devereux

# INSURANCE/REINSURANCE

## COVERAGE TIPS AND TRAPS

RICHARD HARRISON

**Handling Professional Indemnity Coverage Issues in Cases of Suspected Fraud**

'Nothing is so difficult as *not* deceiving oneself.' — Ludwig Wittgenstein

1. The receding tide of the money supply has exposed many longstanding frauds and has spawned new frauds in its wake. Sophisticated frauds often involve professionals whose involvement may be conscious or unwitting. Professional indemnity insurers are often the only deep pockets offering the prospect of redress for claimants. This seminar covers recent developments affecting the handling of claims involving frauds on third parties which the insured professional is suspected to have committed or condoned. It does not concern fraudulent insurance claims.

**What is fraud ?**

2. In this context fraud and dishonesty usually go hand in hand, though they are capable of distinction. Fraud in this context includes misappropriation[1] and fraudulent representation amounting to the tort of deceit - i.e. a statement made knowing that it is untrue, without believing it to be true or made recklessly as to whether it is true or false.

[1] Including, but not limited to offences under the Fraud Act 2006

3. Dishonesty includes fraud but is a wider concept, apt to include a variety of activities by which a professional might facilitate fraud by others. It includes the accessory liability of a person liable for dishonest assistance in a breach of trust and condoning the fraud or dishonesty of another.

4. The courts have wavered as to the element of subjectivity required to satisfy the test of dishonesty. Is it necessary for the individual to realise that by ordinary standards his conduct is dishonest? Or is it sufficient that he has knowledge which, if held by a person with ordinary standards such a person would know that their conduct was dishonest?

5. The balance of the authorities currently favours a more "objective" view of the subjective element of dishonesty "*although a dishonest state of mind is a subjective mental state, the standard by which the law determines whether it is dishonest is objective. If by ordinary standards a defendant's mental state would be characterised as dishonest, it is irrelevant that the defendant judges by different standards*."[2] This was the test applied by Newey J in *Abdul Khudairi & Salaam v Abbey Brokers & Others* [2010] EWHC 1486.

6. The reference to the "defendant's mental state" provides the subjective element. The enquiry is to be conducted by reference to someone of similar intelligence, experience and general attributes as the defendant, putting aside any "warped" conceptions the defendant may have of what amounts to dishonesty.

---

[2] Arden LJ in *Abou- Rahmah v. Abacha* [2007] 1 Lloyd's Rep 115, para 59(a), applied by Newey J in *Abdul Khudairi & Salaam v Abbey Brokers & O's* [2010] EWHC 1486 (mortgage broking company liable for misappropriation of loan advances by director). See further *Royal Brunei Airlines v Tan* [1985] 2 AC 378; *Twinsectra v. Yardley* [2002] UKHL and *Barlow Clowes v. Eurotrust* [2006] 1 WLR 1476. A more "subjective" approach was applied in *Bryant v. Law Society* [2007] EWHC 3043 Admin (solicitor's misconduct). In *Starglade Properties Ltd v Roland Nash & Warners Law LLP* [2010] EWHC 148 (Ch) & [2010] EWCA Civ 1314 Nicholas Strauss QC found that a director was not dishonest because not all "normal people" would regard his conduct - unlawful preferential payments of creditors - as dishonest. The Court of Appeal overturned his decision – it was for the Court to determine the standard and the deliberate removal of assets intended to defeat a claim of another creditor was not honest by "ordinary standards of commercial behaviour"

7. Blind-eye knowledge – a suspicion of fraud or dishonesty combined with a conscious decision not to make inquiries for fear of confirming the suspicion[3] - is sufficient to amount to dishonesty. It is often this form of knowledge that gives rise to difficult judgments as to which side of the line a professional's conduct falls.

8. An accessory need not know the full facts of the fraud or dishonesty that they are involved with:

> "*It is not necessary that he should have been aware of the precise nature of the fraud or even of the identity of its victim. A man who consciously assists others by making arrangements which he knows are calculated to conceal what is happening from a third party, takes the risk that they are part of a fraud practised on that party*"[4]

> "*Someone can know, and can certainly suspect, that he is assisting in a misappropriation of money without knowing the money is held on trust or what a trust means…*"[5]

9. Similarly, when considering what amounts to condoning "*dishonesty or a fraudulent act or omission"* it is not necessary for the insured to be aware of the specific fraudulent acts or omissions giving rise to liability. It is sufficient if the insured condones a general course of dishonest or fraudulent conduct which "*leads to or permits*"[6] the specific acts of omissions upon which a claim is based: *Goldsmith v Travelers Insurance Company* [2010] EWHC 26.

**Composite Cover**

---

[3] As explained by Lord Scott in *Manifest Shipping v Uni-Polaris Co Ltd* [2003] 1 AC 469

[4] Rix LJ in *Abou- Rahmah v. Abacha* [2007] 1 Lloyd's Rep 115, para 38, citing the words of Millet J in *Agip (Africa) Ltd v Jackson* [1990] Ch 265.

[5] *Barlow Clowes v. Eurotrust* [2006] 1 WLR 1476, para 28, per Lord Hoffmann.

[6] Per Wyn Williams J at paragraph 97, applying *Zurich Professional v Karim* [2006] EWHC 3355

10. Public policy prohibits insurers indemnifying fraudulent parties against liability for their own fraud. This is usually backed up by express policy terms excluding cover for such liability. However, parties innocent of fraud can be indemnified against their liabilities arising from fraud. Such cover is provided by most forms of modern professional indemnity policy. This will often be apparent from drafting techniques such anti-avoidance clauses. There are some forms of policies which, at first sight, might appear to exclude cover for all losses arising from fraud or to allow insurers to avoid the policy in reliance on the non-disclosure of the activities of fraudulent insured parties. However, most professional indemnity policies will be construed as providing composite rather than joint cover[7].

11. This approach treats the policy as a bundle of severable contracts with each individual insured. If the policy is composite, rather than joint, breaches of duty or of the terms of the policy by one insured will not (subject to express terms to the contrary) affect the rights of the other insured entities or parties, unless they were parties to those breaches or knowledge of such breaches can be attributed to them. As Rix J (as he then was) explained in *Arab Bank plc* v. *Zurich Insurance Co* [1999] 1 Lloyd's Rep 262:

> *"…the rule in principle in the case of a composite policy is that the breach of the duty of good faith by one assured is not automatically to be laid against another innocent assured…*
>
> *It is I suppose a possible, albeit unlikely and exceptionally draconian remedy, for which underwriters might stipulate, that the whole policy should be forfeit for any fraud by any insured: but as the authorities on composite*

[7] Applying the reasoning set out by Staughton LJ in *New Hampshire Insurance v MGM* [1997] 1 LRLR 24 at, p.57 Col 1 and followed by Rix J in *Arab Bank plc* v. *Zurich Insurance Co* [1999] 1 Lloyd's Rep 262. If a policy does exclude liability for all losses arising from fraud, including those of an innocent insured liable for the fraud of another, the claim will be excluded even if it could be pursued in negligence only *West Wake* v. *Ching* [1957] 1 WLR 45 at 58, *per* Devlin J.

*policies cited above demonstrate, the Court will not in the ordinary case construe a composite policy as being rendered potentially valueless let alone completely destroyed by the fraud of only one insured. If, therefore, underwriters wish to stipulate for such a draconian remedy, they should make their intent perfectly clear."*

12. So, as a rule of thumb, if a policy is composite in nature the activities of a fraudulent insured are unlikely to deprive the innocent insured of the cover provided by their severable contract. However, care must be taken in each case to construe the policy according to its terms and to analyse the attribution of knowledge.

**Coverage for losses arising from fraud**

13. Innocent insureds may be liable for fraud by virtue of :

    (a) vicarious liability for the fraud of fellow partners[8], employees, or directors. If a fraud is conducted within the scope of the ostensible authority of those involved, and the third party claimant relies on that authority to his detriment, the innocent partners or employing company will be liable for the losses caused by fraud. Vicarious liability will also attach if the fraud is an unauthorised manner of conducting an authorised act;[9]

[8] Liability under s.10 of the Partnership Act 1890.

[9] cf *Hornsby v Clark Kenneth Leventhal* [1998] PNLR 635, which provides an example of claimants who were on notice that the fraudulent employee was not acting within the scope of his employment.

(b) freestanding negligence or breach of contract - e.g. on grounds that innocent insureds have negligently failed to prevent or detect the fraud.[10]

14. Most professional indemnity policies will include cover for both these categories of liability. Some may exclude the first category or even both categories (e.g. if a separate cover or extension is offered for liabilities arising from fraud and dishonesty) or impose restrictions (e.g. limiting cover after fraud was first discovered).

**Insurers' liabilities for claims arise from fraud**

15. With larger insured partnerships or companies the extent of the fraud or dishonesty within the insured organisation may only be relevant to the insurers' claims for reimbursement from those involved in the fraud. However, in the case of smaller insureds there may be a prospect of insurers avoiding liability altogether if knowledge of the fraud or dishonesty permeates widely enough.

16. In the case of a partnership, when deciding how widespread such knowledge needs to be it may be necessary to distinguish between true partners (within the meaning of the Partnership Act 1890) and mere employed partners (who may have ostensible authority as partners but not actually be partners). If a claim is made solely against the firm, and not personally against partners with mere ostensible authority, cover can be declined if all the true partners have at least blind-eye knowledge of the fraud or dishonesty, or have otherwise condoned it.

[10] *Abdul Khudairi & Salaam v Abbey Brokers & O's* [2010] EWHC 1486 - mortgage broking company liable for misappropriation of loan advances by a director on grounds of breach of contract in not paying the loan as directed.

17. The distinction between true partners and mere employed partners is outside the scope of this seminar, but can often involve a complex factual enquiry. On true construction of the agreement between the alleged partners a salaried partner who otherwise appears to be a mere employee may be a true partner.[11]

18. If salaried "partners" are not true partners under any express or implied partnership agreement, they are mere employees. As such, they would only liable if sued personally:

    (a) in respect of the advice or assistance he/she provided personally (a direct claim for personal breach of duty);

    (b) if a claimant proves that it relied on the salaried partner allowing himself to be held out as such. This is a clam pursuant to s.14 of the Partnership Act 1890.[12] The burden of proving reliance would be on the claimant, as the party relying on an estoppel.[13]

19. In normal circumstances it would not be difficult, especially for a new client of a firm, to prove that it relied on the partnership status of all the partners of a firm. The client will have seen the firm's letterhead and may have been comforted by reading the list of partners before instructing and acting on advice. However, the firm may have expanded since the client first instructed

[11] Even if other factors point against a true partnership, the fact that the parties intended the partnership to fulfil a Law Society practice rule, which could only be satisfied by a true partnership, may be sufficient to render their relationship a true partnership: *Ogden Lees v M Young Legal Associates & Bahir & others* [2006] EWCA Civ 613. Para 37 Wilson LJ : "*In that the two men intended to comply with rule 13, they must have intended to enter into a contract of partnership. I believe that the judge was entitled to infer, indeed correct to infer, that, notwithstanding the nature of the provisions for the firm's payment to Mr Lees and for the absence of a contribution on his part to its capital, they succeeded in implementing their intention*."

[12] "Everyone who … represents himself, or who knowingly suffers himself to be represented, as a partner in a particular firm, is liable as a partner to anyone who has on the faith of any such representation given credit to the firm …"

[13] *Nationwide Building Society v Lewis* [1998] 2 WLR 915, at 922H-923B, per Peter Gibson LJ

the firm or since the relevant transactions were initiated. Any partners who were merely held out as partners may be able to escape liability unless they were responsible personally for negligent advice. From insurers' perspective it may be possible to decline cover for the partnership if all true partners were involved in dishonesty (though the policy may still cover innocent employees for their personal liabilities). Where this arises there is likely to be a conflict of interest between such partners and the true partners of the firm.

**Fraud Presented as Negligence**

20. Savvy claimants will often restrict their claims to negligence, particularly when the insured is a small firm and the extent of the fraud is uncertain. However, the packaging of the claim by the claimant should not prevent the insurer from establishing fraud or dishonesty as a true proximate cause of the liability. In appropriate cases, if fraud or dishonesty is a proximate cause of losses it can be relied upon to exclude cover even if there are other concurrent causes not affected by the fraud.

21. Some doubt as to insurers' freedom to establish the true proximate cause of liability was created by the decision of Tomlinson J in *London Borough of Redbridge* v *Municipal Mutual* [2001] Lloyd's Rep IR 545. This has now been tacked head on by the judgment of Christopher Clarke J in *Omega Proteins v Aspen Insurance UK Limited* [2010] EWHC 2280. This decision re-affirms insurers' freedom to establish the true proximate cause of the liability, following authorities such as *West Wake* v. *Ching* [1957] 1 WLR 45, *Haydon* v. *Lo & Lo* [1997] 1 WLR 198 and *MDIS* v *Swinbank* [1999] 1 Lloyd's Rep IR 516, with the support of decisions such as *Enterprise Oil v Strand Insurance Co* [2006] 1 Lloyd's Rep 500.

22. Christopher Clarke J summed up the current law as follows:

> "As it seems to me in liability insurance such as this the position, generally speaking, lies thus:
>
> "1. The insured must establish that it has suffered a loss which is covered by one of the perils insured against*: West Wake; Post Office v Norwich Union* [1967] 2 QB 363; *Bradley v Eagle Star Insurance Co Ltd* [1989] 1 AC 191; *Horbury Building Systems Ltd v Hampden Insurance NV* [2007] Lloyd's Rep IR 237,245;
>
> 2. That may be done by showing a judgment or an arbitration award against the insured or an agreement to pay;
>
> 3. The loss must be within the scope of the cover provided by the policy;
>
> 4. As a matter of practicality, the judgment, award, or agreement may settle the question as to whether the loss is covered by the policy because the insurers will accept it as showing a basis of liability which is within the scope of the cover;
>
> 5. But neither the judgment nor the agreement are determinative of whether or not the loss is covered by the policy (assuming that the insurer is not a party to either and that there is no agreement by the insurer to be bound).
>
> 6. It is, therefore, open to the insurers to dispute that the insured was in fact liable, or that it was liable on the basis specified in the judgment; or to show that the true basis of his liability fell within an exception;
>
> 7. Thus, an insured against whom a claim is made in negligence, which is the subject of a judgment, may find that his insurer seeks to show that in reality the claim was for fraud or for something else which was not covered, or excluded by, the policy: *MDIS Ltd v Swinbank*;
>
> 8. Similarly, an insured who is held liable in fraud (which the policy does not cover) may be able to establish, in a dispute with his insurers, that, whatever the judge found, he was not in fact fraudulent, but only negligent and that he was entitled to cover under the policy on that account."

23. It follows from this that even if there is a judgment in negligence against the insured, insurers are free to establish that the real proximate cause of liability was fraud or dishonesty.

24. However, this does not mean that sitting back and awaiting the outcome of proceedings against the insured will always be the best tactical approach. Some policy forms will require the insurer to defend claims until fraud or dishonesty is established against an insured by judgment, award or admission. Thus it may be in the insurer's interests to commence proceedings or arbitration in order to obtain a declaration of dishonesty in order to relieve it of an obligation to defend. In other claims the prospects of proving fraud or dishonesty may be increased by the insurer intervening in a negligence claim brought by the third party claimant. There may also be adverse cost consequences if the point is not taken at an early stage.

**RICHARD HARRISON**

**9 September 2011**