

Professional Services

Case Note

May 2007

McCarthy v St Paul Insurance Co Ltd [2007] **FCAFC 28**

The case considers an appeal against the decision of Dowsett J of the Federal Court of Australia concerning claims made by a firm of solicitors Jonathon James McCarthy, Bruce Michael Durie, Philip Ashley Ryan and Ian Alexander Neil ('MDRN') for indemnity pursuant to a professional indemnity insurance policy held with the appellant, St Paul International Insurance Company Ltd ('St Paul').

MDRN conducted a private mortgage lending business. It solicited funds from potential investors, many of whom were clients of the legal practice. MDRN provided details to potential investors about the specific project for which funds were sought. MDRN also provided details of the borrower and persons associated with the borrower. Loans to the borrower were usually secured by taking a first mortgage over land and investors could nominate the borrower to whom they wished to loan monies and the amount to be loaned.

MDRN defended proceedings commenced by thirty-nine persons who advanced monies, to be applied to a secured loan to Rivett Project Results Pty Ltd (Project Results) for the purpose of a property development project that involved the construction of unit accommodation described as the '*Yandina Greens Retired Folks Home*'. The project subsequently failed. The investors alleged that they were induced to advance monies due to misrepresentations contained in information provided by MDRN.

The misrepresentation relevant to the appeal appeared in an 'investment summary' prepared by MDRN's Loan Manager, Mr Blackadder. The representation greatly overstated the asset position of Project Results and Mr John Rivett, who was a director of, and controlled, the company. Mr Rivett also provided security for the loan by way of personal guarantee.

At first instance, Dowsett J found MDRN liable to thirty-six out of thirty-nine investors for loss and damage suffered as a result of their reliance on representations made by MDRN. One investor succeeded on another basis and the other two investors failed in claims against the MDRN.

MDRN cross claimed against St Paul for indemnity under its policy. St Paul defended the claim by pleading that the insuring clause did not respond to MDRN's claim as the policy excluded indemnity with respect to liability brought about by a dishonest or fraudulent act or omission on the part of the members of MDRN or their employees. St Paul alleged that Mr Blackadder was guilty of such conduct in connection with the preparation of the investment summary and the asset representations concerning Project Results and Mr Rivett.

On 26 May 2006 Dowsett J found that Mr Blackadder was guilty of dishonest conduct. Dowsett J also held that St Paul was to indemnify MDRN only with respect to its liability to the investor who relied upon statements made by MDRN which were misleading but unaffected by fraud or dishonesty.

MDRN appealed against the 26 May 2006 Order on the basis that Dowsett J gave the wrong meaning to the expression '*dishonesty and fraudulent*' and '*brought about by*' contained in the exclusion clause. It was also submitted that the findings of fact made by Dowsett J did not support a conclusion that Mr Blackadder's conduct in making the asset representations was dishonest. Furthermore it was

submitted that Dowsett J did not pose the correct question. Instead of observing that he was unable to identify an honest way in which error could have occurred in relation to the asset representation, Dowsett J should have asked whether he could find to the requisite standard that Mr Blackadder made the asset representation for a dishonest purpose.

With regard to the finding of dishonesty against Mr Blackadder. On appeal Kiefel J, with whom Allsop and Stone JJ agreed, found that the Dowsett J's conclusion of dishonesty at first instance was soundly based. Dowsett J did not reverse the onus of proof but rather drew an inference of dishonesty from the documents and by reference to evidence of Mr Blackadder's understanding of the information provided in the statement of assets and liabilities. It was held on that basis that the exclusion clause applied as Mr Blackadder's conduct had the requisite connection with the MDRN's liability.

On 23 June 2006 Dowsett J made a declaration that St Paul was liable to indemnify MDRN with respect to its costs and expenses incurred in the investigation and defence of the investors' claims. Except for such costs and expenses that related to the investors' claims against the statement of assets and liabilities of Mr Rivett and Project Results.

MDRN appealed the 23 June 2006 declaration on the basis that indemnity given in the policy extended to the costs of investigating and defending all claims made against it. MDRN argued that there was a distinction in meaning between 'loss' in the insuring clause and 'liability' in the exclusion clause such that whilst dishonesty may disentitle it to indemnity with respect to its liability to those persons, the exclusion does not affect the indemnity provided by the policy with respect to costs incurred in connection with the claims.

St Paul appealed against the 23 June 2006 declaration on the basis that Dowsett J should not have limited the operation of the exclusion clause. St Paul submitted that it should not be found liable for any related costs arising from investors' claims brought about by fraud. St Paul Relied on the principle stated in *Wayne Tank & Pump Co Ltd v Employers Liability Assurance Corp Ltd* [1974] QB 57, if a loss has two or more proximate causes and at least one cause is excluded from cover, the insurer is not liable.

St Paul submitted that given the general exclusion is a clear exclusion of indemnity; indemnity is withdrawn against loss (including Related Costs) arising from any claim in respect of civil liability brought about by the dishonest or fraudulent act or omission of Mr Blackadder. It followed therefore, that if a cost can not only be seen to be thus excluded, but can also be seen to be covered because it is a loss arising from a claim in respect of civil liability not brought about by fraud the principle expressed in *Wayne Tank* would deny recovery to MDRN.

Allsop J found it necessary to consider the nature and extent of the Wayne Tank principle. His honour concluded that the principle that truly underlay Wayne Tank was the ascertainment and application of the contractual intentions of the parties. His honour construed the insuring clause and the relevant exclusion thus: at [117]

..there is indemnity against loss (including Related Costs) arising from any claim in respect of any description of civil liability, but not against loss (including Related Costs) arising from any claim in respect of any description of liability brought about by the dishonest or fraudulent act or omission of a relevant person.

On the 23 June 2006 declaration Allsop J, with whom Kiefel and Stone JJ agreed, found that each of the investors had one claim for compensation by MDRN. Therefore subject to the operation of the policy as to the claims not affected by the Mr Blackadder's fraud, MDRN were not entitled to any indemnity against losses which arose from the respective claims of the thirty-six investors that were caused by Mr Blackadder's fraud. Rather, MDRN were entitled to indemnification for costs relating to the other three investors whose claims were not brought about by fraud.

It was held that St Paul was liable for any related costs arising from claims or liability not brought by fraud. St Paul was found to be liable to indemnify MDRN for all costs and expenses incurred in investigation and defence of claims of the other three investors.

Conclusion:

An insurer can rely on an exclusion of indemnity clause for a claim brought about by the dishonesty or fraud of the insured without having to establish the insured's dishonest motive. Kiefel J relied on *Peters v The Queen* 192 CLR 493:

'Mr Blackadder's understanding, gleaned from his experience and questions to him about his knowledge, far from furnishing an explanation of the falsity of the representations made a conclusion of dishonesty the only possible one.' at [39]

The commercial character and context of the parties' pre-contractual negotiations informs the interpretation of insurance contracts. Allsop J rejected MDRN's construction of the contract and employed a contextualist as opposed to literalist approach to the interpretation of the contract of insurance. His Honour preferred a *'commercially coherent'* and *'business-like meaning'* to the relationship between the insuring clause and exclusion clause, in order to avoid *'inconvenient and obviously unintended results'*.

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