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Illinois Coverage Basics

Rescission As a Silver Bullet in Coverage Litigation

Insurance applications demand simple honesty from those who seek insurance. Yet, insurance applications, like tax returns, tempt people to play with the truth. As a result, it is not uncommon to find inaccurate and untrue information in insurance applications. While this lack of honesty creates problems for underwriters, it can provide significant opportunities for insurers involved in coverage litigation.

When an insurer issues an insurance policy based on inaccurate information supplied by an insured, the insurer has a right to ask a court to rescind the policy. If a court rescinds a policy, the policy is declared to be void, retroactively, to the date of its inception. As such, the remedy of rescission provides a “silver bullet” in coverage litigation by releasing the insurer from obligations for all past, present and future claims under a policy.

Since misrepresentations in policy applications are not rare, a potential for rescission lies hidden within many coverage files. Insurers often do not consider the possibility of rescission because they believe rescission may be too difficult to prove, but that is not true under Illinois law. To the contrary, proving a right to rescission in Illinois is less difficult than proving up many coverage defenses based on the insuring agreements, exclusions and policy conditions.

Under Illinois law, an insurance policy may be rescinded based upon a misrepresentation in a policy application that is *either* intentionally made *or* material to the risk.

Two independent theories for obtaining rescission of an insurance policy

The remedy of rescission is created by statute in Illinois. Section 154 of the Illinois Insurance Code authorizes the rescission of an insurance policy when a misrepresentation is made by an insured either (a) with actual intent or (b) the misrepresentation materially affects the acceptance of the risk or the hazard assumed by the company. 215 ILCS 5/154. If a misrepresentation on an insurance application is material, the insurer is not required to prove that the applicant made the misrepresentation intentionally, and rescission may be obtained even if the applicant acted in good faith when filling out the application. Royal Maccabees Life Ins. Co. v. Malachinski, 161 F.Supp.2d 847, 853-54 (N.D. Ill. 2001); see also Methodist Medical Center of Illinois v. American Medical Security Inc., 38 F.3d 316, 320 (7th Cir. 1994).

Whether an applicant’s misrepresentation on an insurance policy satisfies the “actual intent” prong of Section 154 depends upon the totality of the circumstances surrounding the misrepresentation. In re Logan, 327 B.R. 907, 911 (N.D. Ill. 2005). Importantly, an objective standard is used by the courts to determine whether an applicant’s failure to disclose information about potential claims was intentional, meaning that the sufficiency of the applicant’s answer will be determined by what a reasonable person would do. The courts hold that an insurance

application question asking if the applicant knows of information likely to lead to a claim calls for an objective response, not a subjective evaluation by the applicant. Evanston Insurance Company v. Security Assurance Company, 715 F.Supp. 1405, 1414 (N.D. Ill. 1989); International Ins. Co. v. Peabody International Corporation, 747 F.Supp. 477, 482-483 (N.D.Ill. 1990). While an insured's self-serving excuses for misrepresentations made on an insurance application will be admissible in evidence, they will not control the issue of whether the misrepresentations were made with "actual intent."

Whether a misrepresentation "materially affects the acceptance of the risk" within the meaning of Section 154 is determined by evaluating whether a reasonably careful and intelligent person would (a) conclude that the misrepresentation increased the risk and (b) either reject the application outright or accept the application under different conditions, such as charging a higher premium. Royal Maccabees Life Insurance Co. v. Malachinski, 161 F.Supp.2d 847, 853 (N.D.Ill.2001). An incomplete answer or a failure to disclose constitutes a material misrepresentation if the omission prevents the insurer from adequately assessing the risk involved. New England Mutual Life Insurance Co. v. Bank of Illinois in DuPage, 994 F.Supp. 970, 976 (N.D. Ill. 1998).

Rescission tactics and strategy

The insurer has the burden of proof on a rescission claim, but proving that a misrepresentation was made with "actual intent" does not require inquiry into the insured's actual state of mind. Because the standard is objective, proof of the circumstances of the misrepresentation can establish the "actual intent" element of Section 154, even when the insured offers evidence of its subjective good faith.

Proof of the materiality of a misrepresentation rests within the unique control of the insurer and can be established through the testimony of an underwriter or employee of the insurance company. Methodist Medical Center of Illinois, 38 F.3d at 320; see also Sofo v. Pan-American Life Ins. Co., 13 F.3d 239, 242 (7th Cir. 1994); Royal Maccabees Life Ins. Co., 161 F.Supp. 2d at 853. The insurer is not required to show that it would have rejected the application had it known the truth; only that it would not have accepted the application under the same conditions. If the insurer offers underwriting testimony on the issue of materiality but the insured offers no expert testimony on the issue, the issue of materiality may go to the trier of fact unopposed. Summary judgment is appropriate where there is no *bona fide* dispute as to the materiality of the misrepresentation. Methodist Medical Center of Illinois, 38 F.3d at 320.

In Illinois, an insurer is not required to refund the premium until after a court grants rescission of the insurance policy. Dunton v. Connecticut Fire Insurance Co., 371 F.2d 329 (7th Cir. 1967).

When coverage is being disputed, insurers should look carefully to determine whether grounds for rescission may also be present in the file. Rescission is a "silver bullet" for insurers in coverage litigation because it negates all obligations as to all claims under the policy.

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If you have questions or would like to discuss the implications of this report further, please feel free to contact James K. Horstman at Cray Huber Horstman Heil & VanAusdal LLC, 303 West Madison Street, Suite 2200, Chicago IL 60606; 312-332-8494; jkh@crayhuber.com.