Unpicking the fraudulent claims jurisdiction in insurance contract law: sympathy for the devil?

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"If one examined a sample of insurance claims on household contents, I doubt if one would find many which stated the loss with absolute truth."†

The response of most policymakers, including the judiciary, to fraudulent insurance claims has been to insist on clear, Draconian rules to deter prospective fraudsters. However, whilst the recent spate of appellate decisions, led chiefly by (now) Lord Mance, has supported this view, there is evidence of dissent. The contrary view is inspired, at least in part, by the lack of a corresponding rule to control insurer conduct during the settlement of claims. If such negotiations are to remain adversarial in nature, then the regulation of bad faith must be even-handed. This has led to moves away from a Draconian rule, in other jurisdictions (such as Australia) and in other forms of dispute settlement, including the Financial Ombudsman's Service. This article considers the tensions between these two positions, and the likely effect on future insurance practice.

I. INTRODUCTION

The prevalence of fraudulent claims against insurers has long troubled policymakers, including the English courts.[1] In 2004, the insurance industry put the level of reported insurance fraud at £200 million,[2] and estimated the total cost at £1 billion.[3] In recent cases, the public policy of deterring such offences has been reiterated by judges involved in criminal prosecutions for insurance fraud,[4] and in civil cases by and against insurers themselves.[5] This is part of a wider campaign to deter fraudulent insurance claims. Recent developments have included greater co-ordination between insurers and law enforcement

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† *Orakpo* v. *Barclays Insurance Services* [1995] 1 LRLR 443, 450, *per* Staughton LJ.

1. See MA Clarke "Lies, Damned Lies, and Insurance Claims: The Elements and Effects of Fraud" [2000] NZLR 233, 233.

2. *Post* (23 March 2005).

3. Association of British Insurers (hereafter "ABI"), *Fraud Law Reform: Consultation on Proposals for Legislation—A Response by the ABI* (ABI, 2004).

4. *R* v. *Mehboob* [2000] 2 Cr App R (S) 343 (CA). (Four-year custodial sentence for conspiracy to defraud road traffic insurers.)

5. See *AXA General Insurance* v. *Gottlieb* [2005] EWCA Civ 112; [2005] Lloyd's Rep IR 369.

agencies,[6] and a Government White Paper on fraud law reform.[7] The participants, methods and magnitude of insurance fraud are mixed. There is evidence of organized conspiracies seeking to net six figure sums and small-scale personal claim inflation.[8] Despite this width of circumstance, insurance contract law has largely sought to develop a single deterrent to all such dishonest claimants. As Mance LJ[9] stated in *AXA General Insurance* v. *Gottlieb*:[10] "the policy of the rule is to discourage any feeling that the genuine part of a claim can be regarded as safe—and that any fraud will lead at best to an unjustified bonus and at worst, in probability, to no more than a refusal to pay a sum which was never insured in the first place."

The fraudulent claims rule is an addition to the normal rules of coverage. If an entirely invented claim were discovered then the underwriter would not have to pay because contractual liability was not triggered.[11] This requires no special rule. However, the effect of the fraudulent claims rule is to extend this to partially fraudulent claims. Then, not only the dishonest part falls, but also the entire claim.

Despite the apparent simplicity of the rule, the precise legal consequences of the submission of a claim that is not entirely honest have provided a fertile ground for litigation in the appellate courts. Since the House of Lords' decision in *The Star Sea*[12] in 2001, there have been a further four Court of Appeal decisions.[13] These decisions are notable in that they seek to reconcile theories of general insurance law, general contract law and the doctrine of utmost good faith. This rapid development of principle has been led by Mance LJ, who gave the leading judgments in the recent Court of Appeal decisions in *Agnew* v. *Agapitos*[14] and *AXA General Insurance* v. *Gottlieb*.[15] This burst of judicial activity has resolved some of the academic and practical difficulties, but by no means all.

Parts II–III of this article chart the recent growth of the fraudulent claims jurisdiction, and the overt policy statements made by the judiciary during this period. Then, Part IV considers whether the law has gone too far in demonizing "dishonest" insureds, in light of recent statements by the Financial Ombudsman's Service and others. This questions whether judges have been tempted into demonizing insureds, and ignoring the possibility of insurers acting in an unethical fashion. What is not made clear by the judiciary, Mance LJ included, is why a Draconian rule of this type is to be imposed on one side to the claims process when English insurance law has failed to develop any substantive obligations on the insurance companies to observe "good faith" or avoid "bad faith". This article

6. Association of Chief Police Officers (ACPO) & ABI, *Acceptance Criteria and Guidelines for the Reporting of Suspected Fraudulent Insurance Claims to the Police* (ABI, 1999).

7. Home Office, *One Step Ahead: a 21st Century Strategy to Defeat Organised Crime* (Cm 6167, 2004).

8. See *supra*, fns 4 and 5. This mirrors empirical work in the United States. See RW Emerson, "Insurance Claims Fraud: Problems and Remedies" (1992) 46 U Miami L Rev 907.

9. Now Lord Mance.

10. *AXA General Insurance* v. *Gottlieb* [2005] EWCA Civ 112, [31].

11. Moreover, if payment had been made, the insurer could seek recovery of the monies.

12. *Manifest Shipping Co Ltd* v. *Uni-Polaris Insurance Co Ltd and others (The Star Sea)* [2003] 1 AC 469.

13. *K/S Merc-Skandia XXXXII* v. *Lloyd's Underwriters (The Mercandian Continent)* [2001] 2 Lloyd's Rep 563; *Agnew* v. *Agapitos (The Aegeon)* [2002] 2 Lloyd's Rep 42; *Direct Line Insurance* v. *Khan* [2002] Lloyd's Rep IR 364; and, most recently, *AXA General Insurance* v. *Gottlieb* [2005] EWCA Civ 112; [2005] Lloyd's Rep IR 369.

14. *Supra*, fn 13.

15. *Supra*, fn 10.

therefore concludes by exploring means by which the control of claims negotiation could be brought into balance.

II. THE MEANING OF ''FRAUD'' IN FRAUDULENT CLAIMS[16]

During the past five years, the courts have sought to clarify the circumstances in which the fraudulent claims jurisdiction will operate. Some elements have been unproblematic, such as the confirmation that a claim can become fraudulent even if it was initially presented in good faith. Thus, a claim for a lost ring will become fraudulent if the ring is subsequently discovered and the claim continues to be advanced.[17] However, these general principles have been supplemented by Mance LJ, who sought to provide a conceptual framework, linking fraudulent and inflated claims with those genuine cases tainted by the use of fraudulent devices, such as forged evidence. This has led the fraudulent claims rule to the position where it has a clear core, with a penumbra of extended cases.

The courts have been clear in recognizing that not all untruths are dishonest. This is so even where the claim is submitted for a sum above that to which the insured subjectively believes that he is entitled. This flows from an appreciation of the adversarial nature of claims settlement.[18] Most insurance claims will be settled rather than litigated. In many cases, the precise level of indemnity will not be readily identifiable on objective grounds, and will be the subject of negotiation.[19]

Judicial recognition of the adversarial nature of claims settlement is found in both *Orakpo*[20] and *Nsubuga*.[21] The insurer has access to loss adjusters and other experts in its attempts to control the final settlement. Thus, a counter-tactic of the insured will be to submit an initial figure above the true value of the loss in the expectation that it will be negotiated downwards. The most explicit discussion of this point comes in *Nsubuga*,[22] where Thomas J stated:

> as a matter of commercial reality . . . people will often put forward a claim that is more than they believe that they will recover. That is because they expect to engage in some form of "horse trading" or other negotiation. It would not generally in those circumstances be right to conclude readily that someone had behaved fraudulently merely because he put forward an amount greater than that which he reasonably believed he would recover.

16. See Clarke [2000] NZLR 233, 239–246.

17. See *Agnew* v. *Agapitos* [2002] 2 Lloyd's Rep 42, [15], *per* Mance LJ.

18. English law has rejected an obligation to negotiate or to do so in good faith as too uncertain to be enforceable. See *Walford* v. *Miles* [1992] 2 AC 128.

19. Clarke [2000] NZLR 233, 242, would appear to disagree, limiting this to "the kind of claim that is large or complex . . . or to the consumer claim, such as the large and much loved stamp collection".

20. *Orakpo* v. *Barclays Insurance Services* [1995] 1 LRLR 443, 451, *per* Hoffmann LJ. "One should naturally not readily infer fraud from the fact that the insured has made a doubtful or even exaggerated claim. In cases where nothing is misrepresented or concealed, and the loss adjuster is in as good a position to form a view of the validity or value of the claim as the insured, it will be a legitimate reason that the assured was merely putting forward a starting figure for negotiation." See also Staughton LJ at 450: "Of course, some people put forward inflated claims for the purpose of negotiation, knowing that they will be cut down by an adjuster. If one examined a sample of insurance claims on household contents, I doubt if one would find many which stated the loss with absolute truth."

21. *Nsubuga* v. *Commercial Union Assurance* [1998] 2 Lloyd's Rep 682.

22. *Ibid*, 686.

Thus, the exaggeration of a claim is merely the *actus reus*; there is a further need to show the *mens rea* of an intention to recover more than has been lost. The mental element is set at a high level by *Nsubuga*, that the level of exaggeration was so gross that "there was no basis whatsoever for the claim".[23] This is a major obstacle for the underwriter wishing to defend a claim on the grounds of fraud, and other technical defences will often be a preferred means of avoiding payment.[24] However, it should be noted that this recognition of the need for both sides to negotiate hard is not repeated in the more recent decisions of the Court of Appeal, which appear to be less tolerant of deceit. This may demonstrate a shift away from treating such behaviour as not fraudulent, by characterizing it as not *materially* fraudulent.[25]

It is apparent that a range of fraudulent actions will trigger the fraudulent claims jurisdiction. The courts have been consulted on what types of behaviour are controlled. This has proved to be less straightforward than might have been expected. At the heart of the fraudulent claims doctrine is an identifiable category of fraudulent claims proper, defined in *The Captain Panagos DP*[26] as "one which is made on the basis that facts exist which constitute a loss by an insured peril, when to the knowledge of the assured those alleged facts are untrue". This would cover situations where the loss is entirely invented, or where the loss was brought about with the insured's connivance.

However, under the extended rule, the fraud need not be part of the claim itself, but would encompass the making of false statements or the withholding of information related to the insurer's wider liability. Thus, the active withholding of information related to a defence that the underwriter might otherwise use to defeat liability falls within the fraudulent claims rule.[27] This would therefore widen the ambit to include cases where the insured fraudulently withholds information relating to a defence to a *prima facie* honest claim.

Moreover, cases where a genuine claim is supported by evidence that is known not to be true would also fall outside the definition given in *The Captain Panagos DP*. The classic example is where a genuine claim is supported by the presentation of a forged sales receipt. This has become known as the "fraudulent device". The applicability of the fraudulent claim rules to such cases was, until recently, in some doubt. However, in *Agnew* v. *Agapitos* it was proposed to treat such cases as a sub-set of the fraudulent claim proper, and to apply to them the same policy arguments and legal principles.[28] This provides a considerable breadth of circumstances to which the fraudulent claims rules will apply. This spectrum of circumstances was recognized expressly by Mance LJ in *Agnew*[29] where he stated:

> A fraudulent claim exists where the insured claims, knowing that he has suffered no loss, or only a lesser loss than that which he claims (or is reckless as to whether this is the case). 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. There may however be intermediate factual

23. *Ibid.*
24. Fraud may well be the defence of last resort, and be the motivation behind the use of defences of pre-contractual non-disclosure or breach of policy terms (such as warranties or claims conditions).
25. See the discussion of materiality, *infra*, at text to fn 45.
26. *The Captain Panagos DP* [1986] 2 Lloyd's Rep 470, 511, *per* Evans J.
27. See *Agnew* v. *Agapitos* [2002] 2 Lloyd's Rep 42.
28. *Ibid*, [45].
29. *Ibid*, [30].

situations, where the lies become so significant, that they may be viewed as changing the nature of the claim being advanced.

III. MAPPING THE FRAUDULENT CLAIMS JURISDICTION

The English courts have adopted a three-pronged approach in defining the contractual consequences of a fraudulent claim. These differing techniques demonstrate the fuzzy boundary between insurance contract law and general contract law.

The first technique, the forfeiture rule, is based upon an express or implied term of the insurance contract. When the insurance contract contains an express clause, the court's task is one of contractual interpretation. However, the implication of a term is less straightforward. Whilst this is therefore largely based on the application of "standard" principles of contract law (the implication of implied terms), the insurance context provides the justification for judicial intervention.[30] The effect of such a clause is normally to deprive the insured of the "benefit of the policy" where a claim is fraudulent. Recent case law has considered the extent to which a claim needs to be exaggerated in order to trigger the sanction, and the precise nature of the remedy.

The second technique is the invocation of the doctrine of utmost good faith. This is a specific principle of insurance contract law, and is not replicated in general contract law. The doctrine was created to adjust the informational asymmetries present during the negotiation of insurance contracts.[31] Famously, Lord Mansfield stated:[32]

> The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only: the underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge.

Despite the venerable nature of the utmost good faith doctrine, it was not clear until recently whether the doctrine had effect after the formation of the contract. The statutory codification of the doctrine, in the sphere of marine insurance,[33] was not conclusive. Whilst the Marine Insurance Act 1906 provided detailed rules relating to the duties prior to contracting,[34] s 17 merely states: "A contract of marine insurance is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party."

There are two difficulties inherent in the use of s 17 to control the submission of fraudulent claims. First, there are no guiding principles on the post-contractual duties other than the imposition of the remedy—that of avoidance *ab initio*. As this provides the insurers with a weapon of genuine power, a rule had then to be designed to limit this sanction to appropriate cases. This has proved to be no easy task for the English courts.

30. The implication of such a term where there is no express clause appears to be settled judicial practice. See *Agnew* v. *Agapitos* [2002] 2 Lloyd's Rep 42, [2], *per* Mance LJ.

31. This is manifested in a positive obligation to disclose material facts. Whilst strictly bilateral in nature, it is primarily targeted at the insured's behaviour. See H Bennett "Mapping the Doctrine of Utmost Good Faith in Insurance Contract Law" [1999] LMCLQ 165.

32. *Carter* v. *Boehm* (1766) 3 Burr. 1905, 1909.

33. This has been taken to represent the common law position for all forms of insurance and not just marine insurance. See *Pan Atlantic Ins Co* v. *Pine Top Ins Co* [1995] 1 AC 501; [1994] 2 Lloyd's Rep 427.

34. See Marine Insurance Act 1906, ss 18–20.

Secondly, requiring the judiciary to find a rule to fit a stipulated and grave remedy has placed considerable strain on judicial creativity. However, this is the consequence of the "one-off" codification of marine insurance law undertaken in 1906, and the treatment of that code as declaratory of the common law position. Rules that were not yet fully developed were frozen *in utero*. Despite this unhappy state of affairs, Lord Scott of Foscote, in *The Star Sea*,[35] said that seeking to limit the doctrine of utmost good faith to the pre-contractual sphere was "past praying for". Its impact on fraudulent claims must therefore be considered.

The third technique, the use of theories of repudiatory breach, is the least explored. Under general contract law theory, a sufficiently serious breach of contract[36] will enable the innocent party to elect whether to affirm the contract or terminate the agreement. If submission of a fraudulent claim is such a breach, then the underwriter need not rely on insurance-specific doctrines to escape liability but could terminate the agreement under general contract law principles. However, there are considerable difficulties here with timing, because, if the insurer is only discharged from liability from the moment of election,[37] and not from the date of breach itself, then the underwriter could still (in theory) be subject to the claim made, even if the contract is truncated shortly thereafter.

Although these techniques will be considered separately, they are not necessarily mutually exclusive. In particular, the effect of repudiatory breach and forfeiture may overlap, because both provide for a form of prospective diminution of the insurer's liability. In the case of forfeiture the diminution may be limited to liability for the tainted claim alone, whilst repudiatory breach will discharge all future liability. Together, they would normally relieve the underwriter of liability for both the tainted claim and all future claims.

A. The forfeiture rule

Where insurance contracts have contained a fraudulent claims clause, there has been considerable continuity in the form of words used. In 1831, in *Levy* v. *Baillie*,[38] the following clause was inserted in the policy: "And if there appear fraud in the claim made, or false swearing or affirming in support thereof, the claimant shall forfeit all benefit under such policy." A similar form of words, with the sanction given as the forfeiture of all benefit under the policy, is found in modern practice.[39] A common variation is that the claim alone is said to be forfeit.[40] For the purposes of this paper, such clauses will be considered as distinct from the doctrine of utmost good faith. A number of cases had

35. [2003] 1 AC 469, [6].

36. In English law, repudiatory breach is restricted to breach of condition or substantial breach of an innominate term.

37. It is the author's contention that election might, in some circumstances, be exercised retrospectively, ie, back to the moment of breach, but full consideration of this point is beyond the scope of this paper.

38. *Levy* v. *Baillie* (1831) 7 Bing. 349, 349; 131 ER 135. *Cf Roper* v. *Lendon* (1859) 1 EB&E 825; 120 ER 1120.

39. See, eg, *Insurance Corp of the Channel Islands Ltd* v. *McHugh* [1997] LRLR 94 ("If the claim be in any respect fraudulent or if any fraudulent means or devices be used by the insured . . . all benefit under this Policy shall be forfeited.")

40. See *Lek* v. *Mathews* (1926) 25 Ll L Rep 525, which specified that the claim would be forfeit (and not the policy).

suggested that the operation of the forfeiture rule was part of the wider relationship of good faith between insurer and insured.[41] However, the separation of these two streams appears to be the preferred view of Mance LJ in *Agnew* v. *Agapitos*.[42] This was clearly influenced by his preference for the remedy of forfeiture, rather than the fully retrospective remedy of avoidance. He proposed: "to treat the common law rules governing the making of a fraudulent claim (including the use of fraudulent device) as falling outside the scope of s. 17 [the doctrine of utmost good faith] . . . On this basis no question of avoidance *ab initio* would arise."[43]

The forfeiture rule has given rise to two major areas of difficulty: (1) the level and form of impropriety on the part of the insured required to trigger the clause; and (2) the effect of the sanction, namely the forfeiture of the benefit of the policy.

(1) The materiality and magnitude of the fraud: limiting factors on the forfeiture rule

One of the fundamental questions that the modern authorities faced was whether any level of fraudulent behaviour would trigger the forfeiture rule. The nature of the fraud could be questioned in two distinct circumstances. First, there is the issue of magnitude: if the claim was inflated by a small amount, could the underwriter still deny liability for the whole? Secondly, there is the issue of remoteness: if an indirect form of fraud was committed, how closely related to the claim does it need to be? This second factor is particularly relevant when the fraud is committed on a third party, rather than the insurer itself. When combined, these two factors provide that the fraud need be both substantial and related to the claim. However, as will be demonstrated, the courts have failed to provide a clear line on either of these two issues. Indeed, the line between what will be viewed as fraudulent, and what will be treated as fraudulent but not material, is also unclear. When combined with the earlier principle,[44] that not all exaggerations are necessarily fraudulent, we see layered *de minimis* rules in operation. The court has to be convinced that there was intent to defraud, and not merely to negotiate from a starting figure, and that the level of exaggeration was sufficiently great to be actionable, and that the fraud was material to the claim in question.

On the first point, that of magnitude, the issue was considered in *Galloway* v. *GRE*.[45] Lord Woolf MR appeared to accept a degree of tolerance of claim inflation. In *Galloway*, a claim for approximately £16,100 was inflated by the addition of an imaginary computer to the losses by theft. The value of the computer was given by the insured at £2,000. In deciding whether this permitted the forfeiture of the whole, Lord Woolf contended:[46]

> In determining whether or not the fraud is material so that it has that effect [of forfeiture], one of course has, in my judgment, to look at the whole of the claim. But if you have a claim (which admittedly here is for a much more substantial sum than the part which is fraudulent) where the part which is fraudulent is nonetheless in relation to £2,000 (which amounts to about ten per cent of the whole) that is an amount which is substantial and therefore an amount which taints the whole.

41. See *Galloway* v. *Guardian Royal Exchange* [1999] Lloyd's Rep IR 209 (CA), *per* Lord Woolf MR.
42. [2002] 2 Lloyd's Rep 42.
43. *Ibid*, [45].
44. See *supra*, text to fn 22.
45. [1999] Lloyd's Rep IR 209.
46. *Ibid*, 213–214.

This would appear to be recognition that, whilst an exaggeration of £200 would not be immaterial, some lesser sum could be. Lord Woolf did not give examples of immaterial fraud. It should be noted that he did not suggest that this minor claim inflation was not fraud, and merely "horse-trading" (as per *Nsubuga*),[47] merely that some slight frauds could be immaterial. However, this direct recognition of a tolerance was not universally supported. In *Orakpo*,[48] Sir Roger Parker argued on policy grounds that a deliberate fraud should lead to the total loss of benefit under the policy, even where no such express term was included. He did not actively support the inclusion of such a margin of appreciation. Notably, Staughton LJ specifically dissented on this ground, stating:[49]

> I am not convinced that a claim which is knowingly exaggerated in some degree should, as a matter of law, disqualify the insured from any recovery. If the contract says so, well and good—subject always to the Unfair Contract Terms Act. But I would not lend the authority of this court to the doctrine that such a term is imposed by law.

The author is not aware of any case in which the inflated portion of the claim was sufficiently small to be treated as immaterial. However, the second issue, of remoteness, has caused more practical difficulties.

The issue of remoteness and materiality was considered in *The Mercandian Continent*.[50] Longmore LJ was faced with a claim on a marine insurance liability policy following a collision. In order to gain a perceived benefit by litigating the dispute in Trinidad, rather than England, one of the officers of the insured concocted a letter purportedly from the other party to the collision. This was a crude forgery, and quickly discovered. Whilst the fraud was not directed at it, the underwriter still argued that this was a fraud related to the claim and therefore denied liability. Longmore LJ held that the fraud must be material to the claim for the forfeiture rule to apply.[51] He defined materiality by reference to two separate standards, causal relevance and repudiatory breach. First, he stated that: "the conduct of the assured which is relied on by underwriters must be causally relevant to underwriters' ultimate liability, or at least, to some defence of the underwriters before it can be permitted to avoid the policy."[52] However, he also considered that the proper test for materiality was, in his view, that "the gravity of the fraud or its consequences must be such as would enable the underwriters, if they wished to do so, to terminate for breach of contract".[53] These two measures appear to be designed to mirror the requirements for avoidance at the pre-contractual stage. The causal relevance test would appear to be an objective standard, whilst the limits of repudiatory breach would be specific to the policy in question.

This represents a substantial shift away from the approaches in *Orakpo* and *Nsubuga*. Whilst remoteness is a different element of materiality from magnitude, one might have anticipated a similar treatment of the issues. Under *The Mercandian Continent*, the

47. See *supra*, text to fn 21.
48. [1995] LRLR 443.
49. *Ibid*, 451. Staughton LJ is mistaken here—the Unfair Contract Terms Act 1977 does not generally apply to insurance contracts. However, the Unfair Terms in Consumer Contracts Regulations 1999 (and their 1994 predecessors) do apply.
50. [2001] 2 Lloyd's Rep 563.
51. *Ibid*, [37].
52. *Ibid*, [28].
53. *Ibid*, [35].

significance of the fraud was not to be measured by any external standards of morality, but by reference in part to the internal contractual standards established in the particular insurance policy in question. This appears at odds with the normative nature of public policy rules, such as the forfeiture doctrine. Given that the courts will imply a forfeiture rule even where the parties have not bargained for one, it is inconsistent then to consider the parties' express contractual terms in order to determine what will trigger forfeiture. One potential explanation is that Longmore LJ was seeking to place repudiatory breach at the heart of the fraudulent claims doctrine, at the expense of the remedy of retrospective avoidance. This is consistent with the views in *The Star Sea*[54] of Lord Hobhouse, who described avoidance *ab initio* for a failing at the claims stage as not reconcilable with principle. However, it runs contrary to *dicta* of Lord Scott, who saw the minimum level of the good faith obligation on the insured as being "that of honesty in the presentation of a claim".[55] Both these passages are *obiter*, as the claim in *The Star Sea* was not fraudulent. Moreover, none of the other Law Lords expressed their views on the point.[56]

Whatever the basis for Longmore LJ's approach, it has not been supported in the more recent Court of Appeal decisions.[57] Mance LJ suggested in *Agnew*[58] a stricter approach that appears to be of general applicability, namely:

> To treat as relevant for this purpose any lie, directly related to the claim to which the fraudulent device relates, which 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.

Here, Mance LJ combines an objectively judged *actus reus* with a subjective *mens rea*. The lie must, if believed, have provided, on an objective basis, a "not insignificant" improvement in the insured's prospects. The subjective mental element is less complex, requiring only the making of a lie "which is intended to improve the insured's prospects". This is more akin to the approach in *Orakpo* and *Nsubuga*, although with fewer caveats. There is no caution to be aware of the need to "horse trade" in negotiating the claim. The only margin of appreciation given is the concept of an "insignificant" improvement in the insured's prospects. This, it is submitted, appears to be considerably less generous to the insured than the statements by Hoffmann LJ in *Orakpo* and Thomas J in *Nsubuga*.

In conclusion, whilst the notion of a limiting factor of materiality has been subject to considerable discussion, there has been little agreement as to the precise limits of the principle. Indeed, in a number of recent Court of Appeal cases, radically different suggestions have been made. Further litigation will be needed before this issue is settled.

54. *Manifest Shipping Co Ltd* v. *Uni-Polaris Insurance Co Ltd and others (The Star Sea)* [2003] 1 AC 469, 494–495.

55. *Ibid*, 512.

56. Lords Steyn and Hoffmann agreed with both Lord Hobhouse and Lord Scott, and Lord Clyde did not express a view on the issue.

57. Indeed, in *Agnew*, Mance LJ appeared to treat *The Mercandian Continent* as close to limited to its own facts.

58. [2002] 2 Lloyd's Rep 42, [45].

(2) What benefits are forfeited?

The effect of the forfeiture rule was clarified by Lord Scott in *The Star Sea*.[59] He stated: "The presentation of a dishonest or fraudulent claim constitutes a breach of duty that entitles the insurer to repudiate any liability for the claim and, prospectively at least, to avoid any liability under the policy."[60] This rule does not depend on an express clause of the contract, and was viewed as long established. The forfeiture rule will not only operate as a defence to an initial demand for payment, but may be used to recover monies where the fraud is discovered at some later point.

However, this latter point has been subject to further scrutiny in a recent decision of the Court of Appeal. In *AXA General Insurance* v. *Gottlieb*,[61] the insureds had submitted a series of demands for indemnification, each arising from a single cause, that of water damage to the insured property. Later claims were also submitted. It was found that for the two elements of the first claim, for alternative accommodation and for some minor electrical works, the demands were fraudulent. Neither the accommodation nor the works had been provided as claimed.

Mance LJ confirmed that the effect of a fraudulent claim was not limited to the current and future elements of the claim and could operate retrospectively. Thus, earlier settlements of honest elements of the claim would be recoverable for a total failure of consideration.[62] This is distinct from the normal effect of a repudiatory breach of contract, and is closer in practice to the effect of a breach of warranty in insurance contract law.[63] This is not entirely consistent with the statement of Lord Scott, who considered that the underwriter was entitled to repudiate liability. That is the language of election and prospective repudiatory breach, and not retrospective forfeiture. This is a difficulty that insurance law has faced before, in that election and repudiatory breach often seem unsuitable for this area of law. In insurance, new substantive obligations are likely to arise between the moment of breach and the time when the innocent party discovers the breach and accepts the repudiation.[64] This explains why a partially retrospective forfeiture rule is preferred. On this basis, where part of the claim has already been validly submitted, and settled, a later fraudulent action in another part of the same claim will deprive the insured of that settlement. As Mance LJ put it:[65] "The insured may thus not only be exposed to lack of cover in respect of genuine uninsured loss which would, but for his fraud, have been insured, but also to having to repay any sum received by way of indemnity in respect of such loss before the fraud is discovered."

Mance LJ saw the *Gottlieb* approach as consistent with his desire to ensure that the forfeiture rule was an effective deterrent to prospective fraudsters, arguing:[66] "While it may be fanciful to suppose that many dishonest insureds would tailor their fraud so that

59. *Manifest Shipping Co Ltd* v. *Uni-Polaris Insurance Co Ltd and others (The Star Sea)* [2003] 1 AC 469.
60. *Ibid*, [110].
61. [2005] EWCA Civ 112; [2005] Lloyd's Rep IR 369.
62. *Ibid*, [29]–[31].
63. *Ibid*, [17].
64. See, eg, the discussion of the nature of insurance warranties as codified in the Marine Insurance Act 1906, ss 33(3), 34(3) in *Bank of Nova Scotia* v. *Hellenic War Risks Association (Bermuda) Ltd (The Good Luck)* [1992] 1 AC 233 (HL).
65. [2005] EWCA Civ 112 at [26].
66. *Ibid*, [28].

it came at the end, and after settlement of all or the bulk, of their genuine claim, insurance fraud is not uncommon and it is not impossible that some well-informed practitioners might do so." Moreover, in response to counsel's suggestion that the forfeiture rule ought to be ameliorated, he stated:[67] "This invites the question why we should in any way reduce the severity of a rule which is deliberately designed to operate in a draconian and deterrent fashion."

This decision does attempt to resolve the case on a rational basis, so that the result is independent of the particular order of events—in particular, the settlement of part of the claim and the submission of the fraudulent element. However, the precise effect of forfeiture will still depend on whether a loss is seen as giving rise to one claim with a number of heads of recovery, or several distinct claims. Mance LJ was of the opinion that only the claim in question should be forfeited and not other claims.[68] However, he did not find conclusively on this point.

B. The doctrine of utmost good faith in the post-contractual phase

Prior to the House of Lords' decision in *The Star Sea*,[69] much of the discussion of the continuing nature of the doctrine of utmost good faith was found in *obiter* comments in lower courts. However, there was a consistent pattern of judicial comment indicating that the principles of utmost good faith should not end at the moment of contracting, but could influence contractual performance. The explanation for this was clearly expressed by Lord Woolf MR in *Galloway*,[70] when he stated: "Just as the nature of the risk will usually be within the peculiar knowledge of the insured, so will circumstances of the casualty, it will rarely be within the knowledge of the insurance company."

This links the informational asymmetries identified by Lord Mansfield[71] in contract formation with the modern litigation arising out of claims settlement. In each case the insured is perceived as being in a privileged position, which needs to be equalized by the forced transfer of relevant information. The difficulty of linking a duty regulating contractual performance to a principle of contract formation was that the remedy for breach of the umbrella doctrine—utmost good faith—was stipulated in the marine insurance legislation as avoidance of the contract. Such a remedy is normally reserved for vitiating factors, such as misrepresentation, and not for failures in contractual performance. The severity of this remedy of avoidance when employed for breach of contract was not lost on the House of Lords in *The Star Sea*.[72] Indeed, the grave nature of the remedy led the House to doubt whether avoidance *ab initio* was justified even for the submission of a fraudulent claim. Lord Hobhouse stated:[73]

An inevitable consequence in the post-contract situation is that the remedy of avoidance of the contract is in practical terms wholly one-sided. It is a remedy of value to the insurer and, if the defendants' argument is accepted, of disproportionate benefit to him; it enables him to escape

67. *Ibid*, [31].
68. *Ibid*, [22].
69. [2003] 1 AC 469.
70. *Galloway* v. *Guardian Royal Exchange* [1999] Lloyd's Rep IR 209, 212 (CA).
71. See *Carter* v. *Boehm* (1766) 3 Burr. 1905, 1909.
72. *Manifest Shipping Co Ltd* v. *Uni-Polaris Insurance Co Ltd and others (The Star Sea)* [2003] 1 AC 469.
73. *Ibid*, [57].

retrospectively the liability to indemnify which he has previously and (on this hypothesis) validly undertaken

Having found on the facts of the case that the non-disclosure was not fraudulent, the issue did not need to form part of the *ratio* of the case. Lord Scott recognized that the forfeiture provided an alternative model for regulating fraudulent claims:[74]

The presentation of a dishonest or fraudulent claim constitutes a breach of duty that entitles the insurer to repudiate any liability for the claim and, prospectively at least, to avoid any liability under the policy. Whether the presentation of such a claim should be regarded as a breach of a continuing duty under section 17 that entitles the insurer to avoid the policy *ab initio* with retrospective effect, enabling any payments made in satisfaction of previous unimpeachable claims to be recovered by the insurer is more debatable. It is not necessary in this case to decide this point.

The diminution of the significance of the doctrine of utmost good faith as a mechanism for regulating fraudulent claims has been supported by Mance LJ in recent cases. The selection of regulatory principle would appear to be almost entirely motivated by a desire to ensure that the appropriate remedy is applied. As he has proposed:[75] "To treat the common law rules governing the making of a fraudulent claim (including the use of fraudulent device) as falling outside the scope of s. 17 . . . On this basis no question of avoidance *ab initio* would arise." Indeed, the judicial reluctance to impose avoidance *ab initio* has been reflected in the defences raised by insurers in subsequent decisions. In *AXA* v. *Gottlieb*, the underwriter sought to defend the claim on the basis of the forfeiture rule alone, and no reference was made to the doctrine of utmost good faith.

C. Repudiatory breach

The recent decision of the Privy Council in *Super Chem Products Ltd* v. *American Life and General Insurance Co Ltd*[76] has confirmed that an insurer can defend payment on a claim on the alternate grounds that the policy is forfeit for fraud and that other contractual defences apply. On this basis, the insurer is free to claim that the claim has been forfeited and that the contract has been terminated prospectively, if the actions of the insured constitute a repudiatory breach. This is significant, as it enables insurers to rely both on the defence of fraud and on contractual defences. To defeat the claim, insurers are likely only to need succeed on one ground. Even if this combination is sought, the remedy of forfeiture of the claim is akin to the discharge for breach, in that secondary obligations (such as arbitration clauses) would continue to bind the parties. The interpretation placed on this by Friedmann was that the claim is merely avoided automatically, and the underwriter must elect to terminate prospective liability.[77] Mance LJ did not decide this point expressly in *AXA* v. *Gottlieb*,[78] but does confirm that the effect of forfeiture is complete loss of the claim, even where part has already been settled. This restricts repudiatory breach to a secondary role in combating fraudulent claims. If repudiation, and

74. *Ibid*, [110]–[111].
75. *Agnew* v. *Agapitos*, (*The Aegeon*) [2002] 2 Lloyd's Rep 42, [45].
76. [2004] UKPC 2; [2004] Lloyd's Rep IR 446.
77. D Friedmann, "Contract Law and the Law of Insurance" (2004) 120 LQR 407, 410.
78. This issue is likely to be tested in practice. The author is aware of at least one dispute with these facts, where an honest claim followed a purportedly fraudulent claim, since the decision in *Gottlieb*.

consequent discharge from primary obligations, is dependent on an election from the insurer, then that election can only be made after the fraudulent claim has been submitted. The orthodox view is that this would enable the insurer to deny liability for any later claims, even if honest, but would not affect liability for the claim in question.[79]

D. Summary

(i) The English rule on fraudulent claims has a series of legal bases, but most prevalent is the forfeiture rule.
(ii) The forfeiture rule does not depend on an express contractual term to have effect. However, express terms may go beyond the common law rule.
(iii) The forfeiture principle is predominantly a public policy rule, and is avowedly Draconian in nature, in order to deter fraudulent claims.
(iv) The fraudulent claims rule applies to a range of dishonest activities, and includes both fraudulent claims and fraudulent devices. However, the line between "honest horse-trading" and "dishonest claim inflation" may be extremely difficult to draw in practice.
(v) The fraud must be material to the claim. The precise limits of materiality are uncertain.
(vi) The effect of forfeiture is to discharge liability for the claim. This will include elements of the claim that have already been settled, even if they were honest and the fraud post-dates the settlement. Forfeiture does not have full retrospective effect, as earlier claims are unaffected. It does not necessarily bring future performance of the contract to an end.

To gain a full appreciation of the proper ambit of the fraudulent claims jurisdiction, we need to consider the extent to which there are reciprocal duties on the insurer properly to handle and pay claims. As we will see, the underwriter is not subject to a detailed "good faith" or "bad faith" rule. Moreover, even if the continuing duties of utmost good faith considered above are applied bilaterally, the remedies provided (forfeiture or avoidance *ab initio*) are unlikely to assist insureds. This imbalance in insurance contract theory, and possible remedial steps, are the focus of the remainder of this article.

IV. SYMPATHY FOR THE DEVIL: A CRITIQUE OF THE EXTENDED FRAUDULENT CLAIMS RULE

The avowedly Draconian response to the submission of a fraudulent claim can be criticized on two grounds. First, that too great a focus is placed on bad faith by the insured, without corresponding controls on *insurer* bad faith.[80] Secondly, that deterrence is not the

79. *Insurance Corp of the Channel Islands Ltd* v. *McHugh* [1997] 1 LRLR 94, 134.

80. It is recognized that the development of the bad faith doctrine in US insurance law has not been entirely unproblematic. See KS Abraham, "The Natural History of the Insurer's Liability for Bad Faith" (1994) 72 Tex L Rev 1295. This means only that we should not import their rule without careful consideration, not that we should not have such a rule at all.

only relevant policy factor, and that wider considerations would permit a more sophisticated regime to be implemented.

A. Towards a bilateral "bad faith" claims jurisdiction: controlling insurer bad faith

The discussion above assumed that the insured alone would be guilty of bad faith conduct. However, there are examples of insurers and their representatives behaving in a similarly disreputable fashion. It is apparent that judges have been far less willing to impose Draconian rules to control opportunistic behaviour by insurers.

In *Sprung* v. *Royal Insurance*,[81] the claimant had two insurance policies over the contents of his business premises. The first policy (the theft policy) provided insurance against, *inter alia*, the contents being "lost, destroyed or damaged by theft or attempted theft". The second policy covered "sudden and unforeseen damage . . . which necessitates immediate repair or replacement of the Plant before it can resume normal working". During the weekend of 5–6 April 1986, electrical equipment at the premises was damaged by thieves or vandals. One part of the subsequent claim was paid promptly, but the remainder remained unpaid. Under the terms of the second policy, Sprung was unable to repair the extensive damage to the electrical equipment without the consent of the insurers. This caused considerable disruption to Sprung's business, which eventually failed. The delay in payment by Royal Insurance caused considerable additional losses to Sprung. The trial judge found that the claim should have been paid by 31 October 1986 at the latest. The indemnity was finally paid following a court order in March 1990. The claimant sought further compensation for consequential damage to his business, estimated at £75,000.

The Court of Appeal in *Sprung* confirmed that the compensation under an indemnity insurance policy was a claim for unliquidated damages. Evans LJ considered himself bound by the principle in *President of India* v. *Lips Maritime Corp (The Lips)*[82] that "There is no such thing as a cause of action in damages for late payment of damages". Lest it be thought that this is an approach with which Mance LJ disagrees, he confirmed this principle, for non-liability insurance at least, in *Gottlieb*. On this basis, Sprung was entitled to claim interest from the date from which the claim should have been paid, but not for consequential losses. This demonstrates a remarkably different approach to bad faith conduct than that expressed in the fraudulent claims jurisdiction. The deliberately false statements by the representatives of the insurer that Sprung was not covered for wilful damage did not attract any substantive sanction. This is close to the position that Mance LJ argued could not be allowed to stand. In *AXA* v. *Gottlieb*,[83] Mance LJ stated: "the actual rationale of the rule of law relating to fraudulent claims is that an insured should not have the settled expectation that, even if the fraud fails, he will lose nothing."[84]

Following *Sprung*, loss adjusters and insurers have the settled expectation that, if they deny liability without good cause, there is no effective sanction. If the policy of deterrence

81. [1999] 1 Lloyd's Rep IR 111.
82. [1988] AC 395, 425A; [1987] 2 Lloyd's Rep 311, 317, *per* Lord Brandon of Oakbrook.
83. [2005] EWCA Civ 112, [26].
84. *Ibid*, [28].

is to be given full effect, a comparable rule must be created to penalize insurer bad faith. Such a rule exists in many other common law jurisdictions, but not in English law.[85] For Lowry & Rawlings,[86] this would derive from a truly reciprocal doctrine of utmost good faith:

> The deficiencies in the existing remedies for the commercial insured as well as the desirability of a coherent legal regime point to the need for a root-and-branch reform of the law. At the minimum, it requires the English judiciary to take a broader view of the duty of utmost good faith by giving full effect to the reciprocity of the doctrine.

However, just as the forfeiture rule operates outside the utmost good faith framework, so could a reverse forfeiture rule that imposes damages for consequential loss on underwriters.[87] If negotiating stances beyond mere "horse-trading" are to be deterred, then the rule must be applied to both sides to the negotiations. The creation of a rule of law to this effect in the United Kingdom must be some way off. It remains a source of controversy in other common law jurisdictions.[88] Whilst the Law Commission has a current interest in insurance contract law,[89] there is no guarantee that its proposals will be followed.[90] Moreover, judicial reform of the rule in *Sprung* was hoped for following the granting of leave to appeal to the House of Lords in *Pride Valley Foods Ltd* v. *Independent Insurance*[91] but the case settled before reaching the House.[92]

There is, however, some evidence of a nascent consequential damages rule in the practice of the Financial Ombudsman's Service.[93] In resolving cases of consequential losses following insurer misfeasance in resolving claims, the Ombudsman noted the lack of clarity in the application of the existing case law to the recovery of damages for distress and inconvenience.[94] Notwithstanding the legal position, the Ombudsman took the view that such damages could be awarded on the basis of good practice. He paid close attention to the Financial Services Authority's rules on claims handling as evidence of good practice.[95] Rule 7.3.1 requires insurers to handle claims "promptly and fairly". This is then clarified, with differing standards according to the level of sophistication of the

85. See further J Lowry & P Rawlings, "Insurers, Claims & the Boundaries of Good Faith" (2005) 68 MLR 82.

86. *Ibid*, 109.

87. Full treatment of the availability of damages beyond the normal indemnity rules is beyond the scope of this paper, but consideration might be given to the application of *AG* v. *Blake* [2001] 1 AC 268 to insurance contracts.

88. See in relation to Australia, S Drummond, "Damages for consequential loss when the insurer fails to pay" (2005) ILJ Lexis 8 and R Andrew, "Exceeding the limits of indemnity: Consequential damages and repudiation of insurance policies" (2005) ILJ Lexis 7.

89. A "scoping paper" is due in early 2006. See *http://www.lawcom.gov.uk/insurance contract.htm*.

90. The Law Commission report from 1980, *Insurance Law*: *Non-Disclosure and Breach of Warranty* (Report No. 104, 1980 Cmnd 8064) was not implemented in law, though it influenced the creation of the Insurance Ombudsman scheme.

91. [1999] Lloyd's Rep IR 120.

92. See J Birds & N Hird, *Modern Insurance Law*, 6th edn (2004), 271. A further opportunity may arise following *Mandrake Holdings Ltd and another* v. *Countrywide Assured Group Plc* [2005] EWCA Civ 840.

93. FOS, "Awards for non-financial loss" (November 2001) and FOS, "Awards for non-financial loss: case studies" (November 2001). These are available in the briefing notes section on the publications list on FOS website, *http://www.financial-ombudsman.org.uk/*.

94. One question being whether insurance falls within the exception to the general principle, as a contract to "provide pleasure, relaxation or peace of mind", citing *Watts* v. *Morrow* [1991] 1 WLR 1421.

95. See Financial Services Authority, *Chapter 7: Claims Handling in Insurance: Conduct of Business* (hereafter, ICOB), part of the *FSA Handbook* (Release 46, September 2005).

insured.[96] The response of the Ombudsman to this was that the granting of consequential loss damages of more than £1,000 was to be viewed as "exceptional". However, it had been utilized in a case where the insurer failed properly to resolve a subsidence claim over a period of five years.[97] Whilst this rule is targeted as misfeasance, it must *a fortiori* provide a basis for the resolution of malfeasance in claims handling. The question remains, however, whether such principles will spread from "soft law" fora such as the Ombudsman to the courts. If we are not to grant extended remedies to the insured, then we might seek a balance by reducing the severity of the existing fraudulent claims doctrine. This could be achieved by, first, amending the substantive rules—by restricting what will be considered actionable fraud—or, secondly, by ameliorating the remedy given to the insurer. Examples of both types of reform are considered below.

B. Balancing priorities: a proportional regime for insurance fraud

In practice, the vast majority of insurance claims are settled rather than go to trial.[98] The measure of indemnity to be granted to the insured is therefore a matter for negotiation, and will be based on principles of commercial as well as legal principle. Under a peculiarity of English insurance law, the insured's indemnity is normally measured in damages for the insurer failing to prevent the loss.[99] Thus, insurance contracts protect the expectation that the risks covered by the policy will not occur. As will be demonstrated, this means of measuring the indemnity leads to a number of difficulties in theory and practice.

In some cases, the level of indemnity will be fixed by the policy, or otherwise objectively determinable, but this will not always be true. The settlement of an insurance claim therefore often involves the parties' negotiating the appropriate level of indemnity. This will often involve complex issues of causation, valuation and contractual interpretation. One example of the difficulty of measuring the insured's loss is the destruction of buildings under the insurance of real property. In this case, the loss to the insured could be measured by the cost of reinstatement, or by the cost of sale or by a number of other mechanisms.[100] This reflects wider difficulties in the law of contract generally on the protection of the expectation interest.[101] On this basis, the negotiation of claims, rather than immediate payment, would seem to be predictable in a significant percentage of cases.

We can add to this that the courts appear to be prepared to turn a blind-eye to hard bargaining and "horse trading", as suggested in *Orakpo* and *Nsubuga*. If this is so, then there is at least tacit recognition that "bending" the truth is a part of the commercial process. What is not clear is why all dishonest behaviour by insureds should then necessarily trigger the Draconian response of forfeiture. If a claim for £10,000 is inflated by £200, should the underwriter pay nothing? Similarly, if a claim for £10,000 is supported by a forged receipt, the original having been lost, should the underwriter pay nothing? If the answer to both is yes, then any opportunistic behaviour by a claims

96. *Ibid.* See, in particular, the rules described in ICOB 7.3 and 7.5.
97. See Case N in FOS, "Awards for non-financial loss: case studies", *supra*, fn 93.
98. J Mance, I Goldrein & R Merkin (eds) *Insurance Disputes*, 2nd edn (LLP, 2003), [10.150].
99. See *supra*, fn 82.
100. See *Leppard* v. *Excess Insurance Co* [1979] 1 WLR 512.
101. See *Ruxley* v. *Forsyth* [1996] AC 344.

manager should be similarly penalized. As we shall see, the Financial Ombudsman's Service was highly critical of insurers' relying on strict proof as a means of avoiding paying valid claims.[102] Unless and until this divergence in approach is resolved, the courts should consider a less stringent approach.

One such example can be found in the Australian legislation. Having inherited English insurance law, Australia has spent the last 25 years rewriting those insurance principles.[103] On fraudulent claims, we find a modified forfeiture rule that incorporates a judicial discretion.[104] Section 56 of the Australian Insurance Contract Act 1984 provides:

> (1) Where a claim under a contract of insurance, or a claim made under this Act against an insurer by a person who is not the insured under a contract of insurance, is made fraudulently, the insurer may not avoid the contract but may refuse payment of the claim.
> (2) In any proceedings in relation to such a claim, the court may, if only minimal or insignificant part of the claim is made fraudulently and non-payment of the remainder of the claim would be harsh and unfair, order the insurer to pay, in relation to the claim, such amount (if any) as is just and equitable in the circumstances.
> (3) In exercising the power conferred by sub-section (2), the court shall have regard to the need to deter fraudulent conduct in relation to insurance but may also have regard to any other relevant matter.

This does not do away with the desire to deter insurance fraud—indeed it is the only policy factor expressly mentioned—but it does provide the courts with the opportunity to measure the sanction to the appropriate level of fraud. Whilst such discretions are often attacked as creating uncertainty and forcing unnecessary litigation, this assumes that it will not simply provide a basis for insurers to make an offer to the claimant, with a suitable deduction. It is perhaps unlikely that many claimants will sue to challenge a reasonable offer, when an integral part of the court action would be to consider evidence of their own fraud. However, it does reduce the chilling effect of the current forfeiture rule. At present, any material fraud reduces the claim to nil. Whilst s 56 recognizes that total forfeiture will be the default position, it does permit variance to deal with hard cases.

There is further support for a more proportionate response in English insurance practice through the Financial Ombudsman's Service.[105] The Ombudsman has jurisdiction to hear cases from consumers and small businesses.[106] Whilst the Ombudsman has the advantages of being quicker and less costly than litigation, the prime advantage for the complainant is that cases are resolved on the basis of a mixture of law and good practice. Thus, the judges (and perhaps Mance LJ in particular) no longer have total policymaking control over the deterrence of fraudulent claims. To the extent that the Ombudsman feels that the law varies from good practice, the good practice will prevail. This is an important demarcation of responsibility, as a recent poll indicated that small and medium enterprises

102. See *infra*, text to fn 109.

103. The author would admit that, in his view, the Australian reforms were a curate's egg. However, it would be desirable to replicate the process of Australian reform, if not all of its conclusions, in the UK.

104. For further consideration of this provision, see *Walton* v. *Colonial Mutual Life Assurance Society Ltd* [2004] NSWSC 616.

105. See *www.financial-ombudsman.org.uk*.

106. For these purposes, small businesses are those with less than £1 million turnover in the year of the dispute.

are more likely to commit insurance fraud.[107] Thus, the entities most likely to need to be deterred do not fall squarely within the ambit of the courts.

The forfeiture rule which is now at the centre of the courts' attempt to deter insurance fraud has received little support from the Ombudsman. He has stated:[108] "It was deemed to be a matter of public policy that dishonest policyholders should not be able to recover any of their losses . . . However, we have long considered the application of this rule to be unnecessarily harsh."

This would suggest that the Ombudsman is more inclined to adopt the Australian rule than the English. The Ombudsman was particularly critical of the application of the forfeiture rule to fraudulent devices. In particular, reference was made to the common example of a forged receipt being advanced as evidence for an otherwise honest claim. In such cases, the Ombudsman was often prepared to impose no sanction on the insured. This goes beyond merely amending the remedy, to a finding that such actions are not always actionable fraud, at least before the Ombudsman. In allocating responsibility for the forged receipt, it was said:

> A classic example is where the policyholder has lost the receipt for a stolen item and, facing pressure from the insurer, produces a forged receipt to try to substantiate the claim . . . In the example given above, of the forged receipt, the claim should be paid. Indeed, it was the *insurer's unreasonable insistence* on strict proof that *caused* the policyholder to act dishonestly in the first place.[109]

This examination of the reasonableness of the demands of the insurer, and the weighing of these demands against the fraud, shows that the Ombudsman's view of what constitutes good insurance practice differs considerably from that of the courts. The Ombudsman has not been prepared to allow the insurer to defeat the claim where the claim itself was honest but was merely supported by invented evidence. This is exemplified by one of the case studies provided by the Ombudsman. In *Case 42/3*,[110] the policyholder suffered two losses—one in January and the other in May. The first loss was unproblematic and paid by the insurer. In the course of the second claim, the insurer required all original purchase receipts to substantiate the claim. The policyholder had a friend fake a receipt for him. The insurer sought to avoid the policy *ab initio*, and demanded repayment of the January claim. The Ombudsman stressed that the policyholder was not trying to obtain something to which he was not entitled. The decision was that "the fair and reasonable solution was for the insurer to reinstate the policy and pay the claim".[111] Moreover, it denied the availability of avoidance *ab initio* as a remedy even for fraudulent claims. The maximum sanction was forfeiture of the policy from the date of the fraud.[112]

However, in cases where the insured had sought to claim for something for which they knew they were not entitled, the Ombudsman has denied the claims.[113] This appears to provide the "line in the sand" for good insurance practice.

107. "Conference News", in *Post* (17 March 2005).
108. Financial Ombudsman's Service, *Ombudsman News*, Issue 41 (September 2004), 8–9.
109. *Ibid* (author's emphasis).
110. Financial Ombudsman's Service, *Ombudsman News*, Issue 42, (December 2004/January 2005), 8–10.
111. *Ibid*, 9.
112. *Ibid.*
113. See *Cases 42/4* and *42/5*: Financial Ombudsman's Service, *Ombudsman News*, Issue 42 (December 2004/January 2005), 9–10.

V. CONCLUSION

The fraudulent claims rule does nothing to deter those who make entirely fraudulent claims. Not only is the threat of criminal sanction present, but also the underwriter cannot be called upon to meet such a claim even without additional rules. There has been no loss, and therefore, no valid claim. The harder cases, where the claim is only partially fraudulent, or supported by forged evidence, do not seem to be sufficiently homogeneous to attract the imposition of a single Draconian penalty. The approaches of the Australian statutory code, and the Ombudsman, seem to provide the necessary degree of proportionality. If a disproportionate rule were to be maintained on the grounds of deterrence, then insurer bad faith would need to be similarly deterred. Ultimately, we must recognize that very few potential fraudsters will be deterred by the rule because they will not be aware of it. Any larcenous professors of insurance law who would understand it in detail might be clever enough not to get caught. If we are not to simply leave the parties to regulate their own affairs, then we must create rules that require both parties to negotiate within the boundaries of commercial morality. It should be remembered that almost all of Draco's laws were repealed by his successor.[114] This, also, is a lesson for the modern lawmaker.

114. MacDowell, "Draco", in Hornblower and Spawforth (eds), *The Oxford Classical Dictionary* (Oxford University Press, 2003).