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In The News

Legal Malpractice Claims and the Innocent Insured

Illinois State Bar Association Mutual Insurance Co. v. Law Office of Tuzzolino & Terpinas, 2013 IL App (1st) 122660 (Nov. 22, 2013)

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In *Illinois State Bar Association Mutual Insurance Co. v. Law Office of Tuzzolino & Terpinas,* 2013 IL App (1st) 122660 (Nov. 22, 2013) ("Terpinas"), the Court held that the innocent partner of a law firm was entitled to coverage under his legal malpractice policy even though his partner had made false statements on the firm's insurance renewal application.

Tuzzolino and Terpinas were partners of the law firm Tuzzolino and Terpinas (the "Firm"). Tuzzolino represented Antonio Colletta in a lawsuit to recover damages relating to Colletta's investment in Baja Chicago, LLC ("Baja"). Colletta became dissatisfied with Tuzzolino's handling of the Baja litigation and sued him for malpractice. Tuzzolino convinced Colletta to drop that malpractice suit and instead to file a malpractice suit against the attorney who handled Baja's bankruptcy. Colletta agreed to this, but Tuzzolino did not file Colletta's complaint within the required time period. As a result, Colletta's case was dismissed. *Id*. at ¶ 4.

For the next eighteen months, Tuzzolino falsely told Colletta that Colletta's bankruptcy malpractice case was pending. When Colletta learned the truth and confronted him, Tuzzolino offered Colletta $670,000 to settle his claims. Colletta rejected that offer. *Id*. at ¶ 5.

Sometime later, Tuzzolino renewed the Firm's malpractice policy. On its renewal form, the insurer (the "Insurer") asked whether any member of the Firm was aware of any circumstances that could give rise to a claim. In response, Tuzzolino checked the box marked "no." He signed an affirmation stating that he had inquired of all partners in the Firm and that the information on the form was true and complete. He submitted the form, and the Insurer renewed the Policy. Terpinas did not sign the renewal form and did not know about Colletta's malpractice claims against Tuzzolino. *Id*. at 7.

After learning about Colletta's malpractice claims, the Insurer sued to rescind the Firm's malpractice policy (the "Policy") and eventually moved for summary judgment. It argued that Tuzzolino's failure to disclose Colletta's malpractice claims was a material misrepresentation that voided the Policy *ab initio*. *Id.* at 11-13. The trial court granted the Insurer's motion, and Terpinas and Colletta (collectively, "Defendants") appealed. *Id*. at 14-16.

On appeal, Defendants argued that Terpinas's insurance coverage was preserved under both the "innocent insured" clause in the Policy and the common law innocent insured doctrine. *Id.* at 21. The Appellate Court rejected the first of these arguments but agreed with the second. *Id.* at 25, 38.

The malpractice policy contained an innocent insured clause stating that:

> 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.... *Id*. at 8.

The Court held that this clause did not apply because it concerned the failure to report a claim under an existing policy, not the failure to report a claim in a renewal application for what amounted to a new policy. In passing, the Court noted that, if this case involved the first situation, Terpinas's insurance coverage would still be in effect, because Terpinas reported the Colletta malpractice claim as soon as he learned of it. The Court then turned to the common law. *Id*. at ¶ 25.

Under the common law, the innocent insured doctrine applies when one insured commits an act that normally would void the insurer's obligations but it is not reasonable to prevent innocent co-insureds from recovering under the policy. The Court cited several cases where a property owner deliberately set fire to property without the knowledge of co-owners, and the innocent co-owners were allowed to collect their share of the insurance proceeds. The Court said that this case "presents the question of whether the innocent insured doctrine protects an innocent co-insured where a material misrepresentation was made during the formation of the policy." *Id*. at ¶ 27. Ultimately, the Court held that the innocent insured doctrine protected Terpinas. *Id*. at ¶ 38.

The Court relied heavily on *Economy Fire & Casualty Co. v. Warren*, 71 Ill. App. 3d 625 (1st Dist. 1979). *Terpinas*, 2013 IL App (1st) 122660, ¶ 28-31, 34. There, a husband and wife owned a residence that caught fire. They settled with their insurance carrier and received a substantial payment. Later, the wife admitted that she deliberately set fire to the residence, but her husband maintained that he had no knowledge of her actions. The insurance company sued to rescind the settlement agreement, and the trial court ruled that the settlement agreement was procured by fraud and granted restitution of the settlement proceeds. 71 Ill. App. 3d at 626. On appeal, the decision was reversed. The appellate court stated that "[w]e do not think the reasonable person in the position of [the husband] would have supposed that the wrongdoing of his co-insured would be imputed to him." As a result, the husband was allowed to keep his share of the settlement proceeds. *Id.* at 629.

In *Terpinas*, the Insurer tried to distinguish *Warren* because *Warren* did not involve the formation of an insurance policy. The Court rejected this distinction because *Warren* involved the formation of a settlement agreement and an insurance policy, like a settlement agreement, is essentially a contract and governed by the same legal principles. The Court said that the Insurer

provided no reason why a misrepresentation made to obtain an insurance policy "should result in a different application of the innocent insured doctrine" than a misrepresentation made to obtain a settlement agreement. 2013 IL App (1st) 122660, ¶ 29-30, 34.

The Insurer also maintained that, because the Policy was procured by fraud, it was *void ab initio* and never came into being. The Court rejected this argument on the ground that, under Illinois law, a material misrepresentation renders a policy voidable, not void, and whether a particular contract should be rescinded is for the court to decide under all of the circumstances. *Id*. at 29, 31, 34.

Practice Note: There is a substantial amount of uncertainty regarding the issues raised by *Terpinas*, which have been resolved differently by different courts. Many decisions resolve the "innocent insured" question based upon the language in a particular professional liability policy without discussing the common law doctrine. *E.g., Great Am. Ins. Co. v. Christy*, 164 N.H. 196 (2012) (finding that policy language precluded imputing misrepresentation in application to innocent partners); *Bryan Bros., Inc. v. Cont'l Cas. Co.*, 419 F. App'x 422 (4th Cir. 2011) (finding that innocent insured provision in policy did not preclude denial of coverage). Other courts have rejected the applicability of the innocent insured doctrine to a policy application. E.g., *Am. Guarantee & Liab. Ins. Co. v. The Jacques Admiralty Law Firm, P.C.*, 121 F. App'x 573 (6th Cir. 2005). Yet other cases have reached the opposite result. *E.g., First Am. Title Ins. Co. v. Lawson*, 177 N.J. 125 (2003).

A petition has been granted for leave to appeal *Terpinas* to the Illinois Supreme Court. It will be interesting to see if the Supreme Court resolves these issues and eliminates the uncertainty that now hovers over legal malpractice coverage.