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# Reasonable Investigations and the Financial Responsibility Law—Protecting the Innocent Third Party: *Barrera v. State Farm Mutual Automobile Insurance Company*

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## REASONABLE INVESTIGATIONS AND THE FINANCIAL RESPONSIBILITY LAW—PROTECTING THE INNOCENT THIRD PARTY:

### *BARRERA v. STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY*<sup>1</sup>

California law is clear that automobile liability insurers have a general duty to act upon an application for insurance within a reasonable time after its receipt.<sup>2</sup> The rationale is that were this duty not imposed, the applicant would be prejudiced when a loss occurred before the application was formally accepted.<sup>3</sup> Such prejudice has been found when the insurance company has failed to: 1) accept or reject the application prior to the loss, 2) notify the applicant of rejection of the application, or 3) deliver the policy where delivery is required before liability will attach.<sup>4</sup> These cases have been distinguished on the basis of contract and tort liability.<sup>5</sup>

Those cases which impose tort liability hold the insurer to a duty to act upon an application within a reasonable time after its receipt.<sup>6</sup> Upon

<sup>1</sup> 71 Cal. 2d —, 456 P.2d 674, 79 Cal. Rptr. 106 (1969).

<sup>2</sup> See *Stark v. Pioneer Cas. Co.*, 139 Cal. App. 577, 34 P.2d 731 (1934). *Stark* dealt with an automobile liability insurance policy.

<sup>3</sup> Annot., 32 A.L.R.2d 487, 491 (1953). In some instances, the applicant obtains a binder, which has the full force and effect of a policy, immediately after he submits his application to the insurer. However, reference made here is to the situations where the applicant submits his application to the insurer and then waits to receive notification of its formal acceptance. The applicant is not covered until that time.

<sup>4</sup> *Id.* at 493.

<sup>5</sup> *Id.* at 491.

<sup>6</sup> *Id.* at 511. In California, one of the important cases that provided a basis for the tort theory of liability was *Stark v. Pioneer Cas. Co.*, 139 Cal. App. 577, 34 P.2d 731 (1934). *Stark* involved an action predicated upon the negligence of an insurance agent in withholding the plaintiff's application and premium rather than forwarding it to the defendant insurance company. When the plaintiff, as a result of an accident, made a demand upon the company, she discovered that the application and premium were never forwarded to cause a policy to be issued. In affirming a judgment for the plaintiff, the District Court of Appeal stated:

Mere delay in passing upon an application cannot be construed as an acceptance which will support an action *ex contractu*; but the applicant will not be charged with the same degree of diligence as an insurer organized for profit, and the latter may be held liable for actual damage not exceeding the amount of insurance purchased if it be shown to have delayed notice of rejection, and may not complain of inexcusable delay because of its agent's dilatory conduct or inefficiency. *Id.* at 580-81, 34 P.2d at 732.

However, the court stated that a duty did arise:

Insurance companies are held, in law, to a broader legal responsibility than are parties to purely private contracts or transactions. This is based upon the fact that those companies act under franchises from the state, and the policy of the

failure to do so, the insurer is subjected to liability for the breach of this duty.<sup>7</sup>

Other jurisdictions have found a breach where there has been payment of the premium by the applicant, retention thereof by the insurer, and an unreasonable delay in acting upon the application.<sup>8</sup> Where these facts do exist, it has been held that the insurer has a duty to act and cannot idly sit back and retain the premiums.<sup>9</sup> That insurance companies are affected with a public interest, because they receive licenses from the state, has also been suggested as a basis for the duty.<sup>10</sup> Other reasons that have been found for the existence of the duty are the unequal bargaining positions of the parties,<sup>11</sup> and the unfairness of allowing the insurer to unduly prolong the period in which it may retain the premium without incurring a risk.<sup>12</sup> California courts have approved cases which collectively embrace all of these concepts and it may reasonably be stated that it has adopted them.<sup>13</sup>

Many courts emphasize the contractual nature of the relationship and treat the application as an offer, holding that the insurance company does

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state in granting such franchises proceeds upon the theory that it is in the interest of the public to the end that indemnity upon specific contingencies should be provided those who are eligible and desire it, and for their protection the state regulates, inspects and supervises their business. An insurance company having solicited and obtained applications for insurance and having received payment of the fees or premium exacted, is bound, either to furnish the indemnity the state has authorized them to furnish or decline to do so within such reasonable time as will enable them to act intelligently and advisedly thereon. *Id.* at 580, 34 P.2d at 732.

<sup>7</sup> *See, e.g., Stark v. Pioneer Cas. Co.*, 139 Cal. App. 577, 34 P.2d 731 (1934); *Bekken v. Equitable Life Assurance Soc'y*, 70 N.D. 122, 293 N.W. 200 (1940); *Duffy v. Bankers' Life Ass'n*, 160 Iowa 19, 139 N.W. 1087 (1913); *Boyer v. State Farmer's Mut. Hail Ins. Co.*, 86 Kan. 442, 121 P. 329 (1912). *See generally* Annot., 32 A.L.R.2d 487, 511 (1953).

<sup>8</sup> *See, e.g., Wyble v. Preferred Life Assurance Soc'y*, 83 So. 2d 785 (La. Ct. App. 1955); *Kukuska v. Home Mut. Hail-Tornado Ins. Co.*, 204 Wis. 166, 235 N.W. 403 (1931); *De Ford v. New York Life Ins. Co.*, 81 Colo. 518, 256 P. 317 (1927). *See generally* Annot., 32 A.L.R.2d 487, 512 (1953).

<sup>9</sup> *Kukuska v. Home Mut. Hail-Tornado Ins. Co.*, 204 Wis. 166, 171, 235 N.W. 403, 405 (1931); *Security Ins. Co. v. Cameron*, 85 Okla. 171, 180, 205 P. 151, 159-60 (1922).

<sup>10</sup> *See, e.g., Stark v. Pioneer Cas. Co.*, 139 Cal. App. 577, 580, 34 P.2d 731, 732 (1934); *Duffy v. Bankers' Life Ass'n*, 160 Iowa 19, 28, 139 N.W. 1087, 1090 (1913).

<sup>11</sup> *See, e.g., Bekken v. Equitable Life Assurance Soc'y*, 70 N.D. 122, 142-44, 293 N.W. 200, 212-13 (1940).

<sup>12</sup> *See, e.g., Security Ins. Co. v. Cameron*, 85 Okla. 171, 180, 205 P. 151, 159-60 (1922); *Duffy v. Bankers' Life Ass'n*, 160 Iowa 19, 28, 139 N.W. 1087, 1090 (1913).

<sup>13</sup> *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d —, —, —, —, —, 456 P.2d 674, 680, 681, 684, 685, 79 Cal. Rptr. 106, 112, 113, 116, 117 (1969); *Snyder v. Redding Motors*, 131 Cal. App. 2d 416, 421-23, 280 P.2d 811, 814-16 (1955); *Stark v. Pioneer Cas. Co.*, 139 Cal. App. 577, 580-81, 34 P.2d 731, 732-33 (1934).

not have a duty to act within a reasonable time after its receipt.<sup>14</sup> The cases dealing with contractual liability, arising from the insurer's delay in acting upon an application for insurance, generally allow or deny recovery on an implied acceptance theory.<sup>15</sup> The majority holds that delay or inaction is not sufficient, in itself, to enable the court to presume an acceptance.<sup>16</sup> Where the delay is unreasonable and the premiums are retained, however, these cases often find an implied acceptance,<sup>17</sup> as such action is "inconsistent with rejection of the risk."<sup>18</sup>

Whereas prior California cases were concerned with the timeliness of rejecting an application for automobile insurance, *Barrera v. State Farm Mutual Automobile Insurance Company*<sup>19</sup> involved also the broader duty to reasonably investigate an applicant's insurability.

In *Barrera*, an applicant for automobile liability insurance obtained coverage after he had made a material misrepresentation in his application by stating that he had not had his driver's license suspended or revoked in the

<sup>14</sup> See, e.g., *Moore v. Ins. Co. of North America*, 49 Ill. App. 2d 287, 200 N.E.2d 1 (1964); *Phelan v. Everlith*, 22 Conn. Supp. 377, 173 A.2d 601 (1961); *Kelley v. National Life & Accident Ins. Co.*, 81 S.W.2d 755 (Tex. Civ. App. 1935). See generally Annot., 32 A.L.R.2d 493-96 (1953). A listing of the representative cases may also be found in *Zayc v. John Hancock Mut. Life Ins. Co.*, 338 Pa. 426, 431-32, 13 A.2d 34, 37 (1940).

<sup>15</sup> Annot., 32 A.L.R.2d 487, 493 (1953). Where contractual liability is found, the existence of the duty is not expressly discussed. Nevertheless, it should be noted that all contracts involve correlative rights and duties. *Snyder v. Redding Motors*, 131 Cal. App. 2d 416, 280 P.2d 811 (1955), established the foundation for the contractual theory of liability in California. In *Snyder*, one of the defendants was an automobile agency whose owner was an agent for an insurance company, the other defendant was the principal insurance company. The plaintiffs applied to the agency's owner for automobile liability insurance and he, as agent of the insurance company, agreed to insure them. The plaintiffs were subsequently involved in an accident and they discovered that the insurance company neglected to take any action on the application, issue a policy or return the premium. They sued for breach of contract. The District Court of Appeal, in affirming the judgment for the plaintiffs, reasoned that the failure to issue or reject the application and return the premium misled the plaintiffs and gave rise to an implied acceptance of the application which would support an action *ex contractu*. The court mentioned that it could have allowed recovery on either of two theories, stating:

It would seem that this is both negligence and a breach of the contract of its agent to place the insurance and either obtain a policy within a reasonable time or notify the applicant that no policy would be issued. *Id.* at 421, 280 P.2d at 815.

<sup>16</sup> Annot., 32 A.L.R.2d 487, 493 (1953); See, e.g., *Stark v. Pioneer Cas. Co.*, 139 Cal. App. 577, 580, 34 P.2d 731, 732 (1934).

<sup>17</sup> See, e.g., *Davis v. Mut. Benefit Health & Accident Ass'n*, 96 F.2d 165 (5th Cir. 1938); *Harvey v. United Ins. Co.*, 173 Kan. 227, 245 P.2d 1185 (1952); *Reck v. Prudential Ins. Co.*, 116 N.J.L. 444, 184 A. 777 (1936); *Atkinson v. Hawkeye Ins. Co.*, 71 Iowa 340, 32 N.W. 371 (1887). See generally Annot., 32 A.L.R.2d 487, 499-500 (1953).

<sup>18</sup> Annot., 32 A.L.R.2d 487, 499 (1953).

<sup>19</sup> 71 Cal. 2d —, 456 P.2d 674, 79 Cal. Rptr. 106 (1969).

five years preceding the application. But the Department of Motor Vehicles report indicated one suspension and two probationary orders during that period of time. Seventeen months after the policy was issued, the insured's wife, while driving negligently, struck a pedestrian. State Farm received notice of the accident one month after it occurred, and it rescinded the policy five months after it had received notice. Rescission had come almost two years after the policy was initially issued.

The plaintiff-pedestrian obtained a judgment against the insured and his wife as a result of his wife's negligent driving. State Farm had already attempted rescission of the insurance policy and returned all premium payments. The plaintiff subsequently brought an action against State Farm to compel it to pay the judgment obtained against its insured. The plaintiff contended: 1) State Farm negligently failed to discover the misrepresentation within a reasonable time after acceptance of the application, and 2) since the insured was led to believe he was insured, State Farm was estopped to rescind the policy six months after the accident. State Farm denied the validity of the policy it had issued and filed a cross-complaint seeking a declaration that the policy was void *ab initio* because it was issued in reliance on a material misrepresentation by the insured.

The trial court entered judgment for State Farm, finding that it issued the policy in reliance on a material misrepresentation, that rescission was justified, and that it acted promptly upon discovery of the misrepresentation. The court denied plaintiff's motion for a new trial<sup>20</sup> and the plaintiff appealed. The District Court of Appeal reversed and directed the trial court to enter judgment in favor of the plaintiff.<sup>21</sup> Instead of petitioning for a rehearing before the District Court of Appeal, State Farm petitioned for a hearing before the Supreme Court of California.

In its petition,<sup>22</sup> State Farm contended that: 1) the District Court of Appeal opinion was a complete departure from all prior California law and was irreconcilable with the holdings of all previous cases on the subject,<sup>23</sup> 2) a

<sup>20</sup> *Id.* at —, 456 P.2d at 677, 79 Cal. Rptr. at 109. The basis for the plaintiff's motion was the contention that the public policy expressed in California's Financial Responsibility Law required a finding of laches by State Farm in its belated discovery of the misrepresentation and that the insurer's failure to act promptly was detrimental to an innocent member of the public (the plaintiff) who should recover against State Farm.

<sup>21</sup> 68 Cal. Rptr. 285 (1968) *vacated*, 71 Cal. 2d —, 456 P.2d 674, 79 Cal. Rptr. 106 (1969).

<sup>22</sup> Respondent's Petition for Hearing, *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d —, 456 P.2d 674, 79 Cal. Rptr. 106 (1969).

<sup>23</sup> In Respondent's Brief at 4, *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d —, 456 P.2d 674, 79 Cal. Rptr. 106 (1969), State Farm cited the following cases which held that the insurer can rescind *ab initio* where it has relied upon a material misrepresentation of the insurance applicant: *Civil Serv. Employees Ins. Co. v. Blake*, 245 Cal. App. 2d 196, 53 Cal. Rptr. 701 (1966); *Allstate Ins. Co. v. Golden*, 187 Cal. App. 2d 506, 9 Cal. Rptr. 754 (1960); *Standard Accident Ins. Co. v. Pratt*, 130 Cal. App. 2d 151, 278 P.2d 489 (1955); *Allstate Ins. Co. v. Miller*, 96 Cal. App.

uniform interpretation of Insurance Code Sections 650, 651 and 359 was needed,<sup>24</sup> 3) the District Court of Appeal opinion, in effect, would not allow insurers to simply rely on the statements of their insureds; rather, it would force insurance carriers to independently investigate each risk, which would involve tremendous cost to the insurers and the motoring public,<sup>25</sup> and 4) such investigations would be an invasion of privacy.<sup>26</sup>

The pivotal issue in *Barrera* was whether an automobile liability insurer incurs a duty to an innocent third party to reasonably investigate an applicant's insurability within a reasonable time after the issuance of a policy and before an accident in which that party is injured. One of the purposes of the insurer's investigation of an application is to check the verity of the representations made by the applicant. It had been well established that an insurer had the right to rescind a policy *ab initio* upon discovery of a material misrep-

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2d 778, 216 P.2d 565 (1950). In quoting *Allstate Ins. Co. v. McCurry*, 224 Cal. App. 2d 271, 36 Cal. Rptr. 731 (1964), *Blake* stated:

The law seems clear that where the insured has secured a policy of automobile liability insurance through fraud, breach of warranty, or material misrepresentation, the insurer can rescind the policy as of its inception, notwithstanding the existence of any rights in third parties who were injured by the acts of the insured which occurred before the rescission. 245 Cal. App. 2d 196, 198, 53 Cal. Rptr. 701, 703 (1966).

The District Court of Appeal held that CAL. INS. CODE § 651 (West Supp. 1969-70) did not apply to rescission of automobile insurance. In Respondent's Petition for Hearing, *supra* note 22, at 7, State Farm contended that *Blake*, *McCurry*, and *Golden* applied § 651 and allowed rescission, and that these cases were in accord with the general law in the United States. Moreover, it asserted that the consideration of public policy and the close analogy between the California Financial Responsibility Law and compulsory automobile insurance, which the District Court of Appeal based its decision on, were refuted by *Blake*.

<sup>24</sup> In Respondent's Petition for Hearing, *supra* note 22, at 9, State Farm contended that *Civil Serv. Employees Ins. Co. v. Blake*, 245 Cal. App. 2d 196, 53 Cal. Rptr. 701 (1966) held CAL. INS. CODE §§ 359 and 650 (West 1955) applicable to rescission of automobile liability insurance policies, but the District Court of Appeal in *Barrera* held these sections to be abrogated by CAL. INS. CODE § 651 (West Supp. 1969-70).

<sup>25</sup> Respondent's Reply Brief, *supra* note 23, at 15. State Farm also contended that an insurance company is under no duty to inquire as to the truth of representations made, unless it is made aware of facts which bring the representations under suspicion and which would induce a prudent man to make inquiry, citing *Robinson v. Occidental Life Ins. Co.*, 131 Cal. App. 2d 581, 281 P.2d 39 (1955) and *Mirich v. Underwriters at Lloyds*, 64 Cal. App. 2d 522, 149 P.2d 19 (1944). In Respondent's Petition for Hearing, *supra* note 22, at 11, State Farm contended that the District Court of Appeal decision disposed of the implied covenant of good faith and fair dealing between the parties to an insurance contract. This relationship thus appeared to be almost fiduciary in nature. It cited *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 429, 426 P.2d 173, 176, 58 Cal. Rptr. 13, 16 (1967), which stated, "[T]here is an implied covenant of good faith and fair dealing that neither party will do anything which will injure the right of the other. . . ."

<sup>26</sup> Respondent's Petition for Hearing, *supra* note 22, at 6, 13, 14. The court failed to address itself to this argument.

resentation, and it did not matter when the discovery was made.<sup>27</sup> *Barrera* not only held that the insurer had a duty to reasonably investigate within a reasonable time,<sup>28</sup> but it also held that if the insurer breached its duty, it would lose its right to rescind *ab initio*.<sup>29</sup> Therefore, when this duty is breached, the insurer will not be able to successfully assert the insured's misrepresentation as a defense in an action on the policy by an injured third party.<sup>30</sup>

The court did not consider the distinction between a willful and an innocent misrepresentation by the insured. Not only does Section 331 of the California Insurance Code disregard any distinction,<sup>31</sup> but to allow the distinction would invade the contract rights of the insurer and the insured under the policy. Were the distinction made and the insured willfully misrepresented a material fact, the issue ultimately becomes one of indemnification, and the insurer would likely escape liability. In California, however, the innocent accident victim's right to compensation does not depend on what the insurer's rights are against the insured. The *Barrera* court explicitly reaffirmed California's position that the contract provisions in insurance policies must be interpreted in light of the Financial Responsibility Law's purpose to protect those who may be injured by the use of automobiles.<sup>32</sup> Thus compensating the innocent third party is strictly a matter of policy.<sup>33</sup>

<sup>27</sup> The relevant statutes are: CAL. INS. CODE § 331 (West 1955) (intentional or unintentional concealment allows rescission), § 359 (West 1955) (rescission allowed from the time the representation becomes false), § 650 (West 1955) (rescission allowed any time previous to an action on the contract). For the case law, see Respondent's Petition for Hearing, note 23 *supra*.

<sup>28</sup> 71 Cal. 2d —, —, 456 P.2d 674, 677, 79 Cal. Rptr. 106, 109 (1969).

<sup>29</sup> *Id.* at —, 456 P.2d at 690, 79 Cal. Rptr. at 121. The court, in *Barrera*, used both "rescission" and "rescission *ab initio*" in its discussion. The author sees no distinction between the two terms and they will be used interchangeably.

<sup>30</sup> *Id.* at —, 456 P.2d at 677, 79 Cal. Rptr. at 109.

<sup>31</sup> CAL. INS. CODE § 331 (West 1955) states: "Concealment, whether intentional or unintentional, entitles the injured party to rescind insurance."

<sup>32</sup> 71 Cal. 2d —, —, 456 P.2d 674, 683-84, 79 Cal. Rptr. 106, 115-16 (1969).

<sup>33</sup> Beginning with *Continental Cas. Co. v. Phoenix Constr. Co.*, 46 Cal. 2d 423, 296 P.2d 801 (1956), the language of insurance policies has been viewed in the light of the public policy of California's Financial Responsibility Law. In *Continental*, the court said, "If semantically permissible, the [insurance] contract will be given such construction as will fairly achieve its object of securing indemnity to the insured for the losses to which the insurance relates." *Id.* at 437, 296 P.2d at 809. The court further stated that, "Such a [Financial Responsibility] law is remedial in nature and in the public interest is to be liberally construed to the end of fostering its objectives [of providing monetary protection to those injured on the highways through no fault of their own]." *Id.* at 434, 296 P.2d at 808.

In *Wildman v. Gov't Employees Ins. Co.*, 48 Cal. 2d 31, 307 P.2d 359 (1957), it was held as a matter of law, every automobile liability insurance policy covers permissive users. In *Interinsurance Exch. v. Ohio Cas. Ins. Co.*, 58 Cal. 2d 142, 373 P.2d 640, 23 Cal. Rptr. 592 (1962), the court reaffirmed the position taken in *Wildman*. In 1963, the Legislature adopted CAL. INS. CODE § 11580.1 (West Supp. 1969-70) which,

In the situation where an insured has made a material misrepresentation to the insurer, and is injured by an uninsured motorist, can the insured still recover under the uninsured motorist provision of his policy? Assuming the *Barrera* theory could be applied, the insurer's indemnification rights would seem to preclude recovery by the insured. It is possible that a different result might obtain if the court—or legislature—ever determines to distinguish a willful from an innocent misrepresentation.

One of the three bases for the court's imposition of liability upon the insurer was predicated on the public policy underlying the Financial Responsibility Law.<sup>34</sup> California courts have consistently subordinated the contract provisions of automobile liability insurance policies<sup>35</sup> to compensating innocent third party victims.<sup>36</sup> Thus where a policy specifically excluded a particular person from coverage, the District Court of Appeal held that the exclusion was invalid because the injured third party would not otherwise be compensated.<sup>37</sup> This decision was rendered approximately five years after the Legislature had allowed the insurer and the insured, by statute, to agree that coverage under the policy would not apply to specific persons using the insured's automobile. It is apparent that the court had little reluctance in departing from this legislative enunciation.<sup>38</sup>

The genesis for the policy outlined in the District Court of Appeal's decision was espoused in *Continental Casualty Co. v. Phoenix Construction Co.*,<sup>39</sup> which stated that the entire automobile Financial Responsibility Law should

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in applicable part, permitted the insurer and the insured to agree that coverage under the policy would not apply to specific persons using the insured's automobile, but exclusion could not be by class. However, in *Abbott v. Interinsurance Exch.*, 260 Cal. App. 2d 528, 67 Cal. Rptr. 220 (1968), the court nullified an express agreement to exclude the insured's son from coverage under the policy because the result would have otherwise been contrary to the public policy of the Financial Responsibility Law. *Abbott* seems to have nullified the effect of § 11580.1 as to third parties in favor of the public policy of California. It did, however, leave the insurer with an action against the insured for indemnification.

<sup>34</sup> *Id.* at —, 456 P.2d at 682, 79 Cal. Rptr. at 114.

<sup>35</sup> Automobile liability insurance normally provides coverage for injury caused by the insured. Indemnity insurance primarily provides coverage for the insured himself, and it may not be available if the carrier decides the applicant is not an insurable risk. *Id.* at —, 456 P.2d at 683, 79 Cal. Rptr. at 115.

<sup>36</sup> See discussion *supra* note 33. The court reiterated what it stated in *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 270 n.6, 419 P.2d 168, 172 n.6, 54 Cal. Rptr. 104, 108 n.6 (1966), and quoted from R. POUND, *THE SPIRIT OF THE COMMON LAW* 29 (1921), which stated:

[W]e have taken the law of insurance practically out of the category of contract, and we have established that the duties of public service companies are not contractual, as the nineteenth century sought to make them, but are instead relational; they do not flow from agreements which the public servant may make as he chooses, they flow from the calling in which he has engaged and his consequent relation to the public.

<sup>37</sup> *Abbott v. Interinsurance Exch.*, 260 Cal. App. 2d 528, 67 Cal. Rptr. 220 (1968).

<sup>38</sup> *Id.* at 531, 67 Cal. Rptr. at 222.

<sup>39</sup> 46 Cal. 2d 423, 296 P.2d 801 (1956).



be liberally construed to foster its main objective of giving monetary protection to persons who suffer grave injury through the negligent use of the highway by others.<sup>40</sup> *Barrera* is the latest decision, in a line extending from *Continental*, recognizing a clearly discernible pattern—"A desire on the part of the judiciary and the Legislature to . . . provide compensation for those injured through no fault of their own."<sup>41</sup> In view of this well settled policy, the *Barrera* court concluded that a rule permitting an automobile liability insurer to indefinitely postpone a reasonable investigation of insurability, until such time as was financially convenient, would thwart the Financial Responsibility Law's main purpose of providing compensation for otherwise uncompensated innocent accident victims.<sup>42</sup>

The *Barrera* decision resulted in conditionally abrogating the insurer's right to rescind the policy *ab initio* upon the discovery of a material misrepresentation.<sup>43</sup> The right to rescind *ab initio* still exists, but only when the insurer complies with its duty to reasonably investigate the application within a reasonable time after the issuance of the policy. If this duty is breached, the insurer cannot shield itself from liability upon the negligent occurrence of an accident and subsequent claim under the policy provisions.

Although the California Supreme Court vacated the District Court of Appeal opinion, the District Court of Appeal held, perhaps prophetically, that the insurer lost the right to rescind *ab initio* even if it discovered the insured's misrepresentation within a reasonable time.<sup>44</sup> As the insurer would have an absolute duty to compensate the claimants under the policy, in a sense, the insurer would be "strictly liable". The case law in California seems headed in a direction which fixes the insurer's liability upon the happening of the

<sup>40</sup> *Id.* at 434, 296 P.2d at 808.

<sup>41</sup> 71 Cal. 2d —, —, 456 P.2d 674, 683, 79 Cal. Rptr. 106, 115 (1969), citing from *Interinsurance Exch. v. Ohio Cas. Ins. Co.*, 58 Cal. 2d 142, 153-54, 373 P.2d 640, 646, 23 Cal. Rptr. 592, 598 (1962). In *Interinsurance*, the court concluded the trend of the public policy was "clearly discernible" because:

[T]he minimum monetary limits of the financial responsibility law have been greatly increased; every liability policy issued must cover the assured for injuries or damage caused by the negligence of drivers of uninsured motor vehicles; . . . the permissive user statute has been liberally construed . . . . (citations omitted).

<sup>42</sup> 71 Cal. 2d —, —, 456 P.2d 674, 683, 79 Cal. Rptr. 106, 115 (1969).

<sup>43</sup> *Id.* at —, 456 P.2d at 689, 79 Cal. Rptr. at 121 (1969).

<sup>44</sup> *Barrera v. State Farm Mut. Auto. Ins. Co.*, 68 Cal. Rptr. 285, 295 (1968) *vacated*, 71 Cal. 2d —, 456 P.2d 674, 79 Cal. Rptr. 106 (1969).

[T]here is no right to rescind the subject automobile liability policy *ab initio* and . . . the coverage of the policy cannot be terminated except as provided in section 651 . . . . The effect of section 651 is that an insurer is obliged to investigate and discover the fraud as soon as possible so that the rights of innocent third parties may not intervene. By prompt investigation an insurer can minimize the risk of being held liable on the policy. If . . . the insurer prefers to avoid the risk of being held liable on a policy obtained by fraud, from the date of its issuance to a date 10 days after the giving of the notice of cancellation as provided in section 651, it must make its investigation of the applicant's record . . . prior to the issuance of a covering note or [a] binder . . . or an insurance policy. *Id.*

accident.<sup>45</sup> The *Barrera* decision did not require such an extension, but this seems the next logical step. Accordingly, it made the duty to compensate under the provisions of the policy defeasible by conducting a reasonable investigation of the application within a reasonable time after the issuance of a policy.

The court's recognition of the insurance company's role as a public service entity<sup>46</sup> provided a second basis for its decision. Because of the quasi-public nature of the insurance business and the public policy underlying the Financial Responsibility Law, reasoned the court, the duty was owed to the insured and the public.<sup>47</sup> Nor was it essential whether the duty sounded in tort or contract.<sup>48</sup> The court further stated that when an insurer enters into business relations with the public, the resultant rights and obligations should not be determined solely by the general rules applicable to the law of contracts.<sup>49</sup> It is well settled that insurance policies are characteristic of contracts of adhesion.<sup>50</sup>

<sup>45</sup> For example, *Wildman v. Gov't Employees Ins. Co.*, 48 Cal. 2d 31, 307 P.2d 359 (1957), held as a matter of law, that permissive users were covered by automobile liability insurance policies. In 1963, CAL. INS. CODE § 11580.1 (West Supp. 1969-70) was amended to provide that specific persons could be excluded from coverage under the policy, but exclusion could not be by class. However, in *Abbott v. Interinsurance Exch.*, 260 Cal. App. 2d 528, 67 Cal. Rptr. 220 (1968), after the occurrence of an accident, the clause in the insured's policy, which excluded his son, was struck down by the court because it was contrary to the public policy of the Financial Responsibility Law. *Id.* at 533-34, 67 Cal. Rptr. at 223.

<sup>46</sup> 71 Cal. 2d —, —, 456 P.2d 674, 681, 79 Cal. Rptr. 106, 113 (1969).

<sup>47</sup> *Id.* at —, 456 P.2d at 681, 79 Cal. Rptr. at 113.

<sup>48</sup> The *Barrera* court cited Funk, *The Duty of an Insurer to Act Promptly on Applications*, 75 U. PA. L. REV. 207, 224 (1927), which stated:

[T]he insurer [may be] under a duty entirely irrespective of contract, one which the law imposes regardless of the company's desire to assume it. *Whether this duty be called one of tort or of quasi-contract is immaterial.* In either case, its fundamental feature is its non-consensual nature. *It is a duty peculiar to the business of insurance*, and does not extend beyond it.

The court continued, citing *Kukushka v. Home Mut. Hail-Tornado Ins. Co.*, 204 Wis. 166, 172-73, 235 N.W. 403, 405 (1931), stating:

[I]t is not vastly important that the legal relationship be placed in a particular category. If we say it is contractual, . . . or, having a duty to act, the insurer negligently fails in the performance of that duty, or that the duty springs out of a consensual relationship, and is therefore in the nature of a quasi contractual liability, is not vitally important. *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d —, — n.6, 456 P.2d 674, 681 n.6, 79 Cal. Rptr. 106, 113 n.6 (1969).

<sup>49</sup> See *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d —, —, 456 P.2d 674, 683, 79 Cal. Rptr. 106, 115 (1969). Unless the applicant has an attorney with him when he is purchasing insurance, will he really have a full understanding of what he is contracting to purchase? Is there any doubt that the insurance company knows what its own policy means after its staff of lawyers has thoroughly advised it?

<sup>50</sup> See, e.g., *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 269-70, 419 P.2d 168, 171-72, 54 Cal. Rptr. 104, 107-08 (1966). See generally Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943); Isaacs,

A third basis for the decision was the court's expansion of the duty imposed on the insurer in *Stark v. Pioneer Casualty Company*.<sup>51</sup> In concluding that its decision parallels the line of decisions that hold the insurer to a duty to act promptly upon an application, the court said that it:

. . . recognize[s] facts to be what they are. [The court does] not attempt to force the facts to fit a ready-made legal mold. They recognize the status and relationship of the parties, as they are, and measure the obligations of the parties accordingly.<sup>52</sup>

Thus the status and relationship of the insurer and the innocent third party is being recognized, taking into account the quasi-public nature of insurance companies, the public policy underlying the Financial Responsibility Law, and the adhesion contract characteristics of insurance policies.<sup>53</sup>

Whether the duty to conduct a reasonable investigation within a reasonable time has been breached will, as in all negligence actions, usually be a question

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*The Standardizing of Contracts*, 27 YALE L.J. 34 (1917); Sackville, *The Duty of the Insurer to Settle Within the Policy Limit—A Case of the Standard Contract of Adhesion*, 1968 UTAH L. REV. 72. The latter article cites extensively the significant law review articles that discuss the adhesion contract.

<sup>51</sup> 139 Cal. App. 577, 34 P.2d 731 (1934). In expanding the duty imposed by *Stark*, the court reasoned that the following analysis of the insurer's duty to act promptly upon an application applied directly to the insured's analogous duty to reasonably investigate an insurance application within a reasonable time after the issuance of a policy:

Under such circumstances, having in view the nature of the risk against which the insure[d] seeks protection, is there not a duty upon the insurer to act upon the application within a reasonable time? *Can the insurer, having pre-empted the field, retain control of the situation and the applicant's funds indefinitely? Does not the very nature of the transaction impose upon the insurer a duty to act?*

Similarly, the rationale . . . applies as much to the insurer's obligation to investigate insurability after issuance of a policy as to its duty to act promptly on applications: 'It strikes us as manifestly unfair to hold a stipulation in an application for insurance that the company is not bound until the application is received and approved, as warranting an insurance company to delay consummating a contract of insurance for an unreasonable length of time, and then in the event of loss repudiate it. It is in just such situations as this that the insured is allowed, in the event of loss, to recover damage for negligence based upon unreasonable delay. . . . Any other rule would place it in the power of an insurance company to take the chances of a loss, and, if none occurred, retain the premium; but if one does occur, repudiate the contract and compel the assured to bear the loss. (citations omitted). *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d —, —, 456 P.2d 674, 684-85, 79 Cal. Rptr. 106, 116-17 (1969).

See *Stark v. Pioneers Cas. Co.*, *supra*.

<sup>52</sup> 71 Cal. 2d —, —, 456 P.2d 674, 685, 79 Cal. Rptr. 106, 117 (1969).

<sup>53</sup> See *id.* at — n.5, 456 P.2d at 680 n.5, 79 Cal. Rptr. at 112 n.5, where the court, citing *Bekken v. Equitable Life Assurance Soc'y*, 70 N.D. 122, 138-42, 293 N.W. 200, 210-12 (1940), stated:

It has long been recognized that 'the business of insurance is *quasi public* in character' . . . .

The purpose and nature of [life] insurance [contracts], and the duties which the insurer assumes under such contracts, and the manner in which such contracts are negotiated, impress such contracts and the relationship of the parties, even during the negotiations, with characteristics unlike those incident to contracts and negotiations for contracts in ordinary commercial transactions.

for the jury.<sup>54</sup> The court held that the factors to be taken into consideration by a trial court, in assessing the reasonableness of the insurer's course of conduct are: 1) the cost of obtaining the information from the Department of Motor Vehicles, 2) the availability of this information from the Department or elsewhere (e.g., it was claimed that the information was on the back of the insured's driver's license), and 3) the general administrative burden of making such an investigation. These factors, the court continued, must be weighed against the social utility of protecting innocent members of the public against the consequences of automobile owners driving with voidable liability policies.<sup>55</sup>

The court considered only indirectly State Farm's argument that the cost of complying with the duty would be almost intolerable.<sup>56</sup> State Farm contended that it insured approximately eleven million cars in California.<sup>57</sup> It further contended that, every six months, the cost of obtaining reports from the Department of Motor Vehicles, aside from the other investigative and clerical costs, would be approximately four million dollars.<sup>58</sup> State Farm also questioned whether the Department of Motor Vehicles could handle the increased requests for driving records.

State Farm argued that a duty to investigate would increase insurance rates dramatically and supported this position by showing the cost of investigating each policy every six months. This position seems somewhat unreasonable in light of other alternatives which would reduce the financial burden to the insurer. In the alternative, the insurer could assume the risk of material misrepresentations or periodically spot check the driving records of its policy holders. The burden of the latter two alternatives seems considerably less than investigating all policy holders every six months.<sup>59</sup>

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<sup>54</sup> 71 Cal. 2d —, —, 456 P.2d 674, 689, 79 Cal. Rptr. 106, 121 (1969). One of the reasons for reversing the trial court's judgment was that this issue was not submitted to the jury.

<sup>55</sup> *Id.* at 706, 456 P.2d at 690, 79 Cal. Rptr. at 122.

<sup>56</sup> State Farm's argument concerning the cost of complying with the duty appears in Respondent's Petition for Hearing, *supra* note 22.

<sup>57</sup> Respondent's Petition for Hearing, *supra* note 22, at 12.

<sup>58</sup> *Id.* The insured paid his premiums in April, 1958, October, 1958, and April, 1959. 71 Cal. 2d —, — n.5, 456 P.2d 674, 678 n.5, 79 Cal. Rptr. 106, 110 n.5 (1969). From these facts and from the argument made by State Farm in Respondent's Petition for Hearing, *supra* note 22, it may be reasonably inferred that State Farm's automobile liability policies are written for six month periods and that it treats the questionnaire (that it mails on the anniversary date) as a new application for insurance. The total cost is derived by multiplying forty cents (the cost of a D.M.V. report) by approximately eleven million automobiles.

<sup>59</sup> State Farm's annual income statement does not indicate its expenditures in each state and, from the available information, it is virtually impossible to determine the relative burden of complying with the duty. Realistically, it seems that, in certain situations, it would be financially expedient for insurers to fail to comply with the duty imposed by *Barrera*. For example, if State Farm spent approximately \$3.50 per insured for a complete investigation (it cost \$3.35 in 1958), and the investigation was made on

The judicial feeling regarding the burden of implementing public policy was cast recently in *Abbott v. Interinsurance Exchange*,<sup>60</sup> where the court stated:

. . . insurance companies which desire to do business in this state must take the lean with the fat, that is to say, assume, at least in the first instance, the burdens required by public policy in addition to realizing their business profits. . . . [f]uture premiums may well be adjusted by the companies, so that ultimately, if not now, all purchasers of policies of public liability, . . . may pay for this implementation of public policy.<sup>61</sup>

The court dealt also with the question of whether the insurer's duty inures to an injured third party and whether that person stands in the shoes of the insured when bringing suit upon a policy in which the insured would have had no rights. Had the court addressed itself directly to the duty owed to an innocent third party, its discussion of whether the duty inures to his benefit would not have arisen. The holding of the court was that the duty did inure to the benefit of the innocent third party and such person did not stand in the shoes of the insured in an action on the policy.<sup>62</sup> Although allowing the innocent third party to assert the policy provisions is seemingly inconsistent with the insured's disability to assert such provisions, the underlying public policy of the Financial Responsibility Law dictates this result.<sup>63</sup> Consequently, the insured is a mere conduit through which the innocent third party is compensated.

Notwithstanding the insurer's remedy against the insured as a result of the latter's misrepresentation, the injured third party must first proceed against the insured before it seeks compensation from the insurer. This result obtains because insurance policy provisions in California commonly provide that the insurer may not be sued unless there has been full compliance with the terms of the policy or unless the amount of the insured's obligation to pay is finally determined either by judgment or by written agreement of the insured, the claimant, and the insurer.<sup>64</sup> This double litiga-

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the anniversary dates of their policies (every six months), it would cost them approximately \$77,000,000 annually to comply with the duty. Assuming misrepresentations are sufficiently rare, if the insurer, within a one year period, had to pay 7000 judgments of \$10,000 each, it would have still saved \$7,000,000 by not conducting the investigation. However, actuarial tables would determine whether there would be a possibility of ever having that expenditure exceed the cost of investigation.

<sup>60</sup> 260 Cal. App. 2d 528, 67 Cal. Rptr. 220 (1968).

<sup>61</sup> *Id.* at 538, 67 Cal. Rptr. at 226.

<sup>62</sup> 71 Cal. 2d —, —, 456 P.2d 674, 685, 79 Cal. Rptr. 106, 117 (1969). State Farm argued that the plaintiff lacked any basis upon which to sue on the policy. The court rejected that argument by stating that the real beneficiary of the duty imposed on the defendant cannot lose his remedy merely because the party whose relationship with the defendant which gave rise to the duty would be barred from recovery. 71 Cal. 2d —, —, 456 P.2d 674, 687, 79 Cal. Rptr. 106, 119 (1969).

<sup>63</sup> *Id.* at —, 456 P.2d at 682, 79 Cal. Rptr. at 114.

<sup>64</sup> Such provisions also specifically state that they do not give any right to join the insurer in any action to determine the insured's liability.

tion requires a considerable expenditure of time and money, which arguably casts a heavy burden upon the injured third party when he is required to initiate two successive lawsuits. The argument can be advanced that a third party should be able to either join the insurer and the insured or proceed directly against the insurer.<sup>65</sup>

The court held that the third party may recover only up to the limits of the Financial Responsibility Law.<sup>66</sup> If a \$50,000 policy is in force, and a

<sup>65</sup> In *Shingleton v. Bussey*, 223 So. 2d 713 (Fla. 1969), the plaintiff sustained injuries from the negligent operation of the insured's automobile. The trial court dismissed the insurer as a party and the plaintiff appealed. The appellate court reversed the lower court's decision and remanded. The Supreme Court of Florida affirmed the appellate court's holding, stating that since an automobile liability insurance policy is a quasi-third party beneficiary contract, the injured third party had a direct cause of action against the insurance company as a party defendant. In holding that the policy was for the direct benefit of third parties who might be injured through the insured's negligence, the court held that obtaining liability coverage is:

[A]n act undertaken by the insured with the intent of providing a ready means of discharging his obligations that may accrue to a member or members of the public as a result of his negligent operation of a motor vehicle . . . . *Id.* at 716.

The court recognized that the majority of insurance policies, including the one in question, provide that:

[N]o action shall lie against the insurer until the amount of the obligation of the insured shall have been finally determined by judgment and that the policy shall not give any right to join the insurer in any action to determine the liability of an insured. *Id.* at 717.

Nevertheless, the court stated that these provisions seek to defer the right of an injured third party beneficiary to maintain a cause of action against the insurer. The court noted that:

In the modern world which is fraught with public safety hazards, it is unrealistic that mass liability insurance coverage designed to afford protective benefits for the general public should contain such condition precedent as a barrier to the right of identified members of the protected class to pursue a speedy, realistic and adequate recovery action. *Id.* at 717.

The court added that the primary reasons for sustaining "no joinder clauses" in the area of liability insurance is that such a clause serves to prevent prejudice to the insurer through the prophylactic effect of isolating from the jury's consideration any knowledge that coverage for the insured exists." *Id.* at 718.

The court hastened to add that an insurance company as a defendant will not operate to increase the size of jury verdicts because juries today are more mature and a candid admission at trial of the existence of insurance coverage should serve to decrease the number of judgments in excess of the policy limits. If the existence of an insurance company were revealed, the court continued, juries would no longer be misled to think insurance coverage is greater than it is.

The court concluded by stating:

[I]t seems anomalous to public policy to procedurally sanction and condone a situation where the ultimate beneficiary of policy proceeds is deprived by a provision in the policy of an open, speedy and realistic opportunity to pursue by due process his right of an adequate remedy at law jointly against the insured and insurer. *Id.* at 719.

<sup>66</sup> 71 Cal. 2d —, —, 456 P.2d 684, 689, 79 Cal. Rptr. 106, 121 (1969). The limits of the Financial Responsibility Law are set forth in CAL. VEH. CODE § 16023 (West Supp. 1969-70). They are \$15,000, because of bodily injury or death to any one per-

\$50,000 claim is made, *Barrera* holds that the insurer's liability is limited to \$15,000. The court did not explain why this limit was imposed, but it is clearly inconsistent with its decision to support the public policy of compensating innocent third parties. With that policy established, is it complied with by giving the innocent third party \$15,000 when he has sustained \$50,000 in injuries? Perhaps the court's holding can be reconciled by the fact that the minimum limit of the Financial Responsibility Law, for the death or injury of one person, was equal to the maximum limit of the insured's policy. Accordingly, the court may have inadvertently disregarded those instances where the coverage of a given policy exceeds the minimum required liability under the Financial Responsibility Law.

The court did not address itself to State Farm's argument relating to the implied covenant of good faith and fair dealing that exists between the parties to an insurance contract.<sup>67</sup> State Farm contended that, under recent decisions of the court, an insurance company resembles a fiduciary and its relationship with its insured is one of mutual trust.<sup>68</sup> It further contended that not being able to rely on the word of its insured would involve investigating the personal lives of millions of its insureds. The court provided no answer to State Farm's allegation that it was improper to expand the public policy of compensating injured third parties at the expense of the insurer when it has relied on the insured's material misrepresentation.<sup>69</sup>

In its reliance on the Financial Responsibility Law to compensate innocent third parties, the holding of *Barrera*, when juxtaposed with the applicable sections of the California Insurance Code, has created much uncertainty.<sup>70</sup>

In *Barrera*, the plaintiff argued that Section 651 of the Insurance Code<sup>71</sup>

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son; \$30,000, because of bodily injury or death to any two or more persons in any one accident; and \$5000 for destruction to property. The California Supreme Court clerk, on December 3, 1969, confirmed that this portion of the decision had not been modified.

<sup>67</sup> Respondent's Petition for Hearing, *supra* note 22, at 11.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* at 5, 6.

<sup>70</sup> State Farm, in its Reply Brief, *supra* note 23, at 11, quoted Patterson, *Some Contract Provisions of the California Insurance Code*, 32 S. CAL. L. REV. 227 (1959), which confirmed the general belief that the waters in this area are already somewhat muddied:

[T]here are some sections [the contract provisions of the Insurance Code] that are scarcely reconcilable with others in the same chapter. Even when they are not confusing or wrong many of them are at least useless deadwood in the Insurance Code.

Fortunately, the California courts have either ignored the obsolete or irrelevant provisions, or have piously construed the sections to mean what they ought to mean, so that it is not easy to demonstrate that any one of these sections has 'caused' a California court to give an unjust decision affecting the rights and duties of private persons.

<sup>71</sup> CAL. INS. CODE § 651 (West Supp. 1969-70) states: "Notwithstanding any other provisions of this code, no cancellation by an insurer of an auto liability insurance policy shall be effective prior to the mailing or delivery to the named insured at the

applied to rescission as well as to cancellation of automobile insurance policies and that the attempted rescission did not take effect until ten days after the insured had received notice of the rescission.<sup>72</sup> In an explanatory footnote, the court stated that the plaintiff's contention blurred "the clear statutory distinction between 'rescission' (retroactive termination) and 'cancellation' (prospective termination) of insurance policies."<sup>73</sup> The court concluded that Section 650 of the Insurance Code<sup>74</sup> is the general section governing the rescission of insurance policies and Section 651, which specifically refers to "cancellation", does not control the procedure for rescission.<sup>75</sup>

The *Barrera* opinion, following its footnote discussion of the inherent difference between rescission and cancellation, states that a failure of the insurer to reasonably investigate within a reasonable time, "results in the loss of the carrier's right to rescind, as opposed to its right to cancel, the policy."<sup>76</sup> The grounds available to the insurer for cancelling an automobile insurance policy were, however, severely limited in 1968 by the enactment of Insurance Code Section 661.<sup>77</sup> Section 661(a) states cancellation will be effective *only* if it is based on:

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address shown in the policy, of a written notice of the cancellation stating when, not less than ten (10) days after the date of such mailing or delivery, the date the cancellation shall become effective."

<sup>72</sup> 71 Cal. 2d —, —, 456 P.2d 674, 678, 79 Cal. Rptr. 106, 110 (1969).

<sup>73</sup> *Id.* at n.3. The court also explained that the reason CAL. INS. CODE § 651 (West Supp. 1969-70), which specifically refers to cancellation, had been incorporated into the "Rescission" chapter was that the Insurance Code did not contain a separate chapter on "Cancellation" when Section 651 was enacted.

<sup>74</sup> CAL. INS. CODE § 650 (West 1955) states: "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."

<sup>75</sup> 71 Cal. 2d —, —, 456 P.2d 674, 678, 79 Cal. Rptr. 106, 110 (1969).

<sup>76</sup> *Id.* at —, 456 P.2d at 689, 79 Cal. Rptr. at 121.

<sup>77</sup> CAL. INS. CODE § 660 (Ch. 1716, § 1, [1965] Cal. Stat. 3850 [repealed 1968]) stated: "The commissioner, by regulation, shall prescribe the grounds upon which an insurer may cancel a policy of automobile insurance. No insurer shall cancel a policy of automobile insurance except upon such ground or grounds as have been prescribed by the commissioner." The grounds for cancellation, referred to in § 660, are set forth in CAL. ADM. CODE title 10, § 2371 (1966). However, since § 2371 was based on §§ 660-64 of the Insurance Code, and since those Sections were repealed in 1968, the grounds set forth in § 2371 have been invalidated. Those grounds were: 1) risk unacceptable during initial underwriting period, 2) breach of contract or improper conduct by an insured (including obtaining insurance through a material misrepresentation), 3) an operator insured under the policy has been convicted or has forfeited bail for a significant violation or violations of law, 4) an operator insured under the policy presents an unusual hazard, and 5) an insured automobile or its use presents an unusual hazard.

Section 661 of the Insurance Code became operative on January 1, 1969 (Ch. 137, § 2, [1968] Cal. Stat. 352) and allows cancellation *only* if it is based on nonpayment of premium, or suspension or revocation of the named insured's drivers license or motor vehicle registration.



- (1) Nonpayment of premium; or
- (2) . . . suspension or revocation [of the named insured's driver's license or motor vehicle registration] during the policy period, or, if the policy is a renewal, during its policy period or the 180 days immediately preceding its effective date.

The provisions of Section 661(b) state that Section 661 does not apply "to any policy of coverage which has been in effect less than sixty days at the time notice of cancellation is mailed or delivered by the insurer unless it is a renewal policy."

Thus, when the insurer discovers a material misrepresentation, which does not involve the grounds set forth in Section 661(a), and more than sixty days have elapsed since the issuance of a policy, and the trier of fact concludes that the insurer was either unreasonable in conducting its investigation or failed to conduct it within a reasonable time, the insurer cannot rescind (because it has lost that right), and it cannot cancel until the end of the policy period because of the exclusive provisions of Section 661. Since the Insurance Code does not provide grounds for cancelling automobile insurance within sixty days after a policy has been issued, and because Section 661 does not place a limitation upon the right to cancel within that period, it appears that the insurer may cancel for any reason within sixty days from the issuance of the policy.

The impact of the foregoing dilemma is further exemplified by the situation where the insured has been involved in a series of accidents and the insurer attempts to rescind *ab initio* more than sixty days after a policy is issued. If the trier of fact concludes that the insurer was unreasonable in conducting its investigation or failed to conduct it within a reasonable time, the insurer has lost its right to rescind *ab initio*, but it still cannot cancel until the end of the policy period. Although the insurer has not lost its right to indemnification from the insured for the latter's misrepresentation, this right may be valueless when the insured is judgment proof. Moreover, as previously indicated, if the court distinguishes between a willful and an innocent misrepresentation before it allows the insurer to exercise its right to indemnification, the insurer may not be able to recover when the insured makes an innocent misrepresentation.

Possibly the most important problem *Barrera* raises for insurance companies occurs when a material misrepresentation is discovered more than sixty days after a policy is issued, the insurer feels that the trier of fact could conclude that it failed to conform to the duty imposed in *Barrera*, and an accident *has not occurred*. If, at that point, the insurer decides the insured is an unacceptable risk, how will it terminate coverage? Clearly, cancellation will not be allowed because misrepresentation is not a ground for cancellation as set forth in Section 661(a). Can the insurer rescind *ab initio*? *Barrera* holds that the insurer loses this right, when an accident has occurred, if it conducts either an unreasonable investigation or is dilatory in

its investigation. Arguably, the insurer is saddled with the risk until the policy period terminates. If the court imposes the *Barrera* duty which precludes rescission, unless substance is subordinated to form, a "rescission" that operates prospectively will conflict with the noncancellation provisions of Section 661. But should we not allow the insurer to rescind under these circumstances?

The reason for allowing rescission before the occurrence of an accident is more compelling. In *Barrera*, the insurer acted unreasonably in conducting its investigation; permitting it to rescind after the accident would have enabled it to escape making payment to the innocent third party who would have otherwise been uncompensated. When an accident has not occurred, the insurer should be allowed to rescind, since the reason for abrogating that right—the presence of an innocent accident victim who would otherwise be uncompensated—does not exist. It is readily observed that where these facts exist, the purpose of the Financial Responsibility Law is not fulfilled by abrogating the insurer's right to rescind. Actually, the implementation of the Financial Responsibility Law bears no logical connection to this situation.

A problem inherent in permitting rescission in this fact situation is that the ten day notice requirement of Section 651 is not applicable to rescission.<sup>78</sup> There is no reason why innocent third parties should be afforded less protection upon rescission (i.e., the ten day notice period) than upon cancellation.

When an accident occurs after rescission and the insured has not obtained new insurance, the rescission should still operate to shield the insurer from liability. This result should obtain even if the insurer neither conducted a reasonable investigation nor completed it within a reasonable time after the issuance of the policy because the innocent third party has been injured by the insured's intervening dilatory conduct. But because of the Financial Responsibility Law, it is not inconceivable that a court might stretch *Barrera* to compensate the innocent third party. Of course, the compulsion to compensate him diminishes as the time span, between notice from the insurer and a future accident increases, since the insured has had an increasingly greater opportunity to obtain other insurance.

Another problem is presented when the insurer discovers a material misrepresentation more than sixty days after the issuance of a policy, the trier of fact concludes that the insurer was unreasonable in conducting its investigation or did not conduct it within a reasonable time after the policy was issued, an accident has occurred, and the injured third party has been paid by the insurer. Here, Section 661 will not allow cancellation and it is inconsistent to rescind *ab initio* after the insurer has admitted liability and paid the accident victim. The court could also disallow rescission reasoning that the "rescission" is really prospective and therefore violative of Section 661.

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<sup>78</sup> See *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d —, 456 P.2d 674, 79 Cal. Rptr. 106 (1969); CAL. INS. CODE § 650 (West 1955); see also discussion at note 74 *supra*.

Again the dilemma appears. Is there any way for the insurer to rid itself of the unacceptable risk or can it terminate coverage only at the end of the policy period? Under these facts, the underlying reason for abrogating the insurer's right to rescind is, again, not present and the purpose of the Financial Responsibility Law has been met—the injured third party has been compensated.

If the insurer discovers a material misrepresentation more than sixty days after the issuance of a policy and the trier of fact concludes that the insurer was reasonable in conducting its investigation, the right to either rescind or cancel becomes important only when the insurer does not want to return the premiums. Under these facts, the insurer has not lost the right to rescind but the exclusive provisions of Section 661 do not allow it to cancel. Upon rescinding, therefore, the insurer would likely be required to return the premiums paid on the policy.

It should be recalled that where the insurer discovers a material misrepresentation less than sixty days after a policy is issued and the insurer has been reasonable in conducting its investigation and completed it within a reasonable time, the insurer will be allowed to rescind and it will also be allowed to cancel, since no provisions exist to restrict its right to cancel within sixty days after issuance of the policy. When a material misrepresentation is discovered less than sixty days after the issuance of a policy and the insurer has failed to conform to the *Barrera* duty, the insurer has lost its right to rescind but not to cancel.

The foregoing problems are not the only ones created by the enactment of Section 661. Section 661(b) states that Section 661 does not apply "to any policy . . . which has been in effect less than sixty days at the time notice of cancellation is mailed or delivered by the insurer *unless it is a renewal policy.*" (emphasis added.) The Legislature did not indicate whether a renewal policy is a policy purporting to guarantee the renewal of coverage or whether it is a policy in effect during the period subsequent to the original policy. If it is assumed that the Legislature meant the latter, which seems to be more reasonable, further questions arise. Section 661(b) lends itself to a myriad of interpretations. It is likely, however, that reasonable interpretations would be limited to four: 1) The insurer can cancel a renewal policy *only* within sixty days after its anniversary date, and even then, pursuant *only* to the grounds prescribed in Section 661(a). 2) Renewal policies are not within the purview of the section (this approach would nullify the operation of Section 661 on renewal policies). Between these extremes exist the possibilities that 3) renewal policies will be treated on a parity with new policies, or 4) that cancellation may be effected any time during the renewal period pursuant to the grounds prescribed in Section 661(a). In light of the examples drawn earlier, clearly, *Barrera* could further affect the insurer's rights—and hence the innocent third party's recovery—under any of these four interpretations. Clarity awaits judicial or legislative enunciation.

It appears that where the insurer undertakes a reasonable investigation within a reasonable time after the issuance of a policy, and an accident occurs before the investigation is completed, the insurer will be able to escape liability in an action by an innocent third party on the policy. The California Supreme Court held that the defense of rescission *ab initio* is abrogated *only* when the insurer breaches its duty to reasonably investigate an application within a reasonable time after the issuance of a policy. Although this casts an increased burden on automobile insurance companies, it is not yet "strict liability".

*Lyle R. Mink*