Marine insurance – collateral lies: when lies are not fraud

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Abstract

Purpose – The purpose of this study is to review the reasoning of the judgment of the United Kingdom Supreme Court in *Versloot Dredging BV and another (Appellants)* v. *HDI Gerling Industrie Versichering AG and Others (Respondents)* [2016] UKSC 45 in finding that there is no remedy or sanction for the use of fraudulent devices (so-called "collateral lies") in insurance claims and to consider potential implications for underwriters.

Design/methodology/approach – The methodology is a typical case law analysis starting from case facts and the reasoning with short comments on legal implications.

Findings – Despite no sanction provided by law for the use of fraudulent devices, the room still opens for the underwriters to stipulate the consequence of using the fraudulent devices by the express term in the insurance contract.

Research limitations/implications – The main implication from the judgment is that underwriters are likely to incur more investigating costs for insurance claims.

Originality/value – This work raises awareness of the marine insurance industry (especially underwriters) as to the approach of the English law towards the use of fraudulent devices.

Keywords Collateral lies, Fraudulent claims, Fraudulent devices, Marine insurance

Paper type General review

Facts

The *DC Merwestone* had her hull and machinery insurance under the standard Institute Time Clauses (Hulls) 1/10/83 (ITC) and the Institute Additional Perils Clauses (IAPC). Both standard conditions contain certain provisions known in practice as the "Inchmaree Clauses", which provided for the insurance cover unless such loss or damage was caused by the assured's lack of due diligence. The vessel discharged and then loaded cargoes at a port in Lithuania for the voyage bound for Bilbao in Spain. By just one day after the vessel left the port in Lithuania; at night, the engineer observed the flooding in the engine room. Attempts were then made, without success, to pump out the water. The investigation into the cause of flooding revealed that there was seawater that remained in the emergency fire pump by the time the crew had done with using the emergency fire hose at the loading port. Due to the cold weather, the seawater solidified and enlarged, leading to the leakage of the emergency fire pump. When the vessel sailed, the frozen water melted and entered the engine room via the bowthruster space. The consequence of the flooding was that the main engine was extensively damaged and had to be replaced. As noted in paragraph 4 of the judgment, owners submitted a claim of over €3m.

The crux of the argument which was fought up to the United Kingdom Supreme Court lies in the course of investigation by the person from Ince & Co to look into the damage and to enquire the crew of the incident. At the material time, a company holding certain percentage of beneficial

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ownership in the vessel managed the vessel. The person from Ince & Co asked the owners for the explanation as to the cause of the seawater ingress and the reason why the pumping system was not used successfully. Having obtained sound advice from the insurance broker that the owners should try to distance themselves from any potential allegation of lack of due diligence, the owners produced explanation in the letter dated 21 April 2010. The letter gave the account of the facts that the flooding was observed at the night of 28 January 2010. The alarm rang, but the alarm could either be from the bowthruster or the engine room. In any event, the alarm went off around noontime, following the rolling of the vessel. The crew did not check the bowthruster room. Upon further investigation, case handlers at Ince & Co sent further e-mail of 1 June 2010 to ask among other things for the evidence supporting the fact that the alarm went off at around noontime on 28 January 2010. However, this led to a conflicting draft response prepared by another person within the owners' organisation that no crew reported of hearing the alarm at noontime. In the course of trying to reconcile the answers, the owners sent an e-mail to the master asking whether the master thought it would be possible to concur with the explanation provided in the letter of 21 April 2010. Possibly, there was a follow-up conversation between the owners and the master subsequent to this e-mail, whereby the master confirmed the possibility of the explanation in the letter dated 21 April 2010. This led to the response to enquiries from Ince & Co in the letter dated 27 July 2010 in which the owners stated they heard from the master regarding the noon alarm. During the cross-examination, the owners said that he had talked to the master via telephone on 20 April 2010 when he was informed regarding the noon alarm, but the explanation of not checking the bowthruster room due to the rolling of the vessel was simply a plausible assumption. In fact, there had been no information from the master to the owners prior to the production of the letter dated 21 April 2010 regarding the noon alarm. The letter dated 21 April 2010 led to an allegation by the underwriters that the owners used a fraudulent device. Within the context of insurance law, the fraudulent device, as explained by Gilman *et al.* (2008), "is a lie or other falsity (such as a false document) put forward in support of an otherwise genuine claim". An illustration from a case decided by the Full Court of the Supreme Court of South Australia in *GRE Insurance Ltd* v. *Ornsby* [1982] 29 SASR 498 may be used in explaining the fraudulent device. Here, the insurance provided cover against theft. The theft forced entry to the property. Therefore, the loss or damage truly occurred from the theft. The owner of the property who was the assured in this insurance contract, however, caused further damage to the door and the lock of the property. The assured then took a photo and sent to the insurer. The theft really entered the property and the claim submitted by the assured was thus genuine. However, the photo was a fraudulent device as it suggested untrue extent of loss or damage. The owner of the property made such a photo and sent it to the insurer to ensure the insurer had no excuse to doubt the genuineness of the claim, and hence, the chance of getting the claim settled expediently would be boosted. This is to be contrasted with a fraudulent claim. The claim is fraudulent when the claim itself is either unfounded, as in the case where a person makes a claim for a loss of a car while actually the car was parked elsewhere. The claim can also be fraudulent when it is grossly exaggerated, as in the case where a person claims for a loss of his computer in the amount of HK$10,000, whereas the purchase price was only HK$6,000.

So, in the case under consideration of this article, the damage to the ship *DC Merwestone* was a genuine one, the question was whether the letter of 21 April 2010 was a fraudulent device and, if so, what would be the legal consequence of using such a device?

Judgment of the Queen's bench division

Popplewell J in his judgment reported at [2013] EWHC 1666 (Comm); [2013] 2 Lloyd's Rep. 131, followed the earlier statement of Mance LJ (as he then was) in *Agapitos and Others* v. *Agnew* [2002] EWCA Civ. 247; [2002] 2 Lloyd's Rep. 42, found the letter of 21 April 2010 to be

a fraudulent device which leads to a non-payment (forfeiture) of the claim. Mance LJ further explained the consequence of "forfeiture" of claim in his subsequent judgment in *Axa General Insurance* v. *Gottlieb* [2005] EWCA Civ. 112; [2005] Lloyd's Rep I.R. 369 in paragraph 32 that the whole claim to which the fraud relates will not be paid and that any interim payments made in relation to that claim also have to be returned to the insurer. He explained in paragraph 45 of his judgment in *Agapitos* v. *Agnew* that the use of such a fraudulent device will lead to a forfeiture of claims if the use of it:

> […] is intended to improve the insured's prospects of obtaining a settlement or winning the case, and which would, if believed, tend, objectively, prior to any final determination at trial of the parties' rights, to yield a not insignificant improvement in the insured's prospects – whether they be prospects of obtaining a settlement, or a better settlement or of winning at trial.

Popplewell J found the letter of 21 April 2010 to contain such characteristics.

Popplewell J explained the likely significance of this letter in paragraph 223 of his judgment:

> Insurers investigating a casualty of this nature would understandably be sceptical of how delibilative flooding of the engine room could have resulted from a relatively small leak in a bowthruster room, and an explanation for the failure of the vessel's alarms to prevent such a result would be a not insignificant factor in an insurer's assessment of the validity of the claim, in particular consideration of the application of the Inchmaree proviso.

However, he expressed regret with the result he achieved in paragraph 225 of his judgment as he found:

> In a scale of culpability which may attach to fraudulent conduct relating to the making of claims, this was at the low end. It was a reckless untruth, not a carefully planned deceit. It was told on one occasion, not persisted in at the trial. It was told in support of a theory about the events surrounding the casualty which [the owners] genuinely believed to be plausible explanation.

and hence, he found it to be gravely disproportionate that the owners were deprived of their claims of slightly over €3m.

Judgment of the Court of Appeal

The Court of Appeal in the judgment reported at [2014] EWCA Civ. 1349; [2015] 1 Lloyd's Rep. 32 was not convinced by the sympathy of the judge towards the assured. Many reasons were advanced to maintain it is appropriate for the use of fraudulent device to result in the forfeiture of claims. It found the statement of Mance LJ in *Agapitos v Agnew* to be influential. The Court of Appeal further elaborated in paragraph 112 of its judgment that the same common theme can be found in either the case of the fraudulent claim (that is the exaggerated claim or the unfounded claim) or the use of fraudulent device in that the assured seeks to obtain something it did not deserve, namely, "in a fraudulent claim case, the bogus part of the claim; and in a fraudulent device claim, earlier payment than full investigation would otherwise permit". The Court of Appeal further asserted a public policy reason for extending the fraudulent claim rules to the use of the fraudulent device as it explained in paragraph 114 of its judgment: "Most insurance claims get nowhere near litigation because insurers rely on their insured […] insurers are entitled to protection from either type of fraud […]". The Court of Appeal went on to support its policy to deter fraud by citing statistics of fraudulent claims in the United Kingdom in paragraph 116 of its judgment.

Judgment of the United Kingdom supreme court

The judgment of the United Kingdom Supreme Court in this case is reported at [2016] UKSC 45. It was surprising to academics and those in the industry alike that their Lordships in the

Supreme Court (unsurprisingly, Lord Mance disagreed) shared the sympathy to the assured. Their Lordships in the majority judgment unanimously re-branded fraudulent devices as simply "collateral lies", signifying such lies are not relevant to the merits of the claim. Lord Sumption in paragraphs 25 and 26 of his judgment sought to delineate a difference between a fraudulent claim and a collateral lie. In the case of the fraudulent claim, he said, "the insured's dishonesty is calculated to get him something to which he is not entitled". However, in the case of the collateral lie, "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". Lord Hughes echoed this in paragraph 92 of his judgment:

> The collateral lie is certainly told with the aim of improving the position of the liar, but in fact and in law it makes no difference to the validity of his claim whether it is accepted or found out.

Lord Mance raised a rather forceful argument towards the retention of the forfeiture as a legal consequence in the event of the use of the collateral lie. He explained the rationale in support in paragraphs 125 and 127 of his judgment which deserve to be quoted here in length:

> The fraudulent devices rule serves a similar role in encouraging integrity and deterring fraud in the claims process. It should not be forgotten that very frequently fraud in the claims process will be associated with (a) the fraudulent pursuit of a non-existent or bad claim or (b) the fraudulent exaggeration of a good claim. And, aside from cases in which either (a) or (b) is with the benefit of hindsight established, it will, or will almost always, be associated with (c) the pursuit of what the insured believes or fears to be at least a questionable claim […].
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> The fraudulent devices rule means that a fraudulent claimant cannot in cases (a) and (b) safely embellish his bad or exaggerated claim with fraudulent devices, and then, when any such device is discovered, hope to do better with the next device or the lies he will tell in court to pursue his bad or exaggerated claim. In case (c), it means that he cannot safely distort the claims process to his advantage and hope to prevent the insurer identifying, relying on or investigating the weakness which led to the insured telling the lie in the first place. In each of cases (a), (b), and (c), the use of a fraudulent device material to the insurance claim operates as a bar to its further pursuit, making further investigation into the underlying circumstances unnecessary and operating as a clear disincentive to lying. These are significant protective effects, which are entirely consistent with the underlying philosophy of insurance, mutual trust.

Comment

Underwriters would be worried about the decision of the United Kingdom Supreme Court not to sanction the use of the fraudulent device. However, the author thinks that Lord Mance's suggestion towards the end of his judgment should be emphasised. Underwriters can protect themselves against the use of the fraudulent device by making an express term in the insurance contract as to the consequence of such usage. Potential implications of this case may mean that premiums may be increased viewing the underwriters' tougher task in preventing fraud by means of thorough investigation of claims because, in the absence of the express term, the underwriters have to be certain whether the fraud to be alleged on the part of the assured involved the fraudulent claim or the mere use of the fraudulent device. Viewing the decision of the United Kingdom Supreme Court, it means also that the use of fraudulent device, even if it is detected, in the absence of an express agreement, will not be affected by s. 12 of the Insurance Act 2015 which states that the insurer will not be liable to pay the claim in the case of the fraudulent claim and that, with prior notice to the assured, the insurer can even terminate the insurance contract. The Insurance Act 2015 does not define the term "fraudulent claim". It was a deliberate attempt on the part of the draftsman to leave

the scope of the fraudulent claim to the courts to elaborate. The United Kingdom Supreme Court has now come to a decision that the fraudulent device does not fall within the scope of the fraudulent claim. Considering that judicial decisions from the United Kingdom remain highly influential, it is likely that courts in other common law jurisdictions may follow this path if they have to come to decide the case relating to the use of fraudulent devices.

Reference

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