

## ***"Managing the Arson Risk Investigation, Identification and Prosecution"***

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Paul May has a significant interest in fraudulent arson having participated in the Arson Bureau's working party and written a book, "Arson and the Insured" published by the Chartered Insurance Institute.

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### ***Introduction***

Insurance companies operate in a competitive market place where price of premium and speed of claim payment often takes priority over thorough underwriting and claims investigation. Although the problem of fraudulent arson costs the insurance industry many millions of pounds, I fear that it is receiving a lower priority than say mergers and advertising campaigns. I am not as confident as Mr Wagstaff about the ABI's initiatives and personally consider that the ABI cartoon book served to trivialise the crime of fraud.

This paper summarises the current practice for investigation and adjustment of an insurance claim following a fire. Difficulties involved with arson claims are discussed and constructive criticisms are raised.

### ***Fraudulent arson***

Arson per se is not an excepted peril in insurance policies.

If somebody causes a fire without the knowledge or consent of the insured then the policy would be liable to indemnify the insured. The cause of the fire is immaterial except where the fire was caused by;

- a peril which is excepted in the policy; or
- the wilful act or connivance of the insured.

### ***Cost to insurers***

The ABI has stated that fraudulent arson claims are thought to represent between 10 and 20 per cent of all arson claims. There is however no solid basis for this assertion.

Statistics on the incidence and cost of fire damage are kept separately by various organisations including;

- Association of British Insurers
- Fire Protection Association
- Home Office
- Police
- Individual insurance and reinsurance companies.

It is now nearly ten years since the Prevention of Arson Report (1988) made the following recommendation on national statistics:

(2) We recommend that national arson statistics be improved and that the Arson Bureau investigate the possibility of establishing a national arson database. Unfortunately this recommendation is just as applicable today.

The insurance industry cannot provide a figure for claims that have been refused or for reductions that have been made due to compromise settlements.

There is little available evidence to prove or disprove the percentage of arson claims thought by the ABI to be fraudulent. Applying a 20 per cent estimate to the latest ABI figures (ABI 1997) suggests that fraudulent arson in 1995 and 1996 has cost insurers £175,000,000.

Year	Material Damage	Business Interruption	Total
1995	£700m	£163m	£863m
1996	£718m	£179m	£897m

Various percentages have been quoted as to the extent to which arson is the cause of fires. Taking a 50% allocation to arson and applying the 20% fraudulent factor provides the possible cost of £175 million for the last 2 years:

Year	Total Arson	Fraudulent Arson
1995	£863m	£431m
1996	£897m	£448m

These figures do not allow for misallocation of cause or losses incurred by Lloyds of London.

### ***The Chartered Loss Adjuster***

The Chartered Institute of Loss Adjusters (CILA) is the sole professional body representing individual qualified loss adjusters in the UK. The Institute provides technical support to practising adjusters and an examination structure offering specialisations in the disciplines of building, financial, misappropriation, liability and contractors.

The Associateship qualification (ACILA) is essentially a demanding second career examination; the minimum entry for admission to the finals is a professional qualification from one of a number of other related institutes. The Loss Adjuster's examinations are "watchdog" orientated although it has been argued that they should include some "bloodhound" issues. (May, 1994)

The impartial independent approach is a fundamental rule of the CILA code of conduct.

On the basis that 20% of arson claims are said to be the result of a deliberate act or connivance by the insured, then conversely 80 % are not the result of any deliberate act by the insured. Insurers must therefore be sensitive in their approach to the investigation given that a large proportion of arson claims are thought to involve innocent insureds. Records at Companies

House for company closures show that a remarkable number of companies that close have given the explanation as "fire destroyed business". It is vital therefore to keep in mind the heavy responsibility that rests upon the investigating loss adjuster and the insurers involved.

An adjuster's approach should involve the exercise of impartial scepticism: keeping an open mind and constantly reassessing all the information coming from the investigation. The adjuster must show professional concern and courtesy while pursuing all necessary enquiries. Awareness of the customer service aspect of claims handling must be constantly maintained and a balance achieved.

The Loss Assessor represents the policyholder and will generally press for early payment, often without full supporting documents. The Assessor (or Public Adjuster in America) usually receives a percentage of the claim payment.

Through various means Loss Assessors become aware of a fire incident very

quickly and they can often be seen talking with the insured while the fire is still being extinguished.

### ***Liability and quantum***

During the claim assignment there are essentially two questions that an adjuster needs to answer:

- is the loss covered by the policy? And, if so
- how much should be paid?

Other considerations such as possible recovery aspects are also involved, but for the purposes of fraudulent arson the first question must be addressed as soon as possible.

### ***Types of policy***

Domestic policy holders usually have two policies covering the building structure and their contents. Sometime these policies are issued by two separate insurers which may mean that there are two separate loss adjusters involved.

Commercial insurances are also often separated between building structure and internal contents, particularly if the building is rented. Additionally, the insured company may have business interruption insurance and, therefore, there could be three separate insurance companies involved.

The business interruption policy covers loss of profits and extra costs involved in continuing to maintain business operations. The policy contains a proviso that the material damage insurer must have admitted liability under the policy before a claim will be paid under the business interruption policy. If there are separate insurers, it is usually therefore the material damage insurance policy which has to urgently consider the issue of arson by the insured.

### ***Conflicts at the scene***

The responsibility placed on the adjuster is heavy. The results of a fire investigation depend on physical evidence preservation and comprehensive and circumstantial evidence. However, these factors conflict with the demands from the insured in terms of agreeing to salvaging operations and debris removal. Pressures arising from requests for payment on account and business interruption considerations must also be attended to at a time when the adjuster is still not in a position to confirm that the fire has occurred fortuitously without any involvement by the insured.

A recent High Court case reported in July 1996, ICCI/Royal Insurance UK Ltd v. Cf McHugh/Royal Hotel Ltd, involved an action by an insurer to recover interim payments that had been made under a business interruption policy. The Court required the insured to repay interim payments that had been made under the business interruption policy on the basis that fraud had been used in the presentation of the claim. Whilst the actual cause of the fires at the hotel business were considered to be dubious, the insurers did not resist the claim under the material damage policy.

### ***Cause investigation***

It is vital to properly identify the cause of a fire. There is a possibility that some arson fires are incorrectly attributed to:

- smokers' materials;
- electrical appliances and installations;
- unknown.

The adjuster's initial assessment of the cause should involve a close consideration of all the natural and common causes of fire. If difficulty is experienced in deciding upon the cause, or indeed, if the fire appears to have been started deliberately, it is recommended that the adjuster retain the services of a forensic scientist immediately. Unfortunately, information from the fire brigade has to be extracted and this can be a time consuming process. Recent developments

involving liability of fire brigades may make obtaining information even more difficult.

### ***Parties involved***

The number of interested parties is considerable and the adjuster may be involved with all or some of the following:

- customers of the insured;
- fire brigade;
- forensic accountant;
- forensic scientist;
- health and safety inspectorate;
- insured;
- insured's accountant;
- insured's broker;
- insured's supplier's
- insurer;
- landlord;
- police;
- representative from bankers;
- shareholders;
- solicitors;
- suppliers to the insured;
- tenants;
- third parties and their insurers and adjusters;
- utilities;
- VAT inspector.

### ***Onus of proof***

It is for the insurer to prove that the insured started the fire or caused it to be started.

Slattery v. Mance held that once it was shown that loss was caused by fire, the plaintiff had made out a prima fade case and the onus was therefore on the insurer to show that, on balance of probabilities, the fire was caused or connived at by the plaintiff.

I would suggest that if arson is found to be the probable cause then insurers should require the insured to show that he did not start the fire. This reversal of the burden of proof was found in exception 19 (civil commotion etc. peril) of the insurance policy in the case of Spinneys ((1984) v. Royal Insurance Co. Ltd 1980 where the claim stated:

In any claim, and in any other action, suit or proceeding to enforce a claim under this insurance for loss or damage, the burden of proving that such a loss or damage does not fall within this Exclusion shall be upon the assured.

It was decided that the insurer must prove evidence from which it can reasonably argued that:

- i) an event occurred falling within the exception, and
- ii) that expected peril caused the loss.

There is at present no reverse burden clause in UK insurance policies relating to the cause of arson. It would however be a useful shield in the insurance industry's armoury.

### ***Balance of probabilities***

Whereas the police in their investigations are obliged to satisfy the criminal onus of proof ie "beyond reasonable doubt", insurers will only need to prove on a "balance of probability" basis. However, there is a "heavy burden of proof which rests on the insurers" according to Neill J. who also said in Watkins v. Legal and General

I should not make a finding that Mr Watkins deliberately set fire to this warehouse unless I am satisfied that there is a high degree of probability that he did so.

### ***Fire Brigade***

In the event of a fire the fire brigade is required to produce a report which should include the supposed cause. However, the fire brigade does not appear to have;

- any training or interest in assessing the state of a business at the time of a fire;
- any obligation to co-operate with insurers;
- the resources to salvage property and preserve evidence.

The fire brigade's role is to protect life and property. Occasions may therefore arise when the extent of fire damage increases because the fire brigade is concentrating on saving life or protecting adjacent high-value property. Evidence at the scene may be disturbed during damping down and post-fire activities.

### ***Police***

If the fire brigade suspect arson the police will be involved. Arson is a criminal offence and the police are the only organisation empowered to investigate and prosecute. However, the police are not trained in fire science and need to rely on reports from scene of crime officers or forensic investigators.

There is no obligation to assist or co-operate with insurers and in many cases the police have a policy of non-response to enquiries from insurers and loss adjusters.

The police may be able to give assistance from their records and knowledge. The issue is extremely sensitive but potential fraudulent arsonists should be aware that if they are already known to the police that information may well enter the domain of the adjuster's knowledge. It is clearly of paramount importance that any information received in such a fashion is dealt with confidentially by the adjuster. It should serve to point the adjuster in the right direction rather than form the basis for rash comments or premature and unsound policy repudiation.

### ***Co-operation with brigade and police***

It is vital for the adjuster to try and seek a close and confidential working relationship with the officers involved. It should however be recognised that even though criminal charges may have failed against the insured it may still be possible for insurers to successfully defend the civil case. For example, in *Blackmans Glass v. New Zealand Insurance*, the insurers successfully alleged that the fire had been started deliberately by two members of the insured company. This allegation was made despite the fact that criminal charges against both men of conspiracy to commit arson had been dismissed by magistrates at the committal stage in January 1990.

The earlier case of *S&M Carpets v. Cornhill* also resulted in a successful defence for the insurers despite the decision not to prosecute two key suspects, one of whom was the insured company's managing director.

Although insurers endeavour to obtain information from the fire brigade and police, there is sometimes a reluctance by insurers to assist with a criminal prosecution because this could result in premature disclosure of information relating to the civil dispute.

Although insurers could ask for the individuals within the insured company to obtain statements of their criminal record from the local police station, this is not something that is normally requested.

The current situation of confidential whispers is not the ideal. In America, Immunity Acts allow the exchange of information between insurers and police/authorities reducing the risk of defamation and bad faith actions from the policy holder. Introducing such a channel of safe communication between

insurers, the police, the fire brigade and the Crown prosecution service should surely be high on the fraudulent arson agenda.

### ***"Private justice"***

In a recent paper the process by which insurers settle disputed fire claims has been termed as "private justice" (Clarke 1996). His research into a number of disputed fire claims found that

"if a claim is judged to be dishonest it will be resisted, though doing so is difficult because of the circumstantial nature of the evidence and the reluctance of both the parties to go to civil trial. It is this which accounts for the war of position in which the parties engage, both attempting to wear the other down".

Research conducted by the writer (May 1992) found that insurers' internal statistics did not identify claims that had been paid even though they were considered to be suspicious. The cost of the private justice approach to the insurance industry cannot therefore be readily identified. On the whole, individual insurers do not explain their approach to fraud in their Annual Report and auditors do not make any reference to the issue.

### ***Adjuster's investigations***

Investigations by the adjuster can be briefly considered under the headings of cause, motive, opportunity, means of investigation and extent of loss.

#### ***Cause***

The cause investigation will involve the adjuster in forming an early view on whether a forensic investigation should take place. However, the adjuster should not lose control of the cause investigation. A team approach with the adjuster and the forensic scientist working closely together will enable the forensic scientist to gain the information required while at the same time enabling the loss adjuster to maintain full awareness of the cause investigation. The insurance policy allows the insurer to take possession of the property. A building can therefore be padlocked and patrolled to allow site investigation and perhaps to prevent a second attempt.

#### ***Motive***

Considerable thought and enquiry needs to be exercised. Possible motives with regard to arson by the insured include:

- reduced performance and business;
- requirement to upgrade machinery;
- requirement to change and modernise premises.

It is advisable to secure the accounting records as soon as possible. The insured company's insurance files should be located not only for the current period of insurance but also for the previous three years or so. These files will enable the adjuster to gain a picture of the insurance history and the extent of coverage. Any discrepancies between the insured's copy of the current policy and the information from insurers should therefore be identified at an early stage. Previous correspondence and policies will also assist in producing information relating to sum insured levels and claims history.

The adjuster's investigations can be of vital importance not only in terms of the insurance claim but also to support the police investigation. Close and careful questioning of all parties together with detailed enquiries into any significant changes in behaviour must be conducted.

The terms of the policy give the adjuster "trawling rights" and the adjusters net may catch an item that could assist the police.

The following can provide important information to assist a reconstruction of events, verification of fire development and spread, timings in general and security in particular:

- alarm devices and circuitry;
- clocks, flexitime/clock card systems;

- vehicle tachographs;
- premises and mobile telephone call sheets;
- electrical wiring and fuses;
- memory chips in alarm and other control panels;
- debris and partly damaged property;
- fire brigade, police and central station records

Care should be taken to avoid prejudicing the integrity of anything that might be used in evidence.

A full photographic record should be secured shortly after arrival at the site, but this information should not be relied on to the detriment of scene preservation. This is especially important where minute objects of considerable significance such as electrical wiring and items contaminated with accelerant may still be in the debris.

If possible a video recording should be made at the earliest opportunity. At the time of such recording the significance of the areas being recorded may not be clear. However, if a full video record is prepared it can be referred to as other information becomes available during the investigation.

Statements recorded in writing at the scene as soon as possible after the incident with careful attention to timings and whereabouts prove to be most helpful. It is in the fraudulent policy holder's interests to delay the involvement of insurers sufficiently to allow the site to be disturbed by salvaging, temporary demolitions etc. Activities could be taking place during such delays which could strengthen the policy holder's case possibly through falsification or destruction of crucial evidence and documents. At present there does not seem to be a system enabling the fire brigade to provide immediate notification to an insurer of a fire. The writer has previously suggested that a notification system "Firemark" could enable urgent communication to be established with the insurance company claims department or nominated loss adjuster. Essentially the fire brigade could take responsibility for notifying a national or regional central point that a fire had occurred at a particular premises. The central point, possibly a privately operated facility similar to a security company's central station, would have details of the insurance in force at the premises concerned. Whilst various difficulties would be involved with this system, it would be an income generating source for the fire brigade and a strong marketing point for the insurers concerned. An alternative would be for insurers to add a telephone number to the alarm company's keyholder contact list.

#### ***Extent of loss***

While the insured may not have caused the fire they may seek to obtain more than their actual loss. The insured is required to observe utmost good faith which also means that any claim put forward must be honestly made. If it is fraudulent the insured will forfeit all benefit under the policy whether there is a condition to that effect or no.

In *Britton v. Royal Insurance Co.* (1866) Willes, J, stated:

"The contract of insurance is one of perfect good faith on both sides, and it is most important that such good faith should be maintained. It is the common practice to insert in fire policies conditions that they shall be void in the event of a fraud, and there was such a condition in the present case. Such a condition is only in accordance with legal principle and sound policy ... if there is wilful falsehood or fraud in the claim the insured forfeits all claim whatever upon the policy."

#### ***Cause investigation standards***

The loss adjuster on small claims will normally form a view as to the cause of a fire and may not take any further investigation steps apart from requesting the fire brigade report.

On larger, particularly commercial losses, the adjuster is likely to seek authority from the insurer to engage a forensic scientist. In America there are guidelines and standards for forensic investigation laid down by the National Fire Protection Association.

Guide for Fire and Explosion Investigations (NFPA 921) seeks to establish benchmarks for investigators on aspects such as collection, testing, and storage of samples e.g. to avoid contamination. However criminal defence and civil plaintiff lawyers have sought to use the publication as a method of discrediting investigators. Considering that the innocent policyholder's business and/or home and/or liberty may be at stake this is surely the way forward. There must be no place for incomplete, tardy, partial and incorrect cause investigations.

Standard for Professional Qualifications for Investigators (NFPA 1033) - establishes objective competency standards to measure the qualifications and training of fire investigators. Although in the UK there is a guide to good practice for fire brigades, there is at present no laid down standard for the police or private cause investigation profession.

Even in America where the arson issue has been a recognised problem for over 20 years, it is only in the last 7 years or so that National Arson Investigation seminars have taken place. (May, 1995)

#### ***Statement of claims investigation practice***

Providing that the statement asserts what insurers may do rather than what they may not, it should be possible to produce a statement of practice for commercial underwriting, and claims investigation.

It is difficult to understand why insurers should be reluctant to introduce a claims investigation procedure. Is it that they are concerned that they will be 'caught out' by settling claims when they shouldn't? This is doubtful as insurers tend to give policyholders the benefit of the doubt.

Would insurers prefer to have guidelines of a more authoritative nature? The insurer would then be able to refer policyholders to the guidelines as being representative of reasonable market practice. Perhaps insurers should consider this aspect at the highest level where the balancing of shareholder and policyholder interests can be best assessed.

It is probable that the genuine policy-holder, and indeed insurer's shareholders, would wish to see in a policy that:

- there is a procedure to be followed for prudent underwriting,
- all claims are subject to an investigation procedure.

A statement of practice containing brief descriptions of all the usual steps of an investigation and the areas that are considered would leave the individual insurer with discretion as to when the investigation should terminate. It may be that a genuine claim will be identified as such at an earlier stage than a suspect claim producing positive information to certain lines of investigation. The statement would however give an insurer the opportunity of showing an insured that the procedure is a standard approach agreed by ABI member companies.

Through collaboration with the Chartered Institute of Loss Adjusters it should be possible to produce a statement of practice relating to commercial claims investigation.

Recent research in America has shown that the insuring public are becoming more willing to support and pay for fraud investigation and prosecution.

(Insurance Research Council 1996)

How would UK policyholders react to this question? Has anyone asked them?

#### ***Financial aspects***

The adjuster will look closely at the insured's financial history and potential. Independent financial analysis and comment should also be sought to supplement the adjuster's knowledge when necessary.



Working as part of a team the claims accountant can provide specialist support. Just as a specialist engineer may be required to deal with a technical problem so an accountant can be of value when dealing with the financial assessment. However, the involvement of specialist forensic accountants can give the insured the impression that the claim is suspect. This is especially so if the accounting personnel are not sensitive to the fact that many claimants are genuine. Enquiries therefore need to be conducted properly, fully, but in a sensitive and courteous manner. As with all outside specialists the brief for the accountant should be clearly set at the time of instruction to avoid unnecessary activities, duplication and cost. Communication channels should be established with the accountant reporting frequently to the adjuster.

In addition to the micro financial aspects the adjuster should consider the macro issues relating to the insured's markets and competitors. It is often the future prospects of a business that are of more significance than the historical accounts. Accounting and management information that should be gathered at the earliest opportunity include:

- audited accounts;
- auditors' reports and correspondence;
- bank statements;
- board meeting minutes;
- budgets;
- bank debentures and guarantees;
- cashflow forecasts;
- company register;
- creditors with aged analysis;
- cashbook;
- correspondence with authorities over corporation tax, PAYE and VAT;
- cheque book counterfoils;
- debtors with aged analysis;
- paying-in book counterfoils;
- payroll summaries and records;
- stock check papers.

Simple accounting ratio analysis can give indications of trends such as rate of stock turnover and solvency. In the event that the insured refuses to provide information considered necessary by the adjuster reference should be made to the policy condition often termed 'insurer's rights following a claim'. The reason for this condition is generally explained as being to the benefit of both the insured and insurers in terms of damage minimisation, salvaging, etc. However, an important purpose as far as the adjuster is concerned is that this condition can be used to support action to:

- secure the premises;
- gain access to all such property that is required for a full and objective investigation;
- establish any involvement of the insured.

Close attention should be paid to the relationship between the insured company and its bankers especially with regard to the provision of overdraft, finance, capital, and security requirements during the previous years.

Experience in recent years has shown that banks have not always exercised the prudence which traditionally has been expected of them. Lending has sometimes been to excess and often at levels well beyond the ability of a business to meet repayment and interest charges. The basis of asset valuation as security for finance should be checked for authenticity and accuracy. The way in which the bank's interest has been noted in the policy should also be examined.

The situation where the bank has become a named insured on the policy is of particular concern where a claim appears to result from arson by the insured. The case of Samuel & Co. v. Dumas held that

...if two persons insured under the one policy had interests that were separate and distinct, the wilful misconduct on one would not affect the rights of the other. If, therefore, a bank becomes a named insured on the customer's policy, it is regarded as a coinsured and would not suffer from the wilful misconduct of its customer.

### **Adjuster's central role**

The response of a survey of UK insurance and reinsurance companies conducted by the writer ( May 1992 ) confirmed that the loss adjuster continues to be regarded as fulfilling a central role in the investigation of fire claims.

The early formation of a multi-disciplinary team with the adjuster coordinating and working closely with the forensic scientist, accountant, and solicitor is an efficient and proven approach. It helps to conclude genuine claims efficiently. Fraudulent arson claims can be identified at an early stage and evidence properly collected. This should benefit not only the defence of a fraudulent claim by insurers but could also assist police in the prosecution.

A prompt and coordinated approach, including close liaison with the fire brigade and police, should become the 'norm' as it can only be of benefit to genuine policyholders, shareholders of insurance companies and Lloyd's names.

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