



## Reformation of an insurance policy

REFORMATION IS AN EQUITABLE REMEDY THAT IS AVAILABLE WHEN THE POLICY DOES NOT EXPRESS THE PARTIES' REAL AGREEMENT

A basic principle of insurance law is that a policyholder's failure to read the written contract is no excuse for expecting coverage for a claim that the policy excludes. Is this always true? Take the example of an insurer that makes certain representations about coverage in the insurance application, and which then issues a policy with more limited coverage than those promises would lead the insured to expect. In that case, the insured can ask the court to reform the policy to reflect the insurer's original representations of coverage. At the same time, the insured may be excused for failing to discover the change in terms by not reading the policy, because he

relied on the insurer's original representations.

Reformation of a contract is an equitable remedy. An insurance policy may be reformed "where, by reason of fraud, inequitable conduct or mutual mistake, the policy as written does not express the actual and real agreement of the parties." (*American Sur. Co. of N.Y. v. Heise* (1955) 136 Cal.App.2d 689, 695-696.) In California, reformation is governed by Civil Code section 3399, which provides:

When, through fraud or a mutual mistake of the parties, or a mistake of one party, which the other at the time knew or suspected, a written contract does not truly express the intention of the parties, it may be revised on the application of a

party aggrieved, so as to express that intention, so far as it can be done without prejudice to rights acquired by third persons, in good faith and for value.

### Pleading reformation

The elements of a cause of action for reformation of a contract are:

- The "real" agreement or other instrument intended by the parties but not executed;
- The form of the agreement or other instrument as actually reduced to writing; and
- The grounds for reformation: Fraud or mistake; i.e., the defect in the written form and how it came about. (Elements

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of Cause of Action, 5 Witkin, Cal. Proc. 5th Plead § 807 (2008).)

The statute of limitations for a cause of action for reformation based upon fraud or mistake is three years. (Civ. Code, § 338, subd. (d).)

A pleading of reformation fails to state a cause of action if, on its face, it shows “gross negligence” on the part of the plaintiff in failing to read the contract to be reformed. However, where fraud is pled as the ground for reformation, plaintiff’s failure to read the contract is not fatal to the complaint if plaintiff pleads reliance on defendant’s representations regarding the contract. (Effect of Plaintiff’s Negligence, 5 Witkin, Cal. Proc. 5th Plead § 817 (2008), citing *California Trust Co. v. Cohn* (1932) 214 Cal. 619, 626; *Johnson v. Sun Realty Co.* (1934) 138 Cal.App. 296, 301; *Abroms v. New York Life Ins. Co.* (1942) 53 Cal.App.2d 764, 771.)

### Reformation based on mistake

Actions for reformation against insurers typically involve a written policy that the insured alleges differs in a material way from the parties’ true intent and which negates coverage of a claim, as the following two cases illustrate.

In *American Employers’ Ins. Co. of Boston, Mass. v. Lindquist* (N.D. Cal. 1942) 43 F.Supp. 610, Lindquist, a trucking and hauling contractor, looked to replace an expiring public liability policy. His insurance broker placed an order with the plaintiff insurer for a replacement policy. The insurer added an exclusion for the use of explosives in the replacement policy without informing the insured. When the insured was later sued for causing an injury related to the use of explosives, the insurer rescinded the policy on the ground that the insured had not disclosed his work with explosives, in accordance with the newly inserted exclusion. The court found that insertion of this exclusion was contrary to the insured’s order for insurance, and was thus the insurer’s mistake; further, the insured was not asked for an application and made no misrepresentation regarding explosives. The insurer contended that

because the insured kept the policy with the new exclusion for a period of time before making a claim, the insured was estopped from denying the effect of the explosives exclusion.

The court held, “[W]here there is no fraud or misrepresentation and no written application and no inquiry into the particular subject, the failure of insured to discover a false statement inserted by the insurer in the policy is not a defense” (*Id.* at p. 615) – “another instance of an insurance company going to great lengths to get business and then attempting to read itself out of the loss” (*Id.* at p. 616). The court held that reformation was not necessary because the insurer waived, or was estopped from enforcing, the explosives exclusion when it slipped in the exclusion without informing the insured. (*Ibid.*)

In *Everett v. State Farm General Insurance Company* (2008) 162 Cal.App.4th 649, a homeowner first insured her home through State Farm in 1993 at “guaranteed replacement cost.” This obligated State Farm to “pay the full amount needed to repair the damaged or destroyed dwelling with like or equivalent construction, without regard to the policy limits.” (*Id.* at p. 652.)

In 1997, State Farm changed the policy by eliminating guaranteed replacement cost, and establishing a limit that it would pay for damage to the home. State Farm gave conspicuous notice of this change to the plaintiff, who accepted the policy under these new terms. (*Id.* at pp. 652-53.)

From 2000 to 2003, State Farm’s renewal certificate informed Everett that its replacement-cost estimate for her home was only an estimate, and may not be accurate – and that it was her responsibility to select an appropriate limit. If the insured selected a limit higher than State Farm’s estimated replacement cost, and supported the higher limit with an appraisal or contractor estimate, State Farm would consider and accept the higher limit, “if reasonable.” (*Id.* at p. 653.) In October 2003, plaintiff’s home burned down, and State Farm paid the policy limits for the structure and property. (*Ibid.*) Plaintiff sued for bad faith, fraud,

and reformation, among other claims, alleging that State Farm was obligated to pay the actual replacement cost of her home, without regard to the policy limit. The trial court granted State Farm’s motion for judgment on the pleadings as to the reformation claim, and summary adjudication with regard to all other claims. (*Id.* at pp. 654-55.)

Plaintiff appealed on the grounds that (1) State Farm failed to increase the policy limits on the code-upgrade coverage and (2) that “the policy, which promises to replace her home while stating a limit, is unclear.” (*Id.* at p. 655.) The court found that the State Farm policy clearly stated that it would pay the cost to replace the home only up to the stated limit, and that the policy was not unclear. (*Id.* at p. 658.) It further held that State Farm did not underpay for code upgrades; was not obligated to set policy limits that would equal replacement cost; and that its inflation coverage provision was not a promise to cover a loss at one hundred percent of the replacement cost. (*Id.* at pp. 663-64.) The Court of Appeal affirmed the judgment against the insured in its entirety, including the request for reformation, because it found no mistake or misrepresentation. (*Id.* at p. 664.)

The Court of Appeal has held that reformation based on mistake must be proved through “clear and convincing evidence.” (*Dictor v. David & Simon, Inc.* (2003) 106 Cal.App.4th 238, 253 citing Restatement (Second) of Contracts § 155 cmt. c (1981).)

### Reformation based on insurer’s fraud

The following two cases illustrate an insured’s request to reform an insurance policy based on an alleged intentional misrepresentation of the insurer.

*Laing v. Occidental Life Insurance Company of California* (1966) 244 Cal.App.2d 811 involved a group medical insurance policy covering the employees of a manufacturer. (*Id.* at 813.) The company had purchased a policy that covered the plant manager, Laing, in the event of a work injury. Prior to

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purchasing the policy, Occidental Life represented to the company that the plant manager would be covered for any work injury that was not covered under a workmen's compensation policy. At the time, Occidental Life was aware that the plant manager was not insured under the manufacturer's workmen's compensation policy. (*Id.* at 813-14.)

The written policy Occidental Life issued excluded coverage for "[a]ny bodily injury or sickness for which the [claimant] . . . had a right to compensation under any workmen's compensation . . . law." (*Id.* at 814, italics added.)

The court in *Laing* held that trial evidence supported the jury's finding that Occidental Life had promised coverage of a work injury that was not compensated under a workmen's compensation policy. "Having applied for this policy, on that express representation, Laing was entitled . . . to rely on the company's duty to provide a policy as applied for." Finally, the court excused Laing's failure to read the group medical policy because the written policy exclusion was not "obvious or patent." The court reformed the policy to conform to the insurer's representation at the application stage, thus affording coverage to Laing. (*Id.* at pp. 819-20.)

A cause of action for reformation of an insurance contract is likely to share the pleadings with several others. When reformation is grounded on the insurer's alleged misrepresentation – negligent or intentional – a separate cause of action for either negligent misrepresentation or fraud is appropriate.

In *R & B Auto Center, Inc. v. Farmers Group, Inc., et al.* (2006) 140 Cal.App.4th 327, plaintiff R&B, a used-car dealership, bought a liability policy from Farmers to defend and indemnify it in lemon-law suits brought by R&B customers. When R&B was sued, Farmers refused to defend or indemnify it because the Farmers policy covered only sales of *new cars*.

When applying for the Farmers liability policy, R&B had received assurances from Farmers representatives that it would cover lemon-law claims brought by R&B's *used-car* customers. R&B bought the policy, the face page of which

stated that R&B is in the business of selling used cars. (*Id.* at p. 335.)

R&B sued Farmers and its parent company for breach of contract, bad faith, misrepresentation, and reformation, among other claims. The trial court granted Farmers' motions for nonsuit, and R&B appealed from the judgments. (*Id.* at p. 332.)

Much of the Court of Appeal opinion treats the trial court's improper granting of nonsuit before the presentation of any evidence. (*Id.* at pp. 336-348.) The trial court had nonsuited the reformation cause of action, apparently because Farmers had tendered – after the lawsuit was filed – what it believed to be the plaintiff's damages resulting from its denial of defense and indemnity. (*Id.* at p. 348.) The Court of Appeal rejected the trial court's adoption of Farmers' theory, noting that the total amount of damages available to the insured under a reformation theory had not yet been presented. It held that R&B's evidence of misrepresentation regarding coverage of used-car lemon-law claims was not insufficient as a matter of law to support a finding in its favor on a reformation cause of action. (*Id.* at pp. 348-49.)

### Estoppel and waiver claims against the insurer

May a plaintiff plead that an insurer is estopped from denying coverage because it misrepresented terms of coverage before the plaintiff purchased the policy – or that the insurer has thereby waived that policy exclusion? The case law is murky on this point. Most authorities state that, "The rule is well established that the doctrines of implied waiver and of estoppel, based upon the conduct or action of the insurer, are not available to bring within the coverage of a policy risks not covered by its terms, or risks expressly excluded therefrom . . ." (*Aetna Casualty & Surety Co. v. Richmond* (1977) 76 Cal.App.3d 645, 653; see also *Miller v. Elite Ins. Co.* (1980) 100 Cal.App.3d 739, 755 [stating the same rule], and *Manneck v. Lawyers Title Ins. Corp.* (1994) 28 Cal.App.4th 1294, 1303 [stating the same rule].)

But *Fanucci v. Allstate Insurance Company* (N.D. Cal 2009) 638 F.Supp.2d 1125, calls the *Aetna*, *Miller* and *Manneck* cases into question. It cites the holding in *Granco v. Workmen's Compensation Appeals Board, et al.* (1968) 68 Cal.2d 191, 199 ["in some circumstances the acts of an insurer or its agent prior to an oral agreement will be sufficient to estop the insurer from denying coverage"]. *Fanucci* reads *Aetna* as having decided the insured's estoppel and waiver arguments on their merits, and therefore argues that the *Aetna* rule barring these claims is dicta. (*Id.* at p. 1144.) Further, *Fanucci* notes that *Aetna* relied on the American Jurisprudence treatise in formulating its rule, but that the treatise recites the following exception:

There are some cases that support the view, either expressly or by implication, that an insurer may waive or be estopped from asserting particular policy provisions even though the effect may be to bring within the coverage of the policy risks not covered by its terms, or expressly excluded therefrom. Specifically, promissory estoppel may create insurance coverage where to refuse to do so would sanction fraud or other injustice. Thus, for example, where an insurer or its agent misrepresents, even though innocently, the coverage of the insurance contract, or exclusions therefrom, to the insured before or at the inception of the contract, and the insured reasonably relies thereupon to his or her ultimate detriment, the insurer is estopped to deny coverage after a loss or a risk from a peril actually not covered by the terms of the policy. The fact that the insured has not read the insurance policy "word for word" is not, as a matter of law, an absolute bar to his or her theory of estoppel. (*Id.* at pp. 1144-45, citing 43 Am. Jur. 2d, Ins. § 481 & 44A Am. Jur. 2d, Ins. § 1548.) Moreover:

[A]n estoppel may be invoked where (1) the insurer has caused the insured's reasonable belief that the insurer was

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providing coverage, and (2) the insured has detrimentally relied thereon. [See *State Farm Fire & Cas. Co. v. Jioras* (1994) 24 CA4th 1619, 1627-1628, 29 CR2d 840, 845 (rejecting estoppel claim)]

(N. “Estoppel as Basis for Insurance Coverage,” California Practice Guide: Insurance Litigation Ch. 7A-N (The Rutter Group 2017) [discussing the Aetna rule disapproving a plaintiff’s estoppel and waiver claims].)

The *Fanucci* and *Granco* cases form at least a colorable basis for a plaintiff seeking reformation based on misrepresentation to also plead that the insurer is estopped from denying a claim based on an exclusion it misrepresented prior to the purchase of the policy, or that the insurer has by the same logic waived such exclusion. This alternative pleading of waiver and estoppel would support a claim for breach of the policy, as written, and for bad faith.

### Reformation and bad faith

Is a plaintiff who proves that an insurance contract should be reformed because of fraudulent representations by the insurer regarding coverage prior to the purchase of the policy eligible for bad-faith damages?

Generally speaking, ‘the reasonableness of the insurer’s decisions and actions must be evaluated as of the time that they were made.... [Citation.]’ [Citations.] When an insured submits a claim to an insurer and there is no potential for coverage of that claim under the policy, the insurer has no duty to defend and it may reasonably deny the claim. *Since it is reasonable to deny the claim at the time, if the policy is later reformed to provide retroactive coverage, the insurer may not be held liable for bad faith for failing to have the foresight to know that the policy would be reformed.* (*R & B Auto Center, Inc., supra*, 140 Cal.App.4th at p. 354 (italics added).)

I have found no other citable authorities that decided whether an insurer can be liable for bad faith on a reformed policy. But in its unpublished

decision in *Saddleback Inn, LLC v. Certain Underwriters at Lloyd’s London* (Cal. Ct. App., Mar. 30, 2017, No. G051121) 2017 WL 1180419, the same court that decided *R&B Auto* affirmed a bad-faith judgment entered against an insured on a reformed policy.

In *Saddleback*, the insurer erroneously changed the name of the named insured during the underwriting process, and no one caught the mistake. But when the insured property was destroyed in a fire, the insurer claimed that the named insured listed on the policy lacked an insurable interest in the property. Instead of paying the claim it rescinded the policy, and refunded the premium. The insured prevailed on the reformation claim in phase one of the trial, and in phase two, prevailed on a bad-faith claim. On appeal, the insurer argued that *R&B Auto* established a bright-line rule forbidding bad-faith claims based on reformed policies.

The court rejected this view, distinguishing *R&B Auto* as a case where the change in the policy resulting from the reformation increased the insurer’s risk. The court noted that the insurer in *Saddleback* was indifferent to the identity of the owner of the property, and that changing the name of the insured had no impact on the risk insured. While *Saddleback* cannot be cited in California, it can be cited in cases litigated in the federal courts.

The argument that prevailed in *Saddleback* was that the insurer’s refusal to pay the claim in that case based upon the misidentification of the named insured was simply a coverage defense, no different than a defense based on the application of a policy exclusion, or based on a claim that a condition stated in the policy was not satisfied. The implied covenant of good faith and fair dealing allows courts to examine the coverage defenses asserted by the insurer, and to hold the insurer liable for breaching the implied covenant when the defense it asserts is a reasonable one, given the circumstances of the case.

Hence, if an insurer knows the parties intended coverage and then adds an exclusion to the policy that is at odds with its representations to the insured,

and which later negates coverage of the insured’s claim, it is unlikely that the insurer can escape liability for bad faith merely because it technically complied with the policy as written.

### Alternative to reformation: Applying rules of policy interpretation

The courts reform insurance policies to bring them in line with the objectively reasonable expectations of the insured. But over time, the jurisprudence of the insurance relationship has developed many rules of policy interpretation. Courts apply these rules to decide whether to give effect to a policy provision. When a court rules, for example, that a particular provision fails to adequately put an insured on notice of an important coverage limitation, it effectively reforms the contract by invalidating the basis for denying coverage. A plaintiff who succeeds in this type of claim may also be eligible for bad-faith and punitive damages. Plead both reformation and breach of the contract as written, plus bad faith, to cover all possible bases for relief.

A good example of the application of these rules is the 2004 case, *Haynes v. Farmers Insurance Exchange* (2004) 32 Cal.4th 1198. *Haynes* involved the interpretation of language in an auto liability policy limiting coverage when a claim arose from an act of a “permissive driver.” The headnotes from the West report of this case illustrate the breadth of these rules of interpretation:

[1] Where material facts are not disputed, interpretation of an insurance policy presents solely a question of law.

[2] While insurance contracts have special features, they are still contracts to which ordinary rules of contractual interpretation apply.

[3] In interpreting an insurance policy, the Supreme Court seeks to discern the mutual intention of the parties and, where possible, to infer this intent from the terms of the policy. [Citation.]

[4] When interpreting an insurance policy provision, the Supreme Court gives the policy’s words their ordinary and

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popular sense except where they are used by the parties in a technical or other special sense.

[5] An insurer cannot escape its basic duty to insure by means of an exclusionary clause that is unclear; any exception to the performance of the basic underlying obligation must be so stated clearly to apprise the insured of its effect.

[6] Insurance coverage may be limited by a valid endorsement, and if a conflict exists between the main body of the policy and an endorsement, the endorsement prevails.

[7] To be enforceable, any insurance policy provision that takes away or limits coverage reasonably expected by an insured must be conspicuous, plain, and clear.

[8] Any limitation in coverage of insurance policy must be placed and printed so that it will attract the reader's attention.

[9] A provision limiting coverage in an insurance policy must be stated precisely and understandably, in words that are part of the working vocabulary of the average layperson.

[10] The burden of making coverage exceptions and limitations in an insurance policy conspicuous, plain, and clear rests with the insurer.

[13] California insurers may rely on endorsements to modify printed terms of a form policy.

[14] In evaluating conspicuousness of permissive user limitation in automobile liability policy, the Supreme Court would consider the limitation's actual placement in the actual physical policy that was presented to insureds.

[15] Insurance policy should be read as a layman would read it, and not as it might be analyzed by an attorney or an insurance expert.

[16] Mere receipt of an insurance policy endorsement does not serve to charge the insured with constructive knowledge of an exclusion the endorsement contains.

[17] Although an insured has a duty to read his policy, the duty to read is insufficient to bind a party to unusual or unfair language, unless it is brought to the attention of the party and explained.

[18] The rule presuming parties are familiar with contract terms should not be strictly applied to insurance policies.

[19] An insurer's direction to the subscriber to read the entire policy is not a substitute for notice to the subscriber of a loss of benefit.

[20] Rule that exclusionary language in an insurance policy must be plain and clear means more than the traditional requirement that contract terms be unambiguous; precision is not enough, and understandability is also required.

[21] An insurance policy exclusion is subjected to the closest possible scrutiny.

[22] The Supreme Court does not rewrite any provision of any contract, including the standard insurance policy underlying any individual policy, for any purpose.

[24] It is not the Supreme Court's role to speculate on an insurance policyholder's abstract expectations, but rather to consider reasonable expectations defined by the insurer's policy language. (*Id.* at pp. 1198-1200 [West Headnotes; headnote headings, and certain headnotes in their entirety, omitted].)

Headnote 22, above, is interesting: In its opinion, the Supreme Court stated that it never "rewrites" the language of insurance policies:

We do not . . . suggest that Farmers necessarily must correct all of the identified deficiencies in order to

render a permissive user limitation enforceable in future cases. Nor have we the expertise to dictate the precise wording or placement of such a limitation an insurer must adopt in order to satisfy the established legal standard. Indeed, 'we do not rewrite any provision of any contract, including the standard policy underlying any individual policy, for any purpose.' [Citations.] There may be a number of ways for Farmers to correct the problem.

(*Haynes, supra*, 32 Cal.4th at p. 1213 & fn. 9.)

There may be a fine distinction between rewriting and reforming an insurance contract.

## Conclusion

Reformation, in combination with causes of action such as negligent misrepresentation, fraud, breach of contract and bad faith, may yield appropriate remedies for the policyholder whose claim is denied as the result of mistake or fraud in the drafting of the policy.

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