Marine Insurance

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SUPREME COURT DEFINES THE AMBIT OF THE FRAUDULENT CLAIMS RULE

Introduction

At the claims stage of an insurance contract there are three ways in which an assured can try to take advantage of his insurer:

1. Fabricate a claim in its entirety. The event and the loss are pure fiction.
2. Exaggerate his loss from a covered event.
3. Lie in the presentation of an otherwise legitimate claim.

The law in relation to scenarios 1 and 2 is that the insurer is not liable to pay the claim. It is forfeit.

The law in relation to 3 was the issue before the Supreme Court in *THE DC MERWESTONE*[1]. By a four-to-one majority their Lordships found that such a claim is not forfeit. This was the decision of Lords Sumption, Hughes, Clarke and Toulson with Lord Mance dissenting. References to paragraphs in the judgment are in square brackets in this article.

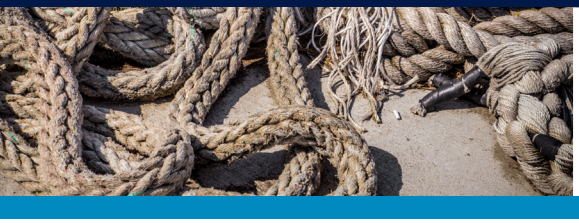
The "fraudulent claims" rule

The fraudulent claims rule is well established in English law. It operates to bar a policyholder's claim in its entirety when that claim is fabricated or fraudulently exaggerated, as per scenarios 1 and 2. The leading case is generally regarded as *Britton v Royal insurance Co*[2] in which Willes J suggested that the rule was a manifestation of the duty of utmost good faith.

The extension of the fraudulent claims rule to include lies told in the claims process (scenario 3) – so called "fraudulent devices" - is at common law a more recent development.

It is unnecessary here to rehearse the way in which the law developed in this regard from *Lek v Mathews*[3] to *Agapitos v Agnew* (The Aegeon)[4] beyond noting Lord Mance's concession in *THE MERWESTONE*[5] that there *"is long-standing if limited authority for the inclusion of fraudulent devices within the ambit of the fraudulent claims principle"* (our emphasis) and Lord Sumption's observation[6] that this *"is the first time that the*

1 [2016] UKSC 45
2 (1866)4 F&F 905
3 (1927) 29 LI L Rep 141
4 [2003] QB 556
5 *Supra 1*, Lord Mance at [115]
6 *Supra 1*, Lord Sumption at [23]



House of Lords or the Supreme Court has had the opportunity to resolve the question of whether the fraudulent claims rule applies to justified claims supported by collateral lies."

There were, as Lord Sumption observed[7] "considerable judicial misgivings about their use as a basis for avoiding liability when the claim is well-founded" before The Aegeon in 2003, but not since. Mance LJ's (as he then was) tentative views and his materiality test in that case became the law, that lies forfeit the claim.

The factual background

DC MERWESTONE was in Klaipeda, Lithuania in late January 2010 loading a cargo of scrap iron. The crew had cause to use the emergency fire pump to supply water on deck. The emergency fire pump, its overboard valve and filter are all located in the bow thruster compartment - forward of the cargo hold and two watertight transverse bulkheads away from the engine room.

The Captain, engaged in work on deck with his crew, slipped and broke six ribs. He was ultimately replaced before the vessel sailed. But in the relatively modest drama that followed, his crew forgot to close the overboard valve and drain the system when they stopped using the emergency fire pump.

Water in the system froze in the prevailing very cold weather conditions and damaged the filter and pump casing. This damage only manifested itself once the vessel had sailed and temperatures increased. The ice in the pump and filter melted and water flooded through the open overboard valve and damaged filter and pump.

From the bow thruster compartment the water found its way to the engine room via cable ducts which had been cut into the transverse bulkheads by a repair yard, but negligently left unsealed.

7 *Supra 1*, at [18]

The lie had no effect on the underwriters. They did not believe it. It was contradicted by the evidence they themselves had taken. Nor did they act upon it.

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Once discovered, pumps were deployed. Given the rate of ingress they should have coped but did not and the engine room flooded. Subsequently various defects were found in the engine room pumping system.

The lie and its context

The owner pursued a claim under his hull policy. Being a commercial man he thought that he had purchased insurance specifically to deal with this type of situation.

Underwriters appointed solicitors at a very early stage and they carried out investigations that included interviewing all crew members and reviewing various contemporaneous documents. In April 2010 they sent a long list of questions to the owner who, advised by his insurance broker, became concerned about the wording of the proviso to the *Inchmaree* clause, *"provided that such loss or damage has not resulted from want of due diligence by the Assured"*.

Frustrated by the commercial pressure he was under from a failure on the part of underwriters to confirm a payment on account and concerned about the policy wording, he told a lie about the factual background to the incident.

The specifics of the lie do not matter. What mattered was that it was a lie **"which would, if believed, have tended, objectively but prior to any final determination at trial of the parties' rights, to yield a not insignificant improvement in the insured's prospects ..."** (the materiality test of Mance LJ in The Aegeon).

The lie and its effect

The lie had no effect on the underwriters. They did not believe it. It was contradicted by the evidence they themselves had taken. Nor did they act upon it. They continued to ask questions and continued with their own investigations.

The assured eventually instructed his own solicitors and proceedings were commenced. By an amendment to the Statement of Claim the misrepresentation contained in the original lie was corrected. But importantly the lie had been told before proceedings were commenced. Whatever the fraudulent claims rule may be, it does not apply once litigation has begun – *THE STAR SEA*[8].

In addition to the fraudulent device defence underwriters raised various other defences, none of which succeeded. At first instance[9] the trial

8 [2003] 1 AC 469

9 [2013] EWHC 1666 (Comm)



judge, Popplewell J, felt bound to follow The Aegeon and hold that the lie forfeited the claim, but he believed that this punishment did not fit the crime. *"To be deprived of a valid claim of some €3.2 million as a result of such reckless untruth is, in my view, a disproportionately harsh sanction."*[10] In fact the owners succeeded on their primary case that the event was a peril of the sea and therefore not subject to the Inchmaree proviso – no doubt adding to the disproportion that Popplewell J perceived in the law's response.

On appeal to the Court of Appeal the decision was upheld.[11]

The Supreme Court judgment

- *"The position is different where the insured is trying to obtain no more than the law regards as his entitlement and the lie is irrelevant to the existence or amount of that entitlement. In this case the lie is dishonest but the claim is not."*[12]
- *"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."*[13]
- *"Suppose a collateral lie is told on a Monday but resiled from, say, a week later, can it sensibly be held that it is then too late because the lie has already caused forfeiture of the claim? Such a principle would in my opinion be disproportionate and contrary to public policy."*[14]
- *"[T]he fraudulent claims rule is of considerable importance and must be preserved, but .... its extension to collateral lies .... is not based on sound authority and would result in a remedy disproportionate to the breach of duty involved."*[15]
- *"I agree with Lord Mance that integrity on both sides of the claims process is an important consideration. So is arriving at a result which is just and reflects the parties' legal rights. In considering whether as a matter of public policy the courts should apply a draconian rule of denying a right of recovery under a contract of insurance to the insured who tells a lie in support of a valid claim, the court must ultimately be guided by its own sense of what is just and appropriate."*[16]

Lord Mance dissented. He might have tinkered with his materiality test, but otherwise was firmly of the view that we, unlike Popplewell J at first instance, should have no sympathy with a liar.

Conclusion

1. The conduct in this case would not support a prosecution under the Fraud Act 2006 – it would fail on the "gain" hurdle of section 5 of that Act. But more importantly, with reference to the three scenarios set out in the introduction above, it is evident that the majority did not think the use of the word "fraud" in relation to scenario 3 was appropriate. Scenario 3 is neither a fraudulent claim nor a dishonest one.
2. The harsh remedy of forfeiture for lies in the The Aegeon has gone. But given Lord Mance's advice to underwriters[17], expect to see express "Merwestone clauses" in policies in the future.
3. This judgment defines what the Insurance Act 2015 does not - a fraudulent claim. It has done so in a manner commensurate with the Act's other provisions. For example, the Act abolishes the draconian remedy of avoidance in relation to non-disclosure and misrepresentation in favour of a system of proportionate remedies, while a new quasi-causation test significantly limits the circumstances in which a breach of warranty will result in the discharge of the insurer's liability.

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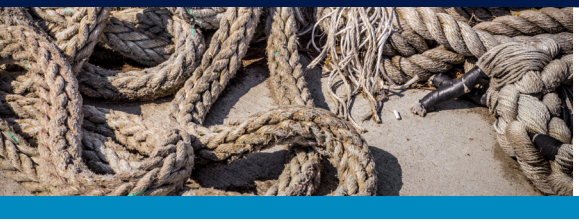
10 *Ibid*, at para 225
11 [2014] EWCA Civ 1349
12 *Supra 1*, Lord Sumption at [26]
13 *Ibid*, Lord Sumption at [36]
14 *Ibid*, Lord Clarke at [46]
15 *Ibid*, Lord Hughes at [103]
16 *Ibid*, Lord Mance at [133]
17 *Ibid*, at [133]

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