the legal standards for rescission had been met.

Case Summary

Atmel had been sued by one of its customers, Seagate Corporation, in a dispute involving the sale of allegedly defective computer chips. Seagate supposedly notified Atmel of the problem in the fall of 2001. Thereafter, Atmel executed an application for Errors and Omissions (E&O) insurance, representing that it had not been aware of any circumstances that might reasonably give rise to a claim. St. Paul alleged that this representation was false in light of Atmel's purported knowledge of the Seagate issues.

Seagate filed its commercial suit against Atmel in 2002. After wrangling over various coverage issues for more than two years, Atmel sued St. Paul, demanding that St. Paul honor its duty to defend the Seagate litigation. Shortly thereafter, in 2004, St. Paul unilaterally rescinded Atmel's E&O policy and offered Atmel a check for premiums paid on the policy, which Atmel rejected. St. Paul denied coverage for any additional defense obligations as a result of the rescission.

The issue was whether St. Paul could extinguish its duty to defend by means of a unilateral rescission of the policy based on alleged misrepresentations in the insurance application. In a ruling in favor of St. Paul, the court stated:

> *"Where grounds for rescission exist and the insurer properly exercises its right to rescind, the insured's contract rights are extinguished* ab initio *(as if the policy had never existed). An insurer may avoid any liability for benefits provided under the policy, even on pending claims: '[A] Rescission effectively renders the policy totally unenforceable from the outset, so that there never was any coverage, and therefore no benefits are payable.'"*

By permitting the insurer to rescind the policy without first obtaining an order, the court implicitly concluded that an insurer's unilateral judgment that it had met the legal standard for rescission was sufficient by itself to allow the insurer to withhold policy benefits, including defense obligations.

The court's analysis in this regard appears to deviate from authority in other jurisdictions. Specifically, in the cases involving the financial scandals of Tyco and Adelphia, two separate courts issued decisions in March 2004 ruling that an insurer who unilaterally rescinds a policy – in those cases, a Directors and Officers (D&O) policy – must continue to fund defense costs incurred by insureds during the time that the insureds challenge the rescission.

Both courts identified the issue as whether the insurers' unilateral rescission excused any existing duty to defend the underlying proceedings. As with St. Paul in the Atmel case, the insurers of Tyco's and Adelphia's directors and officers argued that the policies had been properly rescinded and, as such, no duties arising under those policies were owed to the insureds. They reasoned that if the insurers had a legal right unilaterally to rescind the policies, then no contractual duty to pay defense costs could exist because the contracts themselves are deemed never to have been formed. The judges, however, disagreed, finding that a contract remained in effect until a court confirmed the insurers had met the legal standards for rescission. According to the *Adelphia* court:

> *"Insurance carriers do not function as courts of law. If a carrier wants the unilateral right to refuse a payment called for in the policy, the policy should clearly state that right. This policy does not do so."*

Analysis

It is important to note that the court in *Atmel* did not make any findings on the soundness of St. Paul's decision to rescind. Rather, in denying Atmel's motion for summary judgment, it determined that the facts relating to Atmel's representations in the application were sufficiently disputed so that the court could not decide the ultimate rescission question on the merits. What the court proclaimed, however, was that, until the propriety of an insurer's rescission action is finally determined on the merits, the insurer may disclaim any interim coverage obligations. This is where the Atmel case conflicts with the decisions rendered in *Tyco* and *Adelphia*.

Conflicts in judicial authority among different courts are common, especially on issues of insurance involving different lines of coverage; however, many in the legal and insurance community believed when the Tyco and Adelphia decisions were rendered that the courts' decisions would have had a more significant impact on other courts addressing similar rescission questions. Specifically because those cases emerged in the context of notorious financial frauds, many expected the judges to look for ways to prevent the individuals accused of fraud from being indemnified by insurers who arguably were also victims of the fraud. The courts' refusal to come down on the insurers' side seemed to emphasize the strength of the rule that denials of coverage based on unilateral rescissions were inappropriate.

With the Atmel case, issued without even a reference to the Tyco or Adelphia matters, insureds might not feel as confident that their defense costs would be paid by insurers who rescinded policies based on unilateral findings. Although in similar cases, coverage litigation against rescinding insurers is likely to follow, insureds run the risk that defense costs in the underlying action may remain unpaid while the rescission dispute plays out.

Insurance Considerations

In the area of D&O insurance, the question of rescission and the protection of "innocent" insureds (i.e., insureds unaware of misrepresentations in the application for insurance) has resulted in an enormous amount of negotiation on policy wording and, specifically, on policies' "severability" clauses. Such clauses typically state that the knowledge of one insured shall not be imputed to other insureds for purposes of coverage. As insureds under the D&O policy, board members and those in senior management have demanded such protections, particularly in light of the impact a rescission of a policy due to the misdeeds of a few could have on the personal assets of important innocent individuals. Little has been said, however, about the need for similar protection in other management and professional lines of coverage, such as E&O. The Atmel case, however, appears to require that attention be raised to address these and other underwriting concerns. Specifically:

- Because E&O policies insure not only the company and its executives, but also all employees, can "severability" or similar clauses designed to protect innocent insureds from rescission be included, or, where such protection may already exist, should insureds and their brokers address the adequacy of the protection?

- Can applications themselves provide severability protection on awareness-based questions, such as questions pertaining to known claims or circumstances, the way that many long form D&O policy applications do?

- Can an E&O policy's "prior knowledge" exclusion be crafted to limit coverage for claims only upon a showing that individuals in certain identified senior positions had such knowledge?

- Similarly, can claim and potential claim notification clauses be written to trigger at knowledge of such matters by identified senior officials?

- Can policies be negotiated to provide that, if an insurer believes it has a right to rescind, the parties will agree to adjudicate or possibly arbitrate the matter before defense obligations are extinguished? Can this be done without jeopardizing the insurers' ability to invoke other policy limitations, such as exclusions that may apply in the absence of the rescission issue?

Updates will be provided should additional developments unfold and warrant. In the interim, please feel free to contact Integro to discuss these important issues in more detail. We look forward to hearing from you.

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