Law Commission
Reforming the law

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What price should policyholders pay for fraudulent insurance claims?

In a consultation paper published today, the Law Commissions of England and Wales and of Scotland ask what should happen if a policyholder makes a fraudulent claim on their insurance, and call for clarity in the existing law.

Insurance contracts are based on good faith – that of both the insurer and the policyholder. This is established in section 17 of the Marine Insurance Act of 1906. Under section 17 if a policyholder acts fraudulently, the insurer may deny the whole insurance contract, and demand back any money paid out to a policyholder on previous claims.

In practice, the courts are reluctant to apply this remedy. Instead, they have said that a fraudulent claimant should forfeit their entire claim, even the part that is legitimate, but their other claims should not be affected.

In their paper, The Insured's Post-Contract Duty of Good Faith, the Commissions suggest that the courts are applying the right policy but that the cases appear incompatible with section 17. The Commissions ask:

- Should a policyholder forfeit the whole of a claim if any part of it is fraudulent?
- Should a fraudulent claim affect previous, valid claims?
- Should section 17 be amended?

The paper also asks what should happen where fraudulent claims are made on joint and group insurance.

David Hertzell, the Law Commissioner leading the project for England and Wales, said, "Insurance fraud is relatively common and should be discouraged. But the law we have for dealing with it is confusing and contradictory. If the law is to act as a deterrent, it must be clear and easy to understand."

Professor Hector MacQueen, Scottish Law Commissioner, said, "This consultation aims to establish some clarity in what is a complex and convoluted area of law. It is also an opportunity for us to ask questions such as how should we decide what is meant by 'fraud' and should the duty of good faith itself be codified or left to the courts to define."

The Commissions seek responses **by 11 October 2010.** The paper, including a full list of questions, can be found on the Law Commissions' websites at: http://www.lawcom.gov.uk/insurance_contract.htm and http://www.scotlawcom.gov.uk/downloads/cpinsurance_issue7.pdf.
[Ends]

Notes for Editors

1. The Law Commission and the Scottish Law Commission are non-political independent bodies, set up by Parliament in 1965 to keep all the law of England and Wales and of Scotland under review, and to recommend reform where it is needed.

2. This paper is released as part of the Law Commissions' joint review of insurance contract law. More details can be found at: http://www.lawcom.gov.uk/insurance_contract.htm , and http://www.scotlawcom.gov.uk/html/cpinsurance.php.

3. On 24 March 2010, the Commissions published Damages for Late Payment and the Insurer's Duty of Good Faith. This paper considered the duty of good faith on the insurer and asked what remedies should be available to policyholders if the duty is breached. The paper is available on both Commissions' websites.

4. According to figures issued by the Association of British Insurers, in 2008 1.4 per cent of claims in the UK were refused because of fraud, amounting to 4.2 per cent of the value of claims: see ABI, General Insurance Claims Fraud (July 2009) available at http://www.abi.org.uk/Media/Releases/2009/07/40569.pdf, at p 19.

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EMBARGOED UNTIL 00:01 ON 9 JULY 2010

THE INSURED'S POST-CONTRACT DUTY OF GOOD FAITH

SUMMARY

S.1 Insurance contracts are based on mutual duties of good faith, which apply both before and after the contract is formed. In our last paper, Issues Paper 6,[1] we considered the duties on the insurer after the contract had been formed – including the insurer's duties to investigate, assess and pay valid claims. We asked what remedies should be available to policyholders if the duty was breached.

S.2 This paper looks at the other side of the same coin. It considers policyholders' duties after the formation of the contract. In practice, the policyholder's main duty is to act honestly when making a claim. We consider the law of fraudulent claims, focusing in particular on what remedies should be available to insurers if policyholders act fraudulently.

S.3 The paper sets out our preliminary thinking. Its purpose is to promote discussion before the formal consultation process begins. We seek responses by **Monday 11 October 2010**, to Commercial and Common Law Team, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ.

S.4 The review is limited to insurance contract law. We do not look at fraudulent third party claims, or at the criminal law.

THE DUTY OF GOOD FAITH

S.5 The duty to act in good faith is codified in section 17 of the Marine Insurance Act 1906, which 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.

[1] Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010).

S.6 In Issues Paper 6, we argued that the law was right to recognise mutual duties of good faith. The law should provide safeguards against the moral hazards of insurance – particularly that policyholders may lie, or insurers may delay. However, we thought that the duty was best seen as one of "good faith" rather than "utmost good faith". We also thought that avoidance was often not an appropriate remedy. Instead, the law should allow for more flexible and tailored remedies. Here we apply the same reasoning to the policyholder's duty to act in good faith.

S.7 The courts have held that a policyholder who lies in connection with a claim should forfeit the claim. Thus if a policyholder suffers £18,000 of legitimate loss, but then adds a fictitious claim of £2,000 for an item which never existed, the policyholder loses the whole £20,000 claim. We think this is right. Policyholders should not be able to add invented items to claims safe in the knowledge that even if the fraud is discovered they will lose nothing.

S.8 However, the law on fraudulent claims is unnecessarily confused. The main problem is that section 17 specifies only one remedy – that the insurer may avoid the contract from the start. This means that insurers could require policyholders to repay all claims made under the policy, including perfectly genuine claims which were finalised and paid before the fraud arose. The courts have struggled against such a conclusion, holding instead that a fraudulent policyholder should forfeit the fraudulent claim, leaving the rest of the contract unaffected. We think this is the right policy, but unfortunately it is incompatible with section 17.

THE DUTY NOT TO MAKE A FRAUDULENT CLAIM

S.9 Insurance fraud is relatively common. Figures from the Association of British Insurers suggest that 1.4% of claims were refused for fraud in 2008, amounting to 4.2% of the value of claims.[2] Although insurance fraud is a criminal offence, prosecutions are relatively rare, meaning that the civil law has an important part to play in deterring fraud.

What is fraud?

S.10 In Part 3 we look at how the courts have defined a fraudulent claim. Our tentative conclusion is that the courts have defined fraud in a pragmatic and sensible way. Although there is some ambiguity about the exact definition of fraud, we think this is inevitable, given that dishonesty is a broad and malleable concept, which has to be interpreted in its context. We are concerned that a statutory definition may become ossified or could have unintended consequences.

S.11 We ask consultees if they agree that the definition of fraud can be left to the common law.

[2] Association of British Insurers, General Insurance Claims Fraud (July 2009) available at http://www.abi.org.uk/Media/Releases/2009/07/40569.pdf, at p 19.

Express terms

S.12 Many insurance policies include express "fraud clauses", setting out the consequences of making a fraudulent claim. The courts allow the parties to extend the remedies available for fraud, provided they do so in clear, unambiguous terms. However, in consumer contracts, such terms must be fair within the meaning of the Unfair Terms in Consumer Contracts Regulations 1999.

S.13 The law does not permit a party to exclude liability for his or her own fraud. There is some doubt, however, about whether a party may exclude liability for the fraud of their agent.

S.14 We think that the current law is broadly right. The parties should be entitled to extend liability for fraud, provided they do so in clear terms, but should not be permitted to exclude liability for fraud.

S.15 We welcome views on whether parties should be entitled to exclude or limit liability for the fraud of their agents. In practice, most insurers would be extremely reluctant to assume the risk that the insured's agent is fraudulent. However, we are not sure that the law should prevent an insurer from doing so if the parties so wish.

The remedy for fraud in the absence of an express term

S.16 Even in the absence of an express term, the courts provide insurers with a remedy for a fraudulent claim. However, the law in this area is complex, convoluted and confused.

S.17 We summarise the main cases. The duty not to make a fraudulent claim has variously been characterised as an implied term of the contract,[3] as a breach of section 17,[4] and as a stand-alone common law rule, based on public policy.[5] The House of Lords has severely criticised the idea that an insurer may avoid the contract from the start, without definitely deciding that the clear words of section 17 do not apply.[6]

S.18 Commentators differ over the effect of these cases. The law appears to be that the whole of any claim tainted by fraud is forfeited. However, previous honest claims remain enforceable, and the insurer cannot recover insurance money paid in respect of other claims. This is said to be based on a stand-alone common law rule. However, the issue is open to doubt. An insurer could argue that fraud is a breach of the insured's duty of good faith under section 17, entitling it to avoid the policy and unravel all previous and subsequent claims.

[3] *Orakpo v Barclays Insurance Services Co Ltd* [1994] CLC 373.

[4] *K/S Merc-Scandia XXXXII v Certain Lloyd's Underwriters (The Mercandian Continent)* [2001] EWCA Civ 1275; [2001] 2 Lloyd's Rep 563.

[5] *Agapitos and Another v Agnew and Others (No 1) (The Aegeon)* [2002] EWCA Civ 247; [2003] QB 556.

[6] *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)* [2001] UKHL 1; [2003] 1 AC 469.

S.19 We think that the common law rule is the correct approach: a policyholder who acts fraudulently in connection with a claim should forfeit the whole claim. However, it would be wrong to deny the reality of the insurance contract as a whole, or for the fraudulent claim to affect other claims.

S.20 We tentatively conclude that there is a need for legislation to amend section 17, for three reasons:

(1) The disjuncture between the common law rule and section 17 generates unnecessary disputes and litigation.

(2) Increasingly, UK commercial law must be justified to an international audience. If the UK wishes to influence European and international developments, it must seek to develop its insurance law in a coherent, principled and fair way.

(3) The rules on fraudulent claims are intended to act as a deterrent, and deterrents work best if they are clear and well-understood. Penalties, in particular, should be clearly set out in law.

S.21 In Australia, the remedy of avoidance was removed by the Insurance Contracts Act 1984. Instead, the insurer may refuse payment of the claim.

S.22 We tentatively conclude that forfeiture of the claim is the correct remedy and ask for views. In particular, we ask whether consultees agree that:

(1) The insured should forfeit the whole claim to which the fraud relates.

(2) A fraudulent claim should not affect previous, valid claims, whether or not they have been paid.

(3) A fraudulent claim should give the insurer the right to terminate the contract, but should not affect a valid claim arising between the fraud and the termination.

S.23 We also ask whether the insurer should be entitled to damages from a policyholder for the costs of investigating a fraudulent claim. There may be cases in which the insurer incurs reasonable and foreseeable costs in investigating the claim for which it is not otherwise compensated. If so, we see no reason in principle why the fraudster should not pay damages.

FRAUD BY A CO-INSURED

S.24 Difficult issues arise when two or more policyholders have taken out a single insurance policy. What should happen when one policyholder has acted fraudulently but the other has not?

S.25 The law distinguishes between *joint insurance*, taken out by two or more people to cover joint interests, and *composite insurance*, in which policyholders insure separate interests. With joint insurance, the fraud of one policyholder affects the others. With composite insurance, each policyholder is treated separately.

S.26 The problems arise where policyholders start by taking out insurance together, but later become estranged and act contrary to each other's interest. We consider cases from the USA, Canada, Australia and New Zealand where a husband and wife take out joint insurance on their home, but one spouse later attacks the other by setting fire to the home. It seems unjust to deprive the innocent victim of his or her insurance claim.

S.27 We tentatively conclude that there is a need for reform. We think that in joint insurance, where two or more people act together to insure their joint interests, there should be a presumption that any fraud committed by one party is done on behalf of all the parties.

S.28 However, it should be open to an innocent party to rebut this presumption. If the innocent party produces evidence that the fraud was not carried out on their behalf or with their knowledge, then the claim should be paid. It is important that the recovery is limited to the innocent party's particular loss, and that the guilty party should not benefit. We ask for views.

FRAUD IN GROUP INSURANCE

S.29 Group insurance is an important sector, particularly in long-term insurance. Typically, an employer takes out a policy for the benefit of employees, who are members of the group scheme. The policyholder is the employer.

S.30 As group members are not policyholders, there is some doubt whether they are caught by the obligations imposed on policyholders under insurance contract law. It is possible that a group member who includes a fraudulent element in a claim does not suffer any penalty, but would be entitled to the payment of the remaining valid claim.

S.31 We ask whether there is a need to make special provision for fraudulent claims by group members, to give insurers similar remedies to those available where a policyholder acts fraudulently.

THE DUTY OF GOOD FAITH IN OTHER CONTEXTS

S.32 We consider whether the insured's post-contract duty of good faith has any other effects, outside the context of fraudulent claims. The duty clearly applies when an insured is varying the contract or negotiating a held-covered clause. However, we think these raise issues similar to pre-contract disclosure and misrepresentation, and are best dealt with in that context. Otherwise, the effect of the insured's post-contract duty of good faith is limited.

A duty to report increases in the risk?

S.33 In many European countries, policies tend to last for several years. Policyholders are under a continuing duty to notify the insurer of factors which aggravate the risk. The Principles of European Insurance Contract Law provide the insurer with a remedy if the policyholder fails to do so, but the remedy is limited. The insurer may only refuse payment if the loss was caused by the aggravation of risk. Even if the loss was so caused, the insurer is usually required to pay a proportion of the claim, based on the premium it would have charged had it known the full circumstances. The insured also has a right to a premium reduction if there is a material reduction in the risk.

S.34 By contrast, UK policies are usually renewed annually. The insurer is expected to define the risk precisely, and to continue to cover the risk specified for the contract period. UK law does not recognise an on-going duty of disclosure in the absence of a specific contract term. Even if the contract does include a notification clause, the UK courts will interpret it restrictively. For example, there is doubt over the effect of a term requiring the policyholder to inform the insurer if premises are left unoccupied. The issue is more clearly addressed through an exclusion, by which the policy excludes unoccupied premises unless the parties agree a variation.

S.35 We tentatively conclude that the UK approach is correct. However, we would welcome views on whether there are advantages to following the approach set out in the Principles of European Contract Law.

Preserving the general duty?

S.36 We have not identified other consequences of the insured's post-contract duty of good faith, but it is open to the courts to develop the insured's post-contract duty of good faith in new and unexpected ways.

S.37 We have considered whether any codification of the duty of good faith should be exclusive (so that it covers only the specified instances) or whether it should continue to have some general, unspecified effect. Allowing a general duty might permit the courts to develop the law to meet new challenges. Alternatively, it could add to confusion and uncertainty. We would welcome comments.

S.38 A full list of questions is provided in Part 8.