ARONBERG GOLDGEHN

Insurance Coverage Update

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Illinois Supreme Court Determines Innocent Insured Doctrine Does Not Bar Complete Rescission of Law Firm's Professional Liability Policy

Illinois State Bar Ass'n Mut. Ins. Co. v. Law Office of Tuzzolino and Terpinas
(Illinois Supreme Court)

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In a much-anticipated decision that impacts liability insurers' ability to obtain policy rescission, the Illinois Supreme Court ruled on February 20, 2015 that the "innocent insured" doctrine does not apply to rescission cases. *Illinois State Bar Ass'n Mut. Ins. Co. v. Law Office of Tuzzolino and Terpinas*, 2015 IL 117096 (2015). The Court's 6-1 decision reverses a 2013 Illinois Appellate Court ruling that significantly extended the innocent insured doctrine and changed the landscape for insurers seeking rescission as a result of an insured's material misrepresentations in obtaining coverage. *See, Illinois State Bar Ass'n Mut. Ins. Co. v. Law Office of Tuzzolino and Terpinas*, 2013 IL App (1st) 122660.

Background

The coverage dispute in *Tuzzolino* arose from an underlying legal malpractice claim involving the Law Office of Tuzzolino & Terpinas (the "Firm") and two of the Firm's partners, Sam Tuzzolino and Will Terpinas, Jr. A former client alleged that Tuzzolino mishandled several matters, and Tuzzolino ultimately offered to pay the client $670,000 to settle any potential claim for legal malpractice.

Less then three months after making the settlement offer, Tuzzolino completed an application to renew the Firm's legal malpractice policy with Illinois State Bar Association Mutual Insurance Company ("ISBA Mutual"). On the renewal application, Tuzzolino answered "No" when asked: "Has any member of the firm become aware of a past or present circumstance(s), act(s), error(s) or omission(s), which may give rise to a claim that has not been reported?"

After ISBA Mutual issued a lawyers professional liability policy (the "Policy"), Terpinas learned of the former client's claim and immediately reported it to the insurer. ISBA Mutual filed suit against Tuzzolino, Terpinas, the Firm, and the former client, seeking (1) rescission of the Policy; and (2) a judgment declaring that ISBA Mutual had no duty to defend Tuzzolino or the Firm against the former client's claim. The trial court granted ISBA Mutual's motion for summary judgment, rescinded the Policy, and declared that ISBA Mutual had no duty to defend.

Terpinas and the former client appealed the trial court's judgment, arguing that Terpinas was an innocent insured who was not responsible for Tuzzolino's misrepresentation and, therefore, the Policy should not have been rescinded as to Terpinas. The Illinois Appellate Court for the First District agreed with Terpinas and the former client, reversed the trial court's judgment of rescission as to Terpinas, and held that the common law innocent insured doctrine applied to the misrepresentations made on the renewal application. ISBA Mutual appealed to the Illinois Supreme Court.

Illinois Supreme Court Decision

In deciding whether Illinois law permits rescission of an insurance policy in its entirety for a material misrepresentation on the policy's application, the Illinois Supreme Court first reviewed the Illinois statute governing rescission of an insurance policy, which sets forth a two-prong test for rescission. The two-prong test requires (1) a false statement (2) made with the actual intent to deceive or materially affecting the acceptance of the risk or the hazard assumed by the carrier. See, 215 ILCS 5/154 (West 2008). The Court also noted that it previously recognized that the statute does not mandate that the misrepresentation be made with ill-intent. It permits rescission for an innocent misrepresentation as long as it materially affects the insurer's acceptance of the risk.

ISBA Mutual argued that Tuzzolino's misrepresentation met the Illinois statute's requirements because the misrepresentation materially affected the insurer's acceptance of the risk. Terpinas and the former client claimed that, regardless of the materiality of the misrepresentation, it would be "patently unfair" to rescind coverage for

Terpinas, an innocent insured who had no knowledge of Tuzzolino's previous conduct or misrepresentations and did not cooperate in, or contribute to, a loss.

The Court rejected the innocent insured argument. In doing so, the Court considered the history of the doctrine, which generally operates where a policy insures two or more insureds and permits an insured who is innocent of wrongdoing to recover despite wrongful conduct of other insureds. The Court emphasized that the doctrine has historically been applied in situations involving arson or vandalism, where the innocent insured seeks recovery under a policy that excludes coverage for intentional acts. Those situations involve questions of policy exclusions and coverage under a policy that was undisputedly in effect. And the Court noted those situations are considerably different from the rescission context, where the question is whether a policy should be enforced as a threshold matter. As the Court reasoned, "[a] misrepresentation on the policy application goes to the formation of the contract." While an insured's innocence may be relevant to whether a policy exclusion is triggered by another insured's wrongdoing, the Court noted it has no bearing on rescission, which is an appropriate statutory remedy regardless of innocence in connection with the misrepresentation.

The Court also found that the Illinois Appellate Court erred in partially severing the Policy, pursuant to the Policy's severability clause. That clause provided that "particulars and statements contained in the APPLICATION will be construed as a separate agreement with and binding on each INSURED." The Illinois Supreme Court reasoned that, although the severability clause creates a separate agreement with each insured, it further provides that each agreement is comprised of statements made in the application. And those statements included the representation that no member of the firm was aware of any circumstances, acts, errors or omissions which could give rise to a claim.

Comment: The Court's ruling clarifies uncertainty regarding the application of the innocent insured doctrine in Illinois, which resulted from the Illinois Appellate Court's 2013 decision. The Illinois Supreme Court has now categorically foreclosed the application of the innocent insured doctrine in the context of policy rescission.

If you have any questions about this Insurance Coverage Update, please contact the author listed below or the Aronberg Goldgehn coverage attorney with whom you normally consult:

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