Can a Carrier Rescind the Policy as Against Innocent Insured for Failure to Disclose Potential Claim on the Application?

Imagine that Partner A knows that he or she faces a potential malpractice claim about which he or she has not told Partner B. Partner A completes the firm's malpractice insurance renewal application, deliberately leaving out any reference to the potential malpractice claim, and then submits the application to its carrier. The firm later reports the claim to its carrier. Can the carrier rescind the policy as against both partners and the firm? Or can it rescind the policy only as against Partner A? The Supreme Court of Illinois recently considered these questions.

In *Illinois State Bar Association Mutual Insurance Co. v. Law Office of Tuzzolino and Terpinas et. al*, ___N.E.3d ___, 2015 WL 728111, Partner A knew about several potential malpractice claims against him by a single client, none of which he had previously reported to the carrier or to Partner B. One of the questions on the renewal application, which Partner A completed, stated, "Has any member of the firm become aware of past or present circumstance(s), act(s), error(s) or omission(s), which may give rise to a claim that has not been reported?" In response, Partner A checked the "No" box. The application contained the following language immediately above the signature line: "I/We affirm that after an inquiry of all the members of the applicant firm that all the information contained herein is true and complete to the best of my/our knowledge and that it shall be the basis of the policy of insurance and deemed incorporated therein upon acceptance of this application by issuance of a policy." Partner A signed the application and submitted it to the carrier.

Partner B allegedly first learned about Partner A's malfeasance about a month later when he received a demand letter from a lawyer representing a client. Partner B thereafter reported the claim to the carrier.

In response, the carrier brought suit against the two partners, their firm and the client. The carrier sought "rescission and other relief," contending that Partner A's material misrepresentation voided the contract and that it had "relied to its detriment on the continuing misrepresentation of material fact made by [Partner A], with the knowledge that those misrepresentations were, in fact, untrue as to his knowledge of any circumstance, act, error or omission that could result in a claim." The carrier also contended that it had no duty to defend Partner A or the firm in the anticipated malpractice action.

The carrier moved for summary judgment. Partner A consented to the entry of summary judgment as against him, which resulted in a finding that the carrier owed him no duty or obligation to defend him against the client's claims. The trial court subsequently granted the balance of the carrier's summary judgment motion, rescinding the policy and finding that the carrier had no duty to defend Partner B or the firm against any of the client's claims.

Partner B and the client, but not the firm, appealed to the Illinois intermediate appellate court. They argued that Partner B "was an 'innocent insured' who was not to blame for [Partner A's] misrepresentation and the policy should not have been rescinded as to him." The appellate court held that the "innocent insured" clause contained in the policy does not apply to a misrepresentation contained in the application but that the "innocent insured doctrine" found under common law does apply to misrepresentations contained in the renewal application so as to render coverage to Partner B. It reasoned that the policy could be rescinded as against Partner A and yet not be rescinded as against Partner B.

The Supreme Court of Illinois reversed, finding that the "innocent insured doctrine" does not apply to insurance applications but only to exclusions contained within the policy itself. The former has to do with policy formation. The latter does not concern whether the policy had properly gone into effect but instead whether an exclusion should apply or there is otherwise an absence of coverage for a particular claim.

The court interpreted an Illinois statute "to be read in the disjunctive, so that either an actual intent to deceive or a material misrepresentation which affects either the acceptance of the risk or the hazard to be assumed can defeat or avoid the policy." By way of this interpretation, even an innocent misrepresentation can provide a basis to void the contract so long as it "materially affects the insurer's acceptance of the risk." Stated differently, the court reasoned that the carrier does not have the burden to establish that "a misrepresentation was made with the intent to deceive if it was material to the risk assumed." The court found that "the innocent insured doctrine appears irrelevant to rescission, a recognized remedy for even innocent misrepresentations." Here, the carrier contended and the court found Partner A's failure to disclose the client's potential claims on the application was material so that the carrier would not have renewed the policy had these claims been disclosed.

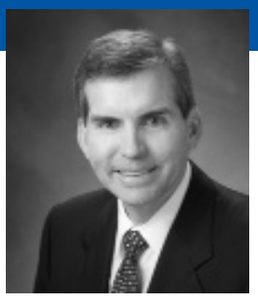
The court rejected Partner B's and the client's argument that "it would be patently unfair in this case to rescind insurance coverage to [Partner B], when he had absolutely no knowledge of his partner's misdeeds and the alleged misrepresentation on the insurance [application]." It also rejected the argument that it is a violation of public policy to allow the carrier to rescind the policy as against an innocent insured.

The court also rejected Partner B's and the client's argument that the severability clause, which requires that each insured should be treated under the policy as if each were the only insured for purposes of applying an exclusion, should apply to save Partner B's coverage. As the carrier noted, "while the severability clause creates a separate agreement with each insured, it states that each separate agreement is made up of the 'particulars and statements contained in the application,' binding on each insured."

A dissenting justice indicated that he would apply the innocent insured doctrine to these circumstances, contending that Partner B had a "reasonable expectation that he maintained professional liability insurance based on his history with [the carrier] and his lack of culpability in the misrepresentation." In the justice's view, the carrier was under a duty to state that it would impute the wrongdoing of one insured to any innocent insureds. Moreover, in his view, because rescission is an equitable remedy, it should not be applied here because "the equities do not favor rescission."

This case certainly presents tough facts and, because Partner B did not know that Partner A was withholding pertinent information, this situation may have been unavoidable for Partner B. But the case graphically demonstrates the crucial importance of making sure that the information on the malpractice insurance application is accurate.

Avoiding Liability



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