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Resolving Insurance Coverage Ambiguities: Discovery and Use of Extrinsic Evidence to Clarify Coverage

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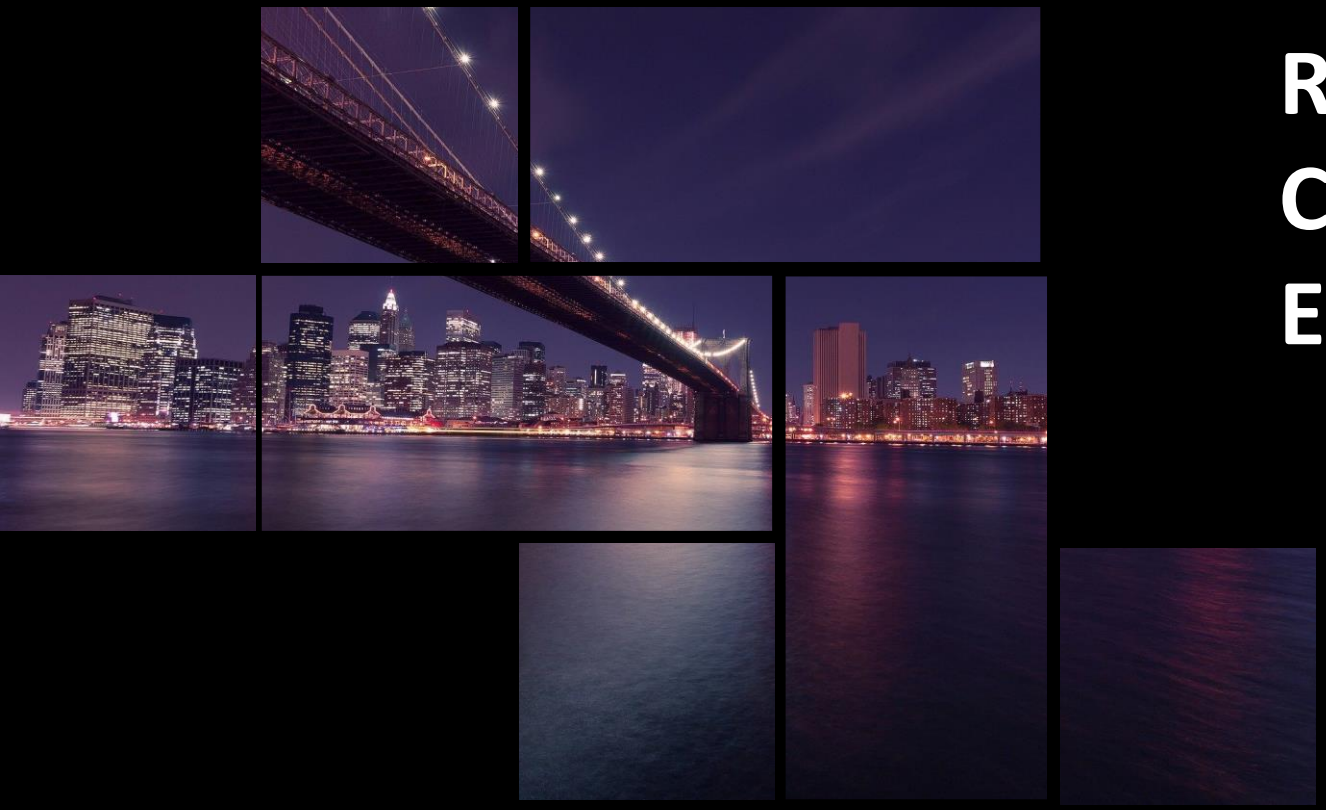


RESOLVING INSURANCE COVERAGE AMBIGUITIES: EXTRINSIC EVIDENCE

Presented by:
Edward J. Guardaro, Jr.
Verne A. Pedro

GENERAL RULES OF POLICY INTERPRETATION

STATE LAW WILL APPLY TO POLICY INTERPRETATION

- Insurance policies are contracts and state law applies to actions on contracts and contractual interpretation

- General principles of insurance policy interpretation are similar in many respects throughout all states

  - However, ***there are subtle differences from one state to the next that can have important consequences***

  - This is important because if an ambiguity exists, the court will resort to tools and rules of construction (interpretation) beyond the corners of the policy.

TIP: When advising clients about insurance policy interpretation, make sure you familiarize yourself with the law of the applicable jurisdiction

  - Keep in mind that there may be uncertainty regarding which state's law applies
  - Choice of law is beyond the scope of this presentation

BASIC RULES OF CONTRACT INTERPRETATION APPLY

- Plain meaning rule: Clear and unambiguous terms in insurance policy must be enforced as written.
- Coverage provisions are construed liberally
- Ambiguities ordinarily construed against the insurer
- Exclusions are construed narrowly
- Courts will not search for ambiguities in insurance policy exclusions where there are none.
- Courts will not re-write insurance policies (or provisions) that are clear and unambiguous.

PLAIN MEANING ISSUES

- An insurance policy generally should be interpreted according to its plain and ordinary meaning. Insurance policies are read in such a way that each term and provision is given meaning.

- Words are given their ordinary, plain and popular meaning, unless the words have acquired a technical meaning (as understood by insurers and policyholders). Courts routinely refer to dictionary definitions to determine plain and ordinary meaning.

- Courts will look for the intent of the parties when interpreting insurance policies. When determining the intent of the parties, the court first looks to the language of the insurance policy.

- Some courts have held that absent fraud or unconscionable conduct the insured is charged with knowledge of the terms and conditions of the policy even if the insured does not read the insurance policy prior to the loss.

- One policy provision is not to be construed separately without regard to other policy provisions; i.e., the policy is to be construed in its entirety

Why special rules of construction for insurance policies?

- Use of Standard Form Policies
  - Forms drafted for industry by rating bureaus (historically controlled by their member insurance companies)
    - Some individual insurers drafted their own forms
  - Developed over many years
  - Non-standard form policies are referred to as “manuscript” policies
    - Who drafts the language of these manuscript policies?
- Contracts of adhesion
  - Terms of insurance offered to policyholder on a “take it or leave it” basis
    - Most policyholders are not able to negotiate regarding terms of insurance
    - Larger companies may have some ability to negotiate
- Disparity in bargaining power
  - Policyholders rely on insurers’ representations regarding the coverage being offered

AMBIGUITY: CONTRA PROFERENTEM

- If after applying the other general rules of construction an ambiguity remains, the ambiguous contractual provision is to be construed against the insurer, as the drafter of the policy, and in favor of the insured.
  - This principle is known as *contra proferentem* (“against the offeror”) – ambiguities in a contract are construed against the drafter.
- Often the most important argument in an insurance coverage dispute often is whether or not a term or provision is ambiguous.
  - If it is ambiguous, the policyholder typically wins; if it is unambiguous, the insurer typically wins.
  - However, rather than applying *contra proferentem*, some courts hold that once ambiguity is found, the meaning of an ambiguous term is an issue of fact that must be resolved by the trier of fact.
    - If extrinsic evidence does not resolve the ambiguity, then *contra proferentem* applies.

AMBIGUITY AND REASONABLE EXPECTATIONS

- One tool that courts use to resolve ambiguity is the "reasonable expectations" doctrine, which contemplates interpreting insurance policies with the "reasonable" expectations of the insured in mind. The New Jersey Supreme Court explained reasonable expectations this way:

When members of the public purchase policies of insurance they are entitled to the broad measure of protection necessary to fulfill their reasonable expectations. They should not be subjected to technical encumbrances or to hidden pitfalls and their policies should be construed liberally in their favor to the end that coverage is afforded to the full extent that any fair interpretations will allow.

Zacarias v. Allstate Ins. Co., 168 NJ 590, 595 (2001)

AMBIGUITY AND REASONABLE EXPECTATIONS

- The reasonable expectations doctrine is based, in part, on the insured not having equal bargaining power and generally being required to accept the insurance policy as written.

- Expectations must be objectively reasonable and not contrary to the plain language of the insurance policy.

- Some courts have held that expectations are different for a sophisticated insured with an in house risk management department or assistance from an insurance broker who obtains a manuscript insurance policy. *See, e.g.,* Chubb *Custom Ins. Co. v. Prudential Ins. Co.*, 195 N.J. 231, (2008).

AMBIGUITY AND REASONABLE EXPECTATIONS

- When insurance policy language is ambiguous, the reasonable expectations of the insured is applied even if a detailed analysis of the policy provisions would result in a finding of no coverage.

- Courts will not enforce subtle or legalistic distinctions when an ambiguity is at play.

- If insurance policy language is clear on its face, the court will determine if the language is sufficiently clear such that the reasonable expectations of the insured can be defeated. *Zacarias*, 168 N.J. at 601.

Why special rules of construction for insurance policies?

- A cynical view of how insurance policies are drafted:

> ***"Ambiguity and incomprehensibility seem to be the favorite tools of the insurance trade in drafting policies. Most are a virtually impenetrable thicket of incomprehensible verbosity. It seems that insurers generally are attempting to convince the customer when selling the policy that everything is covered and convince the court when a claim is made that nothing is covered. The miracle of it all is that the English language can be subjected to such abuse and still remain an instrument of communication."***
>
> *Universal Underwriters Ins. Co. v. Travelers Ins.*, 451 S.W.2d 616, 622-23 (KY. 1970).

WHAT CONSTITUTES AMBIGUITY?

What is ambiguity?

- Generally, an ambiguity arises when the insurance policy's language is susceptible to two or more reasonable interpretations. As explained by the New Jersey Supreme Court:

We conceive a genuine ambiguity to arise where the phrasing of the policy is so confusing that the average policy holder cannot make out the boundaries of coverage. In that instance, application of the test of the objectively reasonable expectation of the insured often will result in benefits of coverage never intended from the insurer's point of view.

Weedo v. Stone-E-Brick, Inc., 81 N.J. 233, 247 (1979).

- Whether the phrasing is confusing may depend on, among other things, the type of coverage provided, the sophistication of the insured, prior relationship between the insured and insurance company, the resolution of prior claims, and the particular facts and circumstances giving rise to the claim.

What is ambiguity?

- What happens when clear (i.e., non-ambiguous) policy provisions conflict? Some jurisdictions, such as California, have rules to resolve ambiguities resulting from inconsistent provisions:

• "Manuscript" provisions control over standard form provisions. [Civ. Code § 1651]

• Information typed or printed on a policy's declarations page prevails over conflicting provisions in the preprinted forms. [Fidelity & Dep. Co. of Maryland v. Charter Oak Fire Co. (1998) 66 Cal.App.4th 1080, 1087]

• Endorsements control over standard form language. [Continental Cas. Co. v. Phoenix Const. Co. (1956) 46 Cal.2d 423, 431]

• Specific provisions control over general. [Jane D. v. Ordinary Mut. (1995) 32 Cal.App.4th 643, 651; Civ. Code § 3534]

– Other "tie breakers" may apply

• Exclusionary provisions are narrowly construed

• Reasonable expectations

Declarations pages

- Declaration page is typically the first page of an insurance policy that provides a broad summary and/or overview of the coverages provided.

- Courts will sometimes look to the declarations page(s) of a policy when analyzing an insured's reasonable expectations.

- In interpreting a personal lines policy, New Jersey's Appellate Division found that it is "the declaration page, the one page of the policy tailored to the particular insured and not merely boilerplate, which must be deemed to define coverage and the insured's expectations of coverage." Lehrhoff v. Aetna Cas. & Sur. Co., 271 N.J. Super. 340, 346-47 (App. Div. 1994).

Declarations pages as evidence of reasonable expectations

- While the declarations page is important to a court's analysis, the New Jersey Supreme Court has held that:

  "an insurance policy is not per se ambiguous because its declaration sheet, definition section, and exclusion provisions are separately presented. A rule of construction forcing insurers to avoid all cross-referencing in policies would require them to reprint the entire definition section on each page of the policy, or to define each term every time it is used. That proliferation of fine print would itself demand strenuous study and run the risk of making insurance policies more difficult for the average insured to understand."

  Zacarias, 168 N.J. at 603.

- In addition to the declarations page, an insurance policy's premium amount could impact an insured's reasonable expectations.

Policyholder has burden of proving coverage

- Policyholder has the burden of showing the claim is covered.

- Where there is a dispute over interpretation of the policy, the policyholder must establish that the claim falls within the basic terms of the policy.

Insurer Must Show Exclusion Squarely Applies

- Exclusionary clauses are “construed more strictly against the insurer than coverage clauses.”

- Language does not have to appear in the “Exclusions” section of the policy to be construed as an exclusion.

- Courts look at whether the effect of the language is to restrict coverage.

- Insurer has the burden of proving a claims is excluded under the policy. Once the insurer establishes that an exclusion is applicable, the burden shifts back to the policyholder to establish the applicability of an exception to the exclusion.

Ambiguity - Sophisticated Insureds

- When a dispute is between an insurer and a sophisticated insured, some courts will take into account the sophistication of the insured when determining the objectively reasonable interpretation of insurance provisions.

- Some courts have found that large multinational corporations, insureds represented by brokers and insureds represented by counsel during the negotiation of the insurance policy to be sophisticated insureds.

- Some courts also have applied a “sophisticated insured” exception to *contra proferentem*:
  If insured is involved in the drafting of the policy, no presumption of construction against the insurer may apply. But: This may only apply if the insured was involved in the drafting of the particular provision at issue.

Use of extrinsic evidence

- Extrinsic evidence is evidence outside of the insurance policy used to determine the intent of the parties.

- Normally, extrinsic evidence is used only when the court finds an ambiguity in the language of the insurance policy.
  - There have been instances when the court has permitted the use of extrinsic evidence to determine whether a policy is ambiguous.

- There are different types of extrinsic evidence that may be used to determine the intent of the parties. This evidence includes custom and practice of the parties, drafting history of the provision in dispute, adoption of standard form language by an insured and the handling of prior losses that involve similar policy language.

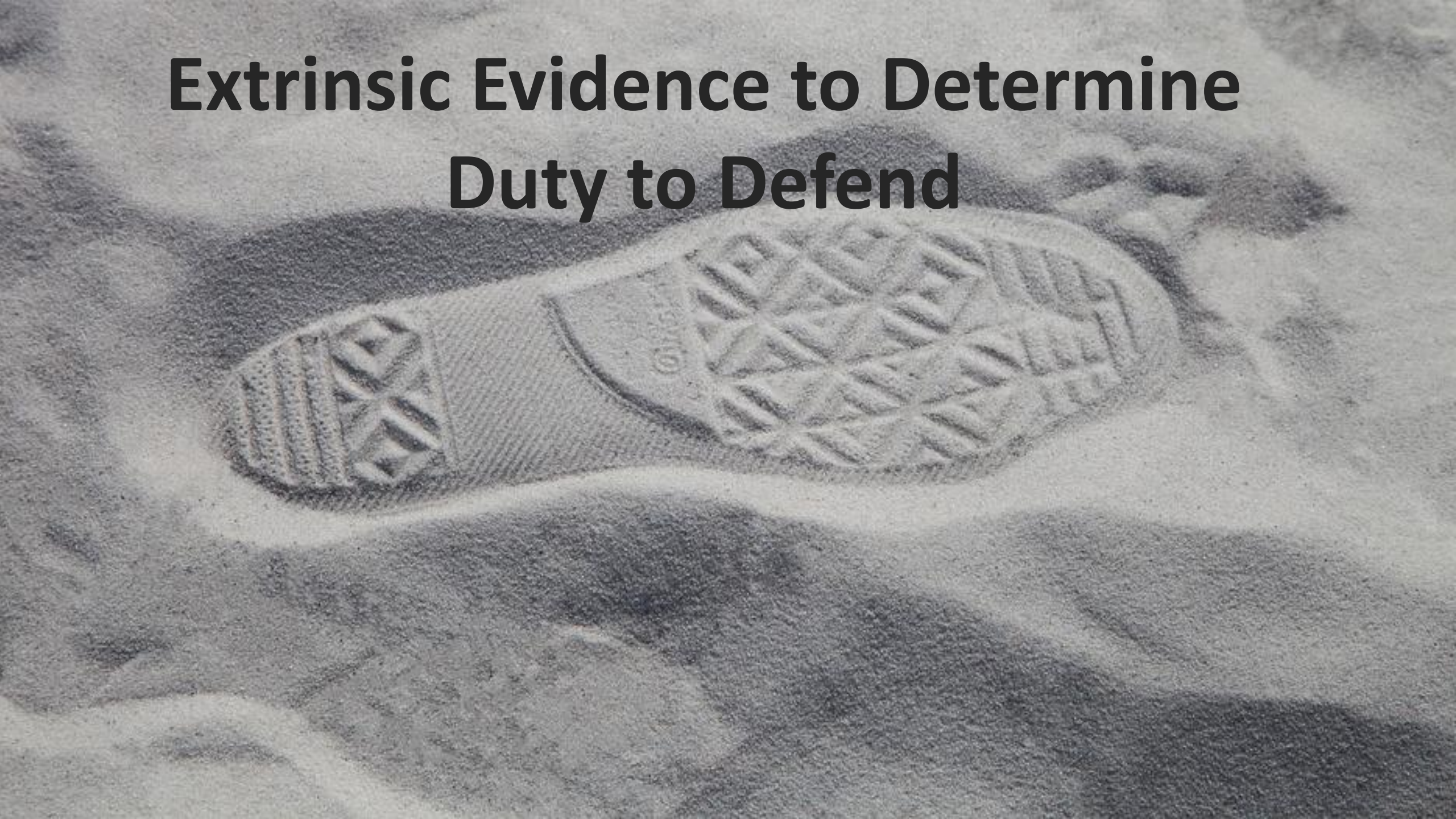
- Discovery of past claims is usually subject to strict limits on the number of claims and, for privacy purposes, significant redaction of information related to the identity of the insureds involved in the past claims.

EXTRINSIC EVIDENCE TO RESOLVE AMBIGUITY

What sources outside the four corners of the policy will be considered:

- The purpose of a form of insurance coverage or a particular policy provision
- Dictionary definitions
- Other judicial decisions, statutes and regulations
- Secondary legal sources
- Custom, practice and usage

Extrinsic Evidence to Determine Duty to Defend



Ambiguity and duty to defend

- An insurer's duty to defend is typically determined by the allegations of the complaint against the policyholder, regardless of the truthfulness or accuracy of such allegations. In some jurisdictions, however, courts will allow parties to rely upon information found outside of the complaint in order to determine whether a duty to defend is owed. This information is known as "extrinsic evidence."

- Policyholders may seek to introduce extrinsic evidence to establish a duty to defend, where the facts of the complaint are insufficient to trigger such an obligation. Conversely, insurers may seek to introduce extrinsic evidence in order to negate any duty to defend. The jurisdictions vary as to whether extrinsic evidence is permitted.

- Some courts allow only a policyholder (but not an insurer) to rely upon extrinsic evidence, other courts allow either party to use such information, while others do not permit the use of extrinsic evidence at all.

Ambiguity and duty to defend

- NJ – Unclear/conflict in cases - *Abouzaid v. Mansard Gardens Assocs., LLC*, 207 N.J. 67, 81 (N.J. 2011) (duty to defend generally determined by the allegations in the complaint, but not limited to only the facts alleged. Defense should be determined by the nature of the claim, not the phrasing of the complaint); compare *Flomerfelt v. Cardiello*, 202 N.J. 432, 444, 446 (N.J. 2010) ("An insurer's duty to defend ... depends upon ... the allegations ... in the pleading and the language of the insurance policy.")

- CT - Extrinsic evidence only allowed to establish coverage. *See Hartford Cas. Ins. Co. v. Litchfield Mut. Fire Ins. Co.,* 876 A.2d 1139, 1144-46 (Conn. 2005) ("insurer has a duty to defend ... if the pleadings allege a covered occurrence, even though facts outside ... those pleadings indicate that the claim may...not [be] covered. It is irrelevant that the insurer may get information...which indicates that the injury is not in fact covered …[T]he insurer [is required] to provide a defense when it has knowledge of facts establishing a possibility of coverage.")

Ambiguity and duty to defend

- New York - Extrinsic evidence only allowed to establish coverage. *See QBE Ins. Corp. v. Adjo Contr. Corp.,* 121 A.D.3d 1064, 1079 (N.Y. App. Div. 2d Dep't 2014) (Insurer must "provide a defense where ... underlying facts … create a reasonable possibility of coverage."); *Fitzpatrick v. Am. Honda Motor Co., Inc.,* 575 N.E.2d 90, 92 (N.Y. 1991) (“Although extrinsic evidence may be used to expand the insurer's duty to defend ... courts of this State have refused to permit insurers to look beyond the complaint's allegations to avoid their obligation to defend.")

- CA - Extrinsic evidence allowed to establish or negate coverage. *See Montrose Chem. Corp. v. Superior Court*, 6 Cal. 4th 287, 291 (Cal. 1993) (“Evidence extrinsic to the underlying complaint can defeat as well as generate a defense duty."); *Scottsdale Ins. Co. v. MV Transp*., 115 P.3d 460, 466 (Cal. 2005) ("Determination of the duty to defend depends … on a comparison between the allegations of the complaint and…[the] policy ... the duty also exists where extrinsic facts known to the insurer suggest that a claim may be covered.")

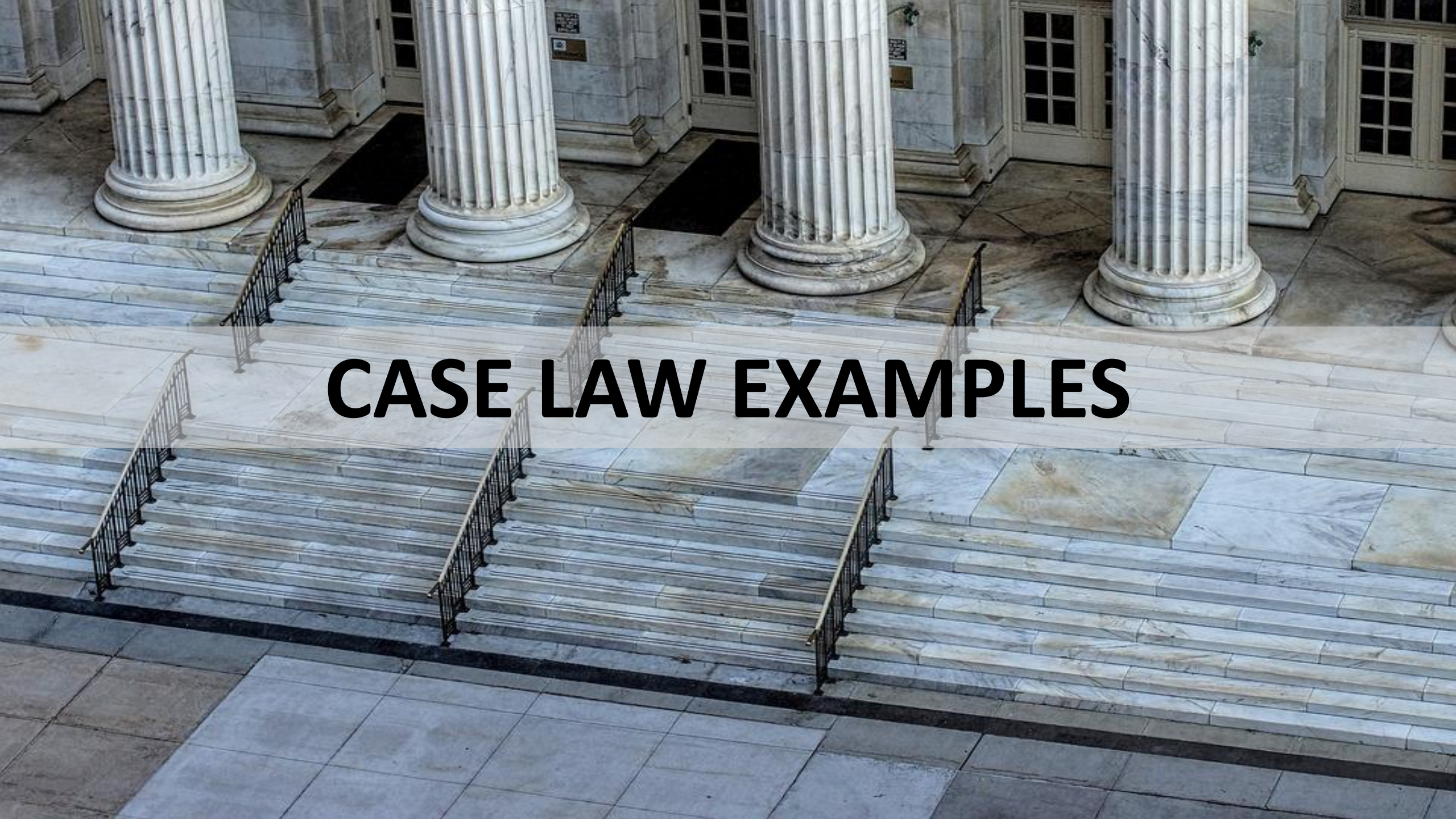
Ambiguity and duty to defend

- Illinois - Extrinsic evidence only allowed in special circumstances. See Pekin Ins. Co. v. Wilson, 930 N.E.2d 1011, 1020 (Ill. 2010) (permitting a trial court to "consider extrinsic evidence beyond the underlying complaint if … court does not determine issue critical to underlying action"); *Am Econ. Ins. Co. v. Holabird & Root*, 382 Ill. App. 3d 1017, 1025 (Ill. App. Ct. 1st Dist. 2008) ("The insurer is obligated to… defend if the insurer has knowledge of true but unpleaded facts, which, when taken together with the complaint's allegations, indicate that the claim is within or potentially within coverage.")

- PA - Extrinsic evidence not allowed. *See Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co*., 908 A.2d 888, 896 (Pa. 2006) ("[A]n insurer's duty to defend is triggered ... by the fact[s] contained in the complaint itself*."); Am. & Foreign Ins. Co. v. Jerry's Sport Center, Inc.*, 2 A.3d 526, 541 (Pa. 2010) ("An insurer is obligated to defend its insured if the factual allegations in the complaint encompass an injury that is within the scope of the policy.")

Ambiguity and duty to defend

- TX - Extrinsic evidence not allowed. *See Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co*., 279 S.W.3d 650, 654-655 (Tex. 2009) ("Under the eight-corners rule, the duty to defend is determined by the claims alleged in the petition and the coverage provided in the policy... [I]n deciding the duty to defend, the court should not consider extrinsic evidence from either the insurer or the insured that contradicts the allegations of the underlying petition.")



CASE LAW EXAMPLES

World Trade Center Properties, LLC v. Hartford Fire Ins. Co., 354 F.3d 154 (2d Cir. 2003)

- Case arises out of 9/11/01 terrorist attacks on the World Trade Center

- Issue was whether two hijacked planes intentionally crashing into the two towers 16 minutes apart embodied one or two "occurrences" as defined in the policies.

- The Hartford case defined occurrence in a form known as the "WilProp Form" as follows: "Occurrence shall mean all losses or damages that are attributable directly or indirectly to one causes or to one series of similar causes. All such losses will be added together, and the total amount of such losses will be treated as one occurrence irrespective of the period of time or area over which such losses occur."

- The Court held this language was unambiguous: "No finder of fact could reasonably find the intentional crashes into the WTC of two hi-jacked airplanes sixteen minutes apart as a result of a single coordinated plan of attack was, at the least, a "series of similar causes." Accordingly, we agree with the District Court that under the WilProp definition the events of September 11 constitute a single occurrence as a matter of law."

SR Int'l Co. v. World Trade Center Properties, LLC, 467 F.3d 107 (2d Cir. 2006)

- This case addressed "event based" occurrence forms, which defined "occurrence" to mean a loss, disaster or casualty, or a series of losses, disasters or casualties ***arising out of one "event."*** Importantly, the policies did not define the term "event."
- The insurers contended that event meant "all related phenomena," while the policyholders contended that event meant "a physical phenomenon"
- The court found the event-based "occurrence" to be ambiguous because "the word 'event' is susceptible to more than one reasonable interpretation."
- Thus, two cases addressing the same issue (whether the attacks
- constituted one or two "occurrences") and the same set of facts reached opposite results based on differing definitions of "occurrence."

New Sea Crest v. Lexington, 2014 WL 2879839 (EDNY June 24, 2014)

- Policyholders sought coverage for losses they sustained during Hurricane Sandy.
- Issue was whether damage caused by "storm surge" is damage caused by "flood" and therefore subject to the flood sublimit under the policy.
- Policyholders argued that "flood" and "storm surge" are separate perils because the policy listed flood and storm surge separately in the "named storm" sublimit.
- The policies defined flood: "**Flood** means, whether natural or manmade, **Flood** waters, surface water, waves, tide or tidal water, overflow or rupture of a dam, levy, dike, or other surface containment structure, storm surge, the rising, overflowing or breaking of boundaries of natural or manmade bodies of water, or the spray from any of the foregoing, all whether driven by wind or not. A tsunami shall not be considered a **Flood.**"
- The court found that the policy unambiguously included storm surge within the definition of flood, and the flood sublimit accordingly applied.

Bamundo v. Sentinel Ins. Co., 2015 WL 1408873 (SDNY March 26, 2015)

- The Policyholder sought coverage for business interruption losses resulting from an ordered evacuation due to Superstorm Sandy. Issue was whether the Policy's Civil Authority provision applies where the evacuation order at issue was prompted by flooding.
- Issued turned on whether the term "Covered Cause of Loss" used in the Civil Authority provision incorporated the Flood Exclusion. The Civil Authority provision read:

q. Civil Authority

(1) This insurance is extended to apply to the actual loss of Business Income you sustain when access to your "scheduled premises" is specifically prohibited by order of a civil authority as the direct result of a Covered Cause of Loss to property in the immediate area of your "scheduled premises".

(2) The coverage for Business Income will begin 72 hours after the order of a civil authority and coverage will end at the earlier of:

(a) When access is permitted to your "scheduled premises"; or
(b) 30 consecutive days after the order of the civil authority.

Held: the court found that the language of the applicable Civil Authority provision was unambiguous, and that plaintiff's business income claim was not covered under the policy. The court reached this conclusion for the "simple reason" that covered cause of loss "is defined in the Policy to exclude loss due to flooding."

Wakefern v. Liberty Mutual, 406 N.J. Super. 524 (App. Div. 2009)

- This case arose out of problems with the interconnected North American electrical power grid in August 2003 that resulted in a four-day electrical blackout over much of the northeastern United States and eastern Canada.

- The policyholders, a group of supermarkets, sought coverage under their commercial property policies for losses due to food spoilage during the blackout and lost revenue.

- The issue was whether the supermarkets' losses resulted from "physical damage" to certain specified electrical plant and equipment. The policies did not define the term "physical damage."

- The court found that "the undefined term 'physical damage' was ambiguous . . . In the context of this case, the electrical grid was 'physically damaged' because, due to a physical incident or series of incidents, the grid and its component generators and transmission lines were physically incapable of performing their essential function of providing electricity."

Hastings Development, LLC v. Evanston Ins. Co., 2015 WL 6618634 (EDNY 0ct. 30, 2015)

- Issue was whether an "Employer's Liability" exclusion applied to bar coverage for a suit brought against a Named Insured by (1) an employee of any Named Insured, or (2) only an employee of the specific Named Insured against whom the suit was brought.

- The policyholder, Hastings, was sued by an employee of its parent company, a co- insured on the policy issued by Evanston.

- Employer's Liability Exclusion stated, in part: "This insurance does not apply to any . . . suit . . . arising out of bodily injury to ... an employee of the Named Insured arising out of and in the course of employment by any Insured, or while performing duties related to the conduct of the Insured's business . . . ."

- The court found the Employer's Liability Exclusion to be ambiguous because "the phrase, 'employee of the Named Insured,' could conceivably encompass employees of any of the Named Insureds, as [Evanston] contends, or be limited only to the Named Insured who employed the injured employee, as [Hastings] contends."

Lantheus v. Zurich, 2015 WL 1914319 (SDNY Apr. 28, 2015)

- Lantheus Medical Imaging, Inc. sought coverage under a commercial property insurance policy for contingent business income loss related to a 15–month shutdown of a nuclear reactor that supplied a radioactive isotope used in Lantheus' diagnostic medical imaging products.
- The issue was whether the shutdown was caused by "corrosion," which was not a covered cause of loss.
- Because the Policy provided no definition for the term "corrosion," the Court referred to a dictionary to determine the ordinary meaning of the term.
- Both parties submitted scientific expert testimony regarding whether "corrosion" caused the shutdown of the nuclear reactor.
- The court noted that "both parties agree that the common meaning of the term 'corrosion'—and not the definition that a scientist or one of the parties' experts might advance—controls the Court's interpretation of the Policy language."

- Held:

Computer Corner, Inc. v. Foreman's Fund Ins. Co., 46 P.3d 1264 (N.M. Ct. App. 2002)

Issue was whether a commercial liability insurance policy provided coverage for liability arising from the loss of data stored on a computer hard drive. The insurer denied coverage based on the "Impaired Property Exclusion," which read:

"[T]his insurance does not apply to:
Property damage to **impaired property** or property that has not been physically injured arising out of:
(1) A defect, deficiency, inadequacy or dangerous condition in **your product** or **your work**; or
(2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.
This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to **your product** or **your work** after it has been put to its intended use."

The court held the exclusion was ambiguous: "[W]e conclude that this exclusion is unintelligible from the standpoint of a hypothetical reasonable insured operating a computer repair service. We find it difficult to believe that anyone genuinely interested in communicating information to another person—whether in a cookbook, a home appliance manual, or a contract—would employ the type of convoluted, intractable language used in Fireman's policy."

Continental Casualty Co. v. Pittsburgh Corning Corp., 917 F.2d 297 (7th Cir. 1990)

- The issue before the Court was whether the insurer, Continental Casualty Company, was obligated to pay defense costs under a CGL policy that agreed to indemnify the policyholder against "loss."
- Loss was defined as: "the sums paid in settlements of losses for which the insured is liable ... and shall exclude all expense and costs."
- Costs were defined as: "interest on judgments, investigations, adjustment and legal expenses (excluding, however, all expense for salaried employees and retained counsel of and all office expense of the insured)."
- The policyholder argued that defense costs fell within the exception from the exclusion for "expense for . . . retained counsel."

Continental Casualty Co. v. Pittsburgh Corning Corp., 917 F.2d 297 (7th Cir. 1990)

- Judge Posner found that legal costs were excluded:

The court acknowledged that the parenthetical "carves out of 'legal expenses' the expense of 'retained counsel,' and most of the defense costs incurred by defendants in products liability suits are the legal fees of the counsel whom they have 'retained' to defend them in those suits."

- Judge Posner based his finding on his understanding of the way in which insurers draft insurance policies, rather than principles of interpretation:

- "The briefs conduct a learned debate over the proper standard for interpreting an insurance contract governed by Pennsylvania law (as, all agree, this one is) -- how strictly the contract should be interpreted against the draftsman (Continental), what significance should be attached to the fact that it is a standard-form contract rather than a dickered contract, and so forth. The debate is irrelevant. For the most part the only significance of interpretive principles is as tie-breakers. And some students of interpretation think that they have no significance -- that they are fig leaves for decisions reached on other grounds. However, that may be, the question whether Continental is liable for the defendants' defense costs is not in equipoise. Continental is not liable.