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Insurable Interest and the Law

Is insurable interest still needed in the 21st century?

Dr Franziska Arnold-Dwyer, Professor James Davey and Dr Terry O'Neill

10 September 2020

Meet the speakers:

- Dr Terry O'Neill
  - Consultant at Clifford Chance
  - 40+ years of experience in contentious and non-contentious insurance, reinsurance, Lloyd's and financial reinsurance
  - Co-author of O'Neill and Woloniecki 'The Law of Reinsurance' (Sweet & Maxwell, 2019) and numerous articles
- Professor James Davey
  - Professor of Insurance & Commercial Law within Southampton Law School at the University of Southampton
  - Leading insurance law academic with focus on law & (behavioural) economics and socio-legal studies
  - Numerous publications: https://www.southampton.ac.uk/law/about/staff/jad1y13.page#publications
  - Deputy President of the British Insurance Law Association
- Dr Franziska Arnold-Dwyer
  - Programme Director of the Insurance Law LLM at the Centre for Commercial Law Studies at QMUL
  - Deputy Director of the Insurance, Shipping and Aviation Law Institute at CCLS
  - Insurance law practitioner with 10+ years experience in contentious and non-contentious insurance and reinsurance
  - Author of 'Insurable Interest and the Law' (Routledge, 2020), contributor to 'The Law of Reinsurance' (Sweet & Maxwell, 2019) and several articles: https://www.qmul.ac.uk/law/people/academic-staff/items/fdwyer.html

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What is an insurable interest?

- A relationship between the insured and the insured-subject matter
- Insurable interest in property:
  - Legal interests: proprietary or contractual rights in the insured property
  - More controversial: economic interests in property (i.e. suffering financial loss as result of the loss of or damage to the property)
- Insurable interest in life: case law-based categories
  - Insurable interest in own life
  - Automatic insurable interest in life of spouse / civil partner
  - Pecuniary interests (e.g. employer/employee, debtor/creditor)
  - NB: no automatic insurable interest in other relationships based on love and affection (e.g. children, parents, grandparents)
- Insurable interest in liability: exposure to liability

What does the doctrine of insurable interest require?

	Marine risks	Non-marine goods	Land and buildings	Life and life-related
Legal basis	Marine Insurance Act 1906, s.4(1) and (2)	Common law (*Lynch v Dalzell* (1729) 4 Bro PC 431) Previously also Gaming Act 1845, s.18 – repealed by Gambling Act 2005	Common law (*Lynch v Dalzell* (1729) 4 Bro PC 431; *Sadlers' Company v Badcock* (1743) 2 Atk 554; *Western Trading Limited v Great Lakes Reinsurance (UK) Plc* [2015] EWHC 103) Life Assurance Act 1774, s.1? (Unlikely following *Siu Yin Kwan v Eastern Insurance Co Ltd* [1994] 2 AC 199 (PC (HK))	Life Assurance Act 1774, ss.1-2
Timing	ii or expectation of acquiring an ii at the time of entering into the contract (MIA 1906, s.4(2) and ii at the time of loss (MIA 1906, s.6(1))	ii at the time of loss	ii at the time of loss	ii at the time of entering into the contract (*Dalby v The India and London Life Assurance Company* (1854) 15 CB 365)
Effect of lack of insurable interest	Contract is void (MIA 1906, s.4(1) and (2))	Uncertain whether whole contract void or whether claims are unenforceable	Uncertain whether whole contract void or whether claims are unenforceable	Contract is void (LAA 1774, ss.1-2)
Illegality	Yes - Marine Insurance (Gambling Policies) Act 1909, s.1	Uncertain; probably not	Uncertain; probably not	Yes - *Harse v Pearl Life Assurance Co* [1904] 1 KB 558
Return of premium	Return of premium under MIA s.84(3)(c) if no wagering contract	Uncertain; probably	Uncertain; probably	Uncertain whether premium is returnable (*Harse v Pearl Life Assurance Co* [1904] 1 KB 558 – no; *Patel v Mirza* [2016] UKSC 42 – may be)

Insurable interest in crisis

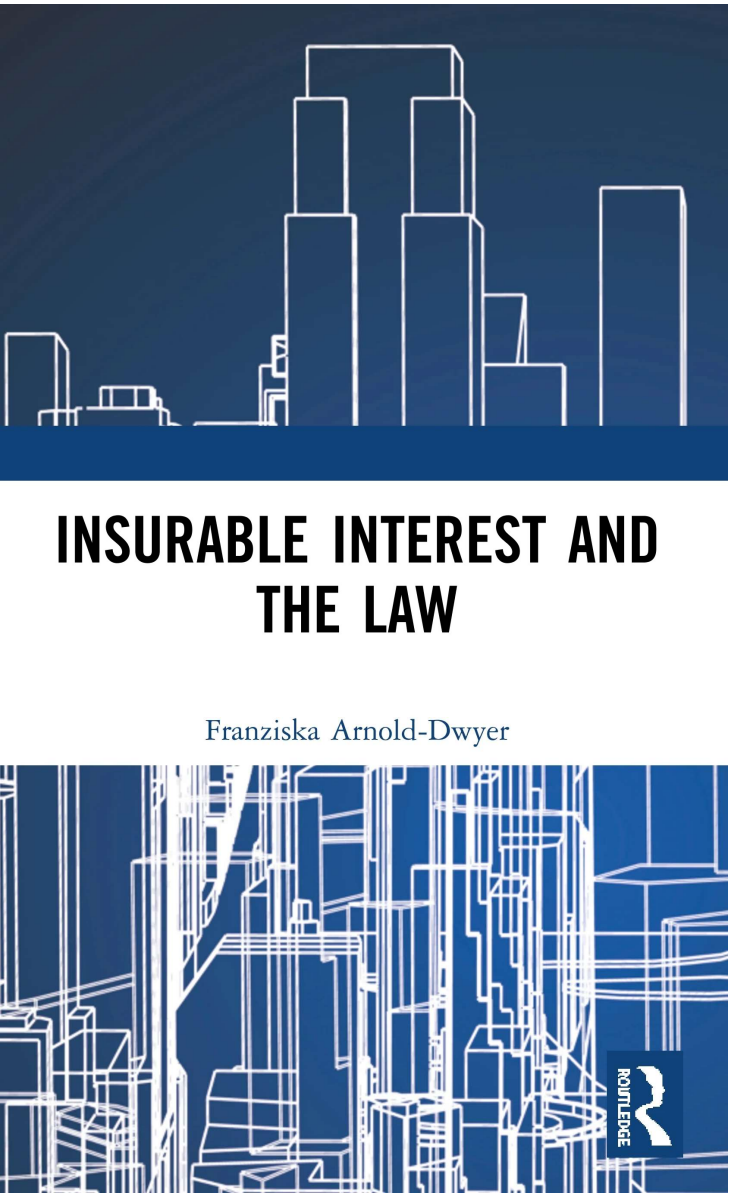
- B Hartnett and JV Thornton, '*Insurable Interest in Property – A Socio-Economic Re-evaluation of a Legal Concept*' (1949) Ins LJ 420: argue that the traditional rationales for insurable interest – the anti-wagering rationale and the moral hazard rationale – do not require a strict legal interest in the property
- Australian Insurance Contracts Act 1984: abolishes insurable interest
- Supreme Court of Canada reduces insurable interest requirement in property to economic interest (*Kosmopoulos v Constitution Insurance Co* [1987] 1 SCR 2)
- The English Courts are increasingly reluctant to accept 'lack of insurable interest' as a technical defence (*Feasey v Sun Life Assurance Co of Canada* [2003] EWCA Civ 885)
- Gambling Act 2005: repeals s.18 of Gaming Act 1845 and provides that gambling contracts are generally enforceable
- Insurable interest is declared messy, anachronistic and redundant by leading insurance law academics (Rawlings and Lowry (2003), Merkin (2006), Clarke (2011), Davey (2014))
- Law Commission proposes that the requirement for an insurable interest in relation to indemnity insurance should be abolished (2008)
- **Yet, the insurance industry came out fighting to retain insurable interest**
- **No strong insured-side appetite for abolition**

Insurable interest reforms?

- Abolition of doctrine
- Clarifying definition / widening categories of insurable interest
- Tidying up the statute book and codifying complex case law
- Do nothing and let the courts carry on with incremental development

My idea for a book …

Fifty Shades of Insurable Interest



Re-assessment of the role of insurable interest in the 21st century

Key issues relevant to its role and reforms:

1. The rationales for insurable interest in modern English insurance law and practice
2. The tension between the doctrine of insurable interest's role as a definitional characteristic of contracts of insurance and its role as a validity requirement
3. To what extent, and how, insurers should take greater responsibility in ascertaining whether a prospective policyholder has an insurable interest

Rationales for insurable interest

1. Anti-wagering rationale
2. Moral hazard rationale
3. Interconnectedness rationale

The anti-wagering rationale: obsolete?

- **Traditional anti-wagering rationale:** the doctrine of insurable interest serves as a dividing line between insurance and gambling (LAA1774, MIA 1906)
- Professors Lowry and Rawlings: gaming has become a legitimate activity and, in so far as regulation is required, such regulation should be a matter of public law, not contract law

  (J Lowry and P Rawlings, 'Rethinking Insurable Interest' in Sarah Worthington (ed.), Commercial Law and Commercial Practice, (Oxford, Hart Publishing, 2003) 335)

- Professor Clarke: preventing gambling under the guise of insurance is no longer a sound reason for the requirement of an insurable interest since gambling is now widespread and has been legalized by the GA 2005

  (M. Clarke, 'An Introduction to insurance contract law' in J Burling and K Lazarus (eds.), Research Handbook on International Insurance Law and Regulation (Edward Elgar, Cheltenham, 2011), 18)

The anti-wagering rationale: wager policies

- Gambling has become ‘mainstream leisure activity’ (Gambling Commission Annual Report 2018/19)
- Gambling is permitted:
  - Privately
  - Commercially: licensed premises with licensed operators
- No need/benefit to gamble ‘under the guise of insurance’
  - Higher transaction costs and more documentation to place insurance
  - More complex claims process under insurance contracts

The anti-wagering rationale: insurers must not gamble

- Existence of an insurable interest distinguishes an insurance contract from other contracts of speculation:
  - Gambling contracts (*Carlill v Carbolic Smoke Ball Company* [1892] 2 QB 484)
  - Credit default swaps (Potts Opinion for ISDA 1997; Lord Mance in *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38 [135])
- Distinction relevant to regulation of insurance business:
  - Policyholder protection (ICOBS, FOS Scheme, FSCS, Insurers (Reorganisation and Winding Up) Regulations 2004 apply to insurance but not to gambling contracts)
  - Refrain from mis-selling products that are unsuitable and under which policyholder is not eligible to claim (FCA Handbook ICOBS)
  - Gambling by insurers can undermine their financial stability (AIG, Langley J in *Feasey v Sun Life Assurance* [2002 EWHC 868)
  - Internal contagion restriction: no business other than insurance business (PRA Rulebook SII Firms: Conditions Governing Business, 9.1)
  - Capital requirements: rules on valuation of assets and liabilities, calculation of SCR and quality of capital held (PRA Rulebook, SII Firms) - multiple exposure risk
  - Investment of assets in accordance with 'prudent person principle' (PRA Rulebook, SII Firms: Investments, 2.1.)
- Distinction relevant for accounting and tax purposes

The anti-wagering rationale: CDS case study

- CDS ≠ insurance contracts because 1) payment under CDS not dependent on loss; and 2) CDS not dependent on an insurable interest (1997 Potts Opinion, 2000 NYSID Opinion, *Belmont Park Investments v BNY Corp Trustee Services* [2013] UKSC 38 [135])
- Case study of CDS highlighted a number of negative implications to which insurance contracts without an insurable interest could become susceptible:
  - empty creditor problem and manufactured credit events (Argentinian sovereign debt crisis 2001; Hovnanian Enterprise)
  - potential devaluing effect of shorting on the underlying asset (European sovereign debt crisis 2009)
  - potential social cost of gambling by financial institutions (AIG and RBS – bail-outs with taxpayers' money)
  - Creation of multiple exposure risk endangering the financial stability of the relevant financial institutions and created systemic risk (2011 Report of the US Financial Crisis Inquiry Commission: CDS transactions in relation to US sub-prime mortgage collateralised debt obligations were major contributor to Financial Crisis 2008)
- Counter-measures applicable to CDS:
  - 2019 ISDA 'Narrowly Tailored Credit Events Protocol' (2019)
  - Enhanced reporting obligations under EU EMIR Regulation (2012), EU Market Abuse Regulation (2014), MiFID II (2014) and US Dodd-Frank Act
  - EU Short Selling Regulations (2012)

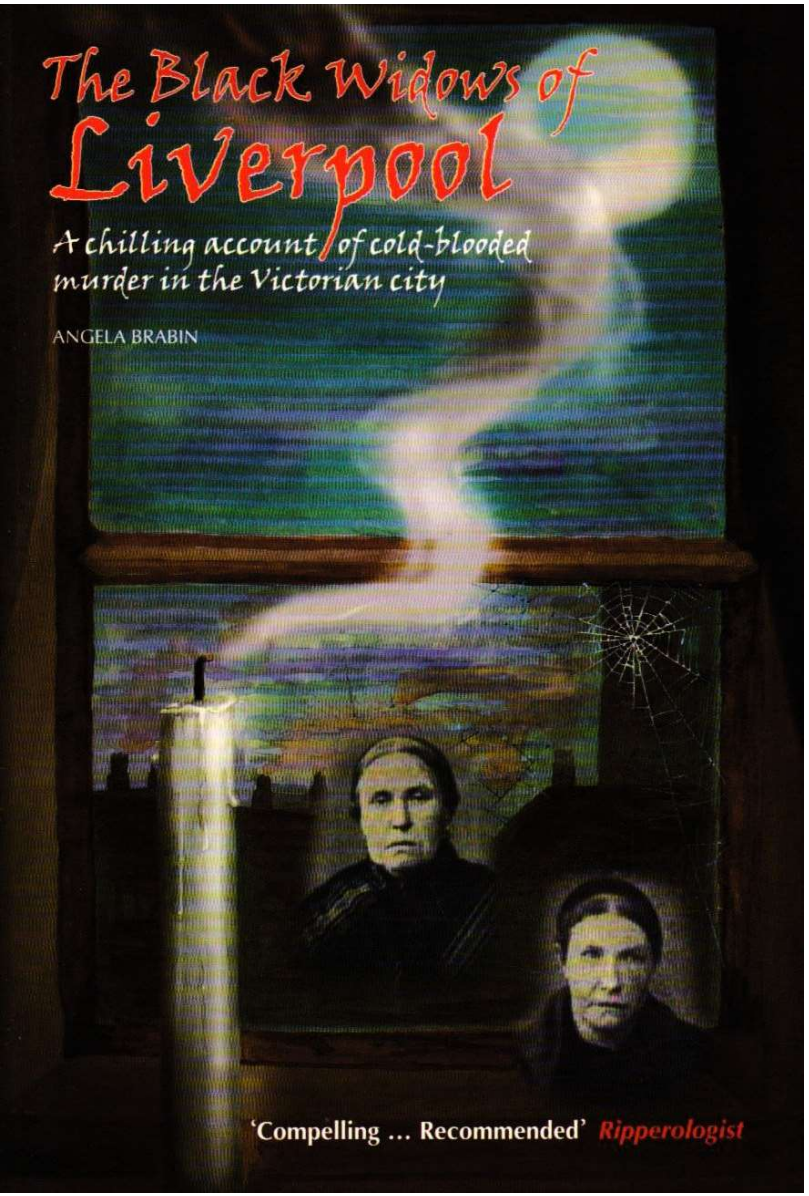
The moral hazard rationale: ineffective and inappropriate?

- **Traditional moral hazard rationale**: the absence of an insurable interest can tempt an insured to bring about the loss in order to gain financially, whereas the presence of an insurable interest minimizes the incentive to do so (MIA 1746, *Sadlers' Company v Badcock* (1743) 2 Atk 554)
- Professor Davey: empirical research does not support the deterrent effect of insurable interest in relation to life insurance: evidence from homicide statistics that spouses murder for life insurance benefits

  (J Davey, 'Dial M for moral hazard? Incentives to murder and the Life Assurance Act 1774' (2014) 25 ILJ 120)
- Professor Clarke: the doctrine of insurable interest, which is an insurance contract law doctrine rooted in common law and statute, is not an appropriate medium to control moral hazard

  (M Clarke - as above)
- J Loshin: the doctrine of insurable interest creates reverse moral hazard – insurers are incentivized to accept insureds with no, or ambiguous, interests in the knowledge that the contract is not enforceable in the absence of a valid insurable interest

  (J Loshin, 'Insurance Law's Hapless Busybody: A Case Against the Insurable Interest Requirement' (2007) 117 Yale LJ 474)



The moral hazard rationale: deterrent effect

- Deterrent effect: some homicides could have been / can be prevented if life insurance would have been / will be refused for lack of insurable interest
  - Historical example: the 1880s burial club murders by the 'Black Widows of Liverpool' - homicides motivated by financial gain from the proceeds of life insurance unsupported by an insurable interest
  - Recent example: in 2017 London couple 'bought' boy for adoption from a destitute family in India, took out life insurance for £150,000 with Indian insurer and then arranged boy's murder (https://www.bbc.co.uk/news/uk-england-london-51415005)
- Probability theory: the greater the number of policyholders without an insurable interest, the greater the circle of people who might benefit from the destruction of the insured subject-matter without suffering any financial prejudice from its loss, and the greater the likelihood that one or more of them might be tempted to act to bring about the destruction of the insured property.

The moral hazard rationale: ‘skin in the game’

- Doctrine of insurable interest should be re-evaluated as a mechanism for aligning the interests of the insured and the insurer: i.e. the preservation of the insured subject-matter
- If the insured has ‘skin in the game’:
  - s/he is likely to take greater care to protect the insured subject-matter from loss or damage (‘endowment effect’)
  - s/he is likely to have access and control to the insured property allowing the insured to perform contractual risk mitigation obligations under the insurance policy
- Insurance contracts operate more efficiently if the insured has ‘skin in the game’
- Parallel development: US and EU risk retention measures applicable to securitisations

The moral hazard rationale: STOLI

- Stranger-originated life insurance (STOLI): investment schemes facilitated or instigated by a third party investor pursuant to which a person, in whose life the investor has no insurable interest, takes out life insurance, with the premium payments being funded by the investor, and with the intention that the policy be assigned to the investor shortly after the policy has been issued. Prevalent in the US until legislative intervention.
- Widely criticised for:
  - Creepiness – a stranger is wishing you to die!
  - Against human dignity: condoning attitudes that people's lives can be treated as an investment asset and as an object of speculation
  - Data breaches as result of on-selling and securitisations
  - Abuses and fraudulent sales practices which can compromise the insured's life future insurability
  - Disrupting life insurance pricing which depends on % of policies lapsing or being surrendered (without pay-out)
- Now 42 US States have passed legislation to ban STOLI transactions where at the inception of the life insurance contract the investor has no insurable interest in the insured, and to prohibit life settlement contracts within a two-year period commencing with the date of the policy
- STOLI highlight moral hazard and ethical concerns associated with the absence of insurable interest

Interconnectedness of insurable interest

- The doctrine of insurable interest is **integral to the operation of other doctrines and principles of insurance law**. Abolition of insurable interest would have significant knock-on effect.
  - Methodology: Review of all major principles of insurance contract law to test whether they would work if the insured had no insurable interest.
  - Findings:
    - The principles of indemnity, abandonment and subrogation all depend upon the existence of an insurable interest.
    - The presence of an insurable interest provides an optimal environment for the discharge of the pre-contractual duty to give a fair presentation of the risk.
    - A strong insurable interest based on proprietary or contractual rights in property also helps to establish that the insured's loss was proximately caused by an insured peril.
    - The doctrine of insurable interest also supports the observance of utmost good faith since it operates as a doctrinal mechanism that counters specific types of moral hazard
- In relation to property insurance, the doctrine of insurable interest is **integral to the operation and performance of standard contract terms**. Abolition of insurable interest would have significant knock-on effect.
  - Methodology: Review of 50+ property policy wordings on a term-by-term basis
  - Findings:
    - The doctrine of insurable interest is embedded in specific contractual terms commonly found in standard property policy wordings.
    - They contain terms that would be rendered inapplicable, or are inconsistent with, the absence of an insurable interest or can create conflicts with the proprietary or contractual rights of third parties.
    - Standard property policy wordings contain a significant number of risk mitigation and control terms that impose obligations on the insured (either directly as duties, or indirectly as exclusions from coverage) which cannot be discharged, or be complied with, by an insured who has no access to or control over the insured property.
    - Where risk mitigation obligations and notice requirements are qualified by 'reasonableness' or 'practicality', they offer little protection to the insurer in relation to a policyholder for whom, on account of having no interest, it would not be reasonable or practicable to take any steps which he cannot practically or legally take on account of having no rights in relation to the insured property.
- The insurance market perceives the requirement for an insurable interest to be part of market practice and as an **essential characteristic of contracts of insurance**.
  - Methodology: interviews with market participants and analysis of responses to Law Commission consultation on insurable interest.
  - Findings:
    - Insurable interest is 'DNA of the Market' and 'hallmark of insurance'
    - It is seen to promote market discipline and guards against moral hazard

Case for retaining the doctrine of insurable interest

1. The policies behind the traditional rationales (anti-wagering and moral hazard) for the doctrine of insurable interest remain relevant and have indeed acquired fresh significance following the Financial Crisis, the expansion of derivative contracts and the liberalisation of gambling.
2. The requirement for an insurable interest delineates insurance contracts from other types of speculative contracts, as well as setting a boundary for insurers' realm of operation and supporting their financial stability.
3. It is a mechanism for aligning the interests of the insured and the insurer in the preservation of the insured subject-matter and supports post-contractual fair dealings between the parties.
4. The doctrine of insurable interest is integral to the operation of other doctrines and principles of insurance law.
5. In relation to property insurance, the doctrine of insurable interest is integral to the operation and performance of standard contract terms.
6. The insurance market perceives the requirement for an insurable interest to be part of market practice and as an essential characteristic of contracts of insurance.
7. No positive case for abolition.

Consequences of lack of insurable interest

- If retention of insurable interest is accepted, also consider remedies and enforcement
- Current position (see above):
  - Contract of insurance is rendered void and/or claims made thereunder are unenforceable
  - Query whether premium returnable
  - Illegality
- Criticisms:
  - Law Commission: insurers can write risks, collect premium and then decline the payment, whereas policyholders are "exposed to having neither their claims paid, nor their premiums returned if a policy is found to be illegal" = asymmetry (sentiment also reflected in courts' approach "to lean in favour of an insurable interest")
  - Professor Davey: the remedial regime for lack of insurable interest is rendered ineffective since its enforcement depends upon the insurer raising the matter as a defence
  - Consensus that 'illegality' consequences is disproportionate and unnecessary
  - Remedial gap in the 'unsuitable policy scenario'

Remedial gap in the unsuitable policy scenario

- Unsuitable policy scenario:
  - Insurer is not required to check for an insurable interest at pre-contract stage; prospective policyholder may not know about the requirement
  - a policyholder suffers a genuine loss (the "Uninsured Loss") in relation to which s/he had thought to have insurance protection but for which s/he is not in fact covered because, unknowingly, s/he lacks an insurable interest in the insured subject-matter BUT
  - the policyholder would have had an insurable interest and, accordingly, an enforceable claim in relation to his/her Uninsured Loss under a different kind of policy OR
  - the policyholder has rights or control over a (legal) person (a "controlled person") who would have had an insurable interest in the subject-matter if the policy had been entered into by that person and s/he could have caused the controlled person to do so and, accordingly, the controlled person would have had an enforceable claim in relation to the Uninsured Loss
  - = the policy is invalid for lack of insurable interest but the interest that the policyholder does in fact have could have been validly covered by another policy (an "Alternative Policy")
- Remedial gap:
  - Policyholder's Uninsured Loss is not covered
  - Policyholder suffered a loss of chance to insure under the Alternative Policy
  - No contractual remedies and no remedies under IA 2015 / CIDRA 2012
  - Potential regulatory contraventions by insurer (terms of insurer's Part 4A Permission, PRIN, ICOBS) but limited rights of private action by a policyholder who has suffered a loss as a result of the contravention pursuant to FSMA 2000, s.138D
  - FOS: very few insurable interest complaints and most of them have been decided along black letter law principles

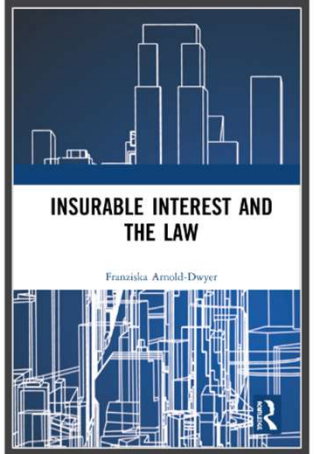
How to make remedies / enforcement regime fairer and more efficient?

Re-balancing the remedies / enforcement regime

- Aim: close remedial gap and insurers to take greater responsibility at pre-contract stage
- How?
  1. Impose a statutory duty on the insurer to decline to enter into a contract of insurance that would be void for lack of insurable interest if, at the time of the contract, the insurer knows, or ought to know, or is presumed to know, that the contract of insurance would be void for lack of insurable interest
  2. Breach of statutory duty by insurer: policyholder has remedy (in damages) if Alternative Policy would have been available and s/he has suffered a loss as result of the breach of the duty
  3. Impose regulatory requirement on the insurer / insurance distributor to provide information on the insurable interest requirement as applicable to the contract as part of IPID (ICOBS, 6.1)
- Too onerous on insurers? No:
  1. Quid pro quo for retention of insurable interest
  2. Within the scope of duty of good faith and within spirit of existing PRIN and ICOBS rules and guidance
  3. Promotes compliance with insurable interest requirement from the outset and pre-empts costly disputes / technical defences at claims stage

The Law Commission's reform proposals

- Law Commission has put forward a revised Insurable Interest Bill (June 2018, https://www.lawcom.gov.uk/project/insurance-contract-law-insurable-interest/)
- Earlier proposals in relation to indemnity insurance have been dropped
- Insurable Interest Bill is confined to contracts of 'life-related insurance': under which the insured event is the death, injury, ill-health or incapacity of an individual, or the life of an individual continuing [cl.1]
- Retention of requirement for an insurable interest at the time of the contract as a validity requirement for contracts of life-related insurance, but they would no longer be rendered illegal for lack of insurable interest [cl.2(1) and cl.6].
- Widened definition of insurable interest for life-related insurance:
  - a broad economic interest test for determining whether the insured has an insurable interest in the life insured: "if there is a reasonable prospect" of suffering "economic loss" on the occurrence of the insured event [cl.2(2)]
  - a non-exhaustive list of specific examples of in which the insured would have an automatic insurable interest: extension of the presumed interest category to cohabitants, children, grandchildren and those treated as children or grandchildren; a person who administers a pension or other group scheme in the lives of the members of the scheme; and an insured who takes out insurance which is for the benefit of the life insured or their nominee (aimed at employers) [cl.2(3)]
  - where insurance is taken out by a trustee, the trustee has an insurable interest in the relevant life if the settlor of the trust would have such an interest (added cater for life investment-linked products where the investor (the settlor) puts money in trust and the trustee then purchases a life assurance bond) [cl.2(4)]
- What next? Waiting for a parliamentary slot …



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Insurable Interest and the Law

Franziska Arnold-Dwyer

Over the centuries, English law on insurable interest – a combination of statutes and case law – has become complex and unclear. Other jurisdictions have relaxed, or even abolished, the requirement for an insurable interest. Yet, the UK insurance industry has overwhelmingly supported the retention of the doctrine of insurable interest. This book explores whether the traditional justifications for the doctrine – the policy against wagering, the prevention of moral hazard and the doctrine's relationship with the indemnity principle – still stand up to scrutiny and argues that, far from being obsolete, they have acquired new significance in the global financial markets and following the liberalisation of gambling. It is also argued that the doctrine of insurable interest is an integral part of a system of insurance contract law rules and market practice. Rather than rejecting the doctrine, the book recommends a recalibration of insurable interest to afford better pre-contractual transparency to a proposer as to the suitability of the policy to his or her interest in the subject-matter to be insured.

Providing a powerful defence for the retention of insurable interest, this book will appeal to both academics and practitioners working in the field of insurance law.

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Thank you.

Over to Professor James Davey …

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