



Alerts

The Texas Supreme Court Expands the Circumstances Under Which Extrinsic Evidence Can Be Used by Insurers to Disclaim A Defense

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Insights for Insurers

On February 11, 2022, the Texas Supreme Court handed the insurance industry an overall victory in an inter-insurer dispute by recognizing an exception to the "eight corners rule" permitting insurers to rely upon extrinsic evidence in some instances to disclaim a defense obligation. *Monroe Guaranty Ins. Co. v. BITCO General Ins. Corp. Inc.*, No. 21-0232 (Tex. Feb. 11, 2022).

The Dispute in The Case

The major issue in the case is whether Monroe had a duty to defend its policyholder in an underlying suit alleging the policyholder negligently drilled an irrigation well resulting in damage to the underlying plaintiff's land. BITCO defended under a reservation of rights, but Monroe refused to defend, contending that any property damage occurred before its policy period began. In the instant action, BITCO and Monroe stipulated that the policyholder's drill bit stuck in the bore hole during its drilling "in or around November 2014," approximately ten months before BITCO's policy ended and the Monroe policy incepted.

Answers to The Certified Questions Regarding Reliance on Extrinsic Evidence

The Texas High Court, in a much-anticipated case ruled on two certified questions from the United States Court of Appeals for the Fifth Circuit. As stated by the court

The certified questions relate to a subsidiary issue: whether Texas law permits consideration of stipulated extrinsic evidence to determine whether the duty to defend exists when the plaintiff's pleading is silent about a potentially dispositive coverage fact. The Fifth Circuit asks, first, whether the Northfield exception to the "eight-corners rule" is permissible under Texas law. See *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523 (5th Cir. 2004). Some Texas appellate courts and some federal courts applying Texas law, relying on Northfield or a similar test, consider extrinsic evidence bearing solely on coverage facts when the eight-corners analysis, due to gaps in the plaintiff's pleading, is not

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determinative of whether coverage exists. **We hold this practice is permissible under Texas law provided the extrinsic evidence (1) goes solely to the issue of coverage and does not overlap with the merits of liability, (2) does not contradict facts alleged in the pleading, and (3) conclusively establishes the coverage fact to be proved. The second certified question asks whether the date of an occurrence is a type of extrinsic evidence that may be considered when these requirements are satisfied. Because we do not adhere to Northfield's requirement that extrinsic evidence may be considered only to determine "fundamental" coverage issues, we answer "yes" but conclude that the stipulation offered in this case may not be considered because it overlaps with the merits of liability.** (Emphasis added.)

The Court's Refinement of The *Northfield* Exception

As a general matter the duty to defend generally is broader than the duty to indemnify. In most jurisdictions, a primary insurer that issued a policy that provides for a duty to defend must defend the policyholder if the claim is "potentially covered" as opposed to "actually covered." Most states follow the "four corners" rule pursuant to which the allegations of the complaint are compared against the policy and if there is any potential for coverage, there is a duty to defend. Texas follows the "eight corners" rule – which is exactly the same test – except everything always is bigger in Texas.

Jurisdictions differ regarding whether and when to look beyond the four corners to extrinsic evidence to determine whether an insurer has a duty to defend. There is considerable variance among the jurisdictions on this issue. There are some fairly common exceptions where insurers are often permitted to rely upon extrinsic evidence: policy formation issues (whether the policy is void or may be rescinded); a parties' status as an insured; sometime extrinsic evidence will be considered with respect to the policyholder's breach of a policy condition. When it is relevant to an independent and discrete coverage issue that does not touch on the merits of the underlying claim or case extrinsic evidence is more likely to be considered.

As the Texas Supreme Court stated in *Monroe*, the eight-corners rule is "a settled feature of Texas law," but it is not absolute. The court in the *Avalos* case, recently adopted an exception that allows courts to consider extrinsic evidence that the policyholder and the third-party claimant colluded to make false representations of fact to secure a defense and create coverage where it would not otherwise exist. *Avalos*, 610 S.W.3d at 879. The court reasoned that an insurer does not agree to undertake, and the policyholder has not paid for, a duty to defend the policyholder against fraudulent allegations brought about by the policyholder itself.

The Fifth Circuit in *Northfield* created an exception to the eight corners rule where extrinsic evidence may be considered. The *Northfield* exception has been followed in some federal court and Texas intermediate appellate court decisions. In *Monroe*, the Texas Supreme Court largely adopted the *Northfield* exception, but expanded it in some respects. According to the Texas Supreme Court, the standard it adopts in *Monroe* "coheres with *Northfield*, with minor refinements."

First, the *Northfield* exception allowed extrinsic evidence to be considered only if it is initially impossible to discern from the operative petition (complaint) and policy "whether coverage is potentially implicated." 363 F.3d at 531. The Texas Supreme Court stated this standard "invites courts to do what our authorities prohibit: 'read facts into the pleadings' or 'imagine factual scenarios which might trigger coverage.'" It believed the better threshold inquiry is to consider whether the pleading in the underlying matter contains the facts necessary to resolve the question of whether the claim is covered.

The second refinement relates to the types of extrinsic evidence that may be considered. *Northfield* required that the extrinsic evidence go to a "fundamental" coverage issue "(1) whether the person sued has been excluded by name or description from any coverage, (2) whether the property in suit is included in or has been expressly excluded from any coverage, and (3) whether the policy exists." The Texas Supreme Court determined that instead of tasking courts with determining which coverage issues are or are not fundamental, the better approach is to eliminate this requirement altogether. In other words, the exception could apply to any coverage issue.

Finally, the court stated that, unlike *Northfield*, Texas law requires that the proffered extrinsic evidence must conclusively establish the coverage fact at issue. The coverage fact need not be the subject of a stipulation. Other forms of proof may suffice. However, extrinsic evidence may not be considered if there would remain a genuine issue of material fact as to the coverage fact to be proved.



The court noted that allowing consideration of extrinsic evidence under the standard it set forth advances the dual goals of effectuating the parties' agreement as written, while protecting the policyholder's interests in defending against the third party's claims. A contrary rule that ignores conclusively proven facts showing the absence of coverage would create a windfall for the policyholder providing coverage it did not bargain for at the expense of all consumers of insurance in the form of higher premiums.

Extrinsic Evidence on The Date of An Occurrence Can Be Considered Where It Does Not Overlap

The second certified question concerns whether, when applying an exception to the eight corners rule to allow consideration of extrinsic evidence, a court may consider extrinsic evidence of the date of an occurrence. In answering the prior question, the court indicated that there is no sound reason to limit consideration to coverage questions considered "fundamental." According to the court, "[b]ecause we do not categorically limit the types of potentially coverage-determinative facts that may be proven by extrinsic evidence, evidence of the date of an occurrence may be considered if it meets the other requirements described above."

In this case, the extrinsic evidence (the stipulation) does not pass the test inasmuch as extrinsic evidence may be considered only if it goes solely to the issue of coverage and does not overlap with the merits of liability. In cases of continuing damage, like the kind alleged here, evidence of the date of property damage overlaps with the merits.

According to the court,

A dispute as to when property damage occurs also implicates whether property damage occurred on that date, forcing the insured to confess damages at a particular date to invoke coverage, when its position may very well be that no damage was sustained at all. The stipulation here proves that the drill bit got stuck in or around November 2014. Monroe argues this relieves it of a duty to defend because it demonstrates property damage occurred at that time, which was months before its policy took effect. Yet in the underlying case, the insured likely would have sought to prove the sticking of the drill bit was not the cause of any damage. And to obtain coverage in the face of Monroe's refusal, the insured would necessarily argue that some of plaintiff's alleged damages (e.g., the sloughing of material into the well) occurred after November 2014. This would undermine its liability defense, which is best served by asserting there was no damage either in November or anytime thereafter. Because the use of the stipulation in the manner urged by Monroe would overlap with the merits of liability in these ways, it cannot be considered in determining whether Monroe owes a duty to defend.

A stipulation worded differently may have produced a different result.