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LIFE INSURANCE AGENT FRAUD IN CALIFORNIA: REBATING AND RELATED MISCONDUCT

*Douglas Hallett**

I. INTRODUCTION

In its September 1, 1975 issue, *Forbes* magazine reported the following:

In April 1974 Aetna Life & Casualty fired its top salesman, Bert Kreisberg, who had written over \$100 million in new policies in 1973 alone (roughly 5% of Aetna's new business that year). Kreisberg was selling multimillion-dollar face-amount policies with high first-year cash value and then offering to pay the premiums on that policy himself in exchange for the cash-value rights. By borrowing on the cash value and then adding in his commissions and expenses, Kreisberg wound up with 140% of the first-year premium. To be sure, he would have netted more than 40% by simply writing those policies in the ordinary manner, but the market for life insurance policies of such size is exceedingly thin. (Unless, of course, they're "free" like Kreisberg's.)¹

Kreisberg's practices constitute a misdemeanor offense by the agent² and, potentially, the policyholder in California.³ As in the other forty-nine states, California law prohibits rebating—that is, providing an inducement to a prospective insured other than that which is stated in the policy.⁴ Kreisberg himself eventually pleaded *nolo contendere*

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1. *A Salesman Who Was Too Successful*, *FORBES*, Sept. 1, 1975, at 79.

2. CAL. INS. CODE § 761 (Deering 1976) provides that: "Any insurer, insurance agent, broker, solicitor, or life agent and any officer or employee of an insurer, insurance agent, broker, or life agent that makes or receives an unlawful rebate is guilty of a misdemeanor."

3. CAL. INS. CODE § 752 (Deering 1976) provides that: "Any person named as the insured in any policy or named as the principal, or obligee, in any surety policy or the agent or representative of any such person who, directly or indirectly, knowingly accepts or receives any unlawful rebate is guilty of a misdemeanor."

4. CAL. INS. CODE § 750 (Deering 1976) provides that:

An insurer, insurance agent, broker, or solicitor, personally or by any other party, shall not offer or pay, directly or indirectly, as an inducement to insurance on any subject-matter in this State, any rebate of the whole or part of the premium paya-

to thirteen counts of grand theft for his activities. However, that conviction has hardly served as a deterrent to other agents, although there are no reliable figures on fraudulent agent activity, it is on the upswing.

The number of life insurance companies has tripled over the last three decades. Inflation and the development of a steadily increasing variety of investment instruments have undermined the marketability of traditional whole life products and have led to a mushrooming of new special risk, term and so-called "universal life" alternatives. Unfavorable economic growth rates and the rise of an underground barter economy to avoid federal and state taxation present even more inducements for agents' rebating practices. The volatility of interest rates has increased both the rewards and risks on premium funds agents may hold for insurers. In addition, the increasing emphasis on deregulation of the economy has made agent discipline a low priority for insurance departments in an era of tight state budgets. The net result is that fraudulent activities by agents are skyrocketing in an environment of increasing tolerance. The public, insurers, and the vast majority of trustworthy agents pay the price.

The most obvious form of agent fraud is outright theft—the expropriation of premium funds received from an applicant or insured. Such activity is expressly proscribed by the California Insurance Code whether it be by an agent⁵ or administrator.⁶ The other most common forms of agent fraud involve representations between an agent or administrator and an applicant or insured. Rebating, of which Kreisberg was guilty, and twisting, the making of misrepresentations to an applicant or insured for the purpose of inducing him to let an insurance

ble on an insurance contract, or of the agent's or broker's commission thereon, and such rebate is an unlawful rebate.

CAL. INS. CODE § 751 (Deering 1976) provides that:

An insurer, or an insurance agent, broker, or solicitor, personally or otherwise, shall not offer or pay, directly or indirectly, as an inducement to enter into an insurance contract, any valuable consideration which is not clearly specified, promised or provided for in the policy, or application for the insurance, and any such consideration not appearing in the policy is an unlawful rebate.

5. CAL. INS. CODE § 1733 (Deering 1976) provides in pertinent part:

All funds received by any person acting as an insurance agent, . . . as premium or return premium on or under any policy of insurance . . . are received and held by such person in his fiduciary capacity. Any such person who diverts or appropriates such fiduciary funds to his own use is guilty of theft and punishable for theft as provided by law.

6. CAL. INS. CODE § 1759.6 (Deering Supp. 1982) provides in pertinent part that: "All insurance charges or premiums collected by an administrator on behalf of or for an insurer or insurers, and return premiums received from such insurer or insurers, shall be held by the administrator in a fiduciary capacity."

contract lapse,⁷ are the classic proscribed forms of agent misconduct. They are often intertwined by agents seeking the high first-year commissions (as high as 250% of the first-year premiums) some companies offer on whole life policies. The burgeoning of multiple-employer trusts and large-scale third-party administrators which not only participate in the sale but also in the administration of insurance contracts has led to new problems resulting from unpoliced accounting practices and misrepresentations that are made to applicants or insureds.

It would be impossible to discuss adequately each variety of insurance agency fraud. All of them, however, ultimately focus on the issue of the agent's authority. The most important consideration for an insurer in most agent fraud situations is the insurer's liability for the insurance policies and representations which were made as a result of the agent's activities. This issue is most clearly brought into focus in the classic insurance agent crime of rebating. While the other insurance agent crimes will not be discussed in any detail in this article, it should be borne in mind that the same issues of agent authority and policy liability with which the insurer must deal in the rebating situation are also found in those cases.

II. AGENT AUTHORITY

As with the traditional forms of agent misconduct, an insurance company's liability for the results of each of these forms of fraud arises out of the agent's or administrator's authority as defined by law to make the representations. Therefore, the first line of defense for an insurer victimized by an agent's fraud is to assert that the agent lacked authority to make the representation.

Most insurance codes do not deal extensively with the authority of an insurance agent. The general rule is that the powers of an agent of an insurance company are governed by the general laws of agency.⁸

7. CAL. INS. CODE § 781 (Deering 1976) provides that:

A person shall not make any misrepresentation

(a) to any other person for the purpose of inducing, or tending to induce, such other person either to take out a policy of insurance, or to refuse to accept a policy issued upon an application therefor and instead take out any policy in another insurer, or

(b) to a policyholder in any insurer for the purpose of inducing or tending to induce him to lapse, forfeit or surrender his insurance therein.

A person shall not make any representation or comparison of insurers or policies to an insured which is misleading, for the purpose of inducing or tending to induce him to lapse, forfeit, change or surrender his insurance, whether on a temporary or permanent plan.

8. *Downey v. Humphreys*, 102 Cal. App. 2d 323, 335, 227 P.2d 484, 492 (1951); *Cronin v. Coyle*, 6 Cal. App. 2d 205, 212, 44 P.2d 385, 388 (1935).

Under California law, "[a]n agent has such authority as the principal, actually or ostensibly, confers upon him."⁹ Actual authority is defined as "such as a principal intentionally confers upon the agent, or intentionally, or by want of ordinary care, allows the agent to believe himself to possess."¹⁰ In most cases, this authority is defined in the agency contract between the insurer and agent. Typical terms of a standard agency contract include the following:

AUTHORITY

The Agent shall solicit within said territory for the purpose of procuring applications for life insurance and annuities on the lives of individuals, which applications shall be submitted to the Company for consideration, and shall deliver policies, premium receipts, premium notes, and interest receipts when sent him by the Company for collection, when the terms and conditions governing such delivery have been complied with and shall transmit all collections to the Company.

ACCOUNTING

All monies received for the Company by the Agent for premiums and otherwise, by reason of this agreement, shall belong to the Company, shall be received and held by the Agent in a fiduciary capacity only, shall not be used for any purpose whatsoever other than specified herein, and shall forthwith be paid over to the Company.

COMMISSIONS

The Company shall pay the Agent as full compensation for his services and his expenses, the commissions computed on the premiums paid to and received in cash by the Company upon policies and annuities procured by the Agent in accordance with this agreement.

REJECTIONS, MODIFICATIONS, DELIVERIES, COMMISSIONS, REFUNDS

The Company, in its discretion, may reject or require the amendment of any application for insurance. No policy shall be delivered save during the applicant's good health and after the first premium shall have been duly settled for. Should the Company for any reason refund the premium on any policy or annuity written on an application secured by said Agent,

9. CAL. CIV. CODE § 2315 (Deering 1981).

10. CAL. CIV. CODE § 2316 (Deering 1981).

then the Agent shall refund to the Company any monies received by him by reason of the payment of such premium.

ASSIGNMENT

No assignment of this agreement or of commissions or other payments due or to become due hereunder shall be binding on the Company unless written acknowledgement of its filing is issued from the Home Office.

LIMITATIONS

The Agent shall not have authority on behalf of the Company to make, alter or discharge any policy or other contract, to waive any forfeiture nor to grant permits, nor to extend the time of paying any premium or premium note; nor to guarantee dividends; nor to receive any monies or premiums due, or to become due, to the Company, except on policies or annuity contracts, premium receipts, premium notes or other items which have been sent him by the Company for collection; nor shall the Agent issue or circulate any advertisements or literature unless the same shall have been first approved in writing by the Company; nor alter the forms which may be sent to the Agent by the Company in connection with the business nor substitute other forms in place of those used by the Company; nor expend nor contract for the expenditure of, the funds of the Company except as expressly authorized by it in writing; nor shall the Agent possess or exercise any authority on behalf of the Company other than that expressly conferred upon him by this agreement.

NOTES

The Agent is not authorized to accept notes, except as specifically authorized by the Company and then only on forms provided by it. Should he do so, he shall immediately pay over to the Company the amount due on items for which such notes have been accepted, and shall hold said note solely at his own risk.

RELATIONSHIP

Nothing herein contained shall be construed to create the relation of employer and employee between the Company and the Agent. Within the territory above described, the Agent shall be free to exercise his own judgment as to the persons from whom he will solicit insurance and annuity contracts and the time and place of such solicitation, but the Company may from time to time prescribe rules and regula-

tions respecting the conduct of the business covered hereby, not interfering with such freedom of action of the Agent, and the Agent agrees to be governed thereby.

TERMINATION

Either party may terminate this agreement by a notice in writing mailed or delivered at least thirty days prior to the date of termination to or at the last known address of the other party; in which event a settlement shall, at the expiration of such thirty days, be had between the parties hereto. The Agent agrees that fraud, malfeasance, misappropriation or withholding of funds by the Agent or his wilful neglect of any duty or obligation hereunder, or retaining of policies, receipts, books or other property of the Company after demand therefore shall have been made by the Company or its authorized representative, shall forthwith, at the option of the Company, terminate this agreement, in which even an immediate settlement shall be had between the parties hereto.

If the Agent's license to solicit insurance for the Company issued by any State Authority is not renewed while this contract is in force such non-renewal shall operate as a suspension of all the Agent's rights to further solicit insurance hereunder until such license shall have been renewed.

An agent, in addition to the authority expressly authorized by the principal, has certain authority conferred by law.¹¹ This includes the authority:

1. To do everything necessary or proper and usual, in the ordinary course of business, for effecting the purpose of his agency; and,
2. To make a representation respecting any matter of fact, not including the terms of his authority, but upon which his right to use his authority depends, and the truth of which cannot be determined by the use of reasonable diligence on the part of the person to whom the representation is made.¹²

By this reasoning, the powers of an insurance agent are coextensive with the business entrusted to his care.¹³ There is law to the effect

11. CAL. CIV. CODE § 2318 (Deering 1981) provides that, "[e]very agent has actually such authority as is defined by this title, unless specially deprived thereof by his principal, and has even then such authority ostensibly, except as to persons who have actual or constructive notice of the restriction upon his authority."

12. CAL. CIV. CODE § 2319 (Deering 1981).

13. *Frasch v. London & Lancashire Fire Ins. Co.*, 213 Cal. 219, 223, 2 P.2d 147, 148

that unless limitations of authority are brought to the attention of an applicant or an insured, the insurer is bound to the agent's representation.¹⁴ However, this law arises in the context of representations within the normal scope of agency, not fraudulent acts. Section 2306 of the California Civil Code states that: "[a]n agent can never have authority, either actual or ostensible, to do an act which is, and is known or suspected by the person with whom he deals, to be a fraud upon the principal."¹⁵ In any event, when limitations of the authority of an agent appear in writing, such as normally appear in insurance policies as well as agency contracts, the insured is presumptively charged with knowledge of the terms.¹⁶ Thus, an acceptance by an applicant of a policy clearly defining the limitations placed on the agent usually charges the applicant with knowledge of the limitations.¹⁷ Most insurance policy contracts contain such limiting terms stating that the agent is not authorized to alter the terms of the contract. A typical limitation in an insurance policy contract states:

No agent or other person, except the President, a Vice President, the Secretary, an Actuary, an Associate Actuary, an Assistant Secretary, or an Assistant Actuary, of the Company, has authority to extend the time for payment of a premium or interest; to make or modify a contract; to waive a forfeiture; or to bind the Company by making any promise or representation or by giving or receiving any information.

Notwithstanding such clear limitations of agent authority, the insurer may still be bound to the agent's representations by the doctrine of ostensible authority. Ostensible authority is defined as "such as principal, intentionally or by want of ordinary care, causes or allows a third person to believe the agent to possess."¹⁸ The doctrine of ostensible authority rests upon the doctrine of estoppel. Its essential elements, therefore, are: (1) representations by the purported principal; (2) *justifiable* reliance on those representations by a third party; and (3) change of position or injury resulting from such reliance.¹⁹

(1931); *Skyways Aircraft Ferrying Serv., Inc. v. Stanton*, 242 Cal. App. 2d 272, 281, 51 Cal. Rptr. 352, 358 (1966) (quoting *Frasch*).

14. *See* *Financial Indem. Co. v. Murphy*, 223 Cal. App. 2d 621, 627, 35 Cal. Rptr. 913, 916-17 (1963).

15. CAL. CIV. CODE § 2306 (Deering 1981).

16. *Porter v. General Accident, Fire and Life Assurance Corp.*, 30 Cal. App. 198, 203, 157 P. 825, 827 (1916).

17. *Iverson v. Metropolitan Life Ins. Co.*, 151 Cal. 746, 750-51, 91 P. 609, 611 (1907).

18. CAL. CIV. CODE § 2317 (Deering 1976).

19. *Hartong v. Partake, Inc.*, 266 Cal. App. 2d 942, 960, 72 Cal. Rptr. 722, 734 (1968).

Under standard insurance agency contracts, an agent usually has authority to accept premium funds from an insured. This leads to almost certain liability on the part of an insurer for a policy issued to an insured even if the agent misappropriates the premium funds himself. The innocent insured has no reason to believe that the agent will misappropriate the funds and the insurer has committed on the agent such incidents of authority which would indicate to the insured that the agent does have the authority to collect premium funds. A more difficult case occurs when an agent seeks to induce a prospective insured to turn over premium funds in return for a waiver of policy provisions. For example, an applicant may note that a health question on the insurance application calls for disclosure of information which may cause the applicant to be rejected. If the agent were to tell the applicant that the term could be waived and that he or she need not provide the information, the insurer's defense to a claim under the insurance contract would depend on how clearly the application indicates that the agent has no authority to make such a waiver. If the applicant were on clear notice of the agent's lack of authority, the insurer would not be bound to the contract. On the other hand, if clear notice is not given, the court might well find the company liable under the policy.²⁰

Unauthorized actions by an agent can also be subsequently ratified

20. An illustration of this principle is found in *Harnischfeger Sales Corp. v. Coats*, 4 Cal. 2d 319, 48 P.2d 663 (1935), where a vendor sued vendee to recover the balance due on a power shovel. The vendee's defense was based on vendor's agent's fraud. The sales contract contained the following provision:

This agreement shall not be considered as executed, and shall not become effective until accepted by the vendee, and executed and approved by the president, or vice-president, or secretary of the vendor, and it is hereby further declared, agreed and understood that there are no prior writings, verbal negotiations, understandings, representations or agreements between the parties not herein expressed.

Id. at 320, 48 P.2d at 663.

In reversing the lower court's judgment for plaintiff notwithstanding the jury verdict for defendant, the supreme court held that:

[A]n innocent principal might by such a stipulation *protect himself* from liability in a tort action for damages for fraud and deceit, but that the third party would nevertheless be entitled to *rescind the contract*. . . . The principal would normally be liable in tort for misrepresentations by an agent acting within the scope of his actual or ostensible authority, and by stipulating in the contract that the agent has no such authority, the principal has done all that is reasonably possible to give notice thereof to the third party. Under such circumstances the innocent principal may justly be relieved of liability for the agent's wrong.

Id. at 320-21, 48 P.2d at 663 (emphasis in original).

In 1977, the California Legislature added section 1759 *et seq.* to the Insurance Code outlining definitions and rules for insurance administrators. In section 1759.2, the Legislature statutorily embodied the principle that receipt by an administrator of a premium constitutes receipt by an insurer, but is no more forthcoming with respect to the issues of authority. CAL. INS. CODE §§ 1759-1759.10 (Deering Supp. 1983).

by a principal. In this regard, section 2307 of the Civil Code states that "[a]n agency may be created, and an authority may be conferred, by a precedent authorization or a subsequent ratification." The question then becomes what actions are sufficient to establish ratification by a principal.

In order for a principal to ratify the unauthorized acts of its "agent," it must engage in confirmatory conduct, or, at the very least, conduct which is necessarily inconsistent with a claim of disapproval. In determining the nature of the principal's conduct, inconclusive or ambiguous acts should not serve as the basis for ratification nor should facts be stretched to find a basis for ratification.²¹ Ratification requires that the agents were acting on behalf of the insurer.²² Put in another way, it is an essential element of ratification that the principal have some knowledge of the unauthorized act of its agent (or a deliberate lack of knowledge) and of the material consequences of the act.²³

A principal's failure to anticipate that its agents will act far in excess of their authority is not, without more, negligence such as would create either ostensible authority or constructive knowledge to support ratification.²⁴ The normal rule is that the authority of an agent cannot be established merely by the representations of the agent.²⁵ And persons dealing with an agent are bound at their peril to ascertain not only the fact of agency but the nature and extent of authority beyond that which is usual and customary.²⁶

III. LIABILITIES UNDER INSURANCE CONTRACTS IN CASES OF AGENT FRAUD

As noted above, the biggest risk to the insurer in most insurance fraud schemes by agents is liability under the policies themselves.²⁷ Rebating, twisting and premium trust fund violations may be accompa-

21. *Gates v. Bank of America*, 120 Cal. App. 2d 571, 576, 261 P.2d 545, 547 (1953).

22. *Schomaker v. Petersen*, 103 Cal. App. 558, 570, 285 P. 342, 347 (1930).

23. *Johnson v. California Interurban Motor Transp. Ass'n*, 24 Cal. App. 2d 322, 336-37, 74 P.2d 1073, 1080-81 (1938).

24. *Cignetti v. American Trust Co.*, 139 Cal. App. 2d 744, 748-49, 294 P.2d 490, 492-93 (1956).

25. *Hilyar v. Union Ice Co.*, 45 Cal. 2d 30, 42, 286 P.2d 21, 28 (1955) (quoting *Fesler v. Rawlins*, 43 Cal. App. 2d 541, 544, 111 P.2d 380, 382 (1941)).

26. *Torrance Nat'l Bank v. Enesco Fed. Credit Union*, 134 Cal. App. 2d 316, 324, 285 P.2d 737, 742 (1955) (quoting *Ernst v. Searle*, 218 Cal. 233, 240, 22 P.2d 715, 717 (1933)).

27. Refusal to pay claims may also lead to tort liability. Recently, a San Diego jury awarded a plaintiff \$10 million in punitive damages and \$350,000 in emotional distress damages when an insurer refused to pay on a \$1 million life policy issued pursuant to an agent rebate. The jury found that the beneficiaries had reasonably relied on misrepresentations of

nied by a large volume of insurance contracts with liabilities extending into the millions of dollars. This potential liability is a far more important area of consideration for the insurer than any loss of commissions in excess of premiums received. In cases of premium trust fund violations, unless clear misrepresentations accompany the theft, the insurer may have difficulty avoiding policy liability. Because the agent normally has the authority to accept premiums on behalf of the insurer, the insurer is ordinarily bound to the policy risk.²⁸ However, if the insured is involved in the agent misappropriation, the analysis discussed below for rebating and twisting situations may be applied.

In suspected cases of rebating and twisting, the insurer must make an early and careful analysis. Once on notice of a rebating and twisting situation, the insurer must make this analysis very quickly in order to avoid potential arguments by the insured that it ratified the acts of the agent.²⁹ Early analysis—even if without complete information—is therefore absolutely essential to the insurer's determination of how to react to the situation. In most cases, a decision to seek rescission of the policies will mean a decision to pursue the agents, if only to assist in getting the policies rescinded. By the same token, a decision not to rescind the policies because of the cost-benefit analysis will generally mean a decision not to pursue the agents.

Although certain provisions of the California Insurance Code provide a right of rescission in some circumstances, none is specifically applicable to a rebating or twisting situation.³⁰ However, the Insurance Code does not provide that it is the sole body of California law governing insurance contracts within the state. It provides only that "[a]ll insurance in this State is governed by the provisions of this code"³¹ and that "[t]he provisions of this code in so far as they are substantially the

the agent. *Hutton Unit Loses Decision in Rebate Case*, Los Angeles Times, Nov. 2, 1983, at 2.

28. See *supra* notes 20-21 and accompanying text; see also Hughes, *Trial Tactics in Defending Life Insurers*, 17 FORUM 1081, 1082-83 (1981-82).

29. See *supra* text accompanying note 22.

The insurer must also note that it is theoretically bound to enforce the rebate and twisting laws. CAL. INS. CODE § 758 (Deering 1976) states that "[e]very insurer shall exercise reasonable diligence in securing the observance of [the unlawful rebates, profits and commissions statutes] by its agents."

30. See, e.g., CAL. INS. CODE §§ 331 (concealment), 338 (intentional or fraudulent omission by insured of matters proving or tending to prove the falsity of a warranty), 359 (representation false in material point), 447 (violation of material warranty or other provision of policy), 1904 (intentionally false representation by insured with respect to policy of marine insurance), 2030 (increased risk due to alteration in use or condition of subject matter insured under policy of fire insurance) (Deering 1976).

31. CAL. INS. CODE § 41 (Deering 1976).

same as existing statutory provisions relating to the same subject matter shall be construed as restatements and continuations thereof, and not as new enactments.”³² Courts freely apply the provisions of other California Codes in cases involving insurance, subject only to the rule that “a special statute dealing with a particular subject [Insurance Code provision] takes priority over the general statute.”³³ With regard to rescission it has been held:

[The] specification in the Insurance Code of circumstances under which a party to an insurance contract may rescind does not mean that rescission in any such case is the exclusive remedy. These provisions of the Insurance Code are in the nature of special provisions pertaining to insurance contracts, which are superimposed upon those provisions of law which govern contracts generally.³⁴

A. *Grounds for Rescission*

Section 1689(b) of the Civil Code sets forth the grounds that a party may rely on to rescind unilaterally a contract. The most useful to an insurer victim of agent fraud is that the contract is unlawful³⁵ or that there was a partial or total failure of consideration.³⁶

1. Unlawfulness of the contract as ground for rescission

Under section 1689(b)(5) of the Civil Code, a party to a contract

32. CAL. INS. CODE § 2 (Deering 1976).

33. *Pacific Auto. Ins. Co. v. Wolff*, 72 Cal. App. 3d 537, 542, 140 Cal. Rptr. 164, 167 (1977).

34. *De Campos v. State Compensation Ins. Fund*, 122 Cal. App. 2d 519, 529, 265 P.2d 617, 622 (1954).

35. CAL. CIV. CODE § 1689(b)(5) (Deering 1976) provides that “[a] party to a contract may rescind the contract . . . (5) [i]f the contract is unlawful for causes which do not appear in its terms or conditions, and the parties are not equally at fault.”

36. CAL. CIV. CODE § 1689(b)(2) (Deering 1976) provides that “[a] party to a contract may rescind the contract . . . (2) if the consideration for the obligation of the rescinding party fails, in whole or in part, through the fault of the party as to whom he rescinds.”

Cases addressing arguments based on prejudice of the public interest, as set forth in CAL. CIV. CODE § 1689(b)(6) (Deering 1976) and contravention of public policy generally, contain strong language limiting the circumstances under which a contract ought to be held void as against public policy. For example, in *Vick v. Patterson*, 158 Cal. App. 2d 414, 417, 322 P.2d 548, 550 (1958), the court stated that rescission should occur “only in cases where the dangerous tendency clearly and unequivocally appears from the contract itself” (quoting *Maryland Casualty Co. v. Fidelity & Casualty Co.*, 71 Cal. App. 492, 497, 236 P. 210, 213 (1925)). An argument for rescission based upon public policy considerations is weaker and less predictable than an argument based upon any of the other grounds set forth in CAL. CIV. CODE § 1689. *People ex rel. Mosk v. Barenfeld*, 203 Cal. App. 2d 166, 182, 21 Cal. Rptr. 501, 510-11 (1962).

may rescind the contract if it is unlawful for causes which do not appear in its terms or conditions and the parties are not equally at fault. Hence, an insurer might argue that an insurance contract issued pursuant to a rebate agreement is unlawful for causes which do not appear in its terms or conditions because it grows immediately out of an unlawful collateral agreement.

An unlawful contract is one which is "1. Contrary to an express provision of law; 2. Contrary to the policy of express law, though not expressly prohibited; or 3. Otherwise contrary to good morals."³⁷ A rebate agreement not only violates an express provision of the law as set forth in Insurance Code sections 750, 751,³⁸ 10113,³⁹ but it is also contrary to the policy of section 1668 of the Civil Code, which provides that "[a]ll contracts which have for their object, directly or indirectly . . . violation of law, whether willful or negligent, are against the policy of the law."⁴⁰

The court in *Miller v. California Roofing Co.*,⁴¹ applied such an analysis to a suit by a corporate manager to rescind a purchase of stock on the ground that the initial collection of consideration violated provisions of the Corporate Securities Act which prohibited collection of any portion of the consideration to be paid on account of a subscription before a permit authorizing such collection was issued. Subsequent transfer of the shares comported with statutory provisions. The court of appeal, in affirming the lower court's decision in favor of the defendant corporation, stated that a court cannot legally lend its aid to enforce either an illegal agreement or the results of one.⁴² However, the court held in favor of the corporation because the plaintiff manager there was *in pari delicto* with the corporation and therefore not entitled to recovery.⁴³

Although the statute violated by the collection of consideration in *Miller* is different from those in a rebate agreement, the factors allowing rescission in each case are identical, i.e., illegality of the agreement and parties not equally at fault.

It has been held that:

"The test . . . [of] whether a demand connected with an illegal

37. CAL. CIV. CODE § 1667 (Deering 1976).

38. See *supra* notes 3 & 4 and accompanying text.

39. CAL. INS. CODE § 10113 (Deering 1976) provides that the policy shall "be deemed to constitute the entire contract between the parties."

40. CAL. CIV. CODE § 1668 (Deering 1976).

41. 55 Cal. App. 2d 136, 130 P.2d 740 (1942).

42. *Id.* at 141, 130 P.2d at 744.

43. *Id.* at 145-46, 130 P.2d at 746.

transaction is capable of being enforced at law, is whether the plaintiff requires the aid of the illegal transaction to establish his case. If the plaintiff cannot open his case without showing that he has broken the law, the court will not assist him, whatever his claim in justice may be upon the defendant.⁴⁴

In *C.I.T. Corp. v. Breckenridge*,⁴⁵ the court of appeal affirmed the lower court decision that, where the plaintiff had no need to prove an illegal transaction to recover on a promissory note, he might recover.⁴⁶ In contrast, were an insured to bring action against an insurer under an insurance contract, it would be necessary to allege a valid contract, including the payment of consideration under the terms of the policy. Because a rebate agreement involves the basic consideration given for an insurance contract,⁴⁷ an insured plaintiff would be unable to establish his case without alleging the illegal transaction.

The second prong of the test may also be met because the parties to an insurance contract may not be equally at fault if an insured has committed a misdemeanor.

Under Insurance Code section 752,⁴⁸ in order to commit a misdemeanor, the insured must "knowingly" accept or receive the unlawful rebate. Thus, if it can be shown that the insured knew that he or she was accepting a rebate *and* knew it to be illegal, the insurer could rescind the contract under Civil Code section 1689(b)(5). However, is an insured who is aware that he is accepting a rebate but does not know of its illegality acting "knowingly" as used in Insurance Code section 752? Although "knowingly" is not defined in the Insurance Code, it seems likely that the Penal Code definition would pertain to criminal statutes contained in other Codes as well, at least where the term is undefined by the Code in which a criminal statute is found. Section 7 of the Penal Code defines the word "knowingly" as "import[ing] only a knowledge that the facts exist which bring the act or omission within the provisions of this code. It does not require any knowledge of the unlawfulness of such act or omission."⁴⁹

Insureds in general, whether or not they have actual knowledge that a rebate agreement violates the provisions of Insurance Code sec-

44. *C.I.T. Corp. v. Breckenridge*, 63 Cal. App. 2d 198, 200, 146 P.2d 271, 272 (1944) (quoting *Berka v. Woodward*, 125 Cal. 119, 127, 57 P. 777, 779-80 (1899) (quoting *Swan v. Scott*, 11 Serg. & Rawle 164 (1824))).

45. 63 Cal. App. 2d 198, 146 P.2d 271 (1944).

46. *Id.* at 200, 146 P.2d at 272.

47. *See infra* Section III. A. 2.

48. *See supra* note 3.

49. CAL. PENAL CODE § 7(5) (Deering 1976).

tion 750, must be aware of the existence of the facts which bring the rebate within the provisions of that section, i.e., that the rebate applied to the first year premiums specified in the policy. An insured is presumed to know the contents of his insurance policy, at least those provisions contained in clear and unequivocal language.⁵⁰

2. Failure of consideration as ground for rescission

Most life insurance policies provide that the consideration for issuing the policy is the application for insurance and payment of the first premium. Three provisions of section 1689(b) of the Civil Code provide for rescission based upon failure of consideration. A party to the contract may rescind under section 1689(b)(2) "[i]f the consideration for the obligation of the rescinding party fails, in whole or in part, through the fault of the party as to whom he rescinds."⁵¹ A party may rescind under section 1689(b)(3) "[i]f the consideration for the obligation of the rescinding party becomes entirely void from any cause."⁵² Finally, a party may rescind under section 1689(b)(4) if such consideration fails in a material respect before it is given to the rescinding party.⁵³

Section 1607 of the Civil Code provides that "consideration of a contract must be lawful within the meaning of section sixteen hundred and sixty-seven."⁵⁴ As previously stated, section 1667 defines unlawful as "1. Contrary to an express provision of law; 2. Contrary to the policy of express law, though not expressly prohibited; or, 3. Otherwise contrary to good morals." Contracts which have wilful or negligent violation of the law directly or indirectly as their purpose are against the policy of law.⁵⁵

In a rebate scheme, the method of payment of the first-year premium violates the express provisions of sections 750-767 of the Insurance Code⁵⁶ and is therefore unlawful consideration under section 1667(1) of the Civil Code. And, under section 1608 of the Civil Code, if any part of several considerations for a single object is unlawful, the

50. *Rice v. California-Western States Life Ins. Co.*, 21 Cal. App. 2d 660, 670, 70 P.2d 516, 521 (1937). However, there may be circumstances where the insurer's own conduct is such that even a technical misdemeanor violation by the insured will not obviate liability under the contract. See discussion of *Homestead*, *infra* notes 90-96 and accompanying text.

51. CAL. CIV. CODE § 1689(b)(2) (Deering 1976).

52. CAL. CIV. CODE § 1689(b)(3) (Deering 1976).

53. CAL. CIV. CODE § 1689(b)(4) (Deering 1976).

54. CAL. CIV. CODE § 1607 (Deering 1976).

55. CAL. CIV. CODE § 1667 (Deering 1976).

56. See *supra* notes 2-4 and accompanying text.

entire contract is void.⁵⁷

In order for the insurer to rescind under Civil Code section 1689(b)(2), failure of consideration must occur through the fault of the insured. As previously discussed, where the insured has actual knowledge that a rebate agreement violates provisions of the Insurance Code, fault may be easily inferred.⁵⁸ Where the insured has knowledge only of the facts bringing a rebate agreement within the proscriptions of the Insurance Code, a finding that he is at fault would arguably depend upon whether the Penal Code definition of "knowingly" applies to a criminal statute found in the Insurance Code section 752.⁵⁹

If the insurer seeks to rescind based on section 1689(b)(3), the consideration for the insurance contract must be entirely void. Consideration for an insurance contract consists of both the premium and the application. As previously noted, the premium payment is void because of illegality. The application would probably be void as well because representations about premium payment are required in a well-drafted insurance application, and commonly incorporated into the contract and, often, into policy delivery forms.⁶⁰ Thus, both parts of the consideration, the premium and the application, can be considered void and the contract rescinded under section 1689(b)(3).

If an insurer can show that an illegal payment of a first premium constitutes a "material" failure of consideration, then section 1689(b)(4) may be applicable. The test of materiality, at least with regard to misrepresentations, "is that the contract sought to be rescinded would not have been made if the representation had been absent."⁶¹ It has not been determined whether the same test of materiality would apply where the failure of consideration consists of payment of the insured's initial premiums by the agent. Assuming the same test applies, it would probably not be difficult for an insurer to show that insurance rates and commissions are based upon the premise that an insured is

57. CAL. CIV. CODE § 1608 provides that "[i]f any part of single consideration for one or more objects, or of several considerations for a single object, is unlawful, the entire contract is void."

58. See *supra* text accompanying note 50.

59. See *supra* note 3 and text accompanying note 50.

60. For example, applicants may be asked to certify that they have paid the full premium due, that they have not received any consideration other than the insurance coverage for doing so, and that they understand that their insurance coverage is dependent upon the fact that they paid for the policy and received no inducements from the agent or other third party other than the terms of the insurance contract itself.

61. *Shirreffs v. Alta Canyada Corp.*, 8 Cal. App. 2d 742, 748, 48 P.2d 55, 58 (1935) (citing *Colton v. Stanford*, 82 Cal. 351, 399, 23 P. 16, 28 (1890); *Craig v. Shea*, 45 Cal. App. 351, 354, 188 P. 73, 74 (1919)).

less likely to allow his policy to lapse after the first year, leaving the insurers with a net loss, if he himself has paid the first year premiums, and that the insurance contract would not have been made if the insurer had known that the agent was providing the first year premiums. Other potentially material misrepresentations—such as income, other insurance, and other applications—may also be involved in rebate cases.

B. Refund of Premiums as Condition Precedent to Rescission of Insurance Contracts

The Insurance Code does not specify a procedure by which to rescind a life insurance contract. The Civil Code, however, sets forth a procedure to be followed by a party in rescinding a contract. Section 1691 provides that:

Subject to Section 1693, to effect a rescission a party to the contract must, promptly upon discovering the facts which entitle him to rescind if he is free from duress, menace, undue influence or disability and is aware of his right to rescind:

(a) Give notice of rescission to the party as to whom he rescinds; and

(b) Restore to the other party everything of value which he has received from him under the contract or offer to restore the same upon condition that the other party do likewise, unless the latter is unable or positively refuses to do so.

When notice of rescission has not otherwise been given or an offer to restore the benefits received under the contract has not otherwise been made, the service of a pleading in an action or proceeding that seeks relief based on rescission shall be deemed to be such notice of offer or both.⁶²

Section 1693,⁶³ referred to above, deals with the effect upon relief of any delay in notice of rescission or in restoration of benefits. It provides:

When relief based upon rescission is claimed in an action or proceeding, such relief shall not be denied because of delay in giving notice of rescission unless such delay has been substantially prejudicial to the other party. A party who has received benefits by reason of a contract that is subject to rescission and who in an action or proceeding seeks relief based upon

62. CAL. CIV. CODE § 1691 (Deering 1976).

63. CAL. CIV. CODE § 1693 (Deering 1976).

rescission shall not be denied relief because of a delay in restoring or in tendering restoration of such benefits before judgment unless such delay has been substantially prejudicial to the other party; but the court may make a tender of restoration a condition of its judgment.

Accordingly, an insurer seeking to rescind is theoretically required to return the premiums received in order to restore the parties, as nearly as possible, to their original positions. Even where a contract is rescinded because of fraud, the value received must be tendered by the rescinding party.⁶⁴ However, there are some exceptions. For example, a rescission is effected without tender where the rescinding party is adjudged to have received nothing of value.⁶⁵ Rescission without tender may also be allowed if the amount of money, if any, to be returned and the proper person to whom it would be returnable are far from clear. In *Sutter Street R.R. Co. v. Baum*,⁶⁶ an action was brought to rescind several promissory notes and a mortgage given by a corporation for money borrowed from a director on the ground of fraud. In affirming the lower court's decision in favor of the plaintiff corporation, the supreme court held that plaintiff was not required to return the money from the director prior to rescission where plaintiff offered to comply with all the terms imposed by the court as conditions to a decree in its behalf, and offered to refund to the defendants any and all sums of money received from either of them, together with interest thereon, as may be just and equitable after an accounting.⁶⁷

Various factors outside of the terms of the contract will determine the amount of premium payments, if any, to be refunded. The Insurance Code contains three pertinent provisions dealing with the return of premiums. Under section 481(a)(1), unless the policy provides otherwise, the insured is entitled to return of the whole premium if the policy is canceled or rescinded if the insurer has not been exposed to any risk of loss.⁶⁸ Section 482 provides that "[e]xcept as provided by section 481, or by the insurance contract, if a peril insured against has existed, and the insurer has been liable for any period, however, short, the insured is not entitled to return of premiums, so far as that particu-

64. *Williams v. Smith*, 127 Cal. App. 2d 607, 612, 274 P.2d 204, 207 (1954).

65. *Modoc Mineral & Oil Co. v. Cal-Vada Drilling & Exploration Co.*, 236 Cal. App. 2d 868, 873, 46 Cal. Rptr. 508, 511 (1965).

66. 66 Cal. 44, 4 P. 916 (1884).

67. *Id.* at 52-53, 4 P. at 918. This ruling was cited with approval in *Conforti v. Dunmeyer*, 209 Cal. App. 2d 41, 47, 25 Cal. Rptr. 504, 508 (1962).

68. CAL. INS. CODE § 481(a)(1) (Deering Supp. 1983).

lar risk is concerned.”⁶⁹ Section 483 provides that:

A person is entitled to a return of the premium:

- (a) When the contract is voidable, on account of the fraud or misrepresentation of the insurer.
- (b) When the contract is voidable on account of facts, of the existence of which the insured was ignorant without his fault.
- (c) When, by any default of the insured other than actual fraud, the insurer did not incur any liability under the policy.⁷⁰

The applicability of Insurance Code sections 481 and 482 to life insurance policies was explained in *Equitable Life Assurance Society of the United States v. Johnson*.⁷¹ In that case, the court of appeal, interpreting the applicability of a tax levied upon “gross premiums received . . . less return premiums,” considered whether the consideration received by an insurer upon the sale of annuity contracts falls within the meaning of “gross premiums received” and whether refunds and cash values to holders of annuity contracts are “return premiums.” In affirming the trial court’s finding that such consideration is included in “gross premiums” and that the term “return premiums” includes cash surrender values paid on cancellation of annuity contracts, the court in dicta discussed the applicability of Insurance Code sections 481 and 482 to life insurance contracts. The court stated that:

They [Insurance Code sections 481 and 482] are obviously applicable to insurance such as fire insurance, but less obviously applicable to life insurance or annuities. However, section 2619 of the Civil Code, as originally enacted provided: “A person insured is entitled to a return of the premium when the contract is voidable, on account of the fraud or misrepresentation of the insurer, or on account of facts, of the existence of which the insured was ignorant without his fault; or when, by any default of the insured other than actual fraud, the insurer never incurred any liability under the policy.” Clearly, that section could, and does, apply to life insurance and annuity policies. The other sections do not suggest what should be done on the cancellation of a life policy or an annuity policy.⁷²

The court illustrated the meaning of “return premium” with the follow-

69. CAL. INS. CODE § 482 (Deering 1976).

70. CAL. INS. CODE § 483 (Deering 1976).

71. 53 Cal. App. 2d 49, 127 P.2d 95 (1942).

72. *Id.* at 73-74, 127 P.2d at 108.

ing example: "In connection with a life policy, the most obvious illustration [of a return premium] is where the premium is paid, but, before the policy takes effect, it is cancelled because of fraud."⁷³ *Johnson* is quoted in *Jennings v. Prudential Insurance Co.*,⁷⁴ which involved the applicability of section 481 where the life insurance policy had been surrendered to the insurer for its cash value a few days before the insured's death and where the policy would have remained in force for about ten more days. The insurer paid the cash value of the policy computed to the last day at paid-up premium but did not return the premium for the ten days remaining in force. The court of appeal affirmed the trial court's judgment for the insurer, holding that even if section 481 were applicable to life insurance policies, the policy did not remain in force simply because the insurer failed to return the unearned premium.⁷⁵

The 1977 amendment to section 481 added subdivision (c), providing that the section "shall not apply to policies of ocean marine insurance."⁷⁶ It seems that, had the legislature wished to exclude life insurance policies from the coverage of section 481, it would have done so. In addition, both *Johnson* and *Jennings* discuss the return of premiums in the context of payment of the policy's cash surrender value. Therefore, by their terms, sections 481 and 482 as well as 483, should apply to life insurance policies issued pursuant to a rebate scheme. However, those statutes do not, in any way, require the return of a premium as a condition precedent to rescission. They merely provide that the insured is entitled to the return if the policy is cancelled or rescinded and the specified conditions exist.⁷⁷ As discussed above, sec-

73. *Id.* at 73, 127 P.2d at 107.

74. 48 Cal. App. 3d 8, 121 Cal. Rptr. 125 (1975).

75. *Id.* at 18-19, 121 Cal. Rptr. at 130.

76. CAL. INS. CODE § 481(c) (Deering Supp. 1983).

77. If an insurer's right to the premium was disputed by the insured, or the former agent, the rule in *Wagner v. Worrell*, 76 Cal. App. 2d 172, 172 P.2d 751 (1946), would be applicable. In that case, plaintiff, executor of his father's estate, brought an action to quiet title to a bank account against an association for whose use and benefit decedent carried on an insurance business. In affirming the lower court's judgment for defendant, the court of appeal held the following:

This suit to quiet title to personal property is of course subject to the same rules as those prevailing in similar suits respecting real property, and the rule is settled by a long line of cases that when it has been determined that the plaintiff in a quiet title suit has no interest in the property in controversy "the case is ended. . . . The want of title in plaintiff renders it unnecessary to examine the title of defendant."

Id. at 179-80, 172 P.2d at 756 (citation omitted). Thus, if an insured or an agent failed to establish his right to the premium money, an insurer could hold the money without the necessity of showing its own right to do so. However, if an insurer sought a declaratory

tion 1691 of the Civil Code sets forth the requirements for an effective rescission.⁷⁸

It is unlikely that an insurer victimized by a rebate scheme could ever be required to return to an agent the premium paid by him on behalf of the insured. Under such circumstances, the money is paid under the terms of an illegal rebate agreement as consideration for the insured's applying for the life insurance policy. In *Mansfield v. Hyde*,⁷⁹ for example, plaintiff sued defendant for money which plaintiff paid under a contract for the care of a minor child. Defendant cross-complained for money still owed under the contract. The contract was held to be illegal because defendant was unlicensed and therefore in violation of provisions of the Welfare and Institutions Code making it a misdemeanor to engage in child care without a permit. In reversing the lower court's judgment for defendant on the cross-complaint, the court of appeal held that plaintiff could not recover money already paid to defendant under the contract. The court stated that:

It is a well settled general rule that a party to an illegal contract may not obtain the aid of the courts either to enforce such agreement directly or to recover any consideration parted with pursuant thereto; the law leaves the parties where it finds them. Nor does there appear here to be any basis for application of the recognized qualification to this general rule, that a party not equally at fault may secure relief from the consequences of an illegal agreement.⁸⁰

Although agents involved in a rebate scheme do not violate a licensing statute, their rebate agreements, like the child care contract in *Mansfield*, violate statutes passed to protect the public against certain acts. In both cases, violation of the statutes constitutes a misdemeanor. The plaintiff in *Mansfield*, although not innocent, behaved in a far less reprehensible manner than most agents who rebate. Therefore, as between an insurer and its former agents, it is unlikely that the agents would be allowed to recover the premium payments.

judgment, under § 1060 of the Civil Code, that the policies were validly rescinded, the insurer would be the moving party and might be required to establish the validity of its title to the premium money.

78. See *supra* text accompanying note 63.

79. 112 Cal. App. 2d 133, 245 P.2d 577 (1952).

80. *Id.* at 139, 245 P.2d at 582 (citations omitted).

C. Return of Premiums as Condition Precedent to Recovery of Commissions

Under section 483(c) of the Insurance Code, an insured is entitled to a return of premium "[w]hen, by any default of the insured other than actual fraud, the insurer did not incur any liability under the policy."⁸¹ Therefore, even where the insurer incurred no liability, an insured who committed actual fraud is not entitled to a return of premium. A similar prohibition would be applicable against an agent who defrauds his principal by paying the premium himself.

In addition, most agent contracts provide that, should a premium be refunded "for any reason," the agent must repay the compensation he received. In cases involving agent fraud, an insurer should be able to attempt to recover commissions—at least those in excess of premiums—without refunding the premiums. Furthermore, if an insurer discovers the rebate scheme before paying commissions, it is probably entitled to hold the commissions as well as retain the premiums.

The applicable rule of law is stated in Restatement (Second) of Agency section 469:

An agent is entitled to *no compensation* for conduct which is disobedient or which is a breach of his duty of loyalty; if such conduct constitutes a willful and deliberate breach of his contract of service, he is not entitled to compensation even for properly performed services for which no compensation is apportioned.⁸²

IV. ENFORCEABILITY OF ILLEGAL REBATE AGREEMENTS

Although a rebate agreement is illegal, it still may have legal effect. A distinction is made in the cases between two kinds of illegal agreements. The first involves violation of a statute that explicitly provides that an act in violation of that statute cannot be the basis of recovery. A court will leave the parties to such an agreement where it finds them. For example, in *Lewis & Queen v. N.M. Ball Sons*,⁸³ a subcontractor, unlicensed in violation of the Business and Professions Code licensing statute, was not allowed to recover for work it had performed even though the general contractor had been paid in full for that work. In affirming the judgment for defendants, the California

81. CAL. INS. CODE § 483(c) (Deering 1976).

82. RESTATEMENT (SECOND) OF AGENCY § 469 (1958) (emphasis added); *see also* J.C. Peacock, Inc. v. Hasko, 196 Cal. App. 2d 353, 358, 16 Cal. Rptr. 518, 522 (1961).

83. 48 Cal. 2d 141, 308 P.2d 713 (1957).

Supreme Court relied on section 7031 of the Business and Professions Code which provides that:

No person engaged in the business or acting in the capacity of a contractor, may bring or maintain any action in any court of this state for the collection of compensation for the performance of any act or contract for which a license is required by this chapter without alleging and proving that he was a duly licensed contractor at all times during the performance of such act or contract⁸⁴

The court, in dicta, stated that:

[E]ven in the absence of a provision such as section 7031, the courts generally will not enforce an illegal bargain or lend their assistance to a party who seeks compensation for an illegal act. The reason for this refusal is not that the courts are unaware of possible injustice between the parties, and that the defendant may be left in possession of some benefit he should in good conscience turn over to the plaintiff, but that this consideration is outweighed by the importance of deterring illegal conduct.⁸⁵

The court in *Lewis & Queen* discussed the kind of illegal act which involves a statute prohibiting certain conduct by providing for a fine or administrative discipline and which "excludes by implication the additional penalty involved in holding the illegal contract unenforceable."⁸⁶ A rebate agreement is not explicitly made unenforceable by statute. Although giving and knowingly receiving illegal rebates are misdemeanors according to sections 752 and 761 of the Insurance Code,⁸⁷ the Penal Code does not provide that contracts involving misdemeanors are unenforceable. It provides only that, unless another penalty is prescribed, "every offense declared to be a misdemeanor is punishable by imprisonment in the county jail not exceeding six months, or by fine not exceeding five hundred dollars, or by both."⁸⁸ The analysis of the enforceability of illegal contracts presented in *Homestead Supplies, Inc. v. Executive Life Ins. Co.*,⁸⁹ is therefore applicable.

In *Homestead*, plaintiff-insured sought a declaration of the correct amount of the annual premium due under a policy of life insurance

84. CAL. BUS. & PROF. CODE § 7031 (Deering 1976).

85. 48 Cal. 2d at 150, 308 P.2d at 719.

86. *Id.* at 151, 308 P.2d at 719.

87. See *supra* notes 2, 3, 50 and accompanying text.

88. CAL. PENAL CODE § 19 (Deering 1976).

89. 81 Cal. App. 3d 978, 147 Cal. Rptr. 22 (1978).

issued to plaintiff by defendant on the life of plaintiff's president. Defendant's agent originally quoted prices lower than those contained in a later written proposal. When questioned, defendant's agent indicated that the policy could be issued for the lower premiums originally quoted. They were then penciled in on the written proposal.

The insurance policy as issued specified the correct premiums for the first seven years and incorrect renewal premiums thereafter. Upon plaintiff's request, defendant's president wrote that the insurer would accept the lower renewal premiums. Plaintiff paid the specified premiums until six years later when defendant demanded the higher renewal premium. Plaintiff paid the higher premium and brought an action against defendant.

The trial court entered judgment in favor of defendant. The court of appeal reversed, holding that plaintiff had supplied valuable consideration for the modification of the insurance contract. The court held that, even assuming that the modification agreement violated both rebate and price discrimination provisions of the Insurance Code, the illegality was not such as to render the agreement unenforceable under the circumstances of the case. In reaching its conclusion, the court stated that:

[T]he effect of illegality on the enforceability of an agreement depends on the facts and circumstances of the particular case including the kind and degree of illegality involved, the public policy or policies to be served, whether those policies will best be served by enforcing the agreement or denying enforcement and the relative culpability and equities of the parties.⁹⁰

The court also listed several factors which the courts have considered when determining the enforceability of an illegal agreement, including whether the violation of law involved serious moral turpitude, whether the parties are *in pari delicto*, whether the adverse party would be unjustly enriched, whether the forfeiture would be disproportionately harsh if enforcement were denied and whether the purpose of the violated statute would best be served by enforcement or denial of enforcement.⁹¹

The Executive Life agent in *Homestead* was, at worst, negligent in failing to quote accurately the premiums payable. The new terms were penciled in and the president of the insurance company promised, in writing, to accept lower premiums. This constitutes clear ratification of

90. *Id.* at 989, 147 Cal. Rptr. at 27-28.

91. *Id.* at 990-91, 147 Cal. Rptr. at 29.

the modification agreement.⁹² In addition, by accepting benefits under the policy for six years before complaining of the invalidity of the agreement regarding renewal premiums, the insurer probably waived any right to attack that agreement later.

An important difference between *Homestead* and most rebate cases involves the insured's knowledge of the illegality involved in the modification agreement and the rebate agreement. In *Homestead*, the insured did not realize that the modification agreement was anything more than a correction, making the written contract conform to the true agreement between himself and the agent. Therefore, not only was he ignorant of the fact that the agreement violated the Insurance Code, but he did not even know of the existence of facts which brought the agreement within the provisions of the statutes that were violated. The insured was, therefore, justified in relying upon the insurance agreement as modified. The court assumed that the modification agreement violated the rebate and discrimination provisions because findings of fact were not requested and therefore the court "presume[d] in favor of the judgment every finding of fact necessary to support it warranted by the evidence."⁹³

However, the court of appeal based its reversal of the judgment for defendant upon the facts of the case indicating that the insurer ratified and waived objections to the contract while the insured was justified in viewing the contract as the original agreement between the insured and the Executive Life agent. The court did not conceal its reservations in this regard:

We are not entirely convinced that either the unlawful rebate or unfair rate discrimination provisions were meant to apply to a situation such as that in the case at bench, namely, an apparently good faith mistake in the quotation of premiums by an agent of the insurer followed by an apparently good faith agreement of the insurer to stand behind the representations of its agent. On the other hand, as the president of a life insurance company, defendant's president should certainly have been aware of the statutes prohibiting rate discrimination and rebate of premiums. In any event, for

92. Principles of agency law also dictated that Executive Life was responsible to the insured for the negligent acts of its agents. CAL. CIV. CODE § 2338 (Deering 1976). However, most insurers, as indicated above, protect themselves from liability by provisions in their insurance contracts which specify that only an officer of the company is authorized to alter the policy or to waive any of the company's rights or requirements and that any change in a policy will be valid only when endorsed by a company officer. See *supra* note 21.

93. 81 Cal. App. 3d at 984, 147 Cal. Rptr. at 25.

purposes of decision, we shall assume, without deciding, the modification agreement was violative of both the rebate and price discrimination statutory provisions.⁹⁴

Finally, neither party in *Homestead* wanted to avoid the life insurance policy based upon illegality derived from the modification agreement. Both parties wanted the insurance policy to continue in force—plaintiff at the lower modified rates and defendant at the rates printed in the policy. The *Homestead* court found that the equities of the case dictated that the modification agreement be enforced and the question of enforceability of the life insurance contract itself was not considered. If insurance contracts are properly subject to rescission, the court may remedy any resultant inequity under authority of section 1692 of the Civil Code, which provides that the court may require the party to whom relief is granted to make any compensation to the other which justice may require and may otherwise in its judgment adjust the equities between the parties.⁹⁵

V. AVOIDING AND RESPONDING TO INSURANCE AGENT FRAUD

A. Avoidance

Juxtaposed against agents' considerable authority and the substantial risks insurance companies are taking in entering into agreements with them, the ease with which some insurance companies do so is remarkable. Many insurance companies rely substantially, and often entirely, on insurance department licensing procedures and perhaps a routine, and often incomplete, commercial background report. At very little cost, much more complete information could be obtained. Insurance Departments make available to the public printouts of agents' licensing history and a listing of companies with which he or she has been affiliated. A simple review of this information may reveal a pattern of switching from company to company which may indicate a continuing rebate and twisting scheme.

Some companies are known within the industry to offer very high commissions on certain whole-life policies while maintaining lax underwriting standards. These companies are recurrent targets of rebating and twisting schemes and their appearance in an insurance agent's background may suggest potential problems.

Merely inquiring about an agent in the insurance community in which he or she operates may also be helpful. It is remarkable how

94. *Id.* at 986-87, 147 Cal. Rptr. at 26.

95. CAL. CIV. CODE § 1692 (Deering 1976).

many times an insurance agent may commit fraud on one company after another simply because an insurer's associations and contacts within the community where he or she operates are never checked.

Many insurers maintain regional vice president or regional director systems specifically to provide this local contact. However, the value of such regional officers is often undercut by compensation agreements which make their income dependent, in whole or in part, upon agent production. This can be an invitation for a regional vice president or regional director to actively recruit agents known for their loose operating procedures.

The second opportunity insurers have to act against agents' fraudulent practices is in the drafting of insurance policies, insurance applications, agent contracts and policy delivery forms. The common practice of allowing agents to enjoy the "float" on premium collections, widely prevalent in the credit industry, can be an invitation for theft. To prevent siphoning off of premium funds, "controlled reinsurance" arrangements must be closely monitored. Under such arrangements, an agent-owned reinsurance company benefits from the long-term investment income from a block of business. Allowing agents to receive policyholder remittances in their own names, rather than in the name of the company, may open the door to rebates. The not uncommon practice of allowing agents to "net" their premiums against commissions by submitting only an insurance application and receiving back a commission in excess of premiums is certainly foolhardy. Insurers would be better protected by insisting upon direct remittances to themselves or, at the least, "lock-box" accounts to which the agent has no access. Failure to maintain the trust status of premiums can also prevent preferential recovery when an agent or administrator goes bankrupt. Agent initiated changes in the way premiums are paid—such as annualizations of what had been monthly premium payments—should be closely watched.

Policy and application language can also be tightened up considerably. Applications should include explicit statements by both the prospective policyholder and the agent that the policyholder is paying the full premium for the policy, without any other consideration from the agent. Policies and applications should state more explicitly that the agent has no authority to modify the premiums or to provide any inducement for acceptance of the contract other than that which is stated in such policy. The policies and application should contain a statement that both the agent and the insured understand the agent's limited authority.

Assistance from an agent in processing premium loans should be more strongly discouraged. In only a few instances is "mini-dipping"—paying a minimal deposit and recovering the remainder of the premium from cash values—in an insured's true economic interest. Language about the policy's premium payment can also be included in policy delivery forms. Such forms should be an express part of the contract and incorporated into its terms. Not only would such changes lessen the likelihood of premium fund, rebating and twisting problems, but, as importantly, it would make the insurer's case against both agent and policyholder easier to prove when violations do occur.

The third, and usually final, opportunity the insurer has to check agent fraud is at the underwriting stage. Underwriters as well as marketing personnel should closely follow agent production. A new agent who immediately becomes an insurer's leading producer should be closely scrutinized as well as rewarded. It may be that his or her high volume is not wholly due to a strong product and a winning personality. However, to the extent underwriting functions are delegated to third-party administrators independent of the insurer itself, often with compensation arrangements tied to production, the insurer will lose the ability to monitor the underwriting.

Although the general principles of agency law have not been overturned as yet, increasing scrutiny is being levelled at insurers who have entered into relationships with third-party administrators, particularly in the context of multiple-employer trusts ("METs"). Efforts are being made to impose liability upon such insurers for the unauthorized acts of the METs and third-party administrators.⁹⁶ Judicial and statutory law could modify insurers' responsibility for their agents' acts in all cases if these efforts show success.

Insurers face another problem involving payments for administrative services to third-party administrators, particularly in cases where the insured self-administers its own insurance program. Such payments can be construed as unlawful rebates where they are covers for illegal commission splitting and do not relate to reasonable charges for the services rendered.⁹⁷

96. *Insurers May Have to Pay Bills, Trustee of Health Plan Contends*, Los Angeles Times, Oct. 25, 1982, § 4, at 1, col. 4.

97. *Associated California Loggers, Inc. v. Kinder*, 110 Cal. App. 3d 673, 681, 168 Cal. Rptr. 67, 71 (1980).

B. Responding

Under section 758 of the Insurance Code,⁹⁸ an insurer has an obligation to enforce the rebating and twisting provisions of the code. Its obligation should be satisfied by reporting a potential rebating situation to the Insurance Department. Whether or not the insurer decides to take further action depends upon the risks present. Because of the multitude of witnesses necessary to construct a rebate or twisting case, they are extremely expensive. Only when there are realistic and highly probable threats of large death claims by purported insureds can these cases be justified on economic grounds. If the insurer is faced with only a very few rebate situations, where the policies are about to expire, and a thorough review of the underwriting files indicates a low risk of death claims, the insurer may be well advised either to take very mild action to preserve a possible defense against an allegation of ratification, or to take no action at all.

An insurer should never count on recovering its commissions in excess of premiums from insurance agents who committed fraud on the insurer.⁹⁹ As a practical matter, these agents have means of concealing assets which are, in most cases, invulnerable to conventional discovery. Auditing considerations may also make aggressive action costly. Assuming a decision is made to take action against an agent in a rebating, twisting or premium trust fund situation, prompt investigation of potential involvement of company officers, agency officials and underwriters should be undertaken. Even where there is no direct involvement, a review of insured files may reveal standards so lax that a court could find an implied ratification of the agents' conduct on the basis of incomplete applications, high premiums compared to applicant incomes, over-insurance, or other factors.

Where initial action is taken against an agent, prompt settlement after an early offense may well be in the company's best interests. In most cases, aggressive discovery in the early stages of the action is vital to assure that accurate testimony from third-party witnesses can be obtained. Such action may also convince the agent that it is in his best interests to cooperate. Such discovery will usually include enough policyholder depositions to develop evidence of pattern and practice. Obtaining records from other insurers at the outset may also help show a history of agent and policyholder misconduct which is hard to refute. On the other hand, a casual attitude early in the case may encourage

98. CAL. INS. CODE § 758 (Deering 1976).

99. *See supra* Section III.C.

both the agent and the policyholders, often led by the agent to be concerned about their own financial and legal liability, to attempt to avert their problem through false testimony and by filing cross-actions against the company alleging unfair competition and bad faith.

Early consideration should also be given to reporting agent fraud to both state and federal prosecutorial authorities as well as to the state Insurance Department.¹⁰⁰ As a practical matter, however, it must be recognized that these prosecutions proceed slowly, if at all. Enforcement agencies generally see agent problems as matters to be resolved by their principals. Historically, probably the best results have been obtained by the Internal Revenue Service which is often interested in pursuing agents, who, in order to increase the profit on fraudulent activities, generally deduct rebates as a purported business expense. The IRS has traditionally considered such deductions improper since the payments are illegal.¹⁰¹ However, in 1982, the United States Tax Court ruled that an Ohio insurance agent was entitled to deduct \$272,270 of rebates to customers as allowable business expense because the State of Ohio did not generally enforce the anti-rebate statutes.¹⁰²

Insurers may also wish to consider an accusation of racketeering under the Racketeer Influenced and Corrupt Organizations Act ("RICO"). That federal statute rests on two concepts, a "pattern of racketeering activity" and the definition of an "enterprise." A "pattern of racketeering activity" is defined as two or more "acts of racketeering activity." An "act of racketeering" is the commission of a variety of crimes, including mail fraud and wire fraud which are often involved in rebating and twisting schemes. An "enterprise" includes any legal entity such as an insurance agency, as well as illegitimate organizations. When a "pattern of racketeering activity" becomes intermingled with an "enterprise" by conducting an enterprise through racketeering activities, the statute is violated. The advantage of a RICO allegation is that it raises both criminal and civil claims, confers federal—often a speedier forum than California—jurisdiction and allows a plaintiff to sue for triple damages, costs, and attorney's fees.¹⁰³

100. The insurer reporting agent fraud to the authorities may expose itself to allegations of defamation or invasion of privacy by those agents. See Alexander, *Insurance Agent Misconduct*, 47 INS. COUNS. J. 558 (1980).

101. The Wall Street Journal, Oct. 24, 1979, at 1.

102. *Custis v. Commissioner*, 43 T.C.M. (CCH) 1511 (1982).

103. 18 U.S.C. §§ 1961-68 (1976).

VI. THE DEREGULATORY ENVIRONMENT

In the wake of the decisions of the United States Supreme Court in *St. Paul Fire and Marine Insurance Co. v. Barry*,¹⁰⁴ *Group Life and Health Insurance Co. v. Royal Drug Co.*,¹⁰⁵ and *Union Labor Life Insurance Co. v. Pireno*,¹⁰⁶ the insurance industry has entered the greatest period of regulatory ferment since the days of the Armstrong Commission in the early years of this century.¹⁰⁷ Whether the erosion of the McCarran-Ferguson Act anti-trust immunity and the new interest in market flexibility will lead to just another form of regulatory constraint, or in fact, to a more competitive industry is the subject of intense debate.¹⁰⁸ What does seem clear, however, is that the present role and status of the insurance agent will come under intense scrutiny and perhaps undergo significant change. Knowledgeable industry observers speculate that the agent fatality rate over the next decade may be as high as eighty percent.¹⁰⁹ Some see a gradual replacement of the traditional insurance agent through direct and mass marketing and consolidation of their functions with those of stockbrokers, banks and other financial personnel and institutions.¹¹⁰ This would almost certainly lead to new efforts to modify agents' roles and status as their traditional political strength at the state level becomes diluted. This trend may be particularly forceful at a time when agent licensing and discipline absorb approximately one-third of many Insurance Department budgets during an era of very tight budgets.

The anti-rebating and twisting statutes are increasingly likened to the old fair trade laws and Wall Street fixed commissions which were

104. 438 U.S. 531 (1978).

105. 440 U.S. 205 (1979).

106. 458 U.S. 119 (1982).

107. See generally Gregory, *Public Regulation of the Insurance Industry After Barry and Royal Drug: McCarran-Ferguson at the End of the Decade*, 16 FORUM 371 (1981-82); Hallett, *Is Time Running Out on the Insurance Industry?*, Legal Times of Washington, Mar. 19, 1979, at 14; Kennedy, *The McCarran Act: A Limited "Business of Insurance" Antitrust Exemption Made Ever Narrower—Three Recent Decisions*, 18 FORUM 528 (1983).

108. See Shenefield, *Insurance—The New Frontier of Deregulation*, 16 FORUM 679 (1981-82); Vinyard & Smith, *Status Controls or State Action Immunity: Unattractive Alternatives for Regulating Insurers*, 15 FORUM 406 (1980-81).

109. *Agency Fatality Rate Put at 80% in Next Decade*, The National Underwriter, Sept. 25, 1982, at 32, col. 1.

110. One commentator has recently suggested that "most policyholders are unlikely to benefit from repeal of anti-rebate laws" and recommends savings bank life insurance as "one of the least expensive and most accessible means for marketing low cost insurance." Frankel, *Insurance Agent Commission Deregulation: Anti-rebate Laws and an Alternative to Repeal*, 2 J. INS. REG. 255, 263-64 (1983-84).

abolished in 1975.¹¹¹ Critics point out that the anti-rebating and twisting laws are only sporadically enforced¹¹² and contend that the regulatory lassitude which led to the Armstrong Commission proposals on rebating and twisting in the early 1900's is long since past. Former Wisconsin Insurance Commissioner Susan Mitchell became the first state insurance commissioner to propose outright repeal of the anti-rebate statutes in 1981.¹¹³ She argued that only in the insurance industry does the term rebate assume an unfavorable connotation. Twisting also can be seen as simply a form of exuberant competition controllable by standard civil law on unfair competition and commercial defamation.

United States Representative John LaFalce (D-N.Y.), Chairman of the Small Business Oversight Subcommittee of the House Committee on Small Business, held hearings on his own legislation to repeal rebate laws in September, 1981.¹¹⁴ While the industry has been almost uniformly opposed to these proposals and has successfully blocked them to date, support for them is increasing. Former California Insurance Commissioner Wesley J. Kinder has even gone so far as to state that agent examination, licensing and discipline is wasteful regulation of an agent of an already licensed principal and should be either abolished or sharply reformed.¹¹⁵ One intermediate possibility is a quasi-public self-regulating agents' association which would function along the lines of the National Association of Securities Dealers or state bar associations.

The pressure has become so great that agent groups themselves are beginning to recognize that the days of high first-year commissions and rapid policy turnovers are coming to an end. The head of the California Association of Life Underwriters has suggested a level commission plan which would eliminate, at least partially, commission structures which make rebating and twisting attractive.¹¹⁶ Charging potential insureds' fees for financial planning consulting services separate from

111. A. TOBIAS, *THE INVISIBLE BANKERS* 163-66 (1982).

112. Kimball & Jackson, *The Regulation of Insurance Marketing*, 61 COLUM. L. REV. 141 (1961).

113. *Wisconsin Commissioner on Anti-Rebate Law Repeal*, *The National Underwriter*, Aug. 1, 1981, at 1.

114. See 127 CONG. REC. H6320-21 (daily ed. Sept. 16, 1981) (statement of Rep. LaFalce); *Industry Associations Rally Against Rebate Bill*, *The National Underwriter*, Sept. 26, 1981, at 1.

115. Address by Wesley J. Kinder before California Association of Life Underwriters, *Regulation—More or Less* (Oct. 1979).

116. Haggerty, *Cal. Agents Chief Proposes Level Commission Plan*, *The National Underwriter*, Oct. 23, 1982, at 2, col. 2.

commissions may be another means of placing agent-customer relationships on a more professional footing.¹¹⁷

VII. CONCLUSION

Despite the ferment in today's insurance industry, present systems of insurance agent regulation and discipline are not likely to change rapidly. But if change does come slowly, it will come nonetheless. The overwhelming majority of insurance agents are honorable and proficient. The minority who are not are not being weeded out by present policies and procedures. Insurers and those who work in the insurance industry, therefore, must become more responsive and more attuned to agent fraud, its prevention and its correction, if they are to maintain the public's trust in an environment of increasing competition in the financial services industry.

117. Reaves, *Fees: To Charge or Not to Charge?*, *The National Underwriter*, Sept. 28, 1983, at 18, col. 1.