

When Can an Underwriter Avoid a Policy of Insurance for Nondisclosure by the Insured?

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This question has recently been considered by the House of Lords in the case of *Pan Atlantic Insurance Company Limited & Ors v Pine Top Insurance Company*.

The facts were as follows:

During 1977 and 1982 Pan Atlantic Insurance Company Limited (Pan Atlantic) wrote a quantity of direct American liability insurance. Much of this was in effect 'long tail' business. The dispute in question related to a contract of reinsurance relevant to the policy in 1982 made between Pan Atlantic and Pine Top Insurance Company Limited (Pine Top').

In relation to the years 1977 and 1979 Pan Atlantic's Casualty Account had been reinsured with other insurers for excess of loss above a certain figure. Pine Top became the re-insurer in respect of this cover for the 1980 policy year and later renewed for two subsequent years. The present appeal being considered by the House of Lords was concerned with only the claim under the 1982 year.

The broking history of this treaty was summarised by the trial judge as follows:

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1 [1994J3WLR677.

The broker who acted on behalf of Pan Atlantic was Mr Robinson of Butcher Robinson and Staples. The underwriter was Mr O'Keefe. On December 22 or 23, 1981 Mr O'Keefe gave a quotation. On January 13, 1982 Mr O'Keefe signed the slip on behalf of Pine Top. Pine Top took a line of 50 per cent on the slip. Guildhall Insurance Co. Ltd signed for the remaining 50 per cent. Guildhall never sought to avoid their liability under the 1982 treaty and therefore drop out of the picture.

The structure of the renewal for 1982 must be briefly explained. For the 1981 year the rate of premium was 10 per cent. When it came to the renewal for 1982, Pan Atlantic wanted the rate reduced to 7 per cent. That could only be done by introducing an aggregate deductible of US\$225,000. That was the way in which the slip was then written and signed.

The main features of the slip were as follows. First, it covered the liability of the reinsurer under:

.. .all policies and/or contracts and/or binders of insurance and for reinsurance ... allocated to their so-called Casualty Account...'

Secondly, the treaty was to pay US \$75,000 excess of US \$25,000 each and every loss on an ultimate net loss basis. Thirdly, it provided for an aggregate deductible of US \$225,000. Fourthly, the rate of premium was 7 per cent. This slip is, of course, in commercial terms the primary evidence of the bargain struck between the broker and underwriter. In the usual way treaty wording was prepared by clerical staff long after the contract was made. It was agreed on October 29, 1992. Article XV reads as follows:

... It is hereby declared and agreed that any inadvertent delays, omissions or errors made in connection with this Reinsurance shall not be held to relieve either of the parties hereto from any liability which would have attached to them hereunder if such delay, omission or error had not been made, provided rectification be made upon discovery, and it is further agreed that in all things coming within the scope of this Reinsurance, the Reinsurer shall share to the extent of their interest in the fortunes of the Reinsured.

The basis of Pine Top's purported avoidance of the reinsurance contract for 1982 was the presentation made by Mr Robinson to Mr O'Keefe. The undisputed evidence was that Mr Robinson was an experienced and respected broker. Mr O'Keefe was an underwriter with some four years experience. They knew one another; they had negotiated the 1981

contract. Mr Robinson and Mr O'Keefe met on December 22 or 23, 1981 and again on January 13, 1982 when Mr O'Keefe signed the slip. The discussions covered the reduced premium and the introduction of the aggregate deductible. There was some discussion of the loss record, and on January 13, 1982 Mr Robinson said to Mr O'Keefe that he had done a quick update and there was little movement in the figures. Mr Robinson had available for Mr O'Keefe's inspection two documents, respectively called the short record and the long record.

The short record contained only the record for the years 1980 and 1981. The long record contained the record for the 1977 and 1979 period when Pine Top was not on risk, as well as the record for the 1980 and 1981 years when Pine Top was reinsurer. The record for the 1977 to 1979 period was so bad that it was eventually common ground at the trial that no prudent underwriter would have signed the slip for 1982 on the terms which Mr O'Keefe accepted.

A major issue at the trial was whether there was a fair presentation in respect of the loss record for the 1977-1978 and 1979 underwriting years. The Judge found that, although to Mr O'Keefe's knowledge, both the short record and the long record were available for inspection, Mr Robinson presented the risk in a way which diverted Mr O'Keefe's attention from examining the loss records for the underwriting years 1977-1978 and 1979. The loss record for 1980 and 1981 was undoubtedly disclosed. But the disclosed record was incomplete.

Pan Atlantic commenced proceedings, and by its defence Pine Top sought to avoid the treaty on the grounds of nondisclosure of the 1977 to 1979 loss record and related misrepresentations. Shortly before the trial, Pine Top amended its defence to add that the 1980 and 1981 loss record as disclosed was incomplete and this constituted a further material misrepresentation and nondisclosure.

Although the issues arose under policies of nonmarine insurance, the Court stated the issues by reference to the *Marine Insurance Act 1906* (UK) (the Act) and stated that in relevant respects the common law (of the United Kingdom) relating to the two types of insurance was the same, and that the Act embodied a partial codification of the common law.

Accordingly, the relevant sections of the UK Act to be considered were as follows:

17 A contract of insurance is a contract based on the utmost good faith and if the utmost good faith be not observed by either party, the contract may be avoided by the other party.

18(1) Subject to the provisions of this section, the assured must disclose to the insurer, before the contract is concluded, every material circumstance which is known to the assured, and the assured is deemed to know every circumstance which, in the ordinary course of business, ought to be known by him. If the assured fails to make such disclosure, the insurer may avoid the contract.

(2) 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.

20(1) Every material representation made by the assured or his agent to the insurer during the negotiations for the contract, and before the contract is concluded, must be true. If it be untrue the insurer may avoid the contract.

(2) A representation is material which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk. •

91(1)...

(2) The rules of the Common Law including the law merchant, save insofar as they are inconsistent with the express provisions of this Act, shall continue to apply to contracts of marine insurance.

The actual questions of law that were considered by the Court were as follows:

1. Where sections 18(2) and 20(2) relate the test of materiality to a circumstance which would influence the judgment of a prudent underwriter in fixing the premium, or determining whether he will take the risk, must it be shown that full and accurate disclosure would have led the prudent underwriter to a different decision on accepting or rating the risk; or is a lesser standard of impact on the mind of the prudent underwriter sufficient; and if so, what is that lesser standard?

2. Is the establishment of a material misrepresentation or nondisclosure sufficient to enable the underwriter to avoid the policy; or is it also necessary that the misrepresentation or nondisclosure has induced the making of the policy, either at all or on the terms on which it was made? If the latter, where lies the burden of proof?

The House of Lords reviewed the decision in *Container Transport International Limited v Oceanus Mutual Underwriting Association (Bermuda)*² (1984) (the 'CTIcase')-

I believe that it is an open secret that the CTI case, the facts of which are not germane, was a very unpopular decision in the insurance industry. The CTI case can be broadly stipulated to have laid down the following principles, that for contracts of insurance and reinsurance to be avoided the following criteria would have to be applied:

1. The actual underwriter who wrote the risk in question does not have to show that it has been induced to do so, or was induced to do so at a lower premium than it would otherwise have done, as a result of the nondisclosure/misrepresentation.
2. Further, it is not necessary for an underwriter to show that the nondisclosed fact, if disclosed, probably would have had a decisive influence on the prudent underwriter's decision on underwriting the risk or on the premium or some other term.
3. For the underwriter to succeed it does, however, have to prove that the prudent underwriter would regard the undisclosed information as probably tending to *increase the risk*.

Unfortunately, as many commentators had aptly distilled, the second and third principles to some degree created an oxymoron, in that a fact which increased the risk would also logically increase the premium.

Lord Mustill concluded that the Act had not fully codified the law and, as in other areas of the law, for an insurer to avoid a contract by reason of a nondisclosure/misrepresentation, it must show that it itself relied upon that misrepresentation.

² [1984] 1 Lloyd's Reps 476.

Lord Mustill approved Kerr LJ's test in *Berger & Light Diffusers Pty Limited v Pollock* in which he had stated the principles in a way which suggested that the insurer could only avoid the policy if it had in fact been influenced by the misrepresentation or nondisclosure.

Lord Mustill stated he preferred Kerr LJ's view in the aforementioned case rather than his change of heart in the *CTI* case. In the *CTI* case, Kerr LJ stated that he had been wrong in the case of *Berger & Light Diffusers Pty Limited v Pollock* and that he now believed on a fuller examination of the authorities (particularly *Zurich Accident and Liability Insurance Company Limited v Morrison* [1942] 2 KB 53) that it was not necessary to prove that the mind of the actual insurer had been affected.

Of particular importance is that the court considered the question of what constituted a 'material misrepresentation/nondisclosure'. Lord Mustill also considered the position of the prudent underwriter as stipulated in the *CTI* case. Many commentators, by that stage, had stated that the Court of Appeal's standard of materiality was too low. It was argued that the law ought to be that circumstances are material only if the disclosure would decisively have influenced the mind of the prudent underwriter. The majority of the House of Lords followed Lord Mustill whose view was based on the statutory interpretation of the words 'which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk'. In this context, Lord Mustill said as follows:

A circumstance may be material even though a full and accurate disclosure would not in itself have had a decisive effect on the prudent underwriter's decision whether to accept the risk and if so at what premium.

In dissenting judgments, Lord Templeman and Lord Lloyd disagreed with Lord Mustill and declined to accept the *CTI* case's criteria of materiality. Lord Templeman said as follows:

I believe that the minority view in this issue is to be preferred and that if it can be demonstrated that a misrepresentation or nondisclosure was not

3 [1973] 2 Lloyd's Rep. 442.

material, in that it would not have affected the acceptance of the risk or the amount of the premium, then the insurer should not be able to avoid the contract of insurance by such misrepresentation/non-disclosure.

It is particularly of interest that the dissenting view of the House of Lords on this issue by and large agreed with the decision of Samuels J in *Mayne Niddess Ltd v Pegler*. Further, the dissenting view considered *Barclay Holdings (Australia) Pty Limited v British National Insurance Company Limited*, in which the Court of Appeal of New South Wales declined to follow the CTI case. In that case, Glass JA, described it as sounding a 'discordant note' and Kirby P said as follows:

As expressed by Samuels J in *Mayne Nickless Ltd v Pegler*, the issue is not whether the insurer would have been interested in the information or would have liked to have had it in order to consider it. It is whether the insurer, acting reasonably, would have been affected in deciding the critical questions mentioned. Such a test is to be preferred to one which affords the insurer the privilege of insisting upon the disclosure of any material whatsoever that could have had an impact on the formation of the insurer's opinion and on its decision-making process, even though, in the end, such information was not critical to or determinative of the conclusions finally reached.

In my view the most important aspect of this case is that while experts will still have to be called they now have to explain how their judgment 'would' have been influenced rather than 'might' have been influenced and the actual underwriter will also have to give evidence (if this decision is followed in Australia). Further, it is likely that the actual underwriter will have to explain how he normally reaches an underwriting decision. I recommend that the prudent underwriter should in future keep detailed records of matters which induced him to write a slip and perhaps in appropriate cases/notes of the factors which would have had a bearing on whether or not to write the policy had they been disclosed.

4 [1974] 1NSWLR 228.

5 (1987) 8 NSWLR 514.

6 *Ibid.*, at 523.