Insurability of the insured's fraudulent acts by virtue of performance bonds issued in Colombia

1. Introduction

The purpose of this work is to reflect upon the insurability of fraudulent acts incurred by the officers of public entities covered by performance bonds issued in Colombia

A discussion of the insurability of said fraudulent acts involves focusing on the assumption that the fraudulent acts incurred by any officer of any insured public entity trigger –wholly or partly– the breach of the contract or the infringement of the legal or regulatory provisions the compliance of which the insurance Company guaranteed.

Examples of the abovementioned assumption would be the case of a public entity officer who, in association with one of said entity's contractors and through criminal acts takes possession of public funds intended for the contract the performance of which was guaranteed or those cases in which officers of public entities responsible for tax collection connive with businessmen to obtain fraudulent tax refunds in exchange for bribes. In both cases, the pertinent insurance policy coverage is triggered and the insurance company obligated to indemnify the public entity for the loss suffered.

The question is, then, to determine if the participation of public entities' officers in fraudulent acts–involving a breach of government contracts or criminal fraud against public assets–has any effect on the performance bond which, with the same entity as beneficiary, was issued by insurance companies, since the conduct of the insured entity's officer was determinant for the occurrence of the loss event.

For that purpose, we will first explore whether the fraudulent conduct of a public entity's officers could compromise the entity's liability for compensation, and then, if that were the case, determine whether this will have any effect on the performance bond.

1. Public administration liability in tort arising from public officers' fraudulent acts

In order to determine whether the insurance company may allege fraud by the insured and hence invalidate the policy–the effects of which will be discussed later–it is necessary to establish whether fraudulent acts by public entities' officers in Colombia have any effect on said entity´s liability.

As regards fraud, it could first be argued that, as it can only be attributed to natural persons, it would be impossible for a legal person to be charged with fraud and, consequently, it would be inappropriate to allege the uninsurability of the fraudulent acts of an insured government entity –a legal person.

However, such allegation would lead to the conclusion that legal persons are never held liable for their officers' acts because they are not natural persons: they necessarily act through natural persons who, being part of their organizational structure and having specific duties within the same, may, in some cases, bind the legal person. In our opinion, there are not enough grounds to support this conclusion which is inconsistent with the well-rooted judicial precedents of both the Supreme Court of Justice and the Colombian Council of State.

On the other hand, it could be argued that one thing is the fraudulent act of a public officer and a very different one the liability attributable to the public entity where the public officer holds office. In line with this, anyone analyzing the problem could conclude that, although the public entity can be held accountable for the fraudulent acts of its officers, it does not follow that the fraudulent act of the latter entails the fraudulent act of the entity itself.

This having been said, it is necessary to point out that any analysis of fraud uninsurability must focus on the economic effects of both the insurance contract and the commission of a crime by an officer. In the face of it, what is important to take into account is who will be held liable–from a financial perspective–for the fraudulent acts, since it is by reference to them that uninsurability must be analyzed.

In other words, while in view of the insurance contract regulation "the insured's fraudulent conduct is uninsurable", the heart of the problem is to establish who will bear the financial effects of this fraudulent conduct to finally come to the conclusion that it is precisely with respect to that person that fraud becomes uninsurable. In concrete terms, if the public entity the officer alleged to have committed fraud belongs to is to bear the financial effects of said fraud, then said public entity will also have to bear the negative consequences of the uninsurability of the fraudulent conduct.

It is then worth reviewing on which grounds the Supreme Court of Justice and the Council of State have decided on the matters brought before them, which claimed for the acknowledgment of liability in tort of the public entities.

2.1. The position of the Supreme Court of Justice

In the beginning, the Supreme Court of Justice, who decided on legal issues involving the State's liability–until 1964[1]–had based public entities' liability on the provisions of the Civil Code, namely sections 2347 and 2349 and, in line with that, it was held that the obligation to compensate resulted from the unfulfillment of the obligation of selection and control–*in eligendo* and *in vigilando.*

Thus, in relation to the Nation's liability for crimes attributable to public officers, whether committed while performing their duties or under the pretext of their duties, the Supreme Court of Justice did not hesitate to hold that in those cases the Nation's liability was indirect based on the above mentioned sections 2347 and 2349 of the Civil Code–as ruled on October 22 1896 and on October 20, 1898 (both judgments quoted in the judgment of June 30, 1962 M.P. Dr. José J. Gómez[2])–. The established precedence was summarized as follows:

> *" […]*
>
> *a. There is indirect civil liability of private and public legal persons for any action causing damage which is performed by their agents while being in office or on the occasion of their office,* ***whatever the hierarchy of their positions or the kind or importance of their duties or tasks;***

[1] See: Hernández Henríquez, Alier Eduardo. "Responsabilidad Patrimonial Extracontractual del Estado Colombiano". Claudia faltan datos bibliográficos

[2] Judgment in turn quoted in Judgment of October 28, 1976. Council of State, Third Section. M.P. Dr. Jorge Valencia Arango, considered as a landmark in connection with State liability in tort.

b. *The legal person' fault is presumed because they are responsible for selecting their agents and supervising them properly;*

c. *Said presumption may be rebutted by proof of lack of fault;*

d. *There is, besides, personal liability for the damage caused, the person causing the damage being liable to the victim sustaining it;*

e. *The legal person and the agent causing the damage are jointly and severally liable to the victim, with the right of the former to recover from the latter;*

*[…]"(*Judgment passed on June 30, 1962. M.P. Dr. José J. Gómez. Civil Court of Appeals of the Supreme Court of Justice).

Notwithstanding, since the judgment passed by the Civil Court of Appeals on August 21, 1939, there gradually took ground the opinion that public and private legal persons were liable for their agents' actions, not indirectly, as stated above, but directly, on the grounds of section 2341 of the Civil Code. This change of opinion was summarized as follows:

"[….]

a. *The personal fault of an agent binds the legal person directly, because its agents' fault, whoever they may be, is its own fault; the damage caused by the agent remains, then, as the basis of the legal person's liability.*

b. *The duty to select and supervise diligently, which is inherent to vicarious liability for the acts of natural persons, set forth in section 2347, does not account for the liability of legal persons and, consequently, the presumption of fault of legal persons disappears when such presumption rests upon said duty.*

c. *The legal person is released from liability by proof of the existence of acts beyond its control, such as acts of God, acts of third parties, or the victim's fault.*

.

d. *The legal person and the person causing the damage are jointly and severally liable, and the former may claim from the latter the value of the compensation paid to the victim.*

[…]".

Afterwards, ground was gained by the so called *organicist thesis*, according to which it was considered necessary to divide the agents of a legal person in two groups: (i) the directors and representatives and (ii) auxiliary commercial agents and employees; the conclusion, based on this division, was that a legal person is directly liable for the actions of the people included in the first group, and indirectly liable for the actions of the people included in the second group.

Finally, the Supreme Court of Justice adopted the position of "*failure to provide service," as a projection of the duty of the State to provide the community with public services, and pursuant to which any damage resulting from irregularities or deficiencies in said services must be repaired by the administration; thus, the concept of fault of the identified agent does not necessarily play a role here, because the failure may be organic, functional or*

anonymous. Or, in other words, the common law fault charged on the negligent agent, according to the direct liability thesis, was transferred to the State, and gave birth to the so called administration´s fault."[3]

2.2. The position of the Council of State.

On the other hand, the Council of State, even before it was given jurisdiction to hear tort liability cases involving the State, tried to set the bases for the same on rules which are proper to public law–Contentious-Administrative Code (C.C.A.) and the Political Constitution–and not on rules of the Civil Code as the Supreme Court of Justice had to a large extent done before. Thus, quoting the courts' words, the Council of State:

> "[…] began with Section 2–referring to the 1986 Political Constitution–which established that '*public powers shall be exercised under the terms set forth in the Constitution,'*and which enshrined the most important principles of modern public law: the principle of legality, the self-limitation of public power and the rule of Law, '*the necessary counterpart of which is liability*.' Next was Section 16, pursuant to which '*the authorities of the Republic are established in order to protect the life, dignity and property of all people residing in Colombia and in order to ensure the fulfillment of the social duties of the State and the Individuals;'* and the Council of State said that this Section 16 "[…] sets forth, in general terms, the duties, rights and obligations of private individuals, and establishes a legal system of balances between the authorities and the individuals. This is how the typical public law relationship is built, which relationship is developed in the Constitution in the following sections. The duty of the administration is to protect people against legal aggressions from private individuals, but more important than that, against the acts and facts of the authorities themselves."[4]

Then, the Council of State built a subjective system–general rule–and an objective system of government liability. As regards the first one, it was necessary to demonstrate a failure in the service which were attributable to the administration; regarding the second one, because of its exceptional character, the special damage was noted as the main cause of liability; even if the acts of the administration were legal, it was considered that, by virtue of special damage if the individual had to bear a special burden with respect to the rest of the people subject to the same administration–that is, an unfair situation regarding the obligations that all citizens must bear in ordinary circumstances–it would be admissible to compensate the damages caused to the individual by the administration acts, even if they were legal acts.

The courts have identified the following characteristics of the subjective system:

> *"a) A failure in service or administration by reason of omission, delay, irregularity or inefficiency or lack or service.* ***The failure or fault in question is not the administration agent's personal fault but the failure in service, or anonymous, of the administration.***

[3] Judgment passed on June 30, 1962. M.P. Dr. José J. Gómez. Civil Court of Appeals of the Supreme Court of Justice. Quoted in Judgment of October 28, 1976. Council of State - Third Section. M.P. Dr. Jorge Valencia Arango.

[4] Hernández Henríquez, Alier Eduardo. "Responsabilidad Patrimonial Extracontractual del Estado Colombiano".

*b) The above means that the administration has acted or has failed to act, **for which reason the agent's acts are excluded, because they are alien to the service and performed in the agent's capacity as citizen.***

c) Damage entailing injury or disturbance of property protected by law, whether civil, administrative or other, with the general characteristics that private law assigns to recoverable damage, namely that it must be certain, clearly determined or determinable, etc.

d) Cause and effect relationship between administration fault or failure and damage. Without this relationship there will be no grounds for compensation, even if the fault or failure in service has been proved."

It is worth noting that the above mentioned judicial precedents emphatically establish that the only acts of an entity's officers or agents the entity cannot be bound by are those performed by said officers or agents with regards to private personal matters, that is to say when they are not acting in their capacity as officers or agents.

The adoption of the Political Constitution of 1991 meant the introduction in Colombia of governmental administration liability, stated in the following terms:

***"SECTION** 90. The State shall be held accountable for compensation for any damages resulting from illegal actions it may be charged with, caused by omission or commission by public authorities.*

Upon a court judgment ordering the State to compensate any of such damage arising from fraudulent acts or gross negligence of any of its agents, the former shall recover from the latter."

The second paragraph of the above quoted section provides that the State shall seek recovery upon court judgment holding the State liable for gross negligence or fraudulent acts of any of its agents, which leads to conclude beyond any doubt that the Political Constitution itself opened the door for public entities to be held liable for the fraudulent acts or gross negligence of their officers.

2.3. The position of legal authors

As regards the position of legal authors on public administration's liability for its officers' fraudulent acts, the Spanish author Jesús Leguina Villa records the following reflections in his work *La Responsabilidad Civil de la Administración Pública (Civil Liability of Public Administration)*, which are worth quoting in full:

" (...) Thus, the ultimate limit to the Administration liability for any event causing damage by reason of its officers' actions is mainly determined by the private actions of said officers; in other words, the public entity is not accountable for any damage arising from purely private acts performed by their agents or, vice versa, the public entity is accountable for the damage arising from the acts of its agents in the performance of their activity as such."

" (…) Holding the Administration liable for any damage caused by one of its agents is established by the legal system and is grounded on the guarantee owed to private individuals, provided there is external and objective evidence that the damage caused is the result or consequence of public activity (rather than the result of the natural person's activity) or, in other words, the result of the behavior of an officer who, from the point of view of the injured subject, has acted in the capacity of a public officer. Consequently, once it has been proved that the act causing damage committed by a public officer has any bearing on the public or private activity of a public entity, the public entity is charged with the damage without it being necessary to inquire further into whether the officer's behavior amounts to a fraudulent or negligent act and, as a result of this, the contingent existence of a fraudulent act–whether or not private– will not prevent the public entity from being held liable for the damage caused.

[…] Summing up, in our view and in agreement with the opinion widely held by legal authors, there is no obstacle that can prevent public officers, taking advantage of their position as such, and in furtherance of a purely private purpose, from causing intentional damage to private individuals: damage for which not only the officers causing it but also the public entity shall be held liable."[5]

It should be noted that this important author also agrees to the fact that the fraudulent acts of the officers who, taking advantage of their position and duties, commit a crime compromise not only their own liability but also the liability of the public entity they work for.

3. Application of Section 1055 of the Colombian Code of Commerce to performance bonds

Having determined the liability or financial effect that on a public entity has the fraudulent acts of any of its officers–who commits the crime taking advantage of a position of privilege– it is now necessary to find out the effect these fraudulent acts have on the performance bond to which the public entity is the insured party.

Thus, upon reviewing the general provisions of the Colombian Code of Commerce as regards insurance contracts, we find that Section 1055 sets forth:

"Fraud, gross negligence and acts within the sole power and authority of the policyholder, insured or beneficiary are uninsurable. Any provision to the contrary shall have no effect whatsoever nor shall have any effect any provision intended to protect the insured against criminal or police penalties."

The above mentioned regulatory provision entails a possible solution to the problem we have been considering since it expressly sets forth that the fraudulent conduct of the insured is uninsurable.

But it is necessary to review several judicial precedents that have repeatedly held that Section 1055 is not applicable to performance bonds because it is contrary to their nature.

We mention, in the first place, the judgment passed on May 2, 2002, where the Civil Court of Appeals of the Supreme Court of Justice held the following:

[5] LEGUINA VILLA, Jesús. "La Responsabilidad Civil de la Administración Pública". Tecnos. Madrid. 2007. Pages 218 to 221.

"[…] To sum up, we have concluded that, as it is indisputable that performance bonds have not disappeared and that their structure does not entirely fit the Code of Commerce, the special regulations governing performance bonds did not fall within the general repealing of Section 2033 because said regulations were not part of the code that was being repealed nor a supplementary law thereof. That was the only way to avoid the clash that would inevitably occur between Section 1099 and Section 2033.

This having been said, and going back to our topic, it should be noted that an insurance company that collects a premium for underwriting performance bonds has neither legal nor ethical arguments to claim that the insurance is not valid on the grounds that it covers a loss event that depends on the debtor's will. No legal arguments, because said performance bonds are based on the legal provisions mentioned above, the special regulations of which eliminate the application of the general principle set forth in Section 1055 of the Code of Commerce; no ethical arguments, because it would be rightful to brand not only as shameful but also as highly harmful the acts of somebody who, knowingly or with the obligation to know given their expertise on the matter, fostered the underwriting of ineffective performance bonds; needless to say, such an attitude means turning one's back to the social function of insurance. Raising false hopes knowingly certainly has a detrimental effect; the reduction of fear which the insured seeks to obtain would become cruel irony, since they would not only remain as unprotected as they were before taking the insurance but they would have added up to their frustration upon finding out that they have been the victims of deceit. Well, an almost humorous insurance."

Now, it should be noted that the above quoted judgment describes a situation in which **the fraudulent conduct of the policyholder** leads to the loss event covered by the performance bond. Here, we agree with the Court in that in this case it would not be proper to admit the uninsurability of the policy holder's conduct based on Section 1055 of the Code of Commerce of Colombia, because that would be like depriving the insurance of its nature or, as the Court holds, we would end up with an inane or humorous insurance, since from the very moment when the policy is issued, it will not be intended to produce any effect given the fact that the purpose of the insurance is precisely to cover those cases in which the holder–whether because of fraudulent conduct typified as a crime under the law or gross negligence or, to sum up, because of merely discretionary acts–fails to comply with legal provisions or breaches the contract the compliance of which is guaranteed by the performance bond.

In this line of argument it could be asked if the other assumptions of fact contained in Section 1055 of the Colombian Code of Commerce are inapplicable to the performance bond or if, on the contrary, they are all definitely contrary to the essence of the performance bond.

Thus, section 1055 puts forward the following assumptions:

- Uninsurability of fraud, gross negligence and merely discretionary acts of the **POLICYHOLDER.**
- Uninsurability of fraud, gross negligence and merely discretionary acts of the **INSURED.**

- Uninsurability of fraud, gross negligence and merely discretionary acts of the **BENEFICIARY.**

We have already concluded that the first assumption is definitely contrary to the performance bond nature, and so we will now consider the other two.

In effect, in our opinion and in relation to the performance bond, it could be argued that, when the loss event arises from the fraudulent conduct or gross negligence of a public officer of the insured entity–the second of the above mentioned assumptions–it would be possible to conclude that, such conduct or negligence being uninsurable, we would be in the presence of an exclusion based on legal grounds that prevents the insurance company from being held liable.

The preceding position might be criticized for dissociating the assumptions from the regulation, causing it to produce different effects; in relation to this, it should be said that the regulation, precisely because it considers three different assumptions of fact, admits of a range of different legal consequences depending on which assumption of fact is considered.

4. CONCLUSIONS

Fraudulent conduct or gross negligence of officers of entities insured under performance bonds risk the entity liability provided such conduct or such negligence is tied to the performance of the officers' duties in their capacity as such or provided such officers, taking advantage of their position, perform acts that contribute to the loss event, that is to say, to the breach of the contract or of the legal provision the compliance of which was guaranteed.

The fact that the public entity becomes liable for compensation by reason of their officers fraudulent conduct or negligence means that the negative financial effects of the same must be borne by the public entity, even if the entity keeps the right to recover from said officers. It is then the public entity that must bear the negative effects that the uninsurability of the fraudulent conduct or gross negligence may have on its financial position or, in other words, the effects of the ineffectiveness of the performance bond to compensate the damage that the officers' acts may entail.

Section 1055 of the Colombian Code of Commerce is inapplicable to the performance bond with respect to the assumption of fact according to which the fraudulent conduct or gross negligence of the policyholder is uninsurable but not with respect to the assumption according to which said conduct or negligence is attributable to the insured–the public entity acting though its officers–, but in that case, the regulation is fully applicable to performance bonds, thus giving way to a legal exclusion which would prevent the insurance company from becoming liable for the loss event.