

The Forfeiture Rule and Deterrence

Katie Richards*

I. Introduction

The insurance forfeiture rule, whereby the fraudulent assured loses the entirety of his claim, has the potential to operate in a harsh fashion. Indeed, the courts have recognised (and welcomed) the severity of forfeiture for decades¹ on the basis that harsh sanctions deter fraud. The problem, however is that this notion of deterrence is assumed; there has never been any empirical evidence to demonstrate the deterrent effect of the rule² and, moreover, the operation of the rule is out of step with modern thinking about decision making and crime prevention. This paper seeks to demonstrate, on the basis of modern deterrence theory, that the forfeiture rule is at best a weak deterrent and further, identifies methods by which insurance fraud could be discouraged during the claims process.

The forfeiture rule is the sole civil sanction for insurance fraud. This means that the rule operates irrespective of the size, scale or moral culpability of the particular fraud.³ This is concerning because insurance frauds can vary infinitely, from the use of a fraudulent statement to bolster a valid claim⁴ to the deliberate destruction of insured property.⁵ The current remedial framework is unable to

*Lecturer and PhD Candidate at Cardiff University School of Law and Politics. This represents work undertaken as part of my PhD and I would like to express my gratitude to my supervisors, Professor James Davey and David Glass, as well as the extremely valuable comments made during this Symposium. I have endeavoured to reflect on those comments in this paper where possible in addition to the recent Supreme Court decision in *Versloot Dredging BV v HDI Gerling Industrie Versicherung (The DC Merwestone)* [2016] UKSC 45. As always, any errors remain my own.

¹ *Versloot Dredging BV v HDI-Gerling Industrie Versicherung AG (The DC Merwestone)* [2014] EWCA Civ 1349; [2015] 1 Lloyd's Rep 32, [75] per Christopher Clarke LJ; *Axa General Insurance Ltd v Gottlieb* [2005] EWCA Civ 112; [2005] Lloyd's Rep. IR 369, [31] per Mance LJ; *Britton v Royal Insurance Co* (186) 4 F&F 905, 909 per Willes J.

² This point is also made by P Rawlings and J Lowry, 'Insurance fraud: The "convoluted and confused" state of the law' [2016] LQR 96, 115: "there is no empirical data to show that the fraudulent claim rule does deter, and a growing literature throws serious doubts on the effectiveness of non-criminal (and even criminal) sanctions in deterring behaviour."

³ For a more detailed explanation of the ways in which these claims differ, see K Richards, 'Deterring insurance fraud: A critical and criminological analysis of the English and Scottish Law Commissions' current proposals for reform' (2013) 24 ILJ 16.

⁴ *Aapitos v Aqnew (The Aegeon)* [2002] EWCA Civ. 247; [2002] Lloyd's Rep IR 573, *The Aegeon* (n1) [30] per Mance LJ, "A fraudulent device is used if the insured believes that he has suffered the loss claimed, but seeks to improve or embellish the facts surrounding the claim, by some lie."

⁵ *P Samuel & Co v Dumas* (1924) 18 Ll L Rep 211; *National Justice Compania v Prudential Assurance Co (The Ikarian Reefer)* [1995] 1 Lloyd's Rep. 455; *The Gold Sky* (n46) [1972] 2 Lloyd's Rep. 187.

distinguish between frauds, as the criminal law would do,⁶ since there is only one tool at the courts' disposal. The argument is that a range of nuanced sanctions is required to reflect the range of fraudulent claims. This paper begins this process by making a number of recommendations for the deterrence of opportunistic claims. These claims require little advance planning and have traditionally comprised the exaggerated claim and the use of false evidence to promote an otherwise valid claim. These claims are to be distinguished from the wholly fraudulent claims, such as the scuttle, which require much greater planning and target significant financial gain.

An exaggerated claim exists when the assured adds additional items to his insurance claim. The case typically cited in the literature concerns exaggeration following a domestic burglary – *Galloway v Guardian*⁷ – but it is equally possible that exaggeration could take place in the marine setting.⁸ Forfeiture has particular bite when it operates in cases of exaggeration. In *Galloway*, for example, the assured lost the genuine portion of his claim – a loss of some £16,000 – due to his fraudulent addition of a computer worth £2000. The courts have repeatedly endorsed the severity of forfeiture for reasons of deterrence. In *Galloway* itself, Millett LJ commented,

The making of dishonest insurance claims has become all too common. There seems to be a widespread belief that insurance companies are fair game, and that defrauding them is not morally reprehensible. The rule which we are asked to enforce today may appear to some to be harsh, but it is in my opinion a necessary and salutary rule which deserves to be better known by the public.⁹

More recently, the House of Lords confirmed the logic of the forfeiture rule,

Just as the law will not allow an insured to commit a crime and then use it as a basis for recovering an indemnity, so it will not allow an insured who has made a fraudulent claim to recover. The logic is simple. The fraudulent insured must not be allowed to think: if the fraud is successful, then I will gain; if it is unsuccessful, I will lose nothing.¹⁰

⁶ Fraud Act 2006; Sentencing Council, Fraud, Bribery and Money Laundering Offences: Definitive Guideline (October 2014) available at: https://www.sentencingcouncil.org.uk/wp-content/uploads/Fraud_bribery_and_money_laundering_offences_-_Definitive_guideline.pdf (accessed 22/08/2016).

⁷ *Galloway v Guardian Royal Exchange (UK) Ltd* [1999] Lloyd's Rep. IR 209.

⁸ *Glencore Ltd v Alpina Insurance* [2003] EWHC 2792 (Comm).

⁹ *Galloway* (n7) 214.

¹⁰ *Manifest Shipping Co Ltd v Uni-Polaris Co Ltd (The Star Sea)* [2003] 1 AC 469, [62] per Lord Hobhouse.

Until the recent case of *Versloot*,¹¹ the forfeiture rule was also imposed to sanction assureds who had bolstered their genuine loss with a lie.¹² This lie could take the form of a forged piece of evidence to substantiate a legitimate transaction or exist as a misleading account of events. The Supreme Court held that forfeiture was an inappropriate response to collateral lies – “a lie which turns out when the facts are found to have no relevance to the insured’s right to recover”¹³ – and this significantly narrows the fraudulent claims jurisdiction. It is important to note, however, that this decision does nothing to abrogate the severity of forfeiture for the assured who exaggerates his claim nor sets in motion any means by which the legal sanction could be made any more effective as a deterrent. The concerns raised in this paper regarding the ineffective nature of forfeiture remain valid notwithstanding this recent decision.

II. The Alignment with Rational Choice Theory

The judicial insistence that harsh sanctions deter fraud mirrors the assertions made by rational choice theorists in relation to crime. Rational choice theory is an important part of the toolkit used in an economic analysis of law. It seeks to determine what impact law has on behaviour, and whether that impact is desirable.¹⁴ To do this, an economic analysis makes a number of assumptions about decision makers. These are usefully summarised by Gary Becker,

[A]ll human behavior can be viewed as involving participants who [1] maximize their utility [2] from a stable set of preferences and [3] accumulate an optimal amount of information and other inputs in a variety of markets.¹⁵

This characterises the process of decision-making as follows: the actor identifies a number of possible actions¹⁶ and then chooses the course of action which best maximises his utility or self-interest.¹⁷ The actor conducts a cost-benefit analysis to reach this decision. In the 1950s, the Chicago School adopted

¹¹ *Versloot Dredging BV v HDI Gerling Industrie Versicherung (The DC Merwestone)* [2016] UKSC 45.

¹² *The Aegeon* (n44).

¹³ *Versloot (Supreme Court)* (n14) [1] per Lord Sumption.

¹⁴ L. Kaplow and S. Shavell, ‘Economic analysis of law’ (1999) available at: http://www.law.harvard.edu/programs/olin_center/papers/pdf/251.pdf (accessed 01/08/16), 3.

¹⁵ G. Becker, *An Economic Approach to Human Behavior* (University of Chicago Press, 1976) 14.

¹⁶ R. Coater and T. Ulen, *Law & Economics* (3rd ed, Addison-Wesley, 2000), 11.

¹⁷ R. Posner, *Economic Analysis of Law* (5th ed. Aspen Law, 1998), 4.

this framework to analyse the law of competition and monopolies,¹⁸ but it was later extended to include virtually every area of law.¹⁹

The application of economic analysis to crime is attributed to the seminal work of Gary Becker.²⁰ He contended that the decision to commit crime was no different from any other decision,²¹ and so should be analysed in the same way. This was an assertion of considerable magnitude given the prevailing theories about crime,²² which attributed offending not to the free will of individuals, but to their psychological and social deficiencies. Accordingly, the rational criminal weighs the costs of crime – the certainty and severity of punishment – against the benefits of crime.²³ He refrains from crime when those costs outweigh the benefits.²⁴

The importance of the legal costs in this framework provides opportunities to policymakers, including the courts, to construct legal penalties which seek to deter fraud. As Richard Posner has suggested,

people act as rational maximizers of their satisfactions in making such nonmarket decisions as whether to...commit or refrain from committing crimes...Rules of law operate to impose prices on...these nonmarket activities, thereby altering the amount or character of the activity...The first two premises lead to such predictions as that...increasing the severity as well as certainty of criminal punishment will reduce the crime rate.²⁵

On this basis, an effective deterrent simply requires policymakers to increase the costs of crime, either by making detection more likely or the ensuing punishment more severe.²⁶ This is no doubt superficially attractive. An unanswered question remained, however: which 'cost' should

¹⁸ Kaplow and Shavell (n14) 3; E Posner 'Values and consequences: An introduction to economic analysis of law' in E Posner, *Chicago Lectures in Law and Economics* (Foundation Press, 2000), 189.

¹⁹ Posner, 'Values and consequences' (n18) 189-190; Papers which are attributed with expanding the law & economics analysis included R Coase, 'The problem of social cost' (1960) 3 J of L and Econ 1 and G Calabresi, 'Some thoughts on risk distribution and the law of torts' (1961) 70 Yale LJ 499.

²⁰ G Becker, 'Crime and punishment: An economic approach' (1968) 76 J of Pol Econ 169, 170 (arguing that the framework was applicable to the entire range of criminal offences, including white collar crimes and more trivial offences such as parking violations.)

²¹ Becker, 'Crime and punishment' (n20) 170, 201; N Mazar and D Ariely, 'Dishonesty in everyday life and its policy implications' (2006) 25(1) J of Pub Pol & Mark. 117, 118.

²² A comprehensive account of the positive school of criminology is beyond the scope of this work. The following provide a representative sample of the causes of crime. R Merton, 'Social structure and anomie' (1938) 3(5) Am. Soc. Rev. 672, 672, 678; A Quetelet, 'Of the development of the propensity to crime' originally published in A Quetelet, *A Treatise on Man* (Chambers, 1842) and reprinted in E McLaughlin, J Muncie and G Hughes (eds), *Criminological Perspectives* (2nd ed. SAGE Publications, 2003), 41; E Ferri, 'Causes of criminal behaviour' originally published in E Ferri, *The Positive School of Criminology; Three Lectures by Enrico Ferri* (Charles H Kerr & Co., 1908) and partially reprinted in E McLaughlin, J Muncie and G Hughes (n22above) 54.

²³ Becker, 'Crime and punishment' (n20) 205.

²⁴ Ibid 242.

²⁵ R Posner, 'The law and economics movement' (1987) 77 (2) American Economic Review 1, 5.

²⁶ G Stigler, 'The optimum enforcement of laws' in G Becker and W Landes (eds.), *Essays in the Economics of Crime and Punishment* (NBER, 1974), 56.

policymakers increase to deter crime? The suggestion made by rational choice theorists was that these legal costs were interchangeable and that the answer in every case should depend on considerations of efficiency.

The suggestion that sanction costs are interchangeable and function cumulatively²⁷ is best illustrated with an example. For example, a fine of \$10,000 with a 0.1 chance of detection has the same expected cost to the offender as a fine of \$1million where the chance of detection is 0.001.²⁸ In both cases the rational offender calculates the expected cost of crime as \$1000.²⁹ Provided that this cumulative cost exceeds the benefits of offending, the precise contribution of each variable – certainty and severity – would seem to matter little. The result of this analysis is that it recognises a very severe but unlikely punishment as having exactly the same deterrent effect as a less severe penalty which is more likely to be imposed.

This means that policymakers would need to determine whether to construct sanctions on the basis of a high certainty/low severity or low certainty/high severity ratio. The answer for rational choice theorists depended on which combination was most efficient.³⁰ The majority of cases, including those offences punished by imprisonment or fines, will tend to favour high severity simply because increasing detection requires significant,³¹ and arguably inefficient, investment in State resources.³² Since the metric by which the appropriate ratio is determined is efficiency, penalties structured in this manner take no account of the particular offence or offender. This means, therefore, that a very severe penalty could be constructed for a relatively minor infraction.

There is a certain symmetry between rational choice theory and the judicial approach to insurance fraud. The judges have consistently argued that harsh penalties deter and that communication of these penalties will serve to reduce fraud. True, the insurance courts do not speak explicitly in economic terms, but this does not preclude the explanatory power of economic theory.³³ While intuitively attractive, these models are far too simplistic. They fail to recognise the complex realities of decision making and the importance of social context for the potential offender. The following section of the discussion will highlight some of the ways in which modern deterrence theory

²⁷ Ibid 56; A Harel, 'Behavioral analysis of criminal law: A survey' in E Zamir and D Teichman, *The Oxford Handbook of Behavioral Economics and The Law* (OUP, Oxford 2014), 575.

²⁸ Posner, *Economic Analysis* (n17) 244.

²⁹ Ibid 244.

³⁰ Becker, 'Crime and punishment' (n20) 183-184; R Posner, 'An economic theory of the criminal law' (1985) 85 *Colum L Rev* 1193, 1206.

³¹ Becker, 'Crime and punishment' (n20) 184; Posner, 'An economic theory' (n30) 1206, 1213; Kaplow and Shavell, *Economic Analysis* (n14) [6.2.2].

³² Posner, 'An economic theory' (n30) 1207.

³³ Ibid 1230 where a similar point is made in relation to the criminal law.

undermines many of the foundational aspects of rational choice theory and with it its policy recommendations.

Before moving on, it is important to justify the use of the rational choice approach to criminal decision making to critique the civil law response to insurance fraud.³⁴ The simple answer is the different purpose for which criminal and civil sanctions are typically employed.³⁵ The civil law typically sanctions individuals who harm others in the course of a socially useful activity.³⁶ The classic example, for our purposes, is the contract breaker who must pay damages to his counterpart. Damages are limited to the party's expectation interest since a more punitive award could inhibit contracting activity.³⁷ By contrast, the criminal law imposes punishments "for doing what is forbidden"³⁸ and is designed to "dissuade the actor from engaging in [the] activity at all."³⁹ Insurance fraud is devoid of any social utility since it results in higher premiums and requires the underwriter to invest (wasted) resources to determine the validity of the claim.⁴⁰ The civil response to fraud – forfeiture – is designed to outlaw the submission of fraudulent claims and is not constrained by the considerations that typically affect the construction of civil remedies. This resembles the type of conduct proscribed by the criminal law and, therefore, by analogy, the economic analysis of the criminal framework provides a much better theoretical underpinning of the forfeiture rule than would a similar analysis rooted in the civil law.

III. The Lessons of Modern Deterrence Theory

Modern deterrence theory is the result of research undertaken to test the assertions of rational choice theory⁴¹ and developments in decision theory from the behavioural and cognitive sciences. This research provides a much richer and more nuanced characterisation of man and the decision-making process which he employs. This research significantly undercuts the logic of rational choice theory and

³⁴ I am grateful to Dr Johanna Hjalmarsson for encouraging me to think about the suitability of this framework in greater depth and to Professor Rick Swedloff for assisting me in reaching the final conclusion on this point.

³⁵ A more comprehensive answer is provided in my PhD thesis, *'Fraud unravels all?' A critical examination of the fraud rules in marine insurance and documentary credits.* (Work in progress).

³⁶ J Coffee, 'Paradigms lost. The blurring of the criminal and civil law models' (1991-1992) 101 Yale LJ 1875, 1876; R Cooter, 'Prices and sanctions' (1984) 84 Colum L Rev 1523, 1525.

³⁷ *Robinson v Harman* 154 ER 363 (1848), 365 per Parke B; Cooter, 'Prices and sanctions' (n36) 1554; M Bedi, 'Contract breaches and the criminal/civil divide: An inter-common law analysis' (2011-2012) 28 Ga St U L Rev 559, 583-584, 588-589. This is the fear of 'over-deterrence', see generally Posner, 'An economic theory' (n30) 1206.

³⁸ Cooter, 'Prices and sanctions' (n36) 1524.

³⁹ Coffee (n36) 1876.

⁴⁰ Cooter and Ulen (n16) 276 make this point in discussing why fraudulent misrepresentation during negotiations will render a contract void.

⁴¹ R Paternoster, 'How much do we really know about criminal deterrence?' (2010) 100(3) J of Crim L & Criminol. 765, 779.

sanctions dependent on the framework. The discussion in this section summarises the major lessons of deterrence theory in order to consider, in part IV, the construction of more effective deterrents.

a) Certainty and severity not interchangeable

The rational choice model of crime provides that an individual will refrain from offending when the costs of crime exceed the benefits. Deterrence then is simply a matter of constructing legal penalties which increase the costs of crime. As discussed in the previous section, the suggestion made by rational choice theory was that the contribution of certainty and severity mattered little, provided their cumulative weight exceeded the benefits of crime.⁴² Research undertaken to substantiate these assertions instead demonstrated the complexity of the cost-benefit analysis. As a starting point, a variety of methods established that certainty of detection was a far greater indicator of deterrence than sanction severity.⁴³ In addition, the particular relationship between certainty and severity was called into question. The contribution of each variable does in fact matter. The modern research demonstrates that both factors must represent a meaningful threat in order that the legal penalty constitutes an effective deterrent. If either cost is perceived to be negligible, the threat of legal sanctions will not inhibit crime.⁴⁴ This suggests that policymakers do not have a choice between a high certainty/low severity and a low certainty/high severity ratio, but instead must ensure that both elements represent a real cost. On the basis that forfeiture is said to derive its deterrent effect from severity, this must enable us to draw the conclusion that it is unlikely to be particularly effective in discouraging fraudulent claims.

b) The significance of social sanctions

The rational actor is presumed to weigh only the objective costs of punishment in deciding whether to commit a crime. This is problematic for a number of reasons. Firstly, the actor will have very limited awareness of the likelihood of detection and punishment and, moreover, will not seek this information

⁴² Stigler (n26) 56; Harel (n27) 575.

⁴³ E Blais and J Bacher, 'Situational deterrence and claim padding: Results from a randomized field experiment' (2007) 3 J Exp Criminol 337, 338; S Klepper and D Nagin, 'The deterrent effect of perceived certainty and severity of punishment revisited' (1989) 27 Criminology 721, 741.

⁴⁴ H Grasmick, and D Green, 'Legal punishment, social disapproval and internalization as inhibitors of illegal behavior' (1980) 71 J of Crim L and Criminol 325, 327.

prior to offending.⁴⁵ In addition, the emphasis on legal penalties ignores the much broader range of factors which contribute to decision making.

These additional variables are generally referred to as social or informal sanctions because they are not imposed by the State as a result of wrongdoing.⁴⁶ Informal sanctions emerge from a number of sources, including from the offender himself in the form of feelings of guilt and embarrassment as a consequence of contravening his own moral standards.⁴⁷ Behaviour which disregards society's accepted standards of conduct will also trigger sanctions from the individual's community. These sanctions will harm the individual's reputation and may result in social exclusion.⁴⁸ If the wrongdoing relates to the individual's business endeavours, the sanctions may take the form of market costs as other market participants become less willing to trade with the individual concerned.⁴⁹ A further category of sanctions should also be mentioned. These are the sanctions which follow the imposition of a formal penalty but are not directly imposed by the State⁵⁰ such as the difficulty of obtaining professional employment⁵¹ and future insurance cover as a result of a civil finding of fraud.

The modern research expands the content of the cost-benefit analysis. The individual weighs not only the possibility of the legal costs of punishment but also the risk of informal sanctions against the benefits of offending. Notably, these informal sanction threats have the capacity to exercise a much stronger deterrent effect than formal legal sanctions⁵² and can do so in a more cost effective manner.⁵³ It is important to note, however, that informal sanctions do not affect every decision maker in an identical fashion, but depend on the extent to which the offender's community is engaged in criminality. If the offender moves in criminal circles, for example, the weight of informal sanctions will be considerably lower than those social sanctions levied by a law-abiding group.⁵⁴ The evidence

⁴⁵ See later, text to fn 68.

⁴⁶ Paternoster (n41) 781.

⁴⁷ N Mazar, O Amir and D Ariely, 'The dishonesty of honest people: A theory of self-concept maintenance' (2008) 45(6) *J of Mark. R* 633, 633 – 634.

⁴⁸ L Bernstein, 'Opting out of the legal system: Extra-legal contractual relations in the diamond industry' (1992) 21 *JLS* 115, 138-140; L Bernstein, 'Private commercial law in the cotton industry: Creating cooperation through rules, norms, and institutions' (2000-2001) 99 *Mich L Rev* 1724, 1748-1750.

⁴⁹ A Ogus, *Costs and Cautionary Tales* (Hart Publishing, 2006), 130.

⁵⁰ The author is grateful to Professor Rick Swedloff for highlighting this distinction in discussions at the Insurance Fraud Symposium (University of Southampton Law School, 13 July 2016).

⁵¹ J Waldfogel, 'The effect of criminal conviction on income and the trust "reposed in the workmen"' (1994) *J Hum Resour* 62, 63, 66, 72.

⁵² S Klepper and D Nagin, 'The deterrent effect of perceived certainty and severity of punishment revisited' (1989) 27 *Criminology* 721, 721; D Kahan 'Social influence, social meaning, and deterrence' (1997) 83(2) *Va L Rev* 349, 354, 357.

⁵³ K Dau-Schmidt, 'An economic analysis of the criminal law as a preference-shaping policy' (1990) 1 *Duke LJ* 1, 30.

⁵⁴ Grasmick and Green (n44) 329; ⁵⁴ P Robinson and J Darley, 'Does criminal law deter? A behavioral science investigation' (2004) 24(2) *Oxford J of Leg Stud* 173, 192. See also, Kahan 'Social influence' (n52) 357.

suggests, however, that the majority of people are honest and this is attributed to the reputational and personal costs associated with lying.⁵⁵ This provides some explanation for the relative strength of informal sanctions and suggests that policies which trigger these 'costs' are likely to be effective.⁵⁶

The relative strength of social sanctions should not be confused with an argument that legal sanctions are wholly ineffective. This is not the case. In many ways, informal sanctions are dependent on formal sanctions.⁵⁷ For example, an offender's community will only be able to impose informal sanctions when they are aware that he has contravened accepted standards of conduct.⁵⁸ The imposition of a formal sanction, be it an arrest or the forfeiture of an insurance claim, signals this transgression to the broader community. In addition, where the legal framework coincides with society's views about a certain offence, formal sanctions serve to confirm the validity of social views and exerts a moralising effect.⁵⁹ The evidence suggests that where the law is regarded as credible, as in circumstances where an alignment between law and social values exists, there is likely to be greater obedience to the particular law.⁶⁰

c) Limited rationality and heuristics

The headline of modern deterrence theory is that decision making is far more complex than asserted by rational choice theory. This complexity means that individuals cannot weigh all possible alternatives⁶¹ or compute the infinitely vast quantities of information needed to make a wholly rational decision.⁶² Instead, individuals adopt mental rules of thumb, known as heuristics, and rely on biases to reach decisions.⁶³ The problem, however, is that these heuristics are apt to mislead and may cause an individual to favour offending in contrast to the predictions of the rational model. The

⁵⁵ J Abeler, D Nosenzo and C Raymond, 'Preferences for truth-telling' (IZA Discussion Paper No. 10188, September 2016) available at: <http://ftp.iza.org/dp10188.pdf> (accessed 15/09/2016), 38-39.

⁵⁶ Ibid 38-39.

⁵⁷ Klepper and Nagin (n52) 741; Ogus (n49) 130.

⁵⁸ ~~H Collins (n65) (missing)~~ H Collins, *Regulating Contracts* (OUP, 1999), 124. Of course, there are some circumstances in which social sanctions will be levied irrespective of formal sanctions. This will be the case where the individual feels guilty because he has crossed a moral line of where misconduct is visible to other market participants.

⁵⁹ R Paternoster and S Simpson, 'Sanction threats and appeals to morality: Testing a rational choice model of corporate crime' (1996) 30 L & Soc Rev 549, 577; J Kidwell, 'A caveat' (1985) Wis L Rev 615, ~~Kidwell (missing) (n80) 618~~.

⁶⁰ D Kahan, 'Between economics and sociology: The new path of deterrence' (1996-1997) 95 Mich L Rev 2477, 2481; P Robinson, 'The criminal-civil distinction and the utility of desert' (1996) 76 Boston Uni. L Rev. 201, 213; from E Zamir and B Medina, *Law, Economics, and Morality* (OUP, 2010), 77-78.

⁶¹ R Korobkin and T Ulen, 'Law and behavioral science: Removing the rationality assumption from law and economics' [2000] 88(4) Cal L Rev. 1051, 1077.

⁶² C Jolls, C Sunstein and R Thaler, 'A behavioral approach to law and economics' [1998] 50 Stan LR 1471, 1477.

⁶³ Ibid 1477.

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research has identified many heuristics which impact the decision-making process and the discussion here focuses on those most relevant for deterrence.

- *The availability heuristic*

Rational choice assumes that individuals know the objective likelihood of detection and punishment when making decisions about crime. This is unlikely,⁶⁴ not least because of the many variables affecting detection and the role judicial discretion plays in sentencing.⁶⁵ ABI statistics on insurance fraud demonstrated that a majority of respondents surveyed considered that fraudsters were 'unlikely' or 'very unlikely' to be detected.⁶⁶ This is despite concerted industry efforts to counter this perception.⁶⁷

Moreover, the evidence demonstrates that potential offenders do not attempt to gather objective information before offending⁶⁸ but instead rely on the availability heuristic. This is a means of assessing the likelihood of a particular event by reference to the ease with which the actor can call to mind similar examples.⁶⁹ Evidently, the individual's personal experiences, those of his community and relevant media coverage will dramatically affect his perception of that particular event.⁷⁰ Availability is not a particularly reliable indicator, however, since "actors are...systematically insensitive to sample size and therefore erroneously take small samples as representative."⁷¹ In the context of insurance fraud, this means that an assured who has successfully exaggerated a previous claim is likely to underestimate the risk of detection.

⁶⁴ T Brooks, *Punishment* (Routledge Cavendish, Oxford 2012), 47; N Mazar and D Ariely, 'Dishonesty in everyday life and its policy implications' (2006) 25(1) *J of Pub Pol & Mark.* 117, 120.

⁶⁵ Robinson and Darley (n54) 177; T Tyler, *Why People Obey The Law* (Yale University Press, 1990) 177.

⁶⁶ ABI, Research Brief: Detering Opportunistic General Insurance Fraud (2010) available at: <http://www.betterregulation.com/external/Research%20Brief%20Detering%20Opportunistic%20General%20Insurance%20Fraud.pdf> (accessed 30/07/16), 6: 51% thought it was 'unlikely' or 'very unlikely' that insurance frauds would be detected.

⁶⁷ ABI, 'Insurers will do whatever it takes to protect honest customers against insurance fraud' (18/01/16) available at: <https://www.abi.org.uk/News/News-updates/2016/01/Insurers-will-do-whatever-it-takes-to-protect-honest-customers-against-insurance-fraud> (accessed 13/08/16).

⁶⁸ Robinson and Darley (n54) 174-176.

⁶⁹ A Tversky and D Kahneman, 'Availability: A heuristic for judging frequency and probability' (1973) 5 *Cognitive Psychology* 207, 208 "Life-long experience has taught us that instances of large classes are recalled better and faster than instances of less frequent classes, that likely occurrences are easier to imagine than unlikely ones, and that associative connections are strengthened when two events frequently co-occur. Thus, a person could estimate the numerosity of a class, the likelihood of an event, or the frequency of co-occurrences by assessing the ease with which the relevant mental operation of retrieval, construction, or association can be carried out."

⁷⁰ Robinson and Darley (n54) 177-178.

⁷¹ M Eisenberg, 'Behavioral economics and contract law' in E Zamir and D Teichman (eds.), *The Oxford Handbook of Behavioral Economics and the Law* (OUP, 2014) 447.

The perceived likelihood of detection and punishment is tied to the availability heuristic. After all, if individuals do not gather objective information before offending, perception is the only basis for decision making.⁷² Perception, much like availability, is affected by the actor's experience and those of his community.⁷³ In addition, however, an individual's decision to comply with the law will also depend on his perception of "others' behaviour and attitude toward the law."⁷⁴ This suggests that changing the law is not enough; policymakers must seek to increase perceptions about the likelihood of punishment in a manner that is capable of influencing decision makers at the relevant stage in the claims process.⁷⁵

- *Hyperbolic discounting*

The recognition that social sanctions are significant in decision-making changes the nature of the model. In addition, the modern research also demonstrates that decision makers do not weigh the relevant factors in the way suggested by rational choice theory. Instead of according each factor an equal weight,⁷⁶ decision makers prioritise the immediate and marginalise the distant.⁷⁷ This is the heuristic of hyperbolic discounting. Its presence in the decision-making process is a useful explanation of short-term decisions which conflict with the individual's self-professed long-term goals.⁷⁸ Hyperbolic discounting is particularly significant in offender decision making. Crime will very often result in immediate (financial) benefits⁷⁹ with punishment postponed until investigative and legal processes have been concluded.⁸⁰ This lag is particularly stark in relation to fraud; victims may not immediately recognise that they have been targeted and lengthy investigations are often needed to substantiate allegations of fraud.⁸¹ In short, the effect of hyperbolic discounting is to skew the cost-

⁷² Paternoster (n41) 780; Robinson and Darley (n54) 184.

⁷³ Robinson and Darley (n54) 177, 178.

⁷⁴ Kahan, 'Social influence' (n52) 354.

⁷⁵ Ibid 361.

⁷⁶ See Zamir and Medina (n60) 86 who suggest that certain factors necessarily have 'lexical priority' over others but that these different weightings are ignored by a conventional cost-benefit analysis.

⁷⁷ T Ulen and R McAdams, 'Behavioral criminal law and economics' (2008) University of Chicago Public Law and Legal Theory Working Paper No. 244, 23; Robinson and Darley (n54) 194; Jolls, Sunstein and Thaler (n62) 1539.

⁷⁸ Jolls, Sunstein and Thaler (n62) 1480.

⁷⁹ Robinson and Darley (n54) 195.

⁸⁰ T Loughran, R Paternoster and D Weiss, 'Hyperbolic time discounting, offender time preferences and deterrence' (2012) 28 J Quant Criminol 607, 608.

⁸¹ R Ogren, 'The ineffectiveness of the criminal sanction in fraud and corruption cases: Losing the battle against white collar crime' (1972-1973) 11 Am Crim L Rev 959, 969. Recent investments in the criminal process, most notably the creation of the Insurance Fraud Enforcement Department (IFED), seeks to expedite the process, see <https://www.cityoflondon.police.uk/advice-and-support/fraud-and-economic-crime/ifed/pages/default.aspx>

benefit analysis in favour of offending even in circumstances where the likelihood and severity of punishment are objectively high.

- *The optimism bias*

If decision makers are naturally programmed to discount potential punishments, by virtue of hyperbolic discounting, the optimism bias exacerbates this tendency. Optimism, on the one hand, leads individuals to believe that negative consequences are more likely to happen to others⁸² and, on the other, increases the perception of benefits which result from crime. In combination, this may tip the balance in favour of offending. Of course, this propensity to optimism may cause the offender to take fewer precautions to avoid detection.⁸³ As McAdams and Ulen have noted, this “would bolster the true probability of detection, which partially offsets the dilution of deterrence excess optimism causes.”⁸⁴ It is important to recognise, however, that while fewer precautions can be easily envisaged in relation to street offences, it is not as easy to translate this to the commercial fraud context. This underlines the need for additional empirical work to consider the impact of behavioural heuristics in the commercial (fraud) context.

The discussion in this part has highlighted that decision-making about crime diverges from the rational choice model in a significant number of ways. The reasons for this are usefully summarised by Robinson and Darley,

Potential offenders commonly do not know the legal rules ...Even if they know the rules, the cost-benefit analysis potential offenders perceive ... commonly leads to ... violation rather than compliance, either because the perceived likelihood of punishment is so small, or because it is so distant as to be highly discounted ... And, even if they know the legal rules and perceive a cost-benefit analysis that urges compliance, potential offenders commonly cannot or will not bring such knowledge to bear [because of] a variety of social, situational or chemical influences. Even if no one of these three hurdles is fatal to the law's behavioural influence, their cumulative effect typically is.⁸⁵

⁸² Jolls, Sunstein and Thaler (n62) 1524; C.Jolls, 'Behavioral economics analysis of redistributive legal rules' (1998) 51 Vand L Rev 1653, 1659.

⁸³ Ulen and McAdams (n77) 17.

⁸⁴ Ibid 17 citing N Garoupa, 'Behavioral economic analysis of crime: A critical review' (2003) 15 European J of Law and Economics 5, 9.

⁸⁵ Robinson and Darley (n54) 174.

If the account of decision-making is inaccurate, the policy prescriptions made by rational choice theorists must be equally erroneous. On this basis, it is difficult to accept the judicial account of the forfeiture rule, namely that its severity deters fraud. This must change the nature of the debate. The onus is on academics and policymakers to construct deterrents which conform to the lessons of modern deterrence theory and subject those tools to rigorous testing. This is no small task. The remainder of this paper builds on existing work and briefly considers how these lessons could be operationalised in the insurance claims context.

IV. Developing Modern Deterrents

The suggestion that modern deterrence theory provides a more solid foundation for policy making should lead us to different recommendations about deterrence. Effective deterrents should seek to override the heuristics which cause individuals to offend and seek to harness the power of social sanctions to curb wrongdoing. Examples drawn from recent empirical work and industry initiatives demonstrate how the insurance claims process can be remodelled in light of the lessons from modern deterrence theory.

The design of the claim form is critical. Blais and Bacher's randomised control trial of the claims process across four insurance companies demonstrates how social sanctions can be employed to reduce the extent of exaggeration.⁸⁶ In half of the claims, the policyholder received a letter in addition to the standard claim form. The letter reminded recipients of the penalties for fraud and continued,

[a]nd we know, as a recent poll has revealed, that a very large majority of people feel that boosting insurance claims is morally wrong...we very well know that the large majority of insurance holders share our beliefs. And this is why we take this opportunity to ask for your help and your cooperation in completing carefully the enclosed forms.⁸⁷

On average, policyholders in receipt of this experimental letter submitted claims worth \$300 less than claimants who were processed according to the company's standard procedure.⁸⁸ This intervention can be viewed as an attempt to overcome some of the biases that result in the decision to commit fraud. Firstly, reminding recipients of the legal penalties may counter the effect of hyperbolic

⁸⁶ E Blais and J Bacher, 'Situational deterrence and claim padding: Results from a randomized field experiment' (2007) 3 J Exp Criminol 337.

⁸⁷ Ibid 350.

⁸⁸ Ibid 344, 347.

discounting by emphasising sanctions at the precise time of decision making. The appeal to morality can also be understood as reifying the social sanctions which serve to deter the individual.

The location of the honesty declaration is also of critical importance. The majority of claims forms require the assured to confirm by signature that the contents of the form are accurate. Research by Shu et al. suggests that this declaration comes too late; by the time the assured signs the form, the exaggeration has already occurred.⁸⁹ Their research suggests that the relocation of this declaration to the top of the form can reduce the amount of fraud.⁹⁰ The reduction in fraud is equated with the process of swearing an oath in court;⁹¹ the individual is reminded of the importance of honesty at the very moment that the opportunity for dishonesty is presented.⁹²

Recent industry initiatives to counter fraud can also be analysed from the perspective of modern deterrence theory. The Insurance Fraud Enforcement Department (IFED), funded by insurers, was established in 2012 and centralised investigation and expertise in financial crimes. To date, IFED's work has resulted in the confiscation of £1.3million from fraudsters and 200 convictions totalling more than 100 years in prison sentences.⁹³ This is an important step forward in the criminal response to insurance fraud.⁹⁴ Most notably for our purposes, the work of IFED has been publicised through a BBC 1 daytime television show, 'Claimed and Shamed', now in its sixth series.⁹⁵ If, as the evidence suggests,⁹⁶ individuals perceive that they are unlikely to be caught, media coverage should increase the ease with which they can call to mind instances of detection and punishment. This overcomes the impact of the availability heuristic which may cause individuals to choose to offend. Furthermore, the television coverage treats insurance fraud in the same way as 'street crimes' are typically portrayed in the media. This may help to alter the perception that insurance fraud is not morally wrong and that it is victimless.⁹⁷

⁸⁹ L Shu et al, 'Signing at the beginning makes ethics salient and decreases dishonest self-reports in comparison to signing at the end.' (2012) 109(38) PNAS 15197, 15198.

⁹⁰ Ibid 15197-15198.

⁹¹ Ibid 15197.

⁹² Ibid 15198. See also N Mazar, O Amir and D Ariely, '(Dis)Honesty: A combination of internal and external rewards' (Working Paper, Sloan School of Management (MIT)) cited in D Ariely, *The (Honest) Truth About Dishonesty* (Harper, 2012), 50-51.

⁹³ IFED, 'IFED News' (22/01/16) available at: <https://www.cityoflondon.police.uk/advice-and-support/fraud-and-economic-crime/ifed/ifed-news/Pages/Insurance-Fraud-Enforcement-Department-announce-new-head.aspx> (accessed 31/07/16).

⁹⁴ *Insurance Fraud Taskforce, Insurance Fraud Taskforce Final Report (2016)*, [2.7], [Law Com. \(reference missing\)](#).

⁹⁵ BBC, 'Claimed and Shamed' available at: <http://www.bbc.co.uk/programmes/b071hmq0> (accessed 01/08/16).

⁹⁶ ABI, 'Deterring general opportunistic insurance fraud' (n66) 6.

⁹⁷ S Viaene and G Dedene, 'Insurance fraud: Issues and challenges' (2004) 29(2) *The Geneva Papers on Risk and Insurance*, 321.

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Granted, the redesign of the claim form is not particularly innovative but these administrative tweaks have the capacity to deter fraud at the relevant time and are underpinned by empirical support. Moreover, these suggestions are relatively cheap⁹⁸ and could be undertaken at the same time as insurers rewrite their policy documentation in light of recent legislation.⁹⁹ More broadly, the work of the industry goes to show that the legal remedy should only be one part of the response to fraud. Prevention – in the form of behavioural triggers in the claim form and elsewhere – must surely be better than cure.

V. Conclusion

The judicial assertion that the forfeiture rule deters depends on an outdated understanding of decision-making. Accordingly, the policy recommendations made on the strength of rational choice theory are likely to be ineffective in deterring crime, and insurance fraud specifically. The argument made here was that modern deterrence provides a much more realistic and empirically robust model for developing deterrents. In particular, modern deterrents should seek to override cognitive biases which currently lead to decisions to offend and trigger social sanctions. These arguments were not well received by the Supreme Court in *Versloot*.¹⁰⁰ In argument, Lord Mance captured the entirety of this discussion, noting the existence of “theories of judicial activity [which] invite us to operate on the basis of rational choice theory which assume that people behave logically and that we have knowledge of the law.”¹⁰¹ The judicial response to the behavioural evidence is disappointing, if not wholly surprising. Indeed, it reflects the fact that the judiciary is inculcated in a particular model of law-making and are generally unable to take account of the social consequences of judicial decisions.¹⁰² This decision does not signal the end for a more nuanced remedial response. In particular, the Insurance Fraud Taskforce has recognised the potential for behaviourally-informed deterrents to counter opportunistic fraud.¹⁰³ This is promising. Until then, academics and policymakers alike must

⁹⁸ Shu et al. (n89) 15198.

⁹⁹ Insurance Act 2015; Consumer Insurance (Disclosure and Representations) Act 2012.

¹⁰⁰ *Versloot (Supreme Court)* (n41) [10] per Lord Sumption: “These points have some force. But I doubt whether they are relevant. Courts are rarely in a position to assess empirically the wider behavioural consequences of legal rules. The formation of legal policy in this as in other areas depends mainly on the vindication of collective moral values and on judicial instincts about the motivation of rational beings, not on the scientific anthropology of fraud or underwriting.”, [124] per Lord Mance.

¹⁰¹ *Versloot Dredging BV v HDI Gerling Industrie Versicherung (The DC Merwestone)* (Hearing on 16/03/16, morning session), 2h 12 per Lord Mance available at: <https://www.supremecourt.uk/watch/uksc-2014-0252/160316-am.html> (accessed 31/07/16).

¹⁰² *Versloot (Supreme Court)* (n41) [10] per Lord Sumption.

¹⁰³ Insurance Fraud Taskforce, *Insurance Fraud Taskforce Final Report* (2016) available at: <https://www.gov.uk/government/publications/insurance-fraud-taskforce-final-report> (accessed 13/09/2016), [3.47].

resist the temptation of lawmaking on the basis of simplistic, untested policy assertions. It is only then that a legal sanction may have some traction in the deterrence of fraudulent claims.