A Brief Definition of Insurance

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Introduction

Once again, the IRS has placed "certain" captive insurance structures on their Dirty Dozen list. This latest inclusion argues that certain structures "… lack many of the attributes of genuine insurance. It therefore seems appropriate to briefly explain the common law definition of insurance. What follows is a brief summation of the primary components of insurance as developed over approximately 150 years of common law. For a more detailed treatment, please contact F. Hale Stewart at 832.330.4101 or Halestewart@halestewartlaw.com.

I.) The Legal Definition of Insurance

> Essentially, insurance is a contract by which one party (the insurer), for a consideration that usually is paid in money, either in a lump sum or at different times during the continuance of the risk, promises to make a certain payment, usually of money, upon the destruction or injury of "something" in which the other party (the insured) has an interest.[1]

[1] 1 Couch on Insurance Section 1:6

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In addition to all contractual elements that must be present, a valid insurance contract must also contain an insurable interest,[2] a definable risk,[3] risk shifting and risk distribution.[4] While the basic elements of a contract are beyond the scope of this article, the four additional elements required for a valid insurance contract will be explained in the order previously presented.

a.) Insurable Interest

The historical roots of this policy date back to England when maritime insurance was sold to an insured whether or not he had a personal or financial interest in the ship or cargo. This sales practice "caused many pernicious practices, whereby great numbers of ships with their cargoes, [were] either … fraudulently lost or destroyed."[5] The second root of the insurable interest doctrine is judicial policy to prevent using insurance for gambling or wagering.[6] During the 1800s, people purchased life insurance on famous elderly persons as a way to speculate on the time of their death.[7] This practice displaces the primary purpose of insurance -- to protect the purchaser against unforeseen losses that directly impact his personal or financial interests.[8] The third root of the insurable interest doctrine is the prevention of waste[9] by preventing non-essential insurance policies (such as those previously mentioned) from being written.

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[2] 1A Couch on Insurance Section 17:1

[3] *Id*

[4] *Helvering v. LeGierse*, 312 U.S. 531, 540 (1941)

[5] Robert H. Jerry II, *New Appleman on Insurance Law Library Edition*, © 2009 Matthew Bender and Co. Section 1.05

[6] 44 Am. Jur. 2d Insurance Section 934

[7] *Appleman,* Section 1.05

[8] *Id*

[9] *Id*

A person has an insurable interest in property "when he or she will derive a pecuniary benefit or advantage from its preservation or will suffer a pecuniary loss or damage from its destruction, termination or injury by the happening of the event insured against."[10] The interest can exist in law or equity[11] and can be found in a legal interest that is slight,[12] contingent or beneficial.[13] In fact, outright ownership or title of ownership is not relevant to the inquiry.[14] Obviously, courts construe the interest very liberally.[15] The amount of insurance purchased cannot be disproportionate to the insurable interest or the court will rule the insurance policy is a wagering contract and therefore void against public policy.[16]

b.) Risk of Loss

The primary purpose of an insurance contract is to transfer risk, which is an unforeseen and uncertain event that is a "disadvantage to the party insured."[17] The insured can't prevent the risk from occurring;[18] it must be accidental[19] or "fortuitous," also defined as

> '…an event which so far as the parties to the contract are aware, is dependent on chance. It must be beyond the power of any human being to bring the event to pass; it may be within the control of third persons; it may even be a past event, such as the loss of a vessel, provided that the fact is unknown to the parties.'[20]

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[10] 44 C.J.S. Insurance Section 318
[11] *Id*
[12] *Id*
[13] 44 Am. Jur. 2d Insurance Section 932
[14] *Id*
[15] 44 C.J.S. Insurance Section 319
[16] 3 Couch on Ins. Section 41:2
[17] 1A Couch on Insurance Section 17.7
[18] *Id*
[19] *Appleman*, Section 1.05[2][a]
[20] *Appleman*, section 1.05[2][b]

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Fortuitous should not be confused with natural degradation or depreciation – which is foreseeable but whose timing is predictable. In contrast, a fortuitous event is unforeseen and its timing is unknown, thereby impacting the insured when he is less prepared to mitigate the damages.[21] The unknown or unforeseen element of the fortuity definition is best explained by the three primary fortuity-related defenses insurers offer to challenge an insured's claim, the first of which is the "known loss" defense, where an insurer will argue the loss had "already occurred or [the insured should have known] the loss already occurred at the time the policy was written."[22] The second fortuity related loss defense is the "known risk" defense, where the insured knew the probability of loss was so high as to warrant some type of advance preparation or attempt to avoid the event on the part of the insured.[23] "Loss in progress" is the third defense, which the insurer will argue when the loss was preceding at the time the insured purchased the insurance contract.[24] The one common element to all of these defenses is actual or legally impugned knowledge on the part of the insured of the risk actually occurring or having a statistically significant possibility of occurring when he purchases the policy.

c.) Risk Shifting and Risk Distribution

The concept of risk shifting and risk distribution was originally advanced in the case *Helvering v. LeGierse*[25] where an 80-year old woman purchased an annuity and life insurance contract from the Connecticut General Life Insurance Company.[26] The woman paid $4,179.00 for the annuity –

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[21] *Id*
[22] *Id*
[23] *Id*
[24] *Id*
[25] *Helvering v. LeGierse*, 312 U.S. 531 (1941)
[26] *Id* at 532

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which paid $589.80 per year for woman's life -- and $22,946 for a $25,000 life insurance policy making her total consideration $27,125.[27] The woman did not have to take a physical for the life insurance policy nor answer any typical questions associated with similar transactions.[28] The difference between the total consideration paid and the life insurance face value was $2,125.00, which means the insurance company received 3.6 years of annuity payments as consideration for the annuity contract. Given the woman's advanced age, the fact no physical was required, and the high premium amount, it seems likely the parties were well aware the woman would soon die, which she did a month after purchasing the contracts.[29] The daughter did not include the life insurance receipts in her gross income, while the Commissioner argued the receipts were income.[30]

The court noted that insurance involves "risk shifting and risk distribution;" that insurance shifts the risk of loss from those who would be harmed and distributes the loss of premature death among other, similar risks to limit the losses impact."[31] Next, the court stated the transactions should be analyzed together, as the insurance company would not sell one without the other.[32] Finally, the court noted the transaction was not insurance, because

> The total consideration was prepaid and exceeded the face value of the insurance policy. The excess financed loading and other incidental charges. Any risk that prepayment would earn less than the amount paid to respondent as an annuity was an investment risk similar to the risk assumed by a bank; it was not an insurance risk.[33]

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[27] *Id*
[28] *Id*
[29] *Id*
[30] *Id*
[31] *Id* at 541
[32] *Id*
[33] *Id* at 542

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The *Helvering* decision does not offer more in the way of definition or guidance as to the specifics of risk shifting or risk distribution. Thankfully, these terms have a rich history. Perhaps the best definition of risk shifting is found in a Private Letter Ruling:

> Risk shifting occurs when a person facing the possibility of economic loss transfers some or all of the financial consequences of the potential loss to the insurer….If the insured has shifted its risk to the insurer, then a loss by the insured does not affect the insured because the loss is offset by the insurance payment.[34]

In other words, when an unforeseen risk occurs to the insured, he is made whole by the payment from the insurer. Risk shifting is seen from the insured's perspective, whereas risk distribution is seen from the insurer's perspective.

Risk distribution utilizes the law of large numbers, which is best explained with an example. Suppose an insurance company only insures single, male drivers aged 30-40. Assume further that 5% of the entire population of these drivers has an accident every year. The larger the population of male drivers aged 30-40 that the insurer can insure, the closer the insurers loss experience will come to that of the entire population of these drivers. Or put another way, "[t]he basic idea of the law of large numbers is that we can be more certain about the future experience of large groups in the aggregate than we can be about the future experience of any particular individuals in that group."[35]

> Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. [citation omitted] Risk distribution necessarily

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[34] PLR 200518010, January 21, 2005

[35] Tom Baker , Insurance Law and Policy, © 2008 Aspen Publishers, page 3

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entails a pooling of premiums, so a potential insured is not in significant part paying for its own risks. [citation omitted].[36]

[36] PLR 200518010, January 21, 2005

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