The English law of non-disclosure revised

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Int. I.L.R. 392 The House of Lords has recently given its decision on the vexed question of what the insurer needs to show if he is to avoid a contract of insurance for non-disclosure or misrepresentation. It has overruled the Court of Appeal on the question of materiality, that is, what information should be disclosed by the insured. However, it has also introduced a new test: the insurer must show that the non-disclosure or misrepresentation actually induced the making of the contract.

THE UNFAIRNESS OF THE RIGHT TO RESCIND

It is probably fair to say that everyone involved in insurance knows that insurance contracts are of the utmost good faith, and that this imposes on the insured an obligation to disclose to the insurer all material facts that are known to him but not known to the insurer, and that if he does not disclose them, or misrepresents them, then the insurer has the right to rescind the contract. These obligations are set out in sections 18 and 20 respectively of the Marine Insurance Act 1906 (”the 1906 Act’), which for these purposes also apply to non-marine insurance, and which are a statutory paraphrase of case law rather than imposing a new statutory regime.

Although this principle is one of the most important features of English insurance law, it has nevertheless been seen as unjust. While there is no objection to the principle in cases where the insurer would not have accepted the risk if he had known the true facts, it seems unfair that he should be able to rescind the whole contract because the insured failed to disclose to him some detail that would merely have led to a higher premium. The point was touched on by Sir Donald Nicholls VC in the Court of Appeal in this case:

Justice and fairness would suggest that when the inadvertent non-disclosure came to light what was required was an adjustment in the premium or, perhaps, in the amount of the cover. Those are not options available under English law. The remedy is all or nothing. The contract of insurance is avoided altogether, or it stands in its entirety. This is not the only field in which English law still seems to adopt an all-or-nothing approach, when what is needed is a more sophisticated remedy more appropriate, and in that sense more proportionate to the wrong suffered.[1]

Int. I.L.R. 393 WHAT IS A MATERIAL FACT?

Given, however, that the principle is good law, the obvious issue is what information the insured should disclose. This depends on whether the information is “material’. Section 18(2) of the 1906 Act defines materiality in relation to non-

disclosure as follows: “Every circumstance is material which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk.’ Section 20(2), which relates to misrepresentation, is basically identical. However, the interpretation of this apparently straightforward sentence has generated a considerable amount of legal debate.

THE PRUDENT INSURER v THE ACTUAL INSURER

The first criticism of this definition is that by making the benchmark a hypothetical prudent underwriter, it is irrelevant whether the actual underwriter concerned would have imprudently accepted the risk on the same terms even if he had been aware of the true position. For example, an “over-enthusiastic’ underwriter in the 1970s or 1980s might have accepted the risk on the same terms even if all the relevant facts had been disclosed to him; it would be unjust for him now, when the claims had come pouring in, to refuse to pay on the basis that the more cautious “prudent insurer’ would never have accepted the business in the first place.

On the other hand, few would want the test for materiality to be based solely on the judgment of the actual insurer, because he might regard a circumstance as material which no prudent or rational insurer would. The notion of the prudent insurer creates an objective and ascertainable test, at least in theory, independent of the whims and idiosyncrasies of the actual underwriter. On this point therefore the insured finds himself caught between two rather unattractive options.

This point had been considered in *Container Transport International Inc. v Ocanus Mutual Underwriting Association (Bermuda) Ltd (”CTI’),* at first instance before Lloyd J,[2] and in the Court of Appeal before Kerr, Stephenson and Parker LJJ.[3] The decisions in this case, both at first instance and the Court of Appeal, have formed the basis of all subsequent discussions of the question of materiality. Indeed the Court of Appeal’s decision is at the heart of the controversy. On this particular point, both Courts had little difficulty in finding that the correct test, given the wording of the 1906 Act, was by reference to the prudent insurer, although Lloyd J reached this conclusion with some reluctance, given the basic injustice of the right to rescind.

”DECISIVE INFLUENCE’

The second problem surrounding the definition of materiality in the 1906 Act concerns what degree of influence is required, that is, what effect the disclosure of the information would have on the prudent underwriter. In *CTI,* the first instance judge, Lloyd J, had held that: “The mind of the reasonable insurer must have been influenced so as to induce him to refuse the risk or alter the premium.’[4] It was not therefore enough for the fact to be of some relevance to the assessment of the risk, it had to have a greater impact and actually affect the premium demanded, or indeed whether the risk was taken or not. This has been named the “decisive influence’ test.

His decision was unanimously reversed by the Court of Appeal. They held that a fact was material merely if it would have an impact on the decision-making process, and it was not necessary for it actually to cause the prudent insurer to decline the risk or charge a higher premium. Kerr LJ said: “The word “influenced” means that the disclosure is one which would have had an impact on the formation of his opinion and on his decision-making process.’[5]

The Court of Appeal’s decision has, however, attracted much criticism (see the list in Steyn LJ’s decision in the Court of Appeal in *Pan Atlantic,* [6] and the summary of the substance of the criticisms in Lord Mustill’s decision in *Pan Atlantic* [7]). Many commentators felt that since the use of the yardstick of the prudent underwriter to measure materiality was so unfair to the insured, it was only reasonable to require a high degree of influence in order to counter-balance this, as Lloyd J had held in *CTI* at first instance. The Court of Appeal’s decision in *CTI* was seen as altogether too favourable to the insurer, who merely had to show that the decision-making process of a prudent insurer would have been affected. There was no need to show that his own decision-making process would have been affected, nor that the decision-making process would have been influenced to the extent that the premium would have been raised. This inequality was, of course, aggravated by the fact that the basic principle of the right to rescind was seen as too favourable to the insurer anyway.

PAN ATLANTIC: FIRST INSTANCE AND THE COURT OF APPEAL

Pan Atlantic underwrote direct American liability insurance between 1977 and 1982. For the first three years, 1977 to 1979, they reinsured the risks, but not with Pine Top. In 1980, they brought the business to Pine Top, and this was renewed for the next two years. There were disputes relating to all three years, but the appeal only concerned the last year, 1982. There were two issues: first, the presentation of the losses for the period 1977 to 1979, before Pine Top was the reinsurer, and second, the presentation of those for 1981.

For the 1977 to 1979 period, Pan Atlantic’s broker presented Pine Top’s underwriter with details of the 1980--81 losses; he

had details of the 1977--79 losses with him, and mentioned that he had them, but did not actually put the details forward. What was presented was therefore incomplete but there was some debate as to whether disclosure had been waived because the underwriter had been made aware of the existence of the figures, but had not asked to look at them. For 1981, the broker presented losses of $235,768 ***Int. I.L.R. 394*** when the actual losses were $468,168. The major question, however, was whether this information, both for 1977--79 and 1981, was material or not.

Waller J, at first instance, said that he was bound by the decision in *CTI* and therefore followed it. He held that the information would have influenced the decision-making process of the prudent underwriter.

The Court of Appeal (Sir Donald Nicholls VC, Farquharson and Steyn LJJ) unanimously upheld Waller J's judgment. However, Steyn LJ thought that there was an element of ambiguity in the *CTI* decision on the "decisive influence' test. There were two alternatives, according to Steyn LJ:

The first solution was that a fact is material if a prudent insurer would have wished to be aware of it in reaching his decision. The second solution involves taking account of the fact that avoidance for non-disclosure is the remedy provided by law because the risk presented is different from the true risk. But for the non-disclosure the prudent underwriter would have appreciated that it was a different and increased risk. Approaching the matter in this way it is possible to say that the test is whether a prudent underwriter, if he had known the undisclosed facts, would have regarded the risk as increased beyond what was disclosed on the actual presentation.[8]

This is to draw a fine distinction. The insured has never been obliged to disclose facts which would "diminish the risk' (section 18(3)(a)). The only other types of facts would be those which would raise the premium, those which might affect the risk but not raise the premium, and those which had no effect on the risk or on the premium. Steyn LJ's decision divides the last two categories.

The Court of Appeal, however, accepted the *CTI* ruling as to whether the correct test was by reference to the prudent or the actual insurer.

PAN ATLANTIC: THE HOUSE OF LORDS

One might have imagined the House of Lords would tackle the issues in the way in which they were presented: that is, two questions relating to the test of materiality. The Lords did indeed answer these two questions, but they approached them more subtly, first by dealing with these two questions on materiality, and then by going on to consider a new issue: whether, having shown that the facts were material, it was necessary to show that the actual underwriter had been induced to enter into the contract as a result of the non-disclosure or misrepresentation. This second issue had previously been bound up with the first of the materiality questions. By separating the materiality and inducement issues, the Lords could approach the 1906 Act, and case law, with greater flexibility.

The two issues were, of course, still intertwined. If the correct test for materiality was the actual insurer, it would obviously follow that he was induced by the non-disclosure or misrepresentation to enter into the contract. On the other hand, if the correct materiality test was the prudent insurer, then it was important to know whether the actual insurer had to go on to show that he had been induced to enter the contract.

THE PRUDENT INSURER

On the first question as to whether the test should be by reference to the prudent underwriter or the actual underwriter, the Lords were unanimous in finding that the test was by reference to the prudent underwriter. Lord Mustill touched on this point in his decision. It had been suggested that the decision in *Ionides v Pender* [9] had substituted the prudent insurer for the actual insurer in the materiality test. Lord Mustill thought that while this case had emphasised the use of the prudent insurer in the test, this feature had always existed in earlier law, and showed that it had been in use at least as early as 1823. Inevitably, he had more to say on the role of the actual insurer when he was discussing inducement.

DECISIVE INFLUENCE -- THE MAJORITY VIEW

This was obviously the most contentious question before the Lords, and it is perhaps not surprising that they were divided. Lord Mustill, supported by Lords Slynn and Goff, said that it was merely necessary for the facts to be relevant to the decision-making process of the prudent insurer, thereby rejecting the decisive influence test. The minority view was that of Lord Lloyd, supported by Lord Templeman, who thought that the decisive influence test was better law.

Lord Mustill believed that his view was supported both by interpreting the 1906 Act in a straightforward way, that it was the most practical solution, and that case law did not suggest otherwise. He held as follows:

Legislature might have said "decisively influence'; or "conclusively influence'; or "determine the decision'; or all sorts of similar expressions But the legislature has not done this, and has instead left the word "influence' unadorned.[10]

And further:

"Influence the mind' is not the same as "change the mind' This expression clearly denotes an effect on the thought processes of the insurer in weighing up the risk, quite different from words which might have been used but were not, such as "influencing the insurer to take the risk'.[11]

He went on to highlight what he saw as various practical difficulties if the decisive influence test was used. First, it would be very difficult for the insured to be able to judge whether a particular fact would decisively influence the judgment of the underwriter; it was in fact easier for an insured to disclose everything relevant to the decision-making process. On this point he said:

I am bound to say that in all but the most obvious cases the "decisive influence test' faces [insureds] with an almost impossible task. How can they tell whether the proper disclosure would turn the scale? By contrast, if all they have to consider is whether the materials are such that a prudent ***Int. I.L.R. 395*** underwriter would take them into account, the test is perfectly workable.[12]

He also pointed out a further practical difficulty with this test:

If there are (say) six items of information bearing on the risk, it will in many cases be easy to say that all of them ought to be disclosed. Yet if the [decisive influence test] is right, it would be necessary for the assured and the broker to decide in advance whether any of them would in itself be enough to turn the scale, and the answer might logically be that none of them were. This answer would be absurd.[13]

Lord Mustill then went on to show why he believed that case law was not inconsistent with his interpretation. His basic thesis was that the particular point had not been addressed before, and therefore there was no clear authority. He looked at case law before the 1906 Act came into force, and he thought that it was far from clear for a number of reasons: the point mentioned above (that the particular point had not been addressed before); that before the Evidence Act 1851 a party could not give evidence in his own case; problems arising from the interpretation of *Ionides v Pender*; and the consequences of the Judicature Act 1873.

For the law after 1906, Lord Mustill highlighted one case only, *Mutual Life Insurance Company of New York v Ontario Metal Products Co. Ltd.* [14] This concerned the failure by a life-policyholder to tell the insurance company of a medical check-up, and the interpretation of section 156(3) and (4) of the Ontario Insurance Act 1914, which had different wording from the Act. The Privy Council had held that:

The appellants' counsel suggested that the test was whether, if the fact concealed had been disclosed, the insurers would have acted differently, either by declining the risk at the proposed premium or at least by delaying consideration of its acceptance until they had consulted [the assured's doctor]. If the former proposition were established in the sense that a reasonable insurer would have so acted, materiality would, their Lordships think, he established, but not in the latter if the difference of action would have been delay and delay alone. In their view, it is a question of fact in each case whether, if the matters concealed or misrepresented had been truly disclosed, they would, on a fair consideration of the evidence have *influenced a reasonable insurer to decline the risk or to have stipulated for a higher premium (emphasis added).* [15]

The choice therefore was between the facts having a decisive influence and the effect of delaying the decision-making process. The Privy Council preferred the "decisive influence' test. Lord Mustill accepted that the case could not be distinguished merely because it concerned different legislation, as the Court of Appeal in *CTI* had done. However, he held that it was distinguishable because choice of degree of influence was not the same as that before the House of Lords.

This is a very narrow distinction, since it involves separating facts that have the effect of delaying the decision-making process and those which influence the decision-making process. It is difficult to see what the purpose of delay is if not to reconsider the assessment of the risk.

To sum up Lord Mustill's judgment, the test should be whether the fact influences the decision-making process of the insurer because:

(1) that is the obvious meaning of the words of the Act;

(2) that is the most practical solution;

(3) there is no authority to suggest otherwise.

DECISIVE INFLUENCE -- THE DISSENTING JUDGMENT

Lord Lloyd's dissenting judgment covers these three points. First, for him, the obvious meaning of the words of the 1906 Act as that the information had to have a decisive influence. He paid particular emphasis to the interpretation of the word "judgment', as follows:

"Judgment' is a word with a number of different meanings, so it is not possible to identify the ordinary meaning in the abstract. In a legal or quasi-legal context, it is often used in the sense of a decision or determination, as in "the judgment of Solomon' or the "Judgment of Paris' or the formal judgment of the court of law. Kerr LJ in the *CTI* case considered that it meant not the decision itself, but what he called the decision-making process. I accept that the word may bear that meaning. But it is not the primary meaning given in the *Oxford English Dictionary* as Kerr LJ's judgment may suggest, and I see no reason to give it that meaning in the present context. A Daniel come to judgment would not ordinarily be understood to mean a Daniel come to a decision-making process.

In a commercial context, "judgment' is often used in the sense of "assessment'. A market assessment means a judgment as to what the market is going to do, not the process by which a stockbroker arrives at that judgment. That is, in my opinion, the sense in which the word is used in section 18(2) of the [Act]. Parker LJ [in *CTI*] attached importance to the words *in fixing* to the premium and in *determining* whether to take the risk. But I do not regard these words as pointing to a decision-making process rather than the decision itself.[16]

Lord Lloyd also disagreed with the second point in Mustill's judgment, concerning the practicality of the test. He held as follows:

The test should be clear and simple. A test which depends on what a prudent insurer would have done satisfies this requirement. But a test which depends, not on what a prudent insurer would have done, but on what he would have wanted to know, or taken into account in deciding what to do, involves an unnecessary step. It introduces a complication of which is not only undesirable in itself, but is also, in the case of inadvertent non-disclosure capable of producing great injustice.[17]

He went on to refer to the judgments of Stephenson LJ and Parker LJ in *CTI,* who had both held the opposite view. Parker LJ had suggested that if five "experienced and prudent' underwriters were to give evidence, they would be able to state what would influence their decision-making process, but they would disagree as to whether the premium would ***Int. I.L.R. 396*** thereby be altered. Lord Lloyd, however, held: "Five experienced and prudent underwriters are just as likely -- in my view more likely -- to disagree what they would want to know as about what would have done.'[18]

It will come as no surprise that, just as he disagreed with Lord Mustill on the first two points, so Lord Lloyd disagreed with him on the third point, that is, the interpretation of the various authorities. He too divided his analysis of authorities into those before the 1906 Act and those after it. In relation to the authorities before it, he referred to much more of the case law than Lord Mustill had done, and indeed referred to very few text-books. He cited a number of cases that he believed supported his argument, including a quotation from Blackburn J in *Ionides v Pender* (at page 539):

We agree that it would be too much to put on the assured the duty of disclosing everything which might influence the mind of an underwriter. Business could hardly be carried on if this was required.[19]

In looking at the authorities since the 1906 Act came into force, he dealt at some length with *Mutual Life.* Inevitably, he interpreted the case as being good authority for the decisive influence test. For instance, he said that:

The board was thus deciding that something which the insurers would have wanted to know, or taken into account and which might have led onto further enquiries, with consequential delay is not by itself material, unless it would have led to a different result.[20]

And later,

In my opinion the *Mutual Life Insurance Company* case remains the leading authority on the application of the prudent insurer test, and the meaning of materiality in English law.[21]

Of the two judgments, which is the better view? On the first point, that of statutory interpretation, the two judgments are fairly evenly balanced and it is difficult to say that either of them strained the wording of this section; much depends on how one interprets the word "judgment' and the weight that one attaches to the words "in fixing' and "determining'. On the second point, that of practicality, they are equally matched, but for different reasons. Lord Lloyd's interpretation does suffer from the problem that the insured will have to decide whether a fact is of *decisive* influence or not, which involves him in a two-stage process: first, deciding whether a fact is of some influence, and second, deciding whether it is of decisive influence. On the other hand, Lord Mustill's judgment means that the insured will have to disclose everything of relevance, which could also be impractical. On the third point, that of the interpretation of the authorities, one must choose between Lord Lloyd's arguments based on a close reading of the case law, and Lord Mustill's rather broader approach which suggests that most of the case law can be distinguished for one reason or another, and which relies on 19th century text-books.

INDUCEMENT -- THE ACTUAL INSURER

While the difference of opinion on the interpretation of materiality is of importance, its potential consequences have been reduced by the fact that the House of Lords was basically in agreement that it is necessary for the actual insurer to show that he had been induced to make the contract because of the non-disclosure or misrepresentation. As Lord Lloyd put it, "Did the misrepresentation or non-disclosure induce the insurer to enter the contract on those terms?'.[22]

At first glance, the surprising thing about this part of the House of Lords' decision is that there is nothing in the 1906 Act to suggest that the insurer needs to prove a connection between the misrepresentation or non-disclosure and the underwriting of the risk. Sections 18 and 20 of the Act seem to suggest that once materiality is shown, the underwriter has the right to avoid the contract. Thus section 18(1) reads: "The assured must disclose to the insurer every material circumstance If the assured fails to make such disclosure, the insurer may avoid the contract.'

The problem facing the Lords was set out by Lord Mustill.

There appear to be three reasons why the Act may have taken the form which it did. First, the common law did not require inducement and was correctly reproduced by the Act. Second, the common law did require inducement but the promoters of the Act wished the law to be changed and Parliament did change it. Third the common law did require inducement and the Act, properly understood, is to the same effect.[23]

Both Lord Lloyd and Lord Mustill show from an analysis of the case law that the common law did require inducement. Since the wording of the 1906 Act was based on the decision in *Ionides v Pender,* both Lords considered this case; unsurprisingly, they felt that it had not affected the question of inducement, and that this was subject to the wider law on misrepresentations which, of course, required proof of actual reliance.

Nevertheless, although being in broad agreement, their Lordships analysed their understanding of the principle of inducement differently. For Lord Lloyd:

The intention was to verify the common law on materiality, without touching the common law on inducement Section 18 does not exclude inducement. It is dealing with a different subject-matter altogether.[24]

Lord Mustill, on the other hand, held that a requirement should be implied into the 1906 Act that it was necessary to show inducement. This was based on the fact that under the general law on misrepresentation, it was necessary to show inducement. Further, this principle should be extended to non-disclosure because the alternative, of not extending it, would be intolerable, especially when the separation of non-disclosure and misrepresentation is usually a practical impossibility. Thus on the facts, one would have to decide whether the failure by Pan Atlantic's broker to disclose all the losses for 1981 amounted to misrepresentation of all the year's losses, or non-disclosure of some of the year's losses. This would be an impossible and artificial task.

***Int. I.L.R. 397** Whether Lord Mustill's or Lord Lloyd's is the better view, it is clear that they are in agreement as to what the law is: actual inducement must be proved. This is the most significant result of the judgment; while it does not resolve the problem of what level of influence is required, it reduces its impact because it turns the spotlight on the individuals involved, and their own procedures for assessing risks. It could be uncomfortable for an underwriter pleading non-disclosure to find that he must produce evidence of the sort of risks he considered, and the attention that he would pay to information about the risk.

CONCLUSIONS: THE FUTURE OF THE RIGHT TO RESCIND

This decision clearly goes some way to resolving the injustice that had surrounded this area of the law, but what the decision

does not resolve is the question of the intrinsic unfairness of the right to rescind, for instance, by providing for a system of proportionality.

These issues have been aired in 1979 and 1980 by the Law Commission, both in a working paper -- No. 73 (1979) -- and in a final report -- No. 104 (1980), Cmnd 8064. Following this, the Department of Trade and Industry proposed a draft Bill in 1984, which provided a new, less strict test for the consumer, but this did not extend to the commercial field. The commission considered that professionals should be aware of the law and it is no surprise to find that the chairman of the commission was Kerr J, who was, of course, later a member of the Court of Appeal in *CTI.*

Despite this draft Bill, no legislation has been enacted, even in relation to consumers. Anyway, the draft Bill would not have resolved what Sir Donald Nicholls VC described as the "fairly crude, all-or-nothing approach' of the right to rescind because it did not alter the basic principle. Unfortunately, given the difficulties facing the insurance market, both domestically and internationally, Parliament seems reluctant to intervene and the possibility of a fairer, more sensibly geared system may be a long way off.

Footnotes

1	[1993] 1 Lloyd's Rep. 496 at 508.
2	[1982] 2 Lloyd's Rep. 178.
3	[1984] 1 Lloyd's Rep. 479.
4	At 188.
5	At 492.
6	[1993] 1 Lloyd's Rep. 496.
7	Transcript, at 17 and onward.
8	At 505.
9	(1874) LR 9 QB 531.
10	Transcript, at 21.
11	*Ibid.*
12	*Ibid.*
13	*Ibid.,* at 22.
14	[1925] AC 344.
15	*Ibid.,* at 351.
16	Transcript, at 51 and onward.
17	*Ibid.,* at 49.
18	*Ibid.,* at 50.

19	*Ibid.,* at 53.
20	*Ibid.,* at 57.
21	*Ibid.,* at 58.
22	*Ibid.,* at 64.
23	*Ibid.,* at 33.
24	*Ibid.,* at 64.