WHEN CAN AN INSURER SUCCESSFULLY REPUDIATE A CLAIM IN NEGLIGENCE ON THE BASIS OF A FRAUD EXCLUSION AND SO SECURE AN EXIT ROUTE?

The fraud exclusion

1. Even without an express exclusion of an insurer's liability to indemnify the insured against his own fraud, as a matter of general construction of an insurance policy, a policy will be interpreted so as to exclude loss which is deliberately self-inflicted; *Beresford v Royal Insurance* [1938] AC 586, a case of suicide. A fraudulent insured inflicts upon himself his liability for his fraud.

2. Invariably, however, Professional Indemnity Insurance cover will expressly exclude liability for dishonesty and fraud, though generally such policies will cover innocent members of a firm against a dishonest partner's wrongdoing. The Law Society's website guidance published in August 2016, commenting on the SRA's minimum terms and conditions ("MTC") states:

> "The MTC does not cover dishonesty or a fraudulent act or omission commissioned or condoned by an individual insured (clause 6.8).
>
> However, it must still cover other insureds who were not complicit in the fraud or dishonesty. In the case of an LLP or body corporate, dishonesty or acts or omissions can only be imputed to the body corporate if they were condoned or committed by all members or directors."

The meaning of dishonesty and fraud

3. What then constitutes dishonesty and fraudulent conduct? Both in civil[1] and criminal law[2], over many decades, the courts have moved back and forth between entirely objective tests, where dishonesty is to be judged by generally acceptable standards of which the alleged wrongdoer's lack of appreciation is irrelevant, and a more subjective test taking into account a defendant's appreciation of those standards. Following the decision of the House of Lords in *Twinsectra v* Yardley [2002] AC 164, it was widely thought that respect for the subjective element was gaining ground. However, in the Privy Council decision of *Barlow Clowes Ltd v Eurotrust Ltd* [2006] 1 WLR 1476 PC, this perception was dispelled for reasons explained by Lord Hoffmann:

[1] See the cases mentioned later in this paragraph.
[2] *Per* Lord Lane CJ in *R v Ghosh* [1982] QB 1053: "… we would reject the simple uncomplicated approach that the test is purely objective, however attractive from the practical point of view that solution may be." Cf *Reg. v. Greenstein* [1975] 1 W.L.R. 1353: "The question is essentially the one for a jury to decide and it is essentially one which the jury must decide by applying its own standards." – the direction of the Judge King-Hamilton QC approved by the Court of Appeal as "beyond criticism".

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> "10. ...although a dishonest state of mind is a subjective mental state, the standard by which the law determines whether it is dishonest is objective. If by ordinary standards a defendant's mental state would be characterised as dishonest, it is irrelevant that the defendant judges by different standards.
>
> 15. ...Their Lordships accept that there is an element of ambiguity in these remarks which may have encouraged a belief, expressed in some academic writing, that *Twinsectra* had departed from the law as previously understood and invited inquiry not merely into the defendant's mental state about the nature of the transaction in which he was participating but also into his views about generally acceptable standards of honesty. But they do not consider that this is what Lord Hutton meant. The reference to "what he knows would offend normally accepted standards of honest conduct" meant only that his knowledge of the transaction had to be such as to render his participation contrary to normally acceptable standards of honest conduct. It did not require that he should have had reflections about what those normally acceptable standards were.
>
> 16. Similarly in the speech of Lord Hoffmann, the statement (in para 20) that a dishonest state of mind meant "consciousness that one is transgressing ordinary standards of honest behaviour" was in their Lordships' view intended to require consciousness of those elements of the transaction which make participation transgress ordinary standards of honest behaviour. It did not also to require him to have thought about what those standards were."

4. It fell to the Court of Appeal, Civil Division, in *Starglade Properties v Nash* [2010] EWCA Civ 1314, one House of Lords, the other Privy Council, to synthesise these decisions which some might think are difficult to reconcile. The Chancellor, Sir Andrew Morritt, went for the purely objective approach. He said at para 32:

> "The relevant standard, described variously in the [cases to which he had referred], is the ordinary standard of honest behaviour. Just as the subjective understanding of the person concerned as to whether his conduct is dishonest is irrelevant so also is it irrelevant that there may be a body of opinion which regards the ordinary standard of honest behaviour as being set too high. Ultimately, in civil proceedings, it is for the court to determine what that standard is and to apply it to the facts of the case."

5. Leveson LJ, agreeing with the Chancellor, at para 42 said that he "would add a note of concern if the concept of dishonesty for the purposes of civil liability differed to any marked extent from the concept of dishonesty as understood in the criminal law." He went on, recognising the tension between this approach and what was said by Lord Lane in *Ghosh*, to say, at para 44 that:

> "… the analysis which has governed the approach of the criminal law may fit more readily into the language of the House of Lords in *Twinsectra* prior to the explanation of the remarks in that case in *Barlow Clowes* in the Privy Council and *Abu Rahman* in the Court of Appeal. It is all the more important, therefore, that at some stage the opportunity to revisit this issue should be taken by the Court of Appeal (Criminal Division)."

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6. Hughes LJ (a judge particularly experienced in criminal law cases), whilst agreeing with the Chancellor, associated himself with these remarks made by Leveson LJ.

7. The unsatisfactory divergence between civil and criminal law as to the meaning of dishonesty lingers on, and was highlighted in a recent dental disciplinary case, *Kirschner v General Dental Council* [2015] EWHC 1377, in which Mostyn J reviewed the leading authorities, and stated at para 13 of his judgment that "It is well known that nowadays in the Rolls Building the *Barlow Clowes* test is routinely applied where adjudicating allegations of dishonesty." Despite this, and expressly stated misgivings, he went on to hold at para 22 that, for the purposes of professional disciplinary proceedings, *Twinsectra* prevails.

8. A recent example of dishonesty where the court held that liability was excluded for fraud judged by this objective standard is the case of *Halliwells v NES* [2011] PNLR 30 (HH Judge McCahill QC, sitting as a judge of the High Court). In that case, in December 2008, a firm of solicitors, NES, undertook on behalf of their client HAH to Halliwells for the benefit of their client GCF, a finance company, to pay £1.5m on or before 10th March 2009, stating that money was held by them on their client's account. For doing this NES were paid a fee of £15,000. GCF advanced funds to GCP, a property company connected with HAH, so that GCP could buy another property company. The loan was to be repaid on 11th March 2009. In truth, NES had no funds to hand for meeting liabilities on the undertaking, nor had it played any part in the underlying transaction other than in the giving of the undertaking. H sued them on the undertaking and obtained judgment, and NES joined their professional indemnity insurers, claiming indemnity.

9. Not surprisingly the insurers resisted the claim, relying on the dishonesty exception, amongst other things. NES disputed that it had been dishonest, saying that it had genuinely believed that a cheque from its client to NES for £1.5m would be honoured, but as Judge McCahill pointed out, there was no getting around the fact that NES was not in funds at the time when the undertaking was given. The judge held, applying ordinary standards of honest behaviour, in accordance with the *Barlow Clowes* and *Starglade* decisions to which he referred, that giving the undertaking in circumstances when both partners knew that they could not honour it amounted to dishonest conduct within the policy exclusion.

10. It must be likely that within the next few years the Supreme Court will definitively be called upon to rule on the applicable civil standard for dishonesty and fraud, and there is much force in the view that the civil and criminal standards should be in harmony on such an important point. The *Ghosh* test now seems entrenched in the criminal law, and therefore it is not possible to predict with any

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degree of confidence how the issue will ultimately be resolved. For the time being, however, it is very likely that at first instance and Court of Appeal level, civil courts, in insurance and other cases, will continue to apply *Barlow Clowes* as Judge McCahill did in *Halliwells.*

Condonation clauses

11. A typical clause of this kind will provide that the policy excludes cover in relation to any claim to the extent that any liability arises from dishonesty or a fraudulent act or omission *committed or condoned* by the Insured.

12. Quite plainly where the insured has been party to a dishonest act, he will not be covered. These clauses are therefore designed to catch conduct falling short of participation, and to exclude cover for people who are not personally liable for fraud or dishonesty, but who are liable vicariously as employers, or jointly as partners. Commonly the clause concerned will provide for an exclusion in the case of "reckless" condonation. The meaning of "recklessness" again is much influenced by criminal law concepts, and is likely to be interpreted as meaning appreciating a risk but deciding to run it, or simply giving no though to a serious and obvious risk.

13. The burden, of course, is upon the insurer to establish the same, to the standard appropriate to an assertion of that kind (see *Hornal -v- Neuberger Products Limited* [1957] 1QB 247).

14. It is necessary to be on guard against confusing knowledge with the means of knowledge; see the observations of Millett LJ in *Bristol & West BS v Mothew* [1998] Ch 1, at page 15G, and also Chadwick LJ in *Unique Pub Properties Ltd v Beer Barrels and Mineral (Wales) Ltd* [2005] 1 All ER (Comm.) 181 at paragraph 36. The fact that something suspicious might have been detected had all enquiries been made, is not to be equated with actual knowledge that something suspicious had occurred, or that suspicious circumstances existed but were ignored. In the words of Chadwick LJ in *Beer Barrels*: "This is not a "blind eye" case; where the defendant has chosen not to search for what he knows is there to be found." It is such Nelsonian blindness that is to be equated with reckless condonation.

15. In *Zurich Professional Ltd v Karim & others* [2006] EWHC 3355 (QB), Irwin J held there had been condonation of fraud where the insureds knew of persistent raiding of a firm's account by another party. He found that there had been improper mixing of funds in the firm's account and that the insureds must have known that the firm's income was inadequate to support drawings which they received which could not, therefore, have come legitimately from the firm's income. The judge held that "I am of the view that you cannot condone an act or omission of which you are unaware" (paragraph 107), although in the light of the knowledge established in respect of

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other dishonest practices he went on to find, at paragraph 108 that "it seems to me the reasonable person would be surprised if this clause allowed the Insurers to step aside from those within the firm who practised or condoned the specific forgery but not from partners who condoned persistent dishonest handling of money, breaches of the rules, and so forth, which allowed the specific act or omission to take place."

16. In *Goldsmith Williams v Travelers Insurance* [2010] EWHC 26 (QB) Wyn Williams J found that there had been condonation in a case where the solicitor knew that mortgage fraud was being practised by another partner in the firm. Having considered *Karim*, the judge held that:

> "… if an Insured condones a course of conduct which is dishonest or fraudulent and that course of conduct leads to or permits the specific acts or omissions upon which the claim is founded the insurer is entitled to repudiate liability."

17. There is little authority on the meaning of condonation, but see the definitions in Stroud's Judicial Dictionary under "condonation" and "allow", and see also the decision of the Privy Council in *Federal Supply & Cold Storage Co v Anghern* [1910] UKPC 32 at page 19 where their lordships held that no-one could condone a wrong which they honestly believed had not been committed. These authorities suggest that knowledge is an essential ingredient of condonation.

Fraudulent claims

18. A closely related problem for claimants, who have to look to insurers of their defaulting professionals for remedy, is the entitlement of insurers to avoid fraudulent claims, that is to say claims that have been pursued by their insured in a fraudulent fashion. The law in this field has very recently undergone significant change, both as a result of statute and a Supreme Court decision.

19. The Insurance Act 2015, which came into force as to ss12 and 13 on 12th August 2016 provides:

> **"12.— Remedies for fraudulent claims**
>
> (1) If the insured makes a fraudulent claim under a contract of insurance—
>
> (a) the insurer is not liable to pay the claim,
>
> (b) the insurer may recover from the insured any sums paid by the insurer to the insured in respect of the claim, and
>
> (c) in addition, the insurer may by notice to the insured treat the contract as having been terminated with effect from the time of the fraudulent act.
>
> (2) If the insurer does treat the contract as having been terminated—

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(a) it may refuse all liability to the insured under the contract in respect of a relevant event occurring after the time of the fraudulent act, and

(b) it need not return any of the premiums paid under the contract.

(3) Treating a contract as having been terminated under this section does not affect the rights and obligations of the parties to the contract with respect to a relevant event occurring before the time of the fraudulent act.

(4) In subsections (2)(a) and (3), *"relevant event"* refers to whatever gives rise to the insurer's liability under the contract (and includes, for example, the occurrence of a loss, the making of a claim, or the notification of a potential claim, depending on how the contract is written).

13.— Remedies for fraudulent claims: group insurance

(1) This section applies where—

(a) a contract of insurance is entered into with an insurer by a person ("A"),

(b) the contract provides cover for one or more other persons who are not parties to the contract ("the Cs"), whether or not it also provides cover of any kind for A or another insured party, and

(c) a fraudulent claim is made under the contract by or on behalf of one of the Cs ("CF").

(2) Section 12 applies in relation to the claim as if the cover provided for CF were provided under an individual insurance contract between the insurer and CF as the insured; and, accordingly—

(a) the insurer's rights under section 12 are exercisable only in relation to the cover provided for CF, and

(b) the exercise of any of those rights does not affect the cover provided under the contract for anyone else.

(3) In its application by virtue of subsection (2), section 12 is subject to the following particular modifications—

(a) the first reference to *"the insured"* in subsection (1)(b) of that section, in respect of any particular sum paid by the insurer, is to whichever of A and CF the insurer paid the sum to; but if a sum was paid to A and passed on by A to CF, the reference is to CF,

(b) the second reference to *"the insured"* in subsection (1)(b) is to A or CF,

(c) the reference to *"the insured"* in subsection (1)(c) is to both CF and A,

(d) the reference in subsection (2)(b) to the premiums paid under the contract is to premiums paid in respect of the cover for CF."

20. The 2015 Act does not identify what constitutes a fraudulent claim, leaving such matters to the common law. However, days before the Act even came into force, the Supreme Court stepped

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in to make a radical change to the law in this regard. In *Versloot Dredging BV and another v HDI Gerling Industrie Versicherung AG and others* [2016] 3 WLR 543, the Court held that where an insured supported a claim with "collateral lies"[3], this would no longer invalidate the claim.

21. This important development in the law was explained by Lord Sumption in this way at para 36:

> "… the fraudulent claims rule applies to a wholly fabricated claim. It applies to an exaggerated claim. It applies even to the genuine part of an exaggerated claim if the whole is to be regarded as a single claim, as it must be. But it does not apply to a lie which the true facts, once admitted or ascertained, show to have been immaterial to the insured's right to recover. It is true that the moral character of the insured's lie is in no way mitigated by the fact that it turns out to have been unnecessary. But there are principled limits to the role which a claimant's immorality can play in defeating his legitimate civil claims. These limits have been applied outside the realm of insurance ever since the failure two centuries ago of Lord Mansfield's attempt to introduce a general duty of good faith in the law of contract. Ultimately, however, even the law of insurance is concerned more with controlling the impact of a breach of good faith on the risk than with the punishment of misconduct. The extension of the fraudulent claims rule to lies which are found to be irrelevant to the recoverability of the claim is a step too far. It is disproportionately harsh to the insured and goes further than any legitimate commercial interest of the insurer can justify."

22. This development will greatly benefit third parties who otherwise would have been prejudiced when their professional advisers sought to mislead their insurers as to the true circumstances applicable to a claim. The fact that the insured may have embellished the facts to present themselves in a better light will no longer work against the interest of their injured client. None of this, of course, qualifies the entitlement of an insurer to rely on a fraud exclusion.

SUMMARY

23. In conclusion:

(i) An insured who has caused loss to his professional client will not be able to recover indemnity from his insurer where the insured has caused loss by dishonesty or fraud.

(ii) Until the topic is reviewed in the Supreme Court, civil courts will approach issues of dishonesty and fraud by reference to an objective yardstick for which purpose the insured's appreciation that he has fallen below the standards of generally accepted honest behaviour is irrelevant. Given the divergence between criminal and civil assessment of dishonesty there is, however, a real likelihood that this issue will be considered at the highest level at some point before many years.

[3] "… collateral lies, by which I mean a lie which turns out when the facts are found to have no relevance to the insured's right to recover" *per* Lord Sumption at para 1.

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(iii) An insured will be held not to have condoned dishonesty, or fraud, by his colleagues unless he turned a "blind eye" to it, but knowledge of generally dishonest systems in a firm will be sufficient to amount to condonation unless active steps are taken to eradicate it.

(iv) Clients claiming against their professional advisers should no longer be prejudiced by any "collateral lies" told by their advisers to insurers, who will not be able to avoid liability simply on the basis of those collateral lies.

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Nothing in these notes or the related seminar constitutes legal advice, and it is not anticipated that it will be relied upon as such.