

ALERT

“Innocent Insured” Doctrine Prevents Rescission

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The Appellate Court of Illinois, applying Illinois law, has held that an insurer could rescind coverage for an insured who made material misrepresentations on the policy application. *Ill. State Bar Assn. Mut. Ins. Co. v. Law Office of Tuzzolino & Terpinas*, 2013 WL 6157417 (Ill. App. Ct. Nov. 22, 2013). However, the court also ruled that the insurer could not rescind coverage for other insureds who did not make misrepresentations, citing both the policy’s severability provision and the “innocent insured” doctrine.

A client of one partner in the insured law firm sued the partner for malpractice in handling litigation with the client’s former partners in a business venture. The partner convinced the client to file suit against the business’s bankruptcy attorney rather than pursue the case against him, but the partner failed to file the complaint within the time required by the statute of repose. The partner then led the client to believe that the bankruptcy malpractice suit was still pending for the next 18 months. When the client learned that the suit had been dismissed, the partner offered to settle any claims the client might have against him.

Shortly thereafter, the partner completed a renewal form for the firm’s malpractice insurance policy. The partner failed to disclose any of the circumstances surrounding the settlement with the client. After the policy was issued, the firm’s other partner learned of the malpractice claims and alerted the firm’s insurer. The insurer then filed suit to rescind the policy on the grounds that the partner’s withholding of information on the application was a material misrepresentation that voided the policy *ab initio*. The trial court granted summary judgment in favor of the insurer, and the partners appealed. In particular, the other partner argued that the policy should provide coverage for him

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because he was unaware of the events at issue or his partner's misrepresentation.

On appeal, the court first considered what it referred to as the policy's "innocent insured" clause. That provision stated:

Whenever coverage under this policy will be excluded or lost because of the insured's failure to provide timely notice, the company agrees that such insurance as would otherwise be afforded under this policy, should be applicable with respect to any insured who do not personally fail to give timely notice after having knowledge of the conduct that forms the basis of the claim. All insured covered by this provision must immediately comply with all policy provisions regarding reporting the claim upon learning of the unreported claim.

The other partner argued that he had lost coverage because his partner had failed to report the client's claim, but the court found that this ignored the distinction between reporting a claim under an existing policy and failing to disclose a claim on an application for a new policy and rejected that argument.

The court then considered whether the common law "innocent insured" doctrine would prevent rescission of the policy as to the other partner. The court held that the common law "innocent insured" doctrine, which preserves coverage for an "innocent insured" where a reasonable person would not understand that the wrongdoing of a co-insured would prevent recovery, applied to these circumstances. The court rejected the insurer's argument that the doctrine should apply only to coverage questions and not to whether the policy was void from its formation. The court held that, under Illinois law, the partner's material misrepresentation merely rendered the policy voidable, not void *ab initio*, and therefore the "innocent insured" doctrine could protect an innocent co-insured where a material misrepresentation was made during the formation of a policy. In addition, the court observed that the Illinois rescission statute demonstrates a public policy disfavoring rescission.

Although the court noted that the "innocent insured" doctrine did not require a divisible contract, the court also examined the policy's severability clause, which stated that the information contained in the application could be construed "as a separate agreement with and binding on each insured." Because the misrepresentation did not void the policy *ab initio*, the court found that the severability clause created separate contracts with each insured, allowing partial rescission of the policy as to the culpable insured.