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S161008

IN THE

Supreme Court

OF THE STATE OF CALIFORNIA

VILLAGE NORTHRIDGE HOMEOWNERS ASSOCIATION,

Plaintiff and Appellant,

vs.

STATE FARM FIRE & CASUALTY COMPANY,

Defendant and Respondent.

ANSWER BRIEF ON THE MERITS

REVIEW AFTER A DECISION BY THE COURT OF APPEAL
SECOND APPELLATE DISTRICT, DIVISION EIGHT
[2d Civil No. B188718]
[L.A.S.C. No. BC265328]

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1. ISSUE PRESENTED

Can a policyholder whose insurer fraudulently misrepresents its policy limits to induce a settlement and release of a first party insurance claim elect the remedy of affirming the Release Agreement and suing for monetary damages resulting from the fraud? Stated otherwise, does the plaintiff have an election of remedies or is he relegated to the remedy of rescission?

2. INTRODUCTION

In this case, State Farm Fire & Casualty Company ("State Farm") misrepresented its policy limits to its insured, Village Northridge Homeowners Association ("Village Northridge"), during the course of handling and negotiating the settlement of a significant Northridge earthquake damage claim. The insured learned after signing a release agreement that its damages drastically exceeded the amount of the settlement and sought additional compensation. State Farm represented the limits to be $4.9 million during the course of the claim when in fact the limits were $11.9 million. [*APP 0284: 3-10, 0295:15-20*]

Village Northridge seeks to affirm the Release Agreement and sue for damages sustained as a result of State Farm's fraudulent misrepresentation of the policy limits which induced Village Northridge to enter into the agreement. State Farm asserts the Release as a complete bar to further liability under the

contract or otherwise. It is State Farm's position that the only remedy available to Village Northridge is rescission and that since Village Northridge has "affirmed" the settlement agreement and disavowed any intention to rescind, Village Northridge has no remedy.

State Farm's assessment of this case is based on this Court's holding in *Garcia v. California Truck Company* (1920) 183 Cal. 767. In *Garcia*, this Court held that a party seeking to avoid a settlement agreement on grounds of fraud must rescind the agreement and return the consideration paid "where the claim is for unliquidated damages or when the settlement is made to adjust a matter in dispute, or where there is a controversy as to the amount owing." *Id.* at 772. This Court further held in *Garcia* that there is a well-recognized exception to this rule – not applicable to the facts of the *Garcia* case – which provides that "one who attempts to rescind a transaction on the ground of fraud is not required to restore that which in any event he would be entitled to retain either by virtue of the contract to be set aside, or of the original liability". *Id.* at 771; quoting *Kley v. Healy* (1891) 127 N.Y. 555, 561, italics omitted. This latter rule is applied to situations where there is no dispute over the settling party's entitlement to the consideration. *See, e.g., Persson v. Smart Inventions* (2005) 125 Cal.App.4th 1141, 1154-1156.

According to State Farm, this case is exactly like *Garcia* in that there was a "controversy as to the amount owing". Village Northridge maintains its position that this case is more like *Persson* in that Village Northridge gave up more than just the right to sue when it signed the Release. Upon a closer look, as recognized by the Court of Appeal, one can see that the instant case <u>does not</u> squarely fit either principle. The Court of Appeal addressed this "incongruity":

> "Because of the underlying insurance obligation, the circumstance is not unlike both (1) cases in which a settlement agreement and the mutual releases in it are considered separable, thus permitting the plaintiff to sue for fraud despite the release (*Persson* at 1154), or (2) cases, as described in *Garcia*, applying the 'well-recognized rule' that one who rescinds a contract for fraud 'is not required to restore that which in any event he would be entitled to retain'. (*Garcia* at 771). While neither principle fits perfectly, either is more appropriately applied to a case in which an insurer has misrepresented policy limits to obtain a settlement than is a principle that requires the return of the insurance settlement monies as the price of a challenge to the insurer's fraud." [Typed Opn. at p. 7]

When Village Northridge signed the Release, the consideration it received from State Farm was not only in exchange for an agreement not to sue but also in exchange for the agreement not to pursue very certain and available policy benefits. Although the "amount owing is in dispute" (as was the case in *Garcia*), Village Northridge gave up much more than the right to sue in exchange for the consideration paid by State Farm (as was the case in *Persson*). The unique facts of this case coupled with the statutory duty to disclose policy benefits at the outset of the claim [Cal. *Code of Regs* §2695.4(a)] and the quasi-fiduciary relationship between the parties [*Love v. Fire Ins. Exchange* (1990) Cal.App.3d 1136, 1147] make this an important case of first impression.

Village Northridge agrees with State Farm that the Court of Appeal overemphasized the importance of *Garcia* and *Taylor* as having to do with personal injury claims. Village Northridge also agrees with State Farm that there is nothing inherently distinctive about a personal injury claim which warrants disparate treatment in the eyes of the law. Unlike personal injury claims, however, there *is* something special – as a matter of law – about the first-party insurer-insured relationship which warrants distinction of this type of case from all others having to do with the fraudulent inducement of a settlement agreement. If any type of case should be singled out as exceptional

in the eyes of the law it is first-party insurance case and there is no better scenario than the case at bar to illustrate why a defrauded insured should be afforded a practical remedy which will discourage fraud in the settlement of insurance claims.

Village Northridge appreciates that confusion may result from the Court of Appeal's opinion as a result of the statement that *Garcia* and *Taylor* "only apply to the release of personal injury claims". [Typed Opn. at p. 2] While Village Northridge agrees with the Court of Appeal that *Garcia* and *Taylor* do not apply to *this* case (nor to other similar first-party insurance cases), it does not see a reason for limiting the applicability of these cases to personal injury claims to the exclusion of all other types of legal disputes. Village Northridge agrees with State Farm that the distinction of personal injury claims as unique is artificial and that in creating this artificial distinction the Court of Appeal created confusion as to whether *Garcia* and *Taylor* apply to any dispute other than one involving a personal injury claim. Village Northridge respectfully submits that while the text of the Court of Appeal's opinion may need clarification, the end result was entirely appropriate given the facts of the case. If this Court finds that the Court of Appeal's opinion would creates dangerous precedent, Village Northridge respectfully submits that depublication would be the most appropriate method of limiting the impact of this decision. State

Farm should not be permitted to exempt itself from liability for its own fraudulent acts by way of a settlement agreement and release. *See* Cal. *Civ. Code* §1668. The Court of Appeal's decision reversing the trial court's order sustaining the demurrer as to the cause of action for fraud should be affirmed.

3. STATEMENT OF FACTS AND PROCEDURAL HISTORY

A. The Earthquake and Insurance Claims

Village Northridge operates a multi-unit residential property in Northridge. [*APP 0295:5-7*] The property sustained extensive damage as the result of the Northridge earthquake on January 17, 1994. [*APP 0295:9-10; 0300:10-14; 291*] State Farm insured Village Northridge's property for earthquake damage. [*APP 0295:12-13*]

The insureds filed a claim on January 22, 1994. [*APP 0295:21-22*] Eighteen months later, State Farm paid $2,060,591.97 on the claim deducting $497,490 for deductible, per State Farm's version of events. [*APP 0295:15-18*] In April of 1996, Village Northridge contacted State Farm to reopen the claim to inspect and address damage to an additional unit. State Farm inspected, found additional damage and paid an additional $7,466.34. [*0296:1-6*] In 1998, Village Northridge found additional damage and sought additional benefits. [*APP 0296:16-18*] State Farm again inspected and confirmed that additional damage was presented but disagreed as to the extent

claimed by Village Northridge. [*APP 0296:19-21*] State Farm paid another $1.5 million to Village Northridge in exchange for a written release, drafted by State Farm. [*APP 0296:23-28; 0297:1-4; 0283:17-23*] At all times throughout the claim, State Farm had represented that the policy limits were $4,974,900 and that a 10% deductible applied. [*APP 0295:15-18; 0040:15-17; 0299:27-28*]

B. The Original Complaint, Motion for Summary Judgment and First Appeal

On December 28, 2001, Village Northridge filed a lawsuit against State Farm for Breach of Contract and Breach of the Covenant of Good Faith and Fair Dealing. [*APP 0001*] On August 28, 2003, State Farm filed a Motion for Summary Judgment wherein it argued that the Release Agreement barred Village Northridge's lawsuit. [*APP 0040*] Soon thereafter, a Declarations Page evidencing policy limits in the amount of $11,905,500 was retrieved from Village Northridge's property manager and viewed for the first time. [*APP 0284*] Village Northridge submitted a copy of this Declarations page in support of its Opposition to State Farm's Motion for Summary Judgment, which was unrefuted by any evidence in State Farm's Reply. [*APP 0295:15-20; 0286-0289*] The discrepancy in limits was factually unresolved at the summary judgment hearing. [*APP 0377:22-28; 0378:1-10; 0380:12-22; 0381:25-28; 0382:1-11; 0383:11-28; 0384:1-6; 0385:3-11 (Oral Argument-*

Reporter's Transcript)] The trial court found no question of fact regarding whether the Release Agreement was a product of undue influence or fraud and granted State Farm's Motion for Summary Judgment. [*APP 0401*] The Court of Appeals reversed the trial court's ruling and remanded the case. [*APP 0550*] State Farm's failure to document its own version of the policy limits was noted by the Court of Appeal and referenced metaphorically as "the elephant in the room". [*APP 0549 at footnote 8*]

C. Motions for Judgment on the Pleadings, Demurrers and Second Appeal

After the case was remanded to the trial court, State Farm filed a Motion for Judgment on the Pleadings wherein it argued that the case should be dismissed because (1) the Release Agreement barred Village Northridge's causes of action for Breach of Contract and Breach of the Covenant of Good Faith and Fair Dealing and (2) Village Northridge had not pled Rescission or Fraud in its Complaint. The Court granted State Farm's motion with 20 days leave to amend. [*APP 0571, 0580:10-11*] In its ruling on this matter, the trial court stated that "plaintiffs need to either rescind the agreement or affirm the agreement and sue for damages". [*APP 0956*]

On August 29, 2005, Village Northridge filed its First Amended Complaint which affirmed the Release Agreement and included a cause of action for fraud. [*APP 0968*] On September 19, 2005, State Farm demurred

to Village Northridge's First Amended Complaint on the grounds that (1) the contract claims were barred by the Release Agreement unless Village Northridge were to rescind the Release Agreement and return the settlement money to State Farm, and (2) that the fraud claim was barred (a) because there was no actionable fraud, (b) because fraud was not pled with particularity, (c) due to the applicable statute of limitations, and (d) because a "material" misrepresentation was not alleged. [*APP 1028*] The Court sustained State Farm's demurrer with 20 days leave to amend. [*APP 1248*] At the hearing, the trial court stated that "One remedy for fraud ... is to rescind the agreement. The other, I guess, would be to affirm the agreement and get any damages that might arise out of that."[*APP 1252*] (emphasis added).

On November 4, 2005, Village Northridge filed its Second Amended Complaint. [*APP 1260*] On November 18, 2005, State Farm demurred to Village Northridge's Second Amended Complaint on familiar grounds: (1) that the contract claims were barred by the Release Agreement unless Village Northridge were to rescind the Release Agreement and return the settlement money to State Farm, and (2) that the fraud claim was barred (a) because there was no actionable fraud, (b) because fraud was not pled with particularity, (c) due to the applicable statute of limitations, and (d) because a "material" misrepresentation was not alleged. [*APP 1320*]

In its Opposition to State Farm's second demurrer, Village Northridge agreed with State Farm that the content of the Complaint was effectively unchanged and suggested that election of remedies was the issue which needed to be addressed by the Court. [*APP 1561, 1572, 1573*] Village Northridge discussed that in order to prevent double recovery that it would need to elect a remedy at some point and informed the Court that if it were inclined to require an election of remedies at that point in time, Plaintiff would elect fraud over breach of contract. [*APP 1572, 1573*]

In its December 20, 2005 ruling on this matter, the court stated that "Plaintiff chooses to affirm the settlement agreement, keep the settlement money paid by State Farm for a release of all claims, but chose [*sic*] not to release the claims. They can't have it both ways." [*APP 1967*] The trial court sustained State Farm's demurrer without leave to amend. [*APP 1967*]

The Court of Appeal reversed the trial court's judgment and remanded the case with directions to vacate its order sustaining State Farm's demurrer and to enter a new order sustaining the demurrer as to the causes of action for breach of contract and breach of the implied covenant of good faith and fair dealing and overruling the demurrer as to the cause of action for fraud. The Court of Appeal noted that the effect of its holding is "that a plaintiff could settle a disputed insurance claim, keep the money paid, and then sue for fraud

(rather than on the released claim) if it was fraudulently induced to settle the claim by a misrepresentation of policy limits". [Typed Opn. at p. 10] Recognizing the unlikelihood of insureds who have settled their claims thereafter asserting groundless claims of misrepresentation, the Court of Appeal indicated that the way to avoid the consequences of applying the principle of this case is to "avoid misrepresenting policy limits when it settles claims". [Typed Opn. at p. 10] Village Northridge submits that the floodgate arguments asserted by State Farm and friends are contrived and exaggerated.

D. State Farm's Continuing Misrepresentations Regarding the Policy Limits

Subsequent to the retrieval of a Declarations Page evidencing policy limits in the amount of $11,905,500, Village Northridge engaged in numerous discovery efforts to seek a Certified Copy of the subject policy from State Farm. The only policy ever produced was a specimen policy, noticeably lacking a Declarations page. [*APP 0243:5-28; 0244:1*] To date, fourteen years since the earthquake which caused the subject damage, nearly seven years since the original complaint was filed and over three years since its failure to produce evidence of its version of the policy limits was pointed out by the Court of Appeal, State Farm has refused to provide Village Northridge with a Certified Copy of the subject policy. [*APP 1839:1-6 and 15-28; 1840:1-9*] Instead, State Farm offers hearsay declarations from claim

personnel [*APP 0153*] and attorney argument [State Farm's Opening Brief at p. 56-57] seeking to refute the written terms of the contract as delineated on the Declarations page submitted by the plaintiffs. [*APP 0287*]. This parole evidence is not admissible and is also prohibited under the terms and conditions of the policy which includes an "integration clause" which categorically precludes deviation from the terms of the contract as stated therein. [*APP 0191, under Section I & Section II Common Conditions; Condition No. 2: "Changes"*] It is noteworthy that State Farm is a proponent of the integration clause when it can used to its own advantage (*see Everett v. State Farm* (Cal. App. 4 Dist. 2008) 75 Cal.Rptr.3d 812; Typed Opn. at p. 19) yet State Farm continues to argue that in *this* case that the policy limits are determined by some other non-policy document in State Farm's records but that its attorneys will not produce.

4. BECAUSE THE RELEASE WAS NOT THE SOLE OBJECT OF THE SETTLEMENT AGREEMENT, *GARCIA* IS NOT CONTROLLING AND VILLAGE NORTHRIDGE IS ENTITLED TO AN ELECTION OF REMEDIES.

One of the many frustrating components of this case is that the trial court categorically recognized the plaintiff's right to "affirm and sue" in its own minute orders. [APP 0956, 1248] After the Court of Appeal remanded and unequivocally ruled that a viable case was presented, undaunted, the trial

court granted a Motion for Judgment on the Pleadings holding that: "Plaintiffs need to either rescind the agreement or affirm the agreement and sue for damages." And so they did. Village Northridge filed a First Amended Complaint which categorically "affirmed the agreement" [¶26; APP 0974:21-28, 0975:1] and added a cause of action for fraud [APP 0979]. State Farm then filed a Demurrer arguing, in effect, that no election of remedies was afforded and that rescission was the exclusive remedy under the circumstances presented. [APP 1025:8-15, 1034:16-24] State Farm's argument is that this case is identical to *Garcia v. California Truck Co., supra*, a case in which this Court held that a party with an unliquidated tort claim who desires to avoid the terms of a release in a settlement agreement based on fraud must rescind and return the consideration, placing the parties in the position they were in before entering into the agreement. The two cases are hardly analogous and State Farm overlooks the recent case of *Persson v. Smart Inventions, supra*, a case wherein the 2nd District applied a different rule permitting the defrauded party to affirm and sue for damages because the plaintiff had an "independent right" to the consideration received. ("There was no dispute about Persson's entitlement to the consideration he received under the stock redemption agreement in return for tendering his shares. The only question was whether he was entitled to receive more." *Persson, supra,* 125 Cal.App.4th at 1155.)

Rescission is simply not the exclusive remedy afforded in all cases.

As stated above, the trial court's own minute order recognized the election of remedies presented:

> "Plaintiffs need to *either* rescind the settlement agreement *or* affirm the settlement agreement and release." [*APP 0956*]

The plaintiff *did* affirm the settlement agreement and release, just as the court specified in Minute Order number one. But this time the trial court added a new twist:

> "Here, the release was the purpose of the settlement agreement and they are all part of the same agreement (*see Garcia v. Ca Truck Co.* (1920) 183 C.767)." [*APP 1248*]

Putting aside the question of what was even meant in this statement, the inescapable fact is that the trial court had acknowledged "affirm and sue" as a viable remedy. [*APP 0956, 1248, 1252*] Of course the release was the purpose of the settlement agreement – at least from State Farm's perspective. What this ruling fails to acknowledge is that the release was not the *sole* object of the settlement agreement; it also resolved State Farm's liability for its underlying contractual obligation. As the Court of Appeal noted, State Farm was not simply "buying peace". [Typed Opn. at p. 11]

Village Northridge filed a Second Amended Complaint which admittedly added nothing to the substantive equation. The error at issue is equally present in both the rulings on the First and Second Demurrers. The trial court ruled as follows on the Demurrer to the Second Amended Complaint:

> "Plaintiff chooses to affirm the settlement agreement, keep the settlement money paid by State Farm for a release of all claims, but choose [*sic*] not to release the claims. They can't have it both ways." [*APP 1967*]

Preliminarily, Village Northridge respectfully submits that the phraseology of this ruling simply makes no sense on its face. Secondarily, it is inconsistent with the trial court's own prior rulings wherein it categorically stated that the plaintiffs need to "either rescind or affirm and sue for damages". [*APP 0956, 1248, 1252*] Village Northridge did precisely what the court specified would remedy the situation and afterward the trial court seemed offended by the fact that the plaintiff had not returned the consideration to State Farm. But the plaintiff has no obligation to do so unless the plaintiff elects the remedy of rescission! The plaintiff categorically stated in each of its amended complaints that rescission was not being sought. [*APP 0974:25-28, 0975:1, 1267:2-6*] As such, the trial court's ruling is erroneous on its face as a matter of law.

Village Northridge submits that the facts of this case do not fit squarely within either *Garcia* or *Persson*; this may shed some light as to why the trial court made such inconsistent rulings. Though the trial court initially recognized Village Northridge's right to affirm and sue, it subsequently denounced such a right in its final ruling. In sustaining State Farm's demurrer, the trial court erroneously categorized this case as identical to *Garcia* when it clearly is not. Although the "amount owing is in dispute" (as was the case in *Garcia*), Village Northridge gave up much more than the right to sue in exchange for the consideration paid by State Farm (as was the case in *Persson*). Inasmuch as the release was not the sole object of the settlement agreement, Village Northridge had a right to affirm and sue and had no obligation to return the consideration to pursue its cause of action for fraud. In fact, as discussed below, there is authority for retention of consideration even in rescission cases under certain circumstances. The remedy of rescission is equitable in nature and when equity dictates that return of consideration is inappropriate or impractical – as is clearly the case here – return of consideration is not required. *Persson v. Smart Inventions* (2005) 125 Cal.App.4th 1141, 1155; citing *Sime v. Malouf* (1949) 95 Cal.App.2d 82, 112. The Court of Appeal got it right when it held "Certainly State Farm's purpose was to obtain a release from any further earthquake damage claims by the

Association, but that was not the 'sole object of the settlement agreement,' which simultaneously resolved State Farm's liability for its underlying contractual obligation." (Typed Opn. at p. 11)

5. STATE FARM'S POSITION THAT RESCISSION IS THE EXCLUSIVE REMEDY IN THIS SITUATION REPRESENTS THE MINORITY VIEW IN A SPLIT OF AUTHORITY.

This case presents an important issue of first impression – whether a policyholder whose insurer misrepresents policy limits to induce a settlement and release of a first party claim can sue for damages. Although it is Village Northridge's position that *Garcia* is not controlling since the release was not the sole object of the settlement agreement, an analysis of out of state forums is necessary in order to competently assess this issue.

There are important recent decisions in the Ninth Circuit and in other influential out of state decisions which shed light on the importance of this issue and the misguided nature of the minority view that State Farm urges.[1]

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[1] Rather than focusing on the merits of the majority rule, State Farm proceeds to split hairs by literally counting number the states which follow this rule and arguing that it is not a "majority" because twelve rather than sixteen states follow it. [Opening Brief @ 37] Regardless of whether the numerical majority is determined by the counting of states, the fact is that the authors of all these appellate opinions categorically refer to the New York rule as the majority rule. Either way, the label is not the point, the better rule should predominate and carry the day.

Virtually all of the cases involve a straightforward attempt to avoid a release by *third* parties – usually in personal injury cases. Here, we have a first party case by an insured against its own insurer. The gravity of the misrepresentation cannot be emphasized enough and the Court of Appeal recognized the same in its first decision in this case. See footnote 5 of the decision. [*APP 0542*] Important public policies are at stake in this case – the public policy favoring settlement, *Bush v. Superior Court* (1992) 10 Cal.App.4th 1374, 1382, 1385, and the legal recognition that an insurer is a quasi-fiduciary with heightened duties to its own insureds, *Love v. Fire Ins. Exchange, supra,* 221 Cal.App.3d at 1147. The majority view permitting a cause of action for fraud is overwhelmingly appropriate in the context of a policyholder that is deceived by its own insurer regarding policy limits. The minority view requires rescission and is the relic of ancient cases with weak facts – primarily disgruntled personal injury plaintiffs who seek to avoid releases on the simple basis that they felt they did not get enough money in their settlement. Much more is at stake here and the authorities State Farm relies upon are questionable at best. Village Northridge will begin its analysis with the minority view as this was the basis of State Farm's argument in the trial court. This presents the issue in chronological fashion and reveals the clear trend of modern cases following the majority view.

A. The Minority View – Rescission As Exclusive Remedy to Fraudulently Induced Release – Should be Rejected in California.

State Farm hangs its hat on *Garcia v. California Truck Co.* (1920) 183 Cal. 767. *Garcia* is an eighty-seven year old case[2], has been criticized by recent cases in and out of California and involves weak and non-analogous facts. Another case briefly mentioned in State Farm's underlying papers and which is of the same genre is *Taylor v. Hopper* (1929) 207 Cal.102. Both of these cases required rescission in order to avoid the binding effect of a release signed by the plaintiff.

Garcia v. California Truck Company
(1920) 183 Cal. 767

In *Garcia*, a personal injury plaintiff (pedestrian) who had settled and released his claim with the at fault trucking company sought additional compensation for his injuries by alleging that the release was "fraudulently induced" based on the argument that the trucking company had undervalued the plaintiff's damages – obviously, a weak factual scenario for the alleged fraud. The court understandably held that the release would be honored based on the merits of that particular case. "The evidence is overwhelming as to the

[2] Ironically, State Farm has criticized plaintiff's position as being based on "World War II" case law. [*APP 1648:26*] To the contrary, State Farm's position is based on *Garcia* and *Taylor*, both 1920's cases, each which have been severely criticized in recent decisions of the majority view.

fairness of the dealings of defendant with plaintiff in the matter of settlement..." *Garcia, supra*, 183 Cal. at 774. "Where the claim is for unliquidated damages or when the settlement is made to adjust a matter in dispute, or where there is a controversy as to the amount owing, and the parties agree upon a sum that shall be paid in settlement, the amount so paid must be returned if the party settled with seeks to avoid the settlement on the ground of fraud." *Id.* at 772. The *Garcia* plaintiff clearly sought to resurrect and sue upon *the original claim*. As will be discussed below, this is distinguishable from the instant affirm and sue scenario.

Shepard's research reveals negative commentary on the *Garcia* case in California[3] and in the vast majority of other jurisdictions, and for good reason. Of great significance is *Persson v. Smart Inventions, supra*, which seriously undermines the impact of *Garcia* on this case.[4] In its demurrers, State Farm framed the issue as *Garcia* -vs- *Persson*. [*APP 1038; 1331*] The tenuous and unliquidated personal injury claim in the 1920 *Garcia* decision cannot be fairly analogized to the first party contract claim of Village Northridge. There was no privity nor any duty between Garcia and the truck that accidentally crossed

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[3] *See, e.g., McKenzie v. Los Angeles Life Ins. Co.* (1929) 97 Cal.App. 659; *Montes v. Peck* (1931) 112 Cal.App. 333; *Persson v. Smart Inventions, Inc., supra,* 125 Cal.App.4th 1141.

[4] Review by the Supreme Court was denied. *Persson v. Smart Inventions* (2005) 2005 Cal. LEXIS 4328.

his path by happenstance. Village Northridge and State Farm, on the other hand, had a special business relationship in the eyes of the law and which was wholly independent of the Release Agreement. Their contract had very certain benefits and limitations – the extent of which were misrepresented by State Farm during the course of the claim. Moreover, a quasi-fiduciary relationship existed as a matter of law. *Love v. Fire Ins. Exchange, supra,* 221 Cal.App.3d at 1147. *Garcia* needs to be viewed with great caution given these distinctions.

The point illustrated by *Persson* is that State Farm's rigid interpretation of *Garcia* is not necessarily the law in every case, depending on the circumstances and the attendant equities:

> "California law is not so short-sighted. The general rules relied upon do not apply to all circumstances. More importantly, there is no support for, and we reject out of hand, the notion that the court has no equitable power to set aside a provision of a contract procured by fraud. Courts have long had the authority to set aside unconscionable or illegal contractual provisions, for example, while enforcing the remainder of a contract. (cites) We fail to discern any reason why the court would not have the same authority when a contract has been procured by fraud."

Persson, supra, 125 Cal.App.4th at 1153.

State Farm argues that *Persson* is distinguishable because in that case the Release was an "incidental" component of the Settlement Agreement whereas here the Release was the "only" purpose of the agreement. The Court of Appeal appropriately dismissed this argument as erroneous. [Typed Opn. at p. 11] State Farm undoubtedly desired a Release – as would any party who was perpetrating a fraud (precisely what transpired in *Persson*). Here, State Farm had a potential contractual liability exposure in excess of $10 million after the deductible. State Farm cajoled its insured into believing that there was only $4.5 million in contractual benefits at stake and had a tiger by the tail. All that was needed was a Release to keep that tiger in the cage. The fact is that Village Northridge had a potential right to those limits and, absent the settlement and release, State Farm was going to have to do something to address that potential and very significant liability. State Farm dismisses Village Northridge's significant claim on the policy as non-existent or "unliquidated". While State Farm might do what it will to dispute the extent of the ultimate liability, the fact of the matter is that the contract was finite and there was over ten million dollars of very certain policy benefits available of which Village Northridge was fraudulently deprived.

Plaintiff maintains that this constitutes an "independent basis" for liability as discussed in *Persson.* Where a releasing party such as Village Northridge had an independent basis for entitlement to the consideration it received then that consideration does not need to be restored in order to avoid the release in a subsequent lawsuit:

> "Rescission and restoration are required only under equitable principals and to prevent the taking of unfair advantage. Restoration is not required unless the ends of justice require it." *Persson, supra*, 125 Cal.App.4th at 1155, citing *Sime v. Malouf*, *supra,* 95 Cal.App.2d at 112.

This needs to be recognized and appreciated. State Farm is up in arms about the $1.5 million it paid on the claim and, in State Farm's view, pursuant to the Release. Let us not forget that Village Northridge had an insurance policy that covered this extensive loss all along and the only thing State Farm paid for was a grossly discounted version of that which it was potentially obligated to pay under the underlying contract. State Farm misrepresented its policy limits thus defrauding Village Northridge of millions in further benefits owed. The bottom line is that *Garcia* is unsound in other contexts and has been criticized by many subsequent cases. More on this below in discussion of the majority view.

Taylor v. Hopper
(1929) 207 Cal. 102

The *Taylor* case was briefly mentioned in State Farm's underlying papers and forms the basis of State Farm's position as *Taylor* and *Garcia* stand for the same principle. *Taylor* involved another auto-personal injury plaintiff who settled, released, dismissed with prejudice and subsequently filed a second lawsuit for the same damages, alleging she was fraudulently induced by the defendant's insurer via understatement of the nature and extent of her damages. The *Taylor* court held that under these circumstances it was necessary for the plaintiff to promptly rescind the settlement agreement and to restore the consideration that was received thereunder before an action can be brought *on the original cause of action*. *Taylor, supra*, 207 Cal. at 991, citing *Garcia*. The case is similarly distinguishable and involves less than compelling facts.

Davis v. N.E. Hargett
(1956) 244 N.C. 157

Herein lies a case which is the poster child for *not* adopting the minority view. In *Davis*, the plaintiff was injured as a passenger in a taxi -vs- taxi auto collision. The same insurer covered both taxis. The at fault taxi driver, under the pretense of friendship and condolence, set out on a scheme to deceive and defraud the injured plaintiff on behalf of the insurer of the taxi company. The

facts in this case are simply outrageous. The plaintiff was removed from the hospital by the at fault driver and placed into sub-human conditions with the initial promise of health care being provided at the new location by the parties responsible for the accident and loss. The claim was then compromised for $5,000 which was the amount of coverage on only one of the taxis. The plaintiff was not informed that the other taxi had an additional and independent limit of $5,000 from the very same insurer. The claim was worth $35,000. The settlement proceeds were delivered by the insurer to the at fault driver in the manner of a trustee who in turn doled out de minimis benefits to the plaintiff while he was in grave health. The plaintiff's health seriously declined and he ultimately sustained a leg amputation.

The plaintiff filed suit and attempted to elect the remedy of affirming the settlement and suing for damages. Plaintiff did not seek to prosecute his automobile/personal injury action against the at fault drivers but instead sued the insurer and the at fault driver, jointly and severally, for the fraudulent inducement. The plaintiff outlined his election options as follows: (1) to rescind the compromise settlement and prosecute the original cause of action, or (2) to affirm the compromise settlement and recover damages from the defendants for the true worth of his original cause of action. *Davis*, 244 N.C. at162. This is how the majority view frames the election of remedies. The

Davis court, however, rejected the election and held that to permit the affirm and sue option would be to permit recovery, indirectly, on the original cause of action against parties who were not involved therein (the insurer who orchestrated the fraud). *Id.* at163. What a horrendous and unjust result. Village Northridge hopes that it is obvious that this reasoning would never carry the day in California jurisprudence. The case has been severely criticized and rejected by recent, well reasoned decisions.[5]

Shallengberger v. Motorists Manual
(1958) 167 Ohio St. 494

This case was cited and submitted by State Farm in its moving papers [*APP 1641:4, 1643:6-16, 1650:4, footnote 4*] and is recognized as a prominent example of the minority view.[6] This is another automobile/personal injury case wherein the plaintiff sought to affirm and sue the tortfeasor's insurer for damages based on alleged fraudulent misrepresentations made in the course of settling the claim. The plaintiff alleged that the insurer misrepresented that the release was merely an inconsequential document which would not affect her rights in any way. The court noted the split of authority and discussed the

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[5] *Matsuura v. Alston & Bird* (1999) 166 F.3d 1006 (9th Cir.); *Phipps v. Winneshiek County* (1999) 593 N.W.2d 143 (Iowa).

[6] For an excellent discussion of the majority/minority views, a.k.a. New York Rule/Common Law Rule, *see Di Sabatino v. USF&G* (1986) 635 F.Supp. 350.

cases approving the cause of action and those of the minority view, disapproving such a cause of action and specifically citing to California's *Taylor v. Hopper* case. *Shallenberger,* 167 Ohio St. at 498-499. Ohio followed the minority view, citing problems with proving damages – the overriding argument in most of the cases in the minority view. *Id.* at 502-503. The policy argument for the minority rule requiring rescission is largely based on the argument that it is unfair for the plaintiff to be permitted to keep the money and sue for more because if he loses he still gets to keep the original settlement money whereas the defendant lost his benefit of the bargain – the settlement. This argument is readily refuted in the recent cases of the majority view, discussed *infra.*

Mackley v. Allstate
(1978) 564 S.W.2d 634

Another automobile/personal injury case wherein the releasor sought to affirm and sue. The Missouri court noted the split of authority that exists on the question (*Mackley,* 564 S.W.2d at 636) and that in Missouri such a cause of action would be permitted (*Id.* at 634). However, the court found an exception in the case of an unliquidated tort claim (as opposed to a contract claim) and held that the releasor of an unliquidated tort claim cannot stand upon a fraudulently induced release and simultaneously maintain an action for fraud and deceit for damages growing out of fraud practiced upon him. The

rationale was that there would be insurmountable difficulty in determining the amount of damages because the jury would have to speculate as to how much a different jury might have awarded had the underlying released claim proceeded to trial. *Id.* at 636, citing *Taylor v. Hopper,* discussed supra.

This constitutes the best and the brightest of the minority view. The discussion of the majority view cases below will overwhelmingly demonstrate that the reasoning of these cases is flawed and should not be adopted in California neither in the third party setting nor in the more compelling first party setting presented here. In the first party setting, where the perpetrator of the fraud owes special duties to its insured, the question is frankly a no-brainer. To deny a remedy would be to ignore the duties attendant with the special relationship that exists between insurer and insured. *20th Century Ins. Co. v. Superior Court (Ahles)* (2001) 90 Cal.App.4th 1247, 1265.

B. The Majority View – Affirm and Sue Permitted – Is Well Reasoned and Should Be the Law of the Land in California.

The majority view does not require rescission as the exclusive remedy for fraudulent inducement and instead recognize a defrauded party's right to affirm and sue for damages. The majority or "New York" rule finds its genesis in *Urtz v. New York Cent. & HRR Co.* (1911) 202 N.Y. 170. In 1945, the Michigan Supreme Court in *Kordis v. Auto Owners Ins. Co.* recognized the

right to affirm a release and sue for damages and rejected the argument that damages are too speculative:

> "It is true that this (plaintiff's damage) could not be definitely fixed by the evidence; witnesses might disagree respecting it; the market value of lands might rise afterwards to an extent that would make the mortgage available to its full amount; but there is nothing unusual in contingencies of this sort being involved in litigation and casting uncertainty upon any attempt to do justice. But controversies of this sort can only be determined in one way: the jury must judge of the extent of the damage by such evidence of value as the parties may be able to produce."
>
> *Kordis v. Auto Owners Ins. Co.* (1945) 311 Mich. 247, 253.

The *Kordis* court noted that "it is well settled that no rescission or restitution is necessary as a condition precedent to maintaining an action for damages arising from false representations and deceit". *Id.* at 252.

DiSabatino v. USF&G (1986) 635 F.Supp. 350
(USDC/Delaware law)

This case involves facts and equities extremely analogous to the Village Northridge/State Farm situation presented. In *DiSabatino*, the insurer of a medical malpractice defendant/doctor **misrepresented the policy limits** to the plaintiff and his attorney who in turn settled the case for $294,000 believing

that the limits were only $400,000 when in fact the limits were $1,000,000. The defrauded plaintiff filed an action directly against the insurance carrier for fraud and deceit based on the misrepresentation of policy limits alleging that absent the misrepresentation of limits a trial or settlement would have resulted in a greater recovery. In defense, the insurer argued that rescission was the exclusive remedy. This was a case of first impression in Delaware – "whether a plaintiff who has settled a negligence suit for personal injuries may affirm the release and sue for damages". *DiSabatino*, 635 F.Supp. at 351. The court held that the tort claimant had an election of remedies to stand on the fraudulently induced release and proceed on a cause of action based on fraud. *Id.* at 352. The court noted and rejected the distinction made by prior courts between released tort cases -vs- released contract cases – the latter receiving greater deference due to the certainty of damages and the notion that tort claimants somehow gave up less than contract claimants.

> "The distinction made by some courts between simple contracts and releases of tort actions rests in part on the theory that the tort claimant has parted with nothing because he can avoid the contract of settlement and reinstitute his original cause of action. Unlike tort claims, commercial contracts often involve commodities whose value diminishes with each transaction. Of

course, proof of damage is a necessary element in an action based on fraud. An Ohio court in *Shallenberger v. Motorists Mutual Ins. Co.* (cite) formulated this theory in convincing and articulate fashion: [outline of the *Shallenberger* holding discussed] ... On close examination, the fallacy of this position is evident. A tort claimant may indeed have lost something by deciding not to prosecute an action and instead to accept a monetary consideration in settlement. The court in *Shallenberger* does not attribute any value to **opportunities foregone**." *Id.* at 354 (emphasis added).

The court dismissed the argument of the minority view of uncertain damages (*Taylor v. Hopper; Mackley v. Allstate;* discussed supra) altogether noting that the fraud damages in the subsequent action would be calculated differently than the underlying damages in the automobile/personal injury case. The underlying and dismissed claim would *not* need to be retried as hypothesized in those decisions.

"Such reasoning simply does not address the interests a plaintiff seeks to vindicate who alleges fraudulent misrepresentation. In any action based on fraud, the fact finder will simply measure the extent of the plaintiff's damages by examining what the

agreement would have been, had the parties known of the actual material facts. The nature of the injuries in the foregone tort action are relevant only to the extent of how they would affect the value of the claim to be compromised in the context of the actual coverage provided by the defendant insurance carrier. The plaintiff has affirmed his agreement to settle; thus the fact finder need not conjecture what another jury would have awarded in tort damages. The damages remain those arising *ex contractu*: the measure of the damages under this second method must take into consideration the salable value of the right of action for the purpose of compromising, and the nature and extent of the injuries known and foreseeable as of the time of the settlement, under the particular circumstances of the parties then shown existing." *Id.* at 355.

Regarding return of consideration, the court held that:

> "The plaintiff may keep what he received and file suit against the ones committing the alleged fraud and recover 'such an amount as will make the settlement an honest one.' In other words, the measure of damages is 'loss of the bargain'. (cites) (true measure of damages is difference in settlement value

before and after discovery of the fraud)." *Id.*

The *DiSabatino* court made a poignant analysis of public policy which illuminates the position of Village Northridge in this case and which is right on target with the reality of this business:

> "Simply as a matter of policy this cause of action should be deemed to exist. First, insurance companies would have everything to gain and nothing to lose by systematically defrauding tort claimants into accepting low settlement offers. In such cases, the company gambles that the deceit will not be uncovered. If the fraud is uncovered, then the company only faces litigation, or the costs of reimbursement, that it would have had to confront without a settlement. In economic terms, some insurance carriers calculate an 'opportunity cost' which is artificially low." *Id.* at 355-356.

Simply put, the "'New York Rule' serves to deter fraud". *Id.* at 356.

State Farm bangs the public policy drum in its briefing arguing that the public policy of California favors settlement. [*APP 0933:16-20, 1037:16-23, 1230:25-28, 1330:11-15*] Village Northridge agrees! This is precisely why misrepresentation of policy limits is such a serious transgression and should be actionable. How is the policy favoring settlement furthered by refusing a

remedy at law to victims of fraud in connection with a fraudulently induced settlement? If there is to be any efficacy to our settlement process – mediations, mandatory settlement conferences, etc. – there absolutely must be a legal remedy for misrepresentation of policy limits. The trial court's willingness to sweep this action under the rug – twice – is mystifying. It is not just Village Northridge that has been defrauded; it is the court itself as well as the system at large.

The *DiSabatino* case is interesting in that the plaintiff settled for less than the misrepresented policy limits. The trial court in the case at bar in granting summary judgment found this to be particularly relevant:

> "Well, if they settled for what State Farm had told them were the policy limits and that turned out to be wrong, I would agree with you [that there is a question of fact regarding materiality], but here, they didn't settle for policy limits." [*APP 0382:26-28, 0383:1 – Reporter's Transcript*] "Plaintiffs have not demonstrated that the Release Agreement was a product of undue influence or fraud." [*APP 0401 – Ruling on Motion for Summary Judgment*]

The Court of Appeal reversed and the *DiSabatino* court is in line with this reasoning. Who knows what Village Northridge would have done had it

known that another seven million dollars was available under its policy. Clearly, viable options were available. To summarily suggest that misrepresentation of limits was not material was a gross and presumptuous error and this identical mind set has prevailed in subsequent rulings. *DiSabatino* illustrates the majority view, discusses at length the history of the minority view and its shortcomings and has been adopted in subsequent influential decisions, discussed below. Moreover, the case is factually analogous in involving misrepresentation of policy limits. Here, the misrepresentation of limits was directed at State Farm's own insured which only intensifies the gravity of the transgression thus rendering the affirm and sue remedy patently appropriate.

Matsuura v. Alston & Bird and E.I. DuPont
(1999) 166 F.3d 1006 (9th Circuit, Hawaii/Delaware Law)

This is a very interesting case which is extremely instructive to the case at bar. *Matsuura* is largely based on the *DiSabatino* case discussed above and therefore Village Northridge will limit its discussion in this brief. Having said that, the case includes an at-length discussion of the minority and majority views and detailed discussion of why the majority view should carry the day. This was a toxic tort/product liability action filed by Hawaiian nurserymen against a chemical manufacturer for herbicidal contamination of their plants via the DuPont fungicide "Benlate". During the pendency of the litigation,

DuPont and its defense lawyers misrepresented that soil tests had produced no evidence of contamination and concealed adverse evidence under the Work Product privilege. The Matsuura plaintiffs settled while others continued on with the litigation. After the Matsuuras settled, DuPont disclosed its testing data which confirmed that the fungicide Benlate was in fact contaminated. Two U.S. District Courts held that DuPont intentionally engaged in fraudulent conduct by withholding this evidence and $1.5 million in sanctions was imposed for discovery abuse. *Matsuura,* 166 F.3d at 1007.

The Matsuuras and other Benlate plaintiffs filed a subsequent suit alleging that they were fraudulently induced to settle their claims against DuPont. The District Court granted DuPont Judgment on the Pleadings ruling that the release barred their action and that the failure to promptly return the settlement proceeds was fatal to the action. In reversing the decision, the appellate court engaged in a thorough analysis of the split of authority as discussed above in this briefing including specific analysis of the cases relied upon by State Farm herein (*Mackley, Shallenberger* and *Taylor*). *Id.* at 1008. Echoing the sentiments of the *DiSabatino* court, and in direct contravention of State Farm's audacious public policy argument in this case, the *Matsuura* court noted as follows:

> "Permitting the Matsuuras to affirm their settlement agreements and sue DuPont for fraud will further Delaware's policy favoring voluntary settlement of legal disputes. Insistence on the finality of settlements is based on the assumption that the parties have freely bargained to exchange the costs, risks and potential rewards of litigation for the certainty of a settlement that seems fair in light of the facts known at the time. Settlements induced by fraud are set aside, however, because the defrauded party has not freely bargained, but has been induced to settle by affirmative misrepresentations by the other party. Enforcing such a settlement would undermine the policy of encouraging voluntary settlement of disputes; if litigants cannot assume the disclosures and representations of the opposing party are made in good faith, they will be reluctant to settle." *Id.* at 1012.

It is truly ironic that State Farm takes the position that the policy favoring settlement would be furthered by leaving its transgression unchecked. This position only exemplifies the fact that State Farm simply does not appreciate the seriousness of what transpired nor that it involves any form of wrong-doing – a classic fact pattern calling out for an appropriate remedy at law.

Phipps v. Winnishiek County
(1999) 593 N.W.2d 143 (Iowa)

One final case worthy of consideration is the *Phipps* case, decided shortly after the *Matsuura* case and again involving avoidance of a prior settlement and release. In this case, an automobile/personal injury plaintiff settled his road design action after the defendant's in-house road design engineer testified at deposition that the intersection was designed according to plans. While the action was still pending against other defendants it was subsequently discovered by the County and its engineer that the engineer's testimony was in fact false – a deviation from the plans had in fact occurred thus posing a liability. The second lawsuit was dismissed as involving intrinsic fraud. The Supreme Court reversed holding that the plaintiff had the right to elect a remedy between rescission and/or an independent action for fraud/damages.

> "We find the majority view persuasive. First, a rule which restricts plaintiffs to a claim for rescission may result in prejudice due to the delay that may result in pursuing their claims (*see Matsuura* (cites)). Second, damages for fraud are conceptually different from the underlying tort claim and are capable of calculation. Third, absent an action for fraud, many plaintiffs who have been fraudulently induced to enter into a

settlement agreement would have no other practical remedy. Finally, a rule which limits the remedy to rescission may do little to discourage fraud." *Phipps*, 593 N.W.2d at 146.

C. Summary

State Farm relies heavily on *Garcia* and *Taylor* which are antiquated cases based on dissimilar factual scenarios. Both cases have been severely criticized by subsequent and recent appellate authorities throughout the country which have adopted the reasoned majority rule. They are also inapplicable to the case at bar given Village Northridge's "independent right" to the contract benefits in dispute. *See, e.g., Persson, supra,* 125 Cal.App.4th at 1154-1155. The irony here is that the trial court recognized the same right in several of its rulings and only after the plaintiff amended to conform and assert this very right did the trial court switch gears and rule that "the plaintiff can't have it both ways". Yes, it can. It is an election of remedies and the plaintiff has no obligation to return consideration under the affirm and sue option. Even rescission permits retention of the consideration under certain equitable fact patterns. The trial court's decision was clearly in error and exhibits bias against this litigant given its prior recognition of the very right it subsequently refused to recognize.

6. THE RETURN OF CONSIDERATION IS NOT REQUIRED REGARDLESS OF THE REMEDY ELECTED.

It has already been demonstrated that Village Northridge is not seeking rescission and that return of consideration is simply not required in a non-rescission action for damages resulting from fraud. Nonetheless, for the sake of equity and thoroughness, the issue of return of consideration will be examined in both rescission and non-rescission settings. The facts of this case cry out for a remedy for Village Northridge and there should be no trepidation about allowing this case to proceed to trial on the merits with another remand.

A. Rescission Cases

The concept of return of consideration is not as rooted as State Farm would like us to believe and *Garcia* is clearly not the only view on the subject. Even certain rescission cases have been allowed to move forward without a return of consideration:

> "One who attempts to rescind a transaction on the ground of fraud is not required to restore that which in any event he would be entitled to retain either by virtue of the contract sought to be set aside, or of the original liability. *Garcia*, 183 Cal. at 771. The point is clarified further in *Sime v. Malouf* (1949) 95 Cal.App.2d 82. In that case, plaintiff executed a general release

of all claims as part of a sale transaction in which defendants acquired his interest in a joint venture project. Plaintiff later sued for damages for fraud but made no offer to restore the consideration he had received in the sale. The Supreme Court found the release should not be construed to embrace unknown claims, but also held that even if it were so construed, 'no restoration of the consideration received by [plaintiff], or any part of it, was required' since the plaintiff had the right, independently of the release itself, to retain the sums he received. The court observed: The law does not require, as the price of attack upon a fraudulently induced release, sacrifice of independent rights, or the doing of idle acts . . . If plaintiff established his [fraud] claim, the $15,600 already received [in the sale transaction] would be deducted from the total amount found to be due . . . ; if, however, he failed to prove the alleged fraud, he would be entitled to retain the $15,600 as the contract consideration for the transfer to defendants of his interest since they stood upon the purchase and retained the property. That is precisely the case. The court expressly pointed out that – as in this case – the plaintiff 'did not attempt to [rescind the sale], nor

> was he required to, in order that he be free to sue for damages. Rescission and restoration are required only under equitable principles and to prevent the taking of unfair advantage. Restoration is not required unless the ends of justice require it.'" *Persson, supra,* 125 Cal.App.4th at 1155.

This is identical to the Village Northridge case and this is precisely the same argument that was addressed at the prior Motion for Summary Judgment and which was rehashed in subsequent law and motion proceedings. As stated in Village Northridge's Opposition to State Farm's MSJ and in its prior Appellate Brief:

> "From an equity standpoint, no harm has been done. State Farm will get an offset for the $1,500,000 claim payment towards the actual original limits of $7,146,891.69 which plaintiff seeks under the Breach of Contract cause of action." [*APP 0231:26-28, 0232, 0233:1-16, 0438*]

Equitable exceptions to the requirement of restoration of consideration are also discussed in *Williston on Contracts*:

> "The requirement of restoration, however, is subject to several exceptions. ... In other cases where on particular facts it seems equitable to allow rescission without complete or perfect

restoration of the consideration, the growing tendency favors the relief, and courts of law adopting the more liberal rule in equity no longer adhere to the strict construction generally upheld in the earlier decisions. (*Restatement of Contracts* §384(2)) Thus, diminution in value of the consideration by lapse of time (cite), **or by reasonable use before the discovery of the fraud** (cite) or the use of part of the consideration in testing (cite) will not prevent rescission, nor will **inability to return the consideration when the inability is due to the wrongful conduct of the fraudulent party** (cite). Impossible or unreasonable things, which do not tend to accomplish equity in the particular transaction, are not required. (*cite – Restatement of Contracts* 384(d)) ... Where circumstances permit, some courts also have allowed as a substitute for restoration of the consideration a deduction of the amount of it from the recovery against the wrongdoer. (cite) **This is the most practicable and satisfactory disposition of many cases.**" *Williston on Contracts* (2005) §69:51. *Restoration of Consideration – Exceptions to Requirement.*

Village Northridge's proposal to allow the case to move forward with a credit being made to State Farm in the amounts paid is not "absurd" and is in accord with recognized authorities in this area. The money was spent precisely as it was contemplated to be spent and on an immediate basis – for earthquake repairs. Requiring that a not for profit HOA drum up seven figures when they are upside down five to six times this amount is wholly inequitable, particularly where the problem is attributable to State Farm, not the HOA. [*APP 0283:17-28, 0284:1-19*]

B. Non-Rescission Cases

There is also support for Village Northridge's position in a non-Rescission setting which is even more on point given that plaintiff does not seek to rescind the Settlement Agreement and Release.

> " . . . a beneficiary under an insurance policy upon whom fraud and deceit is practiced, resulting in release of rights under the same, has the right to repudiate the release contract and continue to claim under the policy, or he may elect to treat the rights released as lost and destroyed, and sue as for fraud and deceit. (cites) A defrauded releasor is not limited to an action to set aside the release, but may affirm it, sue for damages for the fraud, and such suit may be brought **without returning, or**

offering to return, the consideration for the release. (cites)" *Mutual Savings Life Insurance Co. v. Osborne* (1943) 15 So.2d 713, 718 (Ala.) (emphasis added).

The case of *Gaskins v. Southern Farm Bureau Casualty Company* (2003) 354 S.C.416 is remarkably similar to the instant factual scenario with respect to the fraud perpetrated on the releasor. In *Gaskins*, a third party tort victim sued an insurer who had **misrepresented** that the **policy limits** were only $9,000 when they were in fact $100,000. The tort victim had signed a release and sued the insurer alleging that he was fraudulently induced to sign that release based on the misrepresentation of policy limits. The insurer filed a 12(b)(6) motion (tantamount to a demurrer) contending that the Release barred the claim. In reversing the dismissal of the trial court, the appellate court held that a majority of courts now recognize a tort against an insurance company for fraudulently obtaining a release and that a primary reason why courts recognize the tort is to discourage insurance companies from engaging in fraud. *Gaskins, supra*, 354 S.C. at 420. Interestingly, the court noted the existence of statutory law prohibiting misrepresentation of limits to third parties (very similar to California *Insurance Code* §790.03). The duty situation is even stronger for Village Northridge in presenting a first party claim by an insured directly against its carrier. The California Insurance

Regulations specifically require that insurers disclose all benefits available to their insured at the outset of the claim. California *Code of Regulations,* Title 10, §2695.4. [*APP 0542, footnote 5*]

The reasoned authorities and direction of the law in this arena clearly afford a remedy to a policyholder who signs a release after having been misled as to the policy limits. Sound public policy supports this duty, including the policy favoring settlement to which State Farm continually cites. If insurers can misrepresent policy limits in the course of settlement of claims with impunity, the orderly process of settlement will be inhibited and claimants and their attorneys will be reluctant to sign releases. Return of consideration is an equitable factor and is not universally required.

7. THE RULE AGAINST SPECULATIVE DAMAGES DOES NOT BAR THIS LAWSUIT.

State Farm insists that this case is barred by the rule against speculative damages yet cannot seem to find a proper case to support its position. As the Court of Appeal stated, *Cedars-Sinai v. Superior Court,* (1998) 18 Cal.4th 1, was a case wherein the court refused to create a separate tort cause of action for intentional spoilation of evidence, observing it would be impossible for the jury to assess the role the missing evidence would have played in the determination of the underlying action. (Published Opn. at p. 14, footnote 6) The other two cases cited in support of its position, *Viner v. Sweet*, (2003)

30 Cal.4th 1232, and *Wiley v. County of San Diego*, (1998) 19 Cal.4th 532, are legal malpractice cases involving an entirely different causation standard.[7] Once again, State Farm suggests that if the legal malpractice standard were used in this case, Village Northridge would be forced to show what the agreement between the parties would have been had the representations regarding limits not been made. So stipulated. What State Farm fails to mention is that the causation standard used in legal malpractice cases is not the same as that used in this fraud case. Furthermore, causation is a question of fact to be determined at summary judgment or trial, not at demurrer. As such, these cases are inapposite.

Furthermore, it is not as though the damages in this case are inherently speculative; they will be based on the amount of policy benefits available under the subject insurance contract for the loss in question. The amount of damages, based on the amount which the parties would have settled had

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[7] In fact, *Wiley v. County of San Diego, supra*, is a case involving a criminal defendant's legal malpractice case against his public defender and the county, wherein the Court held that the plaintiff was required to prove actual innocence by a preponderance of the evidence as an element of his malpractice claim. The eloquent quotation from *Wiley* appearing at page 9 of State Farm's Petition ["The mental gymnastics required to reach an intelligent verdict would be difficult to comprehend much less execute"] is referring to the difficulty of reaching a verdict which would follow if the plaintiff/former criminal defendant were not required to prove his actual innocence. *Id.* at 544.

Village Northridge known the actual policy limits, will be determined the same way damages are determined by most any other case – via competing expert witnesses and with whatever empirical or statistical evidence is marshalled and presented. "As a general rule, the opinion of an expert is admissible when it is '[r]elated to a subject that is sufficiently beyond common experience that the opinion of an expert would assist the trier of fact ....' Additionally, in California, '[t]estimony in the form of an opinion that is otherwise admissible is not objectionable because it embraces the ultimate issue to be decided by the trier of fact.'" *Piscitelli v. Friedenberg* (2001) 87 Cal.App.4th 953, 972 (citations omitted).

8. EQUITIES OF THE CASE: STATE FARM CONTINUES TO MAKE MISREPRESENTATIONS ABOUT POLICY LIMITS.

State Farm positions this case as the poster child for requiring a defrauded party to return consideration prior to filing suit and is miffed by the Court of Appeal's balancing conclusion that public policy considerations suggest that the risk of overpayment by an insurer who misrepresents policy limits in obtaining a settlement is more acceptable than the risk that an insured will be deprived by fraud of the full insurance protection for which it paid. (Typed Opn. at p. 11, footnote 4) As the Court of Appeal noted, absent an action for fraud, plaintiffs in the insurance settlement context would be left

with no practical remedy because in many cases, plaintiffs have spent much, if not all, of the settlement sum on necessities – the damages which formed the subject matter of the claim – before discovering the fraud. (Typed Opn. at p. 13) Furthermore, inasmuch as there is possibility of the trier of fact finding that State Farm *overpaid* Village Northridge (Opening Brief at p. 23), there is also a possibility of the trier of fact agreeing with Village Northridge's assessment of the damages at approximately $8 million [*APP 0237-0238*] and finding that State Farm *underpaid* Village Northridge even with the higher deductible:

1.	Total Claim	$8,000,000
2.	Deductible on $11.9 million limits	($1,190,000)
3.	Total Due to Village Northridge	$6,810,000
4.	Amount State Farm has paid to date	$3,560,591
5.	Amount underpaid by State Farm	$3,249,409
6.	Interest on underpaid amount (10% simple for 8 years)	$2,599,527.20
	Total underpaid:	$5,848,936.20

For anyone who might not appreciate that equity and the facts are not in State Farm's corner, let us not forget the history surrounding the elusive policy declarations. State Farm never produced a Declarations page evidencing their version of the policy limits, not in discovery, not in the law and motion hearings conducted at the trial court level, and not after the Court

of Appeal characterized its failure to document its version of the policy limits as "the elephant in the room" in the first decision. [APP 0549, footnote 8] Rather than produce a counter-version of the plaintiff's Policy Declarations which State Farm contends are wrong, State Farm submitted inadmissible parole evidence in the form of a hearsay Declaration in attempt to convince the trial court that its version of the terms of the contract are correct ($4.9 million - vs. - $11.9 million). In a continuing effort to pull the wool over everyone's eyes and in total disregard of the facts and prior appellate opinion, State Farm is now attempting to "document" its version of the policy limits with attorney argument:

> "The amounts of coverage are not set forth in the declarations page, but are instead governed by State Farm's records." (Opening Brief at p. 57)

Predictably, no citation to this alleged record follows. If this really is the case, why is State Farm withholding this crucial evidence? That State Farm has the temerity to present this unverified and unsupported attorney rhetoric to this Supreme Court as "evidence" is appalling and is a befitting illustration of why this case was decided correctly. This is exactly the type of shenanigans by insurers which would be permitted to continue unchecked if policyholders were left without the option to affirm and sue.

9. STATE FARM SHOULD NOT BE PERMITTED TO UTILIZE A SETTLEMENT AGREEMENT TO EXEMPT ITSELF FROM RESPONSIBILITY FOR FRAUDULENT INDUCEMENT RELATIVE TO THE AGREEMENT ITSELF

In Section F of its Opening Brief, State Farm suggests a number of "anomalies" which it contends would be created by allowing an "exception" to *Garcia/Taylor* vis-a-vis misrepresentation of policy limits. State Farm references misrepresentation of policy limits in discovery responses and in a mediation setting as being non-actionable. But this is owing to independent statutory privileges that preclude such actions. Village Northridge is not suing for errant discovery responses nor for misstatements in a mediation. The acts and occurrences occurred during the course of an insurance claim and there is a very well defined body of law which prescribes the attendant duties of an insurer relative to an insurance claim. (discussed *supra*)

State Farm's dismissal of California *Insurance Code* 790.03, the related Insurance Regulations and the Court of Appeal's recognition of the same pretty much sums up the problem in this case. What State Farm refuses to recognize is that it is in a special relationship in the eyes of the law and it has commensurate duties which clearly encompass forthright and affirmative disclosure of available policy limits. State Farm's dismissal of these statutes and duties only highlights its complete disregard and abrogation of duty in this

case. State Farm digresses into a completely irrelevant area of the law in referencing the duty to obtain adequate policy limits (citing *Jones v. Grewe* (1987) Cal.App.3d 950). That issue is for another day and will be before this Court soon enough. It has no application here. Similarly, the proposition that the insured "presumably knows *its own* policy limits" is a false proposition, as a matter of law. To make such a presumption would require the Court to assume that the legislature engaged in an idle act in implementing superfluous and meaningless legislation which categorically requires insurers, in a claim setting, to affirmatively disclose and explain to the insured all available policy limits. Cal. *Code Regs., title 10, § 2695*.4 (*See* fn 5 of the first appellate decision [*APP542*] and fn 1 of the second appellate decision [Typed Opn. at p. 6]) Moreover, this very Court has held that "the rule presuming parties are familiar with contract terms should not be strictly applied in insurance policies. It is a matter of almost common knowledge that a very small percentage of policy-holders are actually cognizant of the provisions of their policies . . ." *Haynes v Farmers Insurance Exchange* (2004) 32 Cal.4th1198, 1210 The *Haynes* decision confirms that the statutory duty makes good sense. It promotes the process of reaching a true "meeting of the minds" based on truth and therefore promotes the public policy favoring settlement.

The only "anomaly" which needs to be prevented it is one which would be present but for the Court of Appeal's decision – allowing State Farm to use a contract to exempt itself from responsibility for its own fraud perpetuated in the inducement of the contract itself. This is against the policy of the law and strictly prohibited. *See* Cal. *Civ. Code* §§ 1667, 1668. It also inhibits the public policy favoring settlement. If anything, the settlement agreement and release should be rendered unenforceable in that it was a vehicle allowing State Farm to commit fraud. "Contracts that are contrary to express statutes or to the policy of express statutes ... are illegal contracts. Any such illegality voids the entire contract." *Medical Contractors Assn. v. Greater Bay Area Assn.* (1998) 66 Cal.App.4th 672, 688; quoting *Green v. Mt. Diablo Hospital Dist.* (1989) 207 Cal.App.3d 63, 73 (citations omitted).

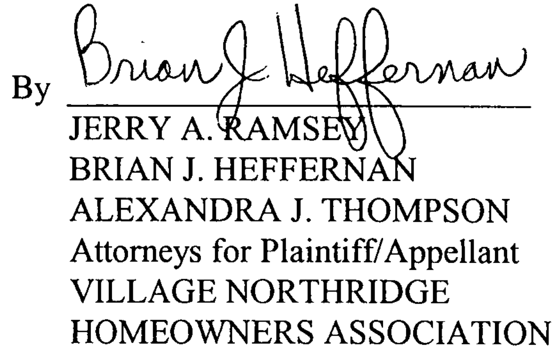
10. CONCLUSION

For the foregoing reasons, while clarification of the Court of Appeal's Opinion may be needed to properly limit its impact to cases involving first party insurance claims, Village Northridge respectfully submits that the end result of the decision was correct. This Court should uphold the Court of Appeal's decision and affirm that *Garcia* and *Taylor* do not apply to cases involving misrepresentation of policy limits to induce a settlement and release

of a first party insurance claim.

May 21, 2008

Respectfully Submitted:
ENGSTROM, LIPSCOMB & LACK



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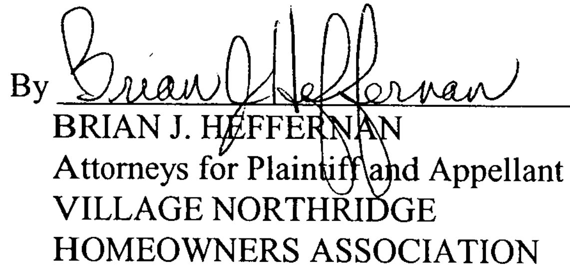
BRIEF FORMAT CERTIFICATION PURSUANT TO CALIFORNIA RULES OF COURT, RULE 8.204(c)

Pursuant to California *Rules of Court*, Rule 8.204(c), I certify that the Answer Brief on the Merits is proportionately spaced, has a typeface of 13 points and contains 11,878 words, including footnotes.

DATED: May 21, 2008

ENGSTROM, LIPSCOMB & LACK



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