Prior Knowledge Provisions and Duty to Defend: An Exception to the Four-Corners Rule

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INTRODUCTION

Insurance coverage attorneys and claims professionals are familiar with the oft-repeated phrase that the duty to defend is determined by the four-corners of the complaint. This maxim is typically referred to as the “four-corners rule” or, in some jurisdictions, the “eight-corners rule” or the “complaint allegation rule.” This general rule is not without exception, however. Where facts outside of the underlying complaint, and unrelated to the merits of the claimant’s lawsuit against the insured, preclude coverage, those facts bear on whether the insurer has a duty to

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1 Not all courts apply the four-corners rule. See, e.g., Advantage Homebuilding, L.L.C. v. Maryland Cas. Co., 470 F.3d 1003, 1013 (10th Cir. 2006) (Kansas law) (rejecting four-corners rule in determining duty to defend because, among other reasons, “there is no language in the Policy that limits [the insurer’s] ability to consider extrinsic evidence”).
defend. In particular, where facts outside of the underlying complaint demonstrate that, before the relevant policy incepted, the insured knew of facts or circumstances that a reasonable insured would recognize might give rise to a claim, a policy’s prior knowledge provision should bar all coverage, including any potential duty to defend.

CLAIMS-MADE POLICIES AND PRIOR KNOWLEDGE PROVISIONS

A typical claims-made errors and omissions policy provides coverage for claims first made against the insured during the policy period. “[A] predicate to claims-made coverage is that the insured neither knew of a claim or error, nor could have reasonably foreseen that a known circumstance, act or omission might reasonably be expected to be the basis of a claim or suit.” 5 Ronald E. Mallen and Jeffrey M. Smith, Legal Malpractice § 38:14, at 96 (2012 ed.) (“Mallen”).

A prior knowledge provision in an errors and omissions policy addresses the legitimate insurance objective that no insured has knowledge, prior to the inception of the policy, of an act that is reasonably likely to become the basis for a claim. Insurers’ use of prior knowledge conditions to coverage and prior knowledge exclusions in claims-made policies is common and “uncontroversially proper.” Truck Ins. Exch. v. Ashland Oil, Inc., 951 F.2d 787, 791 (7th Cir. 1992).

A typical prior knowledge provision specifies that the policy provides coverage for a claim only if no insured “had a basis to believe that any such act or omission [on which the claim is based], or interrelated act or omission, might reasonably be expected to be the basis of a claim.” See, e.g., Bryan Bros., Inc. v. Cont’l Cas. Co., 660 F.3d 827, 830-31 (4th Cir. 2011). Prior knowledge provisions can be found in a policy’s insuring agreement, conditions, exclusions, or some combination of these. Compare Schwartz Manes Ruby & Slovin, L.P.A. v. Monitor Liab. Managers, LLC, 2012 WL 2161640 (6th Cir. June 15, 2012) (insuring agreement afforded coverage only where “prior to the inception date of the first Lawyers’ Professional Liability Insurance Policy issued by the Insurer to the Named Insured, which has been continuously renewed and maintained in effect to the inception of this Policy Period, the Insured did not know, or could not reasonably foresee that such Wrongful Act might reasonably be expected to be the basis of a Claim”), with Colony Ins. Co. v. Kuehn, 2012 WL 4472038 (D. Nev. Sept. 25, 2012) (policy exclusion for any claim “based on or directly or indirectly arising from a ‘Legal Service’ rendered prior to the effective date of the Policy if any insured knew or could have reasonably foreseen that the ‘Legal Service’ could give rise to a claim”), and Cohen–Esrey Real Estate Servs., Inc. v. Twin City Fire Ins. Co., 636 F.3d 1300 (10th Cir. 2011) (“as [a] condition precedent to coverage hereunder[,] … as of the inception date no date no partner, principal, officer, director, or member of the Insured was aware of any Wrongful Act, fact, circumstance or situation that he or she knew or [c]ould reasonably have foreseen might result in a Claim under this Policy”).

DETERMINATION WHETHER INSURED’S PRIOR KNOWLEDGE BARS INSURER’S DUTY TO DEFEND

Both insurers and insureds often address the merits of whether a prior knowledge provision bars the duty to defend without specifically considering the whether the four-corners rule should apply and, if not, why not. Where the issue is squarely addressed, the courts have indicated some confusion. Nonetheless, courts have broadly recognized that where relevant coverage limitations involve factual questions not addressed in the underlying complaint, the insurer is entitled independently to investigate and determine whether policy limitations preclude a duty to defend. Thus, an insurer should not have a defense obligation where it can demonstrate facts that establish a prior knowledge provision bars coverage, even though those facts are not alleged in the underlying complaint.
Some courts considering whether a prior knowledge provision precludes a duty to defend unhesitatingly cite evidence beyond the allegations in the underlying complaint as a basis to evaluate the insured’s knowledge. These courts correctly evaluate the full scope of facts that should be considered to determine whether the prior knowledge provision relieves the insurer of what otherwise would be its coverage obligation, but do not necessarily explain the reason why the four-corners rule is inapplicable.

For example, in *Ulster County v. CSI, Inc.*, 945 N.Y.S.2d 480 (App. Div. 2012), a county had reported a claim to its third party claims administrator, which allegedly failed to timely report that claim, in turn, to the county’s insurer. After the county’s insurer denied the claim based on late notice, the county sued the third party administrator. The third party administrator tendered the claim to its professional liability carrier, which denied any duty to defend or indemnify based on the prior knowledge exclusion in the third party administrator’s policy. The trial court granted the professional liability insurer’s motion for summary judgment based on the prior knowledge exclusion.

On appeal, the *Ulster* court reviewed various extrinsic evidence relevant to the prior knowledge provision that the insurer properly could cite to support its dispositive motion. The court acknowledged that extrinsic evidence, such as letters and statements authored by the third party administrator’s employees, could be cited to support the insurer’s motion, so long as the documents were in admissible form under the local rules and, where necessary, supported by evidence that those employees had authority to speak on the county’s behalf. *Id.* at 482-83. The court took no issue with looking beyond the four-corners of the underlying complaint for information bearing on the insured’s prior knowledge of facts or circumstances that could give rise to a claim; instead, the court focused solely on the admissibility of materials filed in support of a motion for summary judgment under local rules. *Id.*

Similarly, the Fourth Circuit, applying Maryland law, readily considered pleadings from the underlying case to evaluate the insured’s prior knowledge as a possible bar to any duty to defend. In *Westport Insurance Co. v. Albert*, 208 F. App’x 222 (4th Cir. 2006), a decedent’s accountant sued the decedent’s nephew, who had inherited the bulk of the estate, to challenge an annuity agreement that the nephew had devised. The nephew then filed a separate suit, seeking to remove the accountant as the personal representative for the estate. In his filings seeking to remove the personal representative, the nephew accused the accountant of mismanaging the estate and other wrongdoing. Several months later, the nephew filed yet another complaint against the personal representative’s accounting firm, alleging accounting malpractice. The insurer for the accounting firm asserted that the prior knowledge provision barred coverage because the allegations made in the “earlier removal petition would have put any reasonably accountant on notice that a malpractice suit was forthcoming.” *Id.* at 225. After reviewing the allegations from the earlier removal action, the *Albert* court agreed with the insurer that “[a]ccusations of that sort should have put a reasonable accountant on notice that [the nephew] could next file a claim for damages.” *Id.* at 226. In addition, the insured apparently had considered “prior to the effective date of the 2002 policy, ‘whether or not to report [the nephew’s petition] to the insurance company.’” *Id.* The court found that this additional evidence that was not found in the four-corners of the underlying complaint bolstered the conclusion that the prior knowledge provision applied to bar any duty to defend. *Id.*

Likewise, in *American Guarantee & Liability Insurance Co. v. Fojanini*, 90 F. Supp. 2d 615 (E.D. Pa. 2000), Italian investors sued their American business partners after a deal to market and distribute pizza vending machines soured. The Italians filed a law suit against the Americans, alleging fraud and intentional and negligent misrepresentation. The American business partners sought coverage under a directors and officers liability insurance policy. The D&O insurer filed a
declaratory judgment action, seeking a declaration that the prior knowledge exclusion in the policy barred any “duty to cover or defend.” *Id.* at 618. In support of its motion, the insurer presented correspondence between the Italians and the Americans. *Id.* at 621. The court stated that, in addition to the extrinsic evidence that the insurer had cited in support of its coverage position, additional evidence outside of the underlying complaint, including correspondence, deposition testimony, or affidavits, could be used to establish the insured’s subjective knowledge of circumstances that might lead to a claim. *Id.*

One court recently provided a thorough explanation of the rationale for prior knowledge provisions and similar loss and loss in progress principles, and in relied on extrinsic evidence in determining whether a prior knowledge provision precluded any duty to defend in the case at hand. issue of the duty to defend. See Eisenhandler v. Twin City Fire Ins. Co., No. CV095031716S, 2011 WL 5458180 (Conn. Super. Ct. Oct. 21, 2011). In *Eisenhandler*, the insured and insurer did not dispute that the insured knew, before the inception date of the relevant malpractice policy, that he failed timely to file a lawsuit on behalf of his client. The insured submitted an affidavit, however, to explain that his failure resulted from his mistaken belief that he had already settled his client’s case. *Id.* at *4. The court also considered evidence – although ultimately unpersuasive for the purpose of applying the prior knowledge exclusion – that the client told the lawyer at one point that she would not sue him. *Id.* at *5. After carefully weighing the extrinsic evidence in light of the language of the prior knowledge exclusion, the court held that the exclusion barred coverage, including any duty to defend the insured against the legal malpractice claim. *Id.* at *6. The court further explained that failure to conduct the proper analysis and application of the prior knowledge exclusion would undermine public policy. *Id.* See also Darwin Nat’l Assurance Co. v. Hellyer, No. 10 C 50224, 2011 WL 2259801 (N.D. Ill. June 7, 2011) (considering extrinsic evidence, including contracts made by claimants with third parties, as part of analysis of prior knowledge condition); Nat’l Cas. Co. v. Franklin Cnty., 718 F. Supp. 2d 785, 793 n.6 (S.D. Miss. 2010) (considering grand jury testimony in evaluating whether prior knowledge exclusion relieved insurer of duty to defend).

Each of the above-discussed decisions, and many other similar decisions, recognize that facts outside the four-corners of the underlying complaint against the insured should be considered to determine the insured’s knowledge of facts and circumstances that might give rise to a claim, even in the context of evaluating whether a duty to defend exists. These particular decisions do not articulate, however, the reasons why the four-corners rule did not apply to the duty to defend.

**COURTS ADDRESSING THE ISSUE HAVE EVINCED SOME CONFUSION**

Although few courts have squarely considered whether or why the four-corners rule should apply where an insurer asserts that a prior knowledge provision bars any duty to defend, those courts addressing the issue have not reached uniform conclusions. *Navigators Specialty Ins. Co. v. Scarinci & Hollenbeck, LLC*, No. 09-4317 (WHW), 2010 WL 1931239 (D.N.J. May 12, 2010), illustrates one court’s confusion. The coverage action arose out of a real estate foreclosure matter in which the insured lawyers allegedly withheld material information from the foreclosure court and purportedly assisted their clients in various misconduct with respect to the claimants’ property. The lawyers and their firm tendered the claim to their insurer, which agreed to provide a defense subject to a reservation of rights. The insurer then filed a declaratory judgment action, seeking a declaration that the prior knowledge exclusion, among other policy limitations, barred any duty to defend or indemnify.

The *Scarinci* court began its analysis by reciting the four-corners rule, explaining that “[t]he duty to defend comes into being when the complaint states a claim constituting a risk insured against. Whether an insurer has a duty to defend is determined by comparing the allegations in the complaint with the language of the policy.” *Id.* at *8 (quoting Voorhees v. Preferred Mut. Ins. Co., 128 N.J. 165, 173 (1992)). Despite reciting the four-corners rule, the court then considered the evidence outside the underlying complaint cited by the parties in the coverage action,
including the transcript of a deposition of one of the claimants, the positions taken by the lawyers and the firm in the underlying foreclosure matter, and threats made by the claimants before they filed the action against the lawyers and their firm. *Id.* at *11-12. Based on the extrinsic evidence and the policy language, the court then determined that, “well before the [ ] inception date of the policy, Defendants knew of such acts, errors or omissions” that might lead to a claim. *Id.* at *15.

To support its conclusion concerning the insureds’ subjective knowledge, however, the court cited only allegations from the underlying complaint. *Id.* To support its conclusion concerning whether the insureds objectively had reason to believe the claimants might make a claim, the court cited “several direct accusations of fraud and threats of litigation,” which were found in certain emails, pleadings from the foreclosure action, and other documents. *Id.* (citing the insurer’s memorandum of law in support of motion for summary judgment, which referenced and attached extrinsic documents relevant to prior knowledge exclusion). The court’s decision never reconciles its recitation of the four-corners rule with its ultimate reliance on evidence outside of the complaint and the text of the policy to determine that the insurer did not have a duty to defend.

In another recent case, a California court concluded that extrinsic evidence could be relied upon if the prior knowledge provision were located in the insurance policy’s conditions section, but not if it were in the policy’s exclusions section. *M.D. Sass Investors Servs., Inc. v. Reliance Ins. Co.*, 810 F. Supp. 1082 (N.D. Cal. 1992). The court correctly recognized that certain issues, such as late notice, typically are not resolved by a four-corners analysis. *Id.* at 1087. This is for the obvious reason that an underlying claimant would have no knowledge of when an insured provided notice to its insurer, and such an allegation would be entirely collateral to the claimants’ allegations against the insured. However, the court then wrongly deduced based on the generally accepted analysis for the late notice defense, that if the prior knowledge provision were not stated as a condition precedent, but rather set forth in a policy’s exclusion section, then no exception to the four-corners rule could apply. *Id.*

Notwithstanding the host of cases relying on extrinsic evidence to evaluate whether a prior knowledge provision bars the duty to defend, at least one court has erroneously clung to the four-corner rule. *Am. Guar. & Liab. Ins. Co. v. Hoeffner*, No. H-08-1181, 2009 WL 130221 (S.D. Tex. Jan 16, 2009). The *Hoeffner* court rigidly stated that “‘the duty to defend is not affected by facts ascertained before suit, developed in the course of litigation, or by the ultimate outcome of the suit.’” *Id.* at *2 (quoting *Zurich Am. Ins. Co. v. Nokia*, 268 S.W.3d 487, 491 (Tex. 2008)). The court acknowledged that “[a]lthough it appears clear from other sources” that, prior to the policy’s inception, the insured “knew that he was breaching a professional duty or had a basis to foresee that his conduct could result in a claim under the Policy,” the court nevertheless insisted that the absence of such allegations in the underlying complaint against the insured required the insurer to defend. *Id.* at *4.

**WHY EXTRINSIC EVIDENCE IS A PROPER PART OF THE PRIOR KNOWLEDGE ANALYSIS**

As one court recognized, the “suggestion that a trial court is limited solely to a review of the allegations in the tort complaint in ascertaining a duty to defend, while supported by decisions echoing boiler-plate law, is an overstatement.” *Oakley Transp., Inc. v. Zurich Ins. Co.*, 648 N.E.2d 1099, 1102 n.2 (Ill App. Ct. 1995). Indeed, the four-corners “rule” itself is simply a judicial construct. It is not found in the contractual language of insurance policies, nor in insurance rules or regulations. While the four-corners rule may apply in many instances, exceptions to the rule are readily identified and unsurprising. As referenced in the *M.D. Sass* case discussed above, few insurance professionals would balk at the notion of considering the date of a notice of claim, rather than the four-corners of the underlying complaint, to determine the whether the insured provided late notice of a claim, which may bar any duty to defend. The fact that a readily identified exception to the general four-corners rule exists does not rule out any other exceptions, though.
Another exception to the four-corners rule may apply where the underlying complaint contains demonstrably false allegations. For example, a court may look past the allegations in an underlying complaint where the complaint alleges negligent, and therefore potentially covered, conduct, but the insured has admitted to or been convicted of intentional conduct that is not covered by the policy. See, e.g., Home Mut. Ins. Co. v. Lapi, 596 N.Y.S.2d 885, 886-87 (N.Y. App. Div. 1993) (insurer has no duty to defend where insured admitted he intended to cause injury); Or. Ins. Guar. Assoc. v. Thompson, 760 P.2d 890, 893 (Or. Ct. App. 1988) (where policy precluded coverage for intentional conduct, prior ruling that insured’s conduct was intentional defeated duty to defend). Similarly, if the true facts are not disputed, the court may consider those and not be bound by the allegations in the underlying complaint. In Guaranty Nat’l Ins. Co. v. C de Baca, 907 P.2d 210, 214-15 (N.M. Ct. App. 1995), the court held that an allegation in the underlying complaint concerning the date of the accident did not control with respect to when the accident happened, for the purpose of determining which insurer had a duty to defend.

Most critically for the purposes of examining the application of a prior knowledge provision, courts also have recognized an exception to the four-corners rule “when the facts alleged in the complaint ostensibly bring the case within the policy’s coverage, but other facts that are not reflected in the complaint and are unrelated to the merits of the plaintiff’s action plainly take the case outside the policy coverage.” Allan D. Windt, Insurance Claims & Disputes 5th, Section 4:4 (March 2012). As Vermont’s Supreme Court explained in Blake v. Nationwide Insurance Co., 904 A.2d 1071 (Vt. 2006):

> Although in many cases the presence of a duty to defend can be determined by comparing the coverage provisions of the policy with the allegations in the complaint, this is not such a case because the relevant policy exclusions involve factual questions not covered in the complaint, namely, whether the accident occurred in the scope of employment… Nor do we agree with plaintiff that [the insurer] had a duty to seek a declaratory judgment on coverage … If a declaratory judgment action were required in this case, it would be required in every case in which an insurer denied coverage, irrespective of whether the grounds were contested or even contestable. The litigation from such a rule would be significant, and virtually all of it would be unnecessary.

*Id.* at 1076-77.

Thus, in Fred Shearer & Sons, Inc. v. Gemini Insurance Co., 240 P.3d 67 (Or. Ct. App. Sept. 29, 2010), the Oregon Court of Appeals held that a court may consider extrinsic evidence to determine who qualifies as an insured. The Court expressly held that “the inquiry as to whether [the party seeking coverage] was an insured under the policy was not limited to the four-corners of the underlying complaint and the policy. *Id.* at 78. The Fred Shearer court distinguished between evaluating complaint allegations to determine whether any conduct within the scope of the policy is alleged and the separate determination of who qualifies as an insured under the policy, which is not dependent on the allegations of the underlying complaint.\(^2\)

This exception to the four-corners rule is not limited to evaluation of whether a claim falls within the scope of the policy’s insuring agreement. For example, in Talen v. Employers Mutual Casualty Co., 703 N.W.2d 395 (Iowa 2005), an insured bank officer asserted that the insurer wrongly denied coverage based on an employment practices exclusion because the underlying complaint alleged only that the insured had disparaged the claimant, but not that the disparaging comments necessarily related to the claimant’s performance as an employee of the bank. The court rejected the argument that the vague allegations of the complaint alone triggered a duty to

\(^2\) But see Devino v. Md. Cas. Co., 2004 WL 1965788, *4-5 (Conn. Super. Ct. July 30, 2004) (declining to look at evidence outside of the underlying complaints when determining whether an entity was an insured); Chandler v. Doherty, 702 N.E.2d 634, 638-40 (Ill. App. Ct. 1998) (insurer disputing a duty to defend barred from introducing extrinsic evidence to how that insured was not driving car covered by policy where underlying complaint incorrectly asserted that the insured was driving “his motor vehicle”).
defend, stating “it is permissible for a liability insurer, in determining whether to accept a tendered defense to consider facts beyond the allegations of the petition.” Id. at 405 (citing McAndrews v. Farm Bureau Mut. Ins. Co., 349 N.W.2d 117, 119 (Iowa 1984)).

“The scope of inquiry, however, must sometimes be expanded beyond the petition, especially under ‘notice pleading’ petitions which often give few facts upon which to assess an insurer's duty to defend.” [ ] Quoting from an earlier case, we stated that an insurer has no duty to defend “if after construing both the policy in question, the pleadings of the injured party and any other admissible and relevant facts in the record, it appears the claim made is not covered by the indemnity insurance contract.” [ ] We find this principle to be especially relevant when the basis for withholding coverage is a policy exclusion the application of which is not readily ascertainable from the allegations of the petition and will not necessarily be determined in the tort litigation.

Id. at 406 (internal citations omitted).

It would not have been relevant to the underlying action in Talen whether the alleged disparagement was made in the course of the insured’s employment, but that issue was directly relevant to the application of a policy exclusion that would otherwise bar the insurer’s duty to defend. The insurer therefore correctly relied on information beyond the face of the underlying complaint to determine the application of the employment practices exclusion.

These principles are particularly applicable to claims where a policy’s prior knowledge provision may apply. In a typical “prior knowledge” scenario, as illustrated by the Albert case discussed above, an insured accountant began receiving complaints before the professional liability policy at issue incepted on January 1, 2002. In August 1999, the insured accountant sued the decedent’s nephew to challenge an annuity agreement devised by the nephew. Albert, 208 F. App’x at 224. The nephew pushed back, requesting that the insured withdraw the suit and stop “wasting” estate funds. Id. The nephew filed a petition in court in November 2001 to remove the insured as personal representative of the estate. Id. The filings in the removal proceeding accuse the insured of being a “‘malfeasant,’ providing ‘sketchy and inadequate accounting statements,’ ‘breach[ing] his fiduciary duties,’ ‘mismanag[ing] Estate property,’ and ‘failing to perform material duties of his office.’” Id. The nephew then filed a malpractice complaint against the accounting firm on January 30, 2002.

There is no reason why the underlying malpractice complaint before the court in Albert would necessarily recite the rancorous history between the accountant and the nephew, given the bare notice pleading requirements for complaints. Nor would the dates of the accusations and interactions between the nephew and the accountant necessarily be stated in the underlying complaint. The accounting malpractice complaint could have been resolved on the merits without ever addressing the separate factual questions about all of the facts and circumstances known to the accountant that reasonably might give rise to a claim. For this reason, the court properly considered facts outside of the malpractice complaint in evaluating the application of the prior knowledge exclusion.

Thus, the prior knowledge provision fits squarely within a well-recognized exception to the four-corners rule. The prior knowledge evaluation mandates the application of an objective, reasonable person standard to the facts subjectively known to an insured before the inception of the policy. See, e.g., Prof'l Asset Strategies, LLC v. Cont'l Cas. Co., 447 F. App'x 97, 98–99 (11th Cir. 2011) (prior knowledge provision in professional liability insurance policy barred coverage because an objective person in an insured employee’s position should have expected that his theft of money from client accounts might form the basis of a claim); Ross v. Cont'l Cas. Co., 420 B.R. 43, 49 (D.D.C. 2009), aff'd No. 09-7166, 2010 WL 3721542 (D.C. Cir. Sept. 22, 2010) (D.C. law) (prior knowledge provision “unambiguously requires an objective inquiry into what might have been reasonably expected to form a claim based on the knowledge [the insured]
possessed when the policy took effect”). The facts and circumstances that are known to the insured relevant to a potential claim would not necessarily be set forth in the underlying complaint. Provided that the relevant facts will not necessarily be determined in the underlying action against the insured, the insurer fairly may look beyond the allegations of the underlying complaint to resolve any question about the duty to defend.