The recent decision of Mr Justice Popplewell in Versloot Dredging BV v. HDI Gerling and others (The DC Merwestone) [2013] EWHC 1666 (Comm)) in the Commercial Court is of considerable significance to marine insurers and non-marine insurers alike, since it involves a detailed examination and hostile critique of the development and application of the concept of “fraudulent devices” in the context of an insurance claim.

The case involved the defence by hull and machinery underwriters of a claim for the cost of replacing a vessel’s engine following a flooding incident in the Baltic in January 2010. The policy was on the Institute Time Clauses – Hulls 1.10.83, with the Additional Perils Clause. Underwriters ran three defences, namely (1) that the damage to the engine was not caused by an insured peril; (2) that the damage to the engine was attributable to the unseaworthiness of the vessel on sailing, with the privity of the assured; and (3) that, in any event, even if the claim was recoverable in principle, the assured had forfeited its claim by reason of the employment of fraudulent devices in the presentation of the claim.

Overview of the Casualty
The circumstances of the casualty were stark. The vessel called at Klaipeda, Lithuania to load a cargo of scrap metal in January 2010. Whilst she was there, the crew used the vessel’s emergency fire pump and, having done so, negligently failed to purge the pump of water and close the sea valve. In consequence, water remained in the pump. Due to the extremely low ambient temperature (minus 35°C), the water in the pump froze, and expanded as it did so, thus causing the pump casing to crack and the strainer lid in the pump housing to become distorted. The crack and the distortion created a direct opening between the sea water outside the vessel and the interior of the vessel’s bowthruster space, a supposedly watertight compartment at the forward end of the ship. Whilst the vessel remained at the loadport, there was no ingress of water into the bowthruster space because the ice created a watertight barrier. However, when the vessel sailed from the loadport en route to Bilbao, she passed through warmer waters, and the ice melted, with the inevitable consequence that there was an ingress of water into the bowthruster space.

The ingress into the bowthruster room should not have been a problem because that space was supposed to be a watertight space fitted with a bilge alarm which, all being well, should have alerted the crew to any water ingress. Unfortunately, however, the bulkhead between the bowthruster space and the duct keel (a tunnel running the length of the vessel) was not watertight. The water was therefore able to enter the duct keel. The duct keel itself should have been watertight at the aft end of the vessel but, again, it was not, with the consequence that the water was able to enter the engine room. It was admitted that the vessel was unseaworthy with regard to the lack of watertight integrity at both ends of the duct keel. Due to the positioning of the alarms, the crew was not alerted to the ingress of water into the engine room until it had reached a level of about one metre or more above the floor plates in that space.

At that point in time, the crew sought to deploy the vessel’s pumps, which had a theoretical pumping capacity of the order of 300 tonnes per hour, and as such, should have been capable of stemming the ingress (determined to be of the order of 60 tonnes per hour) without difficulty. However, there were a number of deficiencies in the vessel’s pumping system, the combined effect of which was to reduce dramatically the vessel’s actual pumping capacity. In the event, therefore, the crew was unable to stem the ingress using the vessel’s pumps and the ingress continued until such time as the engine was completely submerged.

The assured sought to recover the cost of replacing the engine.

Standing back from the casualty, it will be noted that the critical aspects of the vessel’s flooding defences were deficient (the bilge alarms did not give timely warning of the ingress, bulkheads were not watertight as required and the vessel’s pumping arrangements were seriously deficient and inadequate), with the result that what should have been an inconsequential ingress into the forward space became a major flooding incident which could have led to the vessel’s sinking.
Coverage Issues

The underwriters’ primary case with regard to coverage was that the proximate cause of the ingress and the damage to the engine was crew negligence in terms of the failure to drain the emergency fire pump and to close the sea valve, which negligence caused the crack in the emergency fire pump and the distortion of the strainer cap, and rendered the ingress inevitable. Underwriters argued that although crew negligence was an insured peril under the Inchmaree clause, there had been various respects in which the Assured/Owners/Managers had failed (in a causatively relevant way) to exercise due diligence, such that the due diligence proviso in the Inchmaree clause precluded recovery.

The assured’s primary case was that the proximate cause of the loss was “perils of the seas” on the basis that the ingress was “fortuitous” by reason of the pre-sailing crew negligence that led to the damage that led to the ingress. The assured also contended that crew negligence was a proximate cause of the loss and that there had not been a causative want of due diligence on the part of the Assured/Owners/Managers. Finally, the assured contended that a proximate cause of the loss was repairs’ negligence in terms of their failure in 2001 to seal both ends of the duct keel to make them watertight.

Mr Justice Popplewell held that each of the assured’s contentions regarding coverage for perils were proximate causes of the loss. In the writer’s opinion, the most significant aspect of his judgment in this respect is his determination that although the ingress was inevitable from the moment that the fire pump cracked and its strainer lid became distorted, and, as such, was inevitable prior to the vessel sailing from the loadport, the post-sailing ingress was nonetheless “fortuitous” on the basis that the pre-sailing crew negligence provided the requisite element of fortuity. The judge held that “at the time of the commencement of the voyage the ingress of water was an inevitable certainty” but he held that the dicta of Viscount Finlay Lord Sumner in the House of Lords in Samuel v. Dumas to the effect that “...it is always open to the underwriter on a time policy to show that the loss arose not from perils of the seas but from the unseaworthy condition in which the Vessel sailed” was restricted to circumstances where the unseaworthiness at the point in time of sailing was due to the vessel “debility” (due to wear and tear) as opposed to unseaworthiness caused by some fortuitous pre-sailing act or omission.

Having determined that the loss was proximately caused by perils of the seas, the issues with regard to the other perils and as to due diligence ceased to be relevant. The judge went on to find, however, that if he were wrong on his finding that the loss was proximately caused by perils of the seas, there had not on the facts been a causative want of due diligence on the part of the Assured/Owners/Managers. He made this finding notwithstanding the fact that the evidence demonstrated that no formal guidelines, procedures or checklists had been put in place by the Assured/Owners/Managers to give the crew guidance and a means of reducing the risks posed by the extreme cold weather conditions to which the vessel would be exposed, and notwithstanding the critical and causative respects in which the vessel was unseaworthy. This case exemplifies the considerable difficulty faced by underwriters in making good a defence based on the due diligence proviso.

Other significant aspects of the judgment on coverage, whilst strictly speaking obiter (on the basis that they were not essential to his decision), include dicta with regard to the proper construction of the due diligence proviso in the Inchmaree clause and an implicit finding (the point was not argued) to the effect that, under the Additional Perils Clause, it is not necessary for the peril (repairs’ negligence in this case) and the damage to occur in the same policy year. This is significant because it has been a point of some controversy as to whether under the Additional Perils Clause, it is necessary to have coincidence of peril and damage within the same policy year or whether a peril occurring in a prior policy year which leads to damage in a subsequent policy year, might lead to a recoverable claim on the latter policy.

Underwriters’ defence based on unseaworthiness with privity (s.39(5) of the Marine Insurance Act) failed, on the basis of lack of privity of the unseaworthiness and lack of causation.

In the circumstances, the Court determined that the assured’s claim for the cost of repairing the engine was in principle recoverable in full, having been caused by perils insured against under the Hull and Machinery Policy.

Fraudulent Devices

Underwriters’ final argument, that the claim had been forfeit by reason of the assured’s employment of a fraudulent device or devices, was, however, successful.

Following the casualty, underwriters’ solicitors sought the assured’s input with regard to its case as to the cause of the ingress, its spread and why it could not be controlled by the vessel’s pumps. These questions were asked because underwriters were concerned as to how a minor ingress into the forward space would have led to a major casualty in which the vessel was almost lost.
The assured responded by letter dated 21 April 2010 indicating that its internal investigations had revealed that although a bilge alarm had sounded at noon, this had not been investigated at the time because the vessel was rolling in heavy weather, with the effect that the flooding was not noted until approximately nine hours later. When underwriters’ solicitors asked for details as to the evidence of the noon alarm, the assured responded on 27 July 2010 in terms that it had been informed by the Master that the alarm had sounded at noon but that it had not been investigated because the vessel had been rolling.

In fact, it was subsequently admitted by the assured that the forward bilge alarm had not sounded at noon. It followed that the explanation for not investigating the alarm (i.e. because the vessel was rolling) was also untrue. Material emerged during disclosure to indicate that the assured had no basis for asserting as a fact, as at 21 April 2010, that the alarm had sounded at noon. Underwriters amended their defence to plead that the letter of 21 April 2010 (among other things) was a “fraudulent device”, employed in connection with the claim, and that the claim was therefore forfeit.

The General Manager of the assured, who issued the 21 April 2010 letter, gave evidence to the Court to the effect that he had spoken to the Master on 20 April 2010 and that therefore he had an honest basis for putting forward the narrative relating to the noon alarm the following day. That evidence was rejected by the judge as an “invention”, and the judge concluded that the letter of 21 April was “false and misleading” and that in that respect the Manager had no grounds to believe it was true and was reckless. It was held that this was “an untruth told recklessly in support of the claim”. The judge held that the Manager suspected that the noon alarm narrative might not be supported by the crew and that he did not ask the crew because “he did not want the absence of confirmation from the crew to get in the way of an explanation which involved no fault on the part of the Owners or managers”. In the circumstances the judge found that the statements were put forward by the assured recklessly and without grounds for belief as to their accuracy. The judge further held that the letter was intended by the assured to promote the claim in the hope of prompt settlement and that the false statements met the materiality test (“not insubstantial”, “not immaterial, “not de minimis”) propounded by Mance L.J in Agapitos v. Agnew. On this basis the judge ruled that, applying Agapitos v. Agnew, the assured had deployed a fraudulent device and that its claim was therefore forfeit.

The judge therefore dismissed the assured’s claim.

In doing so, however, the judge expressed regret in reaching this conclusion. He considered that the assured’s fraudulent conduct lay at the lower end of the culpability scale; on the basis that it was “a reckless untruth, not a carefully planned deceit”, and was told on only one occasion and not persisted in at trial (though the Manager did give false evidence about his “invented” conversation with the Master that was said to have taken place on 20 April 2010). The judge considered that the forfeiture of the claim in the circumstances was “disproportionately harsh”.

Although the judge adopted and applied Mance L.J’s dicta in Agapitos v. Agnew (which being obiter was, technically, not binding on him) in the absence of submissions that he should adopt a different approach, the judge did indicate that he considered that “the low and relatively inflexible threshold which is the test of materiality” propounded in Agapitos v. Agnew was “in a number of respects unsatisfactory”. He considered that “if the anomalous [fraudulent claim] rule is to be extended to fraudulent devices used in support of valid claims, it is to my mind important that it should not itself be allowed to be used as an instrument of injustice”.

The judge went further to say that he “would be strongly attracted to a materiality test which permitted the court to look at whether it was just and proportionate to deprive the assured of his substantive rights taking into account all the circumstances of the case”. However, as noted, the judge nonetheless determined to apply the test propounded by Mance L.J in Agapitos v. Agnew despite his stated regret at the consequent result, namely the forfeiture and dismissal of the claim.

Appeal

The judge has since given the assured leave to appeal to the Court of Appeal concerning the dismissal of the claim on the basis of the fraudulent device rule. Permission to appeal has not been limited simply to the issue of “materiality” and it will be interesting to see how the assured’s case is developed in the appeal given that the judge recognised that the fraudulent claim rule (and the fact that forfeiture is the appropriate sanction) is established at the highest judicial level and that the extension of that rule to fraudulent devices in Agapitos v. Agnew “has been recognised by the Supreme Court in Summers v. Fairclough and applied by the Privy Council in Stemson v. AMP General, and recognised or applied in a number of first instance decisions...”. In a very real sense, therefore, if the appeal involves an attempt to overturn the fraudulent devices extension or to introduce a sanction other than forfeiture, it will involve a challenge to what has been viewed and applied as settled law.

The appeal will also proceed in the interesting context of the work currently being undertaken by the Law Commissioners in terms of “Post Contract Good Faith and other Issues” following their recent consultation.
The Law Commissioners accepted the view of the overwhelming majority of respondents; and their recommendations include a proposal for statutory reform to establish forfeiture as the statutory remedy for fraud in the insurance claims context. It will be interesting to see the extent to which the Court of Appeal will take into account the results of the Law Commissioners’ consultation and their recommendation for statutory reform when the case comes before them.

Ince & Co acted for the underwriters.

Contact
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