

Exercising Rescission after Commencement of a Lawsuit

RESCISSION IS AN IMPORTANT and powerful remedy available to insurers that have issued insurance policies based upon an application for coverage containing material misrepresentations or omissions. The effect of a proper rescission is drastic, voiding the insurance policy from its inception and thus relieving the insurer of all obligations under the policy while simultaneously depriving the insured of the ability to sue the insurer for failing to pay policy benefits.

In California, a unique issue arises when an insurer seeks to rescind an insurance policy after the insured files a lawsuit against the insurer based on a failure to pay benefits. With increasing frequency, the plaintiff-insured claims that rescission is inappropriate under California Insurance Code Section 650, which provides that an insurer may not exercise its right to rescind after an insured has commenced “an action on the contract.” While, on its face, this statute appears to present a seemingly insurmountable hurdle for insurers who fail to rescind before being sued, case law demonstrates that a plaintiff-insured seeking to avoid rescission faces, at a minimum, an uphill battle in precluding an insurer from obtaining rescission that is warranted by the facts.

When, after issuing a policy, an insurer discovers that the insured made material misrepresentations or omissions on the application for coverage, the insurer may elect to rescind the policy or may continue coverage and sue for damages.¹ An insurance policy may be rescinded 1) for material misrepresentations or the concealment of material information made in procuring the insurance,² 2) on any basis for rescission specified in the California Civil Code, including fraud and duress,³ 3) for breach of a material warranty,⁴ or 4) by mutual agreement of the parties to the policy.⁵

When misrepresentation is the basis for rescission, rescission is appropriate only when the representation is false in a material way.⁶ An applicant’s misrepresentation is material if the misrepresentation would have resulted in any of the following: 1) rejection of the application, 2) a higher premium, or 3) an amendment of the terms of the contract.⁷ An insurer need not prove that the applicant intended to deceive in order to rescind.⁸ A single material misrepresentation or omission in an insurance application is ground for rescission.⁹

In order to effectuate rescission, notice must be given to the insured, and all premiums must be restored or offered to be restored.¹⁰ When grounds for rescission exist, and the insurer properly exercises its right to rescind or rescission is effectuated by mutual agreement, the contractual rights of the insured and insurer are extinguished ab initio—it is as if the policy had never existed.¹¹

The basic rationale underlying rescission was clearly stated in *Imperial Casualty & Indemnity Company v. Sogomonian*:

[A]n insurance company is entitled to determine for itself what risks it will accept, and therefore to know all the facts relative to the [risk insured]. It has the unquestioned right to

select those whom it will insure and to rely upon him who would be insured for such information as it desires as a basis for its determination to the end that a wise discrimination may be exercised in selecting its risks.¹²

In other words, an applicant for insurance has an unalterable duty to communicate, in good faith, every fact within his or her knowledge that is material to the risk the applicant seeks to insure.¹³ Moreover, an insurer is entitled to take an insured’s application answers at face value in determining whether to issue insurance and need not investigate an application to determine if the applicant lied

Courts that have discussed Section 650 have not applied it to deprive insurers of the ability to rescind.

or omitted material information.¹⁴

Resure v. Superior Court

Fueled by the harsh consequences of rescission, insureds are challenging the timing of the purported rescission with increased frequency. Relying on Section 650, plaintiff-insureds often argue that rescission is inappropriate after the insured files a lawsuit. Section 650 provides:

Whenever a right to rescind a contract of insurance is given to the insurer by any provision of this part such right may be exercised at any time previous to the commencement of an action on the contract. The rescission shall apply to all insureds under the contract, including additional insureds, unless the contract provides otherwise.

On its face, Section 650 appears to support the argument that an insurer may not, under any circumstances, rescind an insurance policy after an insured files a lawsuit to challenge denial of policy (i.e., contract) benefits. Accordingly, relying on this language, a plaintiff-insured will typically claim that unless rescission is effectuated before the filing of his or her lawsuit, rescission is improper and may not be raised in conjunction with defending a lawsuit seeking policy benefits. In other words, under the plain language of Section 650, the insurer is barred from rescinding the insurance policy after a lawsuit is filed, even though grounds for a valid rescission might have existed at the time the lawsuit was filed or were discovered during the course of litigation.

Nevertheless, presumably recognizing the harsh result of such a rule on insurers who have a legitimate basis for rescission, and mind-

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ful of the potential that the literal application of Section 650 could result in sanctioning fraud, courts that have discussed Section 650 have not applied it to deprive insurers of the ability to rescind. For example, the Second District Court of Appeal in *Resure, Inc. v. Superior Court*¹⁵ rejected a literal interpretation of Section 650 and, in fact, read and interpreted the statute to allow insurers to raise rescission even after the plaintiff-insured wins the race to the courthouse.

In *Resure*, the insurance company discovered facts that led it to suspect that the plaintiff-insureds lied or concealed material facts in their application for insurance.¹⁶ The insurer's notice to rescind and offer to restore the premiums were stated only in its complaint for rescission and declaratory relief against its insureds.¹⁷

In opposition to the insurer's motion for summary judgment, the insureds argued that the insurer's lawsuit was, in and of itself, an "action on the contract," and therefore, was barred under Section 650. The trial court agreed and, citing Section 650, held that "since [the insurer] had not noticed or attempted to rescind the policy prior to the filing of the complaint," the action for rescission was barred.¹⁸

The court of appeal reversed, first noting that in interpreting the plain language of Section 650, the phrase "an action on the contract" was ambiguous, and concluded that it meant "an action brought at law to enforce the insurance policy."¹⁹ It also found that the statute as a whole was ambiguous because, at the time it was enacted, there were two distinct types of rescission. The court therefore looked to the state of the law at the time Section 650 was enacted to determine the meaning and purpose of the statute.²⁰

When Section 650 was enacted in 1874, the court explained, there were separate courts of equity and law, and the distinction between an action on the contract at law and an action for equitable rescission was of great significance. At that time, equity would not assume jurisdiction when a plaintiff had a clear remedy at law.²¹ According to the *Resure* court, "It followed that once an action to enforce a contract was commenced at law, the party holding a right to rescind was expected to raise that as a defense rather than bring a new action in equity" because of the equitable nature of rescission. Thus, the *Resure* court concluded, the point of Section 650 "was merely to guarantee that resort to equity was not needlessly made where the insurer had ample opportunity to raise the same issues in defense of the action on the policy."²² The *Resure* court went on to hold that while the statute precludes a "new" action for rescission when one commences

"an action on the contract," it does not deprive the party entitled to rescind from defending an action on the contract by raising the grounds for rescission as an affirmative defense or by way of a cross-complaint:

Established law clearly affords the insurer the right to avoid coverage by way of cross-claims and affirmative defenses when the insured files an action on the contract before the insurer can file its action for rescission.²³

The *Resure* court's affirmation of an insurer's right to raise the grounds for rescission or seek rescission by way of an affirmative defense to an action on the contract is consistent with case law. For example, in *Maddini v. West Coast Life Insurance Company*,²⁴ the court of appeal upheld as correct a jury instruction that provided that the insurer in the case could defend against the insured's claims on the insurance contracts at issue on the basis of material misrepresentations in the insured's applications. According to that court, "[T]hough the insurer had the right to rescind the contracts upon discovery of false representations, it was under no obligation to do so but might elect to await action upon the part of the beneficiary and defend upon that ground."²⁵ Similarly, the *Resure* court's statement that an insurer can "avoid coverage" by way of a cross-claim is consistent with the idea that while Section 650 precludes a separate or "new" action when the insured files first, it should not prevent the insurer from raising rescission in a cross-complaint filed in connection with the insured's already-filed contract action.

This year, a federal court in the Northern District of California reached a conclusion concerning the application of Section 650 that was consistent with that of the *Resure* court. In *Atmel Corporation v. St. Paul Fire & Marine Insurance Company*,²⁶ the insured filed a lawsuit against its insurer for breach of contract and breach of the implied covenant of good faith and fair dealing.²⁷ The insurer counterclaimed, asserting claims for rescission, breach of contract, intentional misrepresentation/concealment, negligent misrepresentation, and breach of the implied covenant of good faith and fair dealing. It also asserted rescission as an affirmative defense. After the complaint was filed, the insurer also notified the insured it was rescinding the policy and offered the insured a check for the premiums it had paid.²⁸

In response, the insured in *Atmel* raised Section 650, arguing that rescission was improper. The court concluded that the insured was correct that the plain language of Section 650 precluded the insurer from unilaterally rescinding the policy after the insured filed suit but, relying upon *Resure*, found

that “although an insurer is precluded from unilaterally rescinding once an insured has filed suit, the insurer may raise ‘the same issues’ by asserting rescission as an affirmative defense and counterclaim.”²⁹

In addition to the fact that Section 650 does not preclude an insurer from raising rescission as an affirmative defense to an action on the contract initiated by the insured or as a cross-claim, case law is clear that an insurer may also raise other affirmative defenses based on facts that would commonly support rescission. For example, in *Williamson & Vollmer Engineering, Inc. v. Sequoia Insurance Company*,³⁰ even though the defendant insurer did not seek rescission, the court held that the plaintiff’s failure to disclose material information as requested on the application constituted misrepresentation and concealment of material facts, and that such misstatements could be raised as a defense to an action on the contract.³¹ The court rejected the insured’s argument that the only option the insurer had was to seek rescission or affirm the contract and sue for fraud.³²

The Practical Impact of Section 650

While a plaintiff-insured may choose to focus his or her argument on the plain language of Section 650 to argue that the right to rescind a contract can only be exercised prior to the

commencement of an action on the contract, that argument is likely to fail based on the holdings in cases such as *Resure*, *Maddini*, and *Williamson & Vollmer Engineering*. Indeed, based on the current state of the law in California, Section 650 has little or no value to insureds who file an action on the contract before the insurer decides to rescind coverage, except that the statute would preclude an insurer from unilaterally rescinding outside the context of the lawsuit.³³

The best approach for plaintiff-insureds when an insurer raises rescission, even though it did not rescind prior to litigation, is to evaluate whether the general requirements of rescission have been met and to be cognizant of asserting any counter-defenses that might exist to rescission. For example, the insured may want to focus on whether the purported misrepresentations or omissions on which the insurer’s rescission argument is based are, in fact, material to the insured risk. He or she should also determine who took the application for coverage. For example, if the application was taken over the telephone by an agent for the insurer, and the agent made an error in completing the application, rescission might be inappropriate. Moreover, depending on the circumstances, an insured may be able to argue that the insurer waived the right to rescind by not

seeking rescission earlier, although proving waiver is often difficult.³⁴ Likewise, generally speaking, an insurer’s right to obtain information of material facts in the application process may be waived “by neglect to make inquiries as to such facts, where they are distinctly implied in other facts of which information is communicated.”³⁵ Thus, an insurer may be found to have waived the right to disclosure of material facts by its failure to investigate obvious leads in the application process that would have disclosed that the application contained misrepresentations or omissions.³⁶

On the other hand, insurers seeking to rescind an insurance policy after an insured has filed suit on the policy must plead grounds for rescission through an affirmative defense for rescission or by way of cross-complaint if the facts support what appears to be a legitimate basis to rescind. If facts are discovered during the course of litigation that suggest rescission is appropriate, an insurer should, at a minimum, promptly seek leave from the court to amend its answer to assert an affirmative defense based on rescission. As an additional protective measure, the insurer may also want to seek leave to file a cross-complaint for rescission. Additionally, insurers may assert affirmative defenses for misrepresentation of fact and suppression of fact as permitted by *Williamson & Vollmer*

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Engineering based on the same facts supporting a defense of rescission.³⁷

In asserting these defenses and cross-claims, whether by leave or in the first instance, insurers should rely on the *Resure* court's reasoning—that is, the purpose of Section 650 was to guarantee that resort to equity (by the filing of a "new" action) was not needlessly made if an insurer could raise the matter defensively in an already-filed action on the contract.³⁸ In this regard, insurers can argue that based on the rationale of *Resure*, a cross-complaint, which was asserted in the action in response to a complaint, is not a "new" action and is consistent with the *Resure* court's analysis of the purpose underlying Section 650—efficient resolution of contract disputes in one action. An insurer may further wish to note that the *Resure* court's reasoning makes sense. If one were to accept that Section 650 stripped insurers of the right to raise rescission when they were misled into issuing insurance that would otherwise not have been issued, it would result "in absurd consequences which the Legislature could not have intended."³⁹ ■

¹ De Campos v. State Comp. Ins. Fund, 122 Cal. App. 2d 519, 527-28 (1954).

² California Insurance Code §§331 and 359, enacted in 1935, explicitly authorize an insurer covered by the rules to rescind a policy for concealment or misrepresentation in an application. Sections 331 and 359 provide that an applicant's omission or misrepresentation of material facts entitled the insurer "to rescind the contract from the time the representation becomes false." See also INS. CODE §332 (noting required disclosures).

³ De Campos, 122 Cal. App. 2d at 529.

⁴ See INS. CODE §447.

⁵ See Stevenson v. Sun Ins. Office, 17 Cal. App. 280, 288 (1911).

⁶ Thompson v. Occidental Life Ins. Co., 9 Cal. 3d 904, 916 (1973).

⁷ Imperial Cas. & Indem. Co. v. Sogomonian, 198 Cal. App. 3d 169, 181 (1988). Materiality is determined solely by the probable and reasonable effect that truthful answers would have on the insurer. *Id.* at 916; INS. CODE §334. The fact that an insurer has demanded answers to specific questions in an application for insurance is, in itself, usually sufficient to establish materiality as a matter of law. Thompson, 9 Cal. 3d at 916; Sogomonian, 198 Cal. App. 3d at 179.

⁸ Cohen v. Penn Mut. Life Ins. Co., 48 Cal. 2d 720, 725 (1957); Thompson, 9 Cal. 3d at 915-16; Telford v. New York Life Ins. Co., 9 Cal. 2d 103, 105 (1937); INS. CODE §331.

⁹ Old Line Life Ins. Co. v. Superior Ct., 229 Cal. App. 3d 1600, 1604 (1991).

¹⁰ CIV. CODE §1691. See also Sogomonian, 198 Cal. App. 3d at 184. Note, however, CIV. CODE §1693:

When relief based upon rescission is claimed... such relief shall not be denied because of delay in giving notice of rescission unless such delay has been substantially prejudicial.... A party who has received benefits by reason of a contract that is subject to rescission and who in an action of proceeding seeks relief based upon rescission shall not be denied relief because of a delay in restoring or in tendering restoration of such benefits before judgment unless such

delay has been substantially prejudicial to the other party; but the court may make a tender of restoration a condition of its judgment.

¹¹ See, e.g., *Sogomonian*, 198 Cal. App. 3d at 182; *Thompson*, 9 Cal. 3d at 916.

¹² *Sogomonian*, 198 Cal. App. 3d at 180-81.

¹³ *Thompson*, 9 Cal. 3d at 916; *Lunardi v. Great-West Life Assur. Co.*, 37 Cal. App. 4th 807, 826 (1995).

¹⁴ See *Robinson v. Occidental Life Ins. Co.*, 131 Cal. App. 2d 581, 585 (1955); *Mitchell v. United Nat'l Ins. Co.*, 127 Cal. App. 4th 457, 476 (2005).

¹⁵ *Resure, Inc. v. Superior Court*, 42 Cal. App. 4th 156 (1996).

¹⁶ *Id.* at 160.

¹⁷ *Id.* at 161.

¹⁸ *Id.*

¹⁹ *Id.* at 163, 167.

²⁰ *Id.* at 162-63.

²¹ *Id.* at 166.

²² *Id.*

²³ *Id.* at 162-63.

²⁴ *Maddini v. West Coast Life Ins. Co.*, 136 Cal. App. 472, 476 (1934).

²⁵ *Id.* at 476-80.

²⁶ *Atmel Corp. v. St. Paul Fire & Marine Ins. Co.*, 416 F. Supp. 2d 802 (N.D. Cal. 2006).

²⁷ *Id.* at 804.

²⁸ *Id.*

²⁹ *Id.* at 805.

³⁰ *Williamson & Vollmer Eng'g, Inc. v. Sequoia Ins. Co.*, 64 Cal. App. 3d 261, 275 (1976).

³¹ *Id.*

³² *Id.* at 274.

³³ Generally, an insurer is advised to rescind when it becomes aware of facts supporting rescission. The danger associated with waiting and continuing to collect premiums is that the insurer may later be found to have waived the right to rescind.

³⁴ "Waiver requires the insurer to intentionally relinquish its right to deny coverage." *Monteleone v. Allstate Ins. Co.*, 51 Cal. App. 4th 509, 517 (1996); *Anaheim Builders Supply, Inc. v. Lincoln Nat. Life Ins. Co.*, 233 Cal. App. 2d 400, 410 (1965). "To constitute a waiver, there must be an existing right, a knowledge of its existence, and an intention to relinquish it, or conduct so inconsistent with the intent to enforce the right as to induce reasonable belief that it has been relinquished." *Silva v. Nat'l Am. Life Ins. Co.*, 58 Cal. App. 3d 609, 615 (1976). "The burden is on the party claiming a waiver of a right to prove it by clear and convincing evidence that does not leave the matter to speculation, and 'doubtful cases will be decided against a waiver.'" *CBS Broadcasting Inc. v. Fireman's Fund Ins. Co.*, 70 Cal. App. 4th 1075, 1085 (1999) (finding no waiver).

³⁵ INS. CODE §336. While "waiver" and "estoppel" are often used interchangeably, they are different doctrines. Waiver always rests upon intent: "Case law is clear that 'waiver' is the intentional relinquishment of a known right after knowledge of the facts." *Waller v. Truck Ins. Exch., Inc.*, 11 Cal. 4th 1, 31-32 (1995) (internal quotes omitted). An insurer may be estopped to assert a policy right or defense when, by words or conduct, the insurer has caused the insured reasonably to change its position to its detriment. See EVID. CODE §623; *Chase v. Blue Cross of Cal.*, 42 Cal. App. 4th 1142, 1157 (1996).

³⁶ *Old Line Life Ins. Co. v. Superior Ct.*, 229 Cal. App. 3d 1600, 1605 (1991). This concept is embodied in the Insurance Code, which prohibits "post-claims underwriting." See INS. CODE §10384.

³⁷ *Williamson & Vollmer Eng'g, Inc. v. Sequoia Ins. Co.*, 64 Cal. App. 3d 261, 275 (1976).

³⁸ *Resure, Inc. v. Superior Ct.*, 42 Cal. App. 4th 156, 166 (1996).

³⁹ *Id.* at 164.



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