COURT OF APPEALS
DECISION
DATED AND FILED

February 26, 2013

Diane M. Fremgen
Clerk of Court of Appeals

Appeal No. 2012AP1601 **Cir. Ct. No. 2009CV207**

STATE OF WISCONSIN **IN COURT OF APPEALS**
DISTRICT III

JEFFREY J. KRAFT,

PLAINTIFF-RESPONDENT,

V.

JEANNIE THOMPSON AND JEANNIE THOMPSON ACCOUNTING, L.L.C.,

DEFENDANTS,

TWIN CITY FIRE INSURANCE COMPANY,

DEFENDANT-APPELLANT.

APPEAL from a judgment of the circuit court for Pierce County: JOSEPH D. BOLES, Judge. *Affirmed.*

Before Hoover, P.J., Mangerson, J., and Thomas Cane, Reserve Judge.

¶1 PER CURIAM. Jeffrey Kraft sued his former accountant, Jeannie Thompson, and her firm, Jeannie Thompson Accounting, L.L.C. (collectively, Thompson) for malpractice. After Kraft obtained a judgment against Thompson, Thompson assigned her claims against her errors and omissions insurer, Twin City Fire Insurance Company, to Kraft. The circuit court subsequently granted Kraft summary judgment against Twin City, concluding that: (1) Twin City had a duty to defend Thompson; and (2) Twin City breached its duty to defend when it unilaterally determined its policy did not provide coverage and withdrew its defense of Thompson without first seeking a judicial resolution of the coverage issue. Twin City appeals, arguing it did not have a duty to defend Thompson and, even if it did, it did not breach that duty. We reject Twin City's arguments and affirm.

BACKGROUND

¶2 Kraft hired Thompson to provide accounting services. In May 2007, the Internal Revenue Service (IRS) notified Kraft that it planned to audit his 2004 and 2005 tax returns, which Thompson had prepared. Later that month, Kraft and Thompson met with an IRS representative to discuss the impending audit. The IRS subsequently determined that Kraft's 2004 and 2005 returns were delinquent, and it assessed penalties against Kraft in August 2007. Shortly thereafter, Kraft fired Thompson as his accountant.

¶3 Thompson wrote to Kraft's tax attorney on August 31, 2007, acknowledging that Kraft no longer had "confidence" in her. Thompson also wrote, "If there are penalties and interest imposed on [Kraft] for any of the work I did based on the information I was supplied on a timely basis, I will use my Error and Omissions Insurance to cover such fines." Thompson had an errors and

omissions policy from Twin City, but she did not notify Twin City that Kraft had a possible claim against her.

¶4 Thompson subsequently renewed her errors and omissions policy. The renewed policy provided coverage for claims made between September 18, 2008 and September 18, 2009. However, the policy's coverage was subject to the following provision:

> [A]s [a] condition[] precedent to coverage hereunder:
>
> **(A)** as of the inception 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 could reasonably have foreseen, might result in a **Claim** under this policy.

¶5 On May 19, 2009, Kraft sued Thompson for accounting malpractice. Thompson faxed Kraft's complaint to Twin City, which promptly opened a claim file and hired counsel to defend Thompson. In July 2009, Thompson gave Twin City a limited number of documents from the IRS's audit of Kraft's 2004 and 2005 tax returns. Then, in December 2009, Thompson provided Twin City with her complete work files for the Kraft audit.

¶6 Jarret Lewis, a claims consultant for Twin City, reviewed Thompson's work files in early 2010. He called Thompson on February 23, 2010 to discuss Kraft's claim. During that conversation, Thompson admitted that, in August 2007, she received a form that summarized the IRS auditor's findings and assessed penalties against Kraft. Thompson stated the penalties were based largely on Kraft's failure to provide her with timely documentation, but she also admitted "there were some mistakes that she made that led to penalties and interest being assessed[.]"

¶7 Based on these admissions, Lewis determined that Thompson was aware of "facts and circumstances … that reasonably could lead to a claim in the summer of 2007, a year before the 2008-2009 policy incepted[.]" Lewis therefore concluded the "prior knowledge" condition precedent to coverage had not been met. Consequently, he informed Thompson that her policy did not cover Kraft's claim and that Twin City would no longer provide a defense for her. Twin City confirmed its decision to withdraw from defending Thompson in a letter dated March 12, 2010. Thompson's defense counsel withdrew the following month.

¶8 On January 3, 2011, Kraft moved for summary judgment against Thompson. Thompson did not respond, and the circuit court granted Kraft's motion. The court entered judgment against Thompson for $151,824.66. Thompson subsequently assigned to Kraft any claims she might have against Twin City.

¶9 Kraft then filed a second amended complaint, in which he alleged that Twin City had breached its duty to defend Thompson. Kraft and Twin City filed cross-motions for summary judgment, and the circuit court ruled in Kraft's favor. The court concluded that Twin City had a duty to defend Thompson and breached that duty by withdrawing its defense without first obtaining a judicial determination of the coverage issue. It therefore ordered Twin City to pay Kraft

the entire amount of the prior judgment against Thompson, plus interest and costs. The court entered judgment in Kraft's favor, and Twin City now appeals.[1]

DISCUSSION

¶10 We review summary judgment decisions de novo, using the same methodology as the circuit court. ***Smith v. Dodgeville Mut. Ins. Co.***, 212 Wis. 2d 226, 232, 568 N.W.2d 31 (Ct. App. 1997). Summary judgment is appropriate if there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. WIS. STAT. § 802.08(2).[2] Here, the circuit court's summary judgment ruling hinged on its determination that Twin City breached its duty to defend. Whether an insurer has a duty to defend is a question of law subject to independent appellate review. *See* ***Grube v. Daun***, 173 Wis. 2d 30, 72, 496 N.W.2d 106 (Ct. App. 1992).

¶11 Liability insurance policies impose two distinct duties on the insurer: a duty to indemnify the insured against damages or losses, and a duty to defend the insured against claims for damages. ***Olson v. Farrar***, 2012 WI 3, ¶27, 338 Wis. 2d 215, 809 N.W.2d 1. The duty to defend is broader than the duty to indemnify. ***Fireman's Fund Ins. Co. v. Bradley Corp.***, 2003 WI 33, ¶20, 261 Wis. 2d 4, 660 N.W.2d 666. While the duty to indemnify requires a finding of

[1] In addition to the duty to defend claim, Kraft's second amended complaint also alleged that Twin City was directly liable to Kraft and that Twin City had a contractual duty to indemnify Thompson. The circuit court concluded these additional claims were moot, in light of its ruling on the duty to defend claim, and it dismissed them. Twin City argues on appeal that it was entitled to summary judgment on Kraft's indemnification claim. We decline to address Twin City's argument because the circuit court properly dismissed the indemnification claim as moot.

[2] All references to the Wisconsin Statutes are to the 2011-12 version unless otherwise noted.

actual coverage, only arguable coverage is needed to trigger the duty to defend. *See* ***id.*** An insurer that breaches its duty to defend "will be held to have waived any subsequent right to litigate coverage." ***Radke v. Fireman's Fund Ins. Co.***, 217 Wis. 2d 39, 45, 577 N.W.2d 366 (Ct. App. 1998). In addition, a breach of the duty to defend makes the insurer liable to the insured for "all damages that naturally flow from the breach." ***Newhouse v. Citizens Sec. Mut. Ins. Co.***, 176 Wis. 2d 824, 837, 501 N.W.2d 1 (1993). This includes the amount of the judgment against the insured, even if that judgment exceeds the insurer's policy limits. ***Id.*** at 838.

¶12 Wisconsin courts employ the "four-corners rule" to determine whether an insurer has a duty to defend. *See* ***Olson***, 338 Wis. 2d 215, ¶¶31-33. Under the four-corners rule, a court compares the allegations within the four corners of the complaint to the terms of the policy. ***Brown v. MR Group, LLC***, 2005 WI App 24, ¶5, 278 Wis. 2d 760, 693 N.W.2d 138. The insurer has a duty to defend when the allegations in the complaint, "if proven, 'would give rise to recovery under the terms and conditions of the insurance policy[.]'" ***Liebovich v. Minnesota Ins. Co.***, 2008 WI 75, ¶16, 310 Wis. 2d 751, 751 N.W.2d 764 (quoting ***Elliott v. Donahue***, 169 Wis. 2d 310, 320-21, 485 N.W.2d 403 (1992)). When employing this analysis, a court is limited to the allegations in the complaint and may not consider extrinsic evidence. ***Grube***, 173 Wis. 2d at 72.

¶13 Applying the four-corners rule in this case, it is clear that Twin City had a duty to defend Thompson against Kraft's claim. Thompson's errors and omissions policy states that Twin City will pay "all sums … that the **Insured** shall become legally obligated to pay as **Loss** and/or **Defense Costs** … for a **Wrongful Act** by the **Insured**[.]" Thompson is an insured under the policy. The term "**Wrongful Act**" means "any actual or alleged negligent act, error or omission in

the rendering of or failure to render **Professional Services**." "**Professional services**" means tax preparation. Thus, the policy covers negligent acts committed by Thompson in her professional capacity as a tax preparer. Kraft's complaint, in turn, alleges that: (1) Kraft hired Thompson to provide accounting services; (2) Thompson was negligent in the provision of those services; and (3) Kraft suffered damages as a result of Thompson's negligence. Kraft's complaint therefore contains allegations that, if true, would give rise to recovery under Thompson's policy. Accordingly, under the four-corners rule, Twin City had a duty to defend Thompson against Kraft's claim.

¶14 Twin City does not dispute that, under the four-corners rule, it owed Thompson a duty to defend. Instead, Twin City argues the four-corners rule does not apply in this case because the rule is implicated only "when a valid insurance contract exists between the parties." Twin City contends there is no valid policy here because Thompson failed to fulfill the "prior knowledge" condition precedent to coverage, and, as a result, "the insurance policy never went into effect." However, Twin City confuses a condition precedent to coverage with a condition precedent to contract formation. The "prior knowledge" condition precedent in Thompson's policy provides that, in order for a claim to be covered under the policy, Thompson must not have had knowledge of the claim before the beginning of the policy period. It does not state that, if Thompson had prior knowledge of a claim, the entire policy is void. We therefore reject Twin City's assertion that the four-corners rule does not apply in this case because Thompson did not have a valid insurance policy.

¶15 Twin City also argues there is an exception to the four-corners rule for cases involving an insured's breach of a condition precedent to coverage. In support of this proposition, Twin City cites ***Magyar v. Wisconsin Health Care***

Liability Insurance Plan, 2001 WI 41, 242 Wis. 2d 491, 625 N.W.2d 291. We do not agree, however, that ***Magyar*** controls the issue before us.

¶16 In ***Magyar***, a dispute over insurance coverage erupted after a clinic was sued for medical negligence. ***Id.***, ¶¶2, 5. The clinic's insurance policy required each of the physicians employed by the clinic to carry an individual liability policy. ***Id.***, ¶3. The clinic's insurer cancelled the clinic's policy after it determined that one of the physicians was no longer insured, but the insurer did not inform the clinic of the cancellation. ***Id.***, ¶¶4-5. It was undisputed that, by failing to send the clinic a notice of nonrenewal, the insurer violated WIS. STAT. § 631.36(4)(a). ***Id.***, ¶9. The disputed issue was the proper remedy for the insurer's violation. ***Id.*** Our supreme court concluded that, under the statute, the clinic was entitled to renewal of its policy for "an additional period of time equivalent to the expiring term." ***Id.***, ¶13. Thus, the policy remained in effect for an additional nine-month period after the date of cancellation. ***Id.*** The claimed negligence did not occur, though, until after that nine-month period had expired. ***Id.*** Consequently, because there was no policy in effect at the time the negligence occurred, the court determined there was no coverage for the plaintiff's claims. ***Id.***

¶17 Thus, contrary to Twin City's assertion, ***Magyar*** did not address whether the four-corners rule applies in cases where the insured allegedly breached a condition precedent to coverage. Instead, the issue in ***Magyar*** was the insured's remedy when the insurer fails to provide proper notice of nonrenewal. The court did not need to employ a four-corners analysis in ***Magyar*** because it determined there was no policy in effect when the alleged negligence occurred. Had the court determined the policy was still in effect at the time the negligence

took place, it presumably would have used the four-corners test to determine whether the complaint stated a covered claim.

¶18 Perhaps realizing that Wisconsin case law does not support its argument, Twin City next argues that "[c]ourts in other jurisdictions routinely consider evidence outside the complaint when determining whether an insured's prior knowledge means an insurance company does not owe a duty to defend." However, controlling Wisconsin precedent clearly states that an insurer's duty to defend is determined based on the complaint alone, without consideration of extrinsic evidence. *See, e.g.*, ***Grube***, 173 Wis. 2d at 72. We may not depart from this well-settled rule of law based on the foreign cases Twin City cites. The four-corners rule applies in this case, and under that rule, Twin City had a duty to defend Thompson.

¶19 In the alternative, Twin City argues that, even if it had a duty to defend Thompson, it did not breach that duty. We disagree.

¶20 In ***Newhouse***, our supreme court stated, "An insurer does not breach its contractual duty to defend by denying coverage where the issue of coverage is fairly debatable as long as the insurer provides coverage and defense once coverage is established." ***Newhouse***, 176 Wis. 2d at 836 (quoting ***Elliot***, 169 Wis. 2d at 317). The court clarified, though, that "when coverage is not determined before a liability trial, the insurer must provide a defense for its insured with regard to liability and damages." ***Id.*** Here, the coverage issue was not resolved before a liability trial, but Twin City nevertheless refused to provide a defense.

¶21 Moreover, Twin City did not follow any of the approved procedures an insurance company may use when it wishes to contest coverage without

breaching its duty to defend. For instance, Twin City did not "request a bifurcated trial on the issue of coverage while moving to stay proceedings on the merits of the liability action until the issue of coverage [was] resolved." *See* ***Liebovich***, 310 Wis. 2d 751, ¶55. Nor did Twin City seek a declaratory ruling on the coverage issue. *See* ***id.*** Finally, Twin City did not provide Thompson with a defense under a reservation of rights. *See* ***id.*** Instead, Twin City unilaterally determined that its policy did not cover Kraft's claim and withdrew its defense without seeking judicial resolution of the coverage issue.

¶22 Twin City makes much of the fact that the ***Liebovich*** court stated the procedures it described for contesting coverage were "not absolute requirements." ***Id.*** However, despite this statement, the ***Liebovich*** court found that an insurer breached its duty to defend because it failed to follow the recommended procedures. *See* ***id.***, ¶56. Thus, we reject Twin City's argument that a breach of the duty to defend cannot be premised on an insurer's failure to follow the procedures outlined in ***Liebovich***.

¶23 Furthermore, by stating that the recommended procedures for contesting coverage were "not absolute requirements," the ***Liebovich*** court simply recognized that an insurer may always make the strategic choice to reject its insured's tender of defense. *See* ***Radke***, 217 Wis. 2d at 45. This strategy has no negative consequences for the insurer if a court ultimately determines the insurer had no duty to defend. *See* ***Production Stamping Corp. v. Maryland Cas. Co.***, 199 Wis. 2d 322, 331 n.4, 544 N.W.2d 584 (Ct. App. 1996). However, if a court determines the insurer had a duty to defend, the insurer will be subject to consequences for its breach of that duty. *See* ***id.*** Specifically, the insurer will be barred from contesting coverage, and it will be liable to the insured for damages caused by its breach. ***Radke***, 217 Wis. 2d at 48. Thus, while an insurer always

has the option to refuse to defend its insured, an insurer chooses that option "at [its] peril." ***Grieb v. Citizens Cas. Co.***, 33 Wis. 2d 552, 558, 148 N.W.2d 103 (1967).

¶24 Here, Twin City had a duty to defend Thompson. *See supra*, ¶¶13, 18. Twin City breached its duty when it withdrew from defending Thompson without first seeking a judicial determination on coverage. As a result of its breach, Twin City was barred from contesting coverage and was liable to Thompson for damages. Consequently, the circuit court properly denied Twin City's summary judgment motion and entered judgment in favor of Kraft.

By the Court.—Judgment affirmed.

This opinion will not be published. *See* WIS. STAT. RULE 809.23(1)(b)5.