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Feature Article

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Barth v. State Farm – Leveling the Playing Field

Introduction

In *Barth v. State Farm Fire and Casualty Co.*, 228 Ill. 2d 163, 886 N.E.2d 976 (2008), the Illinois Supreme Court rejected an argument by counsel for an insured that the court should require an insurer to prove the elements of common law fraud when asserting the policy defense of misrepresentation. The plaintiff argued that the court should impose such a requirement to "level the playing field" between insurers and insureds. *Id.*, 886 N.E.2d at 980. The court, without specifically addressing the plaintiff's assertion that the playing field was somehow not level, applied well-established rules of contract interpretation and declined to engraft the elements of a tort claim for fraud on a defense to a breach of contract claim. The supreme court followed existing precedent and limited the holding in its case to the contractual language before it. By doing so, the court maintained the levelness of the playing field on which insurers must litigate with every other party to a contract that must bring its dispute to the courts for resolution.

The Misrepresentation Defense

The misrepresentation defense derives from a clause that is contained in most insurance contracts, which either voids the policy or voids coverage if an insured intentionally misrepresents or conceals material facts and circumstances related to the insurance. In *Barth*, the clause provided:

> **Concealment or Fraud:** this policy is void as to you . . . , if you . . . intentionally concealed or misrepresented any material fact or circumstance relating to this insurance, whether before or after a loss.

Id. at 981. A simple reading of the clause suggests that to prevail on a defense based on the clause, the insurer must establish the following:

a. the insured misrepresented or concealed;
b. a material fact or circumstance; and
c. the insured did so intentionally.

The intentional misrepresentation of a material fact or circumstance by an insured "renders the policy void." *Id.* at 981-982. *Accord*, *Clafflin v. Commonwealth Ins. Co.*, 110 U.S. 81, 96-97 (1884); *Fine v. Bellefonte Underwriter's Ins. Co.*, 725 F.2d 179, 183-184 (2d Cir. 1984); *Passero v. Allstate Ins. Co.*, 196 Ill.App.3d 602, 608-609, 554 N.E.2d 384, 388 (1st Dist. 1990). The widespread inclusion of such clauses in insurance contracts suggests that insurers believe that the protection provided by such clauses is important.

To understand the practical effect of having such a clause in a policy of insurance, the exigencies of handling insurance claims must be considered. Typically, an insurer receives thousands of claims in any given month. The vast majority of claims are handled by employees, frequently called "front line" or "line" adjusters or claims people, and claims are paid on the submission of a sworn statement in proof of loss or some similar claim form which, in many cases, must be notarized. The vast majority of claims are paid with little or no investigation. Accordingly, the insurer must rely on the honesty of its insureds to properly evaluate claims.

In a small percentage of claims, the insurer may decide to investigate the claim further. In the case of a fire loss to a structure, reports of a suspicious fire by a fire fighter or the Office of the State Fire Marshall may prompt the insurer to retain an expert in determining the origin and cause of fires. In a burglary claim, reports by police officers of suspicious circumstances may cause the insurer to investigate further. When the line unit receives questionable information or any number of red flags of potential fraud or overreaching (many of which are listed on the Insurance Services Office web site, www.iso.com), the line unit may refer the claim to the special investigations unit, which is set up specifically to engage in more detailed investigation that some claims may require.

The Playing Field

Although the supreme court spent little time on the argument, Barth's argument that the court needed to level the playing field raises interesting public policy issues. The court did not identify any evidence or factual support for the argument that the playing field was somehow not level. An analysis of the premise, however, reveals that it is unlikely that it has any factual support; and, in any event, the judiciary does not have the investigative machinery to determine whether it is correct.

The assertion that the trial courts do not provide a level playing field for insureds is difficult to believe. In a typical jury of twelve, the likelihood is high that most, if not all, of the jurors carry insurance of some kind and have asserted at least one claim. In view of the preemptory challenges available to claimants, the chances that an insurance adjuster or any employee of an insurance company will remain on a jury is close to zero. A reasonable argument can be made that a significant portion of any jury pool will harbor some suspicions about the claims process. Indeed, the frequent invectives against insurance companies utilized by counsel representing the insureds during first party insurance cases, whether they involve an issue of misrepresentation or concealment or not, certainly suggest that the plaintiffs' bar believes that a significant number of jurors harbor some propensity to prejudge a defendant insurer.

More importantly, no evidence exists to suggest that juries erroneously find in favor of insurers when the insured should have prevailed. The premise presupposes that the jury system is not working properly in coverage cases involving an assertion that the insured misrepresented or concealed material facts or circumstances.

It is difficult to imagine how a researcher could go about determining whether, in fact, a jury came to an erroneous conclusion in any type of case; but in insurance coverage cases involving concealment or fraud, it may be even more difficult. Coverage cases involving concealment or misrepresentation frequently include a separate claim made by the insurer of a violation of another clause in the policy, such as the intentional act clause, or a failure to produce requested documents or to cooperate. For example, in *Barth*, the insurer claimed that Barth intentionally procured the loss by setting the fire or having someone set it for him. If a case is submitted on a general verdict, a researcher would not be able to determine the basis of the jury's finding in favor of an insurer.

Similarly, no factual support was provided for Barth's reference to the existence of "unscrupulous insurers." *Barth*, 866 N.E.2d at 982. To the extent that unscrupulous insurers exist, it is difficult to believe that a jury would not see the insurer for what it was after hearing all of the evidence in the case.

Perhaps the greatest concern with unscrupulous insurers is the possibility of a denial of a claim based on misrepresentation or concealment without sufficient investigation and factual support. The legislature, however, has already provided a remedy against an insurer who engages in such conduct through §155 of the

Illinois Insurance Code. 215 ILCS 5/155. Under §155, the court can award attorneys fees or a substantial monetary penalty against an insurer if the court finds that the insurer vexatiously and unreasonably refused to pay a claim. *Id*. The appellate courts have interpreted this section to permit the trial court to impose penalties if the insurer did not have a good faith basis to deny a claim. *Willis Corroon Corp. v. Home Ins. Co.*, 203 F.3d 449 (7th Cir. 2000). It is difficult to dispute that the legislature is monitoring the conduct of insurers and insuring that the playing field is level, since the legislature recently increased the penalty against insurers that vexatiously and unreasonably deny claims. Public Acts 93-485 (2003 Ill.Legis.Serv. 1207).

Whether the playing field is level should also be viewed from the perspective of all the policyholders who must pay premiums for their coverage. Payment of false or intentionally inflated claims will result in higher premiums to all policyholders. According to the Association for British Insurers, the "mean total value of dishonest claims detected each week is £3.5 million," which include individual frauds and gang activity such as staging automobile accidents. http://www.lawcom.gov.uk/docs/ins_scoping.pdf.

The concealment or fraud provisions in insurance policies constitute nothing more than a requirement of basic honesty from an insured making a claim. It would be difficult for insurers to function if they could not rely on the basic honesty of their policyholders. Requiring an insurer to extensively investigate every claim submitted by an insured would significantly increase the cost associated with payment of claims and therefore necessarily increase premiums. Policyholders have a legitimate interest in reducing premiums through a requirement that all policyholders avoid intentionally concealing or misrepresenting information material to the issues of whether coverage exists, and if it does, the amount that should be paid.

As the court noted in *Barth*, the requirements that the misrepresentation or concealment be made intentionally and be material protects insureds from unscrupulous insurers and keeps the playing field level. Only when an insured intentionally misrepresents or conceals material information may an insurer deny a claim. Any trial lawyer understands that witnesses frequently are mistaken about facts they believe to be true, and, accordingly, some concern may arise that an insurer will deny a claim when an insured innocently makes a false statement about a matter or fails to reveal something that the insurer believed was material to its claims decisions. The question of whether the misrepresentation made by the insured was intentional, however, will be decided by a jury made up of individuals who should have little problem determining whether the insured was simply mistaken or intentionally misrepresenting or concealing the information.

Finally, the assertion that the playing field is not level in the context of insurance fraud may be correct. Based on available statistics, the playing field may greatly favor arsonists, not insurers. According to the National Fire Protection Association, in 2003 only seventeen percent of known arsons result in criminal charges against anyone; and in only two percent of those cases does the state obtain a conviction. John R. Hall, Jr, *Intentional Fires and Arson*, (National Fire Protection Association, May 2005), available at http://www.nfpa.org/itemDetail.asp?categoryID=952&itemID=
30836&URL=Research%20&%20Reports/Fire%20statistics/Major%20causes%20of%20fire. The number of insureds who set fire to their property and escape detection may be impossible to ascertain. But if the persons committing this species of insurance fraud have so little to fear by way of criminal conviction, criminal prosecution provides little disincentive to fraud. Accordingly, the only tool remaining is to take the profit out of "arson for profit" by precluding the arsonists from benefiting from their crimes financially. The Illinois Criminal Code provides insurers with a civil remedy for insurance fraud, under which an insurer can recover double the amount sought or treble the obtained amount by the insured if the insurer establishes that the claim was based on fraud. 720 ILCS 5/46-5(a). While providing insurers with double or treble the amount recovered if the insurer wins, the statute allows the insured to recover double damages if it can prove that the claim of insurance fraud was made in bad faith.720 ILCS 5/46-5(b). Few appellate cases interpreting the statute exist, which suggests that insurers are not willing to risk the potential of double damages for the potential double or treble penalty against the insured. The civil penalty may be a meaningless remedy, moreover, since if an insured intentionally procured a loss because of desperate financial circumstances, the penalty may never be recovered even if a jury should award it.

The Inability to Cure a Misrepresentation

In *Barth*, the Illinois Supreme Court answered a question that arises frequently in misrepresentation and concealment cases – whether an insured, after intentionally concealing or misrepresenting a material fact or circumstance, could cure the violation of the clause by essentially admitting to the lie. The court answered the question in the negative.

A number of reasons exist why an insured might want to correct a misstatement. The reasons include:

1. the insured was honest but mistaken and wants to provide accurate information to the insurer by correcting the misstatement;
2. the insured intended to mislead the insurer to deflect investigation into the insured's claim but wants to change the story because the insured has become aware the insurer has discovered the truth;
3. the insured intentionally misrepresented or concealed material facts to the insurer, and when the insured discovers that the investigation into the claim will continue, retains counsel; and counsel advises his client to tell the truth, well aware that the insured's failure to do so will result in a violation of the misrepresentation and concealment clause.

In the first scenario, the insured has not violated the concealment or fraud clause, since the insured did not intend to misrepresent or conceal facts and circumstances. In the second and third scenarios, the insured has already violated the provision in the policy and wants to cure the default, not out of honesty, but to salvage the possibility of recovering money on the claim.

The supreme court refused to engraft a detrimental reliance element into the policy defense, apparently understanding that the requirement that an insured be honest with the insurer would be eviscerated if the insured could cure the breach of the clause once he or she discovered that the insurer had information to prove the violation. British law appears to reach a similar result. One recent paper noted: "policies frequently contain specific conditions addressing fraud at the claims stage. In addition, there is a common law rule on fraudulent claims. This rule provides that a policyholder who makes a fraudulent claim forfeits any lesser claim which would have legitimately been made." *Insurance Contract Law: Misrepresentation, Non-Disclosure, and Breach of Warranty by the Insured*, The Law Commission, Consultation Paper No. 182, The Scottish Law Commission, Discussion Paper No. 134, http://www.lawcom.gov.uk/insurance_contract.htm or http://www.lawcom.gov.uk/docs/cp182.pdf (2007).

Again, the court's analysis makes perfect sense in the context of the claims investigation process. If an insurer had to detrimentally rely on a misrepresentation or concealment, no insurer could ever deny a claim based on the violation of the clause, since it would have become aware of the misrepresentation or concealment before paying the claim. Interpreting the clause in such a manner would render it useless, in violation of the well-known maxim that "a court will not interpret a contract in a manner that would render any provision meaningless." *Illinois Farmers Ins. Co. v. Hall*, 363 Ill. App .3d 989, 996, 844 N.E.2d 973, 978 (1st Dist. 2006); *see also White v. White*, 62 Ill. App. 3d 375, 378 N.E.2d 1255 (1st Dist. 1978).

Tort vs. Contract Principles

The Supreme Court of Illinois has traditionally been adept at distinguishing the fundamental purposes of contract law from the fundamental purposes of tort law. For example, in *Moorman Mfg. Co. v. National Tank Co.*, 91 Ill. 2d 69, 435 N.E.2d 443 (1982), the court was careful to limit damages available for a defective product based on the fundamental purposes of contract and tort law. In deciding the *Barth* case, the supreme court continued the tradition.

Courts have recognized that one of the dangers of the tort of common law fraud is potential abuse, since the tort action could be used to extract money from a civil defendant by simply alleging that the civil defendant

said certain things. *See Board of Education of City of Chicago v. A, C, and S, Inc.*, 131 Ill. App. 3d 428, 457, 546 N.E.2d 580, 594, (1989)(stringent standards are needed to protect defendants from baseless complaints and unmeritorious strike suits).

Because of this legitimate concern, courts have placed stringent requirements of proof on the tort, including proof of the following elements:

1. the civil defendant made a representation;
2. the representation was one of fact (and not an opinion or a prediction that a fact would come to pass in the future);
3. the defendant knew the representation was false at the time it was made;
4. the plaintiff did not know that the misrepresentation was false;
5. the plaintiff relied to his or her determent on the representation;
6. such reliance was reasonable; and
7. the plaintiff was damaged as a direct and proximate result.

Doe v. Dilling, Doc. No. 104049, 2008 WL 879039 at *10 (Ill. Apr. 3, 2008). Furthermore, Illinois courts have required that fraud be proved by clear and convincing evidence. "In the context of common law fraud, the law presumes that transactions are fair and honest; fraud is not presumed. Accordingly, fraud must be proved by clear and convincing evidence." *Avery v. State Farm Mut. Auto Ins. Co.*, 216 Ill. 2d 100, 191 835 N.E.2d 801, 856 (2005).

In *Barth*, the Illinois Supreme Court recognized that the case before it was nothing more than a breach of contract case involving a specific provision found in many insurance contracts. It applied standard contract interpretation principles and declined to engraft the elements of the common law tort of fraud upon a breach of contract case simply because one word in the heading of the clause was "fraud."

Burden of Proof

The supreme court noted that the trial court, through its instructions, required the insurer to prove the breach of the concealment and misrepresentation clause "by clear and convincing evidence." *Barth*, 886 N.E.2d at 985. In the trial court, State Farm argued against the instruction, proffered appropriate "preponderance of the evidence" instructions, and provided case law to the trial court supporting the lower burden of proof. Since State Farm prevailed in the trial court, it had no reason to brief or argue the issue on appeal.

The trial court erroneously required the defendant to prove the violation of the contract clause by a higher standard, apparently allowing counsel for the insured to inappropriately blur the distinction between tort and contract law. The Illinois Supreme Court did not decide the issue, since it affirmed the judgment of the trial court upholding the jury's verdict in favor of State Farm.

The supreme court has never held that an insurer must prove that an insured misrepresented or concealed material information during a claim investigation by clear and convincing evidence; and the majority of courts and the leading commentators agree that clear and convincing evidence is not required to establish a breach of the Concealment or Fraud provision of a policy.[1]

No reason exists to change the burden of proof of breach of insurance contract cases and make it a different burden of proof than any other breach of contract case. Indeed, insurers asserting a material breach of the insurance contract should not be placed on an unlevel playing field simply because of their status as insurance companies.

Conclusion

In *Barth*, the Illinois Supreme Court properly declined to blur the contract defense of misrepresentation and concealment found in insurance policies with the common law tort of fraud or fraudulent misrepresentation. The court declined to resurface the playing field in breach of insurance contract cases and preserved the concealment and misrepresentation provisions in insurance policies as a useful tool for combating insurance fraud. Finally, the supreme court tacitly recognized that every policyholder who pays premiums has an interest in combating insurance fraud since the cost of resurfacing the playing field will be borne by the honest policyholders who will pay a higher premium to cover the cost of insurance fraud.

(Endnotes)

[1] *Rego v. Connecticut Placement Ins. Placement Facility*, 593 A.2d 491, 495 (Conn. 1991) ("The majority of courts . . . have concluded that the preponderance of the evidence standard is the appropriate burden to apply to an insurer's defense that a policy is void because the insured has concealed or misrepresented material facts concerning a claim for coverage. The leading commentators take the same position. In addition, we are aware of no jurisdictions that have ruled that the preponderance of the evidence standard applies to an arson defense while a higher burden of proof applies to a defense of concealment or misrepresentation."). *See Keystone Ins. Co. v. Raffile*, 622 A.2d 564, 571 (Conn. 1993); *Hernandez v. Vermont Mut. Ins. Co.*, 2008 WL 1823051 at *4 (Conn. Super. 2008); *American Pepper Supply Co. v. Federal Ins. Co.*, 93 P.3d 507, 509 (Ariz. 2004); *Summer v. Dark County Patrons Bitron Ins. Co.*, 26 N.E.2d 1021, 1023 (Ohio App. 1940); and *Calhoun v. Baylor*, 646 F.2d 1158 (6th Cir. 1981) (applying Tennessee law).

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