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NEWSLETTER

Court Holds California Statute Precludes Unilateral Rescission Once Insured Files Action Seeking Coverage

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A California federal court, applying California law, has held that California Insurance Code Section 650 precludes an insurer from unilaterally rescinding a policy once the policyholder files an action seeking coverage under the policy. However, the court also determined that the insurer retains the right to raise rescission as an affirmative defense in the policyholder's declaratory judgment action. *Atmel Corp. v. St. Paul Fire & Marine Ins. Co.*, 2006 WL 436171 (N.D. Cal. Feb. 21, 2006).

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 did not disclose this fact when asked by the insurer whether it had "knowledge or information of any act, error or omission which might reasonably be expected to result in an Errors and Omissions claim." Ultimately, the client sued the company, and the case settled.

The company submitted the claim to the insurer for coverage, and the carrier denied any obligation to defend the claim. The company then filed a declaratory judgment action. Immediately thereafter, the insurer rescinded the policy. The company initially moved for partial summary judgment on the ground that the insurer's unilateral rescission of the policy was a breach of the duty to defend. The court rejected this motion in an unpublished opinion (*Atmel I*) (summarized in the December 2005 issue of *The Executive Summary*). The company subsequently moved for partial summary judgment, arguing that California Insurance Code Section 650 precluded the insurer from unilaterally rescinding the policy. The insurer moved for summary judgment based on its rescission counterclaim.

The court granted the company's motion for partial summary judgment, concluding that Section 650 precludes an insurer from unilaterally rescinding a policy once a policyholder files a coverage action. The court noted that Section 650, entitled "Time for Exercising Right" provides that "[w]henever a right to rescind a contract of insurance is given to the insurer by any provision of this part such right may be exercised any time previous to commencement of an action on the contract." The court concluded that "[t]he plain language of this statute requires that an insurance company tender rescission of a policy prior to the filing of a lawsuit."

The court then noted that this conclusion does not provide "a substantive advantage" to the policyholder, however, because California law also makes clear that an insurer may raise rescission as a defense to a policyholder's coverage action. The court therefore rejected the company's contention that limiting the insurer to raising rescission as an affirmative defense entitled the company to defense costs until the rescission issue was adjudicated, reaffirming its prior reasoning in the *Atmel I* decision. The court also rejected the company's motion to strike the insurer's rescission counterclaim, noting that the insurer had cited authority suggesting that it could raise rescission both as an affirmative defense and via counterclaim.

Regarding the insurer's motion for summary judgment on rescission, the court held that "there are genuine issues of fact as to whether [the company] misrepresented or concealed information in its application, and whether the information that was not disclosed was material" that precluded summary judgment for either party. The court reasoned that the evidence regarding misrepresentation could be interpreted in favor of either the insurer or the company.

With respect to materiality, the court held that the company had raised a genuine issue of fact by contending that the insurer renewed the policy at issue after the underlying action had been filed and tendered by the company. The court emphasized the actions of the renewal underwriter, noting that "[d]espite [the underwriter's] awareness of the [underlying] action, during the renewal process he did not request any information from [the company] regarding the [underlying] action, nor did he request information from [the company] concerning [its] knowledge of the Seagate issues in December 2001 when it initially applied for insurance, or of [the company's] knowledge of the Seagate issues in the Fall of 2002 when it sought to renew."

Finally, notwithstanding its conclusion that questions of fact as to materiality precluded summary judgment, the court rejected the company's contention that the insurer had waived its right to rescind. The court reasoned that waiver requires intentional relinquishment of a known right and that the company's evidence did not establish that the insurer had intentionally relinquished its right to rescind by issuing the renewal policy.