

# Bad pennies

*Alison Padfield considers the recovery of the costs of investigating insurance fraud: current routes and proposed reform*



Alison Padfield is a barrister at Devereux Chambers and the author of *Insurance Claims* (3rd ed, Bloomsbury Professional, 2012)

According to the United Kingdom's Insurance Fraud Bureau, undetected general insurance claims fraud amounts to £2.1bn a year and adds, on average, £50 to the annual costs individual policyholders face (see [www.insurancefraudbureau.org](http://www.insurancefraudbureau.org)). In cases where insurers suspect fraud, they may investigate and then refuse to pay the claim; but what of the costs that they incur in the investigation? The case-law suggests that there are two potential routes to recovery of the costs of investigating a fraudulent claim: the first is a conventional costs order in legal proceedings, and the second is a claim for damages for the tort of deceit.

### **Owners of the Ship 'Ariela'**

These issues were considered recently in a series of decisions of the Commercial Court in *Owners of the Ship 'Ariela' v Owners and/or Demise Charterers of the Dredger 'Kamal XXVI' and the Barge 'Kamal XXIV'*. Following a collision in 2004, there were separate hearings in the Commercial Court to determine liability and quantum, and then further hearings in relation to costs.

The underlying claim was not a claim by an insured under a policy of insurance, but a claim by an insured against a third party, and was in part a recovery action brought by insurers pursuant to rights of subrogation following payment by them of the claimants' insurance claim. The claim was originally for US\$1,296,583. Within six months of the collision, the defendant's solicitor had formed the view that there was 'over-exaggeration of the claim... in biblical proportions'

([2009] EWHC 3256 (Comm), para 28). By the start of the quantum trial in 2009, the amount of the claim had been reduced, but was still US\$942,670. The trial lasted seven and a half days, and by the time of closing speeches on the last day, the amount of the claim on which the judge, Burton J, was required to adjudicate was a mere US\$26,030. This, as he said, was 'a claim well within the jurisdiction of the Shoreditch County Court' (para 2). There was, in the judge's words, a 'startling picture of wholesale jettisoning of the vast majority of a claim which was so substantially overblown' (para 4); the judge then rejected some elements of the remaining claim and awarded the claimants the sum of US\$6,245 – or less than 0.5% of their purported claim.

Unsurprisingly, in these circumstances, the defendant was awarded the costs of the quantum hearing on the indemnity basis. A costs order had been made in favour of the claimants at the conclusion of the liability hearing, and an application for the costs of this hearing on the indemnity basis was then made, accompanied by an application to set aside the earlier costs order in favour of the claimants. A further hearing took place before Burton J at which the claimants did not appear and were not represented. Following that hearing, the judge found that the claim was fraudulent, saying (paras 18 and 19):

... it was, in fact, the case that no damage was caused to the barge in the collision. The massive claim that was put forward in respect of repairs,

**'A claim in deceit as a basis for recovering the costs of investigating a fraudulent claim has some pedigree. There is tentative support for such a claim in two cases almost 60 years apart.'**

not to speak of the wholly invented claim put forward in respect of loss of use, is, in my judgment, as fraudulent as the claim put forward in respect of the dredger. It is noteworthy that [the claimants] put forward a claim within six days of the collision which was almost identical in amount to the claim eventually put forward in 2007, notwithstanding that the repairs had not been carried out and the dredger had not been inspected in dry dock.

The false claim was maintained, and attempts made to find ever new ways of justifying it, until the quantum trial when, with some damaging disclosure recently made, but in particular with the searchlight finally on the reality of the claim, it collapsed as unsupportable.

The judge then dealt with the technical issue of the setting aside of the earlier costs order. In setting aside that order, he said that he had no doubt whatever that the proper course was to replace it with a similar indemnity costs order in favour of the defendant as he had made at the quantum hearing; that he was satisfied that this was a fraudulent claim from the outset, and was properly marked by indemnity costs. Because this was not a claim under a policy of insurance, the claimants did not forfeit the whole claim on grounds of fraud, but were entitled to recover the amount of the claim that could have been honestly made. Had this been a claim under a policy of insurance, the whole claim would have been forfeited (see *Agapitos v Agnew* [2002]), but this principle does not apply outside the sphere of insurance (see *Shah v Ul-Haq* [2009]).

The application for costs was also made in the alternative as a claim for damages for the tort of deceit pursuant to *Derry v Peek* [1889]. The judge's observations on this cause of action were, strictly speaking, *obiter dicta* (not necessary for his decision and therefore not binding as a matter of precedent), because he had already decided

in the defendant's favour on its primary claim for an order for indemnity costs. They provide a useful illustration of the way in which such an application might be decided in future. Such a claim will be uncommon in practice, but might be made, as here, because there was uncertainty about whether all of the costs of investigating the fraud could be recovered as costs of the action. As the defendant's claim was for all of its costs incurred in defending the proceedings, the claimants' false representations for the purposes of the claim in

amount of the defendant's costs, less the amount of the genuine claim that would have been paid, together with some small professional costs on top.

It was not necessarily for the judge to quantify this alternative claim exactly and he did not do so, but said that one possible answer to the question of what the claimants would have been able properly to put forward had they not created a fraudulent claim was that they could properly and non-fraudulently have put forward those claims, which they did not abandon as unarguable during the quantum

*Essentially, as the judge found, but for the deceit, the claimants would have presented a claim that would have been paid.*

deceit had to be established prior to the commencement of the proceedings, even though that fraud might be further evidenced by what continued thereafter. These restrictions did not apply to the claim for indemnity costs, and represented an additional hurdle for the defendant to overcome.

The defendant also had to show – and did so – that it acted in reliance on the truth of the claimants' representations. This did not require it to show that it believed the representations – it clearly did not, given that its solicitor concluded at an early stage that there was 'over-exaggeration of the claim... in biblical proportions' – but, as the judge found, the defendant was driven to take them seriously, and to resist them, at very considerable cost, and the loss sought flowed directly from the defendant's reliance on the claimant's statement that the sum claimed was a bona fide valuation of the loss caused by the collision. Essentially, as the judge found, but for the deceit, the claimants would have presented a claim that would have been paid, and the quantum of the *Derry* claim would therefore have been the

hearing, totalling US\$26,030, so that he would or might have offset some US\$30,000 from the total cost inclusive of the costs bill. (As an aside, the litigation did not end with the costs judgment: the costs were not paid by the claimants, and the defendant sought an order under s51 of the Senior Courts Act 1981 that the claimants' insurers pay the costs incurred by the defendants in the proceedings, on the basis that they supported and funded the claimants' action and instructed the solicitors who acted on behalf of the claimants in the action to recover uninsured and insured (subrogated) losses.)

#### Deceit

A claim in deceit as a basis for recovering the costs of investigating a fraudulent claim has some pedigree. There is tentative support for such a claim in two cases almost 60 years apart: *London Assurance v Clare* [1937], in which Goddard J remarked in passing (at 270) that the claim for the costs of investigating the fraudulent claims was not put 'as damages for fraud, for which I think there might be something to be said' – ie as a claim for damages for the tort of deceit; and in *Insurance Corporation*

of the *Channel Islands Ltd v McHugh* [1997], in which Mance J appeared (at 135) to countenance the possibility of a claim in deceit by an insurer against an insured, 'if the facts otherwise justified it', based on a 'positive deceitful representation'. Goddard J also suggested in passing, in *London Assurance*, that the insurers would be able to claim the costs of investigating the claims as costs

of a term of the contract of insurance as the conceptual basis of the duty of good faith presents an obstacle to the implication of any term that covers the same ground, such as a term that any claims would be honest and not fraudulent. There may also be more mundane obstacles in the way of such a claim. For example, a claim for breach of contract based on

*The only remedy for breach of the duty of good faith is avoidance of the policy, not damages, so the costs of investigating a claim cannot be recovered by that route.*

in the action. The insurers had paid out in respect of the first fire claim before the second claim had been made, and brought proceedings seeking recovery of the sums paid in respect of the first claim and a declaration that they were not liable in respect of the second claim. Their reasons for seeking to recover the costs as damages for breach of contract were not explained, although it may be that there was at least an element of costs in relation to the first claim that the insurers thought they would not be entitled to recover as costs of the action.

**Duty of good faith or implied term**

What about breach of the duty of good faith, or breach of an implied term that any claims would be honest and not fraudulent? The only remedy for breach of the duty of good faith is avoidance of the policy, not damages, so the costs of investigating a claim cannot be recovered by that route. This was established in *Banque Financière de la Cité SA v Westgate Insurance Co Ltd* [1991], and, in any event, the scope of the duty of good faith is restricted post-contract (see *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd* [2001]). Similarly, the rejection in these and other cases of the implication

breach of an implied term was made in *London Assurance*. This was a long time before the development of the modern law in relation to the conceptual basis for, and consequences of breach of, the duty of good faith, and there is no consideration of the relevance of the duty of good faith. At a jury trial, the insurers had defeated the insured's claims arising out of two fires by showing that the claims were fraudulently exaggerated, and the insurers claimed damages for breach of contract in respect of the costs of investigating the claims. They contended that a term was to be implied into the contract of insurance that the insured should put in an honest claim and not a fraudulent claim, and that if it turned out that the insured had put in a fraudulent claim, they were entitled to recover, as damages for breach of contract, all the expenses to which they had been put in investigating it. Goddard J rejected the claim on the basis that he could not see how the insurers were worse off than if the claim had been an honest claim, in which case they would still have had to investigate, and that in any event the damages were 'far too remote to be said to be damages for breach of contract' (at 270).

**Conclusion**

This area of the law, in common with the law governing fraudulent insurance claims in general, is in a state of flux both in terms of judicial development and potential legislative reform. In its recent Consultation Paper on Insurance Contract Law: 'Post Contract Duties and Other Issues' (Consultation Paper No 201, 20 December 2011), the Law Commission proposed the introduction of 'a statutory right for the insurer to claim damages for the reasonable costs actually incurred in investigating the fraudulent claim, where the insurer would otherwise suffer loss as a result of the fraud' (para 8.3; see also the discussion at paras 7.26-7.37). This would be achieved by awarding damages where the insurer had not already in effect been compensated for the investigation costs by the savings from not paying an otherwise legitimate element of a fraudulent claim (see para 8.3; and see also paras 8.19-8.22). If the proposal is to achieve its stated aim of avoiding 'double recovery' by insurers in this way (para 8.20), it will need to be exhaustive of insurers' remedies, to the exclusion of other causes of action such as a claim in deceit or for breach of contract. ■

*Agapitos & anor v Agnew & ors* [2002] EWCA Civ 247  
*Banque Financière de la Cité SA v Westgate Insurance Co Ltd* [1991] 2 AC 249  
*Derry v Peek* (1889) LR 14 App Cas 337  
*Insurance Corporation of the Channel Islands Ltd v McHugh* [1997] LRLR 94  
*London Assurance v Clare* (1937) 57 Ll L R 254  
*Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd & ors* [2001] UKHL 1  
*Owners of the Ship 'Ariela' v Owners and/or Demise Charterers of the Dredger 'Kamal XXVI' and the Barge 'Kamal XXIV'* [2007] EWHC 2434 (Comm); [2009] EWHC 177 (Comm); [2009] EWHC 3256 (Comm); [2010] EWHC 2531 (Comm)  
*Shah v Ul-Haq & ors* [2009] EWCA Civ 542