

March 1974

## Contracts

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### Recommended Citation

Martin Wayne Johnson, *Contracts*, 62 CALIF. L. REV. 465 (1974).

### Link to publisher version (DOI)

<https://doi.org/10.15779/Z384J3Q>

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### III CONTRACTS

#### A. Late Charges as Liquidated Damages or Penalty

*Garrett v. Coast & Southern Federal Savings & Loan Association*.<sup>1</sup> The supreme court held that plaintiffs had stated a cause of action by alleging that late charges calculated as a fixed percentage of the remaining unpaid principal of secured loans are penal and hence unenforceable.<sup>2</sup> The holding turned on the court's characterization of the charges as liquidated damages and thus subject to statutory provisions<sup>3</sup> which only two previous court of appeal decisions had found applicable to late charges.<sup>4</sup>

The case arose after plaintiffs had been assessed late charges for failing to make timely installment payments to defendant (Coast) on their secured promissory notes. They instituted a class action on behalf of themselves and all similarly situated obligors for recovery of monies paid to Coast as late charges during the four years prior to the filing of the complaint.<sup>5</sup> The notes signed by plaintiffs provided that if they defaulted in the payment of either principal or interest, the holder could, without notice, charge "additional interest" at the rate of two percent per year on the unpaid principal balance.<sup>6</sup> In practice,

1. 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973) (Wright, C.J.) (unanimous decision).

2. The court defined a penalty to be a charge which is deemed void because it cannot qualify as proper liquidated damages within California Civil Code sections 1670 and 1671. *Id.* at 736 n.4, 511 P.2d at 1200 n.4, 108 Cal. Rptr. at 848 n.4. *See also* Better Foods Mkts., Inc. v. American Dist. Tel. Co., 40 Cal. 2d 179, 184, 253 P.2d 10, 13-14 (1953). Unless otherwise indicated the court's definition is utilized herein.

3. *See* note 8 *infra*.

4. *See* *Clermont v. Secured Inv. Corp.*, 25 Cal. App. 3d 766, 102 Cal. Rptr. 340 (2d Dist. 1972); *Los Angeles City School Dist. v. Landier Inv. Co.*, 177 Cal. App. 2d 744, 2 Cal. Rptr. 662 (2d Dist. 1960). *Garrett* has spurred an attack on late charge provisions. *See, e.g.*, *Miller v. Central Valley Nat'l Bank*, Civil No. 406017 (Super. Ct. Alameda Co., Calif., filed Oct. 26, 1970) (class action complaint amended after *Garrett* to include a cause of action to recover late charges).

5. 9 Cal. 3d at 734-35, 511 P.2d at 1199, 108 Cal. Rptr. at 847. The propriety of the class action was not an issue presented on appeal. Plaintiffs alleged that of approximately 32,000 obligors, some 5,000 had paid a total of \$1.9 million in late charges. *Id.* at 735, 511 P.2d at 1199, 108 Cal. Rptr. at 847. The applicable period of limitations was provided by Code of Civil Procedure section 382. *Id.* at 735 & n.2, 511 P.2d at 1199 & n.2, 108 Cal. Rptr. at 847 & n.2.

6. Coast's standardized note read in pertinent part:

The undersigned further agrees that in the event that payments of either principal or interest on this note becomes in default, the holder may, without notice, charge additional interest at the rate of two (2%) percent per annum on the unpaid principal balance of this note from the date unpaid interest started to accrue until the close of the business day upon which payment curing the default is received.

9 Cal. 3d at 735, 511 P.2d at 1199, 108 Cal. Rptr. at 847.

The clause used by Coast in its standardized deed of trust read:

That in the event that default occurs in payments of either principal or inter-

Coast notified obligors that a charge had been assessed when a payment was ten days late.<sup>7</sup> In their complaint, plaintiffs contended that the late-charge provisions constituted improper liquidated damages and were therefore void under Civil Code sections 1670 and 1671.<sup>8</sup>

Coast argued that no damages were involved because the provision simply provided an alternative means of performance. Obligor could make timely installment payments at the contract rate of interest, but they also had the option of making late payments with additional interest on installments during the period of their delinquency.<sup>9</sup> The trial court granted Coast's demurrer, without leave to amend, and plaintiffs appealed from the court's order of dismissal.<sup>10</sup> The supreme court reversed the dismissal, holding that plaintiffs had stated a cause of action.<sup>11</sup>

Section I of this Note will examine the court's analysis of the late charge provisions. Section II will explore alternative theories not used in *Garrett* and the effect these additional lines of analysis could have in future cases. Finally, section III will discuss the implications of *Garrett* and suggest that the Assembly should consider adopting appropriate legislation for all secured transaction late charges.

est on the note secured hereby or any advances made under the provisions of the Deed of Trust, or in the event that there is a default in the payment of performance of any obligation, covenant or agreement contained in this Deed of Trust, Beneficiary may, without notice, charge additional interest at the rate of two percent (2%) per annum on the unpaid principal balance from the date interest started to accrue prior to the default until the close of business day upon which a payment curing the default is received.

*Garrett v. Coast & S. Sav. & Loan Ass'n*, 2d Civil No. 39794 (2d Dist. Cal., filed Nov. 22, 1972) at 2-3 (emphasis added).

7. 9 Cal. 3d at 735 n.3, 511 P.2d at 1199 n.3, 108 Cal. Rptr. at 847 n.3. Plaintiffs alleged that the same charge was made (one-twelfth of 2 percent of the unpaid balance in some cases, and 1.5 percent of the unpaid balance in other cases) whether the obligor made his payment 11 days or 29 days late, or failed to make a payment at all during that particular month. *Id.*

8. Civil Code section 1670 provides:

Every contract by which the amount of damage to be paid, or other compensation to be made, for breach of an obligation, is determined in anticipation thereof, is to that extent void, except as expressly provided in the next section.

CAL. CIV. CODE § 1670 (West 1973).

Section 1671 defines and authorizes liquidation of damages, providing:

The parties to a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.

CAL. CIV. CODE § 1671 (West 1973).

9. 9 Cal. 3d at 735, 511 P.2d at 1199-1200, 108 Cal. Rptr. at 847-48.

10. *Id.* at 734, 511 P.2d at 1198, 108 Cal. Rptr. at 846. Since the case reached the court on demurrer, all proper allegations of the complaint were deemed admitted for purposes of deciding the sufficiency of the complaint as a matter of law. *Id.* at 734, 511 P.2d at 1199, 108 Cal. Rptr. at 847.

11. *Id.* at 734-35, 511 P.2d at 1199, 108 Cal. Rptr. at 847.

## I. THE COURT'S REASONING

The critical factor in the court's analysis was its initial characterization of the late-charge clauses, for only if their "true function and character" is to fix damages in anticipation of breach<sup>12</sup> must the validity of the charges be measured by Civil Code sections 1670 and 1671. The code sections void any provision for liquidated damages except when it would be "impracticable" or "extremely difficult" at the time of contracting to ascertain the actual damages.<sup>13</sup>

Standing in the way of plaintiffs' characterization of late charges as liquidated damages were four previous cases upholding late charges.<sup>14</sup> Only one of them survived *Garrett* intact. In that case, *Thompson v. Gorner*,<sup>15</sup> the note contained late-charge provisions requiring increased interest on the unpaid principal (which was payable at maturity in a lump sum) and unpaid interest (payable monthly), assessed from the date of delinquency and based on the amount delinquent. These charges were upheld on the ground that they provided a means of alternative performance.<sup>16</sup> Prior to default the borrower simply owed the amount he had promised to pay in the absence of default; only if he then chose not to perform would interest accrue at an increased rate.<sup>17</sup> *Finger v. McCaughey*,<sup>18</sup> citing *Thompson* as authori-

12. *Id.* at 735, 511 P.2d at 1199, 108 Cal. Rptr. at 847.

13. *Id.* at 738-39, 511 P.2d at 1202, 108 Cal. Rptr. at 850. This part of the liquidated damages test is known as the "difficulty of ascertainment" test. The difficulty is measured at the time of making the contract. *Id.* at 738, 511 P.2d at 1202, 108 Cal. Rptr. at 850; *Better Foods Mkts., Inc. v. American Dist. Tel. Co.*, 40 Cal. 2d 174, 184-85, 253 P.2d 10, 14 (1953). The leading California discussions of liquidated damages include: J. HETLAND, *COMMERCIAL REAL ESTATE TRANSACTIONS* (1973); J. HETLAND, *CALIFORNIA REAL ESTATE SECURED TRANSACTIONS* (1970) [hereinafter cited as HETLAND, CREST]; Hetland, *The California Land Contract*, 48 CALIF. L. REV. 729, 736 (1960) [hereinafter cited as Hetland, CLC]; Sweet, *Liquidated Damages in California*, 60 CALIF. L. REV. 84 (1972) [hereinafter cited as Sweet]; Comment, *Liquidated Damages and the "No Harm Rule,"* 9 STAN. L. REV. 381 (1957).

14. In arriving at its conclusions, the court overruled what had been thought by some to be settled law. For example, a 1969 court of appeal opinion stated: "It is the rule in this state that late-charge interest is not in the nature of a penalty, and is valid." *Walsh v. Glendale Fed. Sav. & Loan Ass'n*, 1 Cal. App. 3d 578, 585, 81 Cal. Rptr. 804, 809 (2d Dist. 1969); *accord*, *O'Connor v. Richmond Sav. & Loan Ass'n*, 262 Cal. App. 2d 523, 530, 68 Cal. Rptr. 882, 886-87 (1st Dist. 1968). The "rule" had been formulated in two 19th-century cases: *Finger v. McCaughey*, 114 Cal. 64, 45 P. 1004 (1896); *Thompson v. Gorner*, 104 Cal. 168, 37 P. 900 (1894).

15. 104 Cal. 168, 37 P. 900 (1894).

16. The late-charge clause provided:

With interest . . . at the rate of eight percent per annum, payable monthly, in advance, and if said principal or interest is not paid as it becomes due it shall thereafter bear interest at the rate of one percent per month.

*Id.* at 169, 37 P. at 901. The court below had found this late charge to be a penalty. *Id.* at 170, 37 P. at 901.

17. 9 Cal. 3d at 737, 511 P.2d at 1201, 108 Cal. Rptr. at 849.

18. 114 Cal. 64, 45 P. 1004 (1896).

ty, approved a provision assessing increased interest which would apply retroactively to the full term of the loan if the principal was not paid at maturity.<sup>19</sup> Thus, while *Thompson* had held only that amounts in default could bear an increased rate of interest from the date of default, *Finger* held that those amounts could bear the increased rate retroactively.<sup>20</sup> Reconsidering the issue, the court in *Garrett* disapproved the *Finger* extension of *Thompson* and noted that neither case supported Coast's position that upon default increased interest could be assessed against the entire principal balance, whether or not in default.<sup>21</sup>

Having distinguished *Thompson* and disapproved its progeny, the court decided "the only reasonable interpretation of the clause" was that the parties intended a single definite performance with an additional sum as damages for breach of that performance.<sup>22</sup> Although the court cited authority for this finding, it did not openly apply the two tests proposed by these sources to the *Garrett* facts. One suggested test is to find whether the parties conceived that, at the time fixed for performance, either specified alternative might prove the more desirable;<sup>23</sup> another test is whether the debtor reasonably believes he could rationally choose either course.<sup>24</sup> As Professor Sweet has suggested, debtors like *Garrett* and her co-plaintiffs "may not have a real choice as to whether to pay on time or pay slightly later at a much higher rate."<sup>25</sup> Moreover, to be true alternative performance, the debtor

19. *Id.* at 66, 45 P. at 1004. The promissory note provided:

With interest from date at the rate of ten percent per annum, provided this note is paid at maturity, but, if not paid at maturity, then it shall bear interest at the rate of twelve percent per annum from its date until paid . . . .

*Id.* at 65, 45 P. at 1004.

20. 9 Cal. 3d at 736, 511 P.2d at 1200, 108 Cal. Rptr. at 848. The distinction has been made between a retroactive provision for a higher rate of interest and one stipulating for an increased rate after maturity, the former provision being designated a penalty, the latter not. Compare *Krutz v. Robbins*, 12 Wash. 7, 40 P. 415 (1895), with *Pass v. Shine*, 113 N.C. 284, 18 S.E. 251 (1893).

21. 9 Cal. 3d at 736, 737, 511 P.2d at 1200, 1201, 108 Cal. Rptr. at 848, 849. Two court of appeal decisions, *Walsh v. Glendale Fed. Sav. & Loan Ass'n*, 1 Cal. App. 3d 578, 81 Cal. Rptr. 804 (2d Dist. 1969), and *O'Connor v. Richmond Sav. & Loan Ass'n*, 262 Cal. App. 2d 523, 68 Cal. Rptr. 882 (1st Dist. 1968), were also disapproved to the extent they were inconsistent with *Garrett*. *Id.* at 737-38, 511 P.2d at 1201, 108 Cal. Rptr. at 849. Since the notes in both disapproved cases contained provisions essentially equivalent to those in *Garrett*, basically they have been overruled.

22. *Id.* at 738, 511 P.2d at 1201, 108 Cal. Rptr. at 849.

23. 5 S. WILLISTON, WILLISTON ON CONTRACTS § 781 [hereinafter cited as WILLISTON] (3d ed. 1961). The other authority cited by the court dealt with payment of money as an alternative to performance of services and thus cannot easily be applied to the situation of alternative money payments. See *Paolilli v. Piscitelli*, 45 R.I. 354, 121 A. 531 (1923).

24. This test, not suggested by the court's authorities, was recommended by Professor Sweet. Sweet, *supra* note 13, at 141. It is derived from C. McCORMICK, DAMAGES § 154 (1935) [hereinafter cited as McCORMICK].

25. Sweet, *supra* note 13, at 141.

should have the right to choose either mode of performance,<sup>26</sup> but a promissory note often permits foreclosure upon any breach of the agreement and lets the lender decide whether to allow the obligor to pay late at an increased rate.<sup>27</sup> Thus the court's characterization of the late charges as liquidated damages, rather than additional interest for alternative performance, is validated when the suggested tests are applied to the practical realities of the typical obligor-obligee relationship. As the court pointed out, to find otherwise would be to "so subvert the substance of a contract to form that we lose sight of the bargained-for performance."<sup>28</sup>

After concluding that the late charge clauses in *Garrett* provided for liquidated damages, the court assumed the propriety of applying to secured transactions the rules developed in land contract cases, beginning with *Freedman v. The Rector*.<sup>29</sup> These rules permit liquidated damages clauses, if properly drafted, in the marketing land contract, but will not allow "arrangements which purport to legitimate penalties and forfeitures."<sup>30</sup> Since this is precisely the legislative declaration of Civil Code sections 1670 and 1671,<sup>31</sup> the application of these rules to late charges seems appropriate.<sup>32</sup> Utilizing these rules, the court ex-

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26. Professor Williston described a valid alternative performance agreement as one in which either alternative may prove the more advantageous and is as open to the promisor as the other. 5 WILLISTON, *supra* note 23, at § 781.

27. See note 6 *supra* and accompanying text.

28. 9 Cal. 3d at 738, 511 P.2d at 1201, 108 Cal. Rptr. at 849.

29. 37 Cal. 2d 16, 230 P.2d 629 (1951). See *Caplan v. Schroeder*, 56 Cal. 2d 515, 364 P.2d 321, 15 Cal. Rptr. 145 (1961).

The *Freedman* rule has been applied to installment contracts, *Behrendt v. Abraham*, 64 Cal. 2d 182, 410 P.2d 828, 49 Cal. Rptr. 292 (1966) (dictum); J. HETLAND, *COMMERCIAL REAL ESTATE TRANSACTIONS* 25 (1973); HETLAND, *CREST supra* note 13, at § 3.48; leases of real and personal property, *McCarthy v. Tally*, 46 Cal. 2d 577, 297 P.2d 981 (1956); Sweet, *supra* note 13, at 100-04; service contracts, *Atkinson v. Pacific Fire Extinguisher Co.*, 40 Cal. 2d 192, 253 P.2d 18 (1953); *Better Foods Mkts., Inc. v. American Dist. Tel. Co.*, 40 Cal. 2d 179, 253 P.2d 10 (1953); Sweet, *supra* note 13, at 115; construction contracts, Sweet, *supra* note 13, at 116-23; contracts to lend money, Sweet, *supra* note 13, at 128-29; and other miscellaneous contracts, see Sweet, *supra* note 13, at 129-31; Note, *Contracts: Forfeiture Clauses: Relief to Vendee in Default in California*, 40 CALIF. L. REV. 593, 596-97 (1952).

It has also been suggested that the *Freedman* rule should be extended to various willful breach situations, Note, 40 CALIF. L. REV., *supra*, at 597, and that specific legislation providing a liquidated damages test for late payment should be adopted. Sweet, *supra* note 13, at 145.

30. 9 Cal. 3d at 737, 511 P.2d at 1201, 108 Cal. Rptr. at 849.

31. *Id.* at 737, 511 P.2d at 1200-01, 108 Cal. Rptr. at 848-49; Dunbar, *Drafting the Liquidated Damage Clause—When and How*, 20 OHIO ST. L.J. 221, 222 (1959) [hereinafter cited as Dunbar].

32. There is still some awkwardness in applying the penalty concept to late charges, for at least when they are not excessive, late charges can be seen as measures well adapted to avoid putting the debtor in total default. Lecture by John R. Hetland, Professor of Law, University of California, in Berkeley, December 4, 1973. Since even this function, however, is performed by coercing performance, a strict adherence to

amined the late charge provisions in *Garrett* to ascertain whether they were penal in nature. As it observed, this depends both upon "the motivation and purpose in imposing such charges and [upon] their effect."<sup>33</sup> The court presumed that two purposes were served by the late charges in *Garrett*: compensating the lender for administrative expenses and the cost of money wrongfully withheld, and encouraging the borrower to make timely future payments.<sup>34</sup> Because Coast failed to show that the parties had made a reasonable endeavor to estimate the amount of loss that would actually be incurred on breach,<sup>35</sup> the court held that the late charges were penal and therefore void.<sup>36</sup> Moreover, it concluded that:

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antipenalty concepts would justify use of liquidated damages tests.

One might also argue that the liquidated damages concept is simply not appropriate in the late-charge context. It could be said that late charges involve no actual breach of the loan contract, but are only defaults because the lender, by assessing them, forbears calling in the loan. The short answer here is that the default is treated as a breach (see note 6 *infra*), and a loan can usually be called in for nonpayment of an installment. See generally *Caplan v. Schroeder*, 56 Cal. 2d 515, 364 P.2d 321, 15 Cal. Rptr. 145 (1961); *Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n*, 22 Cal. App. 3d 303, 307, 99 Cal. Rptr. 417, 420 (1st Dist. 1971).

33. 9 Cal. 3d at 740, 511 P.2d at 1203, 108 Cal. Rptr. at 851.

34. *Id.* at 739-40, 511 P.2d at 1202-03, 108 Cal. Rptr. at 850-51. To help define the purpose of the late charge, the court cites language in a booklet defendant issued to its borrowers. The booklet warns that the charges are quite high and that they represent an average expense incurred to defray the cost of handling the delinquent accounts. *Id.* at 739 n.7, 511 P.2d at 1202 n.7, 108 Cal. Rptr. at 850 n.7.

Late charges may serve several functions not considered by the court, such as inducing the creditor to delay legal action. They could also serve as compensation for the risk involved in permitting late payments or accepting potentially delinquent debtors, and they could increase the lender's profit. *Hearings on Fees and Charges, Impound Accounts, and Variable Interest Rates Before the California Assembly and Finance Committee 22, 38, 73-74* (1969) [hereinafter cited as *Assembly*]. These latter purposes are doctrinally impermissible, because it is the function of interest, not damages, to compensate for moneylending risks and to provide profit. The former purpose, delaying legal action, is likely to be mutually beneficial, since the lender is probably no more eager to sue than the borrower is to be sued. However, litigation may also be viewed as a risk of doing business, properly compensable out of interest on any money judgment and from the standard loan contract provision awarding attorney's fees to the prevailing party. Therefore, these additional purposes for late-charge provisions fail to justify imposition and thus reinforce the penal nature of such charges.

It can be argued that "administrative costs" include special collection personnel exercising judgment and executive ability. The lender may also argue the right to compensate the risk of permitting the borrower to remain in default without foreclosure. *Id.* at 73-74. It is arguable that no profit factor should be permitted in late charges as that is included in the interest. Furthermore, if the loan is refinanced by the original lender, loan "points" would absorb much of the cost of lateness.

The Chief Assistant Commissioner in the California Department of Real Estate has stated that the primary purpose of the late charge is to stimulate prompt payment of principal and interest in accordance with the terms of the loan contract. *Id.* at 35.

35. "The party seeking to rely on a liquidated damages clause bears the burden of proof." 9 Cal. 3d at 738, 511 P.2d at 1202, 108 Cal. Rptr. at 850.

36. *Id.* at 739, 511 P.2d at 1202, 108 Cal. Rptr. at 850.

[A] charge for the late payment of a loan installment which is measured against the unpaid balance of the loan *must* be deemed to be punitive in character. It is an attempt to coerce timely payment by a forfeiture which is not reasonably calculated to merely compensate the injured lender.<sup>37</sup>

Thus it was the method used to determine the late charges—a percentage of the unpaid principal balance—that the court disapproved in *Garrett*.<sup>38</sup> Such a method, it concluded, would always be deemed punitive because it could never be said to represent a reasonable attempt to estimate damages. The effect of the clause would be to impose a late charge measured neither by the cost of the payment wrongfully withheld nor by the administrative costs of collecting the overdue amount, but by the amount of principal owing at the time of default. Thus the late charge would be much larger if the missed payment came early in the term of the loan than it would be at a time when the unpaid balance was small, even though the actual damage to the lender was the same in each case.<sup>39</sup>

This lack of a proportional relationship to probable actual damages in the event of default is termed by the court as the characteristic feature of a penalty.<sup>40</sup> Furthermore, since the *Garrett* deeds of trust enabled the lender to assess late charges (at the same rate) in the event of *any* default,<sup>41</sup> and since not all contractual breaches involve nonpayment of interest or principal,<sup>42</sup> the late charges could not have been designed solely as “additional interest” to compensate the lender for

37. *Id.* at 740, 511 P.2d at 1203, 108 Cal. Rptr. at 851 (emphasis added).

38. *Id.* at 740, 511 P.2d at 1203, 108 Cal. Rptr. at 851. The court noted that late charges are not unusual in the savings and loan industry, that the defendant used one of many ways of calculating the charge, and that both the Federal Housing Authority and Veteran Administration regulate the size of late charges, although California does not. *Id.* at 740 nn.8-9, 511 P.2d at 1203 nn.8-9, 108 Cal. Rptr. at 851 nn.8-9. See note 81 *infra*.

39. It is probable that costs of levying a late charge do not vary substantially between a late charge on a small loan and a late charge on a larger loan. *Assembly*, *supra* note 34, at 33. The *Garrett* clause, which could result in a large late charge on an early default on a small loan payment and a small late charge on a late default on a large loan payment, does not serve to compensate costs of collection in any rational way.

40. 9 Cal. 3d at 739, 511 P.2d at 1202, 108 Cal. Rptr. at 850.

41. See note 6 *supra*.

42. See note 6 *supra*. Many standard covenants do not involve payment to the lender. These include covenants to keep property in good condition and repair; not to remove or demolish buildings; to comply with all laws affecting the property; not to commit waste; to provide fire insurance; to defend all suits affecting the security; to pay all taxes. The actual ability of the lender to assess late charges for breach of nonpayment covenants is in doubt because the clause itself purports to assess the late charge sum until payment is received. *Id.* Thus, a comparison of the language in the deed of trust with that in the promissory note further demonstrates an intent to coerce performance rather than to provide a serious means of alternative performance. See *Krutz v. Robbins*, 12 Wash. 7, 13-14, 40 P. 415, 417 (1895).

the use of money withheld. This supports the conclusion that the purpose of the charges was at least partially coercive. Furthermore, the period for which the "additional interest" would be charged commenced not on the day the monthly payment was due, but on the *previous* payment date, "when unpaid interest started to accrue."<sup>43</sup> And as the court observed, the amount of the late charge would be the same whether the obligor paid 11 days or 29 days late, or made no payment at all that month.<sup>44</sup> These features of the *Garrett* clauses underscore their penal nature, since the late charges are disproportionate to the actual expected loss.

In *Garrett*, the court did not reach the "difficulty of ascertainment" test provided by section 1671.<sup>45</sup> There are two reasons the court did not use the statutory test. First, because *Garrett* arose on demurrer, the issue was presented on admitted facts which made it unnecessary for the court to decide whether it would have been "impractical" or "extremely difficult" to fix the actual damage. Second, case law has interposed a preliminary requirement that the parties make a reasonable effort to estimate damages,<sup>46</sup> and this effort is deemed absent when there is no showing that the liquidated damages bear some reasonable relationship to anticipated losses.<sup>47</sup> Since it concluded that Coast had made no attempt to estimate damages, there was no need for the court to go further. However, it suggested that, although the defendant had failed on the record before the court to establish the extreme difficulty in anticipating damages, Coast might on a proper showing be able to establish the impracticability of prospectively fixing actual damages.<sup>48</sup>

## II. ALTERNATIVE LEGAL THEORIES

Several legal theories not treated by the court buttress its conclusions and offer means of strengthening the *Garrett* holding in future cases. Among the unused alternatives is the adhesion contract theory.<sup>49</sup> Although Professor Sweet has argued convincingly that the presence

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43. See note 6 *supra*; *Garrett v. Coast & S. Sav. & Loan Ass'n*, 2d Civil No. 39794 (2d Dist. Cal., filed Nov. 22, 1972) at 5.

44. 9 Cal. 3d at 735 n.3, 511 P.2d at 1199 n.3, 108 Cal. Rptr. at 847 n.3.

45. See note 8 *supra*.

46. 9 Cal. 3d at 738-39, 511 P.2d at 1202, 108 Cal. Rptr. at 850.

47. *Id.* at 739, 511 P.2d at 1202, 108 Cal. Rptr. at 850. See HETLAND, *CREST*, *supra* note 13, at § 3.49; J. HETLAND, *COMMERCIAL REAL ESTATE TRANSACTIONS* 26 (1973); McCORMICK, *supra* note 24, at §§ 149-50; Sweet, *supra* note 13, at 138-39. Comment, *Liquidated Damages and the "No Harm Rule,"* 9 STAN. L. REV. 381 (1957).

48. 9 Cal. 3d at 741, 511 P.2d at 1204, 108 Cal. Rptr. at 852.

49. At oral argument before the court of appeal, plaintiffs in *Garrett* acknowledged they had not proceeded on the adhesion contract theory. *Garrett v. Coast & S. Sav. & Loan Ass'n*, 2d Civil No. 39794 (2d Dist. Cal., filed Nov. 22, 1972) at 7 n.3.

of an adhesion contract should influence the court's view of liquidated damages clauses, this factor has been largely ignored in the cases.<sup>50</sup> *Garrett* presented the court with an opportunity to promote the use of adhesion contract analysis in the liquidated damages context. The case involved a standard liquidated damages clause which, in light of the court's other conclusions as to its penal nature, could have been interpreted as an impermissible attempt by the dominant party to coerce performance. This reasoning would have firmly introduced the use of adhesion contract analysis as a factor in evaluating liquidated damages provisions.

Adding this factor would not have been entirely without precedent in California, for the supreme court has held in the context of a "due-on-encumbrance" clause that adhesion contracts are ideal cases for class adjudication.<sup>51</sup> Moreover, a federal court of appeals decided that inequality in the bargaining position of mortgagor and mortgagee (a primary characteristic of the adhesion contract) may force the borrower to risk a potentially large increase in the installment payment upon default.<sup>52</sup> This analysis indicates that late charges are penalties exacted by the stronger party to coerce the weaker party into prompt performance.<sup>53</sup> From this perspective, the party autonomy and freedom-to-contract arguments advanced to justify late charges are less attractive,<sup>54</sup> as are arguments that late charges simply provide an alternative means of performance.<sup>55</sup>

Related to adhesion contract analysis is the unconscionability theory.<sup>56</sup> Professor Williston observed that a provision assessing a higher rate of interest if a note is not paid at maturity is enforceable if not usurious, but that if the rate is unconscionably high the pro-

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50. Sweet, *supra* note 13, at 139. See generally, *Henningsen v. Bloomfield Motors, Inc.*, 32 N.J. 358, 161 A.2d 69 (1960); Wilson, *Freedom of Contracts and Adhesion Contracts*, 14 INT'L & COMP. L.Q. 172 (1965).

51. *LaSala v. American Sav. & Loan Ass'n*, 5 Cal. 3d 864, 877, 489 P.2d 1113, 1121, 97 Cal. Rptr. 849, 857 (1971). Professor Sweet has suggested that *Bauer v. Jackson*, 15 Cal. App. 3d 358, 93 Cal. Rptr. 43 (4th Dist. 1971), also presages greater recognition of the distinction between a negotiated contract and one of adhesion. Sweet, *supra* note 13, at 139-40.

52. *In re Tastyeast, Inc.*, 126 F.2d 879, 882 (3d Cir. 1942).

53. Professor Sweet has noted that, although the stronger party may use penalty clauses to coerce performance, such clauses may have a valid use in controlling the terms and expense of potential litigation. Sweet, *supra* note 13, at 87.

54. *Id.* at 89-90; see *Assembly*, *supra* note 34, at 43 (freedom of contract advanced to support late charges).

55. 9 Cal. 3d at 735, 511 P.2d at 1199, 108 Cal. Rptr. at 847. See text accompanying notes 22-28 *supra*.

56. It has been held as a matter of common law that unconscionable contracts are not enforceable. See *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965).

vision would be penal.<sup>57</sup> A California court of appeal has taken this position, in dictum, as to a forfeiture clause in a land sale contract, noting that an excessive rate of interest made payable only in case of default is not for the use of the withheld money, but is a penalty imposed for nonperformance.<sup>58</sup> The clauses in *Garrett*, which provided for a retroactive rate of interest based upon the entire unpaid balance of the obligation and assessable at the sole discretion of the lender without notice,<sup>59</sup> are attractive candidates to be found excessive and contrary to a court's sense of justice.<sup>60</sup> The excessiveness is apparent when the *Garrett* formula for late charges is compared with statutory limits on such charges in other contexts, where late charges are generally confined to a small percentage of the installment due, with a fixed dollar maximum or minimum.<sup>61</sup>

Although the court in *Garrett* was able to reach its decision without recourse to adhesion contract or unconscionability analysis, it might utilize these theories in extending its disapproval of late charges. For example, the late charges assessed in "wraparound" financing<sup>62</sup> could meet the *Garrett* criteria but still be suspect on further analysis. Even if the charge were based on a percentage of the delinquent installment payment, it could be argued that the late charge is excessive since the lender is already collecting interest on the "override" between the first and second deeds of trust and since the lender has only paid out the second loan plus any payments it has since made on the underlying note.<sup>63</sup>

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57. 5 WILLISTON, *supra* note 23, at § 781 (Cum. Supp. 1973).

58. *Lagorio v. Yerxa*, 96 Cal. App. 111, 117, 273 P. 856, 858 (1st Dist. 1929). It has been held to aid enforceability of a liquidation clause if the amount provided is not "unconscionable." *Escondido Oil & Dev. Co. v. Glasser*, 144 Cal. 494, 500, 77 P. 1040, 1042 (1904), discussed in *Sweet*, *supra* note 13, at 140.

59. Notice is now required. CAL. CIV. CODE § 2954.5 (West Supp. 1973).

60. See *Sweet*, *supra* note 13, at 140.

61. See text accompanying note 81 *infra*.

62. This financing scheme is best explained by illustration: A has executed a \$50,000 promissory note and first deed of trust to Bank X at 5 percent annual interest, secured by property now worth \$150,000. Wishing to obtain a further loan of \$30,000, A finds she can only do so by means of "wraparound" financing. She goes to Bank Y and executes a promissory note and second deed of trust for \$80,000 at 9 percent annual interest. Bank Y pays her \$30,000 and assumes her payments under the first note. Thus, Bank Y earns annual interest on \$30,000 at 9 percent and on \$50,000 at 4 percent, but only pays out \$30,000 to A, plus the periodic payments on her first note.

63. It is arguable that the wraparound late charge is not excessive because it only represents the same charge the lender would bear for delinquencies on both notes. Interview with Gary J. Shapiro, attorney at law in Oakland, California, in Oakland, Jan. 20, 1974. Thus, it may be the structure of wraparound financing that has certain unconscionable aspects, rather than the late charge itself. Those wraparound lenders subject to usury proscriptions may well be collecting more than the 10 percent interest limit. CAL. CONST. art. XX, § 22 (West 1954).

Another example is the *Thompson*<sup>64</sup> type late charge, where increased interest is assessed on the unpaid principal and interest, all of which is in default. Although *Garrett* did not disturb *Thompson*, which upheld such a clause as a valid alternative performance provision rather than an attempt to fix liquidated damages, a *Thompson*-model late charge could still be questioned under adhesion contract or unconscionability analysis.<sup>65</sup> Thus, it arguably remains open whether the court would uphold even a carefully drafted percentage late charge in circumstances where other legal theories could be used to deny effect to the provision.

### III. IMPLICATIONS OF GARRETT

The first California case to label late charges as liquidated damages, *Clermont v. Secured Investment Corp.*,<sup>66</sup> raised a question which *Garrett* seems to answer. The clause at issue in *Clermont* assessed a late charge equal to one percent of the original value of the note, with a \$45 maximum, for each installment more than five days overdue.<sup>67</sup> The court of appeal found that the provisions were an attempt to provide for liquidated damages, because they compensated the lender for the delayed payment without attempting to fix the precise cost of the tardiness.<sup>68</sup> The case was remanded to determine whether the "service charge" provisions met the requirements of section 1671.<sup>69</sup> Since the method used for assessing the charge in *Clermont*—a percentage of the original amount of the note, whether or not the entire amount was in default—was rejected in *Garrett*, it would seem that the *Clermont* clauses would be similarly disapproved. The fact that the maximum penalty was \$45 should not alter this result, since the maximum

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64. *Thompson v. Gerner*, 104 Cal. 168, 37 P. 900 (1968). See text accompanying notes 15-17 *supra*.

65. Usury provisions, where applicable, would prevent patent abuse. CAL. CONST. art. xx, § 22 (West 1954). It has been assumed, in dictum, that palpably exorbitant prepayment charges would be subject to control by judicial decision. *Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n*, 22 Cal. App. 3d 303, 308, 99 Cal. Rptr. 417, 420 (1st Dist. 1971).

66. 25 Cal. App. 3d 766, 102 Cal. Rptr. 340 (2d Dist. 1972).

67. Since the loans were made at the maximum allowable interest rate (10 percent), the lender could not characterize the late charges as additional interest without running afoul of the usury laws. To avoid plaintiffs' alternative contentions that the late charges imposed illegal interest or illegal liquidated damages, defendants termed the charge a service fee. *Id.* at 768-69, 102 Cal. Rptr. at 340-41.

68. *Id.* at 769, 102 Cal. Rptr. at 342.

69. *Id.* at 771, 102 Cal. Rptr. at 343. The court expressly did not reach the question of applicability of the usury laws. *Id.* at 770, 102 Cal. Rptr. at 342. Since the lender in *Clermont* was subject to usury proscriptions, it had an interest in preventing the characterization of late charges as additional interest and may have considered losing on the basis of liquidated damages the lesser of two evils.

is considerably greater than the amounts allowed in other limitations on late charges.<sup>70</sup>

*Garrett* may also help remove some of the obstacles *Smith v. Allen*<sup>71</sup> created in using the *Freedman* forfeiture rules in deed of trust cases. *Smith* held that the *Freedman* analysis was inapplicable to deeds of trust because of the statutory scheme regulating forfeitures. The court took the position that once a forfeiture provision in a deed of trust is controlled by statute, the borrower was adequately protected against forfeitures and his statutory rights are exclusive. It has been suggested, however, that in a nonforfeiture context—for example, a suit to recover prepayment penalties or a suit to compel the lender to accept prepayment without penalty—the *Freedman* doctrine would apply.<sup>72</sup> The *Garrett* holding could strengthen this suggested analysis, since the two hypothetical prepayment penalty cases are analogous to *Garrett* in that all three involve deed of trust provisions not directly regulated by statute.

The court's approach in *Garrett* should encourage the use of standard liquidated damages clauses in deeds of trust and promissory notes, carefully drafted to meet the requirements of section 1671 and the relevant case law. The court suggested how a valid clause could be drafted. The lender's actual damages, it observed,

could be fairly measured by the period of time the money was wrongfully withheld plus the administrative costs reasonably related to collecting and accounting for a late payment.<sup>73</sup>

Using estimates of these costs to determine the liquidated damages would satisfy the requirement that the parties make a reasonable endeavor to fix fair compensation.<sup>74</sup> Although the court evidently considered that these charges would not be extremely difficult to ascertain,<sup>75</sup> it recognized the impracticability of fixing actual damages when

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70. See text accompanying note 81 *infra*; *Assembly, supra* note 34, at 2. These statutes impose limits from \$3.50 maximum to \$5.00 minimum. Under the deed of trust in *Garrett*, a penalty would not exceed \$45 unless the unpaid balance exceeded \$27,000.

71. 68 Cal. 2d 93, 436 P.2d 65, 65 Cal. Rptr. 153 (1968).

72. HETLAND, CREST, *supra* note 13, at § 4.74.

It is also arguable, however, that the *Garrett* holding will not extend *Freedman* to prepayment penalties because the forfeiture limitations in *Garrett* involved a breach of contract, which does not occur with prepayment. See *Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n*, 22 Cal. App. 3d 303, 307, 99 Cal. Rptr. 417, 420 (1st Dist. 1971); Sweet, *supra* note 13, at 128; cf. Note, *Secured Real Estate Loan Prepayment and the Prepayment Penalty*, 51 CALIF. L. REV. 923, 928-37 (1963).

73. 9 Cal. 3d at 741, 511 P.2d at 1203, 108 Cal. Rptr. at 851.

74. *Id.* at 741, 511 P.2d at 1204, 108 Cal. Rptr. at 852. See text accompanying notes 46-47 *supra*.

75. *Id.* at 741 & n.11, 511 P.2d at 1204 & n.11, 108 Cal. Rptr. at 852 & n.11. *But see Assembly, supra* note 34, at 55.

"the cost of ascertaining the same may well be in excess of a reasonable sum agreed to in advance by the parties as fair compensation."<sup>76</sup> Thus, if the lender determines its average costs for enforcing late charges and shows that it would be more costly to figure each such charge separately, it may use a standard liquidation clause for its late charges, provided the amount is reasonably related to the actual average cost. The court suggested indirectly that, after a grace period of 10 days, a charge of five percent of the due installment, or five dollars, whichever is less, would be reasonable.<sup>77</sup> Such a formulation would seem to meet the basic *Garrett* objection to the arbitrariness of a late charge based on the outstanding balance<sup>78</sup> and would place a limit on the charge in order to avoid excessiveness.

A standard late charge for secured transactions could be legislatively imposed, perhaps along the lines suggested by the court in *Garrett*. Control of these late charges is a proper legislative consideration since it is possible that restricting late charges will increase foreclosures. Lenders may prefer to collect on the balance due rather than charge what they consider to be inadequate fees for waiting.<sup>79</sup> These and other features of the lending system<sup>80</sup> warrant legislative action for all secured transaction late charges.<sup>81</sup>

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76. 9 Cal. 3d at 741, 511 P.2d at 1204, 108 Cal. Rptr. at 852 (footnote omitted).

77. *Id.* at 741 n.10, 511 P.2d at 1203-04 n.10, 108 Cal. Rptr. at 851-52 n.10. The court was referring to the late charge limits in the Retail Installment Act, CAL. CIV. CODE § 1803.6 (West 1973). *Id.*

78. The lender must show that the costs of a late payment decrease as the loan balance is paid off in order to demonstrate reasonable proportion.

79. *Assembly, supra* note 34, at 76, 91. It has been suggested that even a 10 percent top limit would encourage foreclosures. *Id.* at 91.

80. Savings and loan associations, the primary lenders to borrowers in single-family residences, are subject to many consumer complaints. *Assembly, supra* note 34, at 4, 7. At the end of 1962, savings and loan associations accounted for 31.6% of the total mortgage debt in the United States which was \$250 billion dollars. These institutions, comparatively new, typically provided nearly half of the total new flow of money into the mortgage market by 1963. J. BOGEN, FINANCIAL HANDBOOK 2-36 (4th ed. 1964) [hereinafter cited as BOGEN]. In California at the end of November, 1973, mortgage loans by insured savings and loan associations totaled \$2.3 billion. San Francisco Chronicle, Jan. 4, 1974, at 51, col. 4.

Commercial banks (which provide another 14% of the total mortgage debt in the United States, BOGEN 2-36) and savings and loan associations are completely exempt from the California usury laws. CAL. CONST. art. XX, § 22. This amendment authorizes the legislature to enact usury laws to regulate exempted lenders, but the legislature has failed to act. Note, *Secured Real Estate Loan Prepayment and the Prepayment Penalty*, 51 CALIF. L. REV. 923, 928 n.36 (1963); *Assembly, supra* note 34, at 39.

81. California presently regulates mortgage loan brokers where loans are less than \$16,000 on first trust deeds, or less than \$8,000 on any junior lien. Such brokers may assess 10 percent of the installment due once per late installment, with a minimum of \$5.00, and the borrower has a 10-day grace period from due date before the charge can be imposed. CAL. BUS. & PROF. CODE § 10242.5 (West Supp. 1974).

Essentially all late charges in secured transactions are subject to notice requirements. CAL. CIV. CODE § 2954.5 (West Supp. 1973). Other California statutory reg-

## CONCLUSION

Because *Garrett* reached the court on demurrer, requiring the court to treat all proper allegations as true, it is difficult to assess the importance of this case in the developing body of secured transactions law. The most *Garrett* can be said to stand for is that late charges are liquidated damages, and that a late charge based on amounts of principal or interest not in default is penal and therefore void. Furthermore, the procedural posture of *Garrett*, combined with the court's preoccupation over the method chosen for determining the amount of the late charge, meant that the additional requirements of section 1671 were left unexamined. Whether these omissions will further the court's policy against penalties, or merely subject borrowers to other varieties of late charges hidden in finely drafted liquidated damages clauses, remains to be seen.

Alan L. Mittman

B. *Conditions Precedent and Misrepresentation  
in Insurance Contracts*

*Thompson v. Occidental Life Insurance Co.*<sup>1</sup> The court upheld the trial court's finding that an insurance contract arose when the decedent completed his application, underwent an initial medical examination, and paid his first premium. The court rejected Occidental's defense that any contract formed was voidable for misrepresentations of his medical history by the deceased. Affirming that the burden of proof was on the insurance company, the court held that it had failed to negate all plausible explanations for the omission of certain facts from the application which was first filled out by a doctor approved and paid by the company, and then signed by the decedent. The court also dismissed the insurance company's contentions that its agent lacked

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ulation of late charges in various contexts includes: Automobile Sales Finance Act, CAL. CIV. CODE § 2982(c) (West Supp. 1973); California Credit Union Law, CAL. FIN. CODE § 14901 (West 1968); California Small Loan Law, CAL. FIN. CODE § 24451 (West 1968); Industrial Loan Law, CAL. FIN. CODE §§ 18655, 18655.1 (West Supp. 1973); Personal Property Broker Law, CAL. FIN. CODE §§ 22003, 22451, 22451.1, 22453, 22454 (West 1968, West Supp. 1973). For a general discussion of delinquency charges in retail installment sales contracts see Note, *Legal Problems of Consumer Credit*, 4 U.C.D.L. Rev. 6, 13-14 (1971).

Federal regulations include those of the Federal Housing Authority, 24 C.F.R. § 241.105 (1973), and the Veterans Administration, 38 C.F.R. § 36.4212(c) (1973). The FHA limits such charges to two percent of each payment more than 15 days late to cover the expense involved in handling delinquent accounts. The VA limits such charges to four percent of any installment that is delinquent 15 days.

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1. 9 Cal. 3d 904, 513 P.2d 353, 109 Cal. Rptr. 473 (1973) (Burke, J.) (4-3 decision) [hereinafter cited as *Thompson*].

authority to modify the contract, that its liability was limited, and that it had rescinded the contract by returning the premium to the decedent's widow.

Between June and August, 1964, Donald L. Thompson visited Kaiser Hospital approximately ten times for medical consultations with five different doctors. During these consultations he complained of chest pain, underwent an electrocardiogram, and was treated for "phlebitis" (vein inflammation). He was advised to keep off his feet to avoid the possibility that a blood clot in a leg vein might break off and travel to his lungs. In addition, his legs were X-rayed for "intermittent claudication" (leg pain) which occurred when Thompson walked further than half a block. He was advised to undergo a minor operation<sup>2</sup> to relieve the pain in his legs. This advice was given on August 10, 1964, the day immediately prior to the insurance examination. Thompson had also seen doctors in 1961 (treatment with tranquilizers, sedatives, and sleeping pills) and 1963 (drinking problem).

During July of 1964, Thompson consulted with his accountant and arranged to meet with John Kelley, Oakland Branch Manager for Occidental Life Insurance Company. Thompson's accountant had advised him about a year before that he should carry more insurance to protect his business, but this advice was not followed until the visits to Kaiser Hospital began.<sup>3</sup> On August 5, 1964, Thompson signed an application for a \$100,000 double indemnity life insurance policy. He paid no premium at that time. He took the insurance medical examination from Dr. Epstein on August 11. None of the doctor visits or conditions enumerated above were listed on the application form which Dr. Epstein filled out. A vein ligation and hernia operation performed in 1963 were listed.<sup>4</sup>

Two days after the medical examination, Kelley went to Thompson and requested payment of the first premium on the policy. Kelley made some explanation of the effect payment would have, but could not recall if he warned Thompson that the payment would not ensure interim coverage if Thompson were ultimately found to be uninsurable. No *receipt* was given Thompson, although one was attached to the application which Thompson had already signed.

Occidental's underwriters received the application on August 17. They decided an additional medical examination was needed. Before

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2. The operation was a "Chemical Sympathectomy." It involved the injection of a local anesthetic into the involuntary nervous system to allow the blood vessels to relax to the maximum, thus increasing circulation. Brief for Respondent at 34, n.8.

3. Opening Brief for Appellant at 17.

4. Occidental had paid for this operation under another policy and was presumably aware of it. Appellant's Reply to Respondent's Petition for a Hearing by the Supreme Court at 12.

Thompson was informed of this decision he slipped in his bathtub and almost drowned. He died of pneumonia in the hospital four days later, on August 28.

Occidental paid \$30,000 under an older, double-indemnity policy, but refused payment under the \$100,000 policy. The company returned the first premium because the additional medical examination had not been completed. Thompson's widow retained the check and recovered \$200,000 plus interest in an action against Occidental.

This Note will focus on the two main issues before the court—whether an insurance contract was formed, and whether the decedent's misrepresentations should have permitted Occidental to rescind. It will also make some predictions on how this decision will affect future judicial appraisal of life insurance contracts in California.

### I. CONTRACT FORMATION

The application Thompson signed stated that the applicant would not be insured "unless the policy is delivery to the owner . . . *except as otherwise provided in the receipt . . .*"<sup>5</sup> and until the full first premium is paid. The receipt stated that the insurance would be in effect from the date of the application or the medical examination, whichever occurred later, if certain conditions were met.<sup>6</sup> The conditions here involved were: 1) the premium was to be paid at the time the application was signed; 2) the company was to be satisfied that the proposed insured was insurable under the company's rules at the time coverage started; and 3) all medical examinations required by the company were to have been completed. The language used clearly indicated that these conditions were intended to be conditions precedent.<sup>7</sup>

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5. The clause read, in relevant part:

The Payment Acknowledged By This Receipt Is Made and Received Subject to the Following Conditions:

(A) 1. If the medical examinations, if any, required by the Company are completed, and

2. If the Company at its Home Office is satisfied that at the time of completing both Part I and Part II of the application the Proposed Insured was insurable under the Company's rules for a policy on the plan, in the amount, at the class of risk and otherwise exactly as applied for in Part I of the application with the same number as this receipt, then, but only after such conditions are met, the insurance will be effective from the date of Part I, the date of Part II, or the date specifically requested in the application, whichever is the latest, regardless of death or change of insurability of the Proposed Insured occurring after completion of both parts of the application. . . .

The receipt provided in bold face type that "This receipt is to be used *only if* payment is made at the time the application is signed; otherwise it must not be detached [from the application]." 9 Cal. 3d at 910 n.1, 513 P.2d at 356 n.1, 109 Cal. Rptr. at 476 n.1.

6. *Id.*

7. ". . . [B]ut *only after* such conditions are met, the insurance shall be effective from the date of Part I. . . ." *Id.* (emphasis added).

Thus if the applicant were ultimately found to be *insurable*, the protection of the policy would relate back to the prior date and protect the proposed insured from changes in health occurring between the time of the medical examination and application signature and time of approval by the company's home office.<sup>8</sup>

Such a clause benefits an insurance company in several respects. In the first place, immediate coverage is an excellent selling point for the company's agents.<sup>9</sup> The premium paid the agent also protects the company against a change of mind by the insured who is tempted by another company or loses interest in insurance altogether. At the least, the first premium payment will cover the company's investigation and medical examination costs, and might deter the insured from thoughts of abandoning the coverage.<sup>10</sup> The amount involved is usually small enough so that if he abandons the coverage the insured will not be likely to sue for its recovery.<sup>11</sup>

The benefits to the insured are more speculative, in that the insured may not receive effective coverage under such a clause. If death occurs between application and approval, the company may defeat coverage by denying that the insured would have been acceptable under the company's rules due to some infirmity discovered in the medical examination or disclosed by the applicant.<sup>12</sup> Even if there were nothing seriously wrong with the applicant at the time of his examination, his survivor would have to obtain a copy of the company's underwriting rules and prove that he would have been insurable at that time to meet the condition precedent and force payment from a recalcitrant insurer. The clause thus permits the company to collect premiums from the

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8. This result is required by statute. CAL. INS. CODE § 10115 (West 1972).

9. For a good example of the risks of this practice, however, see *Wernecke v. Pacific Fidelity Life Ins. Co.*, 238 Cal. App. 2d 884 at 885, 48 Cal. Rptr. 251 at 252 (4th Dist. 1965) where an agent told the applicant and his wife that he would be covered after signing if he died in an auto accident before the policy was issued. The applicant did die in an auto accident several days later and the company refused payment. The court gave effect to the policy, however, and ordered payment to the beneficiary. See also *Maddox v. Life & Cas. Ins. Co.*, 79 Ga. App. 164, 165, 53 S.E.2d 235, 237 (1949) and *Himes v. Metropolitan Life Ins. Co.*, 207 S.C. 420, 422, 36 S.E.2d 137, 138 (1945).

10. Comment, *Life Insurance Receipts: The Mystery of the Non-Binding Binder*, 63 YALE L.J. 523, 524 (1954). See also Comment, *Operation of Binding Receipts in Life Insurance*, 44 YALE L.J. 1223 (1935).

11. 63 YALE L.J., *supra* note 10, at 523.

12. There are two types of binder clauses used by insurance companies. The type involved in this case is the "insurable risk" variety, which covers the insured if he could meet the objective guidelines established by the company on the date of the application. The other type is the "approval" binder, which states no objective criteria, is totally dependent on whether or not the company would have accepted the application, and resembles a personal satisfaction clause. Needless to say, approval if death has intervened is rare with such a clause. 63 YALE L.J., *supra* note 10, at 528.

date of the application while contesting any death occurring before approval if there is any doubt whatsoever as to the applicant's insurability. Effective coverage thus dates only from approval, allowing the insurer to collect a premium for a period during which he assumes little, if any, corresponding risk.<sup>13</sup> But the applicant does receive some benefit from the exchange—e.g., earlier maturity and cash surrender dates—and this is generally held to satisfy the consideration requirement.<sup>14</sup>

Many courts, however, have refused to enforce such clauses because of their misleading wording. In the leading case of *Gaunt v. John Hancock Mutual Life Insurance Co.*,<sup>15</sup> Judge Learned Hand construed one such clause as it would be understood by an ordinary applicant. The court found that the conditions which qualified the promise of immediate coverage were confusing and that the ordinary applicant would believe that he was covered once he had paid the first premium and successfully completed the medical examination. Thus the insured was held to be covered. In California, *Ransom v. Penn Mutual Life Insurance Co.*<sup>16</sup> (relied on by the majority in *Thompson*) followed *Gaunt* in allowing recovery despite a similar clause.<sup>17</sup> The court held that an ordinary person on reading the application would believe that he would secure immediate coverage by paying the first

13. See Comment, "Binding Receipts" in California, 7 STAN. L. REV. 292, 297 (1955); 63 YALE L.J., *supra* note 10, at 533-34; *Starr v. Mutual Life Ins. Co.*, 41 Wash. 228, 83 P. 116 (1905).

14. See 63 YALE L.J., *supra* note 10, at 534. In *Gaunt v. John Hancock Mut. Life Ins. Co.*, 160 F.2d 599, 601 (2d Cir. 1947) (L. Hand, J.), the insurance company suggested six advantages for payment without coverage: 1) an earlier date of incontestability; 2) earlier maturity and cash surrender dates; 3) coverage in the period between approval and delivery (done by statute in California, see note 7, *supra*); 4) coverage if the applicant became uninsurable between the medical exam and approval; 5) premiums at lower rates if the applicant passed a birthday in the interim between application and approval; 6) disability in the interim, if the policy covered disability.

For an expansion of 4) above and a general defense of the insurance industry's practice in this area, see Fortunato, *Conditional Receipts: Should the Uninsurable have Insurance?*, 1 FORUM, April 1966, at 5, 22.

15. 160 F.2d 599 (2d Cir. 1947).

16. 43 Cal. 2d 420, 274 P.2d 633 (1954).

17. The application in *Ransom* contained the following clause:

If the first premium is paid in full in exchange for the attached receipt signed by the Company's agent when this application is signed the insurance shall be in force, subject to the terms and conditions of the policy applied for, from the date of Part I or Part II of this application, whichever is the later, provided the Company shall be satisfied that the Proposed Insured was at that date acceptable under the Company's rules for insurance upon the plan at the rate of premium and for the amount applied for, but that if such first premium is not so paid or if the Company is not satisfied as to such acceptability, no insurance shall be in force until both the first premium is paid in full and the policy is delivered while the health, habits, occupation and other facts relating to the Proposed Insured are the same as described in Part I and Part II of this application and in any amendments thereto.

43 Cal. 2d at 423, 274 P.2d at 634.

premium,<sup>18</sup> and that the ambiguity should be resolved in favor of the insured (*contra proferentum*)<sup>19</sup> by construing the clause as a condition subsequent. The court also stressed that it would be unconscionable for the company to escape the obligation after using language to induce payment at the time of application.<sup>20</sup> The effect of finding the ambiguity and creating a condition subsequent was to extend coverage to the applicant from the time the payment was made until notification by the company that he was uninsurable.<sup>21</sup>

The difficulty with the court's *contra proferentum* approach in *Ransom* was that it left open the possibility that insurance companies could create valid conditions precedent to coverage by drafting a clause that an ordinary applicant could understand.<sup>22</sup> But the basis of the decision was not really ambiguity of the clause in the legal sense. Rather, it was the misleading effect of such a clause upon a layman who expected immediate protection in exchange for his money. Thus one commentator suggested that the court had really outlawed the "illusory nature" of "retroactive immediate coverage,"<sup>23</sup> and the Ninth Circuit has interpreted *Ransom* as holding that taking premiums without providing coverage is unconscionable irrespective of differences in language in the various insurance companies' binders.<sup>24</sup>

Over the last ten years, the California Supreme Court has relied

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18. For an argument that the clause was not ambiguous, see 7 STAN. L. REV., *supra* note 13, at 296.

19. The entire maxim is "*Omnia praesumuntur contra proferentum*," and it expresses the principle that if a written contract contains a word or phrase capable of two reasonable meanings, the preferred interpretation will be that which is less favorable to the party who drafted the contract and had control over the choice of words. Patterson, *The Interpretation and Construction of Contracts*, 64 COLUM. L. REV. 833, 854 (1964).

20. 43 Cal. 2d at 425, 274 P.2d at 636. *Ransom* was followed in *Allen v. Metropolitan Life Ins. Co.*, 44 N.J. 294, 208 A.2d 638 (1965). Other courts have refused to follow California's lead in the area of the "non-binding binder." See *Morgan v. State Farm Life Ins. Co.*, 240 Ore. 113, 400 P.2d 223 (1965).

21. For the view that the clause was not ambiguous, see 7 STAN. L. REV., *supra* note 13, at 296.

22. "Moreover, defendant drafted the clause, and had it wished to make clear that its satisfaction was a condition precedent to a contract, it could easily have done so by using unequivocal terms." 43 Cal. 2d at 425, 274 P.2d at 636. The *contra proferentum* rule is supposed to be used only in doubtful and ambiguous situations, and each clause of the policy is to be given effect if possible. *Jenson v. Traders & Gen. Ins. Co.*, 52 Cal. 2d 786, 790-91, 345 P.2d 1, 3 (1959). In point of fact, courts search long and hard for an "ambiguity" which will enable them to employ the rule. See Patterson, *supra* note 19, at 858. For a recent example, see *State Farm Mut. Auto. Ins. Co. v. Johnston*, 9 Cal. 3d 270, 507 P.2d 1357, 107 Cal. Rptr. 149 (1973).

23. 7 STAN. L. REV., *supra* note 13, at 299-300.

24. *Metropolitan Life Ins. Co. v. Wood*, 302 F.2d 802 (9th Cir. 1962); *Metropolitan Life Ins. Co. v. Grant*, 268 F.2d 307 (9th Cir. 1959). Both cases were cited by the majority in *Thompson*, 9 Cal. 3d at 912, 513 P.2d at 357, 109 Cal. Rptr. at 477.

on principles of adhesion to enforce a contract in many situations involving insurance policies. In *Steven v. Fidelity and Casualty Co.*<sup>25</sup> the court stated that if an insurer deals with the public on a mass basis, a contract of full coverage will be enforced unless all exclusions are "conspicuous, plain, and clear" in situations where the public may reasonably expect coverage.<sup>26</sup> The reasonable expectation of the insured was also the basis for giving effect to an insurance contract in *Gray v. Zurich Insurance Co.*<sup>27</sup> In offsetting the superior bargaining power of the insurer, the court has gradually shifted away from construing the literal language of insurance policies in favor of the insured, as in *Ransom*, and has instead enforced what the insured thought he was getting, or might reasonably expect, from the bargain.

When California appellate courts were confronted with clear "non-binding binder" clauses, they could choose from several analytic approaches. In *Young v. Metropolitan Life Insurance Co.*,<sup>28</sup> the court held that the clause was not ambiguous to the ordinary layman.<sup>29</sup> But

25. 58 Cal. 2d 862, 377 P.2d 284, 27 Cal. Rptr. 172 (1962). *Steven* involved a vending machine life insurance policy which prominently excluded non-scheduled airlines. The court transmuted this exclusion into coverage for an insured who died when a non-scheduled flight crashed with him aboard. For a discussion of the *Steven* case, see Note, *A New Approach to Vending Machine Insurance*, 16 STAN. L. REV. 191 (1963).

26. 58 Cal. 2d at 878, 377 P.2d at 294, 27 Cal. Rptr. at 182.

27. 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966). The court explained its concept of the adhesion contract as follows:

Although courts have long followed the basic precept that they would look to the words of a contract to find the meaning which the parties expected from them, they have also applied the doctrine of the adhesion contract to insurance policies, holding that in view of the disparate bargaining status of the parties we must ascertain that meaning of the contract which the insured would reasonably expect.

65 Cal. 2d at 269-70, 419 P.2d at 171-72, 54 Cal. Rptr. at 107-08 (footnotes omitted).

*Gray* involved the duty of the insurer to defend the insured. For a recent case expanding that duty, see *Wint v. Fidelity & Cas. Co.*, 9 Cal. 3d 257, 507 P.2d 1383, 107 Cal. Rptr. 175 (1973).

28. 272 Cal. App. 2d 453, 77 Cal. Rptr. 382 (5th Dist. 1969). See also *Koerstad v. Washington Nat'l Ins. Co.*, 257 Cal. App. 2d 399, 64 Cal. Rptr. 882 (2d Dist. 1967); *Wernecke v. Pacific Fidelity Life Ins. Co.*, 238 Cal. App. 2d 884, 48 Cal. Rptr. 251 (4th Dist. 1965).

29. The clause read as follows:

(1) All of the following conditions precedent must be fulfilled before the Company has any liability whatsoever under this Paragraph (1):

(a) a payment equal to the full first premium must be made at the time the application is signed by the applicant; and

(b) the person to be insured must have undergone all medical examinations which the Company may require; and

(c) the application must have been approved by the Company at its Home Office for the issuance of a policy of life insurance on the plan and for the class of risk and for the amount of insurance applied for; and

(d) there is no misrepresentation in the application. If and only if all the foregoing conditions precedent have been fulfilled and if the person to be insured dies before the policy applied for becomes effective, the Company

since the "natural tendency" of an applicant was to believe his advance premium payment gave him immediate coverage (citing *Steven*), and since the clause was in fine print and it was unlikely that the applicant had read it, the insurance company was held to have a duty to call the clause to the applicant's attention and to bear the burden of proof that it had done so.<sup>30</sup> Yet, in *Slobojan v. Western Traveler's Life Insurance Co.*,<sup>31</sup> the California Supreme Court held that pointing out or repeating the clause by the agent was insufficient to overcome the applicant's expectation of coverage. The court also stressed that the explanation was made *before*, not at the time, the premium was paid.<sup>32</sup> Apparently, at the very least, a detailed explanation by the agent is called for if the company desires to make the clause effective.

In *Thompson*, the court partially relied on the preceding cases to hold that a contract was formed. It based its conclusion on the theory that an ordinary man in Thompson's position would assume that premium payment would bring immediate protection, and that the conditions limiting the coverage were not stated in "conspicuous, unambiguous, and unequivocal language which an ordinary layman can understand."<sup>33</sup> Insofar as the majority of the court states that it is upholding an ordinary person's understanding of what was bargained for, it reaches an equitable result in the adhesion context. Insofar as it continues to say it will allow conditions precedent in binders if expressed clearly, made conspicuous, and brought to the attention of the applicant, the opinion may be misleading.<sup>34</sup> California courts since *Ransom* have consistently denied effect to such clauses, no matter how clear and conspicuous, and irrespective of whether they were called to the applicant's attention, as the *Young* and *Slobojan* cases amply demonstrate. The supreme court should simply have held that conditions precedent in insurance binders which call for an advance premium payment will never be enforced in California as a matter of public policy. The court may have feared such a holding would look

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will pay an amount equal to the amount of life insurance applied for. Any amount paid under this Paragraph (1) will be paid to the beneficiary or beneficiaries as expressed in the application made this date.

272 Cal. App. 2d at 456, 77 Cal. Rptr. at 383-84.

30. 272 Cal. App. 2d at 460-61, 77 Cal. Rptr. at 387.

31. 70 Cal. 2d 432, 450 P.2d 271, 74 Cal. Rptr. 895 (1969).

32. 70 Cal. 2d at 441, 450 P.2d at 276, 74 Cal. Rptr. at 900.

Contrast with this the lack of importance the court attributes to non-concurrent performance in *Thompson*.

33. 9 Cal. 3d at 912, 513 P.2d at 357, 109 Cal. Rptr. at 477.

34. The clause here in question, *supra*, note 5, contained 3 unambiguous conditions precedent: 1) payment at the time of the application *only*, 2) completion of all medical examinations required by the company, and 3) the home office's satisfaction that the applicant was insurable under their rules. *Thompson* had satisfied none of these conditions.

too much like legislating; yet they achieved the same result by a method nearly as transparent when they partially relied on a fictitious ambiguity in the clause and created such a strict standard of notice to the applicant in order to allow recovery. The illusory nature of the coverage and the unconscionable advantage received by the insurance company under "non-binding binder" clauses would seem to provide ample grounds under other principles of contract law for the court directly to state its policy.

The court's refusal to outlaw conditions precedent in conditional receipts encourages insurance companies to try to avoid the problem by drafting a clause so unambiguous that no court will deny it effect.<sup>35</sup> This leads to litigation which reduces the amount that the beneficiary ultimately receives from the policy when he prevails against the insurer in court, as he inevitably will.<sup>36</sup> It has been suggested, however, that a rule of law requiring insurance companies to cover the unacceptable risk along with the acceptable for the period after receiving the first premium and before notice to the applicant of uninsurability would cause insurers to discontinue the use of conditional receipts. This would deny the benefit of the conditional receipt to the healthy applicant who dies accidentally in the period between application and policy issuance.<sup>37</sup> However, the benefits insurers gain from the practice have apparently proved sufficient to outweigh the calculated risk of an occasional uninsurable's death in the interim period for the conditional receipt is still in wide use.<sup>38</sup>

The next chapter in this struggle will probably follow the lead of the *Young* and *Slobojan* cases. As insurers succeed in drafting an "unambiguous" clause, they will be met with the requirements of calling the insured's attention to it and sufficiently explaining its effect.

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35. Cf. Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 633 (1943) (footnotes omitted).

Still, this roundabout method has its disadvantages as the story of the treatment of warranties in life insurance contracts strikingly demonstrates. Courts, when protecting an innocent policy holder against the harshness of the doctrine, did not state clearly that as a matter of public policy an insurance company cannot avoid liability merely because of the falsity of a statement which has been labeled "warranty." They felt that freedom of contract prevented them from saying so. Instead they disguised as "interpretation" their efforts to change warranties into representations. But this makeshift solution tempted insurance companies to try the usefulness of "warranties" again and again.

Society has thus had to pay a high price in terms of uncertainty for the luxury of an apparent homogeneity in the law of contracts.

36. 63 YALE L.J., *supra* note 10, at 534.

37. Comment, *Good Health Clauses, Conditional Receipts, and the Risk of the Insured's Unknown Ailments*, 41 S. CAL. L. REV. 182 (1968).

38. See, e.g., *Wood v. Metropolitan Life Ins. Co.*, 193 F. Supp. 371, 374 (N.D. Cal. 1962), *aff'd.*, 302 F.2d 802 (9th Cir. 1962).

Because the insurer has the burden of proof on these issues,<sup>39</sup> and because the only living participant in the conversation may be the insurance company's agent (whose testimony is suspect),<sup>40</sup> the court may continue to grant recovery despite the lack of ambiguity or confusing language in the application.

## II. MISREPRESENTATION

The California Insurance Code sets rigorous standards of honesty for dealings between parties to an insurance contract. The Code permits rescission by the party injured by intentional or unintentional omission of material facts (concealment).<sup>41</sup> It also allows rescission by a party injured by material misrepresentation,<sup>42</sup> even in the absence of fraudulent intent.<sup>43</sup> Materiality is determined by the effect disclosure would have had on the party receiving the information;<sup>44</sup> the test is subjective and turns on what the particular insurer involved would have done had the information been disclosed.<sup>45</sup> The courts have interpreted the statutes to require present knowledge by the applicant of facts sought and his appreciation of the significance of this information.<sup>46</sup> Where the insurer demands answers to specific questions,

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39. *Young v. Metropolitan Life Ins. Co.*, 272 Cal. App. 2d 453, 461, 77 Cal. Rptr. 382 (5th Dist. 1969). See also part II of this Note.

40. See, e.g., *McAuliffe v. John Hancock Mut. Life Ins. Co.*, 245 Cal. App. 2d 855, 54 Cal. Rptr. 288 (1st Dist. 1966).

41. Each party to a contract of insurance shall communicate to the other, in good faith, all facts within his knowledge which are or which he believes to be material to the contract and as to which he makes no warranty, and which the other has not the means of ascertaining.

CAL. INS. CODE § 332 (West 1972). "Neglect to communicate that which a party knows, and ought to communicate, is concealment." CAL. INS. CODE § 330 (West 1972). "Concealment, whether intentional or unintentional, entitles the injured party to rescind insurance." CAL. INS. CODE § 331 (West 1972).

42. "If a representation is false in a material point, whether affirmative or promissory, the injured party is entitled to rescind the contract from the time the representation becomes false." CAL. INS. CODE § 359 (West 1972).

43. *Cohen v. Penn Mut. Life Ins. Co.*, 48 Cal. 2d 720, 725, 312 P.2d 241, 244 (1957).

44. Materiality is to be determined not by the event, but solely by the probable and reasonable influence of the facts upon the party to whom the communication is due, in forming his estimate of the disadvantages of the proposed contract, or in making his inquiries.

CAL. INS. CODE § 334 (West 1972).

45. *Burns v. Prudential Ins. Co.*, 201 Cal. App. 2d 868, 871, 20 Cal. Rptr. 535, 537 (2d Dist. 1962). For the suggestion that the alternative tests of 1) all similar insurers or 2) a reasonable and prudent insurer would lead to more just results and would be permissible under the language of section 334 of the Insurance Code, see Note, *Insurance: Concealment and Misrepresentation as Grounds to Avoid Policy*, 5 U.C.L.A. L. REV. 332, 334-36 (1958).

46. *Ransom v. Penn Mut. Life Ins. Co.*, 48 Cal. 2d 720, 274 P.2d 633 (1954); *McAuliffe v. John Hancock Mut. Life Ins. Co.*, 245 Cal. App. 2d 855, 54 Cal. Rptr. 288 (1966); *Jefferson Standard Life Ins. Co. v. Anderson*, 236 Cal. App. 2d 905, 46 Cal. Rptr. 480 (1965).

some cases have held answers to those questions material as a matter of law.<sup>47</sup> These cases make it a simple matter for the insurer to avoid a policy: any incorrect answer would allow rescission by the insurer.<sup>48</sup>

Against this background, it is not difficult to see why the court in *Thompson* placed the burden of proving misrepresentation on the insurer.<sup>49</sup> There was ample precedent for such a result,<sup>50</sup> if, indeed, it was not compelled by statute in cases of knowing misrepresentation.<sup>51</sup> If the court had done nothing more in this case, the result would be unexceptional.<sup>52</sup> But rather than simply placing the burden of proof on the insurer, the majority of the court comes closer to setting up a conclusive presumption against material misrepresentation by the insured.

The defendant in *Thompson* had sought rescission for misrepresentation on two grounds. The first was that in response to specific questions on a medical history form, Thompson had omitted mention of a series of medical consultations with five doctors in the preceding three months. During these consultations he had complained of chest pain, undergone X-rays for leg pain, was treated for phlebitis (vein in-

47. *Cohen v. Penn Mut. Life Ins. Co.*, 48 Cal. 2d 720, 725, 312 P.2d 241, 244 (1957); *California-Western States Life Ins. Co. v. Feinstein*, 15 Cal. 2d 413, 423, 101 P.2d 696 (1940). *Contra*, *Ransom v. Penn Mut. Life Ins. Co.*, 43 Cal. 2d 420, 427, 274 P.2d 633, 637 (1954).

In *Burns v. Prudential Ins. Co.*, 201 Cal. App. 2d 868, 20 Cal. Rptr. 535 (2d Dist. 1962), the court came to the following conclusion on materiality:

The distinction between the various groups of cases appears to rest upon the nature of the information withheld and what the evidence shows as to the practice of the insurance company when confronted with an application containing a truthful disclosure of the fact which was involved.

201 Cal. App. 2d at 872, 20 Cal. Rptr. at 538.

48. 5 U.C.L.A. L. REV., *supra* note 45, at pp. 335-36.

49. CAL. EVID. CODE § 115 (West 1966) defines the burden of proof as follows:

"Burden of proof" means the obligation of a party to establish by evidence a requisite degree of belief concerning a fact in the mind of the trier of fact or the court. The burden of proof may require a party to raise a reasonable doubt concerning the existence or nonexistence of a fact or that he establish the existence or nonexistence of a fact by a preponderance of the evidence, by clear and convincing proof, or by proof beyond a reasonable doubt.

Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence.

50. *Farmers Auto. Inter-Ins. Exch. v. Calkins*, 39 Cal. App. 2d 390, 393, 103 P.2d 230, 232 (4th Dist. 1940) (strong presumption of innocence of fraud); *Mayfield v. Fidelity & Cas. Co.*, 16 Cal. App. 2d 611, 615-16, 61 P.2d 83, 85 (4th Dist. 1936); *K. King & G. Schuler Corp. v. King*, 259 Cal. App. 2d 383, 396, 66 Cal. Rptr. 330, 338 (2d Dist. 1968) (clear and convincing evidence required). *But see* *Sierra Nat'l Bank v. Brown*, 18 Cal. App. 3d 98, 105-106, 95 Cal. Rptr. 742, 746-47 (1st Dist. 1971) (a preponderance of the evidence is sufficient).

51. "The party claiming that a person is guilty of crime or wrongdoing has the burden of proof on that issue." CAL. EVID. CODE § 520 (West 1966).

52. The dissenters agreed with the majority that the burden of proof was properly placed on Occidental. 9 Cal. 3d at 930, 513 P.2d at 370, 109 Cal. Rptr. at 490 (Wright, C.J., Sullivan and Draper, JJ., dissenting).

flammation), was advised to keep off his feet to lessen the danger of a clot breaking off in a leg vein and travelling to his lungs, and was advised to undergo a surgical procedure designed to relieve the leg pain. The second ground was that Thompson represented in writing that the answers to the specific questions on the medical history form were true and complete. The allegation of material misrepresentation was thus based on the alleged omissions of material facts.

The majority of the court in *Thompson* upheld the trial court's finding of no material misrepresentation, concluding that the trial court could have found that the alleged omissions were minor and thus not material, or were believed by Thompson to be related to his varicose vein problems which were disclosed.<sup>53</sup> In such circumstances, the court stated, the trial court could have found that it was the insurance company's doctor's responsibility to elicit the additional details of subsequent treatment.

The court's approach is open to criticism on several counts. First, there is some authority that failure to disclose doctor visits for even minor maladies in response to a specific question is grounds for rescission. The facts in *California-Western States Life Insurance Co. v. Feinstein*<sup>54</sup> were similar to those in *Thompson*. There, in response to a claim of misrepresentation, the appellant contended that the omission of some doctor visits from the application was not material because they had not been for serious complaints. The court rejected that argument since the question did not inquire about the gravity of the illness

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53. The odds that the court would affirm the plaintiff's judgment in *Thompson* were increased by the procedural posture in which the case was reviewed. Thompson had the benefit of findings of no misrepresentation by the trial judge and an advisory jury. On appeal, courts are reluctant to substitute their judgment for that of the trier of fact below if there is any substantial evidence in the record which supports the verdicts. 6 WITKIN, CALIFORNIA PROCEDURE §§ 245-46 (2d ed. 1971); *Green Trees Enterprises, Inc. v. Palm Springs Alpine Estates, Inc.*, 66 Cal. 2d 782, 784, 427 P.2d 805, 807, 59 Cal. Rptr. 141, 143 (1967). Where two or more inferences reasonably can be drawn from the facts, the appellate court will similarly refuse to upset the trial court's verdict. *Green Trees Enterprises v. Palm Springs Alpine Estates*, *supra*, at 784-85, 427 P.2d at 807, 59 Cal. Rptr. at 143. Only if an inference is rebutted by clear and uncontradicted evidence in the record can the appellate court legitimately step in.

[T]he trier of the facts may not indulge in the inference when that inference is rebutted by clear, positive and uncontradicted evidence of such a nature that it is not subject to doubt in the minds of reasonable men. The trier of the facts may not believe impossibilities. When the rebutting testimony is of such a nature that the minds of reasonable men cannot differ on the subject, then the trier of the facts cannot, and should not be permitted to, indulge in the inference.

*Hicks v. Reis*, 21 Cal. 2d 654, 660, 134 P.2d 788, 791 (1943). In *Thompson*, the supreme court refused to find in the record the clear, positive, and uncontradicted evidence necessary to rebut the inference drawn by the trial court. As a result, they affirmed.

54. 15 Cal. 2d 413, 101 P.2d 696 (1940).

treated on each visit but simply whether there were medical consultations at all. The court held the misrepresentation was material. In *McAuliffe v. John Hancock Mutual Life Insurance Co.*,<sup>55</sup> however, the court of appeals found that omission of a doctor visit for a hang-over was not material and knowledge of it would not have affected the insurer's behavior if disclosed. In *Thompson*, the matters discussed in the Kaiser Hospital consultations were serious enough to require recommending surgery on the day before the insurance examination. In such a context, the omissions were clearly material and the court should have followed *Feinstein* and required disclosure.

Second, even if Thompson believed the recent consultations concerning his chest pain, phlebitis, leg pain, and the recommended surgical procedure were all related to his varicose vein problems, this belief furnishes no justification for failure to disclose the facts of these visits in response to a question asking only whether the applicant has "consulted, been examined or been treated by any physician" in the last five years. The court cites no cases in support of its contention that once Thompson disclosed his 1963 vein ligation (treatment for varicose veins) the trial court may have concluded it was the responsibility of the insurer's examining physician to elicit details of treatments for related maladies, and the proposition has no support in logic.

As exemplified by the decision in *Telford v. New York Life Insurance Co.*,<sup>56</sup> California courts have long recognized a duty of fair dealing between the parties to an insurance contract which requires that the applicant read his completed application and report any misstatements or omissions of fact to the insurer or his agent. There is an exception to this requirement, however, when the correct answers of the applicant were incorrectly transcribed by the insurer's agent through fraud, negligence, or mistake. In such a case the company is estopped from asserting the statements' falsity as a defense to recovery under the policy.<sup>57</sup> For example, in *Boggio v. California-Western States Life Insurance Co.*<sup>58</sup> (relied on by the majority in *Thompson*) the court held that an agent's statement that the company "didn't care about all this"<sup>59</sup> led the applicant to believe that the answers as recorded by the agent concealed nothing which was of any interest to the insurer.<sup>60</sup>

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55. 245 Cal. App. 2d 855, 54 Cal. Rptr. 288 (1st Dist. 1966).

56. 9 Cal. 2d 103, 107, 69 P.2d 835, 838 (1937).

57. *Lyon v. United Moderns*, 148 Cal. 470, 83 P. 804 (1906); *Byrd v. Mutual Benefit Health & Accident Ass'n*, 73 Cal. App. 2d 457, 166 P.2d 901 (2d Dist. 1946); *Layton v. New York Life Ins. Co.*, 55 Cal. App. 202, 202 P. 958 (1st Dist. 1921).

58. 108 Cal. App. 2d 597, 239 P.2d 144 (2d Dist. 1952).

59. *Id.* at 598, 239 P.2d at 145.

60. The rule would not apply here to charge Boggio with knowledge he did not have when he signed the application unless he could have ascertained that his statements were false in the sense that they withheld information sought

In *Rutherford v. Prudential Insurance Co.*<sup>61</sup> the strict rule of *Telford* was further relaxed when the court inferred that the incomplete responses on the signed application were due to the misleading impression the doctor created by not writing down all answers given him by the applicant, rather than to a direct misleading statement by the doctor. However, in *Rutherford*, the examining doctor testified that in filling out the medical history form he would interpret what he thought the applicant meant, that he was not very interested in detail, and that he might ignore matters he did not consider serious.<sup>62</sup> This testimony provided a basis for the inference that the applicant was misled. In *Thompson*, the only evidence on this point was Dr. Epstein's testimony that he recorded all of the applicants responses. But rejection of this testimony could not create a factual basis for inferring that the insurer's examining physician had in any way misled Thompson.<sup>63</sup>

The majority states four additional bases for its decision to uphold the trial judge.<sup>64</sup> First, Thompson may have mentioned all his medical problems and consultations to Dr. Epstein, the examining physician, but he failed to record them in the course of the hurried medical examination. The majority asserts that the trial court was not required to believe Dr. Epstein's testimony that he would have recorded this information had it been given, particularly since the doctor testified as to his "invariable practice" of writing down all relevant information rather than relying on his memory of what had occurred at the specific examination.<sup>65</sup> However, a trier of fact's disbelief cannot remedy the lack of affirmative proof<sup>66</sup> and any inference it draws must be based on fact rather than supposition.<sup>67</sup> The only evidence presented by

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to be elicited by the questions contained in the application. This was not the case . . . . Having had the question interpreted for him in this manner, repeated reading of the questions and answers would not have led him to believe that his service injury was material. He knew at all times that his answers were literally untrue but not that they would be deemed untrue by the company in determining whether he was an insurable risk.

*Id.* at 600, 239 P.2d at 146-47.

61. 234 Cal. App. 2d 719, 44 Cal. Rptr. 697 (1st Dist. 1965).

62. *Id.* at 722, 44 Cal. Rptr. at 699.

63. See note 67, *infra* and *Thompson*, 9 Cal. 3d 927-28, 513 P.2d at 368, 109 Cal. Rptr. at 488-89 (Wright, C.J., dissenting).

64. 9 Cal. 3d at 917-18, 513 P.2d at 361-62, 109 Cal. Rptr. at 481-82.

65. Dr. Epstein could not remember what had gone on during the examination, which occurred six years prior to the trial. Appellant's Reply to Respondent's Petition for a Hearing by the Supreme Court at 9. Thus, his testimony was not "direct" evidence of what was said but required an inference which the trial court could refuse to draw. See CAL. EVID. CODE § 420 (West 1966); *Thompson*, 9 Cal. 3d at 918-19, n.6, 513 P.2d at 362, n.6, 109 Cal. Rptr. at 482, n.6.

66. *Casetta v. United States Rubber Co.*, 260 Cal. App. 2d 792, 808, 67 Cal. Rptr. 645, 655 (1st Dist. 1968).

67. "An inference is a deduction of fact that may logically and reasonably be drawn from another fact or group of facts found or otherwise established in the ac-

the plaintiff from which a relevant inference could be drawn related to the brevity of the examination and to omissions or minor discrepancies in the physical examination portion of the application rather than any omissions in the questions on medical history which were asked Thompson by Dr. Epstein.<sup>68</sup> That the physical examination may have been cursory hardly supplies factual support for the inference that Dr. Epstein did not write down all the information he was given by Thompson about his medical history.<sup>69</sup> The majority opinion condoned speculation by the trier of fact and would require the insurer to rebut the active imagination of the trial judge and jury.<sup>70</sup>

The majority's second basis for upholding the trial court's verdict was that Thompson may not have understood the "medical jargon" in which the doctors at Kaiser described his ailments. His inability to appreciate the gravity of the diagnosis, however, does not adequately explain his failure to make any mention of those visits.

The third reason the court gives is that the trial court could have found that Thompson's undisclosed problems related to minor indispositions. Because Thompson was told the preceding day that his ailments required surgical relief, however, that inference is impossible to draw, rebutted as it is by "clear, positive and uncontradicted evidence."<sup>71</sup>

Fourth, the majority reasons that the trial court could have disbelieved the testimony of an Occidental officer that the company could have rejected the application had Thompson's medical history been adequately reported. This is possible under the present law,<sup>72</sup> if somewhat incredible given the facts of the case.<sup>73</sup> It ignores, however, the additional evidence of materiality provided by the insurer's specific

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tion." CAL. EVID. CODE § 600(b) (West 1966). See also *Eramdjian v. Interstate Bakery Corp.*, 153 Cal. App. 2d 590, 315 P.2d 19 (2d Dist. 1957).

68. 9 Cal. 3d at 918 n.5, 513 P.2d at 361-62 n.5, 109 Cal. Rptr. at 481-82 n.5.

69. Although Dr. Epstein testified that he could do three or four such examinations in an hour, he also testified that he ran over this period of time if the particular examination so required. Appellant's Reply to Respondent's petition for a hearing by the Supreme Court at 9.

70. "Thus, the burden was on Occidental to negate to the satisfaction of the trier of fact the *various plausible explanations* for the incomplete answers on Thompson's application." 9 Cal. 3d at 919, 513 P.2d at 363, 109 Cal. Rptr. at 483 (emphasis added).

71. *Hicks v. Reis*, 21 Cal. 2d 654, 660, 134 P.2d 788, 791 (1943). See note 53, *supra*.

72. See *McAuliffe v. John Hancock Mut. Life Ins. Co.*, 245 Cal. App. 2d 855, 858, 54 Cal. Rptr. 288, 289 (1st Dist. 1966).

73. "It is inconceivable that an insurer would not have been affected by the disclosure that an applicant suffered from an advanced condition of arteriosclerosis, a malady which would shorten his life span by one-half to two-thirds." *Thompson*, 9 Cal. 3d at 930, 513 P.2d at 370, 109 Cal. Rptr. at 490 (Wright, C.J., dissenting).

questions regarding ailments of the type from which Thompson suffered.<sup>74</sup> Substantial prior authority has held that such inquiries are material as a matter of law.<sup>75</sup> The majority cites these authorities earlier in its opinion<sup>76</sup> and proceeds to ignore them in reaching its conclusion.

The court thus does far more than affirm that the burden of proof of misrepresentation is on the insurer. It creates a presumption that the applicant is truthful and that the insurance company's agent is either negligent or deliberately misleading the applicant. If the party alleging wrongdoing bears the burden of proof on that issue,<sup>77</sup> it is hard to reconcile the insurer's burden with the presumption of wrongdoing by his agent set up by the majority in *Thompson*.

As the dissent points out,<sup>78</sup> if the majority had only required the insurer to carry the burden of proof as to misrepresentation, it should have reversed. A party may introduce evidence of such overwhelming probative force that no one could reasonably disbelieve it in the absence of countervailing evidence. When this occurs, the burden of producing evidence shifts to the opposing party.<sup>79</sup> Occidental would have met this burden when it introduced the application, certified by Thompson as being true and complete, and then introduced evidence of the substantial omissions Thompson knew it contained. When the plaintiff failed to produce any evidence to rebut this inference of material misrepresentation, the court should have found material misrepresentation as a matter of law.<sup>80</sup>

The ramifications of this case could be substantial. Dr. Epstein's failure to recall the specific examination in question may be a factor

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74. See *Burns v. Prudential Ins. Co.*, 201 Cal. App. 2d 868, 875, 20 Cal. Rptr. 535, 539 (2d Dist. 1962).

75. See note 47 *supra*, and CAL. INS. CODE § 334 (West 1972).

76. 9 Cal. 3d at 916, 513 P.2d at 360, 109 Cal. Rptr. at 480.

77. CAL. EVID. CODE § 520 (West 1966).

78. 9 Cal. 3d at 930, 513 P.2d at 370, 109 Cal. Rptr. at 490.

79. Suppose, however, that the proponent has been able to go further and to adduce evidence which if believed would make it beyond reason to repudiate the proponent's claim,—evidence such that the jury, acting as reasonable men, must be persuaded and must render a verdict on that issue for the proponent. Here the proponent has now put himself in the same position that was occupied by the opponent at the opening of the trial, *i.e.* unless the opponent now offers evidence against the claim and thus changes the situation, the jury should not be allowed to render a verdict against reason,—a verdict which would later have to be set aside as against evidence. The matter is thus *in the hands of the judge again*, as having the supervisory control of the proof; and he may now, as applying a rule of law, *require the opponent to produce evidence*, under penalty of losing the case by direction of the judge.

9 WIGMORE, EVIDENCE § 2487 (3d ed. 1940). See also CAL. EVID. CODE § 550, Law Revision Commission Comment (West 1966).

80. *Thompson*, 9 Cal. 3d at 930, 513 P.2d at 370, 109 Cal. Rptr. at 490 (Wright, C.J., dissenting).

which will limit *Thompson's* application to similar cases in which there is no "direct" evidence relating to the examination. Yet the effect of the decision could easily be broader: it permits the trial court to disregard all evidence given by the insurer's agents and to draw inferences in a vacuum. Moreover, many other doctors may be unable to recall clearly a medical examination of short duration when requested to testify several years later.

*Thompson* could lead to more complete initial medical examinations and less reliance by insurance companies on later discovery of a "misrepresentation" in the application in order to avoid payment on the policy. But the court could have reached the same result by clearly overruling the cases<sup>81</sup> which hold that an incomplete answer to a specific question of the insurer is material as a matter of law. And there are cost limitations on how complete a medical examination the insurer will be able to afford and still keep its premium rates at a reasonable level. Even a fairly extensive examination might fail to discover serious symptoms if the applicant is held to no duty to answer questions about his medical history honestly. It is ironic that the court largely abrogates any duty of fair dealing running from the insured to the insurer at a time when it is expanding the duty the insurer owes the insured in other contexts.<sup>82</sup>

*Thompson* also may cause some life insurance companies to re-examine their use of the conditional receipt to provide immediate coverage for the applicant. Since immediate payment will bring immediate coverage for the uninsurable, and the presumption against misrepresentation by the applicant will make it difficult if not impossible to prevent fraud, insurers may eliminate the use of payments with the application or restrict them to the young and healthy.

The most important aspect of the decision in *Thompson* is the court's refusal to hold the applicant to his signed statement of complete disclosure. There should be some minimal rules of contract law which the court will not abrogate, even in an insurance policy where the parties are of disparate bargaining strength and a form contract is used. A requirement of being bound by what one signs if it is short, intelligible, fair, and directly relevant to the risk undertaken would seem a

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81. *Cohen v. Penn Mut. Life Ins. Co.*, 48 Cal. 2d 720, 312 P.2d 241 (1957). See cases cited in note 45, *supra*.

82. See *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973), decided the same term as *Thompson*. The court created a cause of action for breach of the covenant of good faith and fair dealing implied in every insurance contract when the insurer suggested arson by the insured to the police after the insured building had burned. The insurer then requested the insured to appear while he was undergoing criminal investigation, knowing that he would claim the 5th Amendment's protection and not appear. The insurer refused payment under the policy.