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MATERIALITY OF DISCLOSURES: LEARNED HAND IS MISCONSTRUED IN HIS OWN CIRCUIT (formerly entitled A VIRUS IN THE CIRCUIT...)

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A VIRUS IN THE CIRCUIT

“Melissa” Meddles with Materiality

A court’s harmless but erroneous line is sometimes repeated in later cases as a statement of law, without looking back to its source and gauging its authority. When that happens, we have an infection at work. In one such instance, the Court of Appeals for the Second Circuit has seized a somewhat speculative line out of context and quoted it in such a way as to stand doctrine on its head. One might have hoped the virus would die out but it hasn’t.

It starts innocently enough in 1931, with Judge Learned Hand’s opinion in the Btesh case.¹ The court turned down the assured’s claim against underwriters for loss of cargo on account of its material non-disclosure of the high-risk character of its goods. In passing, Judge Hand referred to the difficulty of defining what is material, “except to say that it must be something which would have controlled the underwriter’s decision. By this we understand only what a reasonable person in the assured’s position would suppose.”² Farther on, he observed that the “books are somewhat vague as to how far he shall be charged at his peril with appreciating the materiality of what he does know”, and he then laid that speculation aside as not involved in the decision.³

Elsewhere in his opinion,⁴ Judge Hand referred to the right authorities on materiality standard. He cited:

(1) the Supreme Court’s opinion in McLanahan, where Justice Story said “The underwriter must be presumed to act upon the belief, that the party procuring insurance, is not, at the time, in possession of any facts, material to the risk, which he does not disclose...” and “the test of materiality...is, ... dependent upon the judgment of underwriters”;⁵

(2) the same court’s opinion in Sun Mutual Insurance, where it said, “That knowledge of the circumstance was material...is so manifest to common reason as to need no proof of usage or opinion among those engaged in the business...Had it been known, it is reasonable to believe that a prudent underwriter would not have accepted the proposal as made...The concealment, whether intentional or inadvertent, we have no hesitation in saying, avoids the policy...”;⁶ and

¹ Btesh v. Royal Ins. Co., Limited, of Liverpool, 49 F.2d 720, 1931 AMC 1044 (2nd Cir. 1931).
² 49 F.2d at 721, 1931 AMC at 1046.
³ 49 F.2d at 721-22, 1931 AMC at 1047.
⁴ 49 F.2d at 721, 1931 AMC at 1046.
(3) the Ninth Circuit’s *St. Paul Fire & Marine* (“It is immaterial whether the omission to communicate a material fact arises from intention, indifference, or mistake, or from it not being present to the mind of the party who should communicate it that the fact was one which it was material to make known…”).7

Both those supreme Court cases, the first by clear implication8 and the second expressly,9 made clear that materiality depends on the effect on the mind of a prudent underwriter. The Marine Insurance Act 1906 agrees,10 as have most American cases since.

The following year Judge Hand joined in an opinion by Swan, J. on a reinsurance claim, under the same rules as marine insurance. He agreed that the doctrine of Lord Mansfield that the “underwriter proceeds upon confidence that [the assured] does not hold back any known fact affecting the risk [not just one he thinks affects it], and is deceived if such a fact is concealed, even though its suppression should happen through mistake and without fraudulent intention … still persists in full vigor in marine insurance…”11 Farther on, Swan, J. alluded to Hand’s words in *Btesh* by writing that, “even if knowledge of materiality [by the assured] is important, but means only what a reasonable person in the insured’s position would have supposed, as intimated by this court in *Btesh* …” (emphasis supplied) the assured was bound to disclose in that case.12 Again in 1939, Hand joined in an opinion citing *Btesh*, but now only for the conventional absolute disclosure rule.13

If Homer nods, so perhaps might Learned Hand. But he would never have meant to turn on its head surreptitiously a doctrine he knew. His musing speculation certainly had nothing to do with the decision of the case. Indeed it did not even purport to relate to the determination of materiality, but only to suggest the possibility of an excuse to an assured who did not recognize the materiality the court found, while not extending such an excuse. It has never been adopted as a rule even in that sense, and cannot be reconciled with the statements of the controlling authorities, although probably courts have exercised their discretion in that direction without stating any general rule delegating the issue of materiality to assureds. There was no harm in it if left to lie where it fell. But, repeated out of context, it has been stated by some courts, not as a possible excuse for the close-mouthed assured but as a definition of materiality, displacing the view of the prudent underwriter.

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9 107 U.S. at 509-10, 1998 AMC at 1212.
10 MIA § 18(2).
11 *Hare & Case v. National Surety Co.*, 60 F.2d 909, 911 (2nd Cir. 1932).
12 60 F.2d at 912.
With one exception, the court that spawned the speculation has ignored it in later cases, citing Btesh only for the good law it stated and followed.\textsuperscript{14} The mischief was launched in 1986 in the \textit{Knight} case.\textsuperscript{15} There the court denied recovery, affirming that uberrima fides “requires the assured to disclose to the insurer all known circumstances that materially affect the risk”, but went on to say: “The standard for disclosure is an objective one, that is, whether a reasonable person in the assured’s position would know that the particular fact is material”, citing \textit{Btesh}. If you say it fast enough, it may sound reasonable. One of the collateral risks the underwriter inevitably assumes is the risk of the assured’s permissible ignorance of material circumstances. But if the assured becomes the judge of materiality, the underwriter must take on the additional risk of the assured’s judgment. No harm was done in \textit{Knight} because of the weight of evidence against the claim. From that day, however, the statement in \textit{Knight}, with \textit{Knight} cited as authority, has been quoted or paraphrased in no fewer than eight cases in various courts as the standard of materiality for disclosure.\textsuperscript{16} In none of those cases does it appear to have controlled the decision. As their numbers mount, however, it will be ever more likely to control decision and the law will have been stood on its head, without any thought of its being a good idea.

When it next deals with the issue of disclosure, the Court of Appeals should take occasion to expunge this virus. Meanwhile, if the matter comes up in any of the district courts of the circuit, counsel and the court should put forth their best efforts to call attention to it and suppress its further spread.

\textsuperscript{14} Id.; Puritan Insurance Co. v. Eagle Steamship Co., S.A., 779 F.2d 866, 870, 1986 AMC 1240, 1245 (2\textsuperscript{nd} Cir. 1985).
\textsuperscript{15} Knight v. U.S. Fire Insurance Co., 804 F.2d 9, 13, 1987 AMC 1, 6 (2\textsuperscript{nd} Cir. 1986), cert. denied, 480 U.S. 932 (1987).