

Resolving Ambiguities in Insurance Policy Language:

The *Contra Proferentem* Doctrine and The Use of Extrinsic Evidence

by
Scott G. Johnson

ROBINS, KAPLAN, MILLER & CIRESI LLP

**5 Hutton Centre Drive
Suite 1050
Santa Ana, California 92707
(714) 434-3400**

***Making and Breaking The Property Insurance Contract*
Property Insurance Law Committee,
Tort Trial & Insurance Practice Section
American Bar Association
Chicago, Illinois
May 19, 2003**

Table of Contents

A.	Introduction	1
B.	Historical Development of the <i>Contra Proferentem</i> Doctrine	2
C.	The Modern Rule—Consideration of Extrinsic Evidence to Remove the Ambiguity	3
D.	The Practicalities of Resolving Ambiguities	5
1.	The Overriding Goal: Ascertaining and Applying the Parties’ Mutual Intent	5
2.	Is Language Ambiguous?	6
3.	Does Extrinsic Evidence Remove the Ambiguity?	11
a.	A Note on the Parol Evidence Rule	11
b.	Limitations on the Use of Extrinsic Evidence	11
(1)	Unexpressed, Subjective Intent is Not Relevant	11
(2)	Extrinsic Evidence Must Pre-Date the Parties’ Controversy	14
c.	Prior and Contemporaneous Negotiations	14
d.	Acts and Conduct Post-Issuance of Policy	16
e.	Drafting History and Regulatory Submittals	19
f.	Trade Custom and Usage	21
E.	Construing Ambiguities Against the Drafter	23
1.	Insured or Broker-Drafted Policies	23
2.	The Sophisticated Insured	28
F.	Conclusion	30

The analysis, conclusions, and opinions expressed in this paper are the author’s own and do not necessarily reflect the position or viewpoints of the law firm of Robins, Kaplan, Miller & Ciresi LLP or that of its clients.

A. Introduction

Anyone familiar with insurance coverage litigation has heard the oft-repeated refrain by policyholders and their counsel that the insurance policy language is ambiguous. The reason, of course, is simple; under the doctrine of *contra proferentem*, ambiguities in contract language are construed against the drafter, typically the insurer.¹

At one time, the existence of an ambiguity in an insurance contract resulted in a presumption of coverage for the insured because many courts did not allow the use of extrinsic evidence to remove an ambiguity. But this is no longer the case.

Indeed, in most jurisdictions today, the determination that an ambiguity must be construed against the drafter comes at the *end* of a court's inquiry, not at the beginning. So before applying the doctrine of *contra proferentem*, courts first attempt to remove the ambiguity by considering certain extrinsic evidence of the parties' intent. Only if the ambiguity remains after consideration of the extrinsic evidence will that ambiguity be construed against the drafter. In short, the *contra proferentem* doctrine is used only as a matter of last resort, after all aids to construction have been employed but have failed to resolve the ambiguities in the contract.

Thus, the current application of the *contra proferentem* doctrine has done away with a presumption of coverage in cases of ambiguous policy language, in favor of a fair and impartial examination of all proffered evidence. Under the modern application, judges and juries are now entitled to consider extrinsic evidence in determining the parties' intent.

This article will discuss the development of the *contra proferentem* doctrine and the modern application of the rule. It will discuss the types of extrinsic evidence that courts consider in trying to resolve ambiguities. Lastly, this article will discuss application of the *contra proferentem* doctrine in cases where the insured (or its broker) drafts the insurance contract.

¹ See, e.g., *United States Fire Ins. Co. v. General Reinsurance Corp.*, 949 F.2d 569, 573 (2d Cir. 1991); *Kunin v. Benefit Trust Life Ins. Co.*, 910 F.2d 534, 538-39 (9th Cir. 1990); *Hansen v. Ohio Cas. Ins. Co.*, 687 A.2d 1262, 1265 (Conn. 1996). See generally RESTATEMENT (SECOND) OF CONTRACTS § 206 (1981); BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 1.03 [b][1], at 15 (10th ed. 2000); PETER J. KALIS ET AL., POLICYHOLDER'S GUIDE TO THE LAW OF INSURANCE COVERAGE § 20.02, at 20-4 (2000).

B. Historical Development of the *Contra Proferentem* Doctrine

In ordinary non-insurance contract litigation, the *contra proferentem* doctrine is often used as a last resort to resolve ambiguous contract language or, as one commentator put it, “a late-inning tiebreaker, one used when the more probative and obvious methods have failed.”² But while the construction of ambiguous language against the drafter is usually a construction tool of last resort in ordinary contract litigation, it has been used as an interpretive rule of first resort in insurance contract disputes.³

This was not always the case. Indeed, insurance contracts used to be construed much like any other business contracts.⁴ But this changed when insurance policies (particularly personal lines policies) were mass marketed. Unlike a negotiated business contract, these insurance policies used standardized language drafted by the insurer; they effectively became “contracts of adhesion” offered on “take it or leave it” basis.⁵ Thus, policyholders typically had no bargaining power and no effective means of changing the terms of the insurance contract. The courts’ logical reaction to this was to place the onus of uncertain or ambiguous terms on the insurers, because they had the better bargaining position and because they drafted the language and, thus, were in a better position to avoid the ambiguity.⁶

² 1 JEFFREY W. STEMPEL, LAW OF INSURANCE CONTRACT DISPUTES § 4.04, at 4.08, at 4-60.1 (2d ed. 2002).

³ *Id.* at § 4.08[a], at 4-66.

⁴ See generally Steven H. Cohen & Kathryn L. Quaintance, *Role of Contra Proferentem in Interpretation of Insurance Contracts*, 2 ENVIRONMENTAL CLAIMS J. 15 (1989); See also David S. Miller, *Insurance as Contract: The Argument for Abandoning the Ambiguity Doctrine*, 88 COLUM. L. REV. 1849, 1850-51 (1988); Patrick E. Shipstead & William H. Stanhope, *Ambiguities in Insurer and Broker-Drafted Policy Forms: Revisiting “Reasonable Expectations” and the Contra Proferentem Rule in Commercial Insurance Disputes* J. Ins. Coverage, Spring 2001, at 3.

⁵ Cohen & Quaintance, *supra* note 4, at 15.

⁶ See generally KALIS, *supra* note 1 § 20.03, at 20-5 - 20-6 (2000); 2 IEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE 3D § 22:18 - 22:21 (1997); STEMPEL, *supra* note 2, § 4.05, at 4-24.

While the *contra proferentem* doctrine largely developed in personal lines cases, the same rule has been applied in cases involving commercial insurance policies.⁷ In fact, some courts have afforded even the most sophisticated commercial policyholders the protection of the *contra proferentem* rule.⁸

C. The Modern Rule—Consideration of Extrinsic Evidence to Remove the Ambiguity

Once insurance policies became mass marketed, the existence of an ambiguity in an insurance contract resulted in a presumption of coverage in favor of the insured.⁹ While this is still the rule in a small number of jurisdictions, it is not the majority rule today.¹⁰

So instead of automatically construing ambiguities against the drafter, many courts today have adopted an approach that considers the primary standards of interpretation—examining the

⁷ See, e.g., *Westchester Resco Co. v. New England Reinsurance Corp.*, 818 F.2d 2, 3 (2d Cir. 1987) (umbrella commercial liability policy); *Arkwright-Boston Mfrs. Mut. Ins. Co. v. Wausau Paper Mills, Inc.*, 818 F.2d 591, 597 (7th Cir. 1987) (all-risk property policy); *Hampton Foods, Inc. v. Aetna Cas. & Sur. Co.*, 787 F.2d 349, 352 (8th Cir. 1986) (commercial property policy); *ACandS, Inc. v. Aetna Cas. & Sur. Co.*, 764 F.2d 968, 972-73 (3d Cir. 1985) (commercial general liability policy); *F.S. Smithers & Co. v. Federal Ins. Co.*, 631 F.2d 1364, 1366 (9th Cir. 1980) (broker's blanket bond); *Union Soc'y of Canton, Ltd. v. William Gluckin & Co.*, 353 F.2d 946, 950-51 (2d Cir. 1965) (fire insurance policy); *American Cas. Co. of Reading, Pa. v. Bank of Montana Sys.*, 675 F. Supp. 538, 541 (D. Minn. 1987) (director's and officer's liability policy); *Ryder Truck Rental, Inc. v. St. Paul Fire & Marine Ins. Co.*, 540 F. Supp. 66, 72-73 (N.D. Ga. 1982) (liability insurance policy). See also *H.K.H. Co. v. American Mortgage Ins. Co.*, 685 F.2d 315, 319 (9th Cir. 1982) ("Although this rule seems designed primarily for the protection of the individual consumer, it is applied even when the insured is a commercial party.").

⁸ See, e.g., *Hampton Foods*, 787 F.2d at 352 (finding "direct physical loss" language to be ambiguous and construed against insurer to find coverage for loss in value of insured's inventory necessitated by sudden evacuation of building which was in imminent danger of collapse); *ACandS*, 764 F.2d at 972-73 (finding CGL policy was ambiguous on issue of trigger of coverage); *American Cas. Co.*, 675 F. Supp. at 541 (finding director's and officer's liability policy ambiguous regarding insurer's obligations to advance defense costs); *Ryder Truck Rental*, 540 F. Supp. at 72-73 (finding employee exclusion in liability insurance policy ambiguous and construed against insurer).

⁹ See generally *Cohen & Quaintance*, *supra* note 4 at 13.

¹⁰ See, e.g., *American Nat'l Fire Ins. Co. v. Rose Acre Farms, Inc.*, 107 F.3d 451, 457-58 (7th Cir. 1997) (applying Indiana law); *Charter Oil Co. v. American Employers' Ins. Co.*, 69 F.3d 1160, 1163 (D.C. Cir. 1995) (Missouri law); *State Farm Mut. Auto. Ins. Co. v. Fermahin*, 836 P.2d 1074, 1077 (Haw. 1992). These states allow extrinsic evidence to be used only to disambiguate a latent ambiguity, that is an ambiguity that is not apparent on the face of the contract. See *Rose Acre Farms* at 457; *Charter Oil* at 1167-68.

language of the clause, public policy, and the purposes of the transaction as a whole—and extrinsic evidence relating to the parties’ negotiations, knowledge, and shared understanding of disputed ambiguous terms.¹¹

If the parties’ intent can be ascertained from this analysis, then that intent is enforced. But if consideration of the extrinsic evidence does not resolve the ambiguity, then the *contra proferentem* rule would be applied as an interpretative rule of last resort.¹² Thus, the ambiguity is construed against the drafter only if the policy language is still ambiguous after application of the primary standards of interpretation and consideration of extrinsic evidence.

In sum, while the *contra proferentem* rule is alive and well, most courts are now applying the rule at the *end* of the interpretative process, not at the beginning. Thus, the rule construing ambiguities against the drafter of the contract is becoming a secondary rule of construction to be applied only if the meaning remains uncertain after attempts to resolve the ambiguity have failed.

¹¹ See, e.g., *Aetna Cas. & Sur. Co. v. Dow Chem. Co.*, 28 F. Supp. 2d 440, 445-46 (E.D. Mich. 1998) (applying Michigan law); *State Farm Mut. Auto. Ins. Co. v. Wilson*, 782 P.2d 727, 734 (Ariz. 1989); *Travelers Indem. Co. v. Howard Elec. Co.*, 879 P.2d 431, 434-35 (Colo. Ct. App. 1994); *Playtex FP, Inc. v. Columbia Cas. Co.*, 609 A.2d 1087, 1092 (Del. Super. Ct. 1991); *Cameron v. USAA Prop. & Cas. Co.*, 733 A.2d 965, 968 (D.C. Ct. App. 1999); *Claussen v. Aetna Cas. & Sur. Co.*, 380 S.E.2d 686, 687 (Ga. 1989); *University of Illinois v. Continental Cas. Co.*, 599 N.E.2d 1338, 1345 (Ill. Ct. App. 1992); *Doerr v. Mobil Oil Corp.*, 774 So. 2d 119, 124 (La. 2000); *Bailer v. Erie Ins. Co.*, 687 A.2d 1375, 1378 (Md. 1997); *Simon v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 782 N.E.2d 1125, 1128-29 (Mass. 2003); *Stine v. Continental Cas. Co.*, 349 N.W.2d 127, 137 (Mich. 1984); *State v. Home Indem. Co.*, 486 N.E.2d 827, 829 (N.Y. 1985); *Walle Mut. Ins. Co. v. Sweeney*, 419 N.W.2d 176, 179-80 (N.D. 1988); *Boso v. Erie Ins. Co.*, 669 N.E.2d 47, 51 (Ohio Ct. App. 1995); *DiFabio v. Centaur Ins. Co.*, 531 A.2d 1141, 1142-43 (Pa. Super. Ct. 1987); *Mescalero Energy, Inc. v. Underwriters Indem. Gen. Agency, Inc.*, 56 S.W.3d 313, 319 (Tex. Ct. App. 2001); *Southern Ins. Co. of Va. v. Williams*, 561 S.E.2d 730, 733 (Va. 2002); *Queen City Farms, Inc. v. Central Nat’l Ins. Co. of Omaha*, 882 P.2d 703, 721 (Wash. 1994). A few jurisdictions allow the use of extrinsic evidence as an aid to determining the meaning of insurance contract language even if the contract is not ambiguous. See, e.g., *Fireguard Sprinkler Sys., Inc. v. Scottsdale Ins. Co.*, 864 F.2d 648, 651 (9th Cir. 1988) (applying Oregon law); *Garcia v. Truck Ins. Exch.*, 682 P.2d 1100, 1104 (Cal. 1984); *Lynott v. National Union Fire Ins. Co.*, 871 P.2d 146, 149 (Wash. 1994).

¹² See generally *Cohen & Quaintance*, *supra* note 4 at 22-24.

D. The Practicalities of Resolving Ambiguities

1. The Overriding Goal: Ascertaining and Applying the Parties' Mutual Intent

The interpretation of insurance policy language is the process by which we determine the meaning of the words.¹³ Initially, this interpretation is a question of law for the Court.¹⁴

And the principles that guide the courts in this task are well-established. The fundamental rules of contract interpretation are based on the premise that the interpretation must give effect to the “mutual intention” of the parties.¹⁵ Thus, the primary purpose of interpretation is to discover that intent and to make it effective.¹⁶

Generally, the parties' intent is found, if possible, solely in the contract's written provisions.¹⁷ In ascertaining the parties' intent, courts will look to the plain meaning of the words as viewed in the context of the contract as a whole.¹⁸ “Equally important are the requirements of reasonableness and context.”¹⁹

¹³ See, e.g., *Taylor v. State Farm Mut. Auto. Ins. Co.*, 175 Ariz. 148, 854 P.2d 1134, 1138 (1993) (“Interpretation is the process by which we determine the meaning of words in a contract.”). See also Restatement (Second) of Contracts § 200 (1981) (“Interpretation of a promise or agreement or a term thereof is the ascertainment of its meaning.”).

¹⁴ E.g., *Sparks v. Republic Nat'l Life Ins. Co.*, 132 Ariz. 529, 534, 647 P.2d 1127, 1132 (Ariz.), *cert. denied*, 459 U.S. 1070 (1982); *Waller v. Truck Ins. Exch.*, 900 P.2d 619, 627 (Cal. 1995). See generally *STEMPEL*, *supra* note 2 § 4.04, at 4-19.

¹⁵ See, e.g., *United Cal. Bank v. Prudential Ins. Co. of Am.*, 681 P.2d 390, 413 (Ariz. Ct. App. 1983); *Waller*, 900 P.2d at 627. See generally *RUSS & SEGALLA*, *supra* note 6 § 22:7, at 22-14.

¹⁶ See, e.g., *Taylor*, 854 P.2d at 1138.

¹⁷ See, e.g., *AIU Ins. Co. v. Superior Court*, 799 P.2d 1253, 1264 (Cal. 1990).

¹⁸ *United Cal. Bank*, 681 P.2d at 411 (Ariz. Ct. App. 1983); *Aydin Corp. v. First State Ins. Co.*, 959 P.2d 1213, 1217 (Cal. 1998). See generally *RUSS & SEGALLA*, *supra* note 6 § 22:9, at 22-17.

¹⁹ *Bay Cities Paving & Grading, Inc. v. Lawyers' Mut. Ins. Co.*, 855 P.2d 1263, 1271 (Cal. 1993).

Contract terms are interpreted using the ordinary and popular meaning a lay person would use.²⁰ If the parties use language that is intended to have a special meaning or is used in a technical sense, then that usage or meaning controls.²¹

So if an insurance provision is unambiguous, the court will go no further; it must construe the language according to its plain and ordinary meaning.²² But if insurance contract language is ambiguous, then a different analysis is required.

2. Is Language Ambiguous?

Insurance policy language is not ambiguous simply because the insurer and the insured disagree about its meaning.²³ If that were the case, then, as Judge Posner noted, a written contract would provide no protection for either party:

The fact that parties to a contract disagree about its meaning does not show that it is ambiguous, for if it did, then putting contracts into writing would provide parties with little or no protection.²⁴

Thus, an insured cannot create an ambiguity merely by urging a conflicting interpretation of the policy.

²⁰ *E.g.*, *AIU Ins. Co.*, 799 P.2d at 1264. *See generally* RUSS & SEGALLA, *supra* note 6 § 22:38, at 22-82.

²¹ *See, e.g.*, *Taylor v. State Farm Mut. Auto. Ins. Co.*, 854 P.2d 1134, 1139 (Ariz. 1993); *AIU Ins. Co. v. Superior Court*, 799 P.2d 1253, 1264 (Cal. 1990).

²² *See, e.g.*, *State Farm Mut. Auto. Ins. Co. v. Wilson*, 782 P.2d 727, 733 (Ariz. 1989); *Bank of the W. v. Superior Court*, 833 P.2d 545, 552 (Cal. 1992)

²³ *See, e.g.*, *American Nat'l Fire Ins. Co. v. Rose Acre Farms, Inc.*, 107 F.3d 451, 457 (7th Cir. 1997) (applying Indiana law); *Solers, Inc. v. Hartford Cas. Ins. Co.*, 146 F. Supp. 2d 785, 792 (E.D. Va. 2001); *General Auth. for Supply, Commodities, Cairo, Egypt v. Insurance Co. of N. Am.*, 951 F. Supp. 1097, 1108 (S.D.N.Y. 1997); *Quaker State Minit-Lube, Inc. v. Fireman's Fund Ins. Co.*, 868 F. Supp. 1278, 1287 (D. Utah 1994); *E.I. du Pont Nemours & Co. v. Allstate Ins. Co.*, 693 A.2d 1059, 1061 (Del. 1997); *State Farm Mut. Auto. Ins. Co. v. Fermahin*, 836 P.2d 1074, 1077 (Haw. 1992); *Hillenbrand v. Meyer Med. Group, S.C.*, 682 N.E.2d 101, 104 (Ill. Ct. App. 1997); *Lupo v. Shelter Mut. Ins. Co.*, 70 S.W.3d 16, 19 (Mo. Ct. App. 2002); *United States Fire Ins. Co. v. Ace Baking Co.*, 476 N.W.2d 280, 282 (Wis. Ct. App. 1991).

²⁴ *Federal Deposit Ins. Corp. v. W.R. Grace & Co.*, 877 F.2d 614, 621 (7th Cir. 1989).

Similarly, language is not ambiguous just because courts have interpreted the language differently.²⁵ Nor is policy language is ambiguous because a relevant term is not defined in the policy.²⁶

Rather, an ambiguity exists where the language is susceptible to two or more *reasonable* interpretations.²⁷ In other words, language is ambiguous only if reasonable persons can fairly and honestly differ in their interpretation of that language. And courts will not distort the language to create an ambiguity.²⁸

Thus, if the insured's proffered interpretation is not reasonable, there is no ambiguity.²⁹ Merely being able to conjure up a remotely possible second interpretation is not sufficient to create an ambiguity.

²⁵ See, e.g., *Solers, Inc. v. Hartford Cas. Ins. Co.*, 146 F. Supp. 2d 785, 792 (E.D. Va. 2001); *Select Design, Ltd. v. Union Mut. Fire Ins. Co.*, 674 A.2d 798, 802 (Vt. 1996); *Peerless Ins. Co. v. Wells*, 580 A.2d 485, 488 (Vt. 1990). But see *Security Ins. Co. of Hartford v. Investors Diversified Ltd.*, 407 So. 2d 314, 316 (Fla. Dist. Ct. App. 1981) (“The insurance company contends that the language is not ambiguous, but we cannot agree and offer as proof of that pudding the fact that the Supreme Court of California and the Fifth Circuit in New Orleans have arrived at opposite conclusions from a study of essentially the same language.”); *Cohen v. Erie Indem. Co.*, 432 A.2d 596, 599 (Pa. Super. Ct. 1981) (“The mere fact that several appellate courts have ruled in favor of a construction denying coverage, and several others have reached directly contrary conclusions, viewing almost identical policy provisions, itself creates the inescapable conclusion that the provision in issue is susceptible to more than one interpretation.”).

²⁶ See, e.g., *Bay Cities Paving & Grading, Inc. v. Lawyers Mut. Ins. Co.*, 855 P.2d 1263, 1270 (Cal.1993); *Heller v. Fire Ins. Exch.*, 800 P.2d 1006, 1009 (Colo. 1990) (the term “surface water” in a water damage exclusion); *Fisher v. United States Fid. & Guar. Co.*, 586 A.2d 783, 789 (Md. Ct. Spec. App. 1991); *United States Fire Ins. Co. v. Ace Baking Co.*, 476 N.W.2d 280, 282 (Wis. Ct. App. 1991). To ascertain the ordinary and popular meaning of undefined insurance policy terms, courts will consult general dictionaries. See, e.g., *Scott v. Continental Ins. Co.*, 51 Cal. Rptr. 2d. 566, 571 (Cal. Ct. App. 1996); *Heller*, 800 P.2d at 1009.

²⁷ E.g., *Producers Dairy Delivery Co. v. Sentry Ins. Co.*, 718 P.2d 920, 924 (Cal. 1986).

²⁸ See, e.g., *Waller v. Truck Ins. Exch.*, 900 P.2d 619, 627 (Cal. 1995); *Atlas Reserve Temporaries, Inc. v. Vanliner Ins. Co.*, 51 S.W.3d 83, 87 (Mo. Ct. App. 2001).

²⁹ See, e.g., *Capelouto v. Valley Forge Ins. Co.*, 990 P.2d 414, 418-19 (Wash. Ct. App. 1999) (insured's argument that the inadequate equipment used by contractor was a distinct peril from the contractor's faulty workmanship was “an awkward interpretation of both the terms used in the [faulty workmanship] exclusion and the events leading to his loss.”).

The case *McDonald v. State Farm Fire & Casualty Co.*³⁰ is illustrative of these principles. There, the foundation of the McDonalds' home was damaged when the supporting soil slid away after heavy rains.³¹ The parties agreed that the efficient proximate cause of the loss was a contractor's faulty construction of filled areas, which was accomplished by using improper and defective fill materials.³² State Farm, the McDonalds' homeowners' insurer, denied the claim based on the following faulty workmanship and materials exclusion:

3. We do not insure under any coverage for loss consisting of one or more of the items below: . . .
 - b. defect, weakness, inadequacy, fault or unsoundness in: . . .
 - (2) design, specifications, workmanship, construction, grading, compaction;
 - (3) materials used in construction or repair; or . . . of any property (including land, structures, or improvements of any kind) whether on or off the residence premises.

However, we do insure for any ensuing loss from items a. and b. unless the ensuing loss is itself a Loss Not Insured by this Section.³³

The policy also excluded earth movement and foundation cracking, in paragraphs one and two.³⁴

³⁰ 837 P.2d 1000 (Wash. 1992).

³¹ *Id.* at 1002.

³² *Id.* at 1004. The McDonalds' foundation was first damaged when the supporting soil slid away after heavy rains occurring in January 1986. *Id.* at 1002. State Farm denied the McDonalds' claim based on the policy's earth movement exclusion. Thereafter, the McDonalds hired a contractor to repair the damage to their house and land. Similar damage occurred again after the repairs failed during another period of heavy rains in March 1987. The subsequent lawsuit against State Farm concerned only the March 1987 damages. *Id.*

³³ *Id.* at 1002 n.3.

³⁴ *Id.* at 1002.

The McDonalds argued that the faulty workmanship exclusion was ambiguous and did not exclude losses caused by defective construction and materials.³⁵ Specifically, they read the language of the exclusion “to exclude only loss consisting of the specified events or actions.”³⁶ Thus, the McDonalds argued that “only loss which is made up of or composed of faulty construction or defective materials is excluded.”³⁷ Because the exclusion “says nothing about loss *caused* by third party negligence, faulty construction, or defective materials,” the McDonalds argued that their claim for such loss was not excluded.³⁸

The Washington Supreme Court held that the McDonalds’ reading of the exclusion was “unreasonable” because it disregarded other portions of the policy.³⁹ The court cited the immediately following exclusion, which provided that there was no coverage for earth movement or foundation cracking where negligent construction or defective materials “directly or indirectly cause” the loss:

We do not insure for loss described in paragraphs 1. [foundation cracking exclusion] or 2. [earth movement exclusion] immediately above regardless of whether one or more of the items in paragraph 3. [faulty workmanship and materials]

- a. directly or indirectly cause, contribute to or aggravate the loss; or
- b. occur before, at the same time, or after the loss or any other cause of the loss.⁴⁰

Finally, the court held that the ensuing loss provision did not apply because the resulting damage was excluded by the earth movement and foundation cracking exclusions.⁴¹

³⁵ *Id.* at 1004.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.* (italics added).

³⁹ *Id.* at 1005.

⁴⁰ *Id.* at 1005 n.6.

⁴¹ *Id.* at 1005-06.

Another good illustration is *Newport Associates Development Co. v. Travelers Indemnity Company of Illinois*.⁴² In *Newport Associates*, the insured owned and operated a marina that included various buildings, docks, berths for boats, and a breakwater. The breakwater, which was located 120 feet from the end of the dock, was designed to limit wave action in the marina.⁴³ In December 1992, the breakwater was damaged in a storm. Thereafter, Newport sought coverage for the breakwater damage from Travelers, its property insurer.⁴⁴ Travelers provided coverage using a manuscript policy drafted by Newport's broker. That policy included coverage for "Slips, consisting of metal slips, walkways, ramps, pilings, power cables, and other integral parts collectively called 'slips.'"⁴⁵ Travelers denied the claim because the insured "slips" did not include the breakwater, reasoning that the coverage applied only to the slips themselves and their physically-attached component parts.⁴⁶ Newport, on the other hand, argued that the phrase "other integral parts" covered the breakwater because a breakwater is functionally necessary to the operation of the slips.⁴⁷

The trial and appellate courts both found that Travelers' proffered interpretation was the only reasonable interpretation of the policy.⁴⁸ The courts explained that all of the specifically listed items in the policy definition of "slips" that preceded the phrase "and other integral parts" were physically attached to the structures on which the boats are berthed.⁴⁹ Accordingly, these courts found that the only reasonable construction of the phrase "and other integral parts" meant

⁴² 162 F.3d 789 (3d Cir. 1998).

⁴³ *Id.* at 791.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.* at 791-92.

⁴⁷ *Id.* at 792.

⁴⁸ *Id.*

⁴⁹ *Id.*

parts consistent with the items mentioned before the phrase.⁵⁰ And since the breakwater was unattached, located 120 feet away, served a very different function from the slips, it could not be considered as “other integral part” covered by the policy.⁵¹

In sum, if insurance policy language is unambiguous, courts will apply the plain and ordinary meaning of that language, and there is no need to go any further. Thus, demonstrating that the policy language is susceptible to only one reasonable interpretation will be the insurer’s first line of defense. But if the policy language is ambiguous, then the parties may attempt to remove the ambiguity by submitting extrinsic evidence.

3. Does Extrinsic Evidence Remove the Ambiguity?

a. A Note on the Parol Evidence Rule

Generally, the parol evidence rule bars the introduction of extrinsic evidence to vary or contradict the terms of a completely written contract.⁵² But the parol evidence rule does not apply where the extrinsic evidence is being submitted to clarify or aid in the interpretation of an ambiguous contract.⁵³ Thus, when policy language is reasonably susceptible to two or more interpretations, parties—in most jurisdictions—may introduce extrinsic evidence of the parties’ intent to support their interpretation of the contract, without running afoul of the parol evidence rule.

b. Limitations on the Use of Extrinsic Evidence

(1) Unexpressed, Subjective Intent is Not Relevant

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *See generally* 17 LEER, RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE 3D § 253:46, at 253-59 (2000).

⁵³ *See, e.g.,* Beneficial Fire & Cas. Ins. Co. v. Kurt Hitke & Co., 297 P.2d 428, 431 (Cal. 1956).

One important limitation on the use of extrinsic evidence is that it may not be used to substantiate a party's unexpressed, subjective intent.⁵⁴ In other words, a party's undisclosed subjective intent, motive, or opinion about the meaning of an insurance policy or about whether coverage exists is irrelevant to determining the meaning of contractual language.

Instead, the relevant intent is "objective"—that is, the objective intent as evidenced by the expressed acts, words, or conduct of the parties with knowledge of the contract terms.⁵⁵ The Restatement (Second) of Contracts states this rule as follows:

Many contract disputes arise because different people attach different meanings to the same words and conduct. The phrase "manifestation of intention" adopts an external or objective standard for interpreting conduct; it means the external expression of intention as distinguished from undisclosed intention.⁵⁶

These principles apply with equal force to insurance contracts.⁵⁷

Because a party's undisclosed intent, motive, or opinion about coverage is not admissible as evidence of the meaning of a written agreement, courts exclude that evidence when offered to interpret the meaning of insurance contract language. The case *Prudential Insurance Co. v.*

⁵⁴ E.g., *Gurney Indus., Inc. v. St. Paul Fire & Marine Ins. Co.*, 467 F.2d 588, 592 (4th Cir. 1972) (applying North Carolina law); *Statewide Ins. Corp. v. Dewar*, 694 P.2d 1167, 1070-72 (Ariz. 1984); *Pardee Constr. Co. v. Insurance Co. of the W.*, 92 Cal. Rptr. 2d 443, 457 (Cal. Ct. App. 2000); *Allstate Ins. Co. v. Juniel*, 931.2d 511, 516 (Colo. Ct. App. 1996); *State Farm Mut. Auto. Ins. Co. v. Yanes*, 447 So. 2d 945, 946 n.2 (Fla. Dist. Ct. App. 1984); *Ponder v. State Farm Mut. Auto. Ins. Co.*, 12 P.3d 960, 965 (N.M. 2000); *Kook v. American Sur. Co. of N.Y.*, 210 A.2d 633, 636 (N.J. Super. Ct. App. Div. 1965); *Frey v. Aetna Life & Cas. Co.*, 633 N.Y.S.2d 880, 843-44 (N.Y. App. Div. 1995); *Celley v. Mutual Benefit Health & Acc. Ass'n*, 324 A.2d 430, 435 (Pa. Super. Ct. 1974); *Lynott v. National Union Fire Ins. Co.*, 871 P.2d 146, 149 (Wash. 1994). See generally RUSS & SEGALLA, *supra* note 6 § 22:12, at 22-29 (1997).

⁵⁵ See, e.g., *Franklin Life Ins. Co. v. Mast*, 435 F.2d 1038, 1045 (9th Cir. 1970) (applying Arizona law); *Fireman's Fund Ins. Co. v. Fibreboard Corp.*, 227 Cal. Rptr. 203, 207 n.3 (Cal. Ct. App. 1986); *Pacific Indem. Co. v. Interstate Fire & Cas. Co.*, 488 A.2d 486, 489 (Md. 1985).

⁵⁶ RESTATEMENT (SECOND) OF CONTRACTS § 2 cmt. b (1982).

⁵⁷ See, e.g., *Isaak v. Massachusetts Indem. Life Ins. Co.*, 623 P.2d 11, 14 (Ariz. 1981) ("[N]o matter what form a written contract takes, it is not the undisclosed intent of the parties to a contract with which we are concerned, but the outward manifestations of their assent.").

*Superior Court*⁵⁸ illustrates this rule. There, a dispute developed concerning the meaning of the phrase “enrolled as a full-time student in a school” in a Prudential group health policy that provided medical coverage to employees’ dependents aged 19 to 24 who meet that description.⁵⁹ The plaintiff, Michelle Dunning, had completed her freshman year at the University of California at Santa Barbara in the spring of 1994. She enrolled for the fall quarter, but cancelled her registration because she wanted to work for a quarter and return for the winter quarter.⁶⁰ During this quarter off, Ms. Dunning, was involved in an accident, and she sought lifetime medical coverage under the Prudential policy.⁶¹ Prudential, however, denied coverage because Ms. Dunning was not registered at an academic institution and was not attending any classes at the time of her accident.⁶² After Ms. Dunning sued, Prudential moved for summary judgment. As part of the opposition, Ms. Dunning and her parents submitted affidavits in which they stated that it was their subjective belief that Ms. Dunning remained a full-time student.⁶³ But the appellate court found that this evidence was not relevant and directed that summary judgment be granted to Prudential.⁶⁴

In short, courts will not consider evidence of a party’s undisclosed subjective intent, motive, or opinion about the meaning of an insurance policy or about whether coverage exists. The reason, of course, that this evidence is invariably self-serving and inherently difficult to verify. Indeed, as one court remarked, if such evidence were permitted, “there would be no limit to an insurer’s responsibility.”⁶⁵ Instead, relevant extrinsic evidence consists of the acts, words or conduct of the parties as expressed to the other party or to others.

⁵⁸ 119 Cal. Rptr. 2d 823 (Cal. Ct. App. 2002).

⁵⁹ *Id.* at 825.

⁶⁰ *Id.* at 836.

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.* at 836-37.

⁶⁴ *Id.* at 837.

⁶⁵ *State Farm Mut. Auto. Ins. Co. v. Yanes*, 447 So. 2d 945, 946 n.2 (Fla. Dist. Ct. App. 1984).

(2) Extrinsic Evidence Must Pre-Date the Parties' Controversy

Another important limitation on the use of extrinsic evidence is that it must pre-date any controversy between the parties about the existence of coverage or the meaning of insurance policy language.⁶⁶ In other words, a party may not offer as evidence a letter written by that party expressing its intent or opinion about the meaning of an insurance policy or about whether coverage exists after a dispute between the parties has already arisen. This evidence, like a party's unexpressed, subjective intent, is self-serving. Hence, to be relevant, extrinsic evidence must pre-date the parties' controversy.

c. Prior and Contemporaneous Negotiations

Probably the most common type of extrinsic evidence offered to explain the meaning of ambiguous policy language consists of the parties' statements before and at the time the policy was issued or renewed. Indeed, in instances where a manuscript policy is used, there may be considerable negotiation about the terms and conditions of that policy. Even where the policy is comprised of standardized forms, there still may be negotiations regarding which forms to use or which endorsements to include in the policy. Additionally, there may be discussions about the scope or extent of coverage provided under standardized forms. And evidence of the discussions and circumstances surrounding the negotiation or issuance of an insurance contract can be taken into account in determining the parties' intent.⁶⁷

The case *Monsanto v. International Insurance Co.*⁶⁸ is a good example. There, Monsanto sought coverage under an environmental impairment liability policy issued by International Insurance Co. ("IIC") for the costs to clean up a contaminated Superfund site.⁶⁹ Monsanto had

⁶⁶ See, e.g., *American Cas. Co. of Reading, Pa. v. Baker*, 22 F.3d 880, 887 (9th Cir. 1994); *Beneficial Fire & Cas. Ins. Co. v. Kurt Hitke & Co.*, 297 P.2d 428, 431 (Cal. 1956).

⁶⁷ See, e.g., *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, 682 P.2d 388, 398 (Ariz. 1984); *Morton Int'l, Inc. v. Thiokol Corp.*, 666 N.E.2d 1163, 1169-70 (Ohio Ct. App. 1995); *Celley v. Mutual Benefit Health & Acc. Ass'n*, 324 A.2d 430, 433 (Pa. Super. Ct. 1974).

⁶⁸ 652 A.2d 36 (Del. 1994) (applying Missouri law).

⁶⁹ *Id.* at 38.

sold toxic styrene tars to the operator of the Superfund site.⁷⁰ IIC denied coverage based on Exclusion 7(a) of the policy, which excluded coverage for environmental impairment arising from “any commodity, article or thing supplied . . . by the Insured.”⁷¹ In granting summary judgment to IIC, the trial court refused to consider Monsanto’s proffer of pre-contract communications it had with IIC.⁷² Specifically, prior to purchasing the policy, Monsanto contacted IIC because it was uncertain whether Exclusion 7(a) applied in cases where liability arose out of waste products that it sold.⁷³ In response, Malcolm Aicken, IIC’s environmental liability policy underwriter assured Monsanto, in a series of letters, telexes, and phone calls, that Exclusion 7(a) did not apply to waste products sold by Monsanto.⁷⁴ The appellate court reversed the summary judgment, holding that the trial erred in refusing to consider Monsanto’s proffered extrinsic evidence.⁷⁵

Evidence of prior and contemporaneous negotiations are not limited to commercial lines policies as was the case in *Monsanto*. To be sure, such evidence can exist in claims involving personal lines policies as well, as the case *Ponder v. State Farm Mutual Automobile Insurance Co.*⁷⁶ illustrates.

There, Nichelle Ponder was seriously injured in an automobile accident involving an uninsured motorist while driving her parents’ pickup truck. State Farm paid Nichelle \$50,000 in uninsured motorist benefits for the pickup truck but denied her request to stack the uninsured motorist benefits on her parents’ seven other auto policies because she had married and moved

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.* at 39.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.* at 40. The court applied Missouri law, which permitted the introduction of extrinsic evidence even in the absence of an ambiguity. *Id.* at 39, 40 n.6.

⁷⁶ 12 P.3d 960 (N.M. 2000).

away from the family home prior to the accident.⁷⁷ The court found the policy ambiguous and considered evidence of Linda Ponder's conversations with her insurance agent. Specifically, before the policies were renewed, Linda Ponder informed the agency that Nichelle had married, was expecting a baby, and was "moving in and out" of the Ponder family home. Linda Ponder testified that she wanted to know whether the change in her daughter's marital status limited her coverage so that, if necessary, she could take the necessary steps to obtain coverage that would also cover Nichelle on the other Ponder vehicles. Linda Ponder maintained that the agent repeatedly used the terms "fully covered" to describe Nichelle's coverage.⁷⁸ During another conversation with the agent, Linda Ponder testified that she asked about the status of her daughter's coverage because Nichelle was married and planning to move, and she wanted to confirm that Nichelle still had insurance coverage. According to Linda Ponder, the agent reassured her, stating "don't worry, everything's taken care of."⁷⁹ The appellate court affirmed the trial court's judgment in favor of Nichelle Ponder find that she was an insured entitled to stack uninsured motorists benefits.⁸⁰

In short, evidence of surrounding circumstances, including the parties' negotiation of the insurance contract and the discussions concerning the scope and extent of coverage provided by an insurance policy at or before the time of issuance or renewal may be taken into account in determining the meaning of ambiguous policy.

d. Acts and Conduct Post-Issuance of Policy

Relevant extrinsic evidence is not limited to the pre-issuance communications between the parties. Indeed, the parties' conduct or acts after issuance or renewal of an insurance policy

⁷⁷ *Id.* at 962. Stacking refers to an insured's attempt to recover policy benefits in aggregate under more than one policy covering more than one vehicle. *Id.* at 964.

⁷⁸ *Id.* at 966.

⁷⁹ *Id.*

⁸⁰ *Id.* at 968-71.

(but before any controversy occurs) provides another source of evidence about the parties' intent as to the meaning of insurance contract language.⁸¹

In fact, the parties' conduct after a contract is formed is considered to be one of the most persuasive items of extrinsic evidence of the parties' mutual intention.⁸² As the United States Supreme Court said regarding a contracting party's intent, "[t]here is no surer way to find out . . . than to see what they have done."⁸³ Similarly, the drafters of the Restatement (Second) of Contracts stated it this way: "The parties to an agreement know best what they meant, and their action under it is often the strongest evidence of their meaning."⁸⁴

The case *Walle Mutual Insurance Co. v. Sweeney*,⁸⁵ is just one example of a court's consideration of the parties' post-contract conduct. There, Sweeney, the insured, sought coverage under a farm liability insurance policy issued by Walle Mutual for a wrongful death claim that arose out of accident that occurred when Sweeney was driving a pickup truck used solely for farming purposes.⁸⁶ The farm liability policy provided coverage for accidents involving a "farm implement" but it excluded coverage for claims arising out of the ownership, operation, maintenance, or use of a "motor vehicle."⁸⁷ Walle Mutual asserted that Sweeney's pickup truck was an excluded "motor vehicle" and not a "farm implement." Finding the policy language ambiguous, the North Dakota Supreme Court found that the parties' mutual intention was ascertainable from the parties' post-issuance conduct. Specifically, some fifteen months after

⁸¹ See, e.g., *American Home Prods. Corp. v. Liberty Mut. Ins. Co.*, 565 F. Supp. 1485, 1503 (S.D.N.Y. 1983); *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, 682 P.2d 388, 398 (Ariz. 1984); *United Cal. Bank v. Prudential Ins. Co. of Am.*, 681 P.2d 390, 410 (Ariz. Ct. App. 1983); *National Union Fire Ins. Co. v. Studer Tractor & Equip. Co.*, 527 P.2d 820, 831 (Wyo. 1974).

⁸² See, e.g., *Federal Ins. Co. v. Americas Ins. Co.*, 691 N.Y.S.2d 508, 512 (N.Y. App. Div. 1999).

⁸³ *Brooklyn Life Ins. Co. v. Dutcher*, 95 U.S. 269, 273 (1877).

⁸⁴ RESTATEMENT (SECOND) OF CONTRACTS § 202 cmt. g (1982).

⁸⁵ 419 N.W.2d 179 (N.D. 1988).

⁸⁶ *Id.* at 177.

⁸⁷ *Id.*

Sweeney purchased the policy, and before any controversy arose, Sweeney and Walle Mutual's agent Duane Larson had a conversation wherein Larson advised Sweeney that his automobiles were partially uninsured and suggested that Sweeney increase his coverage. Sweeney then unsuccessfully sought to have his auto insurance limits raised.⁸⁸ The trial court found that this evidence demonstrated that the parties' intended that "motor vehicles" included, and "farm implements" excluded, Sweeney's pickup truck.⁸⁹

*Zito v. Fireman's Fund Insurance Co.*⁹⁰ is another example. There, Alfred Zito owned a small food processing business and was insured under an auto policy issued by Fireman's Fund. The policy covered Zito's two vehicles for both business and personal use.⁹¹ The policy specifically excluded coverage for non-owned vehicles.⁹² When the Fireman's policy was delivered, Zito told his insurance agent, Floyd Streeter, that he sometimes rented a large truck to pick up supplies for his business.⁹³ Streeter, in turn, told Zito that he did not have non-owned auto coverage in his policy.⁹⁴ Zito told Streeter not to worry about it because he always bought insurance from the rental company when he rented the truck.⁹⁵ Zito declined Streeter's offer to add such coverage to the policy, saying "I don't need it, Floyd. I am all right."⁹⁶

While driving a rented Ford truck, Zito was killed in a multi-car accident in which other persons were injured.⁹⁷ After Zito's estate was sued by these injured persons, Fireman's Fund denied liability coverage based on the non-owned vehicle exclusion. But the plaintiff argued that

⁸⁸ *Id.* at 180.

⁸⁹ *Id.*

⁹⁰ 111 Cal. Rptr. 392 (Cal. Ct. App. 1973).

⁹¹ *Id.* at 394.

⁹² *Id.* at 394-95.

⁹³ *Id.* at 395.

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.* at 395.

the exclusion was ambiguous and applied only to use of a non-owned vehicle driven by a third person while engaged in the business of the insured.⁹⁸ In finding in favor of Fireman's Fund, the trial court and appellate courts found that evidence of Zito's post-issuance conduct demonstrated that there was no coverage:

Zito confirmed his belief that the Fireman's policy did not afford liability coverage for the rented truck not just by words, but by purchasing special insurance to cover that contingency every time he rented the truck. Both by what he said in conversations with Streeter and by his conduct, Zito acknowledged the Fireman's policy was not intended to afford liability coverage when he rented a truck and used it in his business.⁹⁹

In sum, the construction or interpretation given to a contract as evidenced by the acts and conduct of the parties with knowledge of the terms is entitled to great weight. As noted above, courts consider the acts of the parties themselves, before disputes arise, to be the best evidence of the meaning of doubtful contractual terms. Again, this evidence is relevant only if it occurs before a controversy as to the meaning of disputed contract language arises. Indeed, once a controversy has arisen, insureds and insurers alike can be expected to behave according to their perceived self-interest and in a manner consistent with their litigation position.

e. Drafting History and Regulatory Submittals

The drafting history of standard form insurance policies is another interpretative aid that some courts have considered. Many insurers use policy forms drafted by ISO, which have been revised over the years. Even insurers that do not use ISO forms have revised their policy forms. And some courts will consider the "drafting history" in cases where policy language is ambiguous.¹⁰⁰

⁹⁸ *Id.*

⁹⁹ *Id.* at 397.

¹⁰⁰ *See, e.g.,* Fireguard Sprinkler Sys., Inc. v. Scottsdale Ins. Co., 864 F.2d 648, 651 (9th Cir. 1988) (applying Oregon law and considering ISO publications); American Home Prods. Corp. v. Liberty Mut. Ins. Co., 565 F. Supp. 1485, 1500-03 (S.D.N.Y. 1983) (considering evidence of the drafting history of the CGL form when trying to determine what trigger of coverage rule to adopt).

In *Montrose Chemical Corp. v. Admiral Insurance Co.*,¹⁰¹ for example, the court found evidence of the drafting history of the CGL form relevant when trying to determine what trigger of coverage rule to adopt:

In this case we find the drafting history relevant in evaluating Admiral's argument that, from a public policy standpoint, the insurance industry will be harmed by the adoption of a continuous injury trigger that the industry assertedly never anticipated would be applied to these policies.¹⁰²

Similarly, courts have considered insurance industry statements submitted to state insurance regulators.¹⁰³ For instance, in *American Star Insurance Co. v. Grice*,¹⁰⁴ the court considered an ISO submittal to a state insurance commissioner. In *American Star*, the insured, a landfill owner, sought liability insurance coverage for pollution damage to neighboring property that occurred when a fire started on the insured's premises.¹⁰⁵ And the issue was whether an endorsement adding a hostile fire exception to the pollution exclusion applied to preclude coverage. The Washington Supreme Court found the exclusion ambiguous. Thus, the court found relevant a document entitled "Amendment of Pollution Exclusion Endorsement Explanatory Memorandum" sent by ISO to the Washington State Insurance Commissioner, which stated that "[t]hese endorsements state that the pollution exclusion does not apply to bodily injury or property damage caused by heat, smoke or fumes from a hostile fire on the insured's premises

¹⁰¹ 913 P.2d 878 (Cal. 1995).

¹⁰² *Id.* at 891.

¹⁰³ *See, e.g.*, *Claussen v. Aetna Cas. & Sur. Co.*, 380 S.E.2d 686, 687 (Ga. 1989) (considering documents presented to Insurance Commissioner when "pollution exclusion" was first adopted indicating that the exclusion was intended to exclude only intentional polluters); *Queen City Farms, Inc. v. Central Nat'l Ins. Co.*, 882 P.2d 703, 722 (Wash. 1994) (considering insurance industry statements before state insurance regulators to interpret meaning of qualified pollution exclusion in CGL policy).

¹⁰⁴ 854 P.2d 622 (Wash. 1993).

¹⁰⁵ *Id.* at 872-73.

or job location.”¹⁰⁶ The court then found that the exclusion did not apply.¹⁰⁷ Thus, some courts have considered the drafting history of standard form insurance policies as an interpretative aid where policy language is ambiguous. Similarly, courts have also referred to insurer’s statements be state regulators as evidence of intent.

f. Trade Custom and Usage

Other courts have allowed the use of evidence of trade usage to determine the meaning of ambiguous insurance contract language.¹⁰⁸ This evidence can take the form of trade industry publications or expert witness testimony.

In *Golden Eagle Insurance Co. v. Insurance Company of the West*,¹⁰⁹ for instance, the court considered a Fire Casualty & Surety (“FC & S”) Bulletin when interpreting a CGL form’s contractual liability coverage. In *Golden Eagle*, the dispute was whether the indemnitee’s defense costs were included as “damages” under the contractual liability coverage.¹¹⁰ An August 1996 FC & S Bulletin stated that the answer to this question was yes because the current form expressly stated that “reasonable attorney fees and necessary litigation expenses incurred by or for a party other than the insured are deemed to be damages” and this coverage merely clarified coverage that existed under previous versions of the form.¹¹¹ In allowing this evidence, the court

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 880.

¹⁰⁸ *E.g.*, *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 217 F.3d 33, 38-39 (1st Cir. 2000) (applying Massachusetts law); *Travelers Indem. Co. v. Scor Reinsurance Co.*, 62 F.3d 74, 78 (2d Cir. 1995) (applying Connecticut law); *Employers Reinsurance Corp. v. Mid-Continent Cas. Co.*, 202 F. Supp. 2d 1221, 1234 (D. Kan. 2002); *Aetna Cas. & Sur. Co. v. Dow Chem. Co.*, 28 F. Supp. 2d 440, 445-46 (E.D. Mich. 1998); *Gulf Ins. Co. v. Edgerley*, 107 Cal. Rptr. 246, 250 (Cal. Ct. App. 1973); *Marathon Plastics, Inc. v. Int’l Ins. Co.*, 514 E.2d 479, 486 (Ill Ct. App. 1987); *Affiliated FM Ins. Co. v. Constitution Reinsurance Co.*, 626 N.E.2d 878, 881-82 (Mass. 1994); *Mescalero Energy, Inc. v. Underwriters Indem. Gen. Agency, Inc.*, 56 S.W.3d 313, 319 (Tex. Ct. App. 2001).

¹⁰⁹ 121 Cal. Rptr. 2d 682 (Cal. Ct. App. 2002).

¹¹⁰ *Id.* at 684.

¹¹¹ *Id.* at 688-89.

reasoned that the “FC & S bulletin, which is published by the National Underwriters Association, is used by insurance agents and brokers to interpret standard insurance policy provisions.”¹¹²

Similarly, the court in *Coppi v. West American Insurance Co.*¹¹³ allowed expert witness testimony on trade usage. There, Coppi did business as The Factory Beauty Salon, in which he used a number of independent contractor stylists. Typically, after a stylist performed a service, the stylist prepared a ticket which reflected the stylist’s name and the amount of the service performed. The customer would pay in cash or with a check. And the tickets were used at the end of the week to determine the amount payable to each stylist.¹¹⁴ Coppi’s business was burglarized and money was stolen. Coppi’s policy with West American provided coverage for the theft of money.¹¹⁵ But the policy required Coppi to keep records of money in such a manner that West American could accurately determine the amount of loss from them.¹¹⁶ West American denied Coppi’s claim because it asserted that Coppi failed to comply with the record keeping requirement of the policy. At trial, the trial court found the record keeping provision to be ambiguous and permitted, over Coppi’s objection, West American’s adjuster’s opinion as to the custom and practice in the industry.¹¹⁷ The Nebraska Supreme Court affirmed, finding this evidence relevant:

Expert testimony as to the custom and practice of an industry is admissible to elucidate the meaning of ambiguous language. . . .

The recordkeeping provision in question is not clear because it does not specify the type of records to be kept. The provision merely states that the insured shall keep records such that the loss can be accurately determined. In the face of Coppi’s testimony that the records he kept were of the type normally kept by beauty salons, the adjuster’s opinion was relevant as to whether the records were

¹¹² *Id.* at 688.

¹¹³ 524 N.W.2d 804 (Neb. 1994).

¹¹⁴ *Id.* at 809.

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 811.

¹¹⁷ *Id.* at 814.

sufficient to accurately determine the loss. Thus, not only did the adjuster have knowledge superior to that of the general public, his testimony was relevant.¹¹⁸

In summary, some courts have allowed the use of evidence of trade usage to determine the meaning of ambiguous insurance contract language.¹¹⁹ As the foregoing cases illustrate, this evidence can be presented as expert witness testimony or by use of trade industry publications.

E. Construing Ambiguities Against the Drafter

As discussed previously, if the proffered extrinsic evidence does not remove the ambiguity, then that ambiguity will be construed against the drafter, usually the insurer. But there are instances where ambiguities may not be construed against the insurer.

1. Insured or Broker-Drafted Policies

Today, many commercial policyholders place their insurance through insurance brokers.¹²⁰ Brokers such as Marsh and Aon, among others, have the resources and leverage to develop their own policy forms and to apply substantial pressure on insurers to accept them.¹²¹ This is especially true in cases where the broker places coverage in multiple layers, with various carriers taking a portion of each layer. And since insurance brokers act as the insured's agent, the agent's conduct is imputed to the insured under generally accepted principles of agency law.¹²²

¹¹⁸ *Id.* at 815.

¹¹⁹ *E.g.*, *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 217 F.3d 33, 38-39 (1st Cir. 2000) (applying Massachusetts law); *Travelers Indem. Co. v. Scor Reinsurance Co.*, 62 F.3d 74, 78 (2d Cir. 1995) (applying Connecticut law); *Employers Reinsurance Corp. v. Mid-Continent Cas. Co.*, 202 F. Supp. 2d 1221, 1234 (D. Kan. 2002); *Affiliated FM Ins. Co. v. Constitution Reinsurance Co.*, 626 N.E.2d 878, 881-82 (Mass. 1994).

¹²⁰ *See, e.g.*, OSTRAGER & NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, *supra* note 1 § 1.03 [c][3], at 36 (“Most corporations place their insurance through independent insurance brokerage firms.”); KALIS, *supra* note 1 § 19.02, at 19-11 (“Many, if not most, insurance policies are placed through the use of insurance intermediaries, often referred to as insurance brokers and insurance agents.”).

¹²¹ *See* Deborah Lohse, *Marsh & McLennan's Planned Purchase of Sedgwick Stirs Increased Concerns*, WALL. ST. J., Sept. 29, 1998, at A6 (“Aon and Marsh & McLennan have said their market clout and breadth enables them to seek out the best products and prices.”).

¹²² *See, e.g.*, *Marsh & McLennan of Cal., Inc. v. City of Los Angeles*, 132 Cal. Rptr. 796, 802 (continued...)

In these circumstances, the following question arises: Will courts then construe ambiguities against the insured and in favor of the insurer when confronted with an unresolvable ambiguity in policy language drafted by an *insured's* broker?¹²³ No court has yet done so, finding instead evidentiary or interpretational reasons to avoid this result. But language in various opinions, and logic, suggest that courts will construe unresolved ambiguities against the insured.

Language supporting construction of ambiguities against the insured can be seen, for example, in *Fireman's Fund Insurance Co. v. Fibreboard Corp.*¹²⁴ There, Fibreboard sought coverage for asbestos claims under its liability policy. The California Court of Appeal held that asbestos exclusions in the policies clearly and unambiguously precluded coverage.¹²⁵ But in *dicta*, the court addressed Fibreboard's argument that the exclusions should be strictly construed against the insurer. And the court suggested that any ambiguities should be construed against Fibreboard because its broker drafted the policy:

Here, as in *Garcia*¹²⁶ the typical relationship (unequal bargaining strength, use of standardized language by more powerful insurer-draftsman) simply did not exist. Rather, two large corporate entities, each represented by specialized insurance brokers or risk managers, negotiated the terms of the insurance contract. Neither Truck nor other respondents drafted or controlled the policy language: thus, the reasons for the general rule of construction—"to protect the insured's reasonable expectation of coverage in a situation in which the insurer-draftsman controls the language of the policy"—were non-existent. In fact, the record

¹²²(...continued)

(Cal. Ct. App. 1976); *Almerico v. RLI Ins. Co.*, 716 So. 2d 774, 776 (Fla. Dist. Ct. App. 1998); *State Sec. Ins. Co.*, 630 N.E.2d 940, 946 (Ill. Ct. App. 1994); *Nautilus Ins. Co. v. First Nat'l Ins., Inc.*, 837 P.2d 409, 411 (Mont. 1992); *Incorporated Village of Pleasantville v. Calvert Ins. Co.*, 612 N.Y.S.2d 441, 442 (N.Y. App. Div. 1994); *Continental Cas. Co. v. Bock*, 340 S.W.2d 527, 532 (Tex. Ct. App. 1960). *See generally* Lohse, *supra* note 121 at A6.

¹²³ An insurance broker, of course, is the insured's agent. *See, e.g.*, *Fireman's Fund Ins. Co. v. National Bank for Coops.*, 849 F. Supp. 1347, 1364 (N.D. Cal. 1994); *Carlton v. St. Paul Mercury Ins. Co.*, 30 Cal. App. 4th 1450, 1457, 36 Cal. Rptr. 2d 229, 232 (1994).

¹²⁴ 227 Cal. Rptr. 203 (Cal. Ct. App. 1986).

¹²⁵ *Id.* at 205.

¹²⁶ *Garcia v. Truck Ins. Exch.*, 204 Cal. Rptr. 435 (Cal. 1984).

clearly shows that Fibreboard itself proposed or drafted language for the asbestos exclusion.

None of the authorities relied upon by Fibreboard reflects a comparable factual situation where the insured itself drafted or proposed the policy language. Moreover, to the extent that any ambiguity exists, ordinarily it would be interpreted *against* Fibreboard, the party who caused the uncertainty to exist.¹²⁷

Similar comments can be seen in *Metpath, Inc. v. Birmingham Fire Insurance Company of Pennsylvania*.¹²⁸ The policy there covered Metpath's extra expenses of operating its medical laboratory caused by an anticipated air traffic controller strike (scheduled to begin on June 27, 1981), subject to a seven-day waiting period.¹²⁹ The strike occurred, but two days later President Reagan fired all the air traffic controllers, which ended the strike.¹³⁰ Birmingham denied coverage because the loss period did not exceed the seven-day waiting period.¹³¹ After Metpath sued, Birmingham argued that any ambiguity in the policy should be construed against Metpath, the policy drafter. The New York appellate court held that the seven-day waiting period language was unambiguous.¹³² But the court also stated that even if the policy language was ambiguous, any ambiguity would be resolved against Metpath because its broker drafted the policy, including the provisions regarding the seven-day waiting period:

[E]ven if the policy language is considered ambiguous or open to doubt, any ambiguity or doubt must be resolved against Metpath and in favor of Birmingham since the drafter of the insurance policy was Metpath's agent, J&H, and those provisions requested by Metpath's

¹²⁷ *Fireman's Fund*, 227 Cal. Rptr. at 206-07 (italics in original, citations and footnote omitted).

¹²⁸ 449 N.Y.S.2d 986 (N.Y. App. Div. 1982).

¹²⁹ *Id.* at 987.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.* at 989.

representatives are the very provisions which limit the coverage to the period of the strike.¹³³

The Third Circuit Court of Appeals, applying Pennsylvania law, made similar observations in *Eastern Associated Coal Corp. v. Aetna Casualty & Surety Co.*¹³⁴ There, Eastern, a coal mine owner, sought recovery under its business interruption coverage for additional expenses associated with the closure of one of its mines after an underground fire.¹³⁵ Eastern was under contract to provide coal to a customer at a certain price. After the fire, Eastern had to go to the market to buy the coal to meet its contract requirements.¹³⁶ But at that time, the market price of coal had risen sharply (\$2 million for the volume in question) above the contract price agreed with the customer.¹³⁷ Eastern's insurance broker selected the policy forms, prepared the policies, and sent them to the insurance companies for execution.¹³⁸ The court stated that under these circumstances, "the Pennsylvania cases indicate that conflicts over the interpretation of an insurance contract should be resolved against the party preparing the contract."¹³⁹ Because Eastern's broker was the drafter, the court stated that "[a]t a minimum, the above cited cases require that we not construe the language against the defendants [insurers]."¹⁴⁰ But the court found no ambiguity and held that the additional expenses produced by the interruption were not covered by the business interruption provision.¹⁴¹

¹³³ *Id.*

¹³⁴ 632 F.2d 1068 (3d 1980).

¹³⁵ *Id.* at 1071.

¹³⁶ *Id.*

¹³⁷ *Id.* at 1072.

¹³⁸ *Id.* at 1071.

¹³⁹ *Id.* at 1075.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 1076-80.

And in *Puerto Rico Electric Power Authority v. Phillips*,¹⁴² the court also suggested that ambiguities in insured-drafted policy language should be construed against the insured. There, 238 separate acts of sabotage or vandalism had occurred during a four-month strike at the insured's premises. The policy provided coverage subject to a \$1 million deductible, and the issue was the number of applicable deductibles to apply.¹⁴³ The court found that the deductible language, which was written by the insured, was ambiguous. The court then addressed the preliminary question of whether the policy should be construed in favor of the insured where the insured drafted the policy and, thus, created the ambiguity.¹⁴⁴ The court answered this question in the negative.¹⁴⁵ Although the court applied 238 separate deductibles as advocated by the insurer, it reached its decision by using both extrinsic evidence and basic rules of contract interpretation.¹⁴⁶ Thus, the court did not need to employ the "tie-breaker" rule of construing ambiguities against the drafter. But again, the *Phillips* case at least implies that the *contra proferentem* rule would be applied against an insured if it drafted the policy.

Finally, commentators also have recognized the appropriateness of reversing the *contra proferentem* rule when the insured or its broker is the drafter:

Almost everyone would agree that where a policyholder or its bonafide agent drafts a contract term, the rule of *contra proferentem* should not operate in its favor. On the contrary, in these instances, the ambiguity principle should operate in favor of the insurer and against the insured. Although this might shock consumer advocates, it is a sensible approach. *Contra proferentem* becomes an untenable, unprincipled doctrine if it comes to mean the insurer always loses regardless of the situation.¹⁴⁷

¹⁴² 645 F. Supp. 770 (D.P.R. 1986).

¹⁴³ *Id.* at 771.

¹⁴⁴ *Id.* at 773.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 773-74.

¹⁴⁷ STEMPEL, *supra* note 2 § 4.11[f], at 4-201.

In conclusion, while no court has yet construed ambiguities in a broker-drafted policy, there is no reason why those ambiguities should not be construed against the insured where application of interpretational rules or consideration of extrinsic evidence do not remove the ambiguity.

2. The Sophisticated Insured

Many policyholders are extremely large commercial entities with large in-house legal departments, risk management departments, and substantial resources. Such a policyholder is on a somewhat level playing field with the insurer. In these circumstances, the application of the *contra proferentem* doctrine has been called into question.

For example, the court in *Eagle Leasing Corp. v. Hartford Fire Insurance Co.*¹⁴⁸ observed:

We do not feel compelled to apply, or, indeed, justified in applying the general rule . . . in the commercial insurance field when the insured is not an innocent but a corporation of immense size, carrying insurance with annual premiums in six figures, managed by sophisticated businessmen and represented by counsel on the same professional level as the counsel for insurers.¹⁴⁹

But other courts have rejected this view. In *Boeing Co. v. Aetna Casualty & Surety Co.*,¹⁵⁰ for instance, the Washington Supreme Court explained that it would be incongruous to apply different rules of construction based on the size of the policyholder:

The critical fact remains that the policy in question is a standard form policy prepared by the company's experts, with language selected by the insurer. The specific language in question was not negotiated, therefore, it is irrelevant that some corporations have company counsel. Additionally, this standard form policy has been issued to big and small businesses throughout the state. Therefore it would be incongruous for the court to apply different rules of construction based on the policyholder because once the court construes the standard form coverage clause as a matter of law, the

¹⁴⁸ 540 F.2d 1257 (5th Cir. 1976) (applying Missouri law).

¹⁴⁹ *Id.* at 1261.

¹⁵⁰ 784 P.2d 507 (Wash. 1990).

court's construction will bind policyholders throughout the state regardless of the size of their business.¹⁵¹

A review of the cases indicates that courts will not decline to construe ambiguities against the insurer simply because the insured is a sophisticated entity. Rather, courts may decline to construe ambiguities against the insurer where the insured is a sophisticated entity *and* it negotiated the contract terms.¹⁵² Indeed, as the court in *Pittston Co. v. Allianz Insurance Co.*¹⁵³ explained it:

[T]he dispositive question is not whether the insured is a sophisticated corporate entity, but rather whether the insurance contract is negotiated, jointly drafted or drafted by the insured. In such instances, we conclude that the doctrine of *contra preferentum* should not be invoked to inure to the benefit of the insured.¹⁵⁴

So if the ambiguities will not be construed against either party, how are they resolved? According to at least one court, “the ambiguous provisions should be construed in favor of what reason and probability dictate was intended by the parties.”¹⁵⁵

F. Conclusion

A court's first step in interpreting allegedly ambiguous insurance contract language is to determine whether there is in fact an ambiguity. This initial step involves considering so-called allegedly ambiguous terms not in the abstract, but rather in the context of the written policy

¹⁵¹ *Id.* at 514.

¹⁵² *Northbrook Excess & Surplus Ins. Co. v. Proctor & Gamble Co.*, 924 F.2d 633, 639 (7th Cir. 1991) (applying Ohio law); *Travelers Indem. Co. v. United States*, 543 F.2d 71, 74 (9th Cir. 1976) (applying Oregon law); *Fountain Powerboat Indus. v. Reliance Ins. Co.*, 119 F. Supp. 2d 552, 555 (E.D.N.C. 2000); *St. Paul Fire & Marine Ins. Co. v. Microsoft Corp.*, 102 F. Supp. 2d 1107, 1112 (D. Minn. 1999); *Koch Eng'g Co. v. Gibraltar Cas. Co.*, 878 F. Supp. 1286, 1288 (E.D. Mo. 1995); *Industrial Risk Insurers v. New Orleans Pub. Serv., Inc.*, 666 F. Supp. 874, 881 (E.D. La. 1987); *McNeilab, Inc. v. North River Ins. Co.*, 645 F. Supp. 525, 546-47 (D.N.J. 1986).

¹⁵³ 124 F.3d 508 (3d Cir. 1997) (applying New Jersey law).

¹⁵⁴ *Id.* at 521.

¹⁵⁵ *Industrial Risk Insurers v. New Orleans Pub. Serv., Inc.*, 666 F. Supp. 874, 881 (E.D. La. 1987).

itself. Thus, courts will employ standard contractual construction principles, such as reading the contract as a whole, or giving effect to all terms, to properly understand particular terms or words in a full policy context. Only if the policy language is susceptible to two reasonable interpretations will the court find language to be ambiguous.

If there is in fact an ambiguity, most courts today will not immediately construe the ambiguity against the drafter. Before applying the doctrine of *contra proferentem*, courts first attempt to remove the uncertainty surrounding the intent of the policy language by considering certain extrinsic evidence relating to the communications, negotiations, knowledge and common understanding of the parties in order to determine their mutual intent. If a common understanding or intent can be ascertained through such *communicated* extrinsic evidence, that understanding or intent will be enforced. Only if the uncertainty remains after reference to the extrinsic evidence will the ambiguity is construed against the drafter. If the drafter is the insured or its broker, the ambiguity should be construed against the insured. Otherwise, the construction will be against the insurer.