



## *Moral hazard – too easy for insurers?*

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### Why moral hazard? Why not “immoral hazard”?

- Illogical to describe the hazard insurers are concerned with as “moral”
- A “moral hazard” is an acceptable hazard
- It is an “immoral hazard” which is the unacceptable hazard
- Conviction not disclosed is immoral on 2 fronts – first as the conviction and second as the non-disclosed fact



## What is moral hazard

- Blair J in *Sharon's Bakery v Aviva*
- "moral hazard", is "*used to describe circumstances, invariably involving dishonesty on the part of the assured, which give rise to a concern that there will be dishonesty in the reporting and presentation of claims*".
- Invoice provided by Mr Levy used for a dishonest purpose



## Is repudiating the whole claim too easy and unfair?

- If part of a claim is fraudulent, the whole claim is lost, if the fraudulent part is substantial
- The consequences that monies paid on account can be recovered as well as costs
- Is this fair? Is it an unwarranted advantage for insurers?
- Is the public policy right?



## Fraud and avoidance from inception

- At common law, the claim and future insurance are lost from the date of the fraud
- What if there is a policy permitting avoidance from inception, in the event of post inception fraud – Joseph Fielding Properties (Blackpool) Limited v Aviva [2011] Lloyd's Rep IR
- Complete unwinding of a policy and the repayment of premiums and claims since inception



## Representations to the Law Commission

- The Commission received some 33 representations.
- Vast majority in favour of continuation of the law that fraud as to part of the claim entitled insurers to reject the whole of the claim



## Fraudulent claims categories and partly fraudulent claims

- Broadly, 3 categories of fraudulent claims
- No fortuitous loss at all has been suffered and the claim is therefore false.
- Genuine fortuitous loss has occurred, but losses which were not suffered have been claimed for
- Genuine fortuitous loss, but loss value has been inflated



## Summary response in law

- There is little argument that a false claim made for a loss which did not occur or for a loss which was suffered but was not fortuitous, will result in insurers not having to provide an indemnity.
- Two reasons - (1) dishonesty/fraud and (2) no fortuitous loss for which there would be an entitlement to an indemnity.



## How to identify the level of exaggeration

- A claim which is “substantially” exaggerated is fraudulent
- The percentages or something else?
- Consider what it was that was actually exaggerated
- Overvaluation of a genuine loss or claiming for loss which was not suffered?



## *Galloway and Transthene*

- *Galloway* - £2,000 computer out of £16,000 claim – the lost computer was not a genuine loss at all – not just overvaluation of a genuine claim
- *Transthene* - £30,000 printing machine out of £1.3m – but the machine was the subject of a dispute with a supplier because it did not operate properly.
- Claim for replacement in those circumstance held to be false and fraudulent



## Reminder that there is a requirement for fortuity

- The principle of substantial exaggeration is really one of requiring genuine fortuity.
- Claim for damage which has not occurred is not a genuine claim. Overvaluation or inflation of a genuine loss is different.
- Fraud in a liability context less likely to arise as part of the claim for an indemnity



## *Twinsectra Ltd v Yardley* [2002] 2 AC 164 (HOL)

- The combined objective and subjective test
- Defendant's conduct must be dishonest by the ordinary standards of reasonable and honest people
- The Defendant himself is to realise that by those standards his conduct was dishonest
- Subjective element can lead to a problem if the state of mind is dishonest – Insured would argue that he did not realise that by the ordinary standards of reasonable and honest people, his conduct was dishonest



## *Barlow Clowes v Eurotrust* [2006] 1 All ER 333

- The Privy Council clarified the statement of law in *Twinsectra*.
- A dishonest state of mind is a subjective mental state, but the law's assessment of the dishonest state of mind has to be undertaken objectively
- Dishonest insured not entitled to avoid findings of fraud or non-disclosure, by reference to his own subjective mental state – conduct assessed objectively



## Is it possible to control moral hazard?

- The risk posed by the material property to be insured can be controlled by the imposition of conditions, terms and warranties
- The risk posed by a potential insured regarded as a moral hazard, cannot be controlled in the same way.
- Broadly a moral hazard risk is an unacceptable risk



*Joseph Fielding Properties  
(Blackpool) Ltd v Aviva [2011]*  
Lloyd's Rep IR 238

- Mr Leonard bought industrial estate
- Some insurance with Aviva on other properties shortly after purchase
- Industrial estate added to policy in March 2008



The claims before the big one

- Inception - March 2008
- Fire No 1 - June 2008 - £40,000
- The drain and exaggeration - September 2008 - £9,870
- The big one - 11/08 - £2.5m





## Mr Leonard and two sources of insurance

- First party insurance for Joseph Fielding Properties (Blackpool) Ltd.
- Mr Leonard told the roofing contractor to purchase his own third-party insurance.
- Third-party insurance (Faraday) for Mr Marshall (but really for Joseph Fielding Properties Ltd)
- Mr Leonard gave Mr Marshall the premium for the third-party insurance policy.



## Mr Marshall and his insurers

- Mr Marshall notifies his insurers (Faraday)
- Faraday instruct me and other solicitors in the City
- A letter (28 May 2009) repudiating Marshall's claim, for non-disclosure is despatched



## Mr Leonard's third-party insurance

- Mr Marshall was bankrupt - how could he be expected to buy insurance?
- Did Mr Leonard know he might need insurance monies from insurers other than Aviva i.e. from insurers he had not contracted with?
- Mr Marshall went to brokers



## Mr Marshall's response

- We are still waiting.
- Long list of failures by Mr Marshall set out.
- Mr Marshall given an opportunity to respond.
- Mr Leonard was down to one insurer



## Mr Leonard doesn't waste time – issues proceedings

- Fire Nov 08 - PoC May 09 – no stranger to litigation
- Defence required in June - information still being gathered
- Defence based on:
  - 1) Fraud on NIG (water damage claim)
  - 2) Fraud on Aviva (the drain claim) – exaggerated. Salthouse not paid.
  - 3) Non-disclosure to prior insurers to Aviva



## Fraud on NIG

- Unusual defence – fraud on another insurer – best example of moral hazard; or if immoral hazard; worst example.
- The fraud could not be used as a means of avoiding the policy directly, since the fraud had not been perpetrated on Aviva
- The fraud had to be treated as a matter of dishonesty, which should have been disclosed at inception – an issue of moral hazard



## Proving the NIG fraud

- The unusual burden was always on Aviva
- Ordinarily, if fraud was in play, Aviva would be seeking to prove that it was itself had been defrauded.
- Aviva had to prove that NIG had been defrauded - it needed NIG's support and the support of the staff of the holiday park.



## What were those telephone calls about?

- It all came down to what was the purpose of two telephone calls on 14 February.
- Was it to advise Mr Leonard of flooding in the holiday home or, ironically, was it to inquire as to whether Mr Leonard had insurance cover for the home.
- Examination of phone records demonstrated the existence of the telephone calls.



## Why allege fraud on another insurer

- Difficult enough proving fraud on the insurer providing the insurance, without seeking to prove fraud on an earlier insurer.
- Prior fraud obviously discloseable. Inducement inevitably follows.
- If established, it is a knockout blow – Mr Leonard's Counsel did not argue otherwise.



## Telephone records not enough and burden of proof

- An explanation of the content of the phone calls required.
- Aviva's burden of proof – to prove the fraud and the content of the calls.
- Mr Watson and Mr Hodgson – keep in touch with witnesses, in particular one witness who had said that he had found the water leaking from the mobile home.



## Difficult burden of proof

- Content of phone calls disputed.
- Mr and Mrs Leonard saying an employee of the holiday park was phoning to check up on insurance.
- Supported by another employee.
- Mr Leonard's credibility on this issue part of his credibility generally.



## The drain claim - refuting the evidence

- Was the collapse a fortuitous event, or a lack of maintenance, or planned development?
- Loss adjuster accepted it was fortuitous and there were problems with her evidence. Contemporary floods had piled pressure on her.
- The estimate was for about £8000 plus VAT



## Interview by investigators

- Pattington and Wintrip interview Mr Salthouse; comparison of documents begins.
- Invoice to Leonard says “paid in full with thanks”, but Salthouse has received only a couple of thousand pounds.
- The damage may have been fortuitous - the repair costs looked exaggerated.
- The invoice - a fraudulent device?



## Fraudulent means & devices

- *Agapitos v Agnew* [2003] QB 556
- Fraudulent exaggeration - nothing further is necessary. (Paragraph 36)
- Fraudulent device - something which, if believed, would yield a not insignificant improvement in the insured's prospects. (paragraph 38) - Mance LJ's tentative view.



## Fraudulent exaggeration easier than a fraudulent device

- Prove the exaggeration was dishonest.
- Prove the exaggeration was substantial. *Galloway v Guardian Royal Insurance* [1999] Lloyd's Rep IR 209
- Fraudulent claim not the only claim – is it serious enough to taint the whole?
- Don't test the percentage of the bad to the good. Just examine the bad.
- The bad £2,000 in *Galloway* was sufficient for fraud – exaggeration and no fortuity



## How “small” is “not substantial”?

- *Tonkin v UK Insurance* [2006] Claimant judgment for £317,000. “Fraudulent” amount not worth more than £2,000 or 0.3% of claim. Not fraudulent.
- *Transthene v Royal Insurance* [1996] £30,000/£1.25m – c2.4% - fraudulent
- *Fielding* [2010] - c£6,700 of £9,870 inc VAT was genuine. £3,100 exaggerated and fraudulent – nearly 50%.





## Require disclosure of documents proving payment of invoice

- Pleaded defence – did not pay Salthouse £9,870
- No disclosure re drain costs
- Supplemental disclosure – concocted document of expenditure greater than £9,870 – but few documents proving payments
- Tenacious insistence on disclosure of documents and electronic data



24/02/2010

### Break down of payments for drain chain

Payments made ref drain fix bro machine hire on acc	1162.66
Payments made ref drain fix bro concrete on acc	1396.25
Payments made ref for reo bar steel posty cash	90.00
Payment for drainage paid on card b/q	380.00
Payment for safety fence on site A.A.A.	329.00
Payment for woodc waste stone chq 901458 12/9/08	193.99
Additional labour Sean Cummings) cash 19/9/08	1000.00
Payments made to M Salthouse cash 12/9/08	2000.00
Payments made to M Salthouse chq 901462 15/9/08	1000.00
Payments made to M Salthouse cash 19/9/08	2000.00
Payments made to M Salthouse chq 23/9/08	500.00
Total	10053.90

See bank statement for cash with drafts



## Documents are dishonest, false, fraudulent devices

- Salthouse invoice is fraudulent - no payment to Salthouse of £9,870
- Fox Bros invoices false - not paid the invoices and the explanation is false
- Eventually seek to rely on legitimate invoice of Fox Bros from after the major fire
- Fencing invoice - has 15% VAT before the change to 15% - concocted to prove expenditure



## The findings re the drain

- No agreement for a fixed price - only an estimate for £8,000
- The invoice for £9,870 (inc VAT) was false and fraudulent .
- Fraudulently exaggerated - only £6,700 paid, i.e. £3,100 over claimed
- Fraudulent device - because £9,870 not incurred and "PAID IN FULL WITH THANKS" not true



## Claimant's unsuccessful arguments

- A lesser genuine claim – no help. See *Galloway* and *Direct Line v Khan* [2002 Lloyd's Rep IR 364
- Proportionality, most of the money claimed had been paid out – no help. Don't view the fraud proportionally to the harm likely to be done to the insured. *Orakpo* no help.
- Insurer must show reliance – wrong. In any event, there was reliance on the invoice in making the payment.



## Conclusion on the drain claim

- Questioning a transaction, may drive an insured to fraudulent attempts at justifying the transaction
- A collection of “mistakes” will be characterised as “fraudulent” when one or two will not.
- Where there is any suspicion, it is worth reviewing past claims and transactions.



## Non-disclosure of material facts

- *Pan Atlantic v Pinetop* [1995] 1 AC 501 – a material fact is one which a prudent underwriter would take into account in assessing the risk.
- Inducement – would there have been a different underwriting decision?
- *The Dora* [1989] 1 Lloyd's Law Reports, 69 – the full picture has to be assessed – put individual failures into overall context



## The relevance of materiality to the original underwriter

- Argued by the claimant, that if immaterial to the original underwriter, could not be material to Aviva.
- Rejected – what was material to Aviva, were the false statements to earlier insurers.
- Material to Aviva because answers were false, information was false, Leonard was dishonest with prior insurers.



## Previous false answers in proposal form

- Part of a risk which cannot be controlled.
- Physical features of a risk - can be controlled e.g. warranties, conditions, risk improvements.
- *Locker and Woolf v Western Australian Insurance* [1936] - previous false answers in a proposal are very material for a subsequent insurer to know.



## Spent conviction

- Conviction for minor offence of causing damage. When not spent, did not tell prior insurers when asked
- When spent, did tell prior insurers
- Alleged (and found) that even though spent when proposing to Aviva, material to know that Leonard had been in breach of duty to prior insurers



## Use of skeletons in the cupboard

- Non-disclosure of non-disclosures
- Proposer will not disclose past failures
- But non-disclosure and breach of duty to a prior insurer is plainly material – plainly a moral hazard
- False answers in proposals statements of fact, witness statements are breaches of duty - plain moral hazard
- If many different insurers used – the greater the likelihood of false answers and the greater the likelihood of establishing moral hazard



NEW SCHOLAR



NEW SCHOLAR

## Fielding - the outcome – the moral hazard

- The drain claim was exaggerated and fraudulent. Aviva entitled to avoid the policy from inception and recover monies paid on all claims
- The claim made to NIG was fraudulent. That fact ought to have been disclosed to Aviva – Aviva entitled to avoid the policy.
- Non-disclosure of a variety of material facts

## Sharon's Bakery v Aviva [2011] and moral hazard

- Equipment transferred from one company ("Wholesale") to another ("Europe") - related companies
- Application made to Lombard for finance for the new business
- Security to be taken on the equipment
- Lombard require proof of ownership - fictitious, concocted invoice provided to Lombard
- Argued that the invoice was in fact a valuation
- Agreed that the alleged material facts affected moral hazard



## Prior acts of dishonesty even if undetected

- The Judge referred to *Insurance Corporation of the Channel Islands v The Royal Hotel Limited* [1998]
- False invoices which had been created were a matter which any prudent underwriter would have taken account of, if the insured asked for false invoices to be produced, even if the false invoices had not been used
- Accordingly the rendering of false invoices required to be disclosed



## Request for a valuation but a false invoice produced

- A false invoice would have been apparent to the insured's directors
- Sending the invoice to the finance company would have been the adoption and perpetration of the lie within the document and a moral hazard
- Finance company may not have suffered any loss (it obtained suitable security) but the dishonesty and lie amounted to a moral hazard



## Fraudulent means and devices

- *"... if fraudulent means or devices are used ... to obtain any benefit under the Policy ... all benefit under the Policy shall be forfeited."*
- Insurers had to show the use of some lie to seek to improve or embellish the facts surrounding the claim
- Also to show that the lie would, if believed, have tended to yield a not insignificant improvement in the prospects of obtaining a settlement





## False invoice used after the fire

- Insurers expressly requested invoices confirming the transfer of equipment to the insured
- The insured provided an invoice showing the sale of equipment from Bakequip to the insured
- Representation in the invoice of a sale from Bakequip to the insured was a lie
- The lie was adopted by the insured and was an embellishment of the facts surrounding the claim



## The Court's strict approach to dishonest conduct

- Claim itself was on its face, legitimate and the quantum of the claim appropriate
- But dishonest conduct a matter of moral hazard (and therefore required to be disclosed)
- Disclosure required, even of an allegation of dishonesty, which the insured knows to be false (*North Star Shipping Ltd v Sphere Drake Insurance* [2006] EWCA Civ 378)



## Moral hazard – too easy?

- Even if the false invoices had not been submitted to Lombard, the judge would have reached the same conclusion because of the false invoices were produced with the knowledge of the insured
- Moral hazard also arises if a false document was produced without knowledge of the insured, but was subsequently used by the insured with knowledge of the lie within the document



## Professor Merkin's view

- Professor of Commercial Law at Southampton University; editor of the Lloyd's Law Reports; editor of Insurance Law Monthly (July 2011)
- Claimant *"May be thought to have been a little unfortunate"; "Genuine loss"*
- *"This seems to be a case in which the fraud was not an attempt to obtain any dishonest advantage but rather to substantiate the assured's version".*



## What was unlucky or too easy?

- Deliberate dishonest conduct (in setting up the loan and in claiming on an insurance policy)
- Co-ordinated agreement to obtain a false invoice with knowledge of a deliberate plan to obtain that invoice.
- Subsequent deliberate use of a false invoice to establish ownership of equipment, when it was known that the invoice was false



## Genuine loss - genuine and honest documents

- If there was a genuine loss, genuine documents could have been used honestly
- Clear policy of the law to promote fair dealing and honesty – Jackson LJ in *Direct Line v Khan*
- Contested 6 day trial – nothing too easy for insurers in proving false representations



## Compare with civil claim where there is exaggeration

- Exaggeration (even fraudulent exaggeration) does not forfeit the whole claim
- *Zurich Insurance Co Plc. v Hayward* CA 27 May 2011 - settlement in personal injury action allegedly obtained by fraud. Application to set aside the settlement, though did not succeed because insufficient evidence of fraud at the time of the trial.



## *Zurich Insurance v Hayward* [2011] EWCA Civ 641

- Public interest in the integrity of the administration of justice and the private interests of Zurich in seeking the investigation of the allegations of fraud far outweighed the public interest in the finality of litigation. (paragraph 34)
- The Court emphasised the public importance of investigating fraud and protecting honesty and fair dealing



## Nield v Loveday [2011] EWHC 2324

- Claimant alleged as result of RTA, he suffered soft tissue injury to neck and lower back and could not work or drive, was often reliant on a wheelchair, had to be cared for by wife at all times.
- Private investigator footage showed him doing substantially more than claimed.
- Settled for modest sum with Claimant paying more in costs than recovered in damages



## Committed to prison for contempt

- After settlement Defendant's insurer brought contempt proceedings - the claim was inflated and contaminated by dishonesty. The statements had been verified by statements of truth.
- Substantial dishonesty in the presentation of the claim - Claimant's solicitor had been misled. The Claimant had marked up copies of drafts which showed his knowledge of the false evidence.
- Sentenced to 9 months

## Aviva Insurance v Brown [2011] All ER (D) 287

- Subsidence problem for 10 years
- Complaints to Ombudsman – upheld
- Insistence on having alternative accommodation “equivalent” to own accommodation – 6 bedrooms, parking for a number of cars and a boat
- What property to live in as AA is the crux



## Alternative accommodation alternatives

- Various properties in vicinity proposed – unacceptable
- Mr Brown proposed a property, presented to insurers through agents – Mr Brown had provided the agents with the information - £142,992 for 12 months with a 6 month break clause
- Property had in fact been his mother’s – but owned by him



## Mr Brown's letter to agents

"Please find enclosed details of a house that I consider will be suitable as alternative accommodation. I have spoken to the agents who have been in touch with the owner.

Could you please obtain permission from the insurers that I can proceed to rent this house and that they will pay the deposit and rent. I have spoken to Helen from your office and the date that we are aiming at is August 4<sup>th</sup> 2007.



## Mr Brown's letter continued

This matter is urgent, I cannot be certain that the house will remain available if an approval from the insurers is not obtained without undue delay and in any event before August 4<sup>th</sup> 2007.

I have been dealing with Mr Ronnie Goodall a representative of the letting agents. You have my permission to contact him on my behalf. His address and telephone number are on the enclosed sheet"



## Loss adjusters refuse to pay annual rent of c£143,000

- The hunt continued for other property
- 13 Friern Barnet Lane was semi detached
- 15 FBL comprised 7 flats and owned by Northway Design & Development Co Ltd, a company which was within the Brown family. Mr Brown owned 951 shares of 1500, Mrs Brown 49 and the Brown Discretionary Trust 500.
- Mr Brown proposed he rent from Northway



## Solicitors for Northway write to Loss Adjusters

- Mr Regler, a long term friend of Mr Brown wrote to LA advising that his client (Northway) was prepared to grant a tenancy for a period of 6 months, possibly up to 12 months for £7,366 per month (= £1,700 per week).
- Understanding that Aviva would contribute £1,500 per week - the balance of £200 would be paid by Mr Brown
- Did not reveal to LA that the Coy was owned by Brown family





## LA accept the offer – don't know of ownership

- Solicitor's letter was carefully written, avoiding revealing Mr Brown's family was the owner of Northway, and therefore effectively the owner of number 15
- By entering into a tenancy agreement with Northway, effectively, Mr Brown would be renting from himself
- The tenancy agreement which was signed was as proposed, which required Mr Brown to pay £200 per week to Northway



## What did Mr Brown do?

- He said he moved in to number 15
- He received £7666 per month, for payment to Northway - he did not pay those monies directly to Northway - not paid until a dispute blew up
- He did not personally pay £200 per week to Northway
- He did not treat the transaction as an arm's length one



## What did the judge decide?

- Renting from Brown's own company, without telling the insurers or their representatives that he was doing so was not fraudulent in the circumstances
- During claims history of several years, the loss adjusters and/or the insurers were aware of Mr Brown having an interest in the adjacent property (number 15 FBL)



## What about 38 Lyonsdown

- Not owned by a company
- Not owned by a trust, although in evidence Mr Brown said he was in the process of transferring the property to a trust
- Letters written by or for him were misleading
- The claim that he could rent from himself, without revealing that he owned the property was dishonest and fraudulent



## Twinsectra – dishonest in both senses

- Dishonest objectively, by ordinary standards
- Dishonest subjectively because Mr Brown knew or would know that requesting payment of £142,966 per annum for a property he owned and lived in occasionally, was dishonest
- Objective dishonesty was more relevant after *Barlow Clowes*



## Should Mr Brown lose everything?

- The fraudulent claim for alternative accommodation infected the claim as a whole for subsidence repairs.
- As the law stands, the whole claim was unravelled, such that all monies paid to Mr Brown had to be paid by him back to Aviva.
- This was notwithstanding the alleged conduct of Aviva in dealing with the subsidence claim and the findings of the Ombudsman.



## Why should a fraudulent insured not lose everything?

- A fraudulent Claimant who is not an insured and who sues, does not lose everything - but risk of being penalised heavily on costs or being committed to prison
- The law puts similar emphasis on honesty in non-insurance (no duty of good faith) and insurance claims (a duty of good faith)
- Even in cases where a claim has been settled, the Court will still commit a claimant for contempt - (*Nield v Loveday*) - settled for modest amount
- Jackson J in *Direct Line v Khan* - forfeiting all will encourage honesty and straightforward dealing.



## Too easy for insurers

- Emphatically not
- The automatic outcome (repudiation of a claim and discharge from liability under the policy) may look easy, but getting there is far from easy.
- The established policy of the law is to discourage fraud - leaving a discretion to the Court to permit recovery of non-fraudulent parts of a claim will encourage dishonesty - the great moral hazard.



# Graham Eklund QC

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13 September 2011



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