

Chapter 2

Discovery and Evidence in Breach of Contract Cases:

Defining Relevance and an Overview of Objections Not Based on Evidentiary Privileges

by

J. Stephen Gibson
Shannon, Gracey, Ratliff & Miller, L.L.P.
2500 Lincoln Plaza
500 North Akard Street
Dallas, Texas 75201

Telephone: 214.245.3068

Telefax: 214.245.3097

E-Mail: sgibson@shannongracey.com

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J. Stephen Gibson
Shannon, Gracey, Ratliff & Miller, L.L.P.
2500 Lincoln Plaza
500 North Akard Street
Dallas, Texas 75201
Telephone: 214-245-3068
Telefax: 214-245-3097
E-mail: sgibson@shannongracey.com

Practice Areas

Post-Trial and Appellate Practice
Insurance Coverage and Extracontractual Liability
Litigation Support and Jury Charge Submission

Professional Licenses & Associations

Member, State Bar of Texas, November 1984
Admitted, United States Court of Appeals for the Fifth Circuit
Admitted, United States District Court for the Eastern District of Texas
Admitted, United States District Court for the Northern District of Texas
Admitted, United States District Court for the Southern District of Texas
Admitted, United States District Court for the Western District of Texas
Member, Bar Association for the Fifth Federal Circuit
Member, American Bar Association
Member, Dallas Bar Association
Member, Texas Association of Defense Counsel
Member, Defense Research Institute

Published Decisions

Signal Peak Enterprises of Texas, Inc. v. Bettina Investments, Inc., 138 S.W.3d 915 (Tex. App. – Dallas 2004, pet. dism'd)

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Seminars, Papers & Presentations:

Co-Author, *Challenging Experts: The Practical Use of Robinson-Daubert*, 1st Annual Advanced Insurance Law Course, State Bar of Texas, March 2004, and 2nd Annual Advanced Insurance Law Course, State Bar of Texas, March 2005

Speaker and Author, *Expert Witnesses in Bad Faith Litigation*, Insurance Law for Attorneys Representing Insurers, University of Houston Law Foundation, October 2002

Speaker, *Presentation of Oral Arguments: A Demonstration*, Texas Association of Civil Trial and Appellate Specialists, March 2000.

Speaker and Author, *An Outline of Post-Trial and Appellate Practice in State and Federal Courts*, Law Seminars, Inc., May 1999

Speaker, “Reservation of Rights,” *Handling Tort and Insurance Claims*, University of Houston Law Foundation, September 1998

Education

Juris Doctorate Degree:

Baylor University School of Law, Waco, Texas, February 1984

Bachelor of Arts Degree:

Baylor University, College of Arts and Sciences, Waco, Texas, May 1978

Other Professional Activities

Paralegal Studies Program of Southern Methodist University
Instructor, *Legal Writing and Contracts*, 1988-1989

El Centro Community College Paralegal Studies Program
Instructor, *Texas Civil Procedure*, 1986-1987

Court of Appeals for the Fifth District of Texas
Briefing Attorney, 1984 - 1985
Research Attorney, 1985 - 1987

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Discovery and Evidence in Breach of Contract Cases: *Defining Relevance and an Overview of Objections Not Based on Evidentiary Privilege*

I. Introduction

The scope of discovery and evidence in a breach of contract case, at first glance, would seem to be a simple topic not requiring much discussion. After all, the proper scope of discovery is defined in Texas Rule of Civil Procedure 193.3. The general rule is that “a party may obtain discovery regarding any matter that is not privileged and is relevant to the subject matter of the pending action, whether it relates to the claim or defense of ... any party.” The rule provides that information is discoverable even if it would be inadmissible, so long as it “appears reasonably calculated to lead to the discovery of admissible evidence.” Tex. R. App. P. 192.3(a). As the old saying goes, first impressions can be deceiving. And perhaps this saying is no truer than in attempting to define the scope of relevant evidence for discovery and trial in an insurance contract case.

II. General Limitations on Scope of Discovery

A. Relevant to Elements of Claims Alleged

All law students — and, in the age of *Court TV*, *Boston Legal*, and other courtroom-based entertainments, many lay persons — understand that “relevant” evidence is that which is pertinent to the issue at hand. In an unbroken string of decisions over the last decade, the Texas Supreme Court has repeatedly emphasized that, to be sufficiently relevant to be discoverable, the request must seek information that is reasonably expected to obtain information that will aid in the resolution of the pending issues. *In re CSX*, 124 S.W.3d 149, 152 (Tex. 2003)(identity of safety employees of defendant’s subsidiaries before plaintiff’s employment with defendant not sufficiently relevant in toxic tort case); *In re American Optical*, 988 S.W.2d 711, 713 (Tex. 1998)(discovery requests in asbestos case about products to which plaintiffs alleged no exposure and at times other than period of

plaintiffs’ alleged exposure not relevant in toxic tort suit); *K-Mart Corp. v. Sanderson*, 937 S.W.2d 429, 431 (Tex. 1996)(request for all criminal activity reported at any K-mart location for the preceding seven years not sufficiently relevant to case in which plaintiff alleged abduction from parking lot); *Dillard Dept. Stores, Inc. v. Hall*, 909 S.W.2d 491, 492 (Tex. 1995)(request for other claims of excessive force, false arrest and civil rights violations at 226 locations in 21 other states over the preceding seven years irrelevant to simple false arrest case based on incident at one location in Texas). It is not sufficient that the discovery request is calculated to reveal whether a factual basis exists for the assertion of other claims and theories of recovery than those currently alleged. *Dillard Dept. Stores, Inc. v. Hall*, 909 S.W.2d at 492. Thus, the first limitation on scope of discovery is not imposed by discovery rules or the authorities interpreting them. Rather, the boundaries of discovery are described by relevancy to the issues raised by the elements of the substantive causes of action alleged in the pleadings. *In re StarFlite Mgmt. Group, Inc.*, 162 S.W.3d 409, 413 (Tex. App. — Beaumont 2005, orig. proceeding); see *Nissan Motor Co., Ltd. v. Armstrong*, 145 S.W.3d 131, 139 (Tex. 2004)(proof of similar incidents inadmissible to prove cause of particular accident may be admissible for other purposes, such as notice or knowledge of condition or defect).

B. Practical Availability

Relevancy is not the only limitation on the scope of discovery, however. It must also be reasonably practical to obtain the information. Tex. R. Civ. P. 192.4(b). That rule provides that even relevant information may not be discoverable if

the burden or expense of the proposed discovery outweighs its likely benefit, taking into account the needs of the case, the amount in controversy, the parties’ resources, the importance of the issues at stake in the litigation, and the importance of the discovery in resolving the issues.

Id. Information requested in discovery may be relevant, but remain undiscoverable if it fails to meet this practicality test. *In re Sears, Roebuck & Co.*, 146 S.W.3d 328, 332 (Tex. App. — Beaumont 2005, orig. proceeding). Discovery requests that seek information for periods or locations not related to that involved in

the pending litigation do not meet this standard. *In re Alford Chevrolet-Geo*, 997 S.W.2d 173, 181 n.1 (Tex. 1999); see, e.g., *In re Sears, Roebuck & Co.*, 146 S.W.3d at 332 (request for compensation claim files for other employees of employer might be relevant to show knowledge, but burden of \$3,000,000 estimated compliance cost far outweighed value of information).

Discovery that is “unduly burdensome”, “overbroad” or a “fishing expedition,” runs afoul of the practicality requirement. However, requests that are costly or burdensome to answer solely because of the disorganized manner in which the records are maintained is not so impractical to be undiscoverable. *In re Whiteley*, 79 S.W.3d 729, 735 (Tex. App. – Corpus Christi 2002, orig. proceeding).

III. Relevant Issues in Construing the Policy

In contract cases, the issues are whether parties with capacity to contract mutually assented to the terms of an agreement that were supported by consideration and, what the terms of the agreement required of the parties, and whether one or more of the parties failed to perform their part of the agreement. *MG Bldg. Mat. Ltd. v. Moses Lopez Custom Homes, Inc.*, No. 04-04-00336-CV, slip op. at 7, 2005 WL 1774153 (Tex. App. – San Antonio 2005, pet. denied)(not yet reported). Insurance cases typically involve policies that are written. Consequently, the policy is presumed to represent the entire final agreement of the parties. *Hubacek v. Ennis State Bank*, 159 Tex. 166, 317 S.W.2d 30, 31 (1958); *Weinacht v. Phillips Coal Co.*, 673 S.W.2d 677, 679 (Tex. App. – Dallas 1984, no writ). Of course, this presumption does not apply if the document is incomplete on its face. *Harris v. Travelers Ins. Co.*, 80 F.2d 127, 128-29 (5th Cir. 1935)(amount of premium paid omitted from form).

Typically, insurance litigation involves disputes over the terms of the agreement and whether such terms include or exclude the loss. In those cases, interpretation of the policy – and the evidence that the courts can properly consider in that process – depends on the application of the rules of construction.

A. Rules of Policy Interpretation

Insurance policies are generally subject to the same rules of interpretation and construction as any other written contract. *Texas Farm Bureau Ins. Co. v. Sturrock*, 146 S.W.3d 123, 126 (Tex. 2004). Their

interpretation is a question of law for the court, *id.*, as is the question of whether a policy provision is ambiguous. *Gulf Ins. Co. v. Burns*, 22 S.W.3d 417, 423 (Tex. 2000). The goal of policy interpretation is to enforce the intent of the parties to the policy as expressed in written contract. *State Farm Life Ins. Co. v. Beatson*, 907 S.W.2d 430, 433 (Tex. 1995). It is the objective intent of the parties as expressed in the language used in the contract, *Ideal Lease Serv., Inc. v. Amoco Prod. Co.*, 662 S.W.2d 951, 953 (Tex. 1983), not the subjective intent of a particular party, which controls the policy interpretation. *City of Pinehurst v. Spooner Addition Water Co.*, 432 S.W.2d 515, 518 (Tex.1968) Likewise, when interpreting policy forms mandated by a state regulator, the actual intent of the parties is immaterial. *Sink*, 107 S.W.3d at 552; *U. S. Inc. Co. of Waco v. Boyer*, 153 Tex. 415, 269 S.W.2d 340, 341 (1954).

In interpreting the policy, the court considers the entire agreement so that no provision is rendered meaningless. *American Mfrs. Mut. Ins. Co. v. Schaefer*, 124 S.W.3d 154, 158 (Tex. 2003); *R & P Enters. v. LaGuarta, Gavrel & Kirk, Inc.*, 596 S.W.2d 517, 519 (Tex. 1980). Words used in the policy are construed according to their commonly understood meaning unless the term is given a particular meaning by custom or usage in a particular trade. *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118, 121 (Tex. 1986); *National Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W.2d 527, 521 n.6 (Tex. 1995) .

1. If Unambiguous

If a policy can only be given one reasonable meaning after the application of all applicable rules of construction, then it is not ambiguous and must be enforced as written. *State Farm Fire & Cas. Co. v. Vaughan*, 968 S.W.2d 931, 933 (Tex. 1998); *National Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W.2d at 520. Merely because a contract is silent on a particular subject does not make the contract ambiguous. *Lidawi v. Progressive County Mut. Inc. Co.*, 112 S.W.3d 725, 731 (Tex. App. – Houston [14th Dist.] 2003, no pet.). Not every difference in interpretation amounts to an ambiguity. *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132, 134 (Tex. 1994). To be ambiguous, the contract must be capable of more than one reasonable interpretation. *Kelley-Coppedge, Inc. v. Highlands Ins. Co.*, 980 S.W.2d 462, 464 (Tex. 1998).

If the contract is unambiguous, extrinsic evidence contradicting or varying the language of the policy to create ambiguity may not be considered. *San Antonio Foundation v. Lang*, 35 S.W.3d 636, 640 (Tex. 2000); *Sears, Roebuck & Co. v. Commercial Union Ins. Co.*, 982 S.W.2d 151, 154 (Tex. App. – Houston [1st Dist.] 1998, no pet.). Parol or extrinsic evidence is not relevant if the policy is unambiguous. *Quality Oilfield Prods., Inc. v. Michigan Mut. Ins. Co.*, 971 S.W.2d 635, 639 (Tex. App. – Houston [14th Dist.] 1999, no pet.). Rather, if the contract is free of ambiguity, “it is the duty of the court to give the words used their plain meaning.” *Puckett v. U.S. Fire Ins. Co.*, 678 S.W.2d 936, 938 (Tex. 1984). Without an ambiguity, there is no relevant issue of contract interpretation on which discovery can be conducted. The contract will be construed as a matter of law based on the language of the agreement.

For example, in Court in *National Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W.2d 517 (Tex. 1995), the insureds sought a continuance of the motion for summary judgment to conduct further discovery regarding the insurance industry’s understanding of and representations concerning the effect and meaning of the “absolute” pollution exclusion. Specifically, the insureds contended that the evidence would show that, notwithstanding the language of the exclusion itself, the industry never intended for it to eliminate coverage for truly accidental pollution. *Id.* at 521. In support of that contention, they pointed to the testimony of representatives of the insurance industry in a 1985 hearing before the Texas State Board of Insurance. *Id.*, at 519 n.2.

The Court of Appeals was sympathetic to the insureds and ruled that the trial court should have allowed more time to conduct discovery. The Texas Supreme Court, however, disagreed that more time for discovery was necessary. Whatever industry representatives may have said or thought about the language of the exclusion, the Court reasoned that the language of the exclusion itself clearly and unambiguously excluded coverage for liability resulting from pollution regardless of whether it was accidental or otherwise. *Id.* at 522. Consequently, the court concluded that there was no possible ambiguity that would authorize the consideration of parol evidence and, therefore, that the trial court correctly declined to continue the summary judgment hearing.

In *Safeway Managing Gen. Agy. v. Cooper*, 952 S.W.2d 861, 866 (Tex. App. – Amarillo 1997, no pet.), a couple purchased auto liability insurance that excluded the wife because she did not have a driver’s license that would permit her to legally drive a motor vehicle in Texas. After the wife was involved in an accident while she was driving the insured vehicle, the couple sought to invalidate the exclusion for the wife on the theory that the form used for that purpose did not comply with the insurer’s own underwriting manual or the form prescribed by the State Board of Insurance. To support this contention, the couple sought consideration of the carrier’s underwriting manual and the prescribed form. Following the rationale of the decision in *CBI Indus.*, the Court of Appeals ruled, however, that this extrinsic evidence should not be considered because the language of the exclusion form used by the carrier clearly and unambiguously excluded the driver in question. Consequently, the court held that it was not at liberty to consider these forms of extrinsic evidence.

In their practical effect, these cases exemplify the consequences of one of the oft-repeated abstract rules concerning the interpretation of contracts. For example, as *CBI Indus.* illustrates, the mere allegation that a contract is ambiguous is not enough to make discovery concerning extrinsic evidence relevant and within the scope of discovery. Rather, such discovery can be relevant if, and only if, the trial court rules either explicitly or implicitly that the contract is ambiguous. *CBI Indus.*, 907 S.W.2d at 521. Such a ruling is necessary because, as noted in virtually every case where ambiguity is at issue, the existence of an ambiguity is a question of law. *Sturrock*, 146 S.W.3d at 126.

2. If Ambiguous

If, on the other hand, the policy is susceptible to more than one *reasonable* interpretation, then the policy is ambiguous. *Kelley-Coppedge, Inc.*, 980 S.W.2d at 464; *Grain Dealers Mut. Ins. Co. v. McKee*, 943 S.W.2d 455, 458 (Tex. 1997). However, merely because the parties advance differing interpretations or courts disagree over proper construction of a policy does not amount to an ambiguity. *Columbia Gas Transmission Corp. v. New Ulm Gas, Ltd.*, 940 S.W.2d 587, 589 (Tex. 1996)(differing interpretation of parties); *Betso Scaffolds Co. v. Boston United Cas. Ins. Co.*, 29 S.W.3d 341, 344 (Tex. App. – Houston [14th Dist.], no pet.), 986 S.W.2d 749, 756 (Tex. App.

– Dallas 1999, pet denied); *Union Pac. Resources Co. v. Aetna Cas. & Sur. Co.*, 894 S.W.2d 401, 405 (Tex. App. – Fort Worth 1994, writ denied). Nor will the courts strain to find an ambiguity at the expense of the objective intentions of the parties. *Matador Petrol. Corp. v. St. Paul Surplus Lines Ins. Co.*, 174 F.3d 653, 657 (Tex. 1999). The determination whether a contract is ambiguous may only be made after the entire contract is examined in light of the circumstances that existed when the contract was formed. *Vaughan*, 968 S.W.2d at 933.

a. Consideration of Extrinsic Evidence

Generally, extrinsic evidence may be considered only if the contract is first determined to be ambiguous. *Friendswood Dev. Co. v. McDade & Co.*, 926 S.W.2d 280, 283 (Tex. 1996). Extrinsic or parol evidence may not be considered to create an ambiguity; rather, the ambiguity must be evident *before* the extrinsic evidence is considered. *Mustang Tractor & Equip. Co. v. Liberty Mut. Ins. Co.*, 76 F.3d 89, 91 (5th Cir. 1996); *CBI Indus.*, 907 S.W.2d at 521.

b. Patent v. Latent Ambiguities

Ambiguities may be either patent or latent. A patent ambiguity is one that is apparent from an examination of the language of the contract itself. *CBI Indus.*, 907 S.W.2d at 520. A latently ambiguous contract, however, appears unambiguous on its face. *Id.* The ambiguity becomes apparent only when the terms of the contract are applied to the subject matter of the contract. In other words, the ambiguity does not appear until some matter other than the contract itself is considered. *Id.*; *Murphy v. Dilworth*, 137 Tex. 23, 151 S.W.2d 1004, 1005 (1941).

The insured in *CBI Indus.* was asserting that the absolute pollution exclusion was latently ambiguous as its basis for conducting discovery concerning parol evidence. In the usual case of latent ambiguity, the extrinsic evidence about the matter that makes the contract latently ambiguous, is relevant to establish the hidden ambiguity arising not from the contract itself, but rather from the circumstances to which it applies. Borrowing from the example in *CBI Indus.*, a contract that calls for delivery to the green house on Pecan Street is patently unambiguous. The ambiguity arises only when the fact that there are *two* green houses on Pecan Street becomes apparent, which requires consideration of facts outside the contract

itself. Thus, in the ordinary case where a contract is latently ambiguous, discovery about the extrinsic evidence would be relevant.

The court in *CBI* admitted that extrinsic evidence “may, indeed, be admissible to give words of a contract a meaning consistent with that to which they are reasonably susceptible, *i.e.* to ‘interpret’ contractual terms.” *Id.* at 521. However, what made *CBI Indus.* a less than perfect example of latent ambiguity in the view of the Court was that the unqualified language of the exclusion simply eliminated any possibility for any kind of ambiguity at all. And without an ambiguity, parol evidence was inadmissible. *Id.* at 521.

c. Effect on Receipt of Extrinsic Evidence

In the case of a truly latently ambiguous policy, it appears from the very nature of a latent ambiguity that extrinsic evidence will necessarily have to be considered to resolve the ambiguity. *Bache Halsey Smart Shields, Inc. v. Alamo Sav. Ass’n*, 611 S.W.2d 706, 708 (Tex. App. – San Antonio 1980, no writ). However, in the case of a patently ambiguous policy, there should be no need for the admission of extrinsic evidence. In cases of patent ambiguity in an insurance policy, the court applies the doctrine of *contra proferentem* and construes the policy in favor of the insured and against the insurer on the theory that the insurer drafted the policy and should bear the adverse consequences for doing so with less than absolute clarity. *See Puckett v. U.S. Fire Ins. Co.*, 678 S.W.2d at 938. If the ambiguous provision is an exclusion, then the court must adopt the insured’s interpretation even if the insurer’s interpretation is more reasonable or makes more sense in the context of the entire policy. *Vaughan*, 968 S.W.2d at 933; *National Union Fire Ins. Co. v. Hudson Energy Co.*, 811 S.W.2d 552, 555 (Tex. 1991).

B. The Role of “Surrounding Circumstances”

Originally, Texas law only sanctioned examination of the terms of the policy when interpreting an unambiguous contract. *Brown v. Palatine Ins. Co.*, 89 Tex. 590, 35 S.W. 1060, 1061 (1896). Under this strict approach to the interpretation of an unambiguous contract, evidence of the circumstances surrounding its formation would be deemed parol evidence and not considered. *New York Cas. Co. v. Ford*, 145 F.2d 599, 601 (5th Cir. 1944).

However, in the early 1980's, the Texas Supreme Court began to abandon this approach and permit the consideration of the surrounding circumstances in deciding whether a contract was unambiguous. *Airmark, Inc. v. Advanced Systems, Inc.*, 715 F.2d 229, 230 (5th Cir. 1983); *Ideal Mutual Ins. Co. v. Last Days Evangelical Ass'n, Inc.*, 783 F.2d 1234, 1238 (5th Cir. 1986). In *Sun Oil Co. v. Madeley*, 626 S.W.2d 726, 731 (Tex. 1981), the Texas Supreme Court ruled that "[e]vidence of surrounding circumstances may be consulted" in deciding whether a written instrument is unambiguous. "If, in the light of surrounding circumstances, the language of the contract appears to be capable of only a single meaning, the court can confine itself to the writing" alone in interpreting the contract. *Id.* Consideration of surrounding circumstances to determine whether a contract was ambiguous was extended to insurance contracts a year later in *Aetna Life & Cas. Co. v. Gunn*, 628 S.W.2d 758, 760 (Tex. 1982).

As discussed above, this rule does *not* apply to other types of extrinsic or parol evidence. For that type of evidence, the rule is that it cannot be used to create an ambiguity. *Lang*, 35 S.W.3d at 640. After *Madeley*, however, that prohibition did not apply to evidence of surrounding circumstances. As will be discussed in greater detail below, the difficulty sometime lies in distinguishing admissible evidence of "surrounding circumstances" from irrelevant and inadmissible parol evidence.

1. Conflict Between the Parol Evidence Rule and Consideration of Surrounding Circumstances

As the frequently-cited contract interpretation rules demonstrate, extrinsic or parol evidence is not relevant to the construction of an unambiguous contract. However, consideration should be given to the circumstances surrounding the formation of the contract. What is less than clear is the line of demarcation between evidence of "surrounding circumstances", which has significant ramifications for the scope of issues to which discovery must be relevant.

In this connection, it is helpful to revisit the distinction postulated in the case that recognized the need to consider evidence of surrounding circumstances in construing contracts, *Sun Oil Co. v. Madeley*. In that case, the Court explained:

... [T]here must always be an association between words and external objects, and no matter how definite a contract may appear on its face, "words must be translated into things and facts." Thus ... the contract [must] be appraised in view of the surrounding circumstances *known to the parties at the time of its execution* and these reasonably could be looked to without violating the parol evidence rule even though the contract were not deemed ambiguous....

... In interpreting contracts or clauses set forth in "clear and unambiguous" language, the courts do not confine themselves to a mere inspection of the document. Before committing themselves, the courts carefully examine the surrounding circumstances, prior negotiations, and all other relevant incidents bearing on the intent of the parties....

... Only after a careful and painstaking search of all the factors shedding light on the intent of the parties, only after "turning signs and symbols into equivalent realities" will the court conclude that the language in any given case is "clear and unambiguous."

Madeley, 626 S.W.2d at 731, 731 n. 5 (quoting 4 *Williston on Contracts* §§ 600A, 609 (3rd Ed.1961)).

As originally formulated, then, "surrounding circumstances" referred to the things that both parties to the contract knew and so took for granted that they deemed it unnecessary to explicitly mention them in their agreement. It did not and does not include the parties' statements of intent when the contract was made. *Birmingham Fire Ins. Co. v. American Nat'l Fire Inc. Co.*, 947 S.W.2d 592, 603 (Tex. App. – Texarkana 1997, pet. denied). As will become apparent shortly, the seemingly simple notion of the circumstances surrounding the formation of the contract has not remained so clear.

2. Matters Considered as "Surrounding Circumstances"

a. Trade-Specific Meanings

It is clear, however, that one of the best examples of "surrounding circumstances" is evidence of the

specialized meanings of jargon used in a specific trade or industry. Given that surrounding circumstances should be considered in the construction of contracts, it logically follows that it would be both necessary and appropriate to consider specialized or technical meanings of words accepted in a given industry as part of the “surrounding circumstances” to the formation of the contract. Evidence of trade usage is allowed when “the meaning to which a term or phrase is most reasonably susceptible is one which is so regularly observed in place, vocation, trade or industry ... as to justify an expectation that it will be observed with respect to a particular agreement.” *CBI Indus.*, 907 S.W.2d at 521 n.6.

Texas law is well-settled that expert testimony of industry custom is admissible to explain the meaning of technical terms used in an industry. *Zurich American Ins. Co. v. Hunt Petrol. (AEC), Inc.*, 157 S.W.3d 462, 466 (Tex. App. – Houston [14th Dist.] 2004, no pet.); *Royal Indem. Co. v. Marshall*, 378 S.W.2d 364, 370 (Tex. Civ. App. – Austin 1964), *rev'd on other grounds*, 388 S.W.2d 176 (Tex. 1965). The admissibility of such testimony does not depend on the existence of an ambiguity. *PCI Transp., Inc. v. Fort Worth & Western Ry. Co.*, 418 F.3d 535, 542 (5th Cir. 2005).

Rather, admissibility requires evidence that the custom or usage was generally known in the industry or had been established for a sufficiently long time to become generally known., and that it was known to all the parties to the contract or that the parties had contracted with reference to that custom or usage. *Texas Gas Exploration Co. v. Broughton Offshore, Ltd. II*, 790 S.W.2d 781, 785-86 (Tex. App. – Houston [14th Dist.] 1990, no pet.); *Arnold D. Kamen & Co. v. Young*, 466 S.W.2d 381, 386 (Tex. Civ. App. – Dallas 1971, writ ref'd n.r.e.). Obviously, to meet this standard, it is necessary for both parties to participate in the same industry. *Oil Ins. Ass'n v. Royal Indem. Co.*, 519 S.W.2d 148, 150 (Tex. Civ. App. – Houston [14th Dist.] 1975, writ ref'd n.r.e.).

If, for example, one party is engaged in the oil and gas business, and the other is part of the aerospace industry, expert testimony about the specialized meaning of a word used in the aerospace industry is not appropriate. *Id.* Rather, when the parties are engaged in disparate industries, the terms of the contract should be given their plain, ordinary meaning. *Id.*; *see also Millers Mut. Fire Ins. Co. v.*

Schwartz, 312 S.W.2d 313 (Tex. Civ. App. – San Antonio 1958, no writ); *Crombie & Co. v. Employers Fire Ins. Co. of Boston*, 250 S.W.2d 472 (Tex. App. – El Paso 1952, writ ref'd n.r.e.).

However logical the rules concerning consideration of specialized or technical meanings of terms used in a particular industry may be, they have been overlooked in some recent insurance decisions.

1) Ambiguity Not Required, Part I: Arguably Correct Result, Wrong Reason

For example, *Mescalero Energy, Inc. v. Underwriters Indem. General Agency*, 56 S.W.3d 313, 316 (Tex. App.--Houston [1st Dist.] 2001, pet. denied), involved a coverage dispute over a policy endorsement that expanded coverage to include losses resulting from a “blowout”, which was defined to include any “sudden, accidental, uncontrollable and continuous flow of oil, gas or water simultaneously between two or more separate formations.” The insured had been required to abandon equipment below ground as part of measure to control an uncontrolled flow of oil, gas, and water. *Id.* The insurer questioned coverage for this loss, maintaining that the insured had not experienced a “blowout” between two separate formations, but instead lost normal fluid circulation because of excessive pressure in a lower strata of the same formation. *Id.* at 316 n.4.

Both insurer and insured asserted differing definitions of “formation” and “blowout” from treatises and moved for summary judgment based on the affidavits of experts to support their respective coverage positions. Before considering this evidence, the court went through a lengthy analysis of ambiguity to circumvent the general rule that extrinsic evidence cannot be used to create an ambiguity. After a tedious analysis of the rules concerning ambiguity, the court concluded that resorting to expert testimony was not inadmissible merely because it was information extrinsic to the contract. *Id.* at 323.

Arguably, the court’s ambiguity analysis was unnecessary. The rule that extrinsic evidence cannot be used to create an ambiguity has no relevance when the evidence in question concerns the “surrounding circumstances” – i.e., the context – in which the contract was formed. For example, the courts routinely presume the parties to a contract knew the laws affecting matters about which they contracted

and intended to comply with them. Unless a contrary intention appears on the face of the agreement, the courts accept existing law as part of the legal context in which the contract was formed. *Colo. Interstate Gas Co. v. Hunt Energy Corp.*, 47 S.W.3d 1, 8 (Tex. App. – Amarillo 2000, pet. denied); see *Hardware Dealers Mut. Ins. Co. v. Berglund*, 393 S.W.2d 309, 315 (Tex.1965); *Grounds v. Tolar Indep. Sch. Dist.*, 694 S.W.2d 241, 244 (Tex. App. – Fort Worth 1985), *rev'd on other grounds*, 707 S.W.2d 889 (Tex.1986).

Similarly, parties engaged in a particular industry are presumed to use technical terms in accordance with the meaning customarily given those terms in a given industry. Accordingly, as part of establishing the “surrounding circumstances,” extrinsic evidence may be considered to establish the industry understanding of terms regardless of whether the contract is ambiguous. *G.T.E. Southwest v. Public Util. Comm’n of Texas*, 102 S.W.3d 282, 295 (Tex. App. – Austin 2003, pet. dism’d by agr.); e.g., *Monesson v. Champion Int’l Corp.*, 546 S.W.2d 631, 637 (Tex.App. – Tyler 1976, writ ref’d n.r.e.)(ambiguous contract); *Intratex Gas Co. v. Puckett*, 886 S.W.2d 274, 278 (Tex.App.-El Paso 1994, no writ)(unambiguous contract). This aspect of the commercial environment in which the contract was formed is part of the “surrounding circumstances.” And, at least since *Sun Oil Co. v. Madeley*, 626 S.W.2d at 731, was decided in 1981, those circumstances must be considered in ascertaining the objective intent of the parties. *Intratex Gas Co.*, 886 S.W.2d at 278; see also *Southwestern Bell Tel Co. v. Public Util. Comm’n of Texas*, 208 F.3d 475, 486 (5th Cir. 2000).

The interesting issue not discussed in *Mescalero* was whether it was appropriate to consider expert testimony about the custom and practices of the oil and gas industry when both parties were not both involved in that industry. While the court rejected the testimony of two witnesses because they failed to show industry-wide acceptance of their proffered definitions, 56 S.W.3d at 322, the court did not address the fact that the insurer and the insured were not involved in the same industries as required in *Oil Ins. Ass’n*, or why the “plain meaning” rule that controls when parties are engaged in disparate occupations did not apply in that case. One can speculate, however, that the issue did not occur to either the parties or the courts because the insurer had come to the risk. That is, the insurer elected to write

specialized coverage for a specialized industry. Given that election, it would not have been unfair to hold the insurer to the standard of the insured’s industry when it uses industry specific terms like “formation” and “blowout.”

2) Ambiguity Not Required, Part II: Wrong Result, Wrong Reason

In *Royal Maccabees Life Ins. Co. v. James*, 146 S.W.3d 340 (Tex. App.—Dallas 2004, pet. denied), like the court in *Mescalero*, the Dallas Court of Appeals went to great lengths to find ambiguity in order to justify the admission of expert testimony on a term with an alleged technical meaning in the insurance industry. At issue in *James* was whether the insured under a group life policy was qualified at death to receive an optional additional death benefit for which he had applied before dying and for which he paid premiums, but for which he was never approved by the carrier. The group policy provided that an insured would be eligible only for the “non-medical” portion of the group policy until the company reviewed the medical evidence of insurability and approved the applicant in writing. *Id.* at 348. Claiming that “non-medical” had a specialized meaning in the insurance industry, the plaintiff offered and the trial court received testimony from an insurance expert witness who testified that in the insurance industry “non-medical” insurance meant life insurance. *Id.* at 348. On the basis of that testimony, the jury found that the insurer breached its contract with the insured.

As in *Mescalero*, it was unnecessary to engage in the ambiguity analysis at all. If it was appropriate to receive expert testimony about the specialized meaning of “non-medical” in the insurance industry as part of the “surrounding circumstances” in which the life insurance contract was formed, it was not necessary that an ambiguity be established. However, *unlike* the circumstances in *Mescalero*, the reception of a testifying expert on the meaning of “non-medical” in the insurance industry was not consistent with the recognized predicates required by Texas law. First, the insurer and the insured were not engaged in the insurance industry. The plaintiff was a consumer who, as far as can be ascertained from the opinion, had no experience in the life insurance business except as a consumer. Thus, consideration of the testimony cannot be reconciled with existing cases requiring that both parties be in the same industry

before custom and usage in that industry is part of the “surrounding circumstances” of the transaction.

Second, consideration of the particular expert testimony in *James* was inconsistent with the requirement enunciated in its prior decision in *Young* that the expert must prove that the usage was generally known in the industry or had been established for a sufficiently long time to become generally known., and that it was known to all the parties to the contract or that the parties had contracted with reference to that custom or usage.

3) A Better Example

A better example of the proper treatment of expert testimony on the specialized meaning of terms within a given industry is *Zurich American Ins. Co. v. Hunt Petrol. (AEC), Inc.*, in which Zurich, as its insured’s subrogee, sued Hunt for equipment leased by Hunt from Zurich’s insured that was damaged when it was submerged in saltwater floods. 157 S.W.3d at 463. Zurich urged that lease agreement made the lessee liable for this damage by virtue of a provision under which the lessee assumed liability for damage resulting from “exposure to highly corrosive elements.” The lessee, however, urged that exposure to saltwater fell under the exception to liability for damage caused by storms. *Id.* at 464. To support its position on motion for summary judgment, each party offered expert testimony that “highly corrosive” elements had a specialized meaning in the oil and gas industry and, predictably, that this specialized meaning supported the position of the sponsoring party in the litigation. The court of appeals concluded that summary judgment was inappropriate because the conflicting expert testimony raised a fact issue as to whether “highly corrosive” had any specialized meaning universally understood by participants in the oil and gas industry. *Id.* at 467. Moreover, the court ruled that even under the plain language of the agreement, the parties could advance differing reasonable interpretations supporting their positions and, therefore, the provisions in the lease were ambiguous.

While *Hunt Petrol.* is not an insurance case, by comparison, it illustrates how the insurance cases discussed above cannot be reconciled with previous holdings concerning the use of expert testimony on the specialized meaning of terms within an industry. Such testimony is, in this writer’s opinion, correctly

limited to those situations where the parties are involved in or have clearly incorporated such specialized meanings in their written agreements and the expert testimony establishes true universality.

b. Drafting History

As previously discussed, the Texas Supreme Court in *Madeley* justified the need to exempt “surrounding circumstances” from the operation of the parol evidence rule on the basis of realism. That is, it simply was unrealistic in a fast-paced and vital commercial society that parties to contracts would bother to memorialize things that both accepted as part of the environment in which they reached their agreement. In a contract between insurers, it is understandable how the history of a particular policy form or endorsement might form part of the backdrop against which they reached their agreement.

Outside that context, however, it is not clear how evidence of the circumstances surrounding an agreement includes consideration of the history of the drafting of a policy form. Nevertheless, under the rubric of considering the “surrounding circumstances” of the formation of a policy of homeowners insurance, the Texas Supreme Court in *Balandran v. Safeco Ins. Co. of America*, 972 S.W.2d 738, 741 (Tex. 1998), considered the drafting history of a homeowner’s policy to create an ambiguity.

1) Originally Not Considered

Indeed, before the Texas Supreme Court weighed in on the issue, the Fifth Circuit repeatedly made its *Erie* guess that Texas would not permit the drafting history of a policy form to be used to create an ambiguity.

In *Constitution State Ins. Co. v. Iso-Tex, Inc.*, 61 F.3d 405 (5th Cir. 1995), the Fifth Circuit confronted an argument very similar to that presented in *CBI Indus.* shortly after the original opinion in *CBI Indus.* was issued. In *Iso-Tex*, the insured whose business involved handling radioactive waste was sued by residents near one its storage facilities for deaths and injuries allegedly caused by their exposure to the wastes stored nearby by the insured. *Id.* at 406-07. Its liability policy contained an absolute pollution exclusion, but omitted the nuclear material exclusion that had been incorporated in prior policies. *Iso-Tex* argued that the deletion of the nuclear material

exclusion rendered the policy ambiguous about whether it excluded liability for alleged contamination for hazardous wastes.

The Fifth Circuit refused, however, to permit the insured “to manufacture an ambiguity from a comparison of the previous and present policies” which Iso-Tex had urged in the trial court on the basis of “industry custom and the clauses’ regulatory history before the Texas Insurance Board.” *Id.* at 408. Relying on the original opinion in *CBI Indus.*, the court held that the pollution exclusion was facially unambiguous and absolute. As to the effect of the nuclear materials exclusion in prior policies, the court observed:

Given the strict rules of construction against a drafter, an insurance provider would be motivated to draft overlapping and redundant clauses which exclude coverage for the same conduct.

Id. at 409. For that reason, the court refused to consider the omission of the nuclear exclusion as evidence of an intent to cover contamination by nuclear materials despite the presence of an “absolute” pollution exclusion.

If the court in *Iso-Tex* had given some credence to the drafting history of the insured’s own policy, it would have at least been understandable as consideration of the “surrounding circumstances.” After all, both the insured and the insurer knew the history of their dealings with each other. Two years later, and relying on the opinion on rehearing in *CBI Indus.*, the Fifth Circuit again refused to permit a drafting history of which the insured would have been totally unaware to create an ambiguity in a homeowner’s policy. *Sharp v. State Farm Fire & Cas. Ins. Co.*, 115 F.3d 1258, 1262 (5th Cir. 1997).

In *Sharp*, the insured argued that historical treatment of an exception to an exclusion for damages to the *residence* created an ambiguity in a policy after that exception was moved to part of the policy that only dealt with *personal property*. Specifically, the homeowners’ policy contained two insuring agreements: Coverage A all-risks coverage for the dwelling, and Coverage B specified perils coverage for personal property. The dwelling coverage excluded losses due to “settling, cracking, bulging, shrinking, or expansion of foundations” or other parts

of the house. *Id.* at 1261. However, the personal property coverage contained a provision that specifically included coverage for damage caused by plumbing leaks. *Id.* This coverage further provided that the loss covered for plumbing leaks included “the cost of tearing out and replacing any part of the building necessary to repair or replace the system” but not the repair to the system itself. *Id.*

The Sharps’ house had been damaged by foundation movement as the result of a subsurface plumbing leak. *Id.* at 1260. The Sharps attempted to point out that the previous version of the homeowners policy specifically covered the dwelling for the very type of damages named in the specific personal property perils included in their current policy. They reasoned that because the committee that revised the policy form was not charged with substantive changes, the policy form should have included coverage for their loss. *Id.*, at 1262.

In rejecting this argument, which the Texas Department of Insurance supported, the Fifth Circuit refused to treat the drafting history of the homeowners policy form as a “surrounding circumstance” that it could take into account in ascertaining the objective intentions of the parties. Instead, it considered the drafting history as “a form of extrinsic evidence” and ruled that “the prior version of the standardized policy is not relevant unless the current policy is found to be ambiguous.” Because it was not, the insureds could not “point to the revision process to create an ambiguity.” *Id.* at 1262.

2) Texas Supreme Court Treats Drafting History as “Surrounding Circumstances”

a) *Balandran*

When the same issue arose a year later, the Fifth Circuit certified the question to the Texas Supreme Court, which reached a completely opposite conclusion. In *Balandran*, the Texas Supreme Court ruled that the homeowners’ policy was ambiguous because it was subject to two reasonable interpretations: 1) the interpretation adopted in *Sharp* that the loss to the dwelling was excluded because the plumbing leak exception had been moved so that it only applied to personal property; and 2) the interpretation that the exception for plumbing leaks in the personal property section overrode the effect of the foundation movement exclusion. However, in

reaching that conclusion and adopting the construction most favorable to the insured, the Court explained that the insured's interpretation was more reasonable because in light of the circumstances under which the policy form was drafted. *Balnadran*, 972 S.W.2d at 741-42.

The Court first noted the fact that the carriers were required by law to use a prescribed policy form. It then noted that the committee formed by regulators to draft the form presented it the regulators with the statement that its attempt to convert the policy into an "easy-to-read" form had been accomplished without restricting the coverage that had been available under the previous version of the policy. *Id.* at 742. According to its opinion, the majority clearly treated the drafting history as part of "the circumstances surrounding" not the formation of the contract between the insurer and the insured, but the "promulgation of the policy." *Id.*

Nevertheless, it treated that history as if it were a conventional "surrounding circumstance" to the agreement between the insurer and the insured even though there was absolutely no mention in the opinion of whether the insureds were aware of that history before or even after purchasing the policy. the Court explained:

While parol evidence of the parties' intent is not admissible to create an ambiguity... , the contract may be read in light of the surrounding circumstances to determine whether an ambiguity exists.

Id. (citations omitted). The Court concluded:

The circumstances surrounding the drafting of this policy thus support the Balandran's theory that the exclusion repeal provision [for plumbing leaks] is located within coverage [for personal property] merely to simply the policy, not to restrict the scope of the exclusion repealed.

Id. (emphasis added).

That the Court's decision to treat the drafting history as a "surrounding circumstance" was not accidental is made clear by the fact that it made that decision in the face of a blistering dissent charging that the policy was unambiguous on its face and that

the Court had resorted "to inadmissible extrinsic evidence to find support for its construction of the policy." *Id.* at 745.

b) *King*

In *King v. Dallas Fire Insur. Co.*, 85 S.W.3d 185, 192 (Tex. 2002), the Texas Supreme Court again examined drafting history as part of interpreting a policy for purposes of deciding whether a liability carrier was obligated to defend its insured. In *King*, however, unlike *Balandran*, the policy was a Commercial General Liability (CGL) policy which is not prescribed by regulators. At issue in *King* was whether moving the phrase "expected or intended from the standpoint of the insured" from the insuring agreement to an exclusion for expected or intended injuries had the effect of eliminating coverage for harm that an actor inflicted intentionally, even if the actor was not the insured. *Id.* at 187.

In reaching its conclusion that the insurer was obligated to defend an employer against allegations of negligent hiring an employee who assaulted another worker on the job, the Court looked to the "evolution" of the commercial general liability policy to confirm its decision. Relying upon a well known insurance encyclopedia, the Court looked at the development, including drafts and redrafts, of the current and previous versions of the policy form. Curiously, unlike its action in *Balandran*, the Court never invoked the "surrounding circumstances" doctrine as the basis for its consideration of extrinsic evidence concerning drafting history. Moreover, the Court never indicated that it found the policy ambiguous before considering the drafting history of the policy.

3) Partial Reconciliation and Uncertainty

The use of drafting history in *King* irreconcilably conflicts with the holding in *CBI Indus.* foreclosing consideration, absent ambiguity, of the testimony of industry representatives before the Texas State Board of Insurance which the insured contented showed that the absolute pollution was not intended to eliminate all forms of pollution coverage. Even after *Balandran*, the lower appellate courts adhered to the narrower view of *CBI Indus.* that drafting history was extrinsic evidence in violation of the parol evidence rule if the policy were not ambiguous. *See, e.g., Mesa Operating Co. v. California Union Ins. Co.*, 986 S.W.2d 749, 757 (Tex. App. – Dallas 1999, pet.

dism'd)(refusing to consider drafting history of the "sudden and accidental" pollution exclusion when exclusion was found to be unambiguous); *Gulf Metals Indus., Inc. v. Chicago Ins. Co.*, 993 S.W.2d 800, 808 (Tex. App. – Austin 1999, pet denied).

Before *King*, *CBI Indus.* and *Balandran* were reconcilable. In *Balandran*, the regulators' drafting history could rationally be considered "surrounding circumstances" to the formation of the policy's terms. The drafting history was part of the working knowledge and understanding of the drafters. And, when the policy form is mandated by regulators, the Texas Supreme Court considers the knowledge and intent of the regulators who drafted the policy form, not the intent of the insurer and the insured. *Sink*, 107 S.W.3d at 552; *Boyer*, 269 S.W.2d at 341. Agree or disagree with the conclusion as to ambiguity, *Balandran* was certainly consistent with its declaration in *Madeley* that the "surrounding circumstances" of the formation of contracts should be considered when interpreting the contract to place it in its appropriate context.

Of course, the policies involved in *Mesa Operating* and *Gulf Metals* did not involve a prescribed policy form the way *Balandran* did. It was understandable, therefore, that the appellate courts in those cases chose to follow *CBI Indus.* rather than *Balandran* in the way they treated drafting history. Because they were not concerned, like the court in *CBI Indus.* with a prescribed policy form, the drafting history of the form would not have been something necessarily known to the insureds and, therefore, not something that could be considered as part of the "surrounding circumstances."

The decision in *King*, however, cannot be so explained. It did not involve a prescribed policy form. The drafting history there could not have been properly considered as "surrounding circumstance" because there was no showing that such history was known to *both* parties to the policy. As such, *King* is an aberration to the extent that one tries to place it in a framework that harmonizes all of the cases dealing with drafting history as a "surrounding circumstance."¹

¹ Interestingly, the Texas Supreme Court reached a very *King*-like interpretation of a policy in *Utica Nat'l Ins. Co. of Texas v. American Indem. Co.*, 141 S.W.3d 198, 202 (Tex. 2004). There, after commenting that the policy there was a state prescribed form, the court construed an

c. TDI Bulletins and Underwriting Manuals

Given the unresolved conflict between *King* and *CBI Indus.*, it is interesting to consider how the Texas Supreme Court will treat reliance on bulletins from the Texas Department of Insurance commenting on the scope of coverage and the interpretation of the policy. The Texas Supreme Court has held that the contemporaneous construction of a statute by the agency charged with its enforcement is entitled to great weight. *State v. Public Utility Comm'n of Texas*, 883 S.W.2d 190, 196 (Tex. 1994). Nevertheless, the courts of appeals have refused to consider them. In *Safeway Managing Gen. Agency v. Cooper*, 952 S.W.2d at 866, the insureds urged consideration of a coverage form prescribed by regulators and the insurer's underwriting manual in an effort to have the policy construed in his favor. The court treated both the TDI form and the underwriting manual, not as part of the surrounding circumstances, but rather as parol evidence which could not be considered to create an ambiguity.

In *Carlton v. Trinity Universal Ins. Co.*, 32 S.W.3d 454, 460 (Tex. App. – Houston [14th Dist.] 2000, pet denied), the plaintiffs in a class action to recover post-repair diminution in value to their automobiles urged *a la Balandran* that the court should interpret auto policies in light of a bulletin from the Texas Department of Insurance indicating that it believed that the Texas auto policy required such payments. Without noting whether the policies were a prescribed policy, the court indicated that the intent of the regulators would be relevant if the policy were ambiguous. However, the court held that the policy was unambiguous and treated the bulletin from TDI as impermissible parol evidence.

The Dallas Court of Appeals took a stronger stand against consideration of TDI bulletins in *Bailey v.*

exclusion for injuries "due to" the rendition of professional services to not eliminate coverage for injuries that arose in the course of the rendition of a professional service but which was not caused by the professional service itself. *Id.* Before noting that the policy was written on a prescribed policy form, the Court noted that "[r]easonable expectations are often affected by the conditions surrounding the formation of policy language and by the type of clause at issue." *Id.* Unlike *King*, however, the Court did not invoke drafting history as part of the justification for its interpretation.

Progressive County Mutual Insur. Co., 78 S.W.3d 708, 713 (Tex. App.--Dallas 2002, no writ). In that case, it held that the four corners of the contract and the basic rules of contract construction control the interpretation of the policy, not the position taken by the Texas Department of Insurance in a bulletin. The court noted that there was nothing in the case law to suggest that “deference should be given to TDI on a contractual interpretation issue, where the sole objective is to determine the intent of the parties.” *Id.* at 713. Importantly, the court observed that reliance on such evidence was unnecessary because the rules of construction require, in the face of an ambiguity, that the court adopt the construction most favorable to the insured, not the insurer.

Based on these authorities, and the rationale underlying the consideration of drafting history as part of the circumstances surrounding the formation of a contract, it appears that TDI forms and bulletins, to the extent that they opine on non-prescribed policy forms, are not relevant as part of the “surrounding circumstances” concerning the formation of the policy.

C. Other Bases For Parol Evidence

In the interest of completeness, it should be noted that extrinsic evidence can also be relevant and admissible for contracts that are not ambiguous on their face. For example, parol evidence is permitted if the policy was allegedly induced by fraud or misrepresentation. *Fidelity-Phenix Fire Ins. Co. v. Farm Air Serv., Inc.*, 255 F.2d 658, 662 (5th Cir. 1958). However, to be admissible on grounds of fraud or misrepresentation, it must be alleged that the insured relied on the misrepresentation. A party to an insurance contract cannot resort to extrinsic evidence to show misrepresentation if the policy was accepted and retained when the insured was aware of the true facts. *McDaniel v. California Western States Life Ins. Co.*, 181 F.2d 606, 608 (5th Cir. 1950). The parol evidence rule also does not apply when it is alleged that, because of a mutual mistake of both parties, the contract between them does not reflect their true agreement. *Atlantic Lloyds Ins. Co. v. Butler*, 137 S.W.3d 199, 212-213 (Tex. App. – Houston [1st Dist.] 2004, no pet.); *Marcuz v. Marcuz*, 857 S.W.2d 623, 627 (Tex. App. – Houston [1st Dist.] 1993, no writ).

IV. Relevant Issues in Construing Pleadings

Extrinsic evidence may be relevant not only to interpret the policy, but also in the decision of whether allegations in an underlying liability suit invokes a duty to defend under a liability policy. Typically, liability insurance policies provide that the insurer will defend the insured for liability claims that would be covered under the policy even if the allegations are false or fraudulent.

A. Generally: Controlled Only by Facts Alleged

Based on this policy language, the duty to defend is determined by the factual allegations in the petition in the underlying liability suit in light of the policy’s provisions without reference to whether the allegations are true or false. *Heyden Newport Chem. Corp. v. Southern Gen. Ins. Co.*, 387 S.W.2d 22, 24 (Tex. 1965). In *National Union Fire Ins. Co. v. Merchant’s Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997), the Texas Supreme Court made clear that, in reviewing the underlying pleadings to determine whether they fall within the ambit of the losses covered under the liability policy, “the court must focus on the factual allegations that show the origin of the damages rather than the legal theories alleged.”

The insurer is obligated to defend if any set of facts alleged under any cause of action would be covered under the policy, even though alternative facts are asserted that would not be covered. *St. Paul Ins. Co. v. Texas Dept. of Transp.*, 999 S.W.2d 881, 884 (Tex. App. – Fort Worth 1999, pet. denied). Only the facts, not the legal theories, alleged in the underlying suit are considered in determining the duty to defend. *St. Paul Surplus Lines Ins. Co. v. Geo Pipe Co.*, 25 S.W.3d 900, 903 (Tex. App. – Houston [1st Dist.] 2000, no pet.) (op. on reh’g). Any ambiguities in the pleadings must be resolved in favor of defending the insured. *Merchant’s Fast Motor Lines*, 939 S.W.2d at 141. If any set of facts alleged, if true, would make the insured liable for a covered loss, then the carrier is obligated to defend the insured. *Rhodes v. Chicago Insurance Co.*, 719 F.2d 116, 117 (5th Cir. 1983) (applying Texas law); *Maryland Casualty Co. v. Moritz*, 138 S.W.2d 1095, 1097-98 (Tex. Civ. App. -- Austin 1940, writ ref’d); *see also Mary Kay Cosmetics, Inc. v. North River Insurance Co.*, 739 S.W.2d 608, 612 (Tex. App. -- Dallas 1987, no writ); *Colony Insurance Co. v. H. R. K., Inc.*, 728 S.W.2d 848, 850 (Tex. App. -- Dallas 1987, no writ). But, if the pleading against the insured only states facts

supporting a liability that would be excluded under the policy, the insurer is not obliged to defend. *Allstate Ins. Co. v. Hallman*, 159 S.W.3d 640, 643 (Tex. 2005); *Fidelity & Guaranty Ins. Underwriters, Inc. v. McManus*, 633 S.W.2d 787, 788 (Tex. 1982).

B. When the Pleadings Are Silent or Leave Doubts

Although the complaint-allegation or “eight corners” rule is based on the policy language, it does not address what happens when the pleadings are completely silent about a fact that is crucial to the coverage determination. And the opinions concerning the issue are less than completely consistent. On one hand, the Texas Supreme Court has said that an insurer is not obligated to read into the pleadings facts not alleged. If the petition fails to allege facts within the scope of coverage, the insurer is not obligated to defend. *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 187 (Tex. 2002); *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 821 (Tex. 1997); *American Physicians Ins. Exchg. v. Garcia*, 876 S.W.2d 842, 848 (Tex. 1994). This statement of the rule appears to leave no middle ground. While the insurer must liberally construe pleadings in favor of defending the insured, if the facts alleged are not sufficient to state a claim that would be covered, then there would be no duty to defend under this approach.

However, the Texas Supreme Court has also indicated that when a petition or complaint to bring the alleged liability within or without coverage under the policy, the insurer is obligated to defend the insured if the petition or complaint “potentially” states a covered claim. *Merchants Fast Motor Lines, Inc.*, 939 S.W.2d at 141; *Heyden Newport Chem. Corp.*, 387 S.W.2d at 26. Apparently, this iteration of the duty-to-defend test involves an intended combination of the strict version of the complaint allegation rule with the rule that pleadings must be liberally construed in favor of the insured.

The difference between the former and latter versions of the duty-to-defend formulation is not merely semantic. Indeed, it has a significant impact on the scope of relevant issues for discovery and trial and can even be outcome determinative. For example, in *Cowan*, the liability plaintiff alleged that she sustained mental anguish but failed to allege any facts that she suffered any physical symptoms necessary for the recovery of mental anguish damages. Despite previously stating that insurers should defend in cases

where there was the potential for a covered liability, the Court refused to imply that plaintiff suffered physical symptoms of the alleged mental anguish. 945 S.W.2d at 825.

Guaranty Nat’l Ins. Co. v. Azrock Indus., Inc., 211 F.3d 239, 251 (5th Cir. 2000), was an asbestos exposure case. In it, the plaintiffs alleged the dates of their employment, but they failed to allege or even suggest when they were allegedly exposed. The Fifth Circuit, relying on the strict duty-to-defend rule in *Cowan*, refused to “read into” the petition when the exposure occurred and concluded that, without allegations concerning when the exposure occurred, it would not impose a duty to defend on the insurer. The Texas Supreme Court itself reached a similar result in *Garcia*, in which it held that there was no duty to defend a suit alleging medical malpractice until, on the day of trial, the plaintiff specifically alleged when the alleged malpractice occurred. 876 S.W.2d at 848. As these examples show, the results would have been very different if the courts had been able to consider evidence outside the pleadings.

C. Exception for Facts Immaterial to Liability

Under either formulation of the complaint-allegation rule, there are cases where coverage turns on facts that would never be material to the merits of the underlying suit. The prohibition against extrinsic evidence for determining the duty to defend under the complaint-allegation rule was to prevent insurers from refusing to defend based on the relative merit of the underlying suit. *Tri-Coastal Contractors, Inc. v. Hartford Underwriters, Ins. Co.*, 981 S.W.2d 861, 863 (Tex. App. – Houston [1st Dist.] 1998, pet. denied).

1. Omitted Facts Only Germane to Coverage

Some courts, therefore, recognized the need for an exception to complaint-allegation rule where the facts omitted were not material to the resolution of the underlying liability suit. *Cook v. Ohio Cas. Ins. Co.*, 418 S.W.2d 712, 714 (Tex. Civ. App. – Texarkana 1967, no writ); *International Serv. Ins. Co. v. Boll*, 392 S.W.2d 158, 160-61 (Tex. Civ. App. – Houston 1965, writ ref’d n.r.e.). They hold that

when the petition in the underlying lawsuit does not allege facts sufficient for a determination of whether [the] facts [alleged in the petition], even if true, are covered by

the policy, the evidence adduced ... in a declaratory judgment action [to determine duty to defend] may be considered along with the allegations in the underlying petition.

Gonzalez v. American States Inc. Co. of Texas, 628 S.W.2d 184, 187 (Tex. App. – Corpus Christi 1982, no writ).

Under this exception, the courts have allowed consideration of extrinsic evidence to resolve the following issues not addressed by the pleadings:

1. whether the defendant was an insured under the liability policy, *Cook*, 418 S.W.2d at 714; *Boll*, 392 S.W.2d at 161; *Blue Ridge Ins. Co. v. Hanover Ins. Co.*, 748 F.Supp. 470, 473 (N. D. Tex. 1990)
2. whether an exclusion applied to the loss where the facts making the exclusion applicable were not material to the liability determination, *Guaranty Nat'l Ins. Co. v. Vic Mfg. Co.*, 143 F.3d 192, 195 (5th Cir. 1998)(whether discharge of excluded pollution was “sudden and accidental”); *Western Heritage Ins. Co. v. River Entertainment*, 998 F.2d 311, 314 (5th Cir. 1993)(liquor liability exclusion) ; *State Farm Fire & Cas. Co. v. Wade*, 827 S.W.2d 448, 452 (Tex. App. – Corpus Christi 1992, writ denied)(boat liability policy exclusion for business pursuits);
3. whether a loss was in progress or known to the insured before the policy was written, *Encore Homes, Inc. v. Assurance Co. of America*, 2000 WL 798192 (N. D. Tex., 2000); *Essex Ins. Co. v. Redtail Prods., Inc.*, 1998 WL 812394 (N. D. Tex., 1998); *but see Ryland Group, Inc. v. Travelers Indem. Co.*, 2000 WL 33544086 (S.D. Tex. 2000); *Scotsdale Ins. Co. v. Travis*, 68 S.W.3d 72, 75 (Tex. App. – Dallas 2001, pet. denied); *Westchester Fire Ins. Co. v. Gulf Coast Rod, Reel & Gun Club*, 64 S.W.3d 609, 613-14 (Tex. App. – Houston [1st Dist.] 2001, no pet.); *E. L. Chipping Co. v. Hanover Ins. Co.*, 962 S.W.2d 272, 276 (Tex. App. – Beaumont 1997, no pet.);
4. whether the property involved was insured under the policy, *John Deere Ins. Co. v. Truckin' U.S.A.*, 122 F.3d 270, 273 (5th Cir. 1997)(vehicle in an auto policy); *Nat'l Gen. Ins. Co. v. Hunter*, 2001 WL 803728 (N.D. Tex. 2001)(whether house was insured premises);
5. whether the incident occurred before or after the defendant was named as an insured under the policy, *Matagorda Ventures, Inc. v. Travelers Lloyds Ins. Co.*, 203 F.Supp.2d 704, 715 (S. D. Tex. 2000); and
6. when both parties urged that extrinsic evidence should be considered. *Tucker v. Allstate Lloyds Ins.*

Co., 180 S.W.3d 880, 885 (Tex. App. – Texarkana 2005, n. p. h.).

In addition to the foregoing uses of extrinsic evidence, other courts, while not themselves resorting to extrinsic evidence, have acknowledged that under certain circumstances the courts may do so in deciding whether there is a duty to defend. *Utica Lloyds of Texas v. Sitech Eng'g Corp.*, 30 S.W.3d 554, 556 (Tex. App. – Texarkana 2001, no pet.); *Mid-Continent Cas. Co. v. Safe Tire Disposal Corp.*, 16 S.W.3d 418, 421 (Tex. App. – Waco 2000, pet. denied); *Providence Washington Ins. Co. v. A&A Coating, Inc.* 30 S.W.3d 554, 556 (Tex. App. – Texarkana 2000, pet. denied);

2. Contrary Facts Immaterial to Liability

One court has even gone so far as to say that extrinsic evidence can be considered to *contradict* facts included in the underlying complaint if those facts are not material to the determination of the insured's liability. For example, in *Blue Ridge Ins. Co. v. Hanover Ins. Co.*, 748 F.Supp. 470, 473 (N. D. Tex. 1990), the court ruled that whether a person was insured was governed by actual facts, not inaccurate allegations in the underlying liability suit. The following year, the same judge allowed an insurer to introduce extrinsic evidence that contradicted the conclusory allegation in the underlying liability suit that the defendant had acted within the scope of his employment when the actual facts alleged, if true, would have clearly established that the defendant acted outside the scope of his employment. *McLaren v. Imperial Cas. & Indem. Co.*, 767 F.Supp. 1364, 1375 (N.D. Tex. 1991), *aff'd*, 968 F.2d 17 (5th Cir. 1991), *cert. denied*, 507 U.S. 915 (1993). Finally, in *Ohio Cas. Co. v. Cooper Mach. Corp.*, 817 F.Supp. 45, 48 (N. D. Tex. 1993), the same court allowed extrinsic evidence to show contradict the plaintiff's allegation that the project was not completed in an effort to avoid an exclusion in the insured's liability policy.

3. Not Allowed if Germane to Liability

When the exception is recognized, however, most courts do not extend the exception so far. For example, the Fifth Circuit has held that when an act occurred related to the insured's liability and, therefore, that extrinsic evidence could not be considered to establish that the incident occurred

outside the period during which the policy was in effect in order to alleviate the insurer of its defense obligation. *Gulf Chem & Metallurgical Corp. v. Assoc. Metals & Minerals Corp.*, 1 F.3d 365, 367 (5th Cir. 1993).

Likewise, in *Fielder Road Baptist Church v. Guidone Elite Ins. Co.*, 139 S.W.2d 384 (Tex. App. – Fort Worth 2004, pet. granted), the Fort Worth Court of Appeals held that a stipulation that the defendant’s alleged employee ceased to be employed by the insured before the insurance policy took effect could not be considered in the coverage case. The court reasoned that the date of employment not only affected whether the church was insured, it also affected the church’s liability in the underlying suit. Consequently, the court of appeals refused to allow the trial court to entertain the stipulation in the litigation over the duty to defend. 139 S.W.3d at 387.

4. Not Recognized by Some Courts

The Court of Appeals for the First District of Texas has repeatedly refused to recognize such an exception because the Texas Supreme Court has never expressly recognized it. *Chapman v. Nat’l Union Fire Ins. Co.*, 171 S.W.3d 222, 231 (Tex. App. – Houston [1st Dist.] 2005, no pet.); *Landmark Chevrolet Corp. v. Universal Underwriters Ins. Co.*, 121 S.W.3d 886, 890 (Tex. App. – Houston [1st Dist.] 2003, pet. requested); *Tri-Coastal Contractors*, 981 S.W.2d at 863-64. Yet, the Texas Supreme Court has certainly had at least two opportunities to review the issue, but in both cases it refused to review decisions allowing the consideration of extrinsic evidence. Nevertheless, the Houston First remains unconvinced.

Even the Fifth Circuit, appears to have been persuaded by the Houston First’s skepticism. In *Northfield Inc. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 531 (5th Cir. 2004), it retreated from its previous recognition of the exception and predicted that the Texas Supreme Court would not recognize the exception. The issue is currently pending before the Texas Supreme Court in the appeal from *Fielder Road Baptist Church v. Guidone Elite Ins. Co.*, 139 S.W.2d 384 (Tex. App. – Fort Worth 2004, pet. granted).

5. (Sometimes) Limited Exception Recognized

With the divergence of views among the appellate courts, it is worth noting that the United States District

Court for the Eastern District of Texas undertook a comprehensive review of the development of the extrinsic evidence exception to the complaint allegation rule and concluded that only a limited exception existed. *Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka, L.L.P.*, 267 F.Supp.2d 601, 621 (E. D. Tex. 2003). Specifically, the Eastern District ruled that facts extrinsic to those alleged in the underlying liability litigation could be considered only in three situations: 1) whether a person has been excluded by name or description from any coverage under the policy; 2) whether the property in question has been excluded from any coverage under the policy; and 3) whether the policy exists. Moreover, the court ruled that, for any of these narrow exceptions to apply, the issue must be capable of resolution by “readily determined facts.” *Id.*

Curiously, in the same year, the same court that decided *Westport Ins. Corp.*, applied the extrinsic evidence exception in a more sweeping fashion. In *Southwest Tank & Treater Mfg. v. Mid-Continent Cas. Co.*, 243 F.Supp.2d 597, 602-03 (E.D. Tex. 2003), the court confronted a situation in which the pleading in the underlying liability suit said little more than the insured’s negligence resulted in damage to property which had to be repaired or replaced. Relying on *Wade* and *Gonzalez*, the court held that the case was an appropriate exception to the “eight corners” rule where the insurer denied a defense. The court reasoned that the case fell squarely within the *Wade* situation where the pleadings simply did not contain enough information to determine whether or not the liability potentially fell either within or outside coverage.

V. Issues Relevant to Duty to Indemnify

The trial of indemnity issues can involve extensive discovery of issues regarding the underlying suit that may not have been discovered or tried in the underlying suit. Definition of the relevant issues in those suits only requires command of a few additional concepts.

First and foremost among these are that, unlike the duty to defend, the duty to indemnify is determined not by the allegations of the complaint in the liability lawsuit but rather by the actual facts about the insured’s liability. *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 821-22 (Tex.1997). The facts determined in the underlying suit are established

against the insured only if coverage is disputed and the insurer defends or provides a defense under an effective reservation of rights. *Employers Cas. Co. v. Block*, 744 S.W.2d 940, 943 (Tex.1988). Thus, the indemnity case may actually try facts related or that could have been involved in the underlying case. In short, these could be “new” facts.

Second, the decision in *Swicegood v. Medical Protective Co.*, No. A.3:95-CV-0355-D, 2003 WL 22234928, slip. op. at 11-15 (N. D. Tex. 2003), details the various categories of fact that can be tried. Some inquiries involve only historic facts tried or used in the underlying case. Other inquiries may involve new facts, including the use of experts. Some cases will involve combinations of historic and new facts that only an expert can sort out.

Third, some indemnity cases involve a new trial or retrial of issues either not decided in the underlying case or those that may have been decided. In *Utica Nat’l Ins. Co. of Texas v. American Indem. Co.*, for example, the court could not determine whether the critical act of negligence involving professional services had been part of the broad negligence findings of the jury. Those issues had to be litigated anew in the coverage case determining indemnity. 141 S.W.3d at 205-06.

Fourth, federal courts have made clear that they will strive to control the potential “relitigation” mess by carefully mandating the scope of discovery to better preserve judicial resources. *Enserch Corp. v. Shand Morahan & Co.*, 952 F.2d 1485 (5th Cir.1992).

VI. Expert Witnesses

In the breach of contract case, there is but a limited role for expert testimony.

A. Testimony About Trade Usage and Damages

As discussed above, the testimony of a properly qualified expert may, in certain circumstances, be appropriate to establish custom and usage in an industry as part of the circumstances surrounding the formation of the contract. The expert’s testimony may also be relevant to issues such as amount of the loss or the amount of damages sustained.

Also, in *Insurance Co. of Am. v. Morris*, 928 S.W.2d 133 (Tex. App.—Houston [14th Dist.] 1996),

rev’d on other grounds, 928 S.W.2d 133 (Tex. 1999), the court allowed an insurance expert to testify about the concept of suretyship and its role in insurance industry. The court also allowed the expert to testify about the expectation in the industry that it was the responsibility of the agent to explain material aspects of coverage when taking coverage applications from consumers.

B. Legal Opinions Not Relevant

While expert testimony is appropriate to explain industry customs and practices, the courts are in nearly universal agreement that the opinion of expert witnesses on the meaning of the policy is not relevant to the issues in a breach of contract suit. The interpretation of a contract and whether it is ambiguous are questions of law. *Sturrock*, 146 S.W.3d at 126; *Kelley-Coppedge, Inc.*, 980 S.W.2d at 464. Opinions, expert or otherwise, about questions of law are inadmissible because they usurp the role of the court. *See, e.g., Akin v. Santa Clara Land Co. Ltd.*, 34 S.W.3d 334, 339 (Tex. App.-San Antonio 2000, pet. denied); *Dickerson v. DeBarbieris*, 964 S.W.2d 680, 690 (Tex.App.-Houston [14th Dist.] 1998, no pet.).

Likewise, attempts of expert witnesses to testify in legal conclusions about the ultimate issues usurps the role of the trier of fact. *United Way v. Helping Hands Lifeline Found. Inc.*, 949 S.W.2d 707, 713 (Tex. App. – San Antonio 1997, writ denied) (error to witness to interpret law to jury); *Puente v. A.S.I. Signs*, 821 S.W.2d 400, 402 (Tex. App. – Corpus Christi 1991, writ denied)(expert’s testimony that sign violated building code and that defendant was “negligent” were “naked” legal conclusions without probative value).

Consonant with these general rules, a so-called insurance expert may not testify as to the interpretation of a policy or whether it is ambiguous. *See, e.g., Cluett v. Medical Protective Co.*, 829 S.W.2d 822, 827 (Tex. App. – Dallas 1992, writ denied)(expert testimony interpreting the policy based on the “usual and ordinary construction of insurance policies” and “industry custom and practice”); *St. Paul Ins. Co. v. Rahn*, 641 S.W.2d 276, 284 (Tex. App.--Corpus Christi 1982, no writ)(holding that expert testimony regarding whether a temporary substitute automobile was involved was inadmissible and not within a proper area for expert testimony); *see also*

Lasiter v. Washington National Ins. Co., 412 F.2d 594 (5th Cir. 1969)(holding letters inadmissible that contained legal conclusions regarding the meaning of an insurance policy). Even if the expert's testimony might otherwise qualify under the rules as an appropriate topic for expert opinion, the courts hold that the exclusion of the testimony is harmless error when the expert sought to render an opinion on questions of law. *Robbins v. Reliance Ins. Co.*, 102 S.W.3d 739, 748 (Tex. App. – Corpus Christi 2001, no pet.).

Policy interpretation is a "question for the court, to be determined from the intention of the parties as expressed by them in the contract," and not by a stranger to the contract, hired and paid to offer the desired definition without any objective support whatsoever. See *Texas Lloyds v. Laird*, 209 S.W.2d 937, 940 (Tex. Civ. App. – Galveston 1948, writ dismissed). One commentator has described the confusion of roles for the court and fact-finder as follows:

If the testimony by the expert is to instruct the jury on the proper legal issues, the testimony usurps the role of the judge. The judge is the proper party to provide instruction on the law to the jury; and because the jury is instructed to apply the law as set forth by the judge, the testimony by an expert upon the law by definition cannot be of any assistance to the jury. If the expert's testimony conflicts with that of the judge, the testimony may actually make the jury's determination more difficult. This effect would be diametrically opposed to the essential function of expert testimony as contemplated by Rule 702.

Thomas E. Baker, *The Impropriety of Expert Witness Testimony on the Law*, 40 KAN. L. REV. 325, 337 (1992); see also W.B. Stoebuck, *Opinions on Ultimate Facts: Status, Trends and a Note of Caution*, 41 Denver L. Center J. 226, 237 (1964); Fed. R. Evid 702 (advisory committee notes).

This delineation of responsibilities is one of the "cornerstones of the American legal system." Thomas E. Baker, *The Impropriety of Expert Witness Testimony* at 336. Simply put, "it remains the black-letter law that expert legal testimony is not permissible." Thomas E. Baker, *The Impropriety of Expert Witness Testimony* at 362. "Expert testimony

does not assist the jury regarding the interpretation or application of the relevant law." *Id.*; accord *Greater Houston Transp. Co. v. Phillips*, 801 S.W.2d 523, 525 (Tex. 1990) (existence of duty is question of law for the court).

VII. Insurer's Own Evaluations

Another area that is typically the source of discovery disputes in contract litigation are attempts to obtain discovery about the carrier's own evaluation of the claim. The sources usually inquired about for this information are the claim file, reserves, and insurer's communications with reinsurers.

A. Claim File

With respect to the discoverability and relevance of the claim file in the contract claim itself, there is surprisingly little Texas authority. In *Home Indem. Co. v. Giles*, 392 S.W.2d 569 (Tex. App. – Austin 1965, writ refused n.r.e.), the insured sued her insurer to obtain her own claim file and the information gathered by the adjuster in the investigation of her own claim arising from an auto accident. On appeal, the insurer's attorney conceded that the insured was entitled to her own claim file. Without discussion, the court simply held that it agreed and upheld the lower court's decision directing the carrier to produce a copy of the claim file to the insured at its own expense.

This little-known decision has only been cited in a published opinion once since it was announced. That opinion addressed whether a liability defendant with a captive subsidiary as its insurer could be compelled to require the subsidiary to produce the claim file generated following an accident. The decision only addressed whether the single business enterprise theory could be invoked to deem the subsidiary insurer's file subject to the control of the defendant for purposes of compelling production, however. *In re U-Haul International, Inc.*, 87 S.W.3d 653, 656 (Tex. App. – San Antonio 2002, orig. proceeding).

Because the question of coverage is either a question of law in the case of unambiguous or patently ambiguous contracts, and a question of fact in the case of latently ambiguous contracts, it would appear that the claim file would not be relevant to the issues involved in a breach of contract case. In *Thomason v. Touchy*, No. 01-92-00607-CV, 1992 WL 347945 (Tex. App. – Houston [1st Dist.] 1992, no writ)(not

published), the court suggested in the context of a worker's compensation dispute that the entire claims file may not be discoverable when the action is one for policy benefits in a breach of contract action. Of course, even this suggestion is distinguishable from *Giles* on the basis that *Thomason* was only a third-party beneficiary of his employer's worker's compensation coverage, not the insured owner of the policy.

From these tea leaves, it is impossible to reach any definitive conclusions about the relevance of the claim file generally in contract disputes. Examination of authorities from other jurisdictions suggest that the majority rule is that the claim file of the insurer is not relevant to the issues in a breach of contract dispute. *See, e.g., In re Bergeson*, 112 F.R.D. 692, 697 (D. Mont. 1986)(business interruption claim; claim file not relevant until claim denied and bad faith action filed); *State Farm Florida Ins. Co. v. Gallmon*, 835 So.2d 389, 390 (Fla. App. – 2nd Dist. 2003)(property damage claim under homeowner's policy; claim file "irrelevant" to breach of contract dispute). In light of the Texas authorities concerning "expert" opinion on questions of policy interpretation and application to the facts, it would seem consistent for the courts to agree with these other jurisdictions and hold that the contents of the claim file and any unprivileged internal observations of the insurer concerning the claim would be irrelevant to the issues in a simple suit for policy benefits.

B. Reserves

Reserves have been defined as "an assessment of the value of a claim taking into consideration the likelihood of an adverse result" which "does not normally entail an evaluation of coverage that is based on a thorough factual and legal evaluation." *Union Carbide Corp. v. Travelers Indem. Co.*, 61 F.R.D. 411, 414 (W. D. Pa. 1973). To the extent that it is based on the analysis of counsel, the reserves may also be privileged attorney work product or attorney-client communications. *But see State Farm v. Englke*, 824 S.W.2d 747, 753 (Tex. App. – Houston [1st Dist.] 1992, no writ)(questioning privilege claims in bad faith action).

Privilege considerations aside, it appears that the insurer's reserves established for a claim are generally considered no more relevant than its observations on coverage in the claim file. In *Union Carbide*, the

court explained that even though the federal rules were amended to specifically allow expert opinion, the court did "not believe that the proper end of discovery – expedition of the litigation by either narrowing the controversy or by avoiding unnecessary testimony or by providing a lead to evidence – will be served by allowing the discovery of reserves" *Id.* at 413.

The only Texas case on the subject revealed by research implicitly agrees with this analysis. In dealing with a discovery request for reserve information, the Texarkana court of appeals ruled without detailed explanation that discovery seeking "information regarding the setting of reserves for third-party claims against the plaintiffs is improper because the information sought is not admissible and would not lead to the discovery of admissible evidence." *In re American Home Assur. Co.*, 88 S.W.3d 370, 377 (Tex. App. – Texarkana 2002, orig. proceeding).

C. Reinsurance Information

Much like loss reserves, communications an insurer's communications with its own reinsurers is another attractive source of information that can serve as a more candid insight on the carrier's assessment of the contract claim and, possibly, disclose inconsistencies between the insurer's position with its reinsurer and its position with the insured. As one observer commented,

The insurer who wishes to deal in good faith with both its policyholders and its reinsurers finds itself caught in a precarious Catch-22. On the one hand, the insurer is contractually required to provide its reinsurers with timely and accurate information regarding the risk that the insurer bears. Reinsurers justifiably expect to receive this information and have the right to associate in the defense or settlement of the dispute. On the other hand, the insurer, by disclosing what is often highly sensitive information, places itself in the vulnerable position of having the information disclosed during discovery in the litigation with the insured.

Jeffrey S. Burman, *Confidential Insurer-Reinsurer Communications: Are Courts Placing the Reinsurance Relationship in Jeopardy by Ordering Disclosure?*, 27

Rutgers L.J. 727, 736 (1996). However, also like loss reserves, it is arguable that the insurer's own evaluations of the contract are irrelevant to the resolution of any issues surrounding the proper interpretation of the policy and whether the parties performed their respective obligations thereunder. *But see, e.g., PECO Energy Corp. v. Ins. Co. of N. Am.*, 852 A.2d 1230 (Pa. Super. 2004)(allowing discovery of reinsurance information but not reserves).

The practitioner should be aware, however, of Federal Rule of Civil Procedure 26(a)(1)(B), which provides:

A party shall, without awaiting discovery requests, provide to other parties: . . . for inspection and copying as under Rule 34 any insurance agreement under which any person carrying on an insurance business may be liable to satisfy part or all of a judgment which may be entered in the action or to indemnify or reimburse for payments made to satisfy the judgment.

In *Missouri Pac. R. Co. v. Aetna Cas. & Sur. Co.*, No. 3:93-CV-1898-D, 1995 WL 861147 (ND. Tex. 1995), the court held in a first-party claim that this rule required the disclosure of any reinsurance policies because the reinsurer is liable "for all or part of an adverse judgment entered against the primary insurer which obtained the reinsurance policy." The court further cautioned, however, that due to the confidential nature of such arrangements, any such disclosure should be subject to a protective order limiting disclosure.

Since 1999, Texas discovery procedures have also required the parties to disclose "any indemnity and insuring agreements," Tex. R.Civ. P. 194.2(g), of any indemnity or insuring agreements "under which any person may be liable to satisfy all or part of any judgment rendered in the action or to *indemnify or reimburse for payments made to satisfy the judgment.*" Tex. R. Civ. P. 192.3(f).

Under these rules, it appears to be beyond doubt that the *existence* of any reinsuring agreements and the contents of those agreements should be disclosed when the carrier is a party to the litigation. No cases discuss whether the same is true when the carrier is not a party to the litigation, as in a typical liability

claim against an insured. Logic dictates that because the reinsurance agreement is a contract between the insurer and reinsurer to which the insured is not a party, the disclosure of the reinsurance policy would not be required in that situation.

D. Claims and Underwriting Manuals

Lastly, coverage claims will frequently involve discovery requests for items like the claims manual to examine whether the claim was handled correctly or the underwriting manual to ascertain whether a carrier limited or refused to write coverage arbitrarily. Typically, the carrier will object on grounds including² lack of relevancy. Surprisingly few cases have addressed whether the claims manual or underwriting manuals are relevant subjects of inquiry. In *Safeway Managing Gen. Agy. v. Cooper*, 952 S.W.2d at 866, relying on the decision in *CBI Indus.*, the court held that the contents of the underwriting manual was inadmissible extrinsic evidence in a claim based on the contract.

At least one authority from another jurisdiction tends to support this conclusion in the context of the breach of contract claim. In *Garvey v. Nat'l Grange Ins. Co.*, 67 F.R.D. 391, 396 (E. D. Pa. 1996), the court ruled that the claims manuals were irrelevant to the issues in a breach of contract dispute.

VIII. Privacy and Confidentiality Concerns

Discovery in breach of contract cases can also include efforts to delve into confidential matters, both of parties and non-parties. The relevance of such inquiries and the limits imposed on any relevance is the concern to be addressed next.

A. Privacy Rights Generally

Because the next chapter in this seminar is devoted exclusively to privacy issues, only a brief introduction will be attempted here. In addition to specific statutory rights and evidentiary privileges, the

² Trade secret is also a common objection to such a request. As an evidentiary privilege under Texas Rule of Evidence 507, it is beyond the scope of this paper. However, it should be noted that there is little authority in Texas on whether claims or underwriting manuals can be withheld as privileged trade secret or proprietary information. The claim was touched upon, but rejected, in *Engelke*. 824 S.W.2d at 753.

United States Constitution guarantees a right of privacy both against the disclosure of personal matters and the invasion of certain important personal decisions. *Whalen v. Roe*, 429 U.S. 589, 599-600 (1977). As noted in the opinion of the Texas Attorney General in ORD-1461 (1999), the constitutional right to privacy consists of the individual interest and independence in making certain important decisions and the individual interest and independence in avoiding disclosure of personal matters. The privacy right most frequently involved in discovery disputes is the right of “disclosural privacy” – i.e., the right against the disclosure of private facts by others. *Indus. Foundation of the South v. Texas Indus. Acc. Bd.*, 540 S.W.2d 688, 679 (Tex. 1976).

The party asserting privacy rights has the burden of establishing a privacy interest in the information the disclosure of which is sought to be prevented. *Garcia v. Peeples*, 734 S.W.2d 343, 345 (Tex. 1987); *Kessell v. Bridewell*, 872 S.W.2d 837, 841-42 (Tex. App. – Waco 1994, orig. proceeding). The person asserting the privacy right to prevent discovery, either for himself or for a third party, also usually has the burden of showing that the information requested is not relevant. *In re Kemper Lloyds Ins. Reinsurance Co.*, No. 12-05-00309-CV (Tex. App. – Texarkana Feb. 28, 2005, orig. proceeding)(not yet reported); *see also Peeples v. Fourth Court of Appeals*, 701 S.W.2d 635 (Tex. 1985). The only exception to this general rule is when the party requesting discovery is seeking the disclosure of tax returns or tithing records. In that narrow situation, the requesting party must show that the requested information is relevant.

A party can assert the privacy rights of non-parties to prevent discovery. *Alpha Life Ins. Co. v. Gayle*, 796 S.W.2d 834 (Tex. App. – Houston [14th Dist.] 1990, orig. proceeding)(insurer asserting privacy rights of other insureds). And the courts should be especially vigilant in protecting those rights. For example, the court in *In re Temple-Inland, Inc.*, 8 S.W.3d 459 (Tex. App. – Beaumont 2000, orig. proceeding), held that it was abuse of discretion to disclose private information about non-parties without an adequate protective order to protect the confidentiality of the information. Nevertheless, the failure of that party to do so adequately may result in the waiver of the privilege. *Humphreys v. Caldwell*, 888 S.W.2d 469, 471 (Tex. 1994). Needless to say, the best course of action for the person whose privacy is at stake is to assert their rights on their own behalf.

In any case where the rights or privileges of third parties are implicated, that person is entitled to seek a protective and a hearing on the claim order even if not a party to the litigation. Tex. R. Civ. P. 192.6, 193.4; *see also In re CI host*, 92 S.W.3d 514, 517 (Tex. 2002).

B. Adjuster’s Personnel Files

In insurance litigation, the claimant usually asserts not only a breach of contract claim alone, but also joins it with an extracontractual claim asserting that his claim was adjusted in bad faith. No Texas case appears to address the issue. However, in *Humphreys*, the Texas Supreme Court permitted the production of personnel files by an insurer after it failed to properly establish its objections to the disclosure of matters within a third party’s zone of privacy. *Humphreys v. Caldwell*, 888 S.W.2d at 470-71. It appears that other jurisdictions are less than sympathetic to finding such information relevant in the contract claim, and more so for purposes of the bad faith claim.

For example, in *Grange Mut. Ins. Co. v. Trude*, 151 S.W.3d 803, 812-13 (Ky. 2004), the court held that where the claim involved both breach of contract and bad faith claims, however, the personnel records concerning the adjuster’s training and experience, and the claims manuals used were relevant to the issue of whether the claim was denied in bad faith. It should also be noted that one court has held that the insurer has no standing to assert the privacy rights of its employees in response to requests for personnel files. *Alerra Healthcare Corp. v. Shelley’s Estate*, 827 So.2d 936, 940 (Fla. 2002).

C. Privacy Interests of Other Insureds

From a survey of the reported cases, issues concerning the privacy of other insureds arise most frequently in insurance cases for one of two purposes: 1) to show a pattern or practice or to show disparate treatment vis-à-vis other insureds, or 2) to demonstrate the alleged bias of an consulting or testifying expert. In the context of other privileges, the Texas Supreme Court has held that abrogation of the privilege requires more than simple relevancy. Rather, the issue is whether the condition sought to be shown by the discovery is the “ultimate” issue to be decided by the trier of fact. *R.K. v. Ramirez*, 887 S.W.2d 836, 842 (Tex. 1994); *see also In re Christus*

Health Southeast Texas, 167 S.W.3d 596, 599 (Tex.App.—Beaumont 2005, orig. proceeding).

For example, *In re National Health Ins. Co.*, 109 S.W.3d 607 (Tex.App.—Corpus Christi 2003, orig. proceeding) was a suit in which the plaintiffs sued the health insurance company for failure to timely process their application for health insurance. It is undisputed that the carrier’s application inquired whether the applicants abused alcohol or illegal drugs. The wife denied in the application that any family member engaged in these proscribed activities. Shortly thereafter, the husband was hospitalized and his hospital records reflected that he had admitted to drinking heavily and the occasional use of marijuana and cocaine. After obtaining these records, the insurer issued a policy to the wife and children but denied coverage to the husband.

The family sued alleging that the husband’s hospitalization would have been covered had the carrier processed the claim more expeditiously. When the carrier proceeded to take depositions inquiring to the extent of the drinking and illegal drug use by the applicants, counsel for the plaintiffs instructed his clients not to answer the deposition. The carrier then filed a motion to compel and to reconvene the deposition which the trial court refused. The Court of Appeals held that because misrepresentation is a valid defense to both contractual and extracontractual claims, and because the plaintiffs were required to show that failure to timely process the application was a cause in fact of the actual damages, the question of their illegal drug use went to the heart of the misrepresentation defense and was relevant to the subject of the litigation.

1. Pattern of or Disparate Treatment

As mentioned above, one of the goals of discovery about other claims is to engage in the comparison of how this particular claimant was treated in comparison to how other claimants similarly situated fared. If the super-relevancy standard of being germane to the ultimate issue decided by the trier of fact is required in this context as it was in *R.K. v. Ramirez*, then it would appear highly unlikely that in a breach of contract case the manner in which other claims were handled can be germane to the ultimate issue of whether one or both parties breached their obligations under the policy.

Even in the bad faith context, the mere number of claims of wrongdoing alone is not relevant to proving that a right was in fact violated on a particular occasion. *Nissan Motor Co. v. Armstrong*, 145 S.W.3d 131 (Tex. 2004), was a products liability action involving a case of unintended acceleration involving the admissibility of reports of similar incidents. In ruling that such other reports were inadmissible without showing substantial similarity to the circumstances of the accident under consideration, the Court observed:

A number of complaints may require a prudent manufacturer to investigate, and may presage liability if those complaints are substantiated and the manufacturer does nothing. But a large number of complaints cannot alone raise a fact question that a defect exists.

Id. at 140. This observation applied to a bad faith case would indicate that the admission of complaint logs or records of other complaints against a carrier would be irrelevant unless the proponent could establish the similarity of the circumstances surrounding the complaint as well as the validity of the complaint itself.

Alpha Life Ins. Co. v. Gayle, 796 S.W.2d 834 (Tex.App.—Houston [14th Dist.] 1990, orig. proceeding), was an original mandamus proceeding in which the insureds sued the insurer not only for breach of contract, but also for bad-faith denial of a claim. The insureds issued a *subpoena duces tecum* seeking including “[a]ll ‘claims’ and/or ‘underwriting’ files maintained for each file claim made under a similar insurance policy issued by you and subsequently denied or not paid in the past six (6) years in Texas for the reason or reasons you denied Plaintiffs’ claim.” The insurer offered to produce redacted copies in response to this request, but the trial court signed an order directing the insurer to produce *unredacted* copies of the other claim files revealing the identity of the claimants. The insurance company sought temporary relief and petitioned for a writ of mandamus, which the Court of Appeals granted.

The Court of Appeals reasoned that the trial court abused its discretion by ordering the insurer to produce unredacted copies of other claims information to the Plaintiffs because medical records are within a

zone of privacy protected by the U.S. Constitution and Texas Rule of Evidence 509(b)(2), (e)(3), and §5.08(c) of the Medical Practice Act. The court concluded that “if [the insurer] were required to provide unredacted copies of the claims files to the [Plaintiffs], the privacy rights of these non-parties would be violated and [the insurer] would be exposed to liability for invasion of that right of privacy.” 796 S.W.2d at 834. Thus, the court of appeals recognized the insurer’s substantial dilemma: fail to comply and suffer discovery sanctions or comply and face more litigation.

2. Bias of Experts

The other purpose for attempting to discover other claims is usually to show expert bias either through a track record of favorable decisions for the party or by showing that the expert is financially dependent on that party for a substantial portion of his income. The problem with such inquiries is not only that they infringe on third-party privacy rights, but that they also are an impermissible “fishing expedition.”

a. Income and Tax Records

In *Hall v. Lawlis*, 907 S.W.2d 493-95 (Tex. 1995), the Texas Supreme Court noted that the protection of privacy rights requires scrupulous limitations of discovery to relevant and material information that promotes justice between the parties. As a result, the Court refused to permit discovery of an expert witness’s tax returns when the witness had admitted that 90% of his services were provided to defendants in litigation. The court reasoned that:

Subjecting an expert medical witness in a civil case to produce income tax records merely to show that he is a “defense” doctor, particularly when he has admitted that 90% of his work is for defendants, would permit experts on either side of the case to be subjected to harassment and might well discourage reputable experts from accepting employment in other cases.

In *re Weir*, 166 S.W.3d 861 (Tex.App.—Beaumont 2005, orig. proceeding), also involved an effort to impeach an expert witness by compelling a second deposition to testify regarding the percentage of his income that he received from litigation-related work and his total income for three years previous. The

order compelling the deposition came after the expert admitted that the majority of his testimonial experience had been testifying for defendants, disclosed his hourly rate, and disclosed the number of hours he billed in the present case.

The court of appeals disapproved the disclosure. While proof of bias is an appropriate subject for discovery, it noted that pretrial discovery may not be used to question an expert witness regarding his income and financial records solely for the purposes of impeachment. *Russell v. Young*, 452 S.W.2d 434, 436 (Tex. 1970).

The most recent example of an attempt to impeach and show bias through income records was *In re Wharton*, No. 10-04-00315-CV, 2005 WL 1405732 (Tex.App.—Waco June 15, 2005, orig. proceeding) (not yet reported). In the underlying suit, defendant’s expert retained to evaluate plaintiff’s injuries was served with a deposition notice and *subpoena duces tecum* by the intervenor requesting the expert to produce all 1099 tax forms received for expert work for the years 1999 through 2003, all documents reviewed or opinions rendered for defense counsel, all reports written by the expert or his employer since November 25, 2002; and the expert’s Schedule 1040C from his tax return for the years 1999 through 2003 regarding his expert work; and any reports from January 1, 1994 prepared by the expert indicating that medical treatment or surgery was needed; and any reports from January 1, 1994 to the present prepared by the expert without any criticism of the care provider; and the tax return for the years 1999 to 2004 for the expert’s employer, Orthopedic Rehabilitation Associates.

The expert responded that the request for the correspondence between himself and the attorneys should be denied because it was irrelevant; that the request for financial records should be denied in accordance with the decision in *Russell v. Young*, 452 S.W.2d 434; and that the request for prior expert reports should be denied because such reports are irrelevant and the request is overly burdensome. The expert also urged that the documents requested were not physically discoverable to show bias because its credibility had not yet been put at issue by extrinsic evidence. Counsel for the intervenor urged that the expert’s credibility was at issue because of discrepancies between his deposition testimony in the underlying suit and his deposition testimony in a

similar suit regarding the amount of his annual compensation for expert testimony and the number of cases in which he has acted as an expert witness. The intervenor also contended that Wharton testified finding secondary gain in 50% of the cases referred by defense counsel and in only two percent of the cases referred by counsel for plaintiffs.

The central issue in this case was whether the Texas Supreme Court overruled *Russell* in 1999 when it adopted Texas Rule of Civil Procedure 192.3. In *Russell*, the court held that a party may not obtain pretrial discovery of financial records from a non-party expert witness when the expert's credibility "has not been put in issue and where the records do not relate directly to the subject matter of the pending suit and are sought to be discovered for the sole purpose of impeachment of such witness by showing bias and prejudice." 452 S.W.2d at 435. In *Ex parte Sheppard*, 513 S.W.2d 813, 816 (Tex. 1974), the court approved discovery in the condemnation proceeding of an expert's appraisal reports for comparable property that were prepared for prior condemnation proceedings. The court reasoned that these reports were discoverable because the appraiser would testify at trial and because his credibility would be a material issue given the central role that appraisers play in condemnation proceeds.

In *Walker v. Packer*, the court held that it was an abuse of discretion to deny a discovery request by plaintiffs who sought documents concerning whether the University of Texas Health Science Center required prior faculty approval before testifying for plaintiff in a medical malpractice case. The documents were discoverable because of the conflicting deposition testimony concerning UT Health Science Center's policy whether other faculty members had to approve another faculty member testifying for a plaintiff in a medical malpractice case. The court stated that this deposition testimony raised the possibility that the expert witness was biased and, therefore, was subject to the exception created in *Russell*. When the Texas Supreme Court adopted the 1999 version of the discovery rules, those rules expressly permitted discovery regarding the bias of an expert witness. Although some observers had indicated that the amendment to Texas Rule of Civil Procedure 192.3(e)(5) was not intended to overrule *Russell*. See *In re Doctors Hospital of Laredo*, 2 S.W.3d 504, 507 (Tex.App.—San Antonio 1999, orig. proceeding).

The court also found persuasive the comment of the Supreme Court 1999 amendments in which they noted that the notes and comments appended to the revisions are intended to inform the construction application of the rules by courts and practitioners and the comment to 192.3 which stated that the scope of discovery is unchanged. Consequently, the court concluded that the 1999 amendments to the Texas Rules of Civil Procedure were not intended to overrule *Russell* and that a party seeking to obtain documents from a non-party expert for impeachment purposes must first present evidence raising the possibility that the expert is biased. At this point in its analysis, the court then touched the question of whether and when the evidence raised the possibility that the expert is biased. The court concluded that when the record does not reflect that the expert will be called to testify at trial and there is no evidence to substantiate a contention that an expert is biased, the trial court abused its discretion by permitting the discovery of the expert's personal financial records.

b. Conduct in Other Claims

In re Xeller, 6 S.W.3d 618 (Tex.App.—Houston [14th Dist.] 1999, orig. proceeding), was an example of an endeavor to show the latter in the form of an alleged conspiracy between the physician selected by the Texas Worker's Compensation Commission to evaluate the claimant and the carrier to deprive the claimant of worker's compensation benefits. The claimant requested that the carrier produce records of all their payments to the physician or his employer, all TWCC 69 forms prepared by the physician and his employer regarding any employee of Brown & Root, and all contracts or correspondence between carrier and the physician's employer. A similar request was served on all of the healthcare providers for claimant inquiring about their relationship with the carrier or with any person employed by the physician's employer.

In a third request, the claimant demanded production for a period of more than one year before his date of injury until the date of mandamus all medical records and TWCC 69 forms generated by all physicians at any facility operated by the physician's employer in connection with required medical examinations and all payments by any worker's compensation carrier to the physician's employer. The master directed the carrier, the physician, and his

employer to produce all of the requested records under a confidentiality agreement. The master also narrowed the period for documents requested from January 1, 1991 to January 1, 1993 and limited the production until two years after the physician examined the claimant. Otherwise, the insurer, the physician and the company for whom the physician worked were directed to comply with the plaintiff's discovery requests.

In the mandamus proceeding, the insurer contended that the discovery request invaded the physician-client privilege under Texas Rule of Evidence 509, confidentiality provisions of Chapter 151 of the Texas Occupations Code and the zone or privacy protected by the United States Constitution. *See Alpha Life Ins. Co. v. Gayle*, 796 S.W.2d 834, 836 (Tex.App.—Houston [14th Dist.] 1990, no writ); *see also* OpTex Att'y Gen. No. JM-370 (medical records protected by constitutional right of privacy if not also protected by statute). The court ruled that *even if a confidentiality order had been entered* limiting the disclosure, especially when the insurer, the doctor, and the company for whom he works, are subject to civil and criminal liability if they release confidential information about thousands of non-party claimants.

Indeed, Chapter 151 of the Texas Occupational Code provides that violations relating to the unauthorized release of confidential and privileged information may give rise for a cause of action for civil damages. Likewise, section 402.083 and 402.086 of the Texas Labor Code provide, with certain exceptions, that information “in or derived from any claim file” is confidential and cannot be disclosed by either the Texas Worker's Compensation Commission or any person to whom the information is lawfully released. Indeed, under section 402.091 of the Labor Code, it is an offense for a person to knowingly, intentionally or recklessly publish, dispose or distribute confidential claim information to a person not authorized to receive such information from the commission. The court ruled that even though bias is the subject on which discovery may be conducted, the guise of discovery regarding bias may not be turned into a fishing expedition.

In re United Services Automobile Assn., 76 S.W.3d 112 (Tex.App.—San Antonio 2002, orig. proceeding), involved a suit against Liberty Mutual by their insurers for failure to pay a claim for foundation damage. The insureds also sued an engineering firm

and one of its engineers for conspiring with the insurer to underestimate the amount of the claim. The engineers filed a counterclaim for sanctions for filing a frivolous claim. The plaintiffs settled their claim with the insurer and the trial court rendered summary judgment for the engineers.

However, to defend the counterclaim, the plaintiffs served a *subpoena duces tecum* to the engineers requesting production of engineering reports prepared for insurance company on foundation claims involving plumbing leaks and the last 250 reports on foundation claim involving plumbing leaks for any insurance company. The engineers provided the requested reports with the personal information of the insureds redacted. The plaintiffs filed a motion to compel production of the unredacted reports and the engineers entered a Rule 11 agreement to produce these unredacted reports provided that the non-party insurance companies would be given a notice and the opportunity to object. The insurance companies filed motions for protective order which the trial court denied. The insurance companies then petitioned for a mandamus challenging the trial court's order on grounds that the information sought was irrelevant and production of the reports was unnecessarily invasive of the privacy of the non-party insureds. The Court of Appeals agreed that these reports were irrelevant to the only issue in the counterclaim which was whether the plaintiffs had a legal basis for filing their conspiracy claim at the time the suit was filed. Discovery elicited thereafter to support their claims had no bearing on whether the plaintiffs had sufficiently investigated their claim to avoid liability for filing a frivolous suit. Consequently, the court concluded that the reports for non-party insurance companies were not shown to be relevant to the claim that the engineers conspired with Liberty Mutual in connection with their own case. The court concluded that the reports for non-party insurers were an impermissible fishing expedition.

The court further held that Texas recognizes a right of privacy defined as “the right of an individual to be left alone, to live a life of seclusion, [and] to be free from unwarranted publicity.” *Billings v. Atkinson*, 489 S.W.2d 858, 859 (Tex. 1973). Consequently, the court ruled that discovery must be scrupulously limited to matters that are material and relevant. Accordingly, the burden is on the requesting party to show that the information sought is material, relevant and necessary. The court ruled that engineering

reports prepared for non-party insurance companies brought to light after the plaintiffs filed their suit had not relevant to whether the plaintiffs had a good faith legal basis for filing their claim. Further, the reports produced to non-party insurance companies had no bearing on whether the engineers conspired with Liberty Mutual with respect to the plaintiff's claim.

IX. Discovery of Insurance Matters in the Underlying Suit: *In re Dana Corp.*

Discovery of policies and information about the remaining limits of liability under those policies was the issue in *In re Dana Corp.*, 138 S.W.3d 298 (Tex. 2004). This mandamus proceeding arose out of asbestos litigation in which 1260 plaintiffs sought and the trial court ordered the defendant to produce copies of all of its commercial general liability policies since 1930. It ordered this production even though only 49 plaintiffs could identify exposure to any specific product of the defendant and no plaintiff could identify any exposure before 1945. In addition to producing policies for fifteen years before the first known exposure, the trial court also ordered the defendant to produce a witness who could testify about those policies.

Before the Texas Supreme Court, the defendants argued that the trial court abused its discretion in ordering the production of policies without requiring each plaintiff to identify the product to which the plaintiff was allegedly exposed and the dates of exposure. Doing so, the defendants argued, should be necessary to make the information relevant. In other words, to be sufficiently relevant to be discoverable, each policy should be shown to have potential liability on any judgment. In a *per curiam* opinion, the Texas Supreme Court refused to impose such a stringent requirement.

In a two-step analysis, it held instead that the trial court needed no evidentiary support to order the production of policies where the defendant admitted that the policies provided coverage for alleged products liability. *Id.* at 301. However, the Court limited discovery to those policies which may be "liable to satisfy all or part of a judgment" – the constraint imposed under rule 192.3(f). *Id.* at 301; *see also In re CSX, Inc.* 124 S.W.3d 149, 152 (Tex. 2003). To meet this standard, the Court held that the mere assertion of counsel that some plaintiffs' were "probably" exposed as far back as "1930 or '35" was

insufficient. Rather, under rule 192.3(f), the trial court's discretion to order the production of policies was limited to insurance policies for 1945 and thereafter because 1945 was the earliest period of exposure, and thus, potential liability, shown by the plaintiffs in their affidavits.³

With respect to producing a witness to testify about the policies, the dispute was over whether discovery should be permitted about erosion of policy limits by previous claims. Rule 192.3(f) provides explicitly only for the discovery "existence and contents" of policies in underlying liability suits. Yet, the Tyler court of appeals in *In re Senior Living Props., L.L.C.*, held that this rule did not limit discovery about insurance in a liability suit. Rather, it held that rule 192.3(f) also authorized depositions about whether and to what degree the limits of liability had been eroded and how many claims were pending. 63 S.W.3d 594, 597-98 (Tex. App. – Tyler 2002, orig. proceeding), *abated by bankr.*, 46 Tex. Sup. Ct. J. 600 (Tex. Apr. 24, 2003).

The Texas Supreme Court rejected the notion that rule 192.3(f) alone was sufficient to authorize discovery about erosion of policy limits. To hold otherwise, the Court reasoned, "would require us to construe [r]ule 192.3(f) in a manner contrary to its literal meaning" which "neither prohibits nor requires the discovery of more than an insurance agreement's existence and contents." *Id.* at 303. If discoverable at all, the information sought would have to be within the general scope of discovery set forth in rule 192.3(a).

The Court noted that the rationale behind the parallel federal rule allowing the discovery of the existence and contents of applicable insurance was "to enable counsel for both sides to make the same realistic appraisal of the case, so that settlement and litigation strategy are based on knowledge and not speculation." *Id.* (quoting Fed. R. Civ. P. 26(b)(2), advisory committee's note to 1970 amendment). However, the Court further noted that the federal courts interpreting this rule required parties seeking to

³ Although it is unresolved in Texas whether an occurrence transpires at either exposure or manifestation in latent injury cases, the Texas Supreme Court appears to have assumed for purposes of discovery that the period of exposure is relevant in deciding in an asbestos case whether a particular policy is "liable to satisfy all or part of a judgment." *In re Dana Corp.*, 138 S.W.3d at 302.

discover more insurance information than the existence and contents of the policy to demonstrate how that information would be relevant to the pending action.

As an example of where such information would be relevant, the Court cited *Simon v. G.D. Searle & Co.*, 816 F.2d 397 (8th cir. 1987). The plaintiff in *Simon* was allowed to discover information about the insurer's aggregate reserves because the amount reserved for products liability claims was relevant to notice of the alleged product defect, which was relevant to the claim for punitive damages.

Also cited as an example of discoverability was *Dana Corp.* was *Union Carbide Corp. v. Travelers Indem. Co.*, 61 F.R.D. 411, 413 (W.D. Pa. 1973). *Union Carbide*, involved a coverage dispute between two carriers who potentially shared liability for the same loss. One of the carriers, apparently, defended on the ground that its policy was exhausted by payment of other claims. The court in *Union Carbide* held that, in that situation, information about the erosion of policy limits through payment of other claims was relevant to the coverage dispute between the carriers. However, the court in *Union Carbide* ruled that information about reserves represented internal "opinions as to the factual issues in controversy" and were not relevant or discoverable. *Union Carbide*, 61 F.R.D. at 413.

As examples of when discovery of insurance information other than the existence and contents of an insurance policy is *not* relevant, the Court in *Dana Corp.* pointed to *Wegner v. Cliff Viesman, Inc.*, 153 F.R.D. 154, 161 (N.D. Iowa 1994), and *Indep. Petrochem. Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 283, 288 (D.D.C. 1986). In *Wegner*, the court held that it was not sufficient that the insurance information sought was relevant to an evaluation of settlement opportunities. The court in *Wegner* reasoned that the provision in the federal rule 26(b)(2) for the discovery of the existence and contents of applicable insurance policies did not further authorize a plaintiff in a products liability action to discover information about the erosion of policy limits unless that information was shown to be otherwise relevant to the merits of the liability suit. *Wegner*, 153 F.R.D. at 161.

Independent Petrochemical involved a coverage dispute between the insured and over 20 of its insurers

over coverage for claims in a toxic tort latent injury case. 117 F.R.D. at 283. In that case, the insured requested that its insurers disclose the amounts which the insurers had set as reserves on the underlying claims. The federal magistrate disallowed the request, observing that "a reserve essentially reflects an assessment of the value of a claim by taking into consideration the likelihood of an adverse judgment [in the underlying liability suit]." In other words, a reserve is nothing more than an "estimate of potential liability." The magistrate explained that this estimate was not relevant to the coverage dispute because reserves "do not normally entail an evaluation of coverage based on a thorough factual and legal consideration when routinely made as a claim analysis." *Id.* at 288.

Based on these federal authorities, the Court held that the information concerning matters other than the existence of the contents of an insurance policy discoverable in the liability suit in Texas courts only if it was within the general scope of discovery as defined by rule 192.3(a). In other words, information beyond the existence and contents of the defendant's insurance policy is discoverable if can be shown to be relevant to the merits of the underlying action, not merely relevant to settlement evaluations.

Curiously, however, the Court in *Dana Corp.* did not rule directly on whether information about the erosion of policy limits and relevant to settlement evaluation was sufficiently relevant to be within the general scope of discovery under rule 192.3(a) – i.e., relevant to the issues in the underlying suit. 138 S.W.3d at 304. To be sure the court "rejected" the notion that 192.3(f) authorized discovery of more than the existence and contents of the policy merely because the information might facilitate settlement. But the Court carefully avoided answering the question of whether that information was discoverable under rule 192.3(a). It explained that it was not necessary to reach that question because the trial court had only ordered a witness be made available to testify about the insurance policies, not the erosion of limits under those policies. *Id.*

As if to emphasize that its decision should not be read to authorize discovery about erosion of limits, the Court specifically mentioned that the defendant was "free to object to any question regarding policy erosion that does not meet the [Court's] relevancy standard." *Id.* As if to underscore how close it came

to holding that the discovery of insurance information beyond existence and contents is not discoverable unless independently relevant to the issues in the liability suit, the Court distinguished its prior decision in *Carroll Cable Co. v. Miller*, 501 S.W.2d 299 (Tex. 1973), that settlement strategy is sufficient to justify discovery of an adverse party's available policy limits. *Id.* at 304 n.2. The Court stated that the difference in outcomes was not inconsistent because its decision there "rested on the fact that the actual policies were not available for discovery." *Id.*⁴ As a California court of appeals observed, the decision in *In re Dana Corp.* "strongly signaled" that information about policy limits "was not discoverable" in a liability suit when that information was only germane to settlement evaluation. *Catholic Mut. Relief Soc. v. Superior Court*, 27 Cal. Rptr. 3d 515, 525 (Cal. App. – 3rd Dist. 2005, review granted).⁵

⁴ The outcome in *Dana Corp.* is certainly understandable as an interpretation of the language of the discovery rules. However, in the broader context of the Court's jurisprudence, a strong signal that discovering the available limits to evaluate settlement is beyond the general scope of discovery could be considered surprising. After all, the Texas Supreme Court clearly and often has enunciated its preference for rules that encourage settlement. As recently as *Excess Underwriters at Lloyds v. Frank's Casing Crew & Rental Tools, Inc.*, the Court cited encouraging settlement in questionable coverage cases as one of the reasons for recognizing a right of reimbursement for insurers. No. 02-0730, slip op. at 4, 2005 WL 1252321 (Tex. May 27, 2005)(pending rehearing). It has repeatedly observed that Texas law favors settlement. *See, e.g., Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 178 (Tex. 1997); *Williams v. Glash*, 789 S.W.2d 261, 264 (Tex. 1990); *Dallas Farm Mach. Co. v. Reaves*, 158 Tex. 1, 307 S.W.2d 233, 236-37 (1957). And, it has frequently cited encouraging settlements as factors in many of its decisions. *E.g., Interstate Contracting Corp. v. City of Dallas*, 135 S.W.3d 605, 618 (Tex. 2005)(why Court chose to allow pass-through claims); *Ingersoll-Rand Co. v. Valero Energy Corp.*, 997 S.W.2d, 203, 209 (Tex. 1999)(why indemnitee may assert claim against indemnitor before the judgment is assigned against the indemnitee); *American Physicians Ins. Exchg. v. Garcia*, 876, 842, 851 n.18 (Tex. 1994)(why liability plaintiffs should be required to make settlement demands within policy limits as a condition of *Stowers* liability); *American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 482 (Tex. 1992)(reason for authorizing equitable subrogation action by excess carrier against primary carrier).

⁵ The California Court of Appeals reached the same conclusion as the Texas Supreme Court in *In re Dana Corp.* It held that California's version of rule 192.3(f) did not

authorize more than discovery about the existence and contents of the policy, and that discovery about policy limits when that subject was relevant to nothing more than settlement evaluation was outside the scope of discovery. The decision is now pending before the California Supreme Court.