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POLICY INTERPRETATION: LOOKING BEYOND THE WORDS

INSURANCE

By Kirk Pasich

A frequent argument about insurance policies is what evidence is admissible to interpret those policies. Insurers often contend that policies should be interpreted based upon their "plain meaning," citing the parole evidence rule. They urge that unless an ambiguity is found based solely on the policy language, there can be no reference to extrinsic evidence or the parties' negotiations of or performance under the policies. Insurers also often challenge the parties' interpretation of the other insurance policies and contracts to argue, as a stranger to those contracts, that they somehow are not bound by how the contracting parties interpreted them. None of these arguments should be readily accepted.

The time-honored rules governing contract interpretation are embodied in California Civil Code Sections 1635 through 1656. There is no doubt that these rules apply to insurance policies. *See AIU Ins. Co. v. Superior Court*, 51 Cal. 3d 807, 821 (1990) (citing and restating these rules). As the *AIU* court noted, "the mutual intention of the parties at the time the contract is formed governs interpretation."

Insurers often point to Civil Code Section 1639 to support their argument that the parties' mutual intent should be gleaned only from the words of the policy. However, Section 1639, when read in its entirety, does not support this argument: "When a contract is reduced to writing, the intention of the parties is to be ascertained from the writing alone, if possible; subject, however to the other provisions of this title." The other Civil Code provisions clearly call for more. For example, Civil Code Section 1647 specifies, "A contract may be explained by reference to the circumstances under which it was made, and the matter to which it relates."

Furthermore, the California Supreme Court long has recognized that the parol evidence rule does not bar consideration of extrinsic evidence. In *Pacific Gas & Electric Co. v. G. W. Thomas Drayage & Rigging Co.*, 69 Cal. 2d 33, 39-40 (1968), the court held: "[R]ational interpretation requires at least a preliminary consideration of all credible evidence offered to prove the intention of the parties. . . . If the court decides, after considering this evidence, that the language of a contract, in the light of all the circumstances, 'is fairly susceptible of either one of

the two interpretations contended for . . . ," extrinsic evidence relevant to prove either of such meanings is admissible."

While the *AIU* court discussed the general rules governing contract interpretation, it followed the approach stated in *Pacific*. The court provisionally considered extrinsic evidence. However, it noted that the evidence did not "shed light on the meaning to be ascribed to the coverage provisions at issue" and that the provisions at issue were "adopted verbatim from standard form policies." Because of "the absence of evidence that the parties, at the time they entered into the policies, intended the provisions at issue...to carry technical meanings and implemented this intention by specially crafting policy language," it saw "little reason" to depart from the principles it had cited.

California courts have taken the same approach in other cases. *See, e.g., Dore v. Arnold Worldwide, Inc*., 39 Cal. 4th 384, 391-93 (2006) (citing *Pacific* and rejecting, after provisional consideration, the proffered extrinsic evidence because it did not support a reasonable interpretation of the express provision in the written contract establishing an at-will employment relationship); *Vandenberg v. Superior Court*, 21 Cal. 4th 815, 841 (1999) (citing insurance treatises and insurance industry commentary); *Montrose Chem. Corp. v. Admiral Ins. Co.*, 10 Cal. 4th 645, 670-71 (1995) ("interpretative materials have been widely cited and relied on in the relevant case law and authorities construing standardized insurance policy language"); *Lockheed Martin Corp. v. Continental Insurance Co*., 134 Cal. App. 4th 187, 200-07 (2005) (considering range of extrinsic evidence, including statutory definitions, a treatise section, previous policies between the parties, documents evidencing the insurance broker's understanding of policy terms, and the parties' conduct in handling previous insurance claims).

When interpreting a term in an insurance policy, courts often have considered extrinsic evidence such as the usage and understanding of that term in a particular industry. *See, e.g., Wolf v. Superior Court*, 114 Cal. App. 4th 1343, 1358 (2004) (relying on extrinsic evidence of trade usage of "gross receipts" as "expos[ing] a latent ambiguity in the contract language"); *Pac. Grape Prods. Co. v. Commissioner of Internal Revenue*, 219 F.2d 862, 866 (9th Cir. 1955) ("We think it to be a sound rule and one established in California, that a person dealing at a particular market is held to have dealt in accordance with the customs and usages of that market, and this without further proof of such person's knowledge of the usage."). Indeed, this rule is not just based on Civil Code Section 1645, it also is stated in California's Insurance Code under Section 335(b). 335(b)

California courts also long have recognized that extrinsic evidence in the form of how the parties to a contract performed under the contract has great probative value as to the meaning of the contract. As the court held in *City of Hope National Medical Center v. Genentech, Inc.*, 43 Cal. 4th 375 (2008), "[a] party's conduct occurring between execution of the contract and a dispute about the meaning of the contract's terms may reveal what the parties understood and intended those terms to mean."

Given this fact, a third party's interpretation of a contract should not overcome the intentions of the actual parties to the contract when the evidence proves the parties' mutual agreement as to the contract's meaning. California courts repeatedly confirm this. For example, in *Meadows v. Lee*, 175 Cal. App. 3d 475 (1985), a third party challenged the interpretation of a contract. The

court rejected the challenge, relying on how the parties to the contract performed under it, including after the third party initially questioned the interpretation. The court held that "the burden of [a third party] attempting to set aside the contractual relationship between [the contracting parties], to which they seem to be satisfied, is indeed a heavy one." It explained: "If two parties enter into a contract and appear to be satisfied with that agreement, their subsequent happiness with that arrangement, in the absence of fraud or collusion or clear express repudiation, should be a powerful incentive to sustain the continued viability of that contract." Therefore, the court concluded that "a trial court may properly rule in favor of the original contracting parties on the ground that they were, in fact, the original contracting parties."

The California Supreme Court has applied these principles in the insurance context. *Garcia v. Truck Insurance Exchange*, 36 Cal. 3d 426 (1984), a case often relied upon by insurers, highlights precisely how extrinsic evidence is interpreted properly under California law. *Garcia* involved a liability policy that the California Hospital Association purchased for hospitals. After a medical malpractice lawsuit was brought against a hospital and a doctor, the insurer agreed to cover the hospital but not the doctor, citing an exclusion for individuals not employed by the hospital. The doctor, who was not involved with the negotiation or procurement of the insurance policy, challenged the insurer's interpretation of the policy and offered his own interpretation. To support its interpretation, the insurer offered testimony from the Association's general counsel, who was involved in negotiating and procuring the policy many years earlier. He testified that the parties did not intend to provide coverage for private doctors under these circumstances. Citing *Pacific*, the court ruled that the testimony of the Association's general counsel was highly probative and properly admitted to support the insurer's reasonable interpretation of the policy.

Given the decades of California law, those seeking to interpret an insurance policy should recall the words of the *Pacific* court: "The fact that the terms of an instrument appear clear to a judge does not preclude the possibility that the parties chose the language of the instrument to express different terms. That possibility . . . exists whenever the parties' understanding of the words used may have differed from the judge's understanding." Therefore, extrinsic evidence must be at least provisionally considered in interpreting an insurance policy. *See, e.g., Morey v. Vannucci*, 64 Cal. App. 4th 904, 912 (1998) ("it is reversible error for a trial court to refuse to consider such extrinsic evidence on the basis of the trial court's own conclusion that the language of the contract appears to be clear and unambiguous on its face").

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