

THE SUPREME COURT ABOLISHES THE FRAUDULENT DEVICE RULE

It is a well established rule that an insured who fraudulently exaggerates the amount of his claim forfeits the entire claim. However, the English Courts have recently had to consider the slightly different position where the amount of a claim is not fraudulently exaggerated, but the insured has used a “fraudulent device.” A “fraudulent device” can be a lie or false evidence to embellish a claim where the insured genuinely believes he has suffered the full loss claimed. The usual intention behind such a lie or false evidence is to expedite the payment of a claim.

In Bulletin 15/03 we reported on the case of ***Versloot v HDI Gerling***, in which the Court of Appeal held that an insured who used a “fraudulent device” forfeited the entire claim. That case has now been appealed to the Supreme Court which has overturned the Court of Appeal’s judgment and abolished the “fraudulent device” rule. The Supreme Court held that it was “*disproportionately harsh*” to prevent an insured with a genuine claim from making a full recovery just because a lie was told to embellish that claim. The Supreme Court referred to such a lie as a “collateral lie”: whilst the lie is dishonest, the claim is not.

The Background Facts of *Versloot v HDI Gerling*

The insured owned a vessel which was damaged by flooding in the engine room whilst at sea.

Prior to the claim incident, when the vessel was in a Lithuanian port in freezing conditions, the crew had used an emergency fire pump to clear ice from cargo hatches in order to enable cargo to be loaded. However, the crew then negligently failed to drain seawater from the pump and did not close a sea inlet valve. The seawater in the pump then froze and cracked the pump. When the vessel sailed, the ice in the pump melted and sea water leaked into the engine room damaging the engine beyond repair. The insured claimed approximately £2.5m under a Hull and Machinery policy due to crew negligence.

The insured used a fraudulent device to embellish the claim. The device was a letter from the insured’s General Manager embellishing the claim by telling insurers investigating the claim that the crew had reported hearing a “bilge alarm” on the day of the flooding but they did not act on it as they had negligently attributed the alarm to the rolling of the vessel.

The First Instance Decision

The Court found that the General Manager’s statement was a reckless untruth as the crew had not heard any alarm and had not told the General Manager they had heard an alarm. The aim of the General Manager’s statement was to tilt the evidence to establish crew negligence because flooding due to a different cause, such as a lack of seaworthiness, might have given insurers a defence. The judge found that the insured had to forfeit its otherwise valid claim because of its use of a fraudulent device.

The Court of Appeal's decision

The Court of Appeal upheld the position that an insured who uses a fraudulent device will forfeit its claim. The main reasons given were:

1. The rule is consistent with insurance contracts being subject to a continuing duty of good faith.
2. There is a public policy justification as insurers are entitled to protection from fraud.
3. Whilst the effect on an insured may be draconian it only applies to those who are dishonest.

The Decision of the Supreme Court

The Supreme Court held that it was *“a step too far”* and *“disproportionately harsh”* to deprive an insured of his claim just because of a lie when, in fact, the claim was always recoverable and not fraudulently exaggerated.

The Supreme Court considered there was an important difference between a fraudulently exaggerated claim and a legitimate claim supported by a fraudulent statement or evidence. With a fraudulently exaggerated claim, forfeiture is appropriate because the insured is seeking a claim payment it has no entitlement to. However, a legitimate claim supported by a fraudulent statement or evidence is an attempt to obtain the insured's actual legal entitlement.

As a result of the Supreme Court judgment, insurers now have no remedy for the fraudulent presentation of an insurance claim if the fraud was unnecessary because the claim is, and always was, recoverable.

The Supreme Court decision is controversial because it abolishes a rule that discouraged any form of dishonesty in the claims process. There was one powerful dissenting judgment in the Supreme Court, from Lord Mance, who criticised the abolition of the fraudulent device rule as a *“charter for untruth”* which overlooks *“the obvious reality that lies are told”* to have *“the claim considered and hopefully met on a false premise.”*

Risk Management Message

Whilst the fraudulent device rule has been abolished, there are still good reasons for insureds to avoid any form of dishonesty in their dealings with insurers. Not only are insurers not liable to pay fraudulently exaggerated claims (now reinforced by the Insurance Act 2015) but if an insured tells a lie during the claims process, it increases the risk of litigation: any suspected dishonesty may cause an insurer to dispute whether a claim is genuine. In addition, the insured risks an adverse costs order in any such litigation, if the Court considers the insured's lie was a significant cause of the dispute. As a broker, if you have a strong suspicion an insured is providing inaccurate information, it will always be prudent to remind the insured of the importance of providing accurate information otherwise there is an increased risk of a claim being declined.

When acting as a coverholder for an insurer different duties apply. Consideration should be given to recommending to the insurer that it change its policy wordings to establish a contractual right to decline a valid claim where a fraudulent device is used by a policyholder. The potential conflict of interest this could give rise to where a firm acts for both an insured and as coverholder for an insurer will need to be carefully managed, by using appropriate information barriers and the separation of teams.

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