FUJI FINANCE INCORPORATED V AETNA LIFE INSURANCE COMPANY LIMITED

by M.A. Ross

The Issues

This recent Court of Appeal decision (July 4th, 1996) considered two issues of importance to the insurance industry.

First, whether or not an essential feature of life assurance is that the benefit payable on death should be more than, or different from, that payable on surrender.

Second, whether section 16 of the Insurance Companies Act 1982, which prohibits an authorised insurer from carrying on "activities" other than in connection with or for the purposes of its authorised business, renders any contract carried out in breach thereof illegal and therefore unenforceable.

The Facts

In October 1986 a policy, described as a life assurance policy or capital investment bond, was issued by Tyndall Insurance Ltd (the predecessor of Aetna) to Fuji. The life assured was an employee of Fuji named Gary Tait. A single premium of £50,000 was paid by Fuji.

The policy was a unit-linked policy i.e. benefits were determined by the value of units in the funds maintained by the insurance company for investment purposes. Policy benefits were the same on surrender as on death, except in the event of surrender during the first four years when the insurer levied what was effectively an "early encashment" charge.

The terms of the policy conditions allowed the policyholder the freedom to "switch" between funds by giving appropriate notice to the insurer. The insurer's procedures in 1986 were such that switch instructions were required to be given by 2.30 p.m. on the relevant "valuation date". The insurer fixed its unit prices between 9 a.m. and 10 a.m. on the valuation date, on the basis of data taken from the Stock Exchange Data Stream as at 4.00 p.m. on the day prior to the valuation date. Although the prices were not published in the national press until the day after the valuation date, a well-informed investor, armed with the relevant information from the previous day's Stock Exchange Data Stream, together with knowledge of market movements on the morning of the valuation date, could himself estimate on the morning of any given valuation date the approximate prices at which the insurer would fix its prices. A policyholder could therefore give switch instructions before 2.30 p.m. in the certain knowledge that he would make a profit or avoid a loss. By taking full advantage of this "loophole" in the policy terms, Mr. Tait (an experienced investor) increased the benefits payable under the Fuji policy from just under £55,000 to over £1,000,000 within 5 years - an average return of 90% per annum!.

Aetna changed its switch procedures in 1991. From then on, it fixed its unit prices at 4 p.m. on each valuation date. This meant that a policyholder's instructions to switch had to be received at least an hour and a half prior to prices being fixed. The effect was that it was no longer possible to "second guess" the insurance company's prices, thus reducing the potential return from switching. Indeed the average annual return achieved by Fuji then fell to 8%.

In 1992, Fuji surrendered the policy and received a surrender payment in excess of £1.1 million. Fuji also issued a writ against Aetna claiming that the change of switch procedure constituted a repudiation of the policy or breach of a collateral contract under which Aetna had to continue administering switch procedures in the same way. Fuji sought damages for breach of contract with the suggested measure being a sum equal to an average return of 90% per annum on the policy monies, compounded annually for the lifetime of Mr. Tait. Aetna, defending the action, calculated that such a sum would be equivalent to the gross national product of the UK for 460,000 years!

The First Issue

The first issue was whether or not the policy constituted "life assurance" within the meaning of the Life Assurance Act 1774. The importance of this issue related to the amount of damages recoverable. If the policy ***was*** a life assurance policy, then (as Fuji admitted) by virtue of section 3 of the 1774 Act, it was not entitled to any further monies in excess of the £1.1 million already received.

Accordingly Fuji argued that the policy was not a life assurance policy and it could recover more than its insurable interest in Mr. Tait's life.

This argument concerned the construction of sections 1 and 3 of the Life Assurance Act 1774, which provide as follows:

Section 1 "............ no insurance shall be made by any person or persons ...... on the life or lives of any person, or on any other event or events whatsoever, wherein the person or persons for whose use, benefit or on whose account such policy or policies shall be made, shall have no interest, or by way of gaming or wagering; and that every assurance made contrary to the true intent and meaning hereof shall be null and void to all intents and purposes whatsoever."

Section 3 "And .... in all cases where the insured has interest in such life or lives, event or events, no greater sum shall be recovered or received from the insurer or insurers than the amount of value of the interest of the insured in such life or lives, or other event or events."

Aetna argued that Fuji's policy ***was*** a life assurance contract within section 1 of the 1774 Act and accordingly, Fuji had no insurable interest in Mr. Tait's life sufficient to support a payment greater than the £1.1 million already received. Aetna was supported by the DTI, who pointed out that in enacting the 1982 Act and the Financial Services Act 1986, Parliament had regarded the activities of insurance and investment as complementary and not as mutually exclusive.

In the High Court, the Vice-Chancellor, Sir Donald Nicholls, had held in favour of Fuji in determining that the policy was not life assurance, his reasoning being that the amount payable on death was no different to that payable on surrender. He found that since the payment of benefits was unaffected by any consideration of the life expectancy of Mr. Tait, it was not insurance on his life. Accordingly the policy was not subject to the section 3 restriction. Sir Donald added that it could not be that the presence of a minor and insignificant element of insurance sufficed to turn a contract otherwise of a different nature into a contract of insurance.

On this first point, the Court of Appeal was unanimous in overruling the High Court decision and held that the policy was a life assurance contract under the 1774 Act and that therefore Fuji was subject to the section 3 limitation of damages.

Morritt LJ stated that the essence of life assurance is that the right to the benefits is related to life or death. If the event on which a benefit is payable is sufficiently life or death related, then there was no reason in principle why it should matter if that benefit is the same as that payable on another life or death related event. Hobhouse LJ commented that the judgement of the Vice-Chancellor had confused the valuation of the right with its accrual. Since the right remained contingent upon the life or death of Mr. Tait, this was the uncertain event which rendered the policy one of life assurance.

The Second Issue

Following the unanimous decision in the Court of Appeal that the contract was a contract of life assurance, the second issue (i.e. whether section 16 of the 1982 Act rendered the contract unenforceable against the insurance company), did not need technically to be considered since the issuance of the Fuji policy was an authorised activity. However, since this issue had been argued before the High Court, the Court of Appeal gave some consideration to the matter. It should however be noted that the opinions expressed by the Lord Justices are strictly obiter dicta - i.e. whilst they may be persuasive they should not be regarded as being binding.

Aetna had argued that if the policy was not a life assurance contract, it was an investment contract. Hence it was an "activity" in breach of section 16, and illegal and unenforceable.

Fuji argued that even if the policy was for investment, rather than insurance, purposes and hence an "unauthorised activity" a breach of section 16 did ***not*** render an insurance contract void. Fuji was supported in this contention by the DTI.

(By way of background, these arguments were predicated by legal developments in respect of section 2 of the 1982 Act. The courts had determined that any insurance contract effected by an insurer in breach of section 2 of the 1982 Act (i.e. carrying out insurance business in the UK whilst unauthorised) was illegal and void. The uncertainty which this decision introduced into the insurance industry, unsatisfactory to insurers and insureds alike, was remedied by Parliament - section 132 of the Financial Services Act 1986 was amended to give the insured the right to elect to enforce contracts made in breach of section 2 of the 1982 Act).

In the High Court, the Vice-Chancellor had concluded that, although the contract was not one of insurance and hence constituted an unauthorised activity, section 16 was not intended to render a contract made by an insurance company in breach of the section 16 restriction unlawful and unenforceable.

In the Court of Appeal, Morritt LJ agreed with the Vice-Chancellor. He was of the view that the purpose of section 16 was purely to limit the scope of an undertaking's commercial activities and that it was not a necessary implication from that purpose that every contract entered into within the "forbidden sphere" should be invalidated. Morritt LJ found it difficult to believe that Parliament intended that anything within so vague a word as "activities" was to be illegal and void. In his view, this was reinforced by the fact that there are no criminal sanctions for breach of section 16.

Sir Ralph Gibson disagreed entirely with this interpretation and was of the view that a contract made in breach of section 16 was void and unenforceable. He argued that the prohibition in section 16 was wide and the question was whether Parliament had intended to prevent contracts falling within it from being enforced. In his view, a breach of section 16 was intended to have the same effect as a breach of section 2 of the 1982 Act - i.e. contracts in breach were illegal and void. Sir Ralph Gibson stated that the 1982 Act required further amendment by Parliament. In his opinion, Parliament should widen the discretion enacted by section 132 of the Financial Services Act 1986 to allow an insured to enforce a contract made in breach of section 16.

Hobhouse LJ expressed no view on the second issue but agreed that the uncertainty in the 1982 Act should be remedied by legislation.

Comment

The case does (for the time being, at least) confirm that a policy may have an overriding investment element - i.e. offer little or no life cover element - and still qualify as a life assurance contract. This, with respect, must surely be the most sensible analysis, not only from a legal point of view but also from a practical point of view. Huge amounts of money are invested with insurance companies in single premium insurance bond products. The consequences of all such contracts being classified as non-insurance products would be far-reaching.

First, all insurance companies who had issued such policies would be in breach of section 16 of the 1982 Act and, as is illustrated from the differences of opinion demonstrated in the Court of Appeal in ***Fuji***, there would be great uncertainty as to whether such contracts were enforceable or not. Although the vast majority of insurers would surely not seek to avoid, on a legal technicality, large numbers of contracts which they had themselves developed, presented and sold as insurance contracts, the possibility of a small number of insurers seeking to avoid such contracts (e.g. in the event of such insurer's insolvency or in the case of an unscrupulous insurer) could not be ruled out. However, what of the public policy implications of honouring large numbers of (technically) illegal contracts?

Second, the DTI would be placed in the uncomfortable position of having to decide whether it should exercise its statutory powers of intervention against such insurers who were (unwittingly) in breach of the 1982 Act. (A position made no less uncomfortable by the fact that this would include practically every life assurance company in the UK!)

Third, what would the tax status of such products be - if not life assurance contracts, how should they be taxed and should any such treatment be retrospective?

The Court of Appeal's reversal of the High Court's decision on the first issue thus removes considerable potential concern for insurance companies, insureds, the DTI and the Inland Revenue alike.

It is however disappointing (although in the event unsurprising) that the Court of Appeal did not reach a conclusion on the second issue and give clearer guidance on the consequences of a breach of section 16 of the 1982 Act. However, just as amendment to the legislation was required in respect of section 2 of the 1982 Act, it is surely the case that this area of legal uncertainty should similarly be rectified by statute.

In the meantime, Fuji has petitioned the House of Lords for leave to appeal against the Court of Appeal judgement. The petition is due to be heard in December. If leave to appeal is granted, we cannot realistically expect the House of Lords to issue judgement prior to summer 1997.

Watch this space !!

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