

**The Law Commission
and
Scottish Law Commission**

Reforming insurance contract law

Updated draft Insurable Interest bill for review

June 2018

ABOUT THIS DOCUMENT

We are publishing an updated draft Bill to allow stakeholders an opportunity to consider whether the drafting achieves the stated policy aims. The draft Bill, together with a paper on the current law, is available separately. This document seeks to explain the draft Bill in its current form. We ask stakeholders for their views on the draft and about the potential impact of our proposed reforms.

We welcome comments on this draft Bill by **Friday 14 September 2018**, by email to:

commercialandcommon@lawcommission.gsi.gov.uk

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Chapter 1: Introduction

BACKGROUND TO THIS PROJECT

- 1.1 The Law Commission and Scottish Law Commission are reviewing the law of insurance contracts. This project has already resulted in the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA) and the Insurance Act 2015.
- 1.2 Broadly speaking, the requirement for insurable interest means that the person taking out the insurance must be affected by the subject matter of the insurance. They must stand to gain a benefit from its preservation, or to suffer a disadvantage should it be lost or damaged. The Life Assurance Act 1774, the Marine Insurance Act 1906 and Scots common law provide that an insurance contract without insurable interest is void. In England and Wales, such a contract is also illegal.¹
- 1.3 We have been told that the current law,² which is unclear in some respects, and antiquated and restrictive in others, has had the effect of inhibiting the insurance market's ability to write particular types of product for which there is demand. This message has been particularly strong from life and protection insurers.
- 1.4 A review of the law relating to insurable interest has been part of the wide-ranging insurance contract law project from the outset. However, it has proved more difficult to identify a well-supported set of proposals in respect of insurable interest, compared to other aspects of the project. We first consulted on proposals for reform in an Issues Paper in 2008.³ We published updated proposals for consultation as part of our 2011 Consultation Paper,⁴ and again in March 2015.⁵
- 1.5 Our March 2015 proposals were well supported.⁶ They were intended to be relatively permissive to ensure that, broadly speaking, insurance products which insurers want to sell, and policyholders want to buy, could be lawfully made available without technical concerns about insurable interest due to the current narrow definitions.

¹ For example, *Harse v Pearl Life Assurance Co Ltd* [1904] 1 KB 558. The Scottish courts have entertained actions over policies where there was no insurable interest but the insurer had chosen to honour the policy: see (2011) LCCP 201/SLCDP 152 para 10.4, footnote 7.

² We do not set out the current law in this paper. Our 2011 summary of the current law is available at: <https://www.lawcom.gov.uk/project/insurance-contract-law-insurable-interest/>.

³ Issues Paper 4 - *Insurable Interest* (January 2008).

⁴ Chapter 3, *Insurance Contract Law: Post Contract Duties and other Issues* (December 2011) Law Commission Consultation Paper No 201; Scottish Law Commission Discussion Paper No 152 ((2011) LCCP 201/SLCDP 152).

⁵ Issues Paper 10 – Insurable interest: updated proposals (March 2015).

⁶ A summary of responses received to that issues paper is available at <http://www.lawcom.gov.uk/project/insurance-contract-law/> and <http://www.scotlawcom.gov.uk/law-reform/law-reform-projects/joint-projects/insurance-law/>.

- 1.6 In March 2015 and in our earlier consultations, our proposals distinguished between indemnity insurance and contingency insurance. Generally speaking, property and liability insurance, and other “non-life” insurances, are contracts of indemnity. In contrast, life, accident and critical illness insurance policies are not: they generally provide that the insurer will pay a fixed sum of money on the occurrence of the event insured against. This is contingency, rather than indemnity, insurance.
- 1.7 However, some consultees pointed out that these distinctions were not clear cut and were sometimes unnecessary. Some forms of life insurance, such as key employee cover, have an indemnity element. Valued policies over property provide for a pre-agreed amount to be payable on the property’s loss or destruction, meaning that they are not pure indemnity contracts.
- 1.8 We concluded that the distinction between indemnity and contingency was less helpful and relevant than the distinction between life and non-life insurances.
- 1.9 In April 2016, we consulted on a draft Bill which would implement our March 2015 proposals. The draft Bill made the latter distinction.
- 1.10 We received 23 responses to that consultation. After considering the responses, and a period of delay due to Law Commission resources being deployed elsewhere, we have updated the draft Bill and are again publishing it for comment.

RESTRICTING THE DRAFT BILL TO LIFE AND LIFE-RELATED INSURANCES

- 1.11 Reviewing the responses to our various consultation exercises over the years, it is clear that the need for reform in this area exists only on the life and life-related insurance side. In this area, the current law is hindering the development of socially useful products, and our proposals were for substantive law reform. On the non-life side, our proposals were clarificatory only, and there was no suggestion that legislation in this area was necessary.
- 1.12 Particularly at a time when parliamentary time is scarce, and likely to be so for several years, we do not think it is appropriate to recommend legislative reform where there is no call from stakeholders to do so. For this reason, we no longer make proposals for reform of insurable interest in non-life insurances, other than to propose repeal of obsolete statutes.
- 1.13 The focus of the updated draft Bill is therefore on life and life-related insurances.

THE PURPOSE OF THIS DOCUMENT

- 1.14 In Chapter 2, we discuss each clause of the draft Bill as it now stands, and ask a small number of questions to test whether the new drafting adequately reflects the policy.
- 1.15 In Chapter 3, we set out a brief case for reform and ask consultees about the potential impact of our proposals.
- 1.16 We do not ask again about matters on which we have previously consulted, either in terms of policy or drafting. In Chapter 4, we summarise the comments received from stakeholders in response to our April 2016 consultation on the first draft of the Bill.

Chapter 2: Explaining the draft Insurable Interest Bill

- 2.1 Some of the updated draft Bill, insofar as it relates to life-related insurance, is in the same or very similar form as it was at the point of our April 2016 consultation. In this document, we repeat our explanations of those clauses, but do not ask questions on the drafting again. Where the drafting has changed, including in response to stakeholders' comments, we explain these changes.
- 2.2 We also note briefly the views of consultees on each clause. In Chapter 3 we include a fuller summary of responses to our April 2016 questions.

CLAUSE 1: DEFINITIONS

- 2.3 Following our approach in the Insurance Act 2015 and CIDRA 2012, the draft Bill does not define "contract of insurance" itself. This definition will be taken from common law principles.
- 2.4 Clause 1 defines "insurer" and "insured", based on the definitions in the Insurance Act 2015.
- 2.5 Contracts of reinsurance and retrocession are treated as contracts of insurance at common law.⁷ In such contracts, the party purchasing the insurance (the insurer or the reinsurer) is the "insured" for the purposes of the Bill, and the party providing the insurance (the reinsurer or the retrocessionaire) is the "insurer".

Life-related insurance

- 2.6 The draft Bill applies to contracts for "life-related" insurance. A contract of life-related insurance includes any contract of insurance under which the insured event is the "death, injury, ill-health or incapacity of an individual". We use "life-related" insurance rather than "life insurance" because it was clear from responses to previous consultations that stakeholders did not regard "life insurance" as covering insurances against, for example, critical illness, but many said that the same principles should apply to them.
- 2.7 In April 2016, we asked if consultees agreed that personal accident, critical illness, disability and other insurances dependent on human life should be subject to the same insurable interest rules as life insurance. The vast majority of consultees agreed.
- 2.8 We think that "life-related" insurance category will encompass both indemnity and contingency policies as long as they relate to a human life.
- 2.9 The term is intended to cover traditional life insurance contracts which pay out on the death of the life insured (or in some cases the earlier surrender or expiry of the policy).

⁷ *Delver, Assignee of Bunn v Barnes* (1807) 1 Taunt 48; *Forsikringsaktieselskabet National (of Copenhagen) v Attorney General* [1925] AC 639; *Toomey v Eagle Star Insurance Co Ltd* [1994] 1 Lloyd's Rep 516.

It is also intended to capture insurances which otherwise depend on human life or health such as personal accident, critical illness and disability insurances. At the other end of the spectrum, it covers investment-linked insurance products which have a life insurance element.

- 2.10 Investment-linked insurance contracts and investment bonds with an insurance element are marketed and used as investment, rather than as insurance, products. The life assurance element of them (sometimes called the insurance “wrapper”) is usually nominal (around 1.0% or 0.1% of the value of the underlying investments). Such policies are long-term investment vehicles used by individuals, trusts (including pension schemes) and bodies corporate.
- 2.11 Such products typically continue until the death of the last surviving life assured, unless they are surrendered by the policyholder before this. To maximise flexibility and the life of the investment, the practice is generally to have a number of lives assured and to include lives that are likely to outlive the policyholder.
- 2.12 The definition of life-related insurance also refers to contracts under which the insured event is the continuation of an individual’s life. This is intended to capture annuities, which we think must be treated as a type of life-related insurance although they depend on the life continuing.
- 2.13 In April 2016 we also asked whether consultees thought the drafting worked for annuities and insurance-linked investment products. The majority agreed that it did.
- 2.14 One stakeholder suggested that the requirement for insurable interest should be excluded from applying to capital redemption bonds. However, although capital redemption bonds are sometimes said to be similar to life assurance contracts, they are not linked to any “lives assured” at all. They are not contracts of insurance at common law and therefore fall outside of the scope of the draft Bill.

Question 1: Do consultees have any further comments on clause 1 of the draft Bill?

CLAUSE 2: INSURABLE INTEREST

- 2.15 Clause 2 is the key clause in the draft Bill, setting out the requirement for insurable interest in contracts of life-related insurance, and a non-exhaustive list of situations in which an insurable interest will exist.

Clause 2(1): Insurable interest requirement and effect of no interest

- 2.16 Clause 2(1) means that an insured under a contract of life-related insurance must have an insurable interest in the life of the individual who is the subject of the insurance. In legislation, the singular includes the plural so, where a contract pertains to the life or health of more than one individual, then the insured must have an insurable interest in each of them.
- 2.17 The insured must have the insurable interest at the time the insurance contract is entered into (but not necessarily at the time of the loss). This confirms the existing law.

- 2.18 If the insured does not have an insurable interest at the relevant time, the clause provides that the contract will be void (but, in a change from the current law at least in England and Wales, not illegal).⁸

Consequences of a contract being void

- 2.19 When a contract is void, it is as if the contract had never existed. Generally the position at law is that money paid under a void contract may be recovered. There are numerous reasons why a contract may be held to be void, and the right to recover money paid may vary dependent on the reason.
- 2.20 In insurance contracts, the basis for the insured's payment of the premium is that the insurer runs the risk of having to indemnify against the insured event. If the insurer has never been on risk the contract is void as the basis for payment of the premium has failed.⁹
- 2.21 Because the draft Bill (in clause 4, discussed below) repeals the existing rule that makes contracts without insurable interest *illegal* as well as void, premiums will now generally be returnable unless there has been an untrue or misleading statement. The draft Bill does not make specific provision for return of the premium in other cases. That is a matter for the general law.

Clause 2(2): Economic interest

- 2.22 Under the current law, a policyholder may insure the life of another person if they would suffer a financial loss on the other's death. However, this category is extremely limited. The insured must show an interest which is pecuniary and recognised by law.¹⁰ Typical examples include creditors insuring the life of a debtor (to the amount of the loan), and employers insuring the life of an employee (to the value of the period of notice). If the employee is a "key person" it may also be possible to insure the costs of recruiting and training a replacement, and any loss of profits in the meantime, though this is by no means clear.
- 2.23 The cases interpret strictly the requirement for an interest recognised by law, suggesting (for example) that there is no legal obligation on a son to bury his mother.¹¹ This means it is difficult for people to insure the life of a family member other than a spouse, even if they are economically dependent on them and would suffer a loss if the family member died.
- 2.24 Clause 2(2) sets out a broader economic interest test. It does not require a pecuniary interest recognised by law. Instead, an insured would have an insurable interest in any circumstance where they have a "reasonable prospect" of suffering economic loss on the occurrence of the insured event (such as the death or illness of, or injury to, the person insured).

⁸ We discuss the effect of a void contract and the removal of the illegality rule from para 4.67.

⁹ See, for example, *Re London County Commercial Reinsurance Office Ltd* [1922] 2 Ch 67.

¹⁰ In Scotland, "pecuniary interests" are often referred to as "patrimonial interests".

¹¹ *Harse v Pearl Life Assurance Co Ltd* [1904] 1 KB 558.

2.25 In the April 2016 draft, the “economic interest” test was included in the non-exhaustive list (discussed below) of circumstances in which an insurable interest exists. In response to the draft, some consultees suggested that the economic loss test was a more general test than the other specific examples, and thought it should be treated separately in the legislation. We agree, and have moved it into its own sub-section.

Clause 2(3): Other circumstances in which an insured has an insurable interest

2.26 Clause 2(3) sets out a non-exhaustive list of situations in which insurable interest exists for the purposes of a contract of life-related insurance.

2.27 We consider that the situations listed are the most common situations where a policyholder insures the life of others. This list has been developed as a result of discussions with stakeholders, taking into account responses to previous consultations. Some stakeholders suggested that there should be a general definition of insurable interest to guide parties and courts in situations which do not fall within the specific situations on the list. We agree that this would be the ideal situation but we do not consider that it is possible to develop such a definition.

2.28 The list encompasses two broad categories of interest for life insurance purposes. The first is based on specific relationships: if the relationship exists, there is no need for the insured to demonstrate financial dependency or expectation of financial loss. Insurable interest exists on the basis of the nature of the relationship. These relationships have previously been referred to as being those of “natural affection”.

2.29 The second category encompasses policies which are designed to cover multiple lives.

2.30 Clause 2(3) is based on the current law but extends the categories to broaden the scope of the policies which can lawfully be written.

Clause 2(3)(a): “Natural affection”

Self and partner, including cohabitant

2.31 As under the current common law, the draft Bill provides that an insured has an insurable interest in their own life,¹² and in the life of their spouse or civil partner.¹³

2.32 Clause 2(3)(a)(ii) also extends this latter category to include the insured’s cohabitant – that is, an individual who lives with the insured as their spouse or civil partner.

2.33 As set out in our 2015 Issues Paper, we do not consider it necessary for primary legislation to further define the concept of living together as spouses or civil partners, such as by setting a minimum duration. We think that the courts will have regard to definitions of cohabitation in other areas of the law.

¹² Draft Bill, clause 2(3)(a)(i).

¹³ Draft Bill, clause 2(3)(a)(ii).

Children and grandchildren

- 2.34 Several insurance products, such as family and travel insurance, provide relatively small payments to parents on the death or injury of children under 18. Although parents are rarely economically dependent on younger children, there is clearly a demand for such products. Parents may sometimes be economically dependent on adult children, but this does not amount to “a pecuniary interest recognised by law” and so cannot currently be insured.¹⁴
- 2.35 The draft Bill provides that an insured has an insurable interest in the lives of their children and grandchildren, or those they treat as their child or grandchild.¹⁵
- 2.36 A brief overview of policies available in the Irish market, where such cover is permissible, indicates that insurers offer policies covering children for values of around 7000 euros.¹⁶ If thought necessary, regulators and the industry could issue guidance on this point. We do not now propose a statutory limit on the amount of cover.

No automatic insurable interest in the lives of parents and grandparents

- 2.37 A few consultees have suggested that insureds should be able to insure the lives of their parents or grandparents without having to show any reasonable prospect of economic loss on their death or on another insured event (such as illness or need for long term care). They suggested more flexibility was needed to allow for the development of policies providing cover for long-term care needs, and we agree that insurance covering later life care costs could be socially useful.
- 2.38 We have given this question careful consideration, but are not persuaded that an automatic insurable interest, without any need to demonstrate an economic interest, is necessary or appropriate.
- 2.39 Although we set out our reasoning in our April 2016 consultation, we summarise it here for convenience.
- 2.40 There are strong moral hazard arguments against giving an automatic insurable interest in (particularly elderly) parents or grandparents with no need to demonstrate any economic interest. Allowing a person’s children or grandchildren to take out straightforward life insurance over them (providing a payout on their death) raises similar arguments about the vulnerability of older people to those made in assisted dying debates. There are similar moral hazards in allowing a child to take out a policy

¹⁴ *Halford v Kymer* (1830) 10 B&C 724.

¹⁵ Clause 2(3)(a)(iii). The concept of “treated as” is adopted from the Children Act 1989, see section 105(1). As it is used without definition in that Act, we do not think that it is necessary to define it in this Bill. Various statutory provisions state that foster parents have no insurable interest in the life of a foster child, and (in England and Wales) that a prospective adopter has no insurable interest in the child concerned until an adoption or similar order is made. The Adoption and Children (Scotland) Act 2007 does not contain any provision relating to an insurable interest in the life of an adopted child. See Issues Paper 4, para 3.20. We do not propose any changes to these provisions.

¹⁶ See for example, Irish Life, Key features: term life insurance, https://www.irishlife.ie/sites/retail/files/bline-content/Term_life_insurance_key_features.pdf (last visited 15 June 2018). This provides incidental life cover for children up to age 25 for 7000 euros; more in relation to illness cover.

to provide for parents' long-term care costs, when the child has not had to demonstrate that they are likely to have to foot those costs. They may in fact decline to apply any insurance proceeds towards that care. Since our last consultation, we have spoken to Age UK who expressed similar concerns.

- 2.41 We appreciate that (adult) children might wish to take out insurance to provide for parents' care needs if, for example, the parents are not in a financial position to do this themselves. We think that the expanded economic interest test in clause 2(2), discussed above, would assist families who have a genuine concern about incurring economic loss in such circumstances. The economic interest test would be satisfied in cases where an insured could show that there was a reasonable prospect that they would end up covering any (or a proportion of) care costs incurred by their parents, or where grandparents are relied upon for childcare so that their death, illness or incapacity would have a financial impact on a family.
- 2.42 In 2011, the Dilnot Report¹⁷ noted that, at present, the market does not generally offer insurance products which would enable an individual to insure themselves against their own long-term care costs, although we have been told that the availability of such products is increasing. However, there does not appear to be widespread availability or use. Under the current law, the individual would be permitted to take out such cover, so the lack of product availability or purchase does not seem to be attributable to the rules of insurable interest.
- 2.43 It is also open¹⁸ to an individual to take out insurance on their own life and assign the benefit of the policy to their child if the desired effect is to provide a cash benefit immediately upon death.
- 2.44 In our April 2016 consultation, we asked whether consultees agreed that the economic interest test would be sufficient to ensure that families can insure parents or grandparents in appropriate situations. The majority agreed that it was. More detail is given from paragraph 4.24 of the summary of responses in Chapter 3.

Clause 2(3)(b): Group insurance policies

- 2.45 The case of *Feasey v Sun Life Assurance Co of Canada*¹⁹ raised the possibility of there being other categories of insurable interest where it was not necessary to show financial loss, particularly where the insurance covered a number of individuals. That judgment may provide a basis for insurable interest to be found in the group insurance context under the current law, but this is by no means settled. Group insurance is a common and useful insurance product, particularly for long-term insurance. A

¹⁷ The Dilnot Commission was tasked with reviewing the funding system for care and support in England. The final report containing the advice and recommendations of the Commission to Government was published in July 2011 and is available here:

<http://webarchive.nationalarchives.gov.uk/20130221130239/http://dilnotcommission.dh.gov.uk/files/2011/07/Fairer-Care-Funding-Report.pdf>. We understand that there is currently no date for implementation of these recommendations: see House of Commons Library Briefing Paper 7265, 'Social care: Announcements delaying the introduction of funding reforms (including the cap) (England)' (February 2018).

¹⁸ Married Women's Property Act 1882, s 11 and Married Women's Policies of Assurance (Scotland) Act 1880, ss1 and 2; Civil Partnership Act 2004, s 132.

¹⁹ *Feasey v Sun Life Assurance Co* [2003] EWCA Civ 885 [2003]; 2 All ER (Comm) 587.

significant amount of life insurance and critical illness insurance is written through employer sponsored group schemes. It is undesirable for the legal status of these products to be uncertain.

- 2.46 Clause 2(3)(b) therefore provides that the person (such as a trustee or insurance company) who administers a pension or other group scheme has an insurable interest in the lives of the members of the scheme. In response to comments from stakeholders on our April 2016 draft, who pointed out that group schemes are not always structured as trusts, the clause is no longer restricted to trustees as the scheme administrators.

Question 2: Do consultees consider that the updated drafting in clause 2(3)(b) is sufficiently flexible to cover all relevant group schemes?

Clause 2(3)(c): Cases where insurance is taken out for the benefit of the life insured or their nominee

- 2.47 Clause 2(3)(c) goes further and provides that, where an insured takes out a policy which is for the benefit of the life insured or their nominee, the insured will have an insurable interest in that life. This will mean, for example, that an employer will have an unlimited interest in the lives of its employees when entering into a group scheme the purpose of which is to provide benefits for its employees or their families.²⁰ Where the beneficiary is the life insured, we do not think that the moral hazard arguments apply.
- 2.48 This clause was included in our earlier published draft Bill. A small number of consultees were concerned that this clause was too broad and could lead to disputes about what it included. We have reflected on this and consider that there is benefit in the clause being broad and flexible, to cater for the numerous types of insurance product currently on the market or which may be developed in future. Some degree of uncertainty, and the possibility of disputes, is inevitable in these circumstances. We seek consultees' views.

Question 3: Do consultees consider that it is useful to provide that the insured has an insurable interest where the policy is for the benefit of the life insured or their nominee?

Question 4: Can consultees envisage a situation in which an insured should not have insurable interest in these circumstances, or where this clause could be abused?

Clause 2(4): The insurable interest of trustees

- 2.49 Clause 2(4) effectively provides that, where insurance is taken out by a trustee, the trustee has an insurable interest in the relevant life if the settlor of the trust (or "truster", in Scots law) would have such an interest. This clause is new in this draft, and was included in response to consultee concerns that the previous draft did not

²⁰ This will not cover situations where the policy is for the employer's benefit, as in key person insurance.

allow for a common form of investment arrangement in the context of investment-linked insurance products.²¹

- 2.50 In response to our last consultation, some insurers raised concerns that the draft Bill did not cater for the common situation in which the investor puts money in trust, and then the trust purchases a life assurance bond. They queried whether the trustee would have an insurable interest in the lives insured under the Bill as then drafted.
- 2.51 We have now inserted clause 2(4) to cater for this situation. If the settlor (or trustee) would have an insurable interest in the lives proposed to be assured, then the trustee is taken to have insurable interest in those lives. This is likely to mean that the trustee can buy an investment policy which names the settlor, their partner, and their children and grandchildren as lives insured. If the settlor has died before the trustee purchases the policy, the trustee has the same insurable interest as the settlor would have had during his or her life.
- 2.52 Clause 2(4) is broadly drafted and is intended to cover other circumstances in which trusts might be used. In all cases, it is important that the trustee derives a legitimate interest from something other than their status as trustee.

Question 5: Do consultees consider that clause 2(4) is appropriately framed to cater for all the types of trust commonly used?

Clause 2(5): “Mid-term beneficiaries” in multi-life policies

- 2.53 Clause 2(5) was inserted to cater for a comment relating to group policies received from the City of London Law Society (CLLS) in response to our April 2016 consultation. They pointed out that employees may join a company after the group policy is taken out (which is the time at which insurable interest is judged). At that time, the employer-policyholder lacks an insurable interest in respect of those future employees. We can see that it would be desirable for such lives to be covered.
- 2.54 Clause 2(5) therefore states that a policy may provide that a reference to a category or description of lives insured (eg employees of a certain company) includes individuals who do not fall within that category when the contract is taken out, but subsequently do. The policy itself will need to refer to this.

Question 6: Do insurance contracts cater for “mid-term beneficiaries” under the current law? If so, how?

Question 7: Do consultees agree that clause 2(5) caters adequately for “mid-term beneficiaries”?

Question 8: The words in brackets at the end of clause 2(5) are intended to cover lives not yet in existence, such as future grandchildren. Do consultees consider that those words are required?

²¹ We give a brief description of these products from para 2.10 above.

CLAUSE 3: EFFECT OF UNTRUE OR MISLEADING STATEMENTS

- 2.55 Section 84(1) of the Marine Insurance Act 1906 provides for the return of premium where a contract has failed, but includes a specific exception where there has been fraud or illegality on the part of the assured. However, whether section 84 applies to insurance contracts other than marine insurance contracts is unclear.²²
- 2.56 It appears that, without a specific provision to the contrary, an insured may be entitled to recover its premiums even if it had procured the policy through fraud or by deliberately or recklessly misleading the insurer as to its insurable interest.²³
- 2.57 Return of premium to a fraudulent insured is inconsistent with the provisions of CIDRA 2012 and the Insurance Act 2015, which provide that the insurer has the right to retain premiums paid where an insured has acted deliberately or recklessly in the course of its pre-contractual disclosure. These provisions do not apply to a contract which is void for lack of insurable interest because the contract is already void.
- 2.58 Clause 3(1) of the draft Bill therefore provides that, if an insured makes an untrue or misleading statement about the nature of its insurable interest and either knows it is untrue or misleading or does not care whether it is so, then the insurer may retain the premiums paid in pursuance of the void contract.
- 2.59 This reflects the “deliberate or reckless” formulations used in the CIDRA and the 2015 Act.

A limited exception for consumer insurance contracts

- 2.60 The above provision has the potential to produce harsh results, particularly in relation to life insurance policies which include an investment element, and to joint policies where one policyholder makes a deliberate misrepresentation and the other acts honestly and reasonably. For example, if a consumer takes out a life insurance policy with a significant investment element and is subsequently found to have lied about health issues, we think that the court should be able to order the return of the premium with interest. This would deprive the insured or their estate of any increase in value of the investment as opposed to paying the investment element only and retaining the premiums in relation to the life insurance element. This reflects our approach in CIDRA.²⁴
- 2.61 As in CIDRA 2012, clause 3(2) provides that, in the case of a consumer insurance contract, an insurer need not return any of the premiums paid except to the extent that

²² See *Colinvaux’s Law of Insurance* (11th ed 2016), para 9-029, and *MacGillivray on Insurance Law* (13th ed 2015), para 8-030.

²³ See, for example, *Spence v Crawford* [1939] 3 All ER 271 per Lord Wright at 288-289. For Scots law, see R Evans-Jones, *Unjustified Enrichment*, Vol 1, Enrichment by Deliberate Conferral: *Condictio* (2003), paras 9.103-104 and 9.116-118.

²⁴ See Law Commission and Scottish Law Commission, *Consumer Insurance Law: Pre-contract disclosure and misrepresentation*, from para 6.44. http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc319_Consumer_Insurance_Law.pdf

it would be unfair to the insured to retain them. “Consumer insurance contract” is defined in clause 3(3) and reflects the CIDRA definition.

- 2.62 In our 2016 consultation on the draft Bill, we asked whether the exception to retention of premiums in the event of unfairness should extend to commercial insurance contracts as well as consumer.
- 2.63 Fifteen consultees responded to this question. Seven supported extending the exception to all cases in which it would be unfair for the insurer to retain the premiums. Five argued that the fairness of the retention of premiums should only be considered in the context of consumer insurance.
- 2.64 Of the consultees who argued that the exception should apply solely to consumer insurance contracts, several emphasised the importance of aligning the draft Bill with existing provisions of the 2015 Act and CIDRA 2012 (see from paragraph 4.56 for more details of consultees’ comments). Although this was a minority view, on reflection we think that consistency is of overriding importance.
- 2.65 We think that an allegation that a policyholder has fraudulently represented the existence of an insurable interest must be raised under the Insurable Interest Bill rather than under the disclosure and representation provisions of CIDRA or the 2015 Act. This is because the effect of no insurable interest is that the contract is void, and is not therefore a (valid) contract of insurance to which the 2015 Act or CIDRA apply.²⁵ However, we still consider that consistency between the legislation is desirable where possible. For example, it would be strange if a commercial policyholder could in some circumstances reclaim their premiums following a fraudulent misrepresentation about the existence of insurable interest, but never following a fraudulent misrepresentation about another matter of pre-contractual disclosure.

CLAUSE 4: RELATIONSHIP WITH EXISTING LAW

- 2.66 Clause 4 provides that the draft Bill replaces any other rule of law relating to the requirement for an insurable interest in contracts of life-related insurance.
- 2.67 This means that common law rules concerning insurable interest in life-related insurance are effectively repealed. Importantly, it disapplies the rule in England & Wales that contracts which are void for lack of insurable interest are also illegal. Therefore, as discussed above, there is scope for premiums to be recovered by the insured.
- 2.68 This does not affect the law for non-life contracts.

²⁵ Under the 2015 Act and CIDRA 2012, the insurer’s remedy where the policyholder has made a deliberate or reckless untrue or misleading statement is to avoid the contract and keep the premium. This remedy could not apply where there is an absence of insurable interest, because in that case the contract is automatically void.

CLAUSE 5: EXCLUSION FOR MARINE INSURANCE

- 2.69 Sections 4 to 15 of the Marine Insurance Act 1906 govern the requirement for insurable interest for insurance contracts that fall within the ambit of that Act.²⁶
- 2.70 The industry has told us that the provisions of the 1906 Act work well and should not be disturbed. Without a strong case for reform, we agree they should be left as they are. When the draft Bill related to both life-related and non-life insurance, it was clear that an explicit exclusion was required for marine insurance contracts.
- 2.71 However, we have found it difficult to establish whether the provisions of the 1906 Act are ever likely to apply to a contract of life-related insurance. We have therefore retained the exclusion for marine insurance contracts.

Question 9: Do consultees think it is necessary to explicitly exclude marine insurance contracts, given that the draft Bill is now limited to life-related insurance contracts?

CLAUSE 6: REPEALS AND CONSEQUENTIALS

Repeals

- 2.72 Clause 6(1) repeals or partially repeals three pieces of legislation relating to insurable interest.

Life Assurance Act 1774

- 2.73 The previous draft of this Bill repealed the Life Assurance Act 1774 (the 1774 Act) in its entirety. However, in light of the restriction of the draft Bill's scope to life-related insurance, we have revisited this on the basis that the 1774 Act does not only apply to life-related insurances. It also applies to "other events",²⁷ though not to "ships, goods or merchandises"²⁸ or to indemnity insurance of any kind.²⁹ It is not clear which, if any, non-life insurances might be caught. Below, we describe what the 1774 Act does and which sections we think might need to be retained. We ask whether consultees agree.
- 2.74 The 1774 Act comprises four sections:
- (1) Section 1 bans the making of insurances where there is no interest, and renders any policy issued in such circumstances null and void. Section 1 is repealed by the draft Bill, but only insofar as it relates to contracts of life-related insurance.

²⁶ See (2011) LCCP 201/SLCDP 152, paras 12.57 to 12.58.

²⁷ The preamble to the 1774 Act states: "Whereas it hath been found by experience that the making of insurances on lives *or other events* wherein the assured shall have no interest hath introduced a mischievous kind of gaming..." (emphasis added).

²⁸ Life Assurance Act 1774, s 4.

²⁹ *Siu Yin Kwan v Eastern Insurance Co Ltd* [1994] 2 AC 199.

- (2) Section 2 requires the names of those interested to be noted in the policy document. If not, the policy is unlawful. We have argued that this sanction is unfair: the insurer's own failure to insert the name allows the insurer to refuse the claim, which cannot be right. Although it is good practice for insurance contracts to be in writing, such stringent statutory requirements are unnecessary. Section 2 is repealed in its entirety.
- (3) Section 3 limits the amount of any recovery to the value of the interest. We do not think there is any reason to place statutory restrictions on the value of policies in this context. There is no clear rationale for limiting the value of life-related policies in this way (or at all) and it can lead to practical difficulties for those who are insuring themselves or others against future uncertainties. Section 3 is repealed in its entirety. Insofar as any life-related indemnity policies are covered by the 1774 Act, the indemnity principle will serve to limit the value of any recovery.
- (4) Section 4 provides that the 1774 Act does not apply to "ships, goods, or merchandises". Because section 1 is partially retained, we also retain this section to ensure that the residual element of section 1 does not extend to any of these previously excluded categories.

Question 10: Do consultees agree that it is necessary to retain section 1 and section 4 of the Life Assurance Act 1774 in order to cover non-life insurances to which that Act applies? Can consultees give any examples of insurances which would be caught?

Marine Insurance (Gambling Policies) Act 1909

2.75 The 1909 Act makes it a criminal offence to effect a contract of marine insurance without having a bona fide interest. We have not found any evidence of prosecutions under the Act, and we do not think it is necessary to impose criminal liability as any problems in the market are subject to financial services regulation. Although the draft Bill does not otherwise extend to marine insurance, we take the opportunity to repeal this obsolete enactment.

Marine Insurance Act 1788

2.76 This Act requires the names of those interested in the insurance to be inserted into the policy. The Act was repealed by the Marine Insurance Act 1906, but only insofar as it applies to marine insurance. It appears to continue to apply to non-marine insurance but is routinely ignored.³⁰

2.77 If the insurer wishes for clarity about the interested parties, the insurer is free to include in its contracts the names of those interested. We are not convinced that there should be a statutory requirement. It would be unfair for an insurer to escape liability

³⁰ For more information on the Marine Insurance Act 1788 see (2011) LCCP 201/SLCDP 152, paras 12.54 to 12.55.

under a contract because the interested party was not named. Again, we take the opportunity to repeal it.

Consequential amendments

- 2.78 Clause 6(3) introduces a Schedule which sets out various consequential amendments. These either substitute a reference to the draft Bill instead of provisions in the current law, or repeal the current provisions in full where they are superseded by the terms of the draft Bill.
- 2.79 For example, section 99 of the Friendly Societies Act 1992 (insurance of lives of children under 10) is repealed, because the small exception allowing limited insurance to be taken out over children's lives would be superseded by our proposed reforms, which allow an insured to insure their children without any statutory limit on the amount of cover. This is also the case for section 253 of the Civil Partnership Act 2004.
- 2.80 However, the position in the Children Act 1989, which excludes the possibility of a foster parent having an insurable interest in the life of a foster child, is retained. The exception is based on policy considerations which are beyond the scope of this project, so a reference to the draft Bill is substituted.³¹

CLAUSE 7: SHORT TITLE, COMMENCEMENT, APPLICATION AND EXTENT

Application

- 2.81 Clause 7(3) means that the draft Bill applies to contracts entered into after it comes into force. However, clause 7(4) provides that insureds who entered into a contract of life-related insurance before that date will be deemed to have an insurable interest if they would have an insurable interest under the provisions of the draft Bill.
- 2.82 This possibility was raised with us by consultees. We have included it because we think it is undesirable for the current rules, which are unclear and rather arbitrary, to operate to allow insurers or insureds to escape an arrangement which they entered into and which would be valid under the provisions of the draft Bill. This applies to all contracts whenever they were entered into.
- 2.83 In our 2016 consultation, we asked whether consultees anticipated any significant difficulties with such an approach. The majority of consultees agreed with our approach and did not foresee any difficulties. See from paragraph 4.72 for more detail of consultees' views.

Extent

- 2.84 The draft Bill applies to England, Wales and Scotland only. The Law Commissions of Scotland and of England and Wales do not have the jurisdiction to make recommendations for Northern Ireland. However, we note that, when implementing

³¹ This also applies to the Foster Children (Scotland) Act 1984, section 18.

our previous recommendations on insurance contract law in CIDRA 2012 and the 2015 Act, the government decided to extend them to include Northern Ireland.

Chapter 3: The impact of our proposals

THE CASE FOR REFORM

- 3.1 We have been told that the overly restrictive nature of the current law is inhibiting the development and sale of economically and socially useful products in the UK. We believe that our more permissive regime would therefore fuel additional economic activity among UK insurers while making it possible for people and businesses to protect their legitimate interests.
- 3.2 We think that updating and clarifying the law would also save insurers time and money by reducing the involvement of lawyers and risk managers.
- 3.3 Anecdotal evidence we have received suggests that different insurers take differing attitudes to the application of the Life Assurance Act 1774 (the 1774 Act) and subsequent case law. Some are willing to write policies which may not strictly fall within its bounds, and others are not. This means that those who comply with the law are at a competitive disadvantage.
- 3.4 Below, we give some examples of where the law is overly restrictive. We then ask what the costs and benefits of our proposed reforms could be.

“Natural affection”

- 3.5 There is demand for travel and health policies to cover children but, while such products are lawfully available in other jurisdictions including the Republic of Ireland, they are not permitted by UK law.
- 3.6 Similarly, the continued growth in cohabiting couples means that the restriction on relationships of “natural affection” to spouses/civil partners is now outdated.

Group insurance

- 3.7 Although there is significant demand for group life and health policies which provide benefits to employees and their families, there is real uncertainty about whether such policies are lawful. We have been told that insurers would always expect to honour a claim on such a policy, but it is highly undesirable that the law may not support them.

Key person insurance

- 3.8 Section 3 of the 1774 Act limits the amount of any recovery to the value of the legally recognised interest in the life assured. This means that, strictly speaking, the value of key person insurance must be limited to the value of that person’s notice period, because this is the extent of the business’ legal “claim” on them. In reality, the impact on a business of losing a key person is likely to be significantly more. We have been told that small businesses and start-ups are particularly likely to be reliant on one or two people and so are particularly affected by this restriction.

ASSESSING THE IMPACT

3.9 It has been difficult for us to put a number on the benefits or costs associated with our proposals. We call for more evidence from consultees.

Question 11: Do consultees agree that our proposals for reform, as set out in the draft Bill, would make the insurance market work better?

Question 12: We believe that our proposals will allow for the development of new products in the UK insurance market, and will remove the commercial disadvantages potentially suffered by insurers who currently comply with the law. Do consultees agree? Do consultees foresee any other benefits?

Question 13: Are consultees able to give any indication of the monetary value of these, or any such, benefits?

Question 14: We believe that the costs to business of such reform would be minimal. We welcome evidence as to the potential costs.

Chapter 4: Summary of responses to April 2016 consultation on draft Bill

4.1 As we set out in Chapter 1, the responses to our consultation on the draft Bill in April 2016 have led us to restrict our proposals to life-related insurances. This summary of responses therefore covers only consultees' views on the life-related provisions.

Question 1: Do consultees agree that personal accident, critical illness, disability and other insurances dependent on human life be subject to the same insurable interest rules as life insurance?

4.2 There was strong support for this proposition. Of the 14 consultees who responded, 13 agreed that personal accident, critical illness, disability and other insurances dependent on human life should be subject to the same insurable interest rules as life insurance.

4.3 Of the 13 consultees who said yes, three raised concerns about the width of the definition. The British Insurance Law Association (BILA) and BLM were concerned that "the definition could be construed widely as covering other types of liability insurance where the insured event may be death or injury, such as employers' liability insurance."³²

4.4 We agree with BILA that liability insurance should not be regarded as life-related insurance. Even where the policyholder's liability is a "life-related" event such as the death or injury of another, the insured event under a liability policy is the attachment of liability to the policyholder, rather than the death or injury itself.³³ We have discussed above that the effect of the draft bill is now limited to life-related insurance. In these circumstances, we do not therefore consider that liability insurance should be referred to on the face of the bill.

4.5 Lloyd's Market Association (LMA) agreed with the proposition in question 1, subject to a point on severability. They said that a consequence of the definition of "a contract of life-related insurance" was that "a huge number of contracts underwritten on a daily basis will need to be severable in terms of insurable interest". The LMA suggested that the draft Bill should allow for severability explicitly. We discuss the question of severability in relation to question 10, below.

4.6 The British Insurance Brokers' Association (BIBA) acknowledged the logic in distinguishing between contingent policies and indemnity contracts. However, BIBA was concerned that the definitions do not align either with the operation of some of

³² BILA.

³³ An insurance against liability is a contract of indemnity and "no obligation arises on the part of the insurer to pay a claim until the assured has suffered a loss": *MacGillivray on Insurance Law* (13th ed 2015), para 30-002.

these contracts or with the regulatory environment. BIBA suggested that there may be:

scope to align the legal and regulatory regimes to permit market participants to have a clear view on the legal and regulatory requirements for specific contract types, to best ensure the correct treatment for the consumer.

- 4.7 Lloyds Banking Group (Insurance Division) endorsed a “uniform approach to what constitutes an insurable interest”, but suggested that the degree of dependency on human life should be relevant:

In the context of investment bonds which includes only a very notional (between 1-5%) life cover, we remain of the view that insurable interest should not be relevant.

- 4.8 We discuss this issue under question 2 below. We have considered concerns about investment bonds with a small element of life insurance. Our view is that there should not be a carve-out for these types of products. As we said in our 2016 consultation on the draft Bill:³⁴

We do not think that treating [investment products with an insurance element] separately from other insurance contracts in the context of insurable interest is practical or desirable. There are regulatory reasons why such products involve an insurance element and removing the requirement for insurable interest – which is otherwise required in order to have a valid insurance contract – may appear to subvert this.

- 4.9 If a product includes an element of life-related insurance within the definition of the draft Bill, it should be subject to the requirement for an insurable interest in clause 2 of the draft Bill. The draft Bill is already more permissive in scope than the current law (for example, by allowing for children and grandchildren), and we do not therefore think that it will inhibit insurers’ activities in this area. As we discuss below, most consultees agreed that our current approach works for insurance-linked investment products.

Question 2: Do consultees consider that the definition of “life-related insurance” works for insurance-linked investment products, and annuities?

- 4.10 11 of 13 consultees agreed that the definition of “life-related insurance” works for insurance-linked investment products and annuities.

Insurance linked investment products

- 4.11 Some consultees who answered “yes” to the question nonetheless raised concerns about the definition, particularly in relation to the investment-linked insurance market. Lloyds Banking Group (Insurance Division) agreed that the definition worked, but said that they would prefer it to exclude “insurance linked investment products with only a notional amount of life cover”. Legal & General agreed that “predominantly investment contracts should be excluded from the definition”, warning that “any increase in costs

³⁴ At para 2.31.

of administration would need to be assessed and if necessary passed on to customers”.

4.12 Old Mutual Wealth noted that the definition needs to be sufficiently broad

so as not to interrupt [the use of annuities and investment products] as an effective estate planning vehicle, where they may include multiple lives assured and come to an end on the death of the last life assured.

Capital redemption bonds

4.13 The ABI suggested that the requirement for insurable interest should be excluded from applying to Capital Redemption Bonds:

Whilst the wording of the Bill should confirm that Capital Redemption Bonds remain life assurance contracts, nothing in the Bill (or eventual Act) should be construed as introducing an insurable interest requirement for such contracts.

4.14 Although Capital Redemption Bonds are sometimes said to be similar to life assurance contracts, they are not linked to any “lives assured” at all. They are not contracts of insurance at common law and therefore fall outside of the scope of the draft Bill.

Annuities

4.15 Most consultees were satisfied that the definition works for annuities.

4.16 However, BIBA suggested that although the current definition appeared to work for insurance-related investment products, “there is a question around the clarity of the words used with the intention of capturing annuities within the definition”. MetLife also raised a question of drafting. MetLife said that “life continuing” is not a contingent insured event. We have discussed this matter with our parliamentary draftsman who is satisfied that the current drafting is sufficiently clear.

Definition of “insured”

4.17 The Insurance Law Committee of the City of London Law Society (CLLS) suggested that the definition of “insured” is “unnecessarily restrictive” and could—

disqualify contracts taken out by a person on behalf of another, for example where pension fund trustees contract through a common investment fund or where there is a requirement for the insurance contract to be issued to a depositary. This concern could be addressed if the definition of “insured” were to be amended to read: “means the party to a contract of insurance who is the insured under the contract or the person for whose benefit the contract is made.”

4.18 Our view is that the “insured” should be the party entering into the insurance contract with the insurer, including where that party is a trustee or is otherwise taking out insurance on behalf of another. This is consistent with the approach taken in the Insurance Act 2015. However, as we discuss in chapter 2, clauses 2(3)(b) and (c) are intended to ensure that an appropriate insurable interest will exist in cases where a policy is taken out for the benefit of another.

Investment-linked

- 4.19 Investment products with an insurance element clearly fulfil an important economic role. However, we do not think that treating them separately from other insurance contracts in the context of insurable interest is practical or desirable. There are regulatory reasons why such products involve an insurance element and removing the requirement for insurable interest – which is otherwise required for an insurance contract to be valid – may appear to subvert this. There is a strong market for such products under the existing legal regime and insurers have not been calling actively for reform of the legal rules on investment linked insurance products.

LIFE-RELATED INSURANCE

Question 3: Do consultees consider that this non-exhaustive list [setting out circumstances in which an insured has an insurable interest] is appropriately drawn to cover all the key situations in which an insured should be able take out insurance over another person?

- 4.20 Fourteen consultees responded to this question. Ten consultees agreed generally with the non-exhaustive list, with some raising questions about the width of the list. Similarly, the four consultees who disagreed were generally concerned with the width of the list, with three suggesting that it could be expanded.

Non-pension trusts

- 4.21 Lloyds Banking Group (Insurance Division), the ABI and Old Mutual Wealth all queried whether the draft Bill covers all trusts, or whether it is limited to pension trusts. We have now expanded the drafting in clause 2 to address this point.

Group schemes

- 4.22 CLLS and Lloyd's Market Association each pointed out that the list does not clearly cover all cases of group life insurance. CLLS noted:
- (1) This type of insurance does not always involve a trustee, so it would not necessarily fall within the scope of ... the Bill.
 - (2) Employees may join a company after the group policy is taken out, meaning that at the time the policy is taken out, the policyholder lacks an insurable interest in respect of those future employees.

- 4.23 As discussed above, we have made amendments to the draft Bill to accommodate these comments.

Extension of list to include other family relationships

- 4.24 Several consultees argued that the non-exhaustive list should be extended to include other family relationships. In particular, Lloyds Banking Group (Insurance Division) and ILAG maintained that there should be a category for insureds to insure the lives of their parents or grandparents without having to show any reasonable prospect of economic loss. Lloyds Banking Group (Insurance Division) said:

[w]e maintain the need for the inclusion of parents/grandparents based upon a number of factors, such as: (i) the dependency on childcare provision; (ii) looking

ahead to funding later care costs; or (iii) future tax liabilities, e.g. inheritance tax, as the recipients are more motivated to insure this than the person making the gift. Additionally, it may also be beneficial to include siblings as they may take on similar supporting roles to a parent or grandparent in certain situations.

We note the Law Commissions' view that parents/grandparents can be covered with reference to the economic test but we are concerned that reliance on that test could be problematic ... A simpler solution would be to include parents/grandparents as a specific category. We also note the remaining concern regarding moral hazard risk but question whether the risk of moral hazard is removed by requiring the insured to claim there is potential to suffer economic loss on the loss of his or her parent?

- 4.25 We reiterate our conclusion as to parents and grandparents from paragraph 2.37 above.
- 4.26 Old Mutual Wealth went further, and suggested that the list should be expanded to allow for an automatic insurable interest for the wider family, such as nieces and nephews. They noted that “not all modern family arrangements can be described in terms of Parent/Child/Grandchild”. Similarly, Legal & General quoted previous responses to consultation, suggesting that for investment bonds, the list should be widened to include not only grandchildren and parents/children but “also other blood relatives such as siblings”.
- 4.27 We acknowledge that family arrangements can take many forms, and that people may have caring responsibilities for children other than their biological child. However, clause 2(3) is drafted to cover any child treated as a child of the family, and if this did not apply then the economic interest test would be likely to be met if there were caring responsibilities.
- 4.28 In general terms, however, the draft Bill intentionally allows for only a narrow range of people in whom an individual is taken to have an automatic insurable interest without any further economic dependency or contractual relationship. The “natural affection” category is unusual in insurance terms in that it assumes an economic value based on the closeness of the relationship, and its scope is limited accordingly.

Trust arrangements

- 4.29 Legal & General said that the non-exhaustive list did not cover all scenarios in relation to investment bonds where trusts are employed:

The draft bill would affect investment bond business placed under trust more widely as a broad range of family members may also be included as trustees. For example, it would not be possible for grandparents with two or more children (who also have children) to place a bond under trust for the benefit of grandchildren with the parents of the grandchildren as trustees. Two bonds would be required for little or no additional benefit, given that the amount of life cover is minimal and therefore the risk of moral hazard is extremely unlikely.

- 4.30 In response to this point, which was also raised by other stakeholders in discussions, we have included the new clause 2(4). This provides that the trustee or trustees will

have an insurable interest in the lives of the beneficiaries if the settlor or truster of the trust would have an insurable interest in the beneficiaries.

“the contract is for the benefit of the individual, or a nominee of the individual”

4.31 The Bar Council, BILA and the BLM all queried whether draft clause 2(2)(e) (“the contract is for the benefit of the individual, or a nominee of the individual”) is necessary. These consultees suggested that there may be argument and litigation about the interpretation of this paragraph. The Bar Council pointed out:

The Law Commissions’ Notes seem to envisage subclause (e) being relied on by employers with group schemes but we consider that these may be sufficiently covered by (d) and (f). If subclause (e) was dropped from the draft Bill, it would not close down the possibility of maintaining in a suitable case that there is insurable interest in a person where the contract is for the benefit of the individual or a nominee of an individual. The subclauses are only a non-exclusive list of circumstances where there is an insurable interest.

4.32 Although we think that this is a persuasive argument, we want to ensure that we do not remove a necessary category from the list in clause 2. Accordingly, we would be grateful for consultees’ views on whether this limb (now clause 2(3)(c)) should be deleted; see from paragraph 2.47 above.

“reasonable prospect that the insured will suffer economic loss”

4.33 CLLS also recommended the economic interest test (“there is a reasonable prospect that the insured will suffer economic loss if the insured event occurs”) should be separated from the rest of the list in draft clause 2(2).

4.34 We agree that there appears to be a conceptual difference between this paragraph and the rest of the list, which deals with the characteristics of the individual, insured or the contract. On that basis, we have amended the draft Bill as discussed from paragraph 2.22 above.

“lives with the insured as a spouse or civil partner”

4.35 The Faculty of Advocates agreed with the intention of the draft Bill that someone who is living with a person as a partner should have an insurable interest. However, they expressed reservations about the phrase “lives with the insured as a spouse or civil partner”, saying that it is unclear. For example, does the requirement to live “as a spouse” mean simply cohabitation as a partner or does the cohabitation have to have the characteristics required for a common law marriage?

4.36 We set out in Issues Paper 10 and our April 2016 consultation that we do not consider it necessary for primary legislation to define further the concept of living together as spouses or civil partners.³⁵ We did not think it was helpful or necessary to set out arbitrary requirements if both the couple and the insurer felt that insurance in the relevant circumstances was appropriate at the time of the contract. We think that the

³⁵ See The Law Commission and Scottish Law Commission Reforming insurance contract law – Short consultation on draft bill: insurable interest (April 2016), para 2.11.

courts will have regard to definitions of cohabitation in other areas of the law. This approach has been widely supported by consultees in response to Issues Paper 10. In the circumstances we do not propose to amend this provision further.

Non-exhaustive nature of the list

4.37 Although the Faculty of Advocates agreed that the list should be non-exhaustive, they said it was—

“unclear what other factors might be relied upon to establish insurable interest when the proposed [clause 4] arguably has the effect of superseding the existing guidance within the common law”.

4.38 This is a difficult point. Generally, we consider that the economic interest test is the most common basis for insurable interest. The non-exhaustive list of other circumstances could be expanded by the courts in cases where the insured has sought to purchase insurance which appears to have a legitimate aim and it would be fair to do so.

Question 4: Do consultees agree that the economic loss test is sufficient to ensure that families can insure parents or grandparents in appropriate situations?

4.39 Eleven consultees responded to this question. The majority of consultees (seven) agreed that the economic loss test is sufficient to ensure that families can insure parents or grandparents in appropriate situations.

4.40 IUA said:

This reflects the likely increased potential moral hazard in these circumstances. However, the key point for us is that we would expect insurers to deal with such requests according to the specifics of the relationship and identified economic dependency.

4.41 Three consultees argued that the economic loss test is not sufficient to ensure that families can insure parents or grandparents in appropriate situations. Lloyds Banking Group (Insurance Division) maintained that they would prefer to see this relationship explicitly included in draft clause 2(2). They said:

Otherwise, the onus is on the insurer to establish the potential for economic loss. What is unknown is the degree of evidence required, the extent of the investigations conducted by the insurer etc. Where action is required by the insurer, there is scope for dispute as to the amount and quality of evidence received, and reasonable reliance by the insurer thereon. Disputes could arise if the insured later considers the insurance was not necessary or the market performance of the investment bond was such that the insured is better off avoiding the policy and receiving return of premiums.

4.42 Similarly, ILAG said:

While clause [2(2)] improves the situation we feel that the interpretation of ‘reasonable prospect of suffering economic loss’ may create uncertainty about being

able to evidence the required interest, particularly since insurable interest between children/parents in the other direction is explicitly listed.

4.43 ILAG also noted that products are currently sold that allow individuals to insure against their own long-term care costs.³⁶

4.44 Old Mutual Wealth pointed out:

The stages and processes of old age can vary, it would not always be possible to prove an economic loss until it occurs. By this time the assured will likely be uninsurable or require a high premium. Since the parents/grandparents could take out an own life policy and then assign it, the economic test would be an unnecessary barrier. Other safe guards, such as the insured providing permission for the cover, could be used to prevent abuse.

4.45 As discussed in chapter 2, we have considered these arguments carefully. However, for the reasons outlined there, we think that the draft Bill strikes the correct balance.

Children and grandchildren

4.46 Support for extending insurable interest to children and grandchildren has been broad at each stage of the project, but not universal. For example, Professor Andrew McGee from Manchester University argued that parents should not have an automatic interest in children, saying that “in those cases of financial dependency on children, it seems to me that the catch-all of suffering financial loss would apply. In the absence of such loss, there is no reason why parents should be treated as having interest in children”.

4.47 However, most consultees are in favour of this extension. We envisage that parents are more likely to purchase accident and healthcare products such as travel insurance to cover under 18s, rather than life assurance policies.

Question 5: Are there any negative consequences which this Bill could have on investment linked insurance products compared to the current law?

4.48 Only five consultees responded to this question.

4.49 Two consultees, IUA and MetLife, said that the proposed draft Bill should not impact negatively on these products. Three consultees raised concerns that the draft Bill could have negative consequences for such products.

4.50 Both ABI and Old Mutual Wealth raised the question of trusts which are not linked to pensions. They asked whether such trusts are intended to be covered by the draft Bill, and, if so, whether both absolute and discretionary trusts are included. Old Mutual Wealth noted that draft clause 2(2)(e) (now clause 2(3)(c) – “the contract is for the benefit of the individual, or a nominee of the individual”) may apply to non-pension trusts, but that the position is not clear. If that provision would not apply, then Old

³⁶ In the Law Commissions’ April 2016 consultation, we referred to the Dilnot Report which had said that, at present, the market does not offer such products. The Law Commission and Scottish Law Commission *Reforming insurance contract law – Short consultation on draft bill: insurable interest* (April 2016), para 2.24.

Mutual Wealth warned that “there are no other provisions for trustee investments and this will prevent the use of life-related policies by trusts”.

- 4.51 As discussed above, we have considered these comments, and have accordingly included the new clause 2(4) in the draft Bill to cover trusts.
- 4.52 Old Mutual Wealth was also concerned about the width of the proposals. They acknowledged that clause 2 of the draft Bill is wider than the previous position. However, it suggested that “a wider class of extended family is considered and expressly designed as an accepted relationship for determining insurable interest”, saying that “The process of proving economic loss is likely to be too time consuming and costly and rigid to assist for investment products”.
- 4.53 We discuss our reasons for not extending the non-exhaustive list above.
- 4.54 Lloyds Banking Group (Insurance Division) argued that this Bill could have negative consequences for investment linked insurance products.

We could suggest that this may create the scenario where a policy is taken out with an investment element, the market plummets and the insured seeks recovery of the premium citing a lack of insurable interest. This could lead to a detrimental result for the insurer where the return of premiums would be higher than the policy value, so it's in the policyholder's interests (especially in bond cases) to argue lack of insurable interest.

- 4.55 As indicated above, we do not consider it is necessary or appropriate to make special rules for investment products, though the draft Bill is in any case more permissive than the current law. Clarifying the rules for insurable interest in an updated statute would give both policyholders and insurers more certainty that the insurance contracts they are entering into are valid and enforceable against the other party.

CONSEQUENCES OF THE CONTRACT BEING VOID

Question 8: Should an exception to the retention of premiums be limited to consumer contracts only, or extended to all cases where it appears that it would be unfair to the insured for the insurer to retain them?

- 4.56 Fifteen consultees responded to this question. Seven supported extending the exception to all cases in which it would be unfair for the insurer to retain the premiums. Five argued that the position in the draft Bill should be preserved, so that the fairness of the retention of premiums should only be considered in the context of consumer insurance.
- 4.57 The seven consultees who supported extending the unfairness protection to all categories of insureds did so for a variety of reasons. Lloyds Banking Group (Insurance Division) and ABI drew on the FCA's *Principles for Businesses*, principle 6 of which states that “[a] firm must pay due regard to the interests of its customers and

treat them fairly”. The consultees noted that this principle does not distinguish between consumers and commercial customers.³⁷

- 4.58 BILA, the Bar Council and BLM argued that the retention of premiums can be as damaging for people buying commercial insurance as for consumers. BLM noted that, to the extent that the protection in the current clause 3 is aimed at preserving investment bonds with only a nominal insurance component, it does not matter particularly whether the policyholder is a business or a consumer.
- 4.59 In contrast, BIBA stated that “if there has been deliberate reckless or fraudulent misrepresentation then the insurer should be entitled to retain the premiums ... on both consumer and commercial contracts.”
- 4.60 Of the consultees who argued that the exception should apply solely to consumer insurance contracts, three highlighted the importance of aligning the draft Bill with existing provisions of the Insurance Act 2015 (2015 Act) and the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA).
- 4.61 We agree that the exception should apply solely to consumer insurance contracts. It is important that the provisions of the draft Bill, the 2015 Act and CIDRA are consistent. The FCA’s treating customers fairly provisions will still apply.

Administrative costs

- 4.62 Another issue which emerged was whether, where premiums are returned, insurers should be entitled to withhold the administrative costs of transferring these funds. ABI summarised this view as follows:

Firstly, the draft Bill does not allow insurers to offset any administrative or other costs (e.g. cost of capital or the costs of insurance provided) incurred by the insurer when setting up the policy and subsequently. The ABI is of the view that insurers should be entitled to deduct these costs when returning premiums, particularly when a claim of avoidance on grounds of lack of insurable interest is made at the instance of the insured (who chose to purchase the insurance in the first place).

- 4.63 CLLS highlighted the extent to which an insurer is likely to incur costs when underwriting a policy, even where it is never technically put on risk.

The Committee’s view is that the premium should not be returned, as the insurer is likely to have altered its position to its detriment in underwriting a risk, such as by holding capital and reserves against the risk and, potentially, having incurred or paid additional outwards reinsurance premium. In doing so, the capacity of the insurer to write other business is likely to have been reduced.

- 4.64 The LMA also noted that the insurer may have entered into reinsurance arrangements in respect of the primary contract, and said that such costs should also be recoverable.

³⁷ FCA Handbook, *Principles for Businesses*, PRIN 2.1.1 R, available at: <https://www.handbook.fca.org.uk/handbook/PRIN/2/1.html>.

- 4.65 On the other hand, both the Bar Council and BILA noted that an insurer benefits from premiums even when it ultimately returns them. This is because insurers earn interest on premiums and enjoy greater liquidity for the period during which they are retained.
- 4.66 We do not consider that, where premiums are returned, insurers should be entitled to withhold the administrative costs of transferring these funds. This position is consistent with other insurance legislation. Under CIDRA³⁸ and the Insurance Act 2015,³⁹ the insurer may avoid a contract in certain circumstances relating to non-disclosure and misrepresentation. In these cases, the insurer may avoid the contract but must return all premiums without deduction. There is no carve-out for administrative or other costs. The consequences of a contract being void, or voidable, are set out by law.

Return of premiums under a void contract where no deliberate or reckless misrepresentation

- 4.67 Professor Andrew McGee argued that the draft Bill should include a uniform rule stipulating that “the premium is recoverable except in the case [of] deliberate false statement about interest.”
- 4.68 Our view is that the return of premiums is mandated by operation of law, and we think that is the correct result when a contract is void. We do not think that this needs to be stated expressly in the draft Bill.
- 4.69 Under the current law of insurable interest, premiums are not returnable because the contract is not only void but, in England and Wales, also illegal if there is no insurable interest.⁴⁰ Under the draft Bill, lack of insurable interest renders an insurance contract void but not illegal.
- 4.70 Generally the position at law is that money paid under a void contract can be recovered. Where a contract is void, the right to recover money paid under it is not based on any contractual obligation since there can be no duty to perform under a void contract.
- 4.71 In insurance contracts, the basis for the insured’s payment of the premium is that the insurer is on risk and has to pay out in the case of an insured event. If the insurer has never been on risk the contract is void as the basis for payment of the premium has failed.⁴¹

³⁸ Consumer Insurance (Disclosure and Representations) Act 2012, sch 1, para 5.

³⁹ Insurance Act 2015, sch 1, para 4.

⁴⁰ *Harse v Pearl Life Assurance Co Ltd* [1904] 1 KB 558. In Scots law, the law of unjustified enrichment allows premiums paid under an illegal insurance policy to be returned unless the insurer can show that it is inequitable to do so: H MacQueen & J Thomson, *Contract Law in Scotland* (4th ed 2016), para 7.20.

⁴¹ This was held to be the case in *Re London County Commercial Reinsurance Office Ltd* [1922] 2 Ch 67, where insurance premiums were recoverable in relation to reinsurance contracts which were void because they had been entered into subject to a policy proof of interest (PPI) condition.

GENERAL

Question 9: Do consultees foresee any significant difficulties in providing that contracts entered into under the old law are not void for lack of insurable interest if the insured would have an insurable interest under the provisions of the draft Bill?

- 4.72 The majority of consultees agreed with the proposed approach. Ten consultees did not foresee any difficulties in validating existing insurance contracts which meet the new insurable interest requirements. Three consultees questioned the efficacy of this rule.
- 4.73 Lloyds Banking Group (Insurance Division) emphasised that it is difficult to ascertain, at the time of the formation of the contract, whether there is an insurable interest based on reasonable prospects of economic loss. Lloyds Banking Group (Insurance Division) did not therefore oppose the application of the new rules to extant policies; rather, it argued that the rules themselves are unclear. We have discussed insurable interests based on economic loss in our response to question 4, and think that this provision is framed appropriately.
- 4.74 Direct Line Group asked for clarification as to whether what is now clause 7(4) applies to “all contracts being tested after the commencement of the Act, or only those contracts which were entered into and were still in force at the commencement of the Act?” Our view is that it applies to all contracts.
- 4.75 The Faculty of Advocates noted that this introduces an element of retrospectivity into the draft Bill. It argued that, in the interests of fairness, the new rules should only apply to contracts concluded after the draft Bill’s commencement.
- 4.76 We appreciate that this provision involves a degree of retrospectivity. However, as noted in our April 2016 consultation, the current state of the law regarding insurable interests is arbitrary and unclear.⁴² The new rules are wider than the previous position, at least in respect of life-related insurance contracts. We therefore think it desirable to subject existing contracts to the new rules. This way, where a bargain has been struck on the assumption that an insurable interest exists, it is more likely that such an agreement will have legal effect. This would better give effect to the intentions of the parties. Accordingly, we have retained this clause.

Question 10: Do consultees agree that the question of severability is best left to the construction of the contract?

- 4.77 There was strong support for leaving the issue of severability to construction of the contract. Of the 14 consultees who answered this question, 11 endorsed our position. Two consultees disagreed and one sought further clarity.
- 4.78 While LMA agreed with our approach, it suggested that the draft Bill should provide expressly for severability, at least in the case of policies which contain both life and non-life insurance elements.

⁴² The Law Commission and Scottish Law Commission Reforming insurance contract law – Short consultation on draft bill: insurable interest (April 2016), para 5.15.

4.79 Of the consultees who disagreed with this question, BIBA argued that insurers, rather than courts, should determine severability. It stated that “insurers should be able to construct the contract as they see fit.” We think there is a danger that, if the question of severability is left to insurers (or indeed to policyholders), they will choose the construction which best advances their financial interests, regardless of the initial bargain.

4.80 The Faculty of Advocates argued that there should in effect be a presumption of severability:

It would be more desirable to make it clear that a lack of insurable interest under one head of a combined policy would not lead to the remainder of the policy being void or unenforceable unless that was explicitly agreed.

4.81 As noted in our consultation, we are generally in favour of severability. However, we are reluctant to impose a blanket rule on the courts, which are in a position to judge the appropriateness of severability on a case by case basis. We are also conscious that, were we to mandate severability, we would be reducing the capacity of insurers and policyholders to arrive at a tailored and mutually agreeable bargain. On the basis that this approach was supported by the majority of consultees, we do not make specific provision as to severability in the draft Bill.