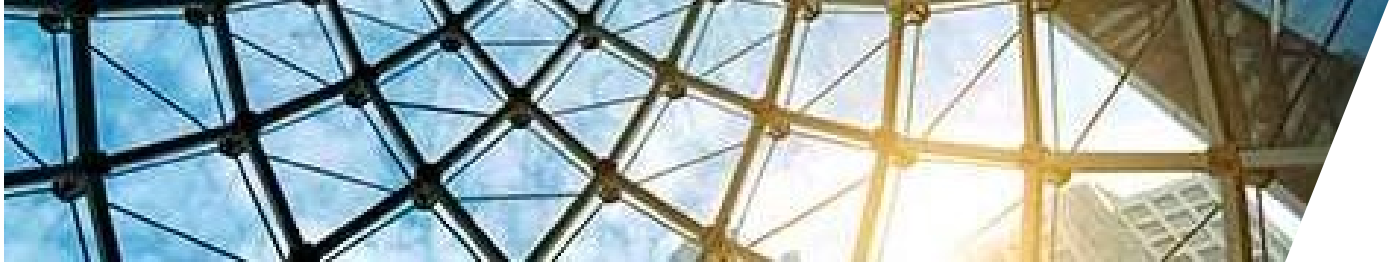

Discovery Land v Axis Specialty: the Dishonesty Exclusion in Solicitors' Policies

INTRODUCTION

In the recent case of *Discovery Land and ors v Axis Specialty* [2023] EWHC 779, the Commercial Court considered whether there was an 'innocent principal' for the purposes of a dishonesty exclusion in a solicitors' professional indemnity policy.

This note reviews the decision and looks at the wider requirements of the dishonesty exclusion.

THE FACTS

Mr Jones was a solicitor and businessman. He controlled a number of corporate entities. Several operated under the 'Jirehouse' brand. They included an LLP and two limited companies ('the Jirehouse Entities'). The Jirehouse Entities provided legal services through offices in London, Nevis and Switzerland. They held themselves out as specialising in, among other things, tax and litigation strategies, corporate finance and estate planning. He also had an interest in various companies said to be engaged in commerce or finance.

Mr Prentice, also a solicitor, was held out as a 'partner' of the Jirehouse Entities[1]. He was aware of but had no involvement with Mr Jones's other companies.

Axis was the professional indemnity Insurer of the Jirehouse Entities.

At least three individuals made reports to the SRA about how the Jirehouse Entities were managed. It investigated the practice twice but seemingly found nothing untoward. There appear to have been ongoing cashflow difficulties within the Jirehouse Entities.

In 2016, one of Mr Jones's commercial companies was served with a winding up petition. Mr Prentice prepared a witness statement which represented that the company was solvent and exhibited draft accounts which purported to prove it. The Judge accepted that his conduct in doing so was *"unprofessional and not honest*".

Also in 2016, one of the Jirehouse Entities was criticised for paying away monies in breach of trust. It maintained (presumably at the instigation of Mr Jones) that the monies were held in an interest-bearing account. The Judge found that Mr Prentice had made no enquiries about whether the monies were in fact held as represented.

In 2017, monies which were supposed to be held on client account were paid away to a company related to Mr Jones. Mr Prentice became involved in the relevant matter. He was copied into an email chain which referred to an alleged agreement to net off a loan to the company. The Judge rejected Mr Prentice's evidence that he did not read down the chain but concluded that he gave it little attention at the time.

[1] As the Jirehouse Entities were corporate bodies, he was strictly speaking a Member and Director, respectively, but consistent with common practice within the profession had the title of Partner.

Mr Prentice went on to write a letter which represented that the monies continued to be held. The Judge accepted Axis's submissions that he was lying about having been shown accounts which purported to evidence this and that no such document existed. However, he concluded that Mr Prentice simply did not concern himself with enquiring whether the representation was true or false.

The underlying claims arose from the purchase of a castle in Scotland. The client put Jirehouse in funds for the US$14m purchase price. Mr Jones lent the client monies to one of his other companies which then used it as capital to make loans to other companies, giving rise to what was referred to as 'the Surplus Funds Claim'. He also procured a loan of £5m secured by a charge on the castle, which he again diverted for his own purposes, leading to what became known as "the Dragonfly Loan Claim".

THE POLICY DISPUTE

It was common ground that the claims fell within the Insuring Clause of the Policy. Axis relied on the dishonesty exclusion which applied to:

*Any **claims** directly or indirectly arising out of or in any way involving dishonest or fraudulent acts, errors or omissions committed or condoned by the **insured**, provided that:*

*(a) the **policy** shall nonetheless cover the civil liability of any innocent **insured**; and*

(b) no dishonest or fraudulent act, error or omission shall be imputed to a body corporate unless it was committed or condoned by, in the case of a company, all directors of that company or, in the case of a Limited Liability Partnership, all members of that Limited Liability Partnership."

Notably, this departed from the Minimum Terms in two material respects. First, the words *"or in any way involving"* were added into the exclusion and expanded its ambit. Secondly, the proviso adopts a different and seemingly narrower form of words than the Minimum Terms which provide that:

> *the insurance must provide that no dishonesty, act or omission will be imputed to a body corporate unless it was committed or condoned by, in the case of a company, all directors of that company, or in the case of an LLP, all members of that LLP.*

There could be no doubt that the claims arose out of or involved dishonest or fraudulent acts committed by Mr Jones. Axis argued that Mr Prentice was not a real director/member and that his appointment was a sham. If this were right, then once Mr Jones's dishonesty was established it followed that the exclusion applied. It added that Mr Prentice in any event condoned Mr Jones's dishonesty.

It was common ground that Mr Prentice did not specifically approve of the thefts giving rise to the claim. Axis contended, however, that he knew that Mr Jones was "*up to no good*" and turned a blind eye to what he was doing.

In the alternative, Axis argued that the Surplus Funds Claim and the Dragonfly Loan Claim aggregated.

THE JUDGMENT

The Judge was satisfied that Mr Prentice's appointments as principal of the Jirehouse Entities were genuine. He attached little weight to the fact that he had minimal involvement in management and that such involvement as he had might readily have been delegated to an employee.

He was very critical of Mr Prentice. He found that he had lied to the court and deliberately downplayed his role. He accepted that he was aware that Mr Jones was prepared to do things which he should not have been prepared to do. Indeed, he found that Mr Prentice was himself prepared to do things he ought not to have done. On what he called the *"altogether separate question"* of whether Mr Prentice was a suitable person to be a principal or even involved with a legal practice, he concluded that he plainly was not.

However, the Judge did not accept that Mr Prentice knew or suspected that Mr Jones had stolen or was prepared to steal client funds. He found that he failed to make enquiries which he should have made, but this was because "*he lacked the necessary sense of professional responsibility and an appreciation of the importance of the regulatory requirements of the profession*".

He added that if, contrary to his findings, Mr Prentice had entertained any suspicion about the misuse of client monies it was that they were being used to address temporary exigencies. The claims did not arise out of such conduct but from a fraud of a different nature and scale. There was, therefore, no condonation.

Axis's case on aggregation also failed. The Judge was satisfied that Surplus Funds Claim and the Dragonfly Loan Claim arose from separate acts.

DISCUSSION

Judicial consideration of the dishonesty exclusion is comparatively rare, as policy disputes are commonly resolved through private arbitration. The decision is, therefore, of note. Some caution should nevertheless be exercised in treating it as a precedent in cases involving a more orthodox wording, or even on different facts.

At a high level, the decision is illustrative of the potential pitfalls for Insurers in dishonesty cases. It is instructive to step back and look at the application of the dishonesty exclusion in the round, drawing in threads from this case.

Was there dishonesty?

It obviously needs to be established in the first instance that the Insured was dishonest. In the right case, this might speak for itself. There could, for example, have been no innocent explanation for Mr Jones's conduct. The exercise is more difficult where there might be several possible explanations for why the Insured acted or failed to act as it did.

The principle of Hanlon's razor suggests that one should *"never attribute to malice that which is adequately explained by stupidity*". *"Never*" is going too far but it would be prudent to keep this in mind when investigating apparent wrongdoing.

The courts have been careful not to elide dishonesty with lesser forms of discreditable conduct such as gross negligence. As Sir Geoffrey Vos MR memorably put it in *SIB v HSBC* [2021] EWCA Civ 535, "*Simply being very bad at what you should be doing is not dishonesty".*

They are rightly slow to make findings of dishonesty. There are numerous statements of principle to this effect, for instance that "*cogent evidence is required to justify a finding of fraud or other discreditable conduct"*[2]*:* that there is a "*conventional perception that it is generally not likely that people will engage in fraudulent or discreditable conduct*[3], that the *"inherent improbability* [of dishonesty] *means that, even on the civil burden of proof, the evidence needed to prove it must be all the stronger"*[4]and that, *"unless it is dealing with known fraudsters, the court should start from a strong presumption that the innocent explanation is more likely to be correct"*[5]*.*

Nevertheless, the point should not be overstated. In *Bank St Petersburg v Arkhangelsky* [2020] EWCA Civ 408, the Court of Appeal stressed that the standard of proof for dishonesty was *"the simple balance of probabilities, neither more nor less*" and concluded that the Judge had erred in suggesting that a claimant had to show that the facts were *"incapable of innocent explanation*".

Does the claim arise from the dishonesty?

Establishing dishonesty by the Insured is not the end of the enquiry. It then needs to be shown that the claim arises out of that dishonesty. For instance, although - as the Judge found - Mr Prentice acted dishonestly in preparing a witness statement to forestall a winding up petition, this had nothing to do with the claims for which indemnity was sought.

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[2] See *Jafari-Fini v Skillgass* [2007] EWCA Civ 261 per Moore-Bick LJ at para 73
[3] See *Fiona Trust v Privalov* [2010] EWHC 3199 (Comm) per Andrew Smith J at para 1438
[4] See *Markel v Higgins* [2009] EWCA 790 per Rix LJ at para 50
[5] See *Jafari-Fini* per Carnworth LJ at para 40

The causal connection required by the words *"arising out of*" has given rise to conflicting decisions. There is support in authorities from outside the field of solicitors' professional indemnity for the conclusion that, where this formulation is used in an exclusion, it is to be equated with proximate cause.

There are other authorities, however, which suggest that a looser causal connection is enough. Directly on point is the solicitors' case of *Goldsmith Williams v Travelers* [2010] EWHC 26 (QB). There, one of the principals, Mr Atikpakpa, made a fraudulent mortgage application. He then stole the monies advanced. The other principal, Ms Usman, who was taken to know that the application contained false statements, witnessed his signature and certified a copy of his passport. In doing so, she was found to have committed a fraudulent act herself. The Judge rejected an argument that the claim arose from the theft of the monies, not the fraudulent application. He concluded that the theft could not have happened but for the fraud in the application.

In reaching this conclusion, however, the Judge made no reference to the authorities on the proper construction of "*arising from*" in a policy exclusion. A different court may take a more restrictive view.

Was the dishonesty condoned by other principals?

Even in the most flagrant cases of dishonesty, the existence of innocent principals often means that Insurers are stuck with indemnifying the claim. This was seen in the case of *Bishop of Leeds v Dixon Coles & Green* [2021] EWCA Civ 1211 which we reviewed in a previous note and where, it may be recalled, the senior partner stole millions of pounds from various clients over an extended period but hid it from the other partners.

It is no surprise that Axis was unsuccessful in its attempt to short circuit the process by asserting that Mr Prentice was not a genuine director or member of the Jirehouse Entities. The Judge appeared to leave open the possibility that the doctrine of sham might have application to a corporate body in the appropriate case, but for the reasons explored in a previous note, it is doubtful whether it can.

This line of argument might have more traction where the Insured is a traditional partnership. *Zurich v Karim* [2006] EWHC 3355 (QB) is a curious case in this respect. The Judge there accepted that the firm was a sham device to allow a struck off solicitor to continue to practice but went on to decide the case on the grounds that the various family members named as partners had condoned her dishonesty.

In *Karim* and *Goldsmith Williams*, the courts construed wording which closely followed the Minimum Terms as being disjunctive, in other words as applying to (a) dishonesty or (b) dishonest acts or (c) dishonest omissions.

In *Karim*, the individuals named as partners were found to know that the firm was making payments, including to them, which could not possibly have been funded from the fees generated by its legal work. The court concluded that it was not necessary to establish that they had knowledge of specific thefts by Mrs Karim.

Similarly, in *Goldsmith Williams*, Mr Atikpakpa committed a further mortgage fraud of which Ms Usman was unaware. However, the court found that she had condoned a dishonest course of conduct which led to the further fraud. In consequence, it was unnecessary to establish that she had condoned each specific dishonest act.

The wider law of dishonesty has evolved since these cases were decided and it may be that they are ripe for review in the appropriate case. In *Discovery Land*, the Judge distinguished them as decided on very different facts and involving different wordings. He placed emphasis on there being no true parallels between the facts of those cases and the case under consideration.

It might be thought that the difference in the policy wording is a more fundamental distinction. On the face of it, the adoption in the Axis wording of the formulation *"no dishonest or fraudulent act, error or omission"* precludes the disjunctive construction adopted in *Karim* and *Goldsmith Williams*.

However, the Judge rejected the Claimants' contention that what needs to be condoned for this exclusion to apply is each specific dishonest act, error or omission which gives rise to the claim. He concluded that this ignored the words *"or in any way including"* in the Axis wording, but these surely should have been ignored: the Minimum Terms are clear that any provision inconsistent with them is to be severed or rectified to comply.

The Judge accepted Axis's contention that it would have been enough for Mr Prentice to have had knowledge of and to have condoned a pattern of dishonest behaviour of which the particular fraudulent act forms part. If this is right, however, it might not be immediately obvious why it should lead to a different outcome from that in *Karim* and *Goldsmith Williams*. The Judge's approach suggests that each case turns on a detailed factual enquiry.

In basing its case on 'blind eye' knowledge, Axis set itself a high bar. The imagery is of Nelson at the Battle of Copenhagen raising a telescope to his blind eye so as to be unable to see a signal ordering him to break off the attack. The requirements are tightly drawn. The Court of Appeal confirmed in *Group Seven v Nasir* [2019] EWCA Civ 614 (in which we were involved) that it needs to be established that the individual alleged to have turned a blind eye (a) had a suspicion firmly grounded and targeted on specific facts and (b) made a deliberate decision to avoid obtaining confirmation of facts in whose existence the individual has good reason to believe.

Vague or inchoate suspicions are not enough, although they can be weighed in the balance in deciding whether the individual has been dishonest. The decision not to investigate has to be a deliberate attempt to avoid acquiring certain knowledge of what the individual already suspects.

The point did not arise on the facts found by the Judge, but if condonation of a pattern of dishonest behaviour is enough, it might be thought that the exclusion would be triggered as soon as Mr Prentice knew or suspected that Mr Jones was misusing client monies, even if 'only' to address temporary exigencies.

It will be interesting to see what the courts make of the decision in future cases.

Further Information

Given the generality of the note it should not be treated as specific advice in relation to a matter as other considerations may apply.

Therefore, no liability is accepted for reliance on this note. If specific advice is required, please contact one of the Partners at Caytons who will be happy to help.

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