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SECRETS CAN COST YOU: LPL COVERAGE AND INNOCENT INSUREDS, BY: DONALD PATRICK ECKLER, ESQ., KELLY S. GEARY, ESQ., AND BRAD BARKIN, RPLU

"Do you trust your wife?" asked Tim Robbins' character, Andy Dufresne, of Captain Bryon Hadley, the chief guard at Shawshank Prison. Enraged at the question Hadley threatened to throw Dufresne off the roof of the prison. But before he can, Dufresne explained that if Hadley does trust his wife, then he can avoid paying income tax on an inheritance by gifting it to his wife.

Lawyers in firms large and small in Illinois and across the country will be asking themselves if they trust their partners in light of the recent opinion in which the Illinois Supreme Court held that the law does not permit partial rescission of policies of professional liability insurance where a material misrepresentation was made on an application for insurance. The Court further held that the entire policy is rescinded, even for any "innocent insured" and not just coverage for the alleged bad actor or the allegedly non-disclosed bad acts.

This article will first analyze *Illinois State Bar Association Mutual Insurance Company v. Law Office of Tuzzolino and Terpinas*, 2015 IL 117096 and then suggest the appropriate manner to handle the implications of the decision from the perspective of law firms and their insurance brokers.

Background Facts

One of the two partners in a two partner law firm, Tuzzolino, allegedly mishandled several cases and took steps to hide that from the client. *Illinois State Bar Association Mutual Insurance Company*, 2015 IL 117096, ¶¶ 3-4. Tuzzolino lied to the client that a case had been settled and signed documents on behalf of the client without informing the client when in fact it had been dismissed because Tuzzolino had failed to retain an expert. *Id*. In another matter, Tuzzolino told the client that it was proceeding, when in fact the case had been dismissed because a violation of the statute of repose. *Id*. Ultimately, the client found out about the dismissal and confronted Tuzzolino. *Id*. Tuzzolino offered to pay the client $670,000 to settle all of the claims the client had against him, and the client agreed, but Tuzzolino never paid the sum. *Id*. None of this was reported to the insurer, Illinois State Bar Association Mutual Insurance Company (hereinafter "ISBA Mutual"). *Id*.

A short time after the settlement of the claims, the law firm applied for a renewal of their malpractice insurance with the plaintiff insurer. *Id*. at ¶ 5. Tuzzolino completed the application for insurance on behalf of the firm, including the affirmation of the truth of the statements in the application, and further

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MEDICAL MALPRACTICE CLAIMS INVOLVING VACUUM ASSISTED DELIVERY, BY: WALTER J. PRICE, III, ESQ.

History and Process of Vacuum Delivery

For centuries, physicians and others have sought means to assist with the difficult delivery. Obstetrical forceps have been used for centuries. Hankins, Clark, et al. *Operative Obstetrics*. Appleton & Lang, 1995, pp. 129-133. A newer tool, vacuum delivery, has also been reported as dating back several hundred years; however, the first widely-used device was introduced in the mid-twentieth century. Hankins, p. 173. Frequent comparison of this aid to the use of forceps has taken place and common themes have been demonstrated. Generally, maternal morbidity and mortality is thought to be less likely with the use of the vacuum extractor; however, neonatal mortality and morbidity is increased. Of course, consideration of these themes must also take into account the increased risk associated with the difficult delivery itself.

A comprehensive study undertaken approximately fifty years ago found few maternal and

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stated that there were no claims or circumstances that could lead to a claim against the law firm or its members. *Id*. The application for insurance executed by Tuzzolino and submitted to ISBA Mutual asked the following questions:

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? Tuzzolino answered this question "no" and signed the application as "owner/partner" under the following affirmation:

> I/We affirm that after an inquiry of all of 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.

Tuzzolino's partner, Terpinas, who was unaware of any of Tuzzolino's misconduct, discovered the claims. *Id*. at 6. Terpinas promptly reported the claim to the insurer, ISBA Mutual . *Id*.

ISBA Mutual filed a complaint seeking rescission of the policy of insurance based upon the misrepresentation in the renewal application completed by Tuzzolino. *Id*. at 7. After briefing and hearing on cross motions for summary judgment the trial court granted summary judgment to the insurer and rescinded the policy issued to the law firm. *Id*. at ¶¶ 8-9. On appeal, the appellate court reversed the judgment and found that Terpinas was an innocent insured who was not to blame for Tuzzolino's misrepresentation in the application and that the policy should not be rescinded as to him. *Id*. at ¶ 10. In adopting a common law innocent insured doctrine, the appellate court found that the policy was rescinded as to Tuzzolino, but not as to Terpinas. *Id*.

The Illinois Supreme Court's Analysis

In reversing the judgment of the appellate court, the Illinois Supreme Court held that rescission in Illinois is governed by Section 154 of the Illinois Insurance Code which refers to misrepresentations "made by the insured or in his behalf" and not necessarily by the insured. *Id*. at ¶ 16. Section 154 of the Illinois Insurance Code states:

> No misrepresentation or false warranty made by the insured or in his behalf in the negotiation for a policy of insurance, or breach of a condition of such policy shall defeat or avoid the policy or prevent its attaching unless such misrepresentation, false warranty or condition shall have been stated in the policy or endorsement or rider attached thereto, or in the written application therefor. No such misrepresentation or false warranty shall defeat or avoid the policy unless it shall have been made with actual intent to deceive or materially affects either the acceptance of the risk or the hazard assumed by the company.

The statute creates a two prong test. *Id*. at ¶ 17. The first prong requires that the statement be false and the second prong requires that the false statement must have been made with the actual intent to deceive or must "materially affect the acceptance of the risk or hazard assumed by the insurer." *Id*. ISBA Mutual argued that "[e]ven if the misrepresentation had not been made with the intent to deceive, it materially affected the insurers acceptance of the risk, as ISBA Mutual would not have renewed the policy had Tuzzolino truthfully answered the question and disclosed his knowledge of the potential claim." *Id*. at ¶ 18.

In opposition the insurer's argument, the defendants argued that the rescission should not have any impact on Terpinas, who was innocent of the alleged wrongdoing and in failing to disclose the alleged wrongdoing in the application. *Id*. at ¶ 19. The defendants argued for the application of the common law innocent insured doctrine which operates where two or more insureds are on a policy and despite wrongdoing by one insured, the innocent insured is allowed to collect under the policy. *Id*. at ¶ 20. The defendants principally relied on *Economy Fire & Casualty Co. v. Warren*, 71 Ill. App. 3d 625 (1979) and *Vasques v. Mercury Casualty Co.*, 947 So. 2d 1265, 1268 (Fla. Dist. Ct. App. 2007). *Id*. at ¶¶ 20-21.

In *Warren*, the insurer sought to rescind a settlement agreement with a husband and wife arising out of a fire loss. *Id*. at ¶ 22. After settling the claim the insurer disclosed that the fire had been intentionally set by the wife. *Id*. The *Warren* court held that the actions of the wife should not be imputed to the innocent husband and that he should still be allowed to collect under the policy. *Id*.

In opposition to this position, ISBA Mutual argued that while *Warren* dealt with a rescission, it did not deal with the rescission of a policy of insurance, but the rescission of a settlement agreement and thus did not implicate the application of Section 154 of the Illinois Insurance Code. *Id*. at ¶ 23. Instead, ISBA Mutual pointed to *Home Insurance v. Dunn*, 963 F.2d 1023 (7th Cir. 1992), in which the Court ruled that the rescission of a policy of insurance is distinct from denial of coverage because of an alleged excluded act. *Id*. at ¶ 25. In *Dunn*, the Court addressed the "waiver of exclusion" clause which states that the policy's "wrongful acts" exclusions do not apply to those "who did not personally commit or personally participate in committing one or more of the acts, errors, omissions or personal injuries described in any such exclusion of condition." *Id*. at ¶ 26. This clause preserves coverage for those who are innocent, just as the innocent insured doctrine seeks to do. *Id*.

"The [waiver of exclusion] clause preserves coverage for those who are innocent, just as the innocent insured doctrine seeks to do."

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The alleged wrongdoer in *Dunn* failed to disclose his wrongdoing to his partners and on the application of insurance and the insurer sought to rescind the policy. *Id*. at ¶ 27. The Seventh Circuit held that though no other attorney in the firm was aware of the wrongdoing and had not made the misrepresentation of the application, just as Terpinas in this case, it mattered not because the failure to disclose the wrongdoing materially affected the risk assumed by the insurer. *Id*. at ¶ 28.

The Court held that the innocent insured doctrine did not apply to situations involving rescission. *Id*. at ¶ 29. In so holding the Court reasoned the issues of coverage deal with the common law rules of coverage, whereas rescission is governed by statute. *Id*. at ¶ 31. Further, the alleged misrepresentation goes to the formation of the contract of insurance in the first instance whereas the innocent insured doctrine has a narrower focus regarding the application of an exclusion. *Id*.

The Court also rejected the application of the policy's severability clause because that clause related to the "particulars and statements contained in the APPLICATION." *Id*. at ¶¶34-35. The severability clause states:

> The APPLICATION, and any addendum or supplements, and the Declarations, are the basis for this Policy. The particulars and statements contained in the APPLICATION will be construed as a separate agreement with and binding on each INSURED. Nothing in this provision will be construed to increase the COMPANY'S Limit of Liability.

The Court reasoned that even if the policy is a separate contract with each insured, there is no way to separate the application which forms the basis of the policy into an individual contract. *Id*. at 35.

Justice Kilbride's Dissent

This opinion was not without dissent. Justice Kilbride disagreed with the majority opinion and held that the innocent insured doctrine should apply under the facts of this case and application of the reasonable expectations of the insured. He argued that Terpinas relied on his relationship with ISBA Mutual, his lack of culpability in the misrepresentation, and his reliance on Supreme Court Rules 721 and 722 because the firm was organized as a limited liability company. *Id*. at ¶ 47. Justice Kilbride focused on the absence of a provision in the policy that stated that each insured faced rescission of their coverage due to misrepresentation by another member of the firm. As to the formation of the firm as a limited liability corporation under the Illinois Supreme Court Rules requires the LLC to have malpractice insurance and looked for an analogue in *First American Title Insurance Co. v. Lawson*, 827 A.2d 230 (N.J. 2003). In *Lawson*, the court held that because the firm was organized as a limited liability company the innocent partner was entitled to coverage and that the opposite conclusion would lead to a "harsh and sweeping result [that] would be contrary to the public interest." *Lawson*, 827 A.2d at 240-241.

The last of Justice Kilbride's criticisms of the majority opinion is the one that will have partners in firms ask their partners the question we posed at the beginning of this article. Justice Kilbride was most troubled by the effect of this ruling on law firms larger than those with only two partners like that addressed in this case. At oral argument, Justice Theis, who sided with the majority, asked counsel for the insurer if the result would be different if the case involved a law firm of 500 or 1500 or if the application had been completed and signed by Terpinas instead of Tuzzolino. http://www.state.il.us/court/Media/On_Demand_2014.asp. The answer to both of those questions by counsel for the insurer and seemingly by the Supreme Court is "no."

Effect of Ruling and Manner to Proceed

The result of this ruling is to squarely place the risk of properly answering the questions on a policy of professional malpractice insurance on the insured. We say insured because this ruling portends effect on all professionals; there is nothing unique about law firms in this regard, but because this opinion arose in the context of a law firm that is where we will focus.

The effect of this decision is not only that an innocent insured will lose coverage for the claims based upon wrongdoing of a fellow partner that gave rise to the rescission, but that all of the attorneys in the firm and the firm will lose coverage for claims that were reported timely in previous policy period or were disclosed on the application for insurance. The effect of a complete rescission of a policy of insurance is exactly that.

Because of the extreme result and risk posed, law firms should take steps to identify claims and report them on the application for insurance. The method typically used by firms to circulate an e-mail and require a response from each attorney, is likely not sufficient to ease the worried minds of partners. And so attorneys in firms, large and small must ask "do I trust my fellow attorneys?" Trust, but verify will need to be the new mantra of firms, but how to verify.

Taking a Step Back

The situation in which Terpinas found himself is, indeed, troubling and the facts of the case are certainly egregious. The question now is: How can attorneys and firms avoid finding themselves in the same situation at Terpinas? In order to answer this question, we must take a step back and examine the circumstances surrounding the placement of the policy at issue as well as the coverage provided. Offense is your best defense. Firms must identify and understand what motivates and allows an insurer to bring a rescission action

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to avoid Terpinas' unfortunate situation.

Most commercial insurers view rescission as a remedy of last resort and will not employ the remedy unless they have the right set of facts. There are multiple factors that motivate and allow an insurer to bring a rescission action. Unfortunately, we are not likely able to point to all of them but there are a few big-ticket items we can discuss.

Size Does Matter – Negotiating the Insurance Contract

A professional liability insurance policy is still the best way to transfer risk of malpractice. However, the strength and effectiveness of insurance coverage varies depending upon the policy wording. The policy at issue in this case, was purchased through ISBA Mutual Insurance Company, a member of the National Association of Bar Related Insurance Companies (NABRICO). The NABRICO companies generally insure small law firms (usually less than 20 attorneys).One of the ways in which direct insurance market insurers keep costs low is to eliminate the cost of commission typically paid to an insurance broker. While the direct market model serves the cost concerns of small firms, the benefit comes at the expense of a broker's expert advice and the leverage of the insurance market with respect to coverage and cost.

As stated above, at oral argument, Justice Theis, who sided with the majority, asked counsel for the insurer if the result would be different if the case involved a law firm of 500 or 1500 or if the application had been completed and signed by Terpinas instead of Tuzzolino. Justices were told by ISBA's counsel that the answer to both of these questions was "no", and thus the result would be the same for a law firm of 500 or 1500 attorneys. However, the likelihood of the circumstances surrounding the placement of the legal malpractice policy being the same for the 1500 attorney firm as they were for the Law Offices of Tuzzolino and Terpinas, is remote. Practically speaking, the size of the firm *would likely* preclude an insurer's decision to bring a rescission action and may impact the outcome of any potential rescission action or other harsh coverage position. Additionally, if the application had been completed and signed by Terpinas (the "innocent" partner) instead of Tuzzolino (the "fraudulent" partner") the result may be different for a larger firm whose broker may have been able to procure a policy with terms different than the ISBA policy regarding severability of representations.

To begin, mid to large[1] size law firms invest an enormous amount of time and money in purchasing a legal malpractice policy and they typically employ insurance brokers that specialize in professional liability insurance. Brokers focused specifically on lawyers malpractice frequently negotiate amendment of policy terms and conditions so that application misrepresentations do not effect coverage for those unaware of the misrepresentation, or for claims that do not involve the misrepresentation. For example, an experienced broker representing a larger firm will approach markets with whom the broker has previously negotiated a non-imputation or severability clause, whereby one individual's knowledge of a misrepresentation will not be imputed to the firm or another insured individual. Depending on the underwriter and the particular circumstances of the firm, underwriters may agree to the full severability of representations, or alternatively at least in the situation where the signer of the application (or a defined group of firm management) is not the one making the misrepresentation Depending on the facts of any case, either of these provisions would likely prevent the insurer from bringing a rescission action against the insured. Moreover, depending on the precise language negotiated, it would matter if the application had been completed and signed by Terpinas instead of Tuzzolino. The ability of the broker to obtain such provisions turns on a variety of factors including the size of the firm, the firm's policies and procedures for discovering and noticing claims and circumstances, and the type of firms the insurance company seeks to insure.[2] Thus while firms and their partners should "trust but verify" that the information provide in the application process is correct, negotiating the policy language can help avoid a rescission when a rogue partner thwarts the verification process.

Business Considerations – The Value of a Broker

Even if the policy at issue does not have the protections mentioned above, large and mid-size firms are still more likely to avoid rescission actions than small firms by working with their brokers. Most brokers experienced in professional liability prompt law firm clients to poll individuals intended for coverage before completion of the application and before binding coverage. Many such brokers provide to their law firm clients risk management services which include training employees on what constitutes a claim and what to do in the event they become aware of a claim. Brokers also encourage law firm clients to report matters in a timely fashion by consulting with firm management about why and how to report the matter, and how the insurer is likely to react. Finally, brokers frequently advocate for their law firm clients when harsh coverage positions arise and can be influential in resolving such positions with insurers. The broker is a particularly valuable ally of law firms in procuring professional liability insurance and managing the risk of uncovered loss.

Take Aways

Unfortunately for the Law Offices of Tuzzolino and Terpinas, the extreme circumstances surrounding completion of their application and placement of their policy left their insurer with virtually no obstacle to the

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PLDF AND DIVERSITY

The Professional Liability Defense Federation supports diversity in our member recruitment efforts, in our committee and association leadership positions, and in the choices of counsel, expert witnesses and mediators involved in professional liability claims.

decision to rescind the policy. They did not have the benefit of a broker to review the coverage, or negotiate favorable severability clause or a non-rescindable policy. And, it is possible, given their size and their insurer's underwriting guidelines, that such protections would not have been available. The circumstances of policy placement coupled with the very egregious set of facts left their insurer with a near perfect case for rescission. Tuzzolino made a clear material misrepresentation on the application and Terpinas was his only partner. The result was, as we know, extreme.

While Terpinas was unfortunately left without coverage, other law firms can learn valuable lessons from this particular situation:

Size Does Matter – Sort of. As we discussed, size does matter in negotiating policy terms upfront. Insurers of large firms must fashion coverage to fit the requirements of the firms they insure. They are, therefore, more inclined to entertain a coverage request and offer a logical solution. However, any firm, large or small, has the option to engage a specialized broker to negotiate and advocate on their behalf. Additionally, insurers of firms of all sizes should entertain modification intended to avoid rescission.

Know Your Policy. Don't assume you know what your insurance policy requires of you. Read it carefully and be sure you have a solid understanding of the key provisions, including: (a) The definition of "claim", most policies require the insured report "claims" as defined by the policy, regardless of whether or not the insured deems the matter to be a claim; (b) Date certain notice requirement; (3) Condition Section of the policy: Specifically, the "Application" section (or equivalent section) of the policy – understand which "insureds" are actually making the representations upon which the insurer is relying and know whether the policy allows the insurer to impute knowledge of misrepresentations to other insureds.

A Specialized Broker Matters. Utilizing a broker who understands the intricacies of legal malpractice coverage, knows the commercial marketplace and can provide risk management advice goes a long way towards protecting your firm. Ultimately, the right broker can help reduce costs in terms of directing you to the best insurer and coverage for your firm, at the lowest cost.

Polling & Active Reporting Are Imperative. Lawyers at the firm should be trained regarding matters that are reportable to insurers. They should be encouraged to report any circumstance that could likely give rise to a claim under their policy and they should be able to identify a reportable circumstance and a claim. Firms should strive to create an open environment within the firm so as to make this possible. Failing to do so could leave the firm with significant uninsured exposure.

You Get What You Pay For. If you are presented with a particularly low price for your legal malpractice insurance, be sure to closely review the coverage being offered, the financial strength of the offering insurer and the insurer's claims handling capabilities. Often times the "low cost options" exist because the insurer is offering less coverage.

Endnotes

1. Generally speaking, a mid-size firm is between 30-250 attorneys and a large firm is 250+ attorneys.
2. This aspect of the policy is one of many coverage and pricing terms that are part of the overall negotiations. The firm in conjunction with their broker need to consider all of the coverage terms (and pricing) available from different underwriters in making their purchasing decision.

"[Lawyers] should be encouraged to report any circumstance that could likely give rise to a claim under their policy … ."

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