

## Fraud and contracts: Jersey's Royal Court provides welcome clarification on the impact of fraud which induces a contract

Insights - 02/11/2022

In the recently issued judgment in *Hore & Anor v Valmorbida & Anor*, the Royal Court has provided important and helpful clarification on two important areas of Jersey contract law.

Primarily:

- the effect on the validity of a contract which a party was induced to enter into by fraud on the part of the other contracting party and
- the test for determining whether the innocent party has affirmed the contract notwithstanding their discovery of the fraud (whether the innocent party has agreed to continue to be bound by the fraudulently induced contract)

Working alongside Mishcon de Reya LLP, partners Damian Evans and Nick Williams, assisted by senior associate Matthew Davies and associate Charlotte Finley, successfully acted for the Plaintiffs.

## | Background

### Factual overview

The case's background and nature of the claims raised by the Plaintiffs were complicated and multi-faceted.

At its heart, the dispute concerned the validity of an agreement (known as the **Settlement Agreement**) which had been entered into by the Plaintiffs and the Defendant during the course of 2018. The First Plaintiff (**Mr Hore**) had been a business partner of the First Defendant (**Mr Valmorbida**). Mr Hore had invested substantial sums of money (by way of a combination of

share purchases and loans) in a company founded by Mr Valmorbida. The business was primarily focussed on the acquisition and exploitation of intellectual property in artworks produced by renowned street artists. Alongside the intellectual property business, the company also speculated in the art market through the acquisition of artworks which were likely to appreciate in value in the short to medium term.

Ultimately, the business relationship between Mr Hore and Mr Valmorbida came to an end, and resulted in the Settlement Agreement. The objective of the Settlement Agreement was to effect a separation of Mr Hore and Mr Valmorbida as business partners, and see that Mr Hore received back all of the sums which he had invested in the business. The Settlement Agreement provided that Mr Hore's investment would be returned to him over a specified number of payments spread over a defined period of time. As security against the possibility that Mr Valmorbida might default on his future payment obligations, Mr Valmorbida offered Mr Hore security in seven pieces of artwork purportedly owned by the company. Those seven pieces had an agreed value of some USD\$15 million. Mr Valmorbida agreed that if he defaulted on his obligation to repay, he would deliver those artworks to Mr Hore so he could sell them to raise the money owed.

It subsequently transpired that Mr Valmorbida had, prior to entering into the Settlement Agreement:

1. sold two of the most valuable paintings and retained or otherwise spent the proceeds of those sales and
2. pledged four of the remaining paintings to a lender as security against a loan taken by Mr Valmorbida

In consequence, and unbeknown to Mr Hore, the security he actually had under the Settlement Agreement consisted of one artwork with an agreed value of USD\$500,000. Mr Valmorbida had withheld the true state of affairs from Mr Hore, and led Mr Hore to believe he had security in all seven pieces of artwork, so as to induce Mr Hore to enter into the Settlement Agreement.

## Legal issues

Through their claim, the Plaintiffs sought, amongst other things, to invalidate the Settlement Agreement on the basis that it had been induced by fraudulent misrepresentations by Mr Valmorbida. In this respect, the Plaintiffs advanced two arguments in the alternative of one another:

1. first, an argument that the effect of fraudulent misrepresentation was to render the Settlement Agreement void ab initio – that is to say, make it so that the Settlement Agreement had never existed and/or
2. secondly, an alternative argument that the effect of the fraudulent misrepresentation was to

render the Settlement Agreement voidable – that is to say, the fraud gave Mr Hore the right to walk away from the Settlement Agreement if he so chose

In addition to these claims, the Plaintiffs also brought various other claims in the alternative, including in the tort of deceit, for breach of fiduciary duty, for a constructive trust and various alternative claims for loss.

In defending the Plaintiffs' claims, the Defendants argued that:

1. there had been no fraudulent misrepresentation. Ultimately, following extensive cross-examination of Mr Valmorbida, the Defendants accepted that Mr Valmorbida had made fraudulent misrepresentations with the intention of inducing Mr Hore to enter into the Settlement Agreement
2. if there had been fraudulent misrepresentation, the effect of it was to render the Settlement Agreement voidable, rather than void ab initio and
3. Mr Hore had affirmed the Settlement Agreement by certain conduct, and as such was legally prevented from exercising his right to walk away from the Settlement Agreement

## **Summary of the Royal Court's findings**

### **The effect of fraud and fraudulent misrepresentation**

Having considered the authorities identified by the parties in their legal arguments, as well as additional authorities identified by the Court, the Royal Court concluded that fraudulent misrepresentation renders a contract voidable rather than void ab initio. In arriving at this conclusion, the Royal Court had regard to historic sources of Jersey law, as well as possible commercial outcomes of fraud rendering a contract void ab initio or voidable.

### **Had Mr Hore affirmed the Settlement Agreement?**

The Royal Court accepted that there was limited authority in Jersey concerning the test for determining whether a party had affirmed a contract. The Court had regard to that limited authority, as well as authorities from other jurisdictions. Having done so, the Royal Court found that Mr Hore had not affirmed the Settlement Agreement, and further held that he was therefore entitled to elect to invalidate the Settlement Agreement on the basis of Mr Valmorbida's fraudulent misrepresentation.

## **The detail: effect of fraud which induces a contract**

The Court confirmed that, under Jersey law, there are four elements which must be present in order for a contract to be validly formed, namely capacity, consent, objet and cause.

The question for the Court was whether the presence of fraudulent misrepresentation had the effect of invalidating the consent element of the contract, with the result that a contract induced by fraud was invalid from the beginning.

The Royal Court ultimately concluded that fraudulent misrepresentation has the effect of rendering the consent to enter into a contract defective rather than invalidating the consent so as to void the contract entirely. As such, Mr Hore had still consented to enter into the Settlement Agreement, but his consent was defective on account of the fraudulent misrepresentations which had induced his consent. Mr Hore therefore had the right to choose whether to continue with the Settlement Agreement, or declare it avoided.

In arriving at its conclusion, the Royal Court accepted that recent authority on the point appeared to conflict on the void ab initio/voidable question. To resolve that conflict, the Royal Court considered various materials, including the writings of historic commentators on Jersey law which were clear that fraud rendered a contract voidable.

Additionally, the Royal Court held that the voidable option was commercially preferable. In particular, the Royal Court was concerned that the automatic avoiding of a contract when fraud is proven might cause the innocent party to suffer an unjust result. The Royal Court identified the hypothetical example of a contract for the purchase of shares which had been induced by fraud. If the fraud rendered the contract voidable, then the innocent party had the right to decide whether to avoid the contract or not. In deciding what to do, the innocent party could look at how successful the company had (or had not) been. If it had been successful, then the innocent party could affirm the contract and retain the valuable shares. Conversely, if the company in which the innocent party had acquired shares was insolvent, then the innocent party may prefer to invalidate the contract and sue for damages. On the other hand, if the contract for the purchase of shares was void ab initio, then the innocent party had no option but to hand back the shares (regardless of whether the company has prospered) and sue for damages. The Royal Court held that the innocent party should have the benefit of the ability to choose the outcome most favourable to them.

## **The detail: the test for determining whether a contract has been affirmed**

Having found that the Settlement Agreement was voidable on account of fraudulent misrepresentation, the next question for the Royal Court was to determine whether Mr Hore had affirmed the contract (and waived his right to avoid it on account of the fraud).

The Royal Court considered the limited authority available in Jersey, together with authorities from England and Wales. Based on those authorities, the Royal Court held that a party will be treated as having affirmed the contract (ie chosen to continue to be bound by it) where:

1. the innocent party has elected to affirm the contract **in full knowledge** of all of the relevant facts – ie knowledge of the fraud and
2. the party alleging that there has been an affirmation can prove
  - a. that the innocent party had the requisite full knowledge and
  - b. that the innocent party has elected to continue to be bound by the contract notwithstanding their full knowledge of the fraud

The Court also noted that it should be slow, in the case of admitted or proved fraud to hold that the innocent party has made such an election in the absence of clear evidence to this effect.

Applying this test, the Court held that Mr Hore had not affirmed the Settlement Agreement and was accordingly entitled to invalidate it on account of the fraudulent misrepresentation.

## | Other interesting points of note

In addition to providing welcome clarification on the effect of fraud on a contract and the test for affirmation, the Royal Court made a number of other interesting observations which are likely to impact the way that Jersey contract law develops in future:

1. the Royal Court approved the recent decision of the Bailiff in *Murray v Camerons* regarding the question of whether consent to enter into a contract is assessed objectively or subjectively. In *Hore v Valmorbida*, the Royal Court emphatically supported the conclusion in *Murray* – that consent was assessed objectively. In fact, the Royal Court went further and stated that "...now that the two full-time judges of the Royal Court and the most recent decision of the Court of Appeal are agreed on this issue it is anticipated that this matter is now resolved and need not be revisited"
2. the Royal Court sounded a note of caution against relying on modern French law in Jersey. The Royal Court identified a number of potential difficulties in doing so including
  - a. the fact that French law is based on the Code Civil which is updated from time to time
  - b. the potential for there to be decisions of French Courts of Appeal which conflict with one another on a point of law and
  - c. the nature of the judgments issued by the French Courts, including their brevity

## | Conclusion

The judgment in *Hore v Valmorbida* provides welcome clarification for contracting parties and practitioners. It is now clear that fraud renders a contract voidable, thereby giving the innocent party an option on how to proceed. In arriving at this conclusion, it is clear the Royal Court was mindful to place the innocent party in as favourable a position as possible and ensure the law

did not operate to impose an unfavourable outcome on them.

The judgment also provides a helpful confirmation of the test for affirmation, which is particularly important given the heightened role that affirmation will now play in contractual disputes involving fraud. Victims of fraud should act carefully when they discover a fraud which affects their contract. It is clear however that the Court will be especially cautious to find that a party has affirmed a contract where fraud is involved. The test for affirmation has wider application than cases of fraud however. As such, parties faced with breaches of contract less severe than fraud will need to be especially careful not to inadvertently affirm a contract and thereby lose their right to action the breach.

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