POHLS & ASSOCIATES
ATTORNEYS AT LAW

California Attorneys for the
Insurance and Financial Services Industries

12657 Alcosta Boulevard, Suite 150 ♦ San Ramon, California 94583-4698
Voice: (925) 973-0300 ♦ Fax: (925) 973-0330 ♦ www.califehealth.com

Defense Strategies for Premium Offset Litigation

by Robert R. Pohls

INTRODUCTION

The insurance buying public does not fully understand that insurers are not immune to economic trends. Therefore, when economic growth is stunted and an insurer experiences a lower rate of return on its own investments, purchasers of universal life insurance who plan to use dividends earned on the cash value of their policies to offset all (or some portion) of their premiums are often surprised to learn that additional premiums will be required to maintain their coverage at existing levels.

Faced with an unexpected premium notice, those policyholders often compare the actual performance of their policies with the performance that was illustrated at the point of sale. When the difference is great, disappointed policyholders who do not recognize the limited purpose of the illustration that influenced their purchase sometimes sue the insurer and/or the sales agent to recover the shortfall.

The resulting litigation can take a variety of forms. However, each case involves an allegation that the sales agent either mislead the policyholder or somehow obligated the insurer to credit dividends equal to those on which the illustration was based. This article will identify the liability theories that are common to such cases and suggest corresponding defense strategies. It also will demonstrate that a successful defense to premium offset litigation almost always turns on how well the illustration and policy documents were drafted.

A. Contract Claims

Because holders of universal life insurance policies have no reason to litigate issues which will determine their future premium payment obligations after the insured has died, premium offset litigation usually arises before the insured's death. However, so long as the policy correctly describes the premium payment obligations, policyholders cannot demonstrate that performance is due under the policy when the insured is alive. Therefore, plaintiffs in premium offset litigation often allege that the illustration (or other representations by the agent) created a separate contract which altered or supplanted the premium payment obligations set forth in the subject policy.

Defending against such claims can be very problematic. Indeed, a finding that the insurer was contractually obligated to credit dividends at the illustrated level (or to forever relieve the policyholder of its obligation to pay premiums if it complies with a predetermined payment schedule) effectively requires that a judgment be entered in favor of the policyholder. For that reason, it is essential that insurers establish from the outset that the underlying insurance policy is the only contract between the parties.

Insurers can accomplish that goal in several ways. In many cases, the policy itself contains language that can preclude the policyholder from claiming a separate contract was formed. In others, reliance on established principles of contract law can produce the same result.

1. Integration and the Parol Evidence Rule. Most insurance policies have an integration clause which provides that the policy is the entire contract between the policyholder and insurer. Even in the absence of such a clause, there may be statutory authorities which require integration. See, e.g., California *Insurance Code* §10113 ["Every policy of life, disability or life and disability insurance issued. . . shall contain and be deemed to constitute the entire contract between the parties."].

If the insurer can establish that the policy is an integrated agreement, the Parol Evidence Rule should foreclose the policyholder from alleging that the illustration or representations by the agent gave rise to a separate contract. In California, the Parol Evidence Rule is set forth in *Civil Code* Section 1625, which provides that:

> ". . . the execution of a contract in writing . . . supersedes all the negotiations or stipulations concerning its matter which preceded or accompanied the execution of the instrument."

See also, California *Code of Civil Procedure* §1856(a). The Parol Evidence Rule also bars claims of promissory fraud which are "directly at variance with the terms of the written agreement." *Bank of America v. Pendergrass* (1935) 4 Cal.2d 258, 263. It therefore requires that the terms of the underlying policy, rather than some unwritten agreement about premium payments, govern the rights of the parties.

2. Requirements for Altering Contract Terms. The Parol Evidence Rule only prohibits the policyholder from offering evidence of pre-contract representations and conduct which contradicts the terms of a written, integrated agreement. Therefore, to escape the effect of the Parol Evidence Rule, policyholders in premium offset litigation sometimes allege that the separate contract regarding premium payments arose from conduct which occurred after the policy was issued.

Well-drafted policies often contain language providing that an alteration of policy terms is void unless written and signed by an officer of the issuing company. In such a case, the insurer should force the policyholder to admit that no signed writing exists. In addition, the premiums paid for coverage under the subject policy cannot constitute consideration for a subsequent contract because consideration must confer some benefit upon the promisor to which it is not otherwise entitled. See, e.g., California *Civil Code* §1605. Paying premiums for coverage under the written policy, even in amounts which exceed the minimum premium required, may not be enough. As a result, insurers should also challenge the policyholder to prove that it gave adequate consideration for the alleged separate contract regarding premium payments.

3. Limitations on Agent's Authority. Even when the subject policy has no integration clause, insurers can sometimes foreclose the policyholder from alleging the existence of a separate contract by demonstrating that the sales agent had no authority to create such a contract.

Most courts recognize that an insurance company has the right to limit the authority of its soliciting agents. See, e.g., *Duarte v. Postal Union Life Ins. Co.* (1946) 75 Cal.App.2d 557, 571. In *Duarte*, the Court further explained that:

> "A mere soliciting agent or other intermediary operating between the insured and the insurer has authority only to initiate contracts, but not to consummate them, and cannot bind his principal by anything he may say or do during the preliminary negotiations."

Id. The insurer's counsel therefore should carefully inspect the application and other policy documents for statements regarding the limits of the sales agent's. If those statements exist, they can be used to disprove an allegation that the agent had actual or ostensible authority to make a separate contract for the company.

4. Statute of Frauds. Although largely dependent on the nature of the separate contract that the policyholder seeks to create from the illustration and/or agent's representations, the Statute of Frauds can assist insurers in defeating claims based on a separate agreement that was never reduced to writing. In California, for example, the Statute of Frauds provides that:

> "The following contracts are invalid, unless they, or some note or memorandum thereof, are in writing and subscribed by the party to be charged or by the party's agent:
>
> (a) An agreement that by its terms is not to be performed with a year from the making thereof. . . . [¶]
>
> (e) An agreement which by its terms is not to be performed during the lifetime of the promisor."

California *Civil Code* §1624. The Statute of Frauds can therefore be used to invalidate an unwritten contract which purportedly makes the premium payment obligation "vanish" after the policyholder pays inflated premiums for a specific number of years or, perhaps, simply requires that the insurer pay a specific sum upon the insured's death.

B. Bad Faith and Other Tort Claims

The prerequisite for any bad faith claim is "the existence of a contractual relationship between the parties, since the covenant is an implied term in the contract." *Smith v. City and County of San Francisco* (1990) 225 Cal.App.3d 38, 49. However, a tenable claim for bad faith also requires that the policyholder prove that the insurer acted unreasonably and without proper cause in withholding a benefit that is payable under the contract. *Gruenberg v. Aetna Insurance Co.* (1973) 9 Cal.3d 566, 575.

In premium offset litigation, policyholders can rarely make that proof. Indeed, once it has shown that the policy is its only contract with the policyholder, the insurer can usually defeat the policyholder's bad faith claim simply by submitting evidence that the insured is still alive. Absent any dispute over that fact, that evidence should be enough to establish that benefits are not yet payable under the contract and, in the process, prove that the bad faith claim is premature.

Insurers involved in premium offset litigation therefore are likely to face other tort claims which charge that the policyholder was mislead by the illustration or other representations made by the agent. Proof that the insurer has complied with its contractual obligations is insufficient to defeat those claims, and uncertainty about what the agent may have said to the policyholder can seemingly make summary judgment impossible. Nonetheless, there are several ways in which the insurer can establish its right to prevail on such claims as a matter of law.

1. Limitations on Agent's Authority. When the policyholder alleges that the agent made misrepresentations which induced its purchase of the subject policy, the policyholder is seeking to hold the insurer vicariously liable for the acts and statements of the agent. As noted above, the application and other policy documents sometimes contain statements which identify the limits of the sales agent's authority to bind the insurer. If those statements exist, they can be used to show that the agent had neither actual nor ostensible authority to bind the company by any statements he made to the policyholder. See, *Duarte, supra,* 75 Cal.App.2d at 571-572 ["An insurer is not bound by the representations or purported agreements made by an unauthorized agent."].

2. Integration and the Parol Evidence Rule. The Parol Evidence Rule promotes at least two important policies. First, it reflects the assumption that "written evidence is more accurate than human memory." *Banco do Brasil, S.A. v. Latian, Inc.* (1991) 234 Cal.App.3d 973, cert. denied, 504 U.S. 986 (1992). Second, it is based on the notion that "fraud or unintentional invention by witnesses interested in the outcome of the litigation will mislead the finder of fact" if allowed to introduce extrinsic evidence on a subject covered by a written, integrated agreement. *Id.*

The Parol Evidence Rule serves those ends by forbidding parties to a contract from offering evidence regarding the pre-contract negotiations that contradicts the express terms of the written agreement. *Pendergrass, supra,* 4 Cal.2d at 263. It therefore properly keeps the focus on the terms of the contract which defines the parties' relationship, rather than allowing "parties to litigate disputes over the meaning of contract terms armed with an arsenal of tort remedies inappropriate to the resolution of commercial disputes." *Price v. Wells Fargo Bank* (1989) 213 Cal.App.3d 465, 485.

3. The Essential Element of Reliance. Some courts have held that, as a matter of law, a party cannot rely on pre-contractual representations that are directly contrary to the terms of a written, integrated agreement. See, e.g., *Hadland v. NN Investors Life Ins. Co.* (1994) 24 Cal.App.4th 1578. Therefore, insurers whose policies and/or illustrations clearly state that dividend levels are not guaranteed can use those statements to disprove an allegation that the policyholder relied on an agent's oral representations to the contrary.

The decision in *Hadland, supra*, is particularly instructive. In that case, the plaintiffs allegedly purchased a health insurance policy in reliance on the sales agent's representation that coverage under the subject policy was "as good if not better" than the coverage under their existing policy. Had the plaintiffs read their new policy when it was delivered, they would have discovered that its coverage was not as good as the coverage under their previous policy. The plaintiffs therefore alleged that they had not read their policy and had instead relied on the agent to explain its terms to them. *Id.*, at 1586.

The trial court granted a nonsuit on the plaintiffs' fraud claim, and the Court of Appeal affirmed. In reaching that result, the Court of Appeal found guidance in an earlier decision by the California Supreme Court, explaining that:

> "As the Supreme Court stated in *Sarchett v. Blue Shield of California* (1987) 43 Cal.3d 1, 15, a court 'must hold the insured bound by clear and conspicuous provisions in the policy even if evidence suggests that the insured did not read or understand them.' The Hadlands, having failed to read the policy and having accepted it without objection, cannot be heard to complain it was not what they expected."

Id., at 1589. The Court therefore concluded that the plaintiffs' "reliance on representations about what they were getting for their money was unjustified as a matter of law." *Id.*, at 1589.

As a result, insurers whose products contain suitable language clarifying that the illustrated dividends are not guaranteed and/or that the dividends earned on the cash value of the policy may not always be enough to offset the required premiums can use those statements to conclusively establish that the policyholder is unable "to establish the requisite fraud element of justifiable reliance." *Id.*, at 1588-89; See, also, *Hackethal v. National Casualty Co.* (1987) 189 Cal.App.3d 1102.

4. Statute of Limitations. One who claims to have been defrauded is charged with constructive knowledge of the facts constituting the fraud (so as to start the running of the statute of limitations) once he has both notice of facts sufficient to put a prudent person on inquiry and the means for discovering those facts. *Sime v. Malouf* (1949) 95 Cal.App.2d 82.

Under California law, an insured has a duty to read his or her policy and is bound by its terms, notwithstanding any contrary oral statements. *Malcolm v. Farmers New World Life Ins. Co.* (1992) 4 Cal.App.4th 296, 304, n. 6; *See also, Hackethal, supra,* 189 Cal.App.3d at 1108-11 [same]. Indeed, well-drafted policies usually caution policyholders to read their policies upon delivery and invite them to surrender any policy that does not conform to their expectations. *Taff v. Atlas Assurance Co.* (1943) 58 Cal.App.2d 696, 702 ["Not only did ordinary prudence require that [each plaintiff] examine [the policy] to see that it was the policy he had intended to purchase but in bold letters on the very face of it he was admonished to read and return it for correction."]. The receipt and acceptance of a policy without objection therefore can give the policyholder constructive knowledge of the policy's terms and prevent any complaint that "he did not read it or know its terms." *Aetna Casualty & Surety Co. v. Richmond* (1977) 76 Cal.App.3d 645, 652.

When the representations attributed to the sales agent directly contradict the express terms of the subject policies, it follows that the policyholder would have discovered that fact if he or she had reviewed the policies. By using these authorities, insurers can therefore charge policyholders with constructive knowledge of the falsity of the agent's alleged representations at the time that the policy was delivered. See, e.g., California *Civil Code* §19. As a result, claims of delayed discovery may be untenable, and the statute of limitations may constitute a complete defense to the policyholder's claims.

CONCLUSION

Premium offset litigation can be extremely frustrating for an insurer that has done nothing more than request that the policyholder pay premiums necessary to maintain the coverage for which the policy provides. That frustration stems from the fact that the insurer is merely exercising its right to collect premiums under the terms of the policy and does not yet have a duty to render its performance. However that frustration also provides the key to a successful defense in premium offset litigation: by keeping the court and/or trier of fact focused on the express terms of a well-drafted policy, insurers can effectively use established legal principles to defeat all of the plaintiff's claims.

About the Author

Rob Pohls has been shaping California insurance law for more than 20 years. He is the principal of *Pohls & Associates*, a firm in the San Francisco Bay Area that he established in 1999 to represent life, health, disability and long term care insurance companies in bad faith, ERISA and other forms of complex litigation. As a member of the Association of Life Insurance Counsel and a former Chair of the American Bar Association's Health & Disability Insurance Law Committee, he is a prolific author and frequent speaker on issues of interest to the insurance and financial services industries. More information about Rob, his firm and his practice is available online at: *www.califehealth.com*. Contact him by e-mail at: *rpohls@califehealth.com*.