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SYMPOSIUM INTRODUCTION

*Peter Nash Swisher**

On January 7, 1998, during the Annual Meeting of the Association of American Law Schools in San Francisco, the AALS Insurance Law Section presented a program entitled "The Insurance Law Doctrine of Reasonable Expectations after Three Decades." The following articles appearing in this law review symposium are the culmination of those program presentations. I would like to thank all the participants once again for their valuable contributions, both to our AALS Program, and to this Symposium issue. I also wish to thank Mr. Michael Ungaro and Ms. Susan Chmieleski and their editorial staff at the *Connecticut Insurance Law Journal* for their invaluable assistance in making this symposium on the insurance law doctrine of reasonable expectations a reality.

One of our program speakers in San Francisco, Professor Robert Jerry, discussed the current jurisprudential clash between a classical Formalist approach to insurance contract interpretation in conflict with the modern Functionalist insurance law doctrine of reasonable expectations of the insured to coverage. Professor Jerry declared that today there is "a battle for the heart and soul—not only of contract law, or insurance law—but of American jurisprudence generally."

Although Professor Ken Abraham, in his symposium article, disagrees with this assessment, I do not believe that Professor Jerry has overstated this crucial observation. Today, as in the past,[1] there still exists a fundamental clash

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1. *See, e.g.*, William Vance, *The History of the Development of the Warranty in Insurance Law*, 20 YALE L. J. 523, 534 (1911):

> Policies became overgrown with a wilderness of warranties, many of the most trivial character, in which the rights of the policyholder, however honest and careful, were in grave danger of being lost.... The unseemly struggle that ensued between the unwise insurers who sought to frame their policies as to compel the courts to allow them the dishonest benefit of forfeitures unsuspected by the insured, and the courts who sought by liberal construction, and sometimes distortion of the language of the policies, to do justice in spite of the warranties, resulted in a mass of litigation and confused precedent, the like of which cannot be found in any other field of our law.

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between two competing theories of American jurisprudence—Legal Formalism and Legal Functionalism in an insurance law context. Other commentators, in addition to Professor Jerry, also have observed the surprising resurgence of Legal Formalism[2] in American jurisprudence generally[3] and in American insurance law in particular.[4] In an insurance law context, Legal Formalism is

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Id. at 534.

2. Legal Formalism, also known as Legal Positivism, is the traditional view that correct legal decisions are determined by pre-existing judicial and legislative precedent, and the law is viewed as a complete, autonomous system of logical, socially neutral, principles and rules. Judging under this formalistic theory is thus a matter of logical necessity rather than a matter of choice.

See generally MARIO JORI, LEGAL POSITIVISM (1992). *See also* Frederick Schauer, *Formalism*, 97 YALE L.J. 509 (1988) (discussing how Legal Formalism still serves a legitimate function in limiting judicial discretion or judicial activisim); and Ernest Weinrib, *Legal Formalism: On the Imminent Rationality of Law*, 97 YALE L.J. 949 (1988) (questioning whether the law is essentially rational as the Formalists believe, or is essentially political, as the Functionalists believe).

Legal Functionalism, also known as Legal Realism or Legal Pragmatism, on the other hand, is based on the belief that the Formalist theory of a logical and socially neutral legal framework is rarely attainable and may be undesireable in a changing society, and the paramount concern of the law should not be logically consistency, but socially desirable consequences. Thus, where Legal Formalism is more logically-based and precedent-oriented, Legal Functionalism is more sociologically-based and result-oriented. *See generally* ROSCOE POUND, JURISPRUDENCE (1959); WILIFRED E. RUMBLE, JR., AMERICAN LEGAL REALISM (1968); ROBERT SAMUEL SUMMERS, INSTRUMENTALISM AND AMERICAN LEGAL THEORY (1982).

3. *See, e.g.*, GARY AICHELE, LEGAL REALISM AND TWENTIETH CENTURY AMERICAN JURISPRUDENCE (1990):

> Not since the late 1920s and 1930s has there been such widespread interest in American jurisprudence. But it is no longer the [Functionalists] who are challenging established norms. The victories at the polls of political conservatives like Richard Nixon and Ronald Reagan [and George Bush] [and the Republican Congress] and the corresponding ideological commitments of many recent appointments to the bench, now threaten the continued prominence of a theory of judicial interpretation first articulated and advanced by the [Formalists]. Impossible only a decade ago, "mechanical jurisprudence" has made a remarkable comeback, and a new Legal Formalism may yet triumph as the principal mode of [judicial] interpretation of the federal courts.

Id. at x.

4. *See, e.g.*, Peter Nash Swisher, *Judicial Rationales in Insurance Law: Dusting Off the Formal for the Function*, 52 OHIO ST. L.J. 1037 (1991):

> Legal Formalism today is far from a dead issue, at least in an insurance law context, and may in fact be in a resurgence, while Legal Functionalism, as exemplified by the insurance law doctrine of "reasonable expectations",

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exemplified through the seminal writings and the major influence of Professor Samuel Williston.[5] A bedrock principle underlying Professor Williston's classical Formalistic view of insurance contract interpretation is that an insurance policy must be construed and enforced according to general principles of contract law,[6] and the courts therefore are not at liberty to reinterpret or modify the terms of a clearly written and unambiguous insurance policy.[7] A number of courts today continue to follow Professor Williston's often-cited legal axioms regarding a contractually based interpretation of insurance contracts. [8]

> may be experiencing a more limited judicial application than various commentators had initially predicted.

Id. at 1074. *See also* Bill Blum, *The California Supreme Court: Toward a Radical Middle,* 77 A.B.A. J. 48 (Jan. 1991):

> [T]he court has also expressed a preference for deferring policy judgments affecting important social issues and commercial relationships to legislative decision making. Some court watchers see this as a healthy return to the proper role of the court as an interpreter, rather than a maker of law. Others. . . .think the court is too deferential. . . ."In the area of the common law," says former Justice Grodin, "I think [the Lucas court's] conservatism is reflected in the notion that it is unwise to expand liability, that liability on the whole should be contracted, that contract principles should be applied strictly and without regard, or with very little regard, for differences in bargaining power between the parties, and in a tendency toward the insistence upon clear, bright lines and rules."

Id. at 50.

Justice H. Walter Croskey's Symposium article *infra* examines this significant change in California insurance law which, since 1990, now places significant limitations on the prior pro-insured California doctrine of reasonable expectations to coverage.

5. *See, e.g.* WILLISTON ON CONTRACTS (Walter H.E. Jaeger ed., 3d ed. 1998 Cum. Supp.). This treatise on contract law comprises 18 substantive volumes and three volumes of forms. Professor Williston also was the Reporter for the RESTATEMENT OF THE LAW OF CONTRACTS (1928).

6. *See* 7 WILLISTON ON CONTRACTS § 900 at 28 (Walter H.E. Jeager ed., 3d ed. 1998 Cum. Supp.) ("[u]nless contrary to statute or public policy, a contract of insurance will be enforced according to its terms"). *Id.*

7. *See* 4 WILLISTON ON CONTRACTS § 610 at 512 (Walter H.E. Jaeger ed., 3d ed. 1998 Cum. Supp.). *See also* BARRY OSTRAGER & THOMAS NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES 3-5 (7th ed. 1994).

8. *See, e.g.,* Schultz v. Hartford Fire Ins. Co., 569 A.2d 1131, 1134 (Conn. 1990) ("[A]n insurance policy is to be interpreted by the same general rules that govern the construction of any written contract and enforced in accordance with the real intent of the parties as expressed in the language employed in the policy.") *See also* American Family Mut. Ins. Co. v. National Ins. Ass'n, 577 N.E.2d 969, 971 (holding that coverage cannot be extended "beyond that

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Although this classical Formalistic contractual approach to the judicial interpretation of insurance policies arguably brings greater uniformity and predictability to insurance contract disputes, a serious problem with this Formalistic interpretive approach is that insurance policies very often are *not* ordinary contracts negotiated by parties with roughly equal bargaining power. Rather, insurance policies very often constitute adhesion contracts, where the insurer has a superior bargaining position, and the insured often must accept the policy on a "take it or leave it" basis if the insured desires any kind of insurance coverage at all.[9] Moreover, in the real world, few insureds take the time or the effort to read and understand their insurance policies, although under a Formalistic contractual interpretative approach they are generally bound by the terms of their insurance contracts, despite any reasonable policyholder expectation of coverage to the contrary.[10] Indeed, if an insurance policy is sold as a "product" by appealing to an insured's "peace of mind," it is still generally construed and interpreted as a "contract," at least by the insurer, when loss occurs.[11]

In reaction to this rather strict Formalistic contractual analysis of insurance policies, a number of courts and commentators, beginning in the early 1970s, and largely influenced by the writings of Professor (now Judge) Robert

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provided in the contract and we may not rewrite the plain and unambiguous language of an insurance contract") (Ind. Ct. App. 1991); Hybrid Equip. Corp. v. Sphere Drake Ins. Co., 597 N.E.2d 1096, 1102 (Ohio 1992) ("Thus, in reviewing an insurance policy, words and phrases used therein 'must be given their natural and commonly accepted meaning, where they in fact possess such meaning, to the end that a reasonable interpretation of the insurance contract consistent with the apparent object and plain intent of the parties may be determined.'").

9. *See, e.g.*, Edwin W. Patterson, *The Interpretation and Construction of Contracts*, 64 COLUM. L. REV. 833, 856 (1964). *See also* Todd Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173 (1983).

10. *See, e.g.*, Powers v. Detroit Auto. Inter-Ins. Exch., 398 N.W.2d 411, 413 (Mich. 1986) ("[t]he common wisdom is that very few insurance policy purchasers read all or even substantially all of the purchased contract, and it is not guaranteeable that they would understand it if they did"). *Id.* at 413. *See also* JOHN A. APPLEMAN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE § 8843 at 231 (rev. ed. 1981) (stating that most insureds never read their policies, and 90% of those who do read their insurance policies would not understand them).

11. *See, e.g.*, Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1417 (1994) (observing that the insurance-as-contract approach is typically the baseline for judging an insurance relationship, and "[m]any, if not most courts—whether deciding in favor of insurance companies or insureds—rely heavily on a straightforward interpretation of the insurance company's printed form").

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Keeton[12] and others,[13] have applied a result-oriented Functionalistic approach to the interpretation of insurance policy disputes in order to protect the reasonable expectations of the insured policyholder to coverage, and from a possible forfeiture of coverage that might occur under a more traditional Formalistic insurance contract analysis. As propounded by Professor Keeton, this Functionalistic insurance law doctrine of reasonable expectations is based upon a two-prong rationale: (1) that an insurer should be denied any unconscionable advantage in an insurance contract; and (2) that the reasonable expectations of insurance applicants and intended beneficiaries regarding the terms of insurance coverage should be honored, even though a painstaking study of the policy provisions contractually would have negated those expectations.[14] A minority of state courts today have adopted this insurance law doctrine of reasonable expectations at variance with the insurance policy language.[15]

A major problem with this Functionalistic reasonable expectations approach regarding the interpretation of insurance coverage disputes generally, however, is that under the Keeton reasonable expectations formula, the insurance policy need *not* be interpreted according to its clear and unambiguous contractual language—which is anathema to a Formalistic theory of insurance contract interpretation.[16] Moreover, those courts purportedly

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12. *See* Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961 (1970); Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part Two*, 83 HARV. L. REV. 1281 (1970).

13. *See, e.g.*, Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151 (1981); William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267 (1986); Mark Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323 (1986); Roger Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823 (1990).

14. *See* Keeton, *supra* note 12, at 963-964.

15. *See, e.g.*, Lambert v. Liberty Mut. Ins. Co., 331 So. 2d 260 (Ala. 1976); Zuckerman v. Transamerica Ins. Co., 650 P.2d 441 (Ariz. 1982); and C & J Fertilizer Inc. v. Allied Mut. Ins. Co. 227 N.W.2d 169 (Iowa 1975). According to Professor Henderson, the following states arguably have adopted the Keeton "reasonable expectations" doctrine: Alabama, Alaska, Arizona, California, Iowa, Montana, Nebraska, Nevada, New Hampshire, and New Jersey. *See* Henderson, *supra* note 13, at 828. Another six states may, or may not, have adopted the Keeton "reasonable expectations" doctrine, but "the decisions from these six jurisdictions are not entirely free from ambiguity themselves and require [further] analysis": Colorado, Delaware, Hawaii, North Carolina, Pennsylvania, and Rhode Island. *Id.* at 829-834.

16. *See, e.g.*, Rahdert, *supra* note 13, at 335:

> The Keeton formula suggests that an insured can have reasonable expectations of coverage that arise from some source *other* than the policy language itself, and that such an extrinsic expectation can be powerful

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applying the doctrine of reasonable expectations in interpreting insurance coverage disputes have been unable to agree on what specific factors would constitute such a reasonable expectation of coverage, and what factors would not.[17] Accordingly, a number of other commentators have been critical of the insurance law doctrine of reasonable expectations,[18] and a number of other

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> enough to override any policy provisions no matter how clear. So interpreted, the Keeton formula pushes insurance law in a dramatic new direction, one that discards the traditional contract premise that a written agreement is the controlling code for determining the parties' rights and duties.

Id.

See also 1 ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES § 6.03, at 376 (3d ed. 1995):

> The reasonable expectations rule, therefore, abandons the general contract principle that the insured's legitimate expectations are necessarily governed and limited by the terms of the policy. That principle will, instead, be applied only when it is fair to do so. As a result, in a proper case, an insured may be held to be entitled to coverage despite unambiguous language in the policy to the contrary.

Id.

17. *See, e.g.,* Abraham, *supra* note 13, at 1153 [footnotes omitted]:

> The [Functionalist] courts have employed the [reasonable] expectations principle in cases where the insured's expectation of coverage was probably real and reasonable. They have also employed it where an expectation of coverage was less probable, but the policy's denial of coverage seemed unfair. Finally, they have relied on the principle even where an expectation of coverage was improbable and the denial of coverage would not appear unfair. In short, the judicial concept of an "expectation" of coverage is not a monolithic one.

Id.

See also Rahdert, *supra* note 13, at 335:

> [T]he Keeton formula gives no hint at what factors other than the policy provisions courts might use to define the "terms" of the insurance arrangement, or how the courts are to measure the force of these external factors against the force of restrictive policy provisions to determine which should prevail in any given instance.

Id.

18. *See, e.g.,* Conrad Squires, *A Skeptical Look at the Doctrine of Reasonable Expectations*, 6 FORUM 252 (1971); Frank Gardner, *Reasonable Expectations: Evolution Completed or Revolution Begun?* 669 INS. L.J. 573 (1978); William Lashner, *A Common Law*

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courts have expressly rejected the insurance law doctrine of reasonable expectations.[19] For example, the Florida Supreme Court on January 29, 1998, in the case of *Deni Associates of Florida Inc. v. State Farm Fire & Casualty Ins. Co.* declared:

> We decline to adopt the doctrine of reasonable expectations. There is no need for it if the policy provisions are ambiguous because in Florida ambiguities are construed against the insurer. To apply the doctrine to an unambiguous provision would be to rewrite the contract and the basis upon which the premiums are charged. *See Sterling Merchandise Co. v. Hartford Ins. Co.*, 30 Ohio App. 3d 131, 506 N.E.2d 1192, 1197 (Ohio Ct. App. 1986) ("The reasonable expectation doctrine requires a court to rewrite an insurance contract which does not meet popular expectations. Such rewriting is done regardless of the bargain entered into by the parties to the contract.") . . . .
>
> Construing insurance policies upon a determination as to whether the insured's subjective expectations are reasonable can only lead to uncertainty and unnecessary litigation. As noted in *Allen v. Prudential Property & Casualty Insurance Co.*, 839 P.2d 798, 803 (Utah 1992):
>
> > Today, after more than twenty years of attention to the doctrine in various forms by different courts, there is still great uncertainty as to the theoretical underpinnings of the doctrine, its scope, and the details of its application.[20]

Alternative to the Doctrine of Reasonable Expectations in the Construction of Insurance Contracts, 57 N.Y.U. L. REV. 1175 (1982); and Stephen Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461 (1989).

19. *See, e.g.*, Meckert v. Transamerica Ins. Co., 701 P.2d 217 (Idaho 1985); Menke v. Country Mut. Ins. Co., 401 N.E.2d 539 (Ill. 1980); and Bond Brothers v. Robinson, 471 N.E.2d 1332 (Mass. 1984). According to Professor Henderson, nine state courts have expressly declared that the Keeton reasonable expectations doctrine has *not* been adopted in their respective jurisdictions: Idaho, Illinois, Massachusetts, North Dakota, Ohio, Oklahoma, South Carolina, Washington and Wyoming. Henderson, *supra* note 13, at 834 n.68.

20. 711 So. 2d 1135, 1140 (Fla. 1998).

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A majority of American courts today, however, have neither expressly adopted nor expressly rejected the doctrine of reasonable expectations,[21] and a number of these courts arguably apply a "middle ground" interpretive approach to insurance coverage disputes—somewhere between a classical Formalistic contractual approach on one hand, and the doctrine of reasonable expectations on the other hand. [22] Thus, as Professor Roger Henderson aptly observes, "[serious] questions remain as to whether the [reasonable expectations] principle has developed into a full-fledged doctrine which can be applied in a predictable and evenhanded manner by the courts."[23]

This Symposium addresses a number of these serious questions and issues involving the insurance law doctrine of reasonable expectations after three decades. We are fortunate to have ten excellent symposium articles analyzing the doctrine of reasonable expectations from various perspectives, written by seven academic lawyers, two prominent insurance law practitioners, and an eminent jurist.

Professor Robert Jerry II is the Missouri Endowed Floyd R. Gibson Professor of Law at the University of Missouri-Columbia Law School. He is

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21. *See, e.g.,* Collins v. Farmers' Ins. Co., 822 P.2d 1146, 1162 ([t]his court has not explicitly adopted the doctrine of 'reasonable expectations,' at least by name, in any of its forms. Neither has this court explicitly rejected it. . . At some point, this court will have to address this series of conflicting precedents in our cases which today's majority opinion simply ignores.") *Id.* at 1162 (Unis, J., dissenting).

22. *See, e.g.,* Jeffrey W. Stempel, *Reassessing the "Sophisticated" Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807, 827-29 (1993):

> [A] third of the states appear receptive to the underlying notion of vindicating the reasonable expectations of the policyholder but stop short of treating the notion as a distinct doctrine or principle for decision. Instead, these courts introduce reasonable expectations thinking into their opinions, often combining it with the ambiguity doctrine and relatively broad notions of promissory and equitable estoppel, waiver, unconscionability, and public policy review, but stop short of using the policyholders' expectations, however reasonable, to override policy language viewed as clear.

See also Peter Nash Swisher, *Judicial Interpretations of Insurance Contract Disputes: Toward a Realistic Middle Ground Approach*, 57 OHIO ST. L.J. 543 (1996) (arguing that this "middle ground" interpretive approach constitutes a realistic and viable reconciliation of Legal Formalism and Legal Functionalism in an insurance law context).

23. Roger Henderson, *supra* note 13, at 824. *See also* Stempel, *supra* note 22, at 827-28 (where Professor Stempel argues that trying to characterize the various states' use of the reasonable expectations doctrine is to a great extent an exercise in futility).

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also the author of a prominent insurance law treatise.[24] Professor Jerry's Symposium article presents an excellent overview and introduction to the insurance law doctrine of reasonable expectations. The doctrine's roots, Professor Jerry contends, are in the law of contract, but the influential analysis of Judge Keeton in his 1970 article in the Harvard Law Review gave this doctrine very different dimensions. Even so, this "new" doctrine of reasonable policyholder expectations had anchors in other legal principles with which courts and lawyers were (and are) well familiar, even if this "new" doctrine, as applied by the courts, gave these familiar legal principles a wider sweep. Professor Jerry's overview thus sets the stage for a closer look at the insurance law doctrine of reasonable expectations' contours by the other contributors to this Symposium.

Professor Kenneth Abraham is the Class of 1962 Professor of Law at the University of Virginia Law School, and author of a definitive article on the doctrine of reasonable expectations.[25] In his present Symposium article, Professor Abraham observes that the present-day doctrine of reasonable expectations has had very little impact on the rise of managed health care insurance, on Commercial General Liability insurance coverage disputes, in determining automobile insurance rates, and in bad faith claims litigation over the past twenty years. Today, Professor Abraham states that the doctrine of reasonable expectations is infrequently invoked, and that it is rarely utilized in most commercial disputes. Nevertheless, this "fairly minor" legal doctrine still has fundamental importance in bringing a sense of equity and fairness to both the insured and the insurer alike.

In contrast to a number of Symposium contributors who believe that the interpretive split among the jurisdictions is part of a struggle for "the heart and soul of insurance law," Professor Abraham asserts that this difference reflects the normal and longstanding tension within insurance law between the insurer's need for predictability of obligation, and the policyholders' comparative lack of information about the scope of coverage that they have actually purchased. This healthy tension, according to Professor Abraham, has been incompletely resolved—and in all probability will always be incompletely resolved—in the law of both the minority of jurisdictions that honor the reasonable expectations of the insured, and in the majority of jurisdictions that do not.

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24. *See* ROBERT JERRY II, UNDERSTANDING INSURANCE LAW (2d ed. 1996).

25. *See* Kenneth Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151 (1981).

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Professor Roger Henderson is the Joseph Livermore Professor of Law at the University of Arizona College of Law. Professor Henderson wrote an earlier article assessing the doctrine of reasonable expectations after two decades,[26] and in his Symposium article, he analyzes the formation of the doctrine of reasonable expectations in relation to the influence of forces outside insurance law. Professor Henderson notes that almost three decades have elapsed since the doctrine of reasonable expectations was first recognized, but the doctrine has not swept the country. In fact, less than one-fourth of the states have clearly adopted the doctrine as a substantive rule of insurance law that permits courts to ignore unambiguous terms in insurance policy forms that would otherwise defeat the expectations of the insured. Part of the reason for this failure to thrive, Professor Henderson believes, may stem from the confusion that still exists regarding the nature of the doctrine. This confusion is perpetrated by courts that purport to adopt the doctrine, but who continue to speak of it in a manner that fails to distinguish it from the canon of construction *contra proferentem*, or doctrine of ambiguities. Whereas the latter operates to resolve competing constructions of insurance policy terms, it should be clear by now that the doctrine of reasonable expectations may operate without regard to the existence of any ambiguities. On the other hand, the doctrine of reasonable expectations may also suffer from the fact that many courts have never come to grips with these competing formulations that were articulated at the outset.

Professor Henderson notes that Professor (now Judge) Robert Keeton offered a formulation in his landmark Harvard Law Review articles that differs materially from that rendered by the American Law Institute in revising the RESTATEMENT OF CONTRACTS. Despite these differences, the courts have spoken of the two formulations as if they were the same. This has created questions about the substantive nature of the doctrine and its limits, questions that would not work in favor of its recognition by more jurisdictions. This situation, however, may be on the verge of change—a change that may be dictated by forces outside the law of insurance.

The American Law Institute and the National Conference of Commissioners on Uniform State Laws are currently revising Articles 2 and 2A of the Uniform Commercial Code, and are drafting a new article—Article 2B—dealing with licenses. In the process, they are considering the competing formulations advanced by Judge Keeton and the ALI regarding the enforceability of standard form contracts. They have found that there are strong business and consumer forces that have entrenched views regarding the

26. *See* Roger Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823 (1990).

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doctrine of reasonable expectations. Although no acceptable compromise between these competing views has yet been crafted, there undoubtedly will be some subsequent accommodation. Whatever the result, the doctrine of reasonable expectations as it emerges from this process will very likely be restated as the law in general when it comes time to draft a third Restatement of Contracts, and since courts have uniformly cited the Restatement of Contracts in support of a decision to adopt the doctrine of reasonable expectations in insurance cases, Professor Henderson believes that the work of the American Law Institute and the National Conference of Commissioners on Uniform State Laws on the Uniform Commercial Code may well have a significant impact on the doctrinal developments in insurance law in the future.

Professor Mark Rahdert is the I. Herman Stern Professor of Law at Temple University Law School. Professor Rahdert believes that the reasonable expectations doctrine, which enables courts to consider the reasonable expectations of the insured as an aid to policy interpretation and as a guide for guaranteeing the insured rights that the policy language may not itself provide, has steadily gathered force, and has become the key principle of policy interpretation in a number of major jurisdictions. At the same time, the doctrine of reasonable expectations has sparked a great deal of controversy over the extent to which this doctrine should be carried. This controversy has prevented many courts from the wholesale embrace of the doctrine. In 1986 Professor Rahdert wrote an article entitled *Reasonable Expectations Reconsidered.*[27] In that article, he detected opposition to the "strong" form of the reasonable expectations doctrine, though he argued for its continued application where restrictions on coverage amounted to "naked preferences" favoring the insurer. He also offered suggestions for making the reasonable expectations doctrine clearer, more consistent, and perhaps more defensible. A dozen years later, however, the same uncertainties that plagued the doctrine of reasonable expectations then, still linger today.

Professor Rahdert's Symposium article discusses "two relatively small but significant points." Initially, he argues that part of the difficulty with the doctrine of reasonable expectations is that it means too many different things to different people. The doctrine can be invoked in at least four different ways, and courts that utilize the doctrine in these different ways rarely distinguish clearly among them. Usually, courts rely on the reasonable expectations of the insured (1) simply as an interpretive device for ascertaining the meaning of the policy language. This interpretive technique fits within traditional precepts of

27. Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323 (1986).

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insurance law and should not be controversial. With reasonable frequency, courts also employ reasonable expectations (2) to adjust contract terms that, when applied to the insured's situation, would otherwise seem unconscionable.

While this idea might have been more controversial thirty years ago, it is now a relatively widely accepted power of the courts. Moreover, what makes the insured's expectation "reasonable" in this context is that it rests on a *plausible* interpretation of the policy language, making this use of the reasonable expectations doctrine a small leap from traditional practice. Insurers can also modify policy language to adjust to these judicial determinations. On rare occasions, courts also employ the reasonable expectations doctrine (3) to avoid enforcing policy language that, even when clear, defeats the essential objectives of the insurance policy. These instances involve a greater leap from traditional insurance contract interpretation, but it is one that the courts seldom take. Finally, in but a handful of instances, courts have invoked reasonable expectations (4) to avoid policy limitations that would defeat public policies regarding assured compensation. Only the more aggressive uses of (3) and (4) ought to stir much controversy. Moreover, given the infrequency with which these aggressive uses of the reasonable expectations doctrine occur, Professor Rahdert believes, they amount to a tempest in a teapot.

Yet, from another perspective, the controversy surrounding the reasonable expectations doctrine is well-deserved, because an aggressive use of the doctrine challenges time-honored contract law assumptions that undergird the basic structure on which insurance law depends—particularly the notion of the policy as a fixed bargain. Since courts are basically unwilling to overhaul insurance law in its entirety, or rethink its basic assumptions, it is difficult to reconcile these aggressive applications of the reasonable expectations idea with the other insurance law principles that routinely guide their decisions. The result is instability about the role of reasonable expectations in insurance law analysis.

Professor James Fischer is a Professor of Law at Southwestern University School of Law, and he is the author of a seminal article on the construction and interpretation of insurance contracts.[28] The focus of Professor Fischer's Symposium article is on what he perceives to be the failure of the proponents of the doctrine of reasonable expectations to align the doctrine with the larger goals that we believe insurance law should advance. In this context, Professor Fischer looks at the doctrine of reasonable expectations in terms of how it relates to policyholder and carrier conduct. For example, does the

28. *See* James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation: Text Versus Context*, 24 ARIZ. ST. L.J. 995 (1992).

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doctrine of reasonable expectations encourage policyholders to read or seek assistance to understand the policy they purchase? Is this conduct that insurance law should encourage? With respect to insurance carriers, does the doctrine of reasonable expectations encourage carriers to write clearer, more reasonable policies? Professor Fischer argues that in each case the answer is "no." As presently formulated and applied, the doctrine of reasonable expectations "accomplishes little more than to apply a label to a result already reached, and sugarcoat that result with the patina of doctrinal respectability." The doctrine of reasonable expectations' emphasis on "policyholder" expectations also misdirects analysis away from what Professor Fischer contends should be a public policy orientation toward the construction of insurance contracts generally.

Professor Jeffrey Stempel is the Fonvielle & Hickle Professor of Law and Associate Dean for Academic Affairs at the Florida State University College of Law. He is also the author of a leading treatise on the interpretation of insurance contracts.[29] The thesis of Professor Stempel's Symposium article is that the doctrine of reasonable expectations, although long a tacit pull on insurance coverage jurisprudence, has never really been fully utilized as an analytical tool and has not been fully deployed in a self-consciously thoughtful and comprehensive manner. In part, this unfortunate underuse of the reasonable expectations thinking resulted from the manner in which the doctrine burst on the scene, with emphasis on the reasonable expectations concept as something creating rights "at variance" with the language of the insurance policy. Although the reasonable expectations approach does this in a relatively small segment of the case law, it has far more potential impact as a tool for addressing uncertain policy language and application, a potential that has largely been overlooked due to an overfixation on the role of reasonable expectations in overcoming clearly worded insurance policy language.

Viewed comprehensively, Professor Stempel argues that the reasonable expectations of the parties to an insurance contract can be used not only to construe ambiguous policy text or to overcome clear text violative of the insured's reasonable expectations, but also to serve as a check on absurd hyperliteral interpretations of policy text. In addition, the reasonable expectations approach can assist courts in determining whether policy provisions are ambiguous or whether "painstaking" study of the policy suggests a clear meaning for problematic text. All of these varieties of the reasonable

29. *See* JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS: LAW AND STRATEGY FOR INSURERS AND POLICYHOLDERS (1994).

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expectations approach, Professor Stempel believes, merit fuller use by the courts.

The doctrine of reasonable expectations is viewed by the legal political mainstream as too inconsistent with the prevailing American paradigm of judicial restraint, strict construction of disputed texts, and minimal governmental involvement in market activity. Properly seen, however, the reasonable expectation doctrine, even in its strong "rights at variance with the policy language" form, is actually consistent with the prevailing jurisprudential ethos because of the context of insurance coverage. Determining the "correct" meaning of an insurance policy inevitably requires not only a sharp focus on policy text, but also full consideration of the reasonable expectations of *both* insurer and insured, even where those expectations to some extent run counter to the policy text, and certainly where the policy text is unclear, insufficiently certain, or applied to unanticipated situations. Contrary to the assertions of some courts and commentators, Professor Stempel argues that a strong judicial invocation of the reasonable expectations doctrine poses no threat to separation of powers and little serious obstacle toward vindicating the intent of the parties to the insurance contract as well as the purpose of the insuring agreement.

Professor Jeffrey Thomas is an Assistant Professor of Law at the University of Missouri-Kansas City. In his Symposium article, Professor Thomas takes an interdisciplinary approach to the doctrine of reasonable expectations. The traditional rules of insurance policy interpretation, he argues, have developed within a "rational bargaining" paradigm. The reasonable expectations doctrine, which permits courts to ignore express policy language, is perhaps the most notable exception to the traditional rules of insurance contract interpretation. Although the doctrine of reasonable expectations, which is intended to provide greater protection for unsophisticated insurance consumers, is nontraditional, it is nevertheless an extension of the "rational bargaining" paradigm. Professor Thomas uses information available from other academic disciplines to show that the "rational bargaining" paradigm and the reasonable expectations doctrine do not accurately reflect insurance consumer behavior.

Eugene Anderson, Esquire is a partner in the New York City law firm of Anderson, Kill & Olick P.C. with offices in Washington D.C., Philadelphia, Newark, San Francisco, Phoenix, and Tucson. The author of numerous articles on insurance law, as well as a recent two-volume treatise on insurance

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coverage litigation,[30] Mr. Anderson has been called "the dean of insurance policyholder attorneys" by *Business Week* magazine.

Mr. Anderson's thesis in his Symposium article asserts that an insurance policy is a consumer product, not merely a contract. After years of premium payments, and after a claim is made, policyholders all too often are shocked to discover that the insurance coverage they *thought* they had purchased was illusory. Unfortunately, an insurance product is much different from other products. An insurance policy cannot be replaced after a policyholder suffers a loss; it cannot be replaced after an insurance company breaches its obligation to cover such a loss. A policyholder cannot decide to take its business elsewhere once it has suffered a loss—by then, it is too late.

Traditional contract law principles, Mr. Anderson argues, do not adequately compensate a policyholder who has been wrongfully denied insurance coverage, since Anglo-American legal doctrines too often reward a party who breaches a contract. Opportunistic breaches of insurance contracts are common, and they are overwhelmingly cost-effective for insurance companies. Insurance companies win by saying "No." The reasonable expectations doctrine thus gives policyholders the insurance coverage they thought they had, and the courts should apply the doctrine of reasonable expectations more fully to protect a policyholder's rights as the purchaser of a product, not a contract.

Susan Popik, Esquire is a partner in the San Francisco law firm of Chapman, Popik & White. Ms. Popik is a prominent insurance defense attorney, and she also serves on the editorial board of the *CGL Reporter* and as a contributing editor for the *California Civil Litigation Reporter* in the area of insurance litigation.[31]

The thesis of Ms. Popik's Symposium article is that in theory, and when properly limited, the insurance law doctrine of reasonable expectations serves a useful consumer protection function. In practice, however, the doctrine—intended as a shield against contractual overreaching—has too often been used as a sword to eviscerate clear and unambiguous policy language. In the hands of a result-oriented court, invocation of the "reasonable expectations" mantra becomes a license to rewrite the policy to ensure a result that benefits the insured. In these instances, the question becomes not what the insured, at the time of purchase, reasonably expected the policy to cover, but what he or she, following a loss, fervently wished it covered.

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30. *See* EUGENE ANDERSON, ET AL., INSURANCE COVERAGE LITIGATION (Giovanni Rodriguez ed., John Wiley & Sons, Inc. 1997)

31. *See* CAL. CIV. LITIG. REP. (1985-Present).

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Although it would seem that one answer to this problem would be to limit the doctrine of reasonable expectations to a rule of construction, thus requiring a judicial finding of ambiguity before the doctrine could be invoked, the case law does not support this conclusion. Ambiguity is in the eye of the beholder, argues Ms. Popik, and result-oriented courts have had no greater difficulty divining multiple meanings than they have conjuring disappointed expectations.

Whether employed to defeat the terms of unambiguous policy language or as a variation of the *contra proferentum* doctrine, Ms. Popik argues that the reasonable expectations doctrine must be confined to those relatively few situations in which there is objective evidence beyond the insured's personal assurances to support the application of the doctrine. To accept any other rule would be to countenance a form of post-loss underwriting that leads to inconsistent and unpredictable results, which ultimately inures to the detriment of insurers and insureds alike.

The Honorable H. Walter Croskey is Associate Justice of the California Court of Appeal, Second Appellate District. In addition to his busy judicial workload, Justice Croskey also is a noted authority on California insurance law.[32] In his Symposium article, Justice Croskey discusses the development, evolution, and the current status of the doctrine of reasonable expectations in California insurance law from a judicial perspective.

Justice Croskey notes that in the context of the construction and interpretation of insurance policy provisions, California insurance law has long recognized the importance of an insured's reasonable expectations to coverage. For example, in 1936, a California Court of Appeal decision noted that an insurance policy's provisions "must be construed so as to give the insured the protection which he *reasonably had a right to expect*, and to that end [any] doubts, ambiguities, and uncertainties arising out of the language used in the policy must be resolved in his favor." Prior to 1990, this summarized California's very wide open *pro-insured* approach to the resolution of policy ambiguity issues. The doctrine of reasonable expectations therefore was the effective rationale justifying a bias in favor of coverage when any ambiguity in the policy language *semantically* could be demonstrated.

However, in 1990 this all changed. In what can only be described as a major departure from prior law, the California Supreme Court adopted a more restrictive rule of construction with the emphasis now placed on the *objectively* reasonable expectations of the insured. Now, in California, no ambiguity can

32. *See, e.g.*, H. Walter Croskey, *Bad Faith in California: Its History, Development and Current Status*, 26 TORT & INS. L.J. 561 (1991).

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be resolved in favor of the insured unless it comports with the insured's objectively reasonable expectations in light of: (1) the language used in the entire policy; (2) the total circumstances of the case; and (3) common sense. Thus, the doctrine of reasonable expectations, which had served as the rationale for a pro-insured interpretive approach in California, now serves as an analytical tool in California for limiting coverage. Justice Croskey's Symposium article examines this significant change, the full scope of which was not initially appreciated by the bench and bar, and the court's rationale for its adoption, and how it is being currently applied in particular cases. We are honored to include Justice Croskey's article in our Symposium issue on the insurance law doctrine of reasonable expectations after three decades.

The Doctrine of Reasonable Expectations and Related Insurance Coverage Issues:
A Selected Bibliography

In addition to these ten Symposium articles, the reader is also directed to the following related articles and treatises analyzing the insurance law doctrine of reasonable expectations:

Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions* (Parts I & II), 83 HARV. L. REV. 961 (1970) and 83 HARV. L. REV. 1281 (1970) (developing the modern insurance law doctrine of reasonable expectations). *See also* Robert E. Keeton, *Reasonable Expectations in the Second Decade*, 12 FORUM 275 (1976); and ROBERT E. KEETON & ALAN WIDISS, INSURANCE LAW §§ 6.01-6.10 (1988).

Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151 (1981).

Kenneth S. Abraham, *A Theory of Insurance Contract Interpretation*, 95 MICH. L. REV. 541 (1996).

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Fredrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1971).

William Mark Lashner, *A Common Law Alternative to the Doctrine of Reasonable Expectations*, 57 N.Y.U. L. REV. 1175 (1982).

David Leitner, *Enforcing the Customers "Reasonable Expectations" in Interpreting Insurance Contracts*, 38 FED. INS. & CORP. COUNS. Q. 379.

William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267 (1986).

Note, *Reasonable Expectations Approach to Insurance Contract Interpretation Modified in Missouri*, 47 MO. L. REV. 577 (1982).

BARRY OSTRAGER & THOMAS NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 1.03 (9th ed. 1998).

Jeffrey Pawelski, *Insurers Don't Need the Courts to "Babysit" Them: An Argument for Reasonable Expectations in American Family Mutual Ins. Co. v. Elliot*, 41 SAN DIEGO L. REV. 375 (1996).

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INSURANCE, CONTRACT, AND THE DOCTRINE OF REASONABLE EXPECTATIONS

Robert H. Jerry, II[1]

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1. Missouri Endowed Floyd R. Gibson Professor, University of Missouri-Columbia School of Law. The author expresses his appreciation to Melissa Hilton and Daniel Lovett, both 1998 graduates of The University of Memphis School of Law, for their excellent research assistance. He also thanks the trusts of the Herff Chair of Excellence in Law at The University of Memphis and the Missouri Endowed Floyd R. Gibson Professorship for its support. In the interest of full disclosure, the author notes that he has occasionally consulted with attorneys for both policyholders and insurers regarding insurance contract interpretation and other issues.

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INTRODUCTION

Legal rules, somewhat like laws of science,[2] await discovery by explorers whose prescience enables them to understand something others observed but could not comprehend. We honor the explorer's achievements; if the discovery is important enough, we are likely to celebrate the discovery at periodic intervals and to re-examine where legal analysis or scientific discovery has taken us in the intervening years.

In the field of insurance law, Judge Robert Keeton is one of the grandest explorers of them all. In 1970, he published a prescient two-part article in the *Harvard Law Review*[3] in which he identified "two broad principles [that] account for such a high percentage of what might otherwise appear to be deviant decisions that the remainder can be accepted as within the margin of error one should expect in the administration of any set of guidelines."[4] The first of these principles was that "an insurer will be denied any unconscionable advantage in an insurance transaction, and [the second was that] the reasonable expectations of applicants and intended beneficiaries will be honored."[5] With time, the second of the two principles became known as a "doctrine," and the so-called "doctrine of reasonable expectations" (or "DRE") is nearing almost three decades of evolution. During this period, insurance law scholars have followed the ritual of assessing the state of the doctrine in roughly ten-year intervals,[6] and the calendar tells us it is time for another look.[7]

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2. The metaphor is inspired by Roger Henderson, 5 CONN. INS. L.J. 69 (1998) who likens Professor Keeton to the discoverer of a comet. Id. at 70.

3. Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions* 83 HARV. L. REV. 961 (1970) (hereinafter "Keeton Part One"); Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part Two,* 83 HARV. L. REV. 1281 (1970).

4. Keeton Part One, *supra* note 3 at 961.

5. *Id.*

6. *See* Robert E. Keeton, *Reasonable Expectations in the Second Decade,* 12 FORUM 275 (1976); Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades,* 51 OHIO ST. L. J. 823 (1990).

7. Some though not all, of other reassessments of reasonable expectations occurred near the ten-year anniversary of the doctrine's recognition. Some of the works include: Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured,* 67 VA. L. REV. 1151 (1981); Arnold P. Anderson, *Life Insurance Conditional Receipts and Judicial Intervention,* 63 MARQ. L. REV. 593 (1980); Gary L. Birnbaum, et al., *Standardized Agreements and the Parol Evidence Rule: Defining and Applying the Expectations Principle,* 26 ARIZ. L. REV. 793 (1984); Mark S. Rahdert, *Reasonable Expectations Reconsidered,* 18 CONN. L. REV. 323 (1986); Stephen W. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine,* 56 U. CHI. L. REV. 1461 (1989); Karen K. Shinevar, Comment, *A Reasonable Approach to the Doctrine of Reasonable Expectations as Applied to Insurance Contracts,* 13 U. MICH. J. L. REFORM 603 (1980);

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This article examines the connections between the doctrine of reasonable expectations and the law of contract. Judge Keeton urged in his 1970 article that protecting the insured's reasonable expectations is a better justification for results in many reported cases than the rationales offered by judges.[8] Without disagreeing with that point, it can be claimed, as this article does, that insurance law's efforts to explain outcomes that contradict the plain language of contractual text are appropriately viewed as a subset of a larger effort to rationalize contract law with the challenges presented by the widespread use of standardized forms in consumer transactions. When viewed from this different perspective, Judge Keeton's 1970 article was important not only for what it said about the contours of insurance law but also for what it suggested about the stance insurance law should take in an ongoing—and still continuing —battle for the soul of contract law.

Whether or not one embraces the doctrine of reasonable expectations, it is undeniable that Judge Keeton's doctrine has relevance well beyond the boundaries of insurance law. Indeed, reasonable expectations have long been the salient feature of the law of promissory obligations, as illustrated by the brief tour in the next section of some of contract law's familiar terrain.

I. REASONABLE EXPECTATIONS AND CONTRACT LAW

A fundamental purpose of contract law is protecting the expectations of contracting parties. Because our society views utility-increasing exchanges between consenting parties as something well worth promoting, contract law encourages such relationships by giving parties a predictable basis for relying upon and enforcing bargains. Expectations constitute, of course, the core of these relationships; whenever two parties exchange promised performances, the manifested commitments excite reciprocal expectations. If one side's expectation is disappointed, contract law entitles the aggrieved party to respond in a way that, at least in theory, restores that party to the position he or she

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William Lashner, Note, *A Common Law Alternative to the Doctrine of Reasonable Expectations in the Construction of Insurance Contracts,* 57 N.Y.U. L. REV. 1175 (1982); *see generally* ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 25D, at 141-47 (2d ed. 1996); ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW § 6.3, at 627-46 (student ed. 1988); JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS §§ 11.1-11.4, at 311-58 (1994); BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 1.03, at 17-38 (1997); EUGENE R. ANDERSON, ET AL., INSURANCE COVERAGE LITIGATION, vol. 1, at 66-76 (1997). For a detailed accounting of articles, essays, notes, and comments published as of 1990, *see* Henderson, *supra* note 6, at 823-24 nn.6-8.

8. Keeton, Part One, *supra* note 3, at 972-73.

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expected to occupy as a result of full performance of both sides' contractual commitments.

Yet the protection afforded by contract law to disappointed expectations is not unlimited. Not all promises are or should be enforceable; accordingly, much of contract law is concerned with establishing the boundary between enforceable promises and promises that have no remedy if not performed or otherwise discharged.[9] Stated otherwise, much of contract law explains whether it is reasonable or unreasonable for a promisee to expect the promisor to perform his or her promise. Some of the more prominent features of contract law where the reasonableness of expectations is the controlling concept are discussed in the following subsections.

A. Remedies

Perhaps the most obvious role expectations play in the law of contract is defining the remedy to which a party aggrieved by another's breach is entitled. The formula taught in first-year contracts courses and applied in countless decisions puts the aggrieved promisee in the position he or she would have occupied if the promise had been performed. Compensating an aggrieved party for disappointed expectation ordinarily produces a damage recovery that is larger, and perhaps much larger, than what reimbursing the promisee's reliance would require. Likewise, protecting the promisee by requiring the breaching party to disgorge benefits received under a restitution analysis would almost always produce a smaller recovery for the victim of a breach.[10] By allowing aggrieved promisees to recover the broadest of the measures, contract law encourages wealth-producing transactions and provides a strong incentive for productive reliance on the commitments of others. Indeed, in a complex credit-oriented economy such as ours, protecting expectation is essential if investment capital is to be channeled toward wealth-producing activities.[11]

Expectation, relative to reliance and restitution, is the broadest measure of recovery for breach of contract, but most of the remaining principles of contract remedies have the effect of limiting, rather than expanding, the obligation of the breaching party.[12] These principles stand, in effect, for a set of rules that explain when an aggrieved party's expectations are unreasonable

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9. RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981).

10. *See id.* §347 (articulating the expectation theory).

11. *See* Central Trust Co. v. Chicago Auditorium Ass'n, 240 U.S. 581, 591 (1916) (providing that "[c]ommercial credits are, to a large extent, based upon the reasonable expectation that pending contracts of acknowledged validity will be performed in due course").

12. *See also* E. ALLAN FARNSWORTH, CONTRACTS 871-946 (2d ed. 1990) (hereinafter FARNSWORTH TREATISE); E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145 (1970).

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and therefore undeserving of protection. For example, the rule of *Hadley v. Baxendale*[13] provides that the aggrieved party can recover only those consequential damages which naturally arise from the breach and which were foreseeable at the time of contracting. Under this rule, it is unreasonable to expect to recover consequential damages that were unforeseeable at the time of contracting. To state it otherwise, one cannot reasonably expect to recover damages that the other party could not know to guard against; to allow a greater recovery would risk placing a potentially crushing burden on the breaching party, a risk which would deter beneficial entrepreneurial activity.

To take another example, it is well settled that one cannot recover damages that could have been reasonably avoided. It is, to state the proposition otherwise, unreasonable to expect to recover damages that one could easily avoid with reasonable efforts. The same point can be made with respect to the rules governing whether an aggrieved promisee's expectation recovery should be measured by reference to the cost of finishing the uncompleted performance or the net economic loss occasioned by the promisor's breach. One cannot have a reasonable expectation of recovering the cost to finish an uncompleted performance if the diminution in value from the shortfall in completion is less than the cost of completion. But the answer changes if the promisee contracted for a specific outcome—even an economically inefficient one—in circumstances where the promisor knew or had reason to know of the promisee's expectation; in such an instance, even an economically detrimental expectation can be reasonable.

To summarize, the package of rules defining the breaching party's contract liability essentially describes what the aggrieved party can reasonably expect to recover on account of the promisor's breach.

B. Contract Formation and Validation

Contract law also invokes reasonable expectations when determining whether a contract has been formed. Under classical bargain theory, contract formation requires a manifestation of mutual assent and consideration.[14] To manifest mutual assent to a bargain, each party must make a promise; the beginning or rendering of a performance can be the equivalent of a promise if the beginning or rendering is conduct manifesting assent or if it is what the other party is seeking.[15] Moreover, "promise" is defined as "a manifestation of intention to act or refrain from acting in a specified way, so made as to

13. 156 Eng. Rep. 145 (Ex. 1854).

14. *See* RESTATEMENT (SECOND) OF CONTRACTS § 17 (1981).

15. *See id.*, §§ 18, 19.

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justify a promisee in understanding that a commitment has been made."[16] Thus, when reduced to its essential ingredients, contract formation involves at least one promise and one promisee who has a reasonable expectation that the promise will be performed.

A depression-era case provides a useful illustration.[17] In *In re Home Protection Building & Loan Ass'n Appeal of Harris,*[18] appellant undertook to perform accounting services for a building and loan association from 1933 through 1936. He billed the association periodically, and payment was made by crediting the amount of each bill to a mortgage given by appellant to the association. When the association was liquidated by the state Secretary of Banking, the Secretary refused to compensate appellant, claiming that no express contract of employment existed. In finding an "implied contract" based on the conduct of the parties, the court explained that

> [a] promise to pay the reasonable value of the service is implied where one performs for another, with the other's knowledge, a useful service of a character that is usually charged for, and the latter expresses no dissent or avails himself of the service. A promise to pay for services can, however, only be implied when they are rendered in such circumstances *as authorized the party performing to entertain a reasonable expectation of their payment* by the party benefited.[19]

There is nothing controversial about the idea that contract formation presupposes the parties' mutual and reasonable expectations of being bound to each other. The cases tend to involve situations where a misunderstanding arises between the parties as to what their manifestations mean,[20] or where one party does not intend legal consequences but either knows or has reason to know that the other party expects a binding relationship in the circumstances.[21]

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16. *Id.*, § 2.

17. The use of older cases throughout this article to illustrate these ideas is deliberate. It is against the background of these cases that the early contracts scholars would have formed their views about contracts jurisprudence. *See infra* notes 39-41 and accompanying text.

18. 17 A.2d 755 (Pa. Super. 1941).

19. *Id.* at 757 (emphasis added).

20. *See* RESTATEMENT (SECOND) OF CONTRACTS § 20 (1981) (accompanying comments and illustrations).

21. This limitation fits under the umbrella of RESTATEMENT (SECOND) OF CONTRACTS § 20; the most common illustrations involve the joker being bound to his or her word in circumstances where the other side had no knowledge or reason to know that the promisor was

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In either situation, the question is what the parties understand or have reason to understand in the circumstances. Thus, the promisee who is aware the promisor is bluffing cannot reasonably expect the promisor to perform; but when the promisee is unaware of the "joke" and the promisor should reasonably know of the promissee's lack of knowledge, the promisor will be held to his or her word.

Even if the parties manifest mutual assent to be bound, a contract will not be enforced absent consideration or the presence of a recognized substitute. The consideration doctrine, although something of an historical accident, works as a proxy for societal norms that separate enforceable (typically, bargained-for exchanges) from non-enforceable agreements (e.g., promises to make future gifts, promises given in exchange for a pre-existing duty, promises to forbear asserting invalid claims). Although consideration is most often understood as a rule that distinguishes the enforceable agreement from the unenforceable one, it is appropriate to view it as furthering the unarticulated purpose of promoting reasonable expectations. Under the prevailing societal norms that the consideration doctrine promotes, one cannot reasonably expect to enforce another's promise if nothing of value is traded. Thus, if A convinces B to promise something of value in return for A's promise to forbear from doing something A had no legal right to do or to perform an act that A was already obligated to do, A should not reasonably expect to be able to enforce B's valuable promise.

When the doctrine of consideration is invoked either by a party in argument or by a court as the basis for a decision, the role that reasonable expectations plays is not typically explained or articulated. Reasonable expectations have played a more obvious role in the development of an alternative kind of contract which is enforceable without consideration.[22] Under the doctrine of promissory estoppel,[23] a promise is enforceable in the absence of a bargained-for exchange if the promisor should reasonably expect that the promise will induce the promisee's reliance. What distinguishes a contract enforceable by promissory estoppel from the garden-variety bilateral contract

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joking, but the joker knew or had reason to know that the promisee would understand the words to be language of commitment.

22. That the consideration substitute—detrimental reliance—is a theory grounded in reasonable expectations shows, in and of itself, that the consideration doctrine has a direct, even if unarticulated, relationship to reasonable expectations.

23. *See* RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981) ("A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.").

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is that the former has no agreement, no bargained-for exchange, no consideration, and only one promise instead of two. Yet, when a promise is enforceable under promissory estoppel, reasonable expectations must exist on both sides of the transaction, even if a promise exists on only one. The promisee relies on the promise because the promisee reasonably expects the promisor to fulfill the promise; the promisor is bound because he either reasonably expects or should reasonably expect the promisee to rely on the promise. Although the doctrine of promissory estoppel does not seem particularly radical from the perspective of the end of the twentieth century, historians may judge the emergence of the doctrine as the most significant contract law development of the last one hundred years, and subsequent generations may mark the advent of promissory estoppel as the beginning of the end for the centuries-old doctrine of consideration.

Whatever course this evolution takes, it is already apparent that reasonable expectations are at the core of promissory estoppel. Promissory estoppel originated as a response to a perceived deficiency in the way contract law's bargain theory treated promises for future gifts. Under the rule that a bare promise to make a future gift was unenforceable for lack of consideration, the recipient of the promise was in a particularly difficult spot. Because the promise was not an offer seeking something in exchange, the promisee could not give an acceptance that would make the promise binding or prevent its revocation. In several early twentieth century cases involving charitable subscriptions,[24] the promise of a gift was deemed binding by virtue of the reliance that the promised gift would foreseeably induce on the part of the promisee. Yet judges were uncomfortable enforcing promises in the absence of consideration, and it was therefore common for courts to find consideration somewhere in the transaction, even if the basis for recognizing it was extremely tenuous.[25] Embedded in the holdings of these early cases was the promisee's foreseeable reliance because of a reasonable expectation that the promisor's promise would be performed. Chief Judge Cardozo recognized this in his celebrated opinion in *Allegheny College v. National Chautauqua County Bank of Jamestown,*[26] where he stated, even as he found consideration for the donor's promise in an implied promise by the college to set up a memorial fund:[27]

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24. *See* FARNSWORTH TREATISE, *supra* note 13, at 93-94.

25. *Id.* at 94; *see, e.g.*, I. & I. Holding Corp. v. Gainsburg, 12 N.E.2d 532 (N.Y. 1938); Allegheny College v. National Chautauqua County Bank of Jamestown, 159 N.E. 173 (N.Y. 1927).

26. 159 N.E. 173 (N.Y. 1927).

27. *Id.* at 176.

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> There has grown up of recent days a doctrine that a substitute for consideration or an exception to its ordinary requirements can be found in what is styled "a promissory estoppel." . . . Very likely, conceptions of public policy have shaped, more or less subconsciously, the rulings thus made. Judges have been affected by the thought that "defenses of that character" are "breaches of faith toward the public and especially toward those engaged in the same enterprise, and *an unwarrantable disappointment of the reasonable expectations of those interested.*"[28]

In other words, the essential point of promissory estoppel was that the reasonable expectations of the relying promisee deserved protection when the promisor could foresee (i.e., reasonably expect) such reliance.

Whether a contract is formed by bargain or reliance, the reasonable expectations of the parties are fundamental to the creation of a contractual obligation. Indeed, it is apparent that the promissory estoppel doctrine emerged in response to the bargain theory's inability to prevent the disappointment of a promisee's reasonable expectations in some circumstances.

C. Modification of Agreements

The issue of contract modification is, in some respects, simply one facet of contract formation. To modify or rescind an existing contract, the parties must have mutual assent to do so, or one party must reasonably rely on the

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28. *Id.* at 175 (emphasis added). The reasonable expectations underpinning for promissory estoppel was reiterated in other New York decisions. In *Matter of First M.E. Church of Mount Vernon v. Estate of Howard,* 233 N.Y.S. 451 (N.Y. Sup. Ct. 1929), *aff'd,* 250 N.Y.S. 906 (N.Y. App. Div. 1931), the court stated: "The Allegheny College case indicates the growth of the judicial process wherein the law is made to conform to the justice of the case, *and wherein the law enforces the reasonable expectations arising out of conduct.*" *Id.* at 455 (emphasis added). *See also* Barnes v. Perine, 12 N.Y. 18, 24 (1854), wherein the court made the same point:

> The objection of want of consideration for promises [of charitable subscriptions] has not always been regarded with favor; and judges, considering defences of that character as breaches of faith towards the public, and especially towards those engaged in the same enterprise, and *an unwarrantable disappointment of the reasonable expectations of those interested*, have been willing, nay apparently anxious, to discover a consideration which would uphold the undertaking as a valid contract.

12 N.Y. at 24 (emphasis added).

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other's promise of a modification or rescission.[29] Under bargain theory, the consideration requirement must also be met. Much like contract formation, situations arose where the requirements of a contract to modify were not met but the values of promoting fairness and preventing unfair surprise called for recognizing the validity of the attempted modification. Like the contract formation rules, the law in the area of modification of agreements has also been influenced by reasonable expectations.

This is particularly evident in those cases where the parties altered a contract in response to unforeseen or unexpected conditions and the technical requirements of the consideration doctrine were not met. *William Lindeke Land Co. v. Kalman*,[30] a 1934 Minnesota Supreme Court decision, is illustrative. The lessee, like many tenants during the depression, was losing money in its operation of several eating establishments and faced the need to vacate its leased premises unless the lessor would agree to reduce the rent. The lessor agreed to a reduction of rent, but later denied the validity of the modification on the ground that no consideration was received for it. In finding the modification to be enforceable, the court stretched the consideration doctrine to prevent a finding of invalidity, holding that a good faith modification of a contract in response to unforeseen, substantially different circumstances was enforceable. In rejecting strict application of the consideration doctrine in such circumstances, the court described consideration "as a medieval doctrine" and referred to the no-settlement-without-consideration rule as one "responsible for the greater part of the objectionable applications of the doctrine of consideration, whereby the *reasonable expectations* of business men have been disappointed."[31]

D. Contract Interpretation and Scope of Obligations

Reasonable expectations have long played a decisive role in contract interpretation. The principles approved by the court in *Terrell v. Alexandria Auto Co.*[32] are representative of judicial sentiment:

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29. The promise of rescission is functionally the equivalent of a promise to release the other party from his or her contract duties. This idea is also closely connected to the doctrines of waiver and estoppel.

30. 252 N.W. 650 (Minn. 1934).

31. *Id.* at 613 (emphasis added) (quoting James Barr Ames, *Two Theories of Consideration*, 12 HARV. L. REV 515, 524-525). *See also* Watkins & Son v. Carrig, 21 A.2d 591 (N.Y. 1941) ("[c]hanges to meet changes in circumstances and conditions should be valid if the law is to carry out its function and service by rules conformable with reasonable practices and understandings in matters of business and commerce.").

32. 125 So. 757 (La. App. 1930).

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> In interpreting a contract not specific in its wording, it is necessary to take into consideration the custom of the place and the usual and customary manner of fulfilling like contracts in arriving at what was *the reasonable expectation of the parties* to the contract at the time it was made.[33]

Implicit in the foregoing statement is the observation that a promisee is not entitled to receive whatever performance he or she subjectively desires; what the promisor reasonably expected must be given some account. Furthermore, the Anglo-American system of contract law sorts out disputes over the scope of contractual obligations by measuring rights and duties in predominantly objective terms: the scope of an obligation is measured not by what the speaker subjectively intends, but by what the speaker apparently manifests. Thus, when A speaks to B, the words A uses are given the meaning that B could reasonably understand the words to mean in the circumstances in which they were uttered.[34] The rubric of plain meaning interpretation would seem to undercut this framework, but the essence of plain meaning is that the person to whom words are manifested should reasonably understand the words in accordance with their plain meaning because attaching any other meaning to them is unreasonable.[35] Whatever significance one ultimately gives plain meaning,[36] the fact remains that the predominantly objective system of contract law protects the reasonable expectations of contracting parties, even if there is some disagreement in the cases over what rules should be applied to determine what a promisee might reasonably expect in any particular set of circumstances.[37]

These principles were recognized and applied by Judge Cardozo in *Bird v. St. Paul Fire & Marine Insurance,*[38] the famous insurance causation case decided in 1918. The question in *Bird* was whether a policy of fire insurance covered damage to a vessel, which was located about 1,000 feet away from a

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33. *Id.* at 758.

34. This rather simple statement disguises some rather subtle and complicated problems. For more discussion in the context of insurance, *see* Robert H. Jerry, II, *Consent, Contract, and the Responsibilities of Insurance Defense Counsel*, 4 CONN. INS. L.J. 153 (1997-1998).

35. *Id.* at 166.

36. The status of the so-called "plain meaning rule" is a subject of considerable dispute in contract law. *See generally* FARNSWORTH TREATISE, *supra* note 12, at § 7.12 (providing more detailed discussion on the contract law dispute regarding the "plain meaning rule").

37. See ARTHUR C. CORBIN, THE LAW OF CONTRACTS § 1, at 2 (1950) (one-volume edition) ("The law does not attempt the realization of every expectation that has been induced by a promise; the expectation must be a reasonable one. . . . The expectation must be one that most people would have; and the promise must be one that most people would perform.").

38. 120 N.E. 86 (N.Y. 1918).

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fire which never reached the vessel, in circumstances where the loss resulted from a concussion accompanying an explosion that resulted from the fire. The case turned on whether the fire, a covered cause, was the "proximate cause" of the loss, and the court held that it was not. In reaching that result, the court framed the issue as one of contract and invoked reasonable expectation as the "guide:"

> Our guide is *the reasonable expectation and purpose* of the ordinary business man when making an ordinary business contract. It is his intention, expressed or fairly to be inferred, that counts. There are times when the law permits us to go far back in tracing events to causes. The inquiry for us is how far the parties to this contract intended us to go. The causes within their contemplation are the only causes that concern us.[39]

Moreover, Cardozo viewed reasonable expectations as a two-way street; each party was as entitled to assert them as the other. Thus, in an insurance setting, Cardozo thought it as important to consider the reasonable expectations of insurers as it was to examine the expectations held by insureds. In *Smith v. Northwestern Fire & Marine Ins. Co.*,[40] where the insurer sought to deny coverage on account of the insured's alleged breach of a warranty of seaworthiness, Cardozo wrote:

> The primary purpose of a voyage policy is insurance of the risk during a voyage then in view. Whatever insurance attaches at the home port is incidental and preliminary. There can be little doubt that the reasonable expectations of the insurer are frustrated if the vessel starts on her voyage without suitable equipment.[41]

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39. *Id.* at 87 (emphasis added). Cardozo must have been fond of this passage, for he quoted it in later cases. *See* World Exch. Bank v. Commercial Cas. Ins. Co., 173 N.E. 902 (N.Y. 1930) (citing both *Bird* and *Silverstein*); Silverstein v. Metropolitan Life Ins. Co., 171 N.E. 914 (N.Y. 1930). Cardozo also invoked "reasonable expectation" to help explain the meaning of the tort doctrine of proximate cause. *See* Perry v. Rochester Lime Co., 113 N.E. 529 (N.Y. 1916).

40. 159 N.E. 87 (N.Y. 1927).

41. *Id.* at 93. In other contexts, courts have used reasonable expectations to delineate the scope of contractual duties. For example, in *Daggett & Graves v. Johnson*, 49 Vt. 345 (1877), the court explained that a buyer who agreed to pay for milk pans "if satisfied with the pans" could not arbitrarily indicate his dissatisfaction and thereby refuse to pay for the pans. Instead,

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The parol evidence rule, which receives more attention below,[42] is a substantive doctrine that can be determinative in cases where the scope of contractual obligations is disputed. If the parties execute a writing and one party claims that a prior or contemporaneous oral statement or writing is part of their overall agreement, the parol evidence rule's machinery is triggered. If the court concludes that the writing sought to be supplemented or contradicted is an integration (either complete or partial), then the rule will be applied for the purpose of determining whether the collateral statement or writing is part of the parties' agreement. Those who have tried to justify the parol evidence rule usually explain its purpose as protecting the integrity of a writing intended by the parties to be a final, and perhaps complete, expression of their agreement. To state this purpose in other words, a party who enters into a complete integration should not reasonably expect to be able to contradict or supplement the writing with evidence of prior or contemporaneous negotiations or statements. Also, a party who enters into a partial integration should not reasonably expect to be able to contradict the writing with such evidence, although consistent supplementation is not outside the zone of reasonable expectation. From the opposite perspective, a party who stands on the writing and seeks the protection of the parol evidence rule will assert a reasonable expectation that the writing should be treated as final and perhaps complete as well.

To summarize, reasonable expectations set the coordinates for the process of identifying the terms of a contract, determining the meaning of disputed or ambiguous terms, and otherwise defining the scope of contractual duties.

E. Rights of Third-Party Beneficiaries

The reasonableness of a third party's expectations is important in determining whether that party has rights as an intended beneficiary of a contract. Although it is not essential that a beneficiary know of the contract

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"[h]e must act honestly and in accordance with the reasonable expectation of the seller, as implied from the contract, its subject-matter, and surrounding circumstances." *Id.* at 348-49. *See also* Olympia Bottling Works v. Olympia Brewing Co., 107 P. 969 (Or. 1910) (approving *Daggett & Graves*). In *Dunham, Carrigan & Hayden Co. v. Thermoid Rubber Co.*, 258 P. 663 (Cal. App. 1927), the court explained that a seller under an output contract could not recover damages from a buyer based on the buyer's failure to resell a large volume of tires; "The large volume now claimed essential by [seller] appears from the evidence to have been so far beyond all reasonable expectation at that time that it was never mentioned." Dunham, 258 P. at 665.

42. *See infra* note 58 and accompanying text.

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made for his or her benefit to have a right to recover on it,[43] whether a beneficiary has third-party rights is affected by whether "the beneficiary would be reasonable in relying on the promise as manifesting an intention to confer a right on him."[44] This factor was recognized in *Trustees of the M.E. Protestant Church v. Adams*,[45] an 1870 Oregon case. The court explained that

> [t]he rule ordinarily is, that a mere stranger to an executory contract between third persons cannot avail himself of the benefits of its provisions, although named therein as a beneficiary; but where the contract is of such a nature and has been so far acted upon as to change the condition in life of the stranger, and *to raise reasonable expectations in him*, grounded upon the contract, it constitutes an exception to the general rule.[46]

Thus, whether a party not in privity with the contracting parties has a reasonable expectation of receiving a benefit under the contract can affect whether the party has rights as a third-party beneficiary.

F. Policing Doctrines

Protecting expectations is a fundamental objective of contract law, but promoting fairness is no less important. Although the strength of judicial concern for fairness has varied across generations, the status-based, centuries-old capacity rules for infants, the infirm, and others provide ancient evidence of judicial regulation of contractual exchanges for fairness. In the late twentieth century, many doctrines serve a policing function, including the doctrines of duress, fraud, concealment, misrepresentation, unconscionability, mistake, impracticability, and supervening frustration. Professor Farnsworth's scholarship labels these doctrines as "policing doctrines," that is, doctrines pursuant to which courts "police" the fairness of contracts.[47]

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43. *See* RESTATEMENT (SECOND) OF CONTRACTS, § 302 cmt. c (1981) (referring to donee beneficiary, neither contact nor communication between the beneficiary and the contracting parties is essential). An obvious application of this rule in insurance involves life insurance beneficiaries, who do not need notice that they have been made beneficiaries on the contract between the policyholder and the insurer in order to have rights under the insurance contract.

44. *Id.* § 302 cmt. d.

45. 4 Or. 76 (1870).

46. *Id.* at 87 (emphasis added).

47. *See generally* FARNSWORTH TREATISE, *supra* note 12; E. ALLAN FARNSWORTH & WILLIAM F. YOUNG, CONTRACTS: CASES AND MATERIALS (5th ed. 1995).

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To some extent, the twin purposes of protecting expectations and promoting fairness conflate. When a court declares that an expectation asserted by a promisee is outside the zone of reasonableness, the application of the relevant contract law principle carries with it a corollary assertion: it would be unfair to the promisor if the promisee's expectation was protected. To illustrate the point, consequential damages outside the range of foreseeability are not part of a reasonable expectation that contract law will protect; yet implicit in that principle is a normative judgment that imposing unforeseen, and perhaps crushing, consequential damages on a breaching party would be unfair.

The policing doctrines, as applied by courts, regulate the allocation of risks in contractual exchanges and protect parties from conduct or substantive outcomes offensive to a sense of justice grounded in judicially-recognized collective norms. Because standardization has put pressure on the classical contract paradigm, the policing doctrines embraced by contract law have been put to frequent use when consumers have contested the implications of text in standardized forms, including insurance policies. This particular context is, of course, where Judge Keeton offered his insights.

II. JUDGE KEETON'S DOCTRINE OF REASONABLE EXPECTATIONS

In the first part of his 1970 article, then-Professor Keeton identified "two broad principles [that] account for . . . a high percentage of what might otherwise appear to be deviant decisions" in insurance jurisprudence.[48] The first involved judicial disallowance of unconscionable advantage: "An insurer will not be permitted an unconscionable advantage in an insurance transaction even though the policyholder or other person whose interests are affected has manifested fully informed consent."[49]

In the fashion of contract law's substantive unconscionability doctrine,[50] Keeton's first principle noted those cases in which the substantive unfairness of insurance contracts was regulated and observed that the principle operated without regard to the insured's expectations. In other words, a finding of unconscionability would not depend on the insured's expectation; the insured's expectation of something different from what the insurer promised was not a predicate to the application of the unconscionability principle. Even if the insured expected restrictive coverage by virtue of an accurate understanding of

48. Keeton, Part One, *supra* note 3, at 961.

49. *Id.* at 963.

50. *See* UCC § 2-302 (1978); Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965).

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clear language negating coverage, the plain language of the policy would not be enforced if to do so would give the insurer an "unconscionable advantage." In Keeton's assessment,

> [t]his principle explains much that is called waiver or estoppel in insurance law, in circumstances involving neither voluntary relinquishment nor detrimental reliance — the essence of waiver and estoppel respectively. It also accounts for most of the distinctive controls over defenses based on warranty, representation or concealment. . . . In addition, the principle underlies the formulation of the precise terms of choice imposed upon insurers in the most common applications of the doctrine of election. . . .[51]

The second principle, which Keeton called "honoring reasonable expectations," was articulated in the now-famous and oft-repeated formulation: "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."[52] In elaboration upon the principle, Keeton noted the historic inequality in bargaining power between insurer and insured, the adhesive nature of the contractual relationship, the absence of choice among standardized forms, and inert statutory and regulatory oversight. Though Keeton pointed out that "judicial regulation of contracts of adhesion . . . remains appropriate," he concluded that embedded in the array of regulatory doctrines was "a principle broader than the separate bodies of doctrine it has sustained."[53]

As a statement of principle, the doctrine of reasonable expectations articulated by Keeton overlapped with many other rules. Indeed, he said as much in the introduction to his article; he specifically observed that the principle purported to synthesize what was occurring in many insurance law cases.[54] In particular, he acknowledged that the reasonable expectations principle overlapped in significant ways with the unconscionability principle. Because insureds do not expect insurers to seek unconscionable advantages, any effort by the insurer to constrain or deny coverage in substantively unfair ways is inconsistent with the insured's reasonable expectations. By the same

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51. Keeton, Part One, *supra* note 3, at 963-64.
52. *Id.* at 967.
53. *Id.*
54. *See id.* at 961-62.

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token, the insured does not expect fine-print, or even some bold-print, exclusions or definitions that significantly constrain coverage. Thus, in many situations, pro-insured results could be obtained by resort to either the unconscionability or the reasonable expectations principle.

What seemed new about reasonable expectations, as articulated by Keeton, was its transcendence of *contra proferentem*. The widely recognized principle that contracts, when ambiguous, are to be construed against the drafter depended, by its own terms, on the existence of an ambiguity. The reasonable expectations principle, as articulated by Keeton, had no such limitation; on the contrary, the essential point was that the insured's reasonable expectations could be enforced even in the face of unambiguous policy language. This particular aspect of the Keeton formulation was important for at least two reasons.

First, when the Keeton formulation stated that plain, unambiguous text could be trumped by an insured's expectations, the formulation created an alarming challenge to insurers' efforts to draft and achieve predictability. It was not the case, of course, that insurers had never before confronted judicial regulation through waiver, estoppel, election, and other principles, all of which frequently did excuse the insured from the full consequences of unambiguous text. Each situation, however, tended to turn on the facts of the specific case, and while some statements of principle emerged from these cases (e.g., an insurer that delays investigating a claim might be estopped to deny the claim's validity), these principles would not operate to change the insurer's obligations for an entire category of cases. In fact, these principles created a right in variance with coverage only if the facts of the specific transaction seemed to justify it. The Keeton formulation went beyond these other kinds of regulation to which insurers had comfortably, if not willingly, adapted.

Keeton's formulation, unlike most other kinds of judicial regulation, seemed to present a frontal challenge to insurers' ability to control how they separated risks and priced policies. An insurance company's ability to calculate premiums depends on its ability to measure risk with some precision, even as it takes advantage of the laws of large numbers to facilitate distribution of the losses associated with random events. The delineation of coverage in the contract is intended, of course, to correlate closely with the risks the insurer is willing to assume in exchange for the insured's payment of a premium. To the extent the scope of the risk transferred in the insurance contract depends on the scope of the insured's expectation, the insurer confronts a variable in its pricing strategy that is difficult to measure, at least as unpredictable as jury verdicts or judicial findings, and hard to control. From the insurance industry's perspective, any insurer that succeeds in drafting clear, unambiguous text ought

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to enjoy the benefit of that text, notwithstanding a different understanding or expectation held by the insured (assuming that the insurer or its agent did nothing to promote that different understanding and that the text is not unconscionable). The Keeton doctrine, however, challenged this assumption; from the insurer's perspective, the doctrine put the *insurer's* reasonable expectation at risk.

Second, implicit in the observation that the Keeton principle was stronger than *contra proferentem* was the notion that something beyond contract law was being invoked to create rights at variance with policy provisions. Keeton described the principle as one that synthesized many "doctrinal theories," including waiver, estoppel, *contra proferentem*, reformation, rescission, modification rules in contract, and agency.[55] Because the policyholder's right was not recognized by the text of the contract, the unstated implication was that contract was not the source of the right. Treating the doctrine of reasonable expectations as extracontractual also coincided with the argument that an insurance policy, because of the "special relationship" at its core, is something more than a contract and should be viewed as a product or some kind of chattel or quasi-chattel.[56]

Ironically, at the same time Keeton's reasonable expectation principle seemed new and dramatic, it also seemed to restate existing law. The cases Keeton cited and discussed did contain what he described as "compelling currents of principle,"[57] even as they applied a wide variety of doctrinal theories. Yet the "compelling currents" he observed were also a shared current, in that running through the cases was a single shared principle. This singularity devolved from the fact that the courts in these cases were answering one common question:

> Under what circumstances can unambiguous language in an insurance policy be disregarded in favor of an expectation of the insured that is inconsistent with or contradicted by the language of the policy?

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55. *See id.* at 962.

56. *See, e.g.*, Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholders' Objectively Reasonable Expectations of Insurance* Coverage, 5 CONN. INS. L.J. 335 (1998); 1 EUGENE R. ANDERSON, ET AL., INSURANCE COVERAGE LITIGATION, 57-58 (1997); 8 JOHN ALAN APPLEMAN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE (1981); 7 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 900, at 34 (Jaeger ed. 3d ed. 1963) (stating that insurance might evolve into "a new and special form of chattel, or perhaps, quasi-chattel").

57. Keeton, Part One, *supra* note 3, at 961.

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The common answer Keeton saw in the cases was what he articulated as his second principle, which can be rephrased so that it answers the common question directly:

> Unambiguous language in an insurance policy is disregarded when the policyholder has objectively reasonable expectations inconsistent with the policy language.

With respect to the common question being asked and answered by courts and by Judge Keeton, the contracts scholar would observe that the common question sounds very much like a very ordinary parol evidence rule question in contract law.[58] An insurance policy is an integrated agreement; barring extraordinary circumstances, it is almost certainly a completely integrated agreement. The parol evidence rule does not forbid admitting evidence for the purpose of determining meaning, but the absence of ambiguity means no basis exists for invoking the rules of contract interpretation. The insured who has adhered to the form now wants to contradict the integration with different terms or to supplement the integration with additional consistent terms. These different or additional terms are, of course, those that are alleged to reflect the insured's reasonable expectations. If an ambiguity existed, there would be no need to worry about the parol evidence rule because any evidence could be

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58. Keeton mentioned the parol evidence rule as something an insurer might assert as a defensive strategy when resisting a claim for a right at variance with policy language, but did not discuss it. *See id.* at 962. An early writer who saw the connection was Professor George Goble, who wrote in 1937:

> A problem intensified by the wide use of standardized contracts is: To what extent should oral understandings inconsistent with a written contract be allowed to prevail? The parol evidence rule, which renders invalid oral agreements prior to or contemporaneous with a written agreement, seems entirely reasonable where the written document is the result of mutual bargain. But where the terms of the document are dictated by business practice or statute, the rule is not so just in application. This is because such documents are seldom read, or if read seldom understood by the public, and, therefore, there is a complete absence of assent to its provisions. The result is that the courts have frequently come to the rescue of the helpless or misled citizen, and have given effect to oral statements made by him or to him in his behalf, at the time he accepted the document, sometimes even in spite of an express provision that printed terms of the contract could not be waived or modified. This is especially true in contracts of insurance.

George W. Goble, *Trends in the Theory of Contracts in the United States,* 11 TUL. L. REV. 412, 422-23 (1937).

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offered for the purpose of interpretation; by the same token, if an ambiguity existed, there would be no need to invoke the doctrine of reasonable expectations which refers to enforcing objectively reasonable expectations despite unambiguous language to the contrary.

Even granting some disagreement among contracts scholars and courts about how parol evidence rule issues should be resolved, contract law provides an answer to the question posed. One formulation of contract law's answer is set forth in section 211 of the *Restatement (Second) of Contracts*, which addresses the parol evidence rule question when standardized forms are involved. Although this section was already in draft when Keeton's article was published in 1970 and during the time he must have been ruminating about the ideas that would become his famous article, it is interesting that the article does not acknowledge or refer to the deliberations of the American Law Institute. Section 211(1) states that the standardized form to which the consumer assents is an integration with respect to the terms included in the writing, assuming (as is likely to be the case) that the consumer has reason to believe that "like writings are regularly used to embody terms of agreements of the same type." Section 211(2) articulates a default premise: the writing is to be interpreted as treating all adherents alike and "without regard to their knowledge or understanding of the standard terms of the writing." As comment e to section 211 explains, "courts in construing and applying a standardized contract seek to effectuate the reasonable expectations of the average member of the public who accepts it." Thus, section 211(2) endorses an objective standard. Indeed, the text of comment e bears a striking resemblance to Keeton's reasonable expectation principle. This is probably not accidental; Keeton's article is cited in the Reporter's Note to the comment. Section 211(3) completes the framework by describing when terms are excluded from the contract: where the drafter has "reason to believe" that the adhered party would not have assented to the form "if he knew that the writing contained a particular term" that term is excluded from the agreement. As Professor Henderson has explained in more detail,[59] section 211(3) treats the drafter's expectations as controlling; a drafter who does not expect (i.e., have reason to believe) that the adhered party would object does not lose the benefit of the term in question, even if the adhered party claims that his or her expectations are being disappointed. Under section 211(3), even the adhered party's reasonable expectations do not matter if the drafter did not have "reason to believe" that the adhered party would object.

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59. *See* Henderson, *supra* note 6, at 848-53.

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There are many nuances in section 211, as Professor Henderson's contribution to this symposium makes clear.[60] If comment e is telling us that section 211(2) is, in effect, the Keeton doctrine of reasonable expectations, then sections 211(2) and 211(3) can be synthesized as follows: terms in the writing are to be interpreted in a manner consistent with the objectively reasonable expectations of the adhered party (see section 211(2)), except that terms in the writing will be excluded (and therefore not interpreted at all) if the drafter has reason to believe the adhered party would not manifest assent if he or she knew the particular terms were included in the writing (see section 211(3)).

Section 211 is controversial, and the content of the rule is being revisited and debated in the discussions of the proposed revisions of Articles 2, 2A, and 2B of the Uniform Commercial Code.[61] But the important point for this discussion is that section 211, a contract law rule, answers the right question —under what circumstances unambiguous language in an insurance policy is trumped by an expectation of the insured that is inconsistent with or contradicted by the policy's language. Moreover, the answer given in section 211 applies to much more than insurance policies; section 211's answer is meant to be given whenever the same question is asked with respect to *any* standardized form. Indeed, there is no obvious reason why the question ought to have a different answer with respect to standardized insurance policies than with respect to standardized forms used in any other industry where standardized contracts with consumers are routine. If this point is granted, the common question addressed by Keeton and by courts in the insurance cases he discussed should be rephrased:

> Under what circumstances can unambiguous language *in a standardized form* be disregarded in favor of an expectation of the adhering party that is inconsistent with or contradicted by the language of the form?

This rephrased common question has challenged contracts scholars for decades, and by 1970 it had received attention from some of the giants in that field. Some of this history is discussed in the next section.

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60. *See id.*

61. *See id. See also* Michael M. Greenfield, *The Role of Assent in Article 2 and Article 9*, 75 WASH. U. L. Q. 289 (1997); James J. White, *Form Contracts Under Revised Article 2*, 75 WASH. U. L. Q. 315 (1997).

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III. STANDARDIZED FORMS AND REASONABLE EXPECTATIONS

The reasons for the widespread use of standardized forms in consumer transactions in the twentieth century do not need extended discussion here. Suffice it to say that the advantages of standardization are considerable. Mass production reduces per-unit costs, which benefits both parties to the transaction. When products are standardized, the number of alternative products is reduced, which tends to simplify the consumer's selection process and make it easier for the consumer to compare alternatives based on the features of the product offered. With respect to standardized contracts, the cost advantages are much like those with standardized products, except that the advantage of cost savings produced by the elimination of negotiation over terms is counterbalanced by the potential for unfairness in circumstances where the drafter of the form imposes terms that the consumer does not expect. Courts have policed this unfairness in particular cases, and legislatures and administrative agencies have promulgated rules to deal with the risks of unfairness in particular kinds of contracts, including insurance policies.[62]

Arguably the most famous of the early explorations of the challenges standardization poses to the principles of classical contract law was Friedreich Kessler's famous 1943 article in the *Columbia Law Review* titled *Contracts of Adhesion—Some Thoughts About Freedom of Contract.*[63] In the article's opening paragraph, Kessler observed that contract law had evolved in recent centuries to become "a tool of almost unlimited usefulness and pliability," giving order and rationality to the market system.[64] He explained:

> Rational behavior within the context of our culture is only possible if agreements will be respected. It requires that *reasonable expectations created by promises receive the protection of the law* or else we will suffer the fate of Montesquieu's Troglodytes, who perished because they did not fulfill their promises. This idea permeates our whole law

62. *See* RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. c ("The obvious danger of overreaching has resulted in government regulation of insurance policies, bills of lading, retail installment sales, small loans, and other particular kinds of contracts. Regulation sometimes includes administrative review of standard terms, or even prescription of terms.").

63. Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943). This article was not cited or referenced in the Keeton article.

64. *Id.* at 629.

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> of contracts, the doctrines dealing with their formation, performance, impossibility, and damages.[65]

In the next few pages, he discussed the increased reliance on standardized forms by businesses, the advantages of standardization, and the efforts of courts to protect the weaker party in such exchanges without appearing to modify the rules of classical contract law.[66] To illustrate his point, Kessler used insurance policies.[67] He referred to the "remarkable skill" of some courts "in reaching 'just' decisions by construing ambiguous clauses against their author even in cases where there was no ambiguity,"[68] and how under the guise of interpretation courts "change[d] warranties into misrepresentations."[69]

Kessler then took up the issue of the consequences of an insurer's delay in acting upon an application, noting that whatever skills courts had acquired in clever interpretations of policy language was useless in dealing with a problem of contract formation.[70] Contract law, he reasoned, could not impose the duty to act promptly on applications because insurers would simply include language in applications negating any implied promise.[71] He explained that many courts, however, had found in tort law a duty to act promptly:

> Thus the courts pay merely lip service to the dogma that the common law of contracts governs insurance contracts. With the help of the law of torts they nullify those parts of the law of contracts which in the public interest are regarded as inapplicable. . . . This approach enables them to disregard the clause in the application by means of which the company attempted to avoid liability prior to the delivery of the policy.[72]

Kessler noted that this judicial approach, applied inconsistently in the cases, was criticized for "undermining legal certainty and the stability of the insurance business."[73] That criticism was not unlike the alarm that greeted the

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65. *Id.* (emphasis added).
66. *See id.* at 629-33.
67. *See id.* at 633-36.
68. *Id.* at 633.
69. *Id.*
70. *See id.* at 634.
71. *See id.* at 635 (quoting Carl W. Funk, *The Duty of an Insurer to Act Promptly on Applications*, 75 U. PA. L. REV. 207, 214 (1927)).
72. *Id.*
73. *Id.* at 635-36.

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Keeton formulation of reasonable expectations in some circles.[74] After quoting at length from a 1933 Connecticut case,[75] which identified the reasons that imposing a duty on insurers to act promptly on applications would create instability in the insurance business,[76] Kessler put his finger on the fundamental issue:

> This line-up of arguments [in the Connecticut case] brings out clearly the basic issue with which the courts in the insurance cases are confronted. It is: can the unity of the law of contracts be maintained in the face of the increasing use of contracts of adhesion? The few courts which allow recovery in contract and the many which allow recovery in tort feel more or less clearly that insurance contracts are contracts of adhesion, and try to protect the weaker contracting party against the harshness of the common law and against what they think are abuses of freedom of contract. The courts denying recovery, on the other hand, cling to the belief that an application for insurance is not different from any other offer, and they are convinced that efforts to build up by trial and error a dual system of contract law must inevitably undermine the security function of all law, particularly since courts are ill equipped to decide whether and to what extent an insurance contract has compulsory features.[77]

One page later, he identified the engine that drives the results in cases allowing recovery for the policyholder:

> The idea implicit in the cases which allow recovery seems very fruitful indeed. In dealing with standardized contracts courts have to determine what the weaker contracting party *could legitimately expect* by way of services according to the enterpriser's "calling," and to what extent the stronger party *disappointed reasonable expectations* based on the typical life situation.[78]

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74. *See supra* notes 3-7 and accompanying text.
75. Swentusky v. Prudential Life Ins. Co., 165 A. 686 (Conn. 1933).
76. *See* Kessler, *supra* note 63, at 636.
77. *Id.*
78. *Id.* at 637 (emphasis added).

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In the next two sentences, Kessler anticipated and addressed the argument that the rewriting of contract text in standardized forms is outside the judicial role: he stated that "the judge-made law in the field of constructive conditions is amply proving the opposite."[79] Kessler did not explain this point in detail, and it is one that may not be obvious to those who have forgotten some lessons of contract law. By the beginning of the seventeenth century, English law recognized that a bilateral contract with executory promises on both sides was enforceable. Unless, however, the parties put language in the contract making each party's performance expressly conditional on the other's performance, one party could enforce the other's promise without showing that the party had given or tendered to the other what was promised in the exchange. In the famous eighteenth-century case of *Kingston v. Preston*,[80] Lord Mansfield recognized the inherent dependency of promises exchanged in bilateral contracts and reasoned that the court—not the contract's text, although parties could still draft express conditions if they desired—decides whether the first party's performance is conditional upon the other side's prior performance.[81] The law has since evolved to the point where the following default principle is unquestioned: each party's promise in a bilateral contract is constructively conditioned on the other side's promise, and a material breach of either side's promise will give the other a right to suspend performance, even if the contract does not expressly so provide.[82]

The doctrine of constructive conditions is, of course, one that protects reasonable expectations: in a wholly executory bilateral contract between A and B, A reasonably expects that A will not have to perform if B commits a material breach, and vice versa. Whatever intentions the parties bring to a particular contract, it is an objectively reasonable expectation across all transactions that executory promises in a bilateral contract are dependent. This doctrine rewrites text in the sense that it adds terms to the contract that are simply not there; but no one seriously argues that courts, at least with respect to the doctrine of constructive conditions, should abstain from rewriting text to enable the reasonable expectations of the parties to be protected.

Kessler criticized courts that "prefer to convince themselves and the community that legal certainty and 'sound principles' of contract law should not be sacrificed to dictates of justice or social desirability."[83] Indeed, as the

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79. *Id.*

80. 99 Eng. Rep. 437 (K.B. 1773).

81. For a more detailed discussion of *Kingston*, see FARNSWORTH TREATISE, *supra* note 12, at 637.

82. RESTATEMENT (SECOND) OF CONTRACTS § 237 (1981).

83. Kessler, *supra* note 63, at 637.

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law of constructive conditions demonstrates, courts have long regulated text in order to achieve justice. Kessler explained the point in this way:

> [T]he rules of the common law are flexible enough to enable courts to listen to their sense of justice and to the sense of justice of the community. Just as freedom of contract gives individual contracting parties all the needed leeway for shaping the law of contract according to their needs, the elasticity of the common law, with rule and counter-rule constantly competing, makes it possible for courts to follow the dictates of "social desirability."[84]

As important as Kessler's article was, he was not the first to appreciate the connection between standardized forms and the potential for impairment of the consumer's reasonable expectations. Professor Alan Schwartz has collected and analyzed the contracts and sales articles written by Karl Llewellyn between 1925 and 1940,[85] and Schwartz's research shows that Llewellyn had focused on the link between reasonable expectations and standardization at least two decades before Kessler. In a 1925 article published in the *American Economic Review*,[86] Llewellyn recommended that courts read contracts to contain what the weaker party would expect the contract to contain, and he used the example of insurance contracts to make his point. Specifically, he advocated giving "the insured . . . the protection he might decently believe he was buying, without too close regard to the exceptions of the policy."[87] In so many words, this was the Keeton formulation of the reasonable expectations doctrine: plain language in the policy's exclusionary language should not be applied to eliminate coverage if the insured had a "decent" (i.e., objectively reasonable) understanding of the coverage his premium was purchasing.[88] Llewellyn made

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84. *Id.* at 638.

85. Alan Schwartz, *Karl Llewellyn and the Origins of Contract Theory*, *in* THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW (Jody S. Krauss & Stephen D. Walt, eds., forthcoming 1999) (manuscript at 48-59, on file with author).

86. Karl Llewellyn, *The Effect of Legal Institutions Upon Economics*, 15 AM. ECON. REV. 665 (1925). This piece was Llewellyn's first major publication; the article urged reform of commercial law, suggesting that economics and the realities of modern business practices be used guide these reforms. He explicitly credited Roscoe Pound (and some others) as the originators of many of the ideas. *See* N.E.H. HULL, ROSCOE POUND AND KARL LLEWELLYN: SEARCHING FOR AN AMERICAN JURISPRUDENCE 139 (1997).

87. Llewellyn, *supra* note 86, at 673.

88. As Professor Schwartz observes, the proposed revisions to Article 2 of the Uniform Commercial Code adopt what Llewellyn was urging nearly 75 years earlier. Schwartz, *supra* note 85 (manuscript at 54). Proposed UCC 2-206(b) states that "a term in a . . . standard form

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the point again in a 1939 book review published in the *Harvard Law Review*,[89] where he argued that "when bargaining is absent in fact," courts should "read into" a form contract the terms "which a sane man might reasonably expect to find on that paper."[90]

The common ground in the writing of Llewellyn, Kessler, and Keeton is striking. In his early sales scholarship, Llewellyn considered many of the same issues with respect to standardized sales contracts that Keeton considered with respect to insurance policies. Llewellyn urged in no uncertain terms that plain text in standardized sales contracts should be given a meaning that a reasonable consumer would expect in the circumstances. Kessler built upon these same points in his *Columbia Law Review* article. Almost fifty years after Llewellyn and approximately twenty-five years after Kessler, Keeton found evidence that courts were reaching exactly that conclusion in the decided insurance cases under a wide range of doctrinal theories. These common insights and shared principles should not surprise us; after all, insurance policies are but one kind of standardized form.

To the important work of Llewellyn and Kessler should be added the insights of Spencer Kimball, another of the great scholars in insurance law. He examined the shared currents of contract law and insurance law in a remarkable study of insurance regulation in Wisconsin, which was published as a book in 1960.[91] Kimball discussed in several passages the protection of the insured's "reasonable expectations" as a regulatory objective. Kimball, utilizing the insights of the early twentieth-century realists, tended to view insurance law in contractarian terms.[92] Building on the jurisprudence of Roscoe Pound,[93] Kimball saw in the *laissez faire* era of the late nineteenth century a formal view

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. . to which a consumer has manifested assent by a signature or other conduct is not part of the contract if the consumer could not reasonably have expected it unless the consumer expressly agrees to the term." The proposed revisions have been controversial, and, as Professor Henderson discusses in more detail in his contribution to this symposium, the debate over Article 2 is replicated with some variations in the discussion about the proposed revisions to Articles 2A and 2B. Roger C. Henderson, *The Formulation of the Doctrine of Reasonable Expectations and the Influence of Forces Outside Insurance Law*, 5 CONN. INS. L.J. 69 (1998).

89. Karl Llewellyn, Book Review, 52 HARV. L. REV. 700 (1939) (reviewing O. PRAUSNITZ, THE STANDARDIZATION OF COMMERCIAL CONTRACTS IN ENGLISH AND CONTINENTAL LAW).

90. *Id.* at 704.

91. SPENCER L. KIMBALL, INSURANCE AND PUBLIC POLICY: A STUDY IN THE LEGAL IMPLEMENTATION OF SOCIAL AND ECONOMIC PUBLIC POLICY, BASED ON WISCONSIN RECORDS, 1835-1959 (1960).

92. *Id.* at 210 ("Underlying the tough taught dogma of contract law, against which the growth of insurance case law must be viewed. . . .").

93. ROSCOE POUND, THE FORMATIVE ERA OF AMERICAN LAW 82-84, 114 (1938).

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of contract law in which individuals contracted freely for the objects of their wants. This public policy—contract freedom—meant that contracts "entered into freely and voluntarily shall be held sacred and shall be enforced by the courts of justice."[94] The elevation of contract text over other values was, nevertheless, subject to judicial erosion by courts that "skillfully used the canons of construction to relieve the insured of various stipulations, and resorted often to the doctrine that ambiguity must be resolved against the draftsman of the contract."[95] Interpretive techniques were accompanied by judicial disregard of insureds' nonsatisfaction of conditions to coverage under the reasoning that enforcement of the conditions would result in a forfeiture, which are abhorred in equity.[96] The freedom of contract tradition remained predominant, however, until the twentieth century, and this simply encouraged insurers to draft explicit forms that would exceed the reach of judicial efforts to interpret them.[97] This placed, he reasoned, two public policies in frequent conflict:

> There was, first, *the pervasive policy of giving effect to the reasonable expectations of contracting parties.* Persons who took out insurance expected to obtain protection, and it was the concern of the law to assure them that protection. At the same time, however, it was the policy of the law to preserve the integrity of the [insurance] fund by preventing unwarranted raids on it by persons not entitled to share.[98]

In this context, the securing of reasonable expectations to which Kimball referred was the product of a judicial process through which the literal terms of contractual relationships were adjusted to attain fairness between the contracting parties.[99]

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94. KIMBALL, *supra* note 91, at 210 (quoting Houlton v. Nichol, 67 N.W. 715 (Wis. 1896), in turn *quoting* Printing, etc., Co. v. Sampson, L.R. 19 Eq. 462).

95. *Id.* at 211.

96. *See id.*

97. *See id.*

98. *Id.*

99. Essentially the same point was made in another passage in the 1960 text. In explaining how courts regulate insurance, Kimball described one of insurance law's themes as determining who, within a pool of insureds, is entitled to draw from the insurance fund. This required balancing two competing public policies: "the preservation of the integrity of the insurance fund against improper raids by persons not entitled to participate and the satisfaction of the reasonable expectations of the insured." *Id.* at 7.

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Kimball, like Keeton, also appreciated how judicial manipulation of the law of agency could produce results that protected the reasonable expectations of insureds.[100] In discussing the efforts of insurers to circumscribe the authority of their agency force, Kimball noted that courts often found ways to circumvent the limitations and to enable "an agent [to] modify an insurance policy to conform to the needs of the insured."[101] In analyzing an 1861 Wisconsin case where the court held that the contract modification was within the scope of the agent's apparent authority, Kimball explained that "[t]hough the result can be explained by an apparent authority doctrine, that is nothing but a rationalization of the victory of reasonable expectations over the principal's power to define the scope of the agency."[102] In other words, the fairness inherent in protecting reasonable expectations trumped literal language in the contract between insurer and agent purporting to narrow the insurer's responsibility for acts of the agent.

To summarize, Llewellyn in the 1920s, Kessler in the 1940s, and Kimball in the 1960s understood reasonable expectations as more than a strict application of *contra proferentem*. Each of these scholars represented a school of thought that envisioned contract law in functional terms, where the objectively reasonable expectations of consumers or policyholders could trump unambiguous text that, if read and understood, would defeat those expectations. These scholars were not, however, writing in a vacuum. All of them were familiar with the work of those who proceeded them, and all were reacting in varying degrees to results in decided cases and judicial opinions in those cases. These scholars would have been familiar with the rhetoric of reasonable expectations in contract law and were undoubtedly intimately familiar with the contemporaneous debates over promissory estoppel as an alternative to consideration. They were also familiar with the important contracts and insurance cases of their times. Llewellyn, of course, had the smallest data set, but he would have been aware of Justice Cardozo's opinion in *Bird*,[103] where reasonable expectations were used to set the parameters for causation under an insurance policy. Kessler had the benefit of Llewellyn's thinking[104] plus the cases grappling with the scope of the insurer's duty to act

100. For an early article exploring how the acts of agent could bind the insurer in ways that contradict the language of the insurance policy, see Philo C. Calhoun, *The Liberal Construction of Insurance Contracts*, 1 CONN. B. J. 49 (Jan. 1927).

101. KIMBALL, *supra* note 91, at 224.

102. *Id.*

103. Bird v. St. Paul Fire & Marine Ins., 120 N.E. 86 (N.Y. 1918).

104. Kessler cited the 1939 Llewellyn book review. Kessler, *supra* note 63, at 637 n.27.

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promptly on an application.[105] Kimball was no doubt well familiar with *Gaunt v. John Hancock Mutual Life Insurance Co.*,[106] where Judge Learned Hand declined to enforce literally the language of a conditional binder for life insurance under the reasoning that persons unacquainted with such receipts (i.e., ordinary consumers) would not understand the form in accordance with the narrow reading urged by the insurer.[107] Kimball would have also been familiar with *Lacks v. Fidelity & Casualty Co.*,[108] where the court not only found an airline travel insurance policy ambiguous despite clear text and prominent signage near the vending machine from which the policy was purchased but also paid homage to the fact that the decedent expected coverage and would not have purchased the policy had she been informed at the time of purchase that the policy provided no coverage for the trip on which she would meet her death.[109]

No doubt these scholars also influenced the path of subsequent cases, even if it is impossible to quantify this effect. Two important cases involving reasonable expectations receive special treatment in the next section.

IV. REASONABLE EXPECTATIONS, INSURANCE, CONTRACT, AND COURTS

Several important cases invoked the rhetoric of reasonable expectations in the 1960s,[110] but arguably the most notorious of these[111] was the 1961 decision

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105. *See, e.g.*, Duffie v. Bankers Life Ass'n, 139 N.W. 1087 (Iowa 1913); Savage v. Prudential Life Ins. Co., 121 So. 487 (Miss. 1929). These cases remain leading cases on the issue, even in contemporary discussions. *See, e.g.*, ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 32(a), at 178-82 (2d ed. 1996).

106. 160 F.2d 599 (2d Cir. 1947).

107. *Id.* at 601.

108. 118 N.E.2d 555 (N.Y. 1954).

109. *Id.* at 559.

110. *See, e.g.*, Klos v. Mobil Oil Co., 259 A.2d 889 (N.J. 1969) (insurance solicited by mail); Gray v. Zurich Ins. Co., 419 P.2d 168 (Cal. 1966) (duty to defend under liability insurance).

111. Judge Keeton was the keynote speaker at a conference sponsored by the Insurance Law Institute at the University of Connecticut Law School on October 17, 1997, in Hartford, Connecticut. In a conversation with Judge Keeton at the conference, I mentioned to the Judge that Professor Kimball's book had some passages which, though less fully developed than the Judge's 1970 analysis, had some interesting parallels, and I asked if the Judge had discussed reasonable expectations with Professor Kimball prior to publishing his article. Judge Keeton said he had not, but that there had been a very important New Jersey case that had garnered his attention and no doubt Professor Kimball's as well, and that this case probably accounted for the similar, but independently formed views about reasonable expectations. Judge Keeton could not remember the case's name at the time, but I believe he must have been thinking of

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of the New Jersey Supreme Court in *Kievit v. Loyal Protection Life Insurance Company.*[112] In *Kievit*, the insured purchased an accident policy providing coverage for loss "resulting directly and independently of all other causes from accidental bodily injuries," and excluding loss "resulting from or contributed to by any disease or ailment." The coverage-granting provision was common at the time, but not all policies contained the exclusionary language. One might speculate that the drafters thought the coverage-granting provision, even with its lack of any further exclusion, was clear enough; by its plain language, the policy covered loss due to accident, not loss caused by illness or disease. But courts in a number of cases had to apply the language in multiple causation situations, such as where the accident aggravated a dormant medical condition which, in turn, led to the loss. Insurers lost many of these cases; courts held that the coverage-granting provision articulated a requirement that the accident be the "efficient" or "proximate" cause of the loss, and this led to a finding of coverage in many situations even though a medical condition was operative to some extent at the time of the loss. To counter this trend, some insurers added exclusionary language, like that found in the policy at issue in *Kievit*, which purported to eliminate coverage as long as a medical condition or illness even "contributed" to the loss.

In *Kievit,* the insured's disability was caused in part by Parkinson's disease, which developed at the same time the insured's accident occurred. The court concluded that the insured's disability was covered, even though the policy's language, applied literally, would have eliminated coverage. The court explained:

> When members of the public purchase policies of insurance they are entitled to the broad measure of protection necessary to fulfill their reasonable expectations. They should not be subjected to technical encumbrances or to hidden pitfalls and their policies should be construed liberally in their favor to the end that coverage is afforded "to the full extent that any fair interpretation will allow." Francis, J., in Danek v. Hommer, 28 N.J.Super. 68, 76, 100 A.2d 198, 202 (App.Div. 1953), affirmed 15 N.J. 573, 105 A.2d 677 (1954). [Citations omitted.] Where particular provisions, if read literally, would largely nullify the insurance, they will be severely restricted so as to enable fair fulfillment of the stated policy objective.

Kievit. Kievit was decided nine years before Judge Keeton's article, but one year after Professor Kimball's book was published.

112. 170 A.2d 22 (N.J. 1961).

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> See Richards [on Insurance], supra, p. 742, where the author notes that the common clause to the effect that the death or disability must result from accident "independently of all other causes" would, if taken literally, be so unreasonable and repugnant to the main purpose of the policy "that the courts construe it very strictly against the insurers, and sometimes really seem to disregard it altogether."[113]

The first sentence of the passage sounded much like a robust reasonable expectations principle. But because the rest of the passage referred alternately to enforcing reasonable expectations, giving policy language fair interpretations, and construing text strictly against insurers, it was far from clear that this court's opinion stood apart from other cases where courts found ambiguities where none existed. Moreover, the authorities cited in the passage fell short of endorsing a reasonable expectations principle. The reference to the Richards treatise, which stated that "sometimes" courts "really seem" to disregard plain text when construing language "very strictly" against the insurer, was hardly a ringing embrace of a reasonable expectations principle. *Danek* did not involve a situation where the court disregarded policy language; instead, the court in *Danek* utilized traditional interpretation principles to find that the insurer owed the insured a defense under the policy.

Later in the opinion, the *Kievit* court drew upon an appellate court's opinion in *Mahon v. American Casualty Company,*[114] which had been decided only three months earlier. In *Mahon*, the court stated that the judicial role is to interpret the policy's text in light of the "reasonable expectations" of the insured in purchasing it.[115] But in *Mahon*, there was no indication that text would be disregarded; rather, the court in *Mahon* seemed to be saying that the policy's text would be interpreted to further reasonable expectations whenever ambiguities are present.

Near the end of the *Kievit* opinion, another passage more directly suggested that something beyond *contra proferentem* was being endorsed by the court. The court explained that it attached

> little significance to the presence of the exclusionary clause in view of the primary provision limiting coverage to loss from accidental bodily injuries, directly and independently of all other causes. . . . the court's goal in construing an accident

113. *Id.* at 26-27.
114. 167 A.2d 191 (1961).
115. *Id.* at 196.

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> insurance policy is to effectuate the reasonable expectations of the average member of the public who buys it; he may hardly be expected to draw any subtle or legalistic distinctions based on the presence or absence of the exclusionary clause for he pays premiums in the strong belief that if he sustains accidental injury which results (in the commonly accepted sense) in his disability he will be indemnified and not left empty-handed on the company's assertion that his disability was caused or contributed to by a latent disease or condition of which he was unaware and which did not affect him before the accident.[116]

By one reading, this passage simply reaffirmed the earlier discussion, stating that the court must interpret the policy language in question to effect the reasonable expectations of the policyholder. Yet the court in the later passage did not claim that the exclusionary language was ambiguous, and the court clearly stated that it attached "little significance to the presence" of the exclusion given the expectations that would be created by the coverage-granting section. If one emphasized this aspect of the passage, *Kievit* could be read as embracing a reasonable expectations principle along the lines of what Keeton would later articulate in his article.

However one reads *Kievit*, the case was at least an important milestone in the evolution of the reasonable expectations principle. But this case, like Judge Keeton's 1970 article, must be read in a broader context. *Kievit* followed by only one year an even more prominent decision rendered by the New Jersey Supreme Court. In *Henningsen v. Bloomfield Motors, Inc.*,[117] plaintiff Mr. Henningsen purchased a new 1955 Plymouth automobile from an authorized Plymouth dealer. The purchase order was a one-page standardized form with text of varied sizes and fonts on the front and back. The seventh paragraph on the back of the form, which contained sixty-five lines of type in ten separate paragraphs, purported to exclude all warranties on behalf the dealer and manufacturer, express or implied, except as set forth in the paragraph. Further, this paragraph limited the manufacturer's warranty to repairing or replacing any defective parts which failed within ninety days after purchase or until the car had been driven 4,000 miles, whichever occurred first. Although the paragraph did not mention personal injury, under the plain terms of the text the manufacturer had no liability for anything else, including personal injury, resulting from any defect in the vehicle. Ten days after the purchase, something

116. *Kievet*, 170 A.2d at 30.
117. 161 A.2d 69 (N.J. 1960).

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failed in the steering mechanism while Mrs. Henningsen was driving the vehicle. This caused an accident, Mrs. Henningsen suffered physical injury, and the plaintiffs sued the dealer and the manufacturer for damages on account of her injuries. The defendants denied liability based upon, *inter alia*, the disclaimer of liability on the back of the purchase order.

In a lengthy opinion, the court canvassed many issues and ultimately affirmed the jury's verdict for the plaintiffs. At one point in the opinion, the court considered whether, assuming there were grounds to charge Mr. Henningsen with awareness of the text of the limitation of liability, it could "be said that an ordinary layman would realize what he was relinquishing in return for what he was being granted."[118] The court concluded that

> only the abandonment of all sense of justice would permit us to hold that, as a matter of law, the phrase "its obligation under this warranty being limited to making good at its factory any part or parts thereof" signifies to an ordinary reasonable person that he is relinquishing any personal injury claim that might flow from the use of a defective automobile.[119]

In essence, the court reasoned that the limitation of liability was not binding on the buyer because the buyer would not reasonably expect this disclaimer to take away the claims for personal injury, notwithstanding the literal terms of the text. Furthermore, the court implied that the defendants knew or had reason to know that the recipient of the form would not reasonably expect this disclaimer to take away the personal injury claims. The court mentioned that the drafters and presenters of the form could have done more to inform buyers of their intention to disclaim liability for injury claims.[120] Also, the court cited evidence that Chrysler was aware of the terms of the warranty drafted by the Automobile Manufacturers Association, but that Chrysler did "nothing . . . to stimulate the idea that the intention of the warranty is to exclude personal injury claims."[121] In short, under the court's reasoning, it would not matter if the buyer were aware of the disclaimer because the buyer would not expect the disclaimer to reach as far as the defendants urged.

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118. *Id.* at 92.
119. *Id.* at 93.
120. *Id.*
121. *Id.*

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But the court's opinion went even farther than that. Because the court also held that the disclaimer was invalid on grounds of public policy,[122] the result would not change if the buyer had read and understood the limitation of liability. The seller could not have obtained a safe harbor by bringing the disclaimer to the buyer's attention and explaining it. In other words, this standardized form was inconsistent with the objectively reasonable expectations of a member of the buying public, and these expectations trumped the clear, unambiguous language of the form that, if applied literally, would negate those expectations. This was, in effect, the reasonable expectations principle articulated by Judge Keeton, albeit in a contract for the sale of goods made pursuant to a standardized form.

Thus, both *Kievit* and *Henningsen* stand as cases that favor the consumer's reasonable expectations against unambiguous contract text that, if enforced literally, would negate those expectations. That one case involves an insurance policy and the other a limitation of liability in a contract for the sale of goods does not seem to matter, for the cases have a shared current of principle.[123] The law of contract, apart from whatever insurance law might require, is flexible and pliable enough to embrace the proposition that a consumer's reasonable expectations has the potential to trump unambiguous text. This invites us to view Judge Keeton's discovery in 1970 of a new principle or doctrine in a broader context, as the next and final section explains.

CONCLUSION

Throughout most of the twentieth century, courts and scholars have battled for the soul of contract law. On one side are the formalists or classicists, whose champions are Professor Williston and the first *Restatement of Contracts*. The formalists care mightily about texts and the four corners of documents. They believe that words often have a plain meaning that exists independently of any sense in which the speaker or writer may intend the words. They insist that a court or a party can discern the meaning of contractual language without asking about the intentions or expectations of the parties. They contend that interpretation is appropriate only if an ambiguity appears on the face of the document, which means that the parties by their own testimony about what they intended or expected cannot create an ambiguity where none exists. Because they feel strongly about the integrity of writings intended as final expressions, they approve of the parol evidence rule. Thus, if a contract appears complete on its face, they would have the parol evidence rule keep out

122. *Id.* at 95.

123. *See supra* notes 111-12, 117 and accompanying text.

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evidence of inconsistent or additional terms regardless of whether the parties actually intended the document to speak finally or completely to their agreement. In the world of the formalists, an insurer that drafts a clear form should be entitled to rely on that form in setting rates without worrying that a court will disregard the finely tuned, clear language. In this world, Judge Keeton's 1970 article is radical and dangerous. Even if the principles stated in the article are not new to the contract formalist, they are to be reckoned with, given the extraordinary articulateness, cogency, and incisiveness with which Judge Keeton presented his ideas.

The other contestants in the battle for the soul of contract law are the functionalists, who are sometimes also labeled as the progressives, the realists, or the post-classicists. The champions of this side are Professor Corbin and the *Restatement (Second) of Contracts*. The functionalists care less about the text of contracts, believing it to be most useful as an articulation of the objective manifestations of the contracting parties and as a means to understanding their intentions and expectations. They concede that contracting parties normally intend words in their customary usages, but the more important question to the functionalist is what the parties intend by the words, and, in situations where disputes over meaning arise, what the party who utters or uses a word knows or has reason to know the other party is likely to understand from the party's expression of the word in the context in which it is used. Text does not have inherent meaning, but text means what the drafter or speaker knows or should know the other side will understand those words to mean in context. In negotiated bargains where misunderstandings arise after the parties agree upon a common text, this system protects the expectations of the party who has less knowledge or reason to know what the other side means. Where a form is standardized, the functionalists substitute objectively reasonable expectations for whatever the particular recipient of the form understood, given that the recipient has less reason to know what the drafter means, while the drafter has insights into what the ordinary, reasonable recipient of the form is likely to understand. In the functionalists' world, Judge Keeton's doctrine of reasonable expectations is far from threatening. Indeed, insurance law's doctrine of reasonable expectations simply restates for insurance lawyers what contract law is (or should be) saying to all lawyers.

From this perspective, one of the important contributions of Judge Keeton in his 1970 article was that he took sides in an ongoing battle for the soul of contract law. His article was descriptive when it told us where insurance law, as it stood in 1970, was leaning in this battle. His article was normative to the extent it suggested that insurance law should ally itself with the functionalist view of contract law. Given that the battle for contract law's future is far from

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settled, it should not be surprising that courts are presently divided in their receptivity to Judge Keeton's formulation. And, as Professor Henderson describes in more detail,[124] the battle between the formalists and functionalists is particularly intense on the field where proposed revisions of Articles 2, 2A, and 2B of the Uniform Commercial Code are being considered. This means that Judge Keeton's article is not just about insurance law; it speaks to consumers and businesses in any industry where standardized forms are used. Thus, the debate over reasonable expectations is not just an insurance law debate. It is a contract law debate, and the prize to the winner is ownership of a major piece of the soul of contract law.

124. *See* Henderson *supra* note 88 at 80-105.

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THE EXPECTATIONS PRINCIPLE AS A REGULATIVE IDEAL

*Kenneth S. Abraham**

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INTRODUCTION

For over three decades now, the courts of some states have followed the doctrine permitting them to honor the "reasonable expectations" of the insured as to coverage, notwithstanding clear policy language to the contrary.[1] Most courts, however, have either expressly rejected this doctrine or quietly ignored it.[2] In contrast to a number of the contributors to this Symposium on the expectations principle, I do not believe that this split among jurisdictions is part of a "battle for the soul of contract law" or indicative of a deep jurisprudential division between consumer-oriented and insurer-oriented states.[3] Indeed, some of the states that have adopted the expectations doctrine are insurer-oriented in other respects, and some of the states that have not adopted the doctrine are consumer-oriented in other respects.[4]

Rather, in my view this difference among the states reflects the normal and longstanding tension within insurance law between insurers' need for predictability of obligation and policyholders' comparative lack of information about the scope of the coverage that they need and have actually purchased. This is a healthy and inevitable tension that is incompletely resolved, and probably will remain incompletely resolved, in the law of both the minority of jurisdictions that honor the reasonable

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1. *See* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES § 6.3, at 627 (1988).

2. *See* Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L. J. 823, 834-35 (1990).

3. *See, e.g.*, Robert H. Jerry II, *Insurance, Contract, and the Doctrine of Reasonable Expectations*, 5 CONN. INS. L.J. 21, 23 (1998).

4. For example, North Carolina has adopted the reasonable expectations doctrine, *see* Great American Ins. Co. v. C.G. Tate Constr. Co., 279 S.E.2d 769 (N.C. 1981) *rev'd on other grounds*, 340 S.E.2d 743 (N.C. 1985), but has adopted a pro-insurer interpretation of the exception to the "pollution exclusion" in CGL insurance policies. *See* Waste Management of Carolinas, Inc. v. Peerless Ins. Co., 340 S.E.2d 374 (N.C. 1986). Similarly, Wisconsin has adopted the expectations doctrine, *see* Patrick v. Head of the Lakes Ass'n, 295 N.W.2d 205, 207 (Wis. Ct. App. 1980), but follows a pro-insurer interpretation of the "as damages" clause in CGL insurance policies. *See* City of Edgerton v. General Cas. Co. of Wisconsin, 517 N.W.2d 463 (Wis. 1994). On the other hand, Washington has not adopted the expectations doctrine, *see* Keenan v. Industrial Indem. Ins. Co., 738 P.2d 270, 275 (Wash. 1987), but takes a pro-consumer stance on the concurrent causation issue under first-party property insurance policies. *See* Graham v. Public Employees Mutual Ins. Co., 656 P.2d 1077 (Wash. 1983)). The reasons these states have taken such positions is a matter of some complexity—but that is my point. Easy distinctions sometimes hide more than they reveal.

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expectations of the insured and the majority of jurisdictions that do not. Thus, even in the same state, some but not all ambiguous policy provisions are interpreted in favor of coverage;[5] claims of waiver and estoppel are available to policyholders, but are subject to substantial restrictions;[6] and there are other rights at variance with policy provisions, but these rights are limited.[7]

The rule that reasonable expectations are to be honored notwithstanding clear and contrary policy language is a minor "doctrine" that fits comfortably within this complex body of insurance law rules that shade sometimes toward policyholders and sometimes toward insurers. In contrast, I contend that the expectations "principle" that lies behind the doctrine is of major significance. That principle, in fact, animates much of insurance law that lies far beyond the limited scope of the expectations doctrine. This seeming contradiction actually makes good sense, for the reasons I shall indicate below.

I. THE LIMITED SCOPE OF THE EXPECTATIONS "DOCTRINE"

The expectations "doctrine" is limited to the point of being of minor significance. For a number of reasons, this doctrine rarely determines or even directly influences the outcome of insurance coverage disputes. First, the doctrine has been adopted in only one-third of the states.[8] In most states, therefore, the doctrine does not and cannot affect the outcome of a coverage dispute. Second, as Roger C. Henderson has so effectively shown, the courts in a number of the states that have expressly adopted the doctrine probably do not fully appreciate what they purport to have done and may not adhere fully to their stated position.[9] These courts at one time said that they would follow the doctrine, but probably are not doing so with anything like complete fidelity. Third, my own reading of the case law leads me to conclude that even in the states that have adopted and continue to adhere to the expectations doctrine, the courts rarely invoke the doctrine in practice. Very few cases turn on application of the doctrine.

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5. *See* Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 533 (1996).

6. *See* KEETON & WIDISS, *supra* note 1, § 6.1, at 617-18; ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 25E, at 149-50 (2d ed. 1996).

7. *See* KEETON & WIDISS, *supra* note 1, § 6.10(a), at 734.

8. *See* Henderson, *supra* note 2, at 828.

9. *See id.* at 828-29.

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Finally, the doctrine is even more rarely invoked in commercial coverage disputes than in consumer cases.

Part of this difference lies in the view of some courts that "sophisticated" policyholders should not get the benefit of consumer protection legal doctrines;[10] but I suspect that the expectations doctrine has less appeal to the courts in commercial than in consumer cases even in the jurisdictions that have never expressly distinguished between the rights of policyholders in these two kinds of cases. After all, a commercial policyholder's argument that it expected coverage even when its policy unambiguously says otherwise is less likely to convince a court that this expectation is reasonable than is an ordinary consumer's argument to the same effect.

In addition, the relative unimportance of the expectations "doctrine" is confirmed by its absence from, and irrelevance to, four of the most important developments in insurance, and therefore in insurance law, over the last two decades: (1) the rise of managed health care; (2) the explosion of CGL insurance coverage claims in connection with the toxic tort and environmental cleanup liabilities that policyholders began to face during this period; (3) the occasional but highly significant entry of multi-million dollar judgments against insurers for bad-faith denial of claims that were virtually unheard of until the 1970's; and (4) the periodic, often-recurring disputes over auto insurance rates in such states as California and New Jersey that have come to prominence in the last decade or more.

The expectations doctrine has at least the potential to figure in the first three of these developments, which in one way or another involve litigation over the terms and meaning of insurance policies. But despite this potential, the expectations doctrine has played a minimal role at most in disputes over managed health care and CGL coverage. Moreover, to my knowledge the expectations doctrine has played no role at all in bad-faith cases, where it would have been quite extraordinary for a court to have permitted the imposition of liability for a "bad-faith" denial of coverage that clear policy language excluded. And of course the expectations doctrine does not even have a potential role to play in controversies over rising auto insurance rates, which do not take place in the courtroom at all

10. *See, e.g.*, Halpern v. Lexington Ins. Co., 715 F.2d 191 (5th Cir. 1983) (applying Louisiana law); Eagle Leasing Corp. v. Hartford Fire Ins. Co., 540 F.2d 1257 (5th Cir. 1976) (applying Missouri law); McNeilab, Inc. v. North River Ins. Co., 645 F.Supp. 525 (D.N.J. 1986) (applying New Jersey Law); JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS: LAW AND STRATEGY FOR INSURERS AND POLICYHOLDERS § 23.4, at 525 (1994). Few courts, however, adhere consistently to a sophisticated insured "defense."

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and do not involve the meaning or application of specific policy provisions.

Finally, even in the states where it is in force, the expectations doctrine is static. It is not developing, evolving, or changing. There are very few if any decisions that apply the doctrine in a new way or uncover unrecognized implications of prior applications. On the contrary, the expectations doctrine is going nowhere.

In short, the expectations doctrine is a weapon in the insured's arsenal in the minority of states that have adopted it, and is a threat to insurers in those states, but the doctrine is of minor significance. The doctrine should be taught in the classroom, employed by insureds where possible, and anticipated as a potential threat by insurers. But the doctrine is not an important feature on the landscape of insurance law.

II. THE SIGNIFICANCE OF THE EXPECTATIONS "PRINCIPLE"

Despite the minor nature of the expectations "doctrine," I believe that the "principle" that lies behind the doctrine actually is of major significance. That principle serves as a regulative ideal: the expression of a value that should help to shape the development of insurance law. Honoring policyholders' reasonable expectations is not something we can always achieve; in fact, it is not something we will always even attempt to achieve. But honoring reasonable expectations as to coverage is a good of sufficient importance that we should continually measure our progress toward achieving that good in a world of insurance that is limited by imperfect information, strategic behavior, the partial incompatibility of that good with other goods, and the practical compromises that markets are always in the process of making.

As a regulative ideal, the expectations principle reflects an elegantly simple notion, which is why the principle serves so powerful an ideal. This is the notion that people should be able to buy the insurance that they reasonably want. Accompanying this notion is a corollary: people should not be led to believe that they have the insurance they reasonably want, when in fact they do not have that insurance. Since both the principle and the corollary refer to *reasonable* expectations of coverage, these are for the most part statements about the expectations of the vast majority of policyholders, not of isolated individuals. An expectation of coverage is most likely to be reasonable, after all, if a large number of people hold it in common. Indeed, most expectations of coverage held by the vast majority

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of policyholders are reasonable, and most expectations that are not held by the vast majority of policyholders are not reasonable.[11]

Thus, taken together, the expectations principle and its corollary constitute a normative statement about the proper relation between the supply side of the insurance market and the demand side of the market. As a normative statement about this relation, the expectations "principle" is a regulative ideal that influences legal and policy decisionmakers in a variety of ways far more important than does the expectations "doctrine" proper. Re-addressing what I described earlier as four of the major developments in insurance law in the last two decades reveals how influential the expectations "principle" actually is.

A. The Rise of Managed Health Care

Managed care began to make substantial inroads in the health insurance market early in the 1990's. Almost from the beginning of this development, there were outcries from both consumer interests and the medical profession over "excess" insurer involvement in medical treatment decisions.[12] The basis for these concerns almost always boils down to the notion that patients can reasonably expect that treatment decisions will not be made by reference to cost-containment considerations, and certainly not exclusively by reference to cost. The tension between health-care costs on the one hand, and access to quality treatment on the other hand, raises important issues of public policy that have yet to be sorted out. I predict, however, that as legal standards eventually emerge to regulate managed-care treatment decisions—whether the standards are embodied in legislation, regulatory rules, or judicial decisions—these standards will be heavily influenced by, and perhaps largely based on, the principle of reasonable expectations.

B. The Explosion of CGL Coverage Litigation

If any single insurance development over the past two decades could rival the rise of managed health care in importance, it would be the

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11. The exceptions to this generalization can be found in the occasional cases in which the expectations doctrine is employed because particular insurance company behavior created an individual policyholder's expectation. *See* KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 104-09 (1986).

12. *See generally*, Symposium, *On Physician Decision Making and Managed Care*, 6 HEALTH MATRIX 1 (1996); *Symposium On Consumer Protection in Managed Care*, 26 SETON HALL L. REV. 1007 (1996); Symposium, *Managed Care Systems: Emerging Health Issues from an Ethics Perspective*, 23 J. L. MED. & ETHICS 221 (1995).

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explosion of litigation regarding coverage of toxic tort and environmental cleanup liabilities under CGL insurance policies. This litigation is prolonged, uncertain, expensive, complex, and involves enormous economic stakes.[13] However, the post-modern insight that CGL insurance policy language is often inherently ambiguous when applied to such unanticipated forms of loss as toxic tort and environmental cleanup liability leads to a quandary. Although virtually any policy provision is potentially ambiguous, courts often do not permit policyholders to have all the coverage that interpretation of an ambiguous policy provision in favor of coverage would generate.[14] Under these circumstances, what standard will guide results in interpretive disputes?

Thirty years ago, when he first identified the expectations principle, Judge Keeton gave the answer. He described the role that the expectations principle plays in disputes over the meaning of policy provisions in the following way:

> It seems likely, however, that, even though not often expressed, there has always been an implicit understanding that ambiguities, which in most cases might be resolved in more than just one or the other of two ways, would be resolved favorably to the insured's claim only if a reasonable person in his position would have expected coverage.[15]

Keeton's insight that the expectations principle can function not only as a sword for policyholders, but also as a shield for insurers, was prophetic. In CGL coverage litigation that is precisely what has happened. Many decisions have employed the principle that the reasonable expectations of the policyholder are a limit on the extent to which an arguably ambiguous policy provision may be interpreted in favor of coverage. For example, for roughly fifteen years between 1970 and 1985, the standard-form CGL policy contained a "pollution exclusion," excluding coverage of liability for damage resulting from the discharge of pollutants, unless the discharge was "sudden and accidental." A number of courts have interpreted this exception to the exclusion by ruling that a policyholder whose policy contained such an exclusion could not

13. *See generally* Kenneth S. Abraham, *The Maze of Mega-Coverage Litigation*, 97 COLUM. L. REV. 2102 (1997).

14. *See* Kenneth S. Abraham, *supra* note 5, at 540-50.

15. ROBERT E. KEETON, INSURANCE LAW § 6.3(a), at 352 (1971).

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reasonably have expected coverage of liability for damage caused by a gradually-occurring discharge of pollutants.[16] One finds this same theme running through any number of decisions rejecting interpretations proposed by policyholders.

C. Large Verdicts for Insurer Bad Faith

Over the past two decades the courts of many states have increasingly recognized a cause of action for extracontractual damages suffered by policyholders as a result of an insurer's bad-faith denial of coverage.[17] As I noted above, however, typically the expectations "doctrine" does not figure in bad-faith cases: an award for bad-faith denial of coverage that the policy language itself excludes would be extraordinary, though I suppose not impossible. But this does not mean that the expectations "principle" is absent from bad-faith cases. On the contrary, in a sense the very right to recover extracontractual damages for the insurer's bad faith owes its existence to the expectations principle.

In fact, the whole purpose of the cause of action for bad faith is to protect the policyholder's reasonable expectation that valid claims will be paid. A policyholder's right to recover extracontractual damages for bad faith breach threatens insurers with the prospect of liability substantially in excess of its contract obligation, thereby encouraging insurers to pay valid claims. Thus, the purpose of imposing liability for bad faith is not merely to afford compensation for losses caused by bad faith, but to ensure good-faith payment of claims—precisely what policyholders reasonably expect. In this sense, if the threat of liability for bad faith breach of an insurance contract worked perfectly, there would never be a breach. In short, the expectations principle does not merely influence the law in this area, but is the very source and touchstone of this body of law.

D. Auto Insurance Rate Controversies

From the enactment of Proposition 103 in California in 1988 to the re-election of Governor Whitman in New Jersey in 1997, auto insurance rates have been a subject of extended and sometimes intense public

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16. *See, e.g.*, Northville Industries Corp. v. National Union Fire Ins. Co., 679 N.E.2d 1044, 1048 (N.Y. 1997); Truck Ins. Exch. v. Pozzuoli, 21 Cal. Rptr. 2d 650, 652 (Cal. 1993); ACL Tech., Inc. v. Northbrook Property and Cas. Ins. Co., 22 Cal. Rptr. 2d 206, 215-16 (Cal. 1993); Vantage Dev. Corp., Inc. v. American Env't Tech. Corp., 598 A.2d 948, 953 (N.J. Super 1991).

17. *See generally Symposium on the Law of Bad Faith Contract and Insurance*, 72 TEX. L. REV. 1203 (1994).

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controversy.[18] The expectations principle has a more attenuated influence on this issue than on the other three, but the principle has been influential nonetheless, in the following manner. In a sense high auto insurance rates limit the amount of coverage that people can afford to purchase. And if people have a reasonable expectation that they should be able to purchase a certain amount of insurance protection against loss for an affordable price, then that expectation is defeated by high rates.

It does not automatically follow, of course, that high auto insurance rates should be reduced. The viability of the distinction that I have been drawing between the expectations "doctrine" and the expectations "principle" requires only that the expectations principle have *figured* in controversies about auto insurance rates, not that the principle have *determined* the outcome of those controversies. As a regulative ideal, the expectations principle will sometimes merely identify a goal that cannot yet be feasibly achieved.

In the case of high auto insurance rates, because such factors as claims-fraud, vehicle-thefts, and the high cost of litigation contribute so substantially to the cost of coverage, it may not be possible to charge honest policyholders affordable prices for the amounts of coverage they reasonably expect. In my view the continuing ferment over the possible shift to no-fault insurance in the auto field is in part a reaction to this predicament. Thus, the reasonable expectations ideal has generated pressure for a solution to the problem of high cost auto insurance, even if that means shifting to a new form of coverage.[19]

CONCLUSION

A good deal of scholarly effort has been expended in recent years examining the features of the demand side of the insurance market that limit the scope of coverage—principally, adverse selection and moral hazard.[20] The insights developed by this scholarship are important, because the idea that there is something about the *demand* for insurance

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18. *See, e.g.*, Calfarm Ins. Co. v. Deukmejian, 771 P.2d 1247 (Cal. 1989) (ruling on the constitutionality of Proposition 103).

19. *See generally* Jeffrey O'Connell et al., *The Comparative Costs of Allowing Consumer Choice for Auto Insurance in All Fifty States*, 55 MD. L. REV. 160 (1996).

20. *See, e.g.*, ABRAHAM, *supra* note 11, at 64-100; Seth J. Chandler, *Visualizing Moral Hazard*, 1 CONN. INS. L. J. 97 (1995); Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996); George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE. L. J. 1521 (1987).

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that leads to necessary *limitations* on the form and amount of insurance that is sold is counterintuitive. Although this insight is not unique to insurance,[21] insurance is certainly the field in which this phenomenon is most salient.

But in the laudable scholarly effort to uncover and explore the implications of adverse selection and moral hazard, the importance of the reasonable expectations of all policyholders—including those who have sought insurance because they are at high risk of loss (i.e., those who have adversely selected) and those whose behavior is less careful once they are insured (i.e., those subject to moral hazard)—has sometimes been underemphasized. Perhaps my identification of the expectations principle as a regulative ideal will help to emphasize anew that even as the expectations "doctrine" remains in obscurity, the "principle" at the heart of the doctrine has a powerful effect on the broader normative posture of insurance law.

21. *See, e.g.*, George Akerloff, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 74 Q. J. ECON. 488 (1970).

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THE FORMULATION OF THE DOCTRINE OF REASONABLE EXPECTATIONS AND THE INFLUENCE OF FORCES OUTSIDE INSURANCE LAW

Roger C. Henderson[*]

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INTRODUCTION

Due to sheer longevity and probably little else, I have been fortunate during my legal career to have witnessed the revelation of a number of new legal doctrines, perhaps analogous to an astrologer who watches for new comets. *Greenman v. Yuba Power Products, Inc.*,[1] for example, was decided by the Supreme Court of California in 1962, my first year in law school. Although its origins, somewhat like that of a comet, were obscure and not visible to the ordinary observer, at the time Chief Justice Roger Traynor was no ordinary observer of the legal universe. He revealed, so to speak, a new doctrine as having emerged into view, announcing that liability for defective products was not governed by the law of contract warranties; rather it was governed by the law of strict liability in tort.[2] The rest, as they say, is history, as most jurisdictions in the thirty-odd years since Traynor's opinion have come to recognize that, at least for manufacturing defects, strict tort liability is the rule.

In a similar vein, at least two revelations have occurred as far as insurance law is concerned. One example that readily comes to mind concerns the tort of bad faith in first-party insurance transactions which also was revealed by the still talented Supreme Court of California in *Gruenberg v. Aetna Ins. Co.*[3] In part dictated by the wide reception this new tort had received,[4] it was the subject of the AALS Insurance Law Section meeting in San Francisco in 1993. Of course, the second example of creative star gazing in the galaxy of insurance law involves that of an equally gifted legal astrologer, Professor (now Judge) Robert E. Keeton of the Harvard Law School.

It has been almost three decades since Judge Keeton wrote his insightful article identifying what he called the emerging principle of reasonable expectations[5] and, of course, that is the subject of the current Insurance Law Section program. However, unlike strict tort liability for manufacturing defects and the tort of bad faith, the law, as Judge Keeton described it, regarding the reasonable expectations of insureds has not gained as wide acceptance. It is

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1. 377 P.2d 897 (Cal. 1962).

2. *Id.* at 901.

3. 510 P.2d 1032 (Cal. 1973).

4. *See* Roger C. Henderson, *The Tort of Bad Faith in First-Party Insurance Transactions After Two Decades*, 37 ARIZ. L. REV. 1153 (1995).

5. Robert E. Keeton, *Insurance Law Rights At Variance With Policy Provisions: Part One*, 83 HARV. L. REV. 961 (1970) [hereinafter Keeton, *Rights at Variance: Part One*]. *See also* Keeton, *Insurance Law Rights At Variance With Policy Provisions: Part Two*, 83 HARV. L. REV. 1281 (1970).

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possible that this failure, at least by comparison, may be attributable in part to some confusion about the nature of the principle. If so, this is a minor matter that should present no real obstacle once the nature is properly understood. In contrast, however, there appears to be a more fundamental problem with its relative failure to thrive and that problem may well be grounded in the formulation of the principle itself, a formulation that is cast in the normative terms of the *reasonable expectations* of a party that has no choice but to adhere to a standard form insurance contract. It is the latter problem that undoubtedly will occupy most of our attention, but it might be helpful first if the nature of the principle articulated by Judge Keeton is made clear. In doing so, it will be more convenient for the moment to speak as courts and commentators have come to speak. What Judge Keeton originally was careful to call a "principle," we, for now, will refer to as the "doctrine" of reasonable expectations. Even though the propriety of the doctrinal appellation may be seriously questioned, it nonetheless has become the name of choice.

I. UNDERSTANDING THE SUBSTANTIVE NATURE OF THE DOCTRINE

Identification of any doctrine may be facilitated by recognizing what is not essential for its invocation. Such recognition is particularly helpful here because there has been a tendency to confuse the substantive nature of the doctrine of reasonable expectations with a canon of construction for contracts—*contra proferentem*. Courts long have honored the reasonable expectations of insureds where a policy provision is ambiguous.[6] This is the very essence of *contra proferentem*, the rationale for the legion of opinions construing ambiguities against insurers. However, it is to be contrasted with the doctrine of reasonable expectations as identified by Judge Keeton. It was the very fact that courts had taken a more liberal view of what constitutes an ambiguity (as well as what evidence would support a theory of waiver, estoppel, or election) than was actually justified under the circumstances that attracted the attention of Judge Keeton nearly three decades ago. Moreover, it was this observation that caused him to conclude that something new was actually going on in the way of doctrinal development—something that could not be explained by such existing orthodoxy as construing ambiguities, waiver, estoppel, election, reformation, and rescission. Recognition of two broad principles, he submitted, would explain most of what otherwise appeared to be

6. "Where words or other manifestations of intention bear more than one reasonable meaning an interpretation is preferred which operates more strongly against the party from whom they proceed, unless their use by him is prescribed by law." RESTATEMENT OF CONTRACTS § 236(d) (1932).

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an undue number of aberrational decisions in insurance cases. He stated the principles as follows: (1) an insurer will be denied any unconscionable advantage in an insurance transaction, and (2) the reasonable expectations of insurance applicants and intended beneficiaries will be honored.[7]

It is the second principle that has come to be known as the "doctrine of reasonable expectations," a doctrine that has been embraced by at least ten jurisdictions.[8] In doing so, these jurisdictions have made it clear that the doctrine may apply despite the fact that there is no ambiguity in the policy.[9] According to these courts, and as envisaged by Judge Keeton, it is substantive in nature and not merely a rule of construction to resolve competing interpretations of policy language. Yet, there are other jurisdictions whose courts have in some fashion stated that they have adopted the doctrine but have confused the issue by not clearly distinguishing the substantive nature of the doctrine from the canon of construction that resolves ambiguities against the drafter of an adhesion contract.[10] It is one thing to make a clear and outright rejection of the doctrine, which courts certainly are free to do,[11] but there is no excuse at this late date to continue to confuse the doctrine with a rule whose application is dependent upon the existence of an ambiguity in the contract. The doctrine of reasonable expectations is not dependent on the existence of an ambiguity. Rather, it is a legal concept that courts have employed, even though no ambiguity is involved, to nullify certain provisions of standard form contracts that are found to be unfair to those who have no opportunity but to adhere to the agreement. That much should be clear about the doctrine.

What is not clear, however, is whether after nearly three decades there is any real substantive content to the so-called doctrine? Or, is it like its closely related cousin, the doctrine of unconscionability—another black hole in the law

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7. Keeton, *Rights At Variance: Part One*, *supra* note 5, at 961.

8. *See* Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 828 (1990).

9. *See, e.g.*, Continental Ins. Co. v. Bussell, 498 P.2d 706, 710 (Alaska 1972); Gordinier v. Aetna Cas. & Sur. Co., 742 P.2d 277, 283 (Ariz. 1987); Rodman v. State Farm Mut. Auto. Ins. Co., 208 N.W.2d 903, 905-06 (Iowa 1973); Sparks v. St. Paul Ins. Co., 495 A.2d 406, 412-14 (N.J. 1985).

10. *See* Henderson, *supra* note 8, at 828-34.

11. *See, e.g.*, Deni Assoc. of Florida, Inc. v. State Farm Fire & Cas. Co., 711 So.2d 1135 (Fla. 1998); Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d 798 (Utah 1992). *But cf.* Max True Plastering Co. v. United States Fidelity & Guar. Co., 912 P.2d 861 (Okla. 1996)(court rejected insured's argument that a finding of ambiguity should not be required in order for the doctrine of reasonable expectations to apply, but held that it may be invoked where an ambiguity exists in the policy or the policy contains exclusions which are hidden or masked by technical or obscure language).

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from which no guiding rule hardly ever emerges other than one that merely says we know those provisions that deserve to be struck down when we see them? If the latter is true, it surely has profound implications for an industry that is so dependent for its fiscal soundness, if not its very survival, on predictability. Nor, in turn, does it bode well for the success of any human activity or goal that is seriously dependent on private risk spreading arrangements, the cost of which should be allocated on a fair and nondiscriminatory basis. Thus, a closer examination is in order, an examination that needs to take into account the fact that there were competing formulations almost from the beginning.

II. THE PROBLEM OF COMPETING FORMULATIONS

Although the body of law passing under the head of reasonable expectations is almost always referred to as a doctrine, it was not originally advanced as such by Judge Keeton. He denominated it a principle and rendered it in the following formulation:

> The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations.[12]

In doing so, he did not assert that the proposed principle sprang fully formed from the cases that he surveyed. On the contrary, he recognized at the outset that, as stated, this principle was too general to serve as a guide from which particularized decisions could be derived through an exercise of logic, and too broad to be universally true.[13] Nevertheless, he submitted that the principle accurately identified the direction in which insurance law was and should be moving.[14] In addition, Judge Keeton recognized, as with most new principles, that it would take time for the common law process to work out the exact doctrinal dimensions.[15] Whether or not this development has occurred

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12. Keeton, *Rights At Variance: Part One, supra* note 5, at 967.

13. *Id.*

14. *Id.*

15. In 1976, six years after his original article, Judge Keeton discussed the distinctions between the recognition of a principle and the development of its doctrinal aspects:

> Principles collide in a sense beyond doctrinal conflict. Doctrines are sets of explicit rules of decision—the outcomes of accommodation among

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has been the subject of much discussion,[16] the continuation of which undoubtedly will occupy a good portion of this program.

My role on the program, however, is not so much to review the past or even to address the efficacy of the doctrine, but is mainly to focus your attention on forces outside the realm of insurance law that undoubtedly could have a serious impact on future developments in the doctrine of reasonable expectations. In order to do this, it would help at the outset to recall the work of the American Law Institute in addressing the problem of enforcement of standard form contracts in general and the relation of that work to the doctrine of reasonable expectations. This is pertinent because the Institute was grappling with this problem in connection with its efforts to draft the second edition of the *Restatement of Contracts* at the time when Judge Keeton's article was published in the Harvard Law Review.[17] Moreover, a number of courts that have adopted the doctrine of reasonable expectations have cited the *Restatement* as well as Judge Keeton's formulation in reaching their decisions.[18] Yet, there are significant differences between the two formulations, differences that have largely been ignored.

When it came time for the American Law Institute to revise the original *Restatement of Contracts* in the 1960s, it had to address the modern revolution in the manner in which most contractual relationships are formed, a revolution

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> competing principles. Conflicts among doctrines are imperfections yet to be worked out as the operational rules of the legal system evolve. The collision of principles, on the other hand, is a phenomenon that does not signal imperfection of the legal system but rather signals the underlying conflict of interests with which the legal system must grapple.
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> A principle is a generalization so broad that it does not express all the qualifications and limitations that must be expressed in an accurate statement of a rule, or a set of rules of decision that constitute at least the framework, though not the full body, of a doctrine. The qualifications and limitations arise because of the collision of underlying principles. In short, a principle, as Professor Austin Scott has observed, is a proposition that is not true, exactly.

Robert E. Keeton, *Reasonable Expectations in the Second Decade,* 12 FORUM 275, 277 (1976).

16. For a list of the many articles discussing the doctrine of reasonable expectations, *see* Henderson, *supra* note 8, at 823-24 nn.6-8.

17. Keeton, *Rights At Variance: Part One, supra* note 5.

18. *See, e.g.,* Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388, 396-97, 405-06 (1984); C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 176 (1975).

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brought about through the proliferation of standard form agreements.[19] In the process, the Institute came to the conclusion that a number of cases, in which courts were asked to enforce standard form contracts, had recognized an exception and that these cases had to be accounted for in the revised *Restatement of Contracts*. The approach of the Institute was to transform section 237 of the *Restatement*, which originally contained the parole evidence rule,[20] into a provision that dealt with the enforceability of standardized agreements.[21] The new provision, which eventually became section 211 in the final draft,[22] provided that standardized written agreements will be enforced without regard to knowledge or understanding of the standard terms if a party to such an agreement has reason to believe that like writings are regularly used to embody terms of the same type.[23] The rule, however, is qualified by an exception. If the other party—the insurer in our case—has reason to believe that the party manifesting such assent—the insured—would not do so if she knew that the writing contained a particular term, the term is not part of the agreement.[24]

Although section 211 itself does not define what constitutes "reason to believe," comment *f* to the section elaborates on this point:

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19. *See* W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529 (1971).

20. RESTATEMENT OF CONTRACTS § 237 (1932).

21. *See* RESTATEMENT (SECOND) OF CONTRACTS § 237 (Tent. Draft No. 5, March 31, 1970).

22. RESTATEMENT (SECOND) OF CONTRACTS § 211 (1981).

23. *Id.*

> (1) Except as stated in Subsection (3), where a party to an agreement signs or otherwise manifests assent to a writing and has reason to believe that like writings are regularly used to embody terms of agreements of the same type, he adopts the writing as an integrated agreement with respect to the terms included in the writing.
> (2) Such a writing is interpreted wherever reasonable as treating alike all those similarly situated, without regard to their knowledge or understanding of the standard terms of the writing.
> (3) Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement.

RESTATEMENT (SECOND) OF CONTRACTS § 211 (1981).

24. *Id.*

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> Although customers typically adhere to standardized agreements and are bound by them without even appearing to know the standard terms in detail, they are not bound to unknown terms which are beyond the range of reasonable expectation. A debtor who delivers a check to his creditor with the amount blank does not authorize the insertion of an infinite figure. Similarly, a party who adheres to the other party's standard terms does not assent to a term if the other party has reason to believe that the adhering party would not have accepted the agreement if he had known that the agreement contained the particular term. Such a belief or assumption may be shown by the prior negotiations or inferred from the circumstances. Reason to believe may be inferred from the fact that the term is bizarre or oppressive, from the fact that it eviscerates the non-standard terms explicitly agreed to, or from the fact that it eliminates the dominant purpose of the transaction. The inference is reinforced if the adhering party never had an opportunity to read the term, or if it is illegible or otherwise hidden from view. This rule is closely related to the policy against unconscionable terms and the rule of interpretation against the draftsman.[25]

In comparison with the Keeton formulation, there is no doubt that the "black letter" formulation of the *Restatement*, along with its commentary, reflects a more conservative approach in its recognition of an exception to the rule that standardized agreements will be enforced as written. As comment *f* shows, the exception was narrowly drawn so as to assess the situation from the drafter's perspective. Even then the contested term is to be ignored only if the drafter has "reason to believe"[26] that the other party, one who understands that a typical form contract is being used, would not have assented to the term. This formulation, if applied literally, could significantly affect the outcome of adjudications where insureds assert that their reasonable expectations have been violated by insurers.

In most modern insurance transactions, there will be little argument over the fact that the insured will be taken to understand that a typical or standard form is being used to embody the terms of the agreement. It is also the case

25. RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. *f* (1981).

26. It was suggested that the latter was more restrictive and would narrow the applicability of the exception. *See* 47 A.L.I. PROC. 525, 534 (1970).

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that it will almost always be the insured who will want to avoid one or more of the terms contained in that agreement. Yet, a court in deciding whether to apply the exception contained in section 211 is required to focus on information that was available to the insurer, *i.e.*, what the insurer had reason to believe. This approach could result in a significantly different result from that derived by application of the Keeton formulation.[27] The difference in result under the Keeton formulation is likely because his formulation does not dictate that the arbiter's decision be informed solely from the perspective of the insurer. In contrast, the Keeton formulation contemplates that the insured's expectations should be protected as long as they are "objectively reasonable from the layman's point of view."[28]

In a relationship between insurer and insured, the insurer knows more about insurance transactions and therefore will know many things of which the insured is quite likely ignorant. In fact, it is often this very lack of information that causes an insured to mistakenly expect coverage once a loss occurs. For example, the insurer will be conversant with important underwriting considerations (including differentials in premiums arising from the inclusion or exclusion of certain terms or clauses), industry practices with regard to the prevalence of certain terms or clauses in various types of policies, and the problems arising from the claims process where certain terms or clauses are included or omitted. The fact that the insurer probably has this information and much more could well affect a decision about what an insurer has reason to believe about an insured's expectations. A court might conclude, in such circumstances, that the insurer did not have "reason to believe"—a term that may require a stronger form of cognition than "reason to know"[29]—the insured would not have assented.

Under the *Restatement* formulation, the insurer would be entitled to prove the complete extent of its knowledge and experience with regard to any determination of whether it had reason to believe even though the standard employed in section 211(3) is an objective one.[30] For example, should not the

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27. *See supra* note 12 and accompanying text.

28. *See* Keeton, *Rights At Variance: Part One, supra* note 5 at 967.

29. Perhaps this is why the Reporter for the Restatement (Second) of Contracts thought "believe" was more restrictive than "know." *See supra* note 26.

30. This is made clear by the Reporter's response to an inquiry regarding the nature of the standard, *i.e.*, whether it involved an objective or subjective determination:

> PROFESSOR BRAUCHER: Well, "reason to believe" is an objective standard requiring the exercise of judgment by the reasonable man, but it is a

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insurer's perspective include a life insurer's knowledge of the benefits of a conditional receipt that inure to an insured and the reasons why such receipts are utilized in marketing life insurance? And should not this knowledge tip the scales away from a finding that a reasonable insurer had "reason to believe" that an applicant would expect immediate coverage upon payment of the first premium despite the fact that the receipt does not so provide? What about the marketing of air-travel trip insurance through vending machines? Should not the insurer's knowledge about the greater incidence of private aircraft accidents in contrast to those of commercial airlines, not to mention the comparative cost of extending coverage to the former, weigh in the balance and affect the decision as to whether an insured's expectations of being covered for all types of air travel were reasonable, even though the policy states otherwise? In fact, the very use of industry-wide standard forms to define coverages so that an insurance applicant has little, if any, choice, even if the applicant had tried to shop around, would support an argument that an insurer had no reason to believe that a reasonable applicant—compared to the particular applicant—would have expected anything different than what was available in the market place.

Of course, the *Restatement* formulation does not exclude information possessed by an insurer that is favorable to an insured's claim that her expectations have been unfairly defeated. For example, the fact that a reasonable insurer may be aware that insureds often do not understand the terms of a particular type of conditional receipt or certain limitations of air-travel trip insurance should be relevant in an inquiry regarding what an insurer had reason to believe. Yet, the more widely a form is used, the more difficult it will be for a particular insured to argue that his or her expectations should be enforced. Consequently, although the entire body of knowledge of the insurer surely should be considered in such a determination, the *Restatement* formulation clearly invokes a perspective, perhaps even a bias, that does not exist in the Keeton formulation.

The Keeton formulation, in contrast with that of the *Restatement*, would appear to be more faithful to the notion that the drafter of the adhesion agreement must bear the consequences of any reasonable misunderstanding by the adhering party, even where there is no ambiguity in the language of the contract, so long as the misunderstanding is fostered by the drafter. Unlike the *Restatement*, there is no requirement that an insurer be aware of facts that

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> judgment exercised in the light of the facts available to the party whose reason to believe is in question . . . .

47 A.L.I. PROC. 535 (1970).

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would cause it to believe the insured's expectations would be defeated. Moreover, there is no requirement that the facts even be available to the insurer so that it should have known of the insured's expectations. Under the Keeton formulation, the insurer could be completely ignorant of the obfuscating factors or their effect and the insured might still prevail, whereas the opposite result could well obtain if the *Restatement* were to be applied literally.

In addition to the requirement that courts consider the insurer's perspective when asked to apply the exception set out in subsection (3) of section 211 of the *Restatement*, the entire section seems to contemplate that application of the exception requires a conclusion that the insurer had "reason to believe" that the insured would misunderstand a particular term, not merely that the insurer had "reason to believe" that the insured would expect the contract as a whole to provide coverage that it in fact did not provide.[31] This interpretation of the section is reinforced by the notion that there must be an actual offending term—one that is bizarre or oppressive, eliminates the dominant purpose of the transaction, or eviscerates terms which were the subject of actual agreement—not merely an omission or failure to provide coverage. In other words, the exception under section 211 can be applied, arguably, only to actual terms establishing exclusions, conditions, or definitions that affect the insured's expectations about another term, for example a coverage provision, in the policy. It cannot be applied to create a coverage provision that is not already present in the policy.[32] This limitation does not exist in the Keeton formulation either.

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31. Although the Reporter indicated there was no intent not to cover the case of expected but omitted terms, *id.* at 526-27, the matter was not clarified in the final draft. Perhaps the Reporter believed such situations would be adequately covered under the law of reformation, *id.* at 533-34, because this term would be one that the insurer had reason to believe the insured wanted included. Thus, there would be either a mutual mistake or unilateral mistake induced by inequitable conduct on the part of the insurer, types of conduct that give rise to the remedy of reformation. *See* DAN B. DOBBS, LAW OF REMEDIES § 4.3(7) (2nd ed.1993). Proving the type of inequitable conduct by an insurer that would lead to reformation, however, is not always easy. *See, e.g.*, Mutual of Omaha Ins. Co. v. Russell, 402 F.2d 339 (10th Cir. 1968).

32. This position would be consistent with what was once clearly the majority rule that the doctrine of estoppel is not available to bring within the coverage of an insurance policy risks not covered by its terms, *see* W. C. Crais, III, *Doctrine of Estoppel or Waiver as Available to Bring Within Coverage of Insurance Policy Risks Not Covered by Its Terms or Expressly Excluded Therefrom*, 1 A.L.R.3d 1139 (1965), but there are a growing number of jurisdictions that have rejected it. Two of the jurisdictions that have adopted the minority position happen to be states that have clearly adopted the doctrine of reasonable expectations. *See* Darner Motor Sales v. Universal Underwriters Ins. Co., 682 P.2d 388, 400 (Ariz. 1984); Harr v. Allstate Ins. Co., 255 A.2d 208, 218 (N.J. 1969). *But see* State v. Underwriters at Lloyds, London, 755 P.2d 396 (Alaska 1988) (indicating doctrine of reasonable expectations may not apply to create

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The fact that there are two different formulations of the doctrine of reasonable expectations raises some interesting issues as to what courts mean when they announce that they have adopted this new method of judicially regulating standard form contracts. Do they mean to include the more restrictive limitations contained in the *Restatement (Second) of Contracts* or is there life beyond section 211? This I have explored elsewhere[33] and it does not serve my purpose to repeat it here. Rather, it serves to point up the importance of the American Law Institute's role in establishing the doctrine and, more importantly, the impact it has had on its substantive formulation. And, most importantly for purposes of this program, it also should remind us that, in addition to the courts and law reviews, there are other oracles of the law that often play a significant role in doctrinal developments. In fact, as we speak there are forces again at work that are impacting the development of the law known as the doctrine of reasonable expectations in general. There is no doubt in my mind that these developments ultimately will have serious implications for parties to insurance contracts in this country.

Although the American Law Institute is not currently revising the *Restatement (Second) of Contracts*, it will eventually turn its attention to that task. In the meantime, it is seriously engaged in an effort, along with another important organization, that, once again, has caused it to revisit issues regarding the enforceability of standard form contracts. The process of resolving these issues—a process that does not have insurance contracts as its focus—may dictate the Institute's position on the doctrine of reasonable expectations when it eventually undertakes to draft the third *Restatement of Contracts*.

III. THE REVISION OF THE "2S".

The American Law Institute (ALI) and the National Conference of Commissioners on Uniform State Laws (NCCUSL) are currently engaged in an effort to revise Articles 2 and 2A of the Uniform Commercial Code (UCC), the articles dealing with the sale and lease of goods, respectively. In addition, these two organizations also are engaged in drafting a new article of the UCC—Article 2B—which deals with licensing of information and software contracting. In all three of these projects, the subject of enforceability of form

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coverage that does not otherwise exist). *See also* Max True Plastering Co. v. United States Fidelity & Guar. Co., *supra* note 11.

33. *See* Henderson, *supra* note 8, at 846-53.

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contracts looms large.[34] Yet, despite the importance of the subject—or perhaps because of it—the preliminary formulations of exceptions to enforceability have not been uniform but have proceeded along different tracks.[35] Things, however, are coming to a head.

A. The 1996 Drafting Efforts

The first opportunity for either of the sponsoring organizations to consider drafts of Revised Article 2 and the new Article 2B simultaneously came at the annual meeting of the National Conference of Commissioners on Uniform State Laws in the summer of 1996.[36] At that time, the revisions to Article 2 contained a provision—section 2-206—stating that, except for two situations, a party who signs or otherwise assents to a form contract is bound by its terms without regard to whether the party has read it or knows or understands its terms.[37] The first exception, which applied to all form sales

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34. Article 2A is based largely on and contains many of the same provisions as Article 2. Whereas the effort to revise Article 2 is *de novo,* Article 2A is being revised only to take into account the amendments to Articles 2 and 9, which is also being revised, and the promulgation of Article 2B. *See* Prefatory Note, U.C.C. Revised Article 2A (1997 NCCUSL Annual Meeting Draft). Thus, the initial conflict over the formulation of the doctrine of reasonable expectations is primarily a result of the efforts of the drafting committees for Articles 2 and 2B. It should be noted that all NCCUSL drafts and related Reporter's memorandum, including those concerning Articles 2, 2A, and 2B referred to in this article, are available on the internet through the University of Pennsylvania School of Law website at <http://www.law.upenn.edu/library/ulc/htm>.

35. Although there are liaisons and other means of communications between the drafting committees, the chairs, reporters, and members are sufficiently different so as to make the committees independent of each other in their drafting efforts.

36. The work on drafting the new Article 2B only began in January of 1996, whereas efforts to revise Article 2 of the UCC had begun earlier. During the early work to revise Article 2, it was contemplated that it would include new sections on licenses of information and computer software, but this approach was eventually abandoned and a separate drafting committee was established to draft a new article—Article 2B—to deal with these and related licenses. Since the work on revising Article 2A was limited to conforming it to Revised Article 2 and Article 2B, *see supra* note 34, it was not scheduled for discussion at the 1996 annual meeting.

37. SECTION 2-206. STANDARD FORM RECORDS.

> (a) If all of the terms of a contract are contained in a record which is a standard form or contains standard terms and the party who did not prepare the record manifests assent to it by signature or other conduct, that party adopts all terms contained in the record as part of the contract except those terms that are unconscionable.

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contracts, involved unconscionable terms.[38] The second was more limited; it dealt with terms in form sales contracts that are not reasonably expected by a consumer.[39] Although Revised Article 2A was not scheduled for discussion at this meeting, it tracked the provision in Article 2.[40] Thus, the articles dealing with sales of goods and commercial leases of personal property basically contained the Keeton formulation of the doctrine of reasonable expectations, which sometimes will be referred to below as the Article 2-Keeton formulation.

In comparison, the counterpart section in Article 2B borrowed to some extent from the language in comment *f* of section 211 of the *Restatement (Second) of Contracts*. Section 2B-307 first reiterated the general rule that a party who assents to a form contract—a license in this case—is bound by its terms, whether or not the party has read or understands those terms,[41] unless

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(b) A term in a record which is a standard form or which contains terms to which a consumer has manifested assent by a signature or other conduct is not part of the contract if the consumer could not reasonably have expected it unless the consumer expressly agrees to the term. In determining whether a term is part of the contract, the court shall consider the content, language, and presentation of the standard form or standard term.

(c) A term adopted under subsection (a) becomes part of the contract without regard to the knowledge or understanding of individual terms by the party assenting to the standard form record, whether or not the party read the form.

U.C.C. § 2-206 (1996 NCCUSL Annual Meeting Draft).

38. *Id.*

39. *Id.*

40. *See* U.C.C. § 2A-206 (September 1996 NCCUSL Tentative Draft).

41. SECTION 2B-307. STANDARD FORM RECORDS.

(a) Except as otherwise provided in subsection (c) and Sections 2B-308, 2B-309, and 2B-310, if all or part of an agreement is to be represented by a standard form, a party adopts the terms of the form if, before or within a reasonable time after beginning to use the information pursuant to an agreement or commencing performance, the party who did not prepare the form signs or otherwise by its behavior manifests assent to it.

(b) A term adopted under subsection (a) becomes part of the contract without regard to the knowledge or understanding of the term by the party assenting to the standard form and whether or not the party read the form.

(c) A term of a standard form which is unenforceable under other provisions of this [article], such as a provision that expressly requires conspicuous language or assent to the term, does not become part of the contract unless those other provisions are satisfied.

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saved by the rule regarding unconscionability [42] or one of the rules in two other sections, one of which does not bear discussion here.[43] The other of these—section 2B-308[44]—which does bear discussion, provides that the general rule

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U.C.C. § 2B-307 (July 1996 Annual NCCUSL Meeting Draft).

42. SECTION 2B-110. UNCONSCIONABLE CONTRACT OR TERM.

> (a) If a court finds as a matter of law that a contract or any term of a contract was unconscionable at the time it was made, the court may refuse to enforce the contract, enforce the remainder of the contract without the unconscionable term, or so limit the application of any unconscionable term as to avoid any unconscionable result.
>
> (b) Before making a finding of unconscionability under subsection (a), the court, on its own motion or that of a party, shall afford the parties a reasonable opportunity to present evidence as to the setting, purpose, and effect of the contract or term thereof or of the conduct.

U.C.C. § 2B-110 (July 1996 NCCUSL Annual Meeting Draft).

43. Section 2B-309 of the 1996 Annual Meeting Draft of Article 2B deals with cases where two standard forms involving differing terms are traded between the parties, whereas sections 2B-307 and 308 govern cases involving the use of only one standard form. Section 2B-309 adopts a knock-out rule: Varying or conflicting terms in the two forms are excluded unless a party manifests assent to particular term. A party does not manifest assent by mere silence or retention of a form. Assent requires an affirmative act that reflects agreement to terms that the party had an opportunity to review and reject. U.C.C. § 2B-309 (1996 NCCUSL Annual Meeting Draft).

44. SECTION 2B-308. MASS-MARKET LICENSES.

> (a) Except as otherwise provided in subsection (b) and Section 2B-309, a party adopts the terms of a mass-market license if, before or within a reasonable time after beginning to use the information pursuant to an agreement or commencing performance, the party signs or otherwise by its behavior manifests assent to the license.
>
> (b) Terms adopted under subsection (a) include all of the terms of the license without regard to the knowledge or understanding of individual terms by the party assenting to the form. However, except as otherwise provided in subsection (c), a term does not become part of the contract if the term creates an obligation or imposes a limitation:
>
> > (1) that is not consistent with customary industry practices at the time of the contract and which a reasonable licensor should know would cause an ordinary and reasonable licensee to refuse the license if the term were brought to the attention of the licensee; or

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of enforceability applies to mass-marketed licenses, many of which would include consumer transactions, except that a term would not become part of the contract if the term creates an obligation or imposes a limitation that:

> (1) is not consistent with customary industry practices at the time of the contract and which a reasonable licensor should know would cause an ordinary and reasonable licensee to refuse the license if the term were brought to the attention of the licensee; or
>
> (2) conflicts with the terms of a previous agreement of the parties which were negotiated and agreed to relating to the transaction and the party assenting to the form does not manifest assent to that particular term.[45]

As can be seen, there are not only differences between the 2B formulation and the Article 2-Keeton formulation, but the former also differs from the formulation contained in section 211 of the *Restatement (Second) of Contracts*.

> (2) that conflicts with the terms of a previous agreement of the parties which were negotiated and agreed to relating to the transaction and the party assenting to the form does not manifest assent to that particular term.
>
> (c) A term excluded under subsection (b) becomes part of the contract if:
>
> (1) the term creates rights for or restrictions on the licensee which give the licensee no fewer rights than would be given to a purchaser at a first sale under federal intellectual property law; or
>
> (2) the licensee manifests assent to the term.
>
> (d) A term of a standard form which is unenforceable under other provisions of this [article], such as a provision that expressly requires conspicuous language or assent to the term, does not become part of the contract unless those other provisions are satisfied.
> (e) A licensor has the burden of proving customary industry practices under subsection (b)(1).

U.C.C. § 2B-308 (July 1996 NCCUSL Annual Meeting Draft).

45. *Id.*

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First examining the second provision in section 2B-308 set out above, it arguably is nothing more than the so-called "dickered deal" provision described in comment *f* of section 211 of the *Restatement (Second) of Contracts*.[46] If there is a deal, it is assumed to be binding until the parties come to some other agreement. A later inconsistent term, to which there has been no assent, does not trump a prior term to which there has been assent. This is a reasonable expectation that certainly should be honored and there should be no quarrel about this exception to the general rule that form contracts will be enforced whether or not they are read or understood. The other exception, however, is more controversial.

Turning now to the first exception set out above dealing with licensing industry practices, it would appear to be both narrower and broader than that found in comment *f* to section 211 of the *Restatement (Second) of Contracts*. It is narrower because it uses a test that is limited to what is customary in the industry to determine whether a party's expectations are defeated, albeit that the burden is placed on the licensor to show that the license terms are customary in the industry.[47] Although a form developed by a consensus of the industry may as a rule contain less offensive terms than a form developed by just one party, it stands to reason that an industry form may still contain some unfairly surprising terms as far as the other party—particularly a consumer—is concerned. Yet, under this version of section 2B-308, a mass market licensor of information is home free as long as the licensor uses a form that is not inconsistent with customary industry practices, unless the consumer can persuade a court to declare the unexpected term to be unconscionable. Thus, the position of the Article 2B drafting committee in the summer of 1996 was in one respect even more conservative than the formulation of the ALI found in section 211 of the *Restatement (Second) of Contracts*.

On the other hand, the 1996 Article 2B formulation was in another respect arguably more liberal than the *Restatement* position. If the licensor's form is not consistent with customary industry practices, the licensee's burden is not one of having to show that the licensor "has reason to believe" that the licensee would not have agreed to the term, as is required by section 211.[48] Rather, it is a burden of having to show that a reasonable licensor "should know" that the licensee would not have agreed had the licensee known of the term.[49] The latter language imposes, at least under *Restatement* parlance, a duty to

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46. *See supra* note 25 and accompanying text.

47. *See* subsection (e) of U.C.C. § 2B-308, *supra* note 44.

48. *See supra* note 23.

49. *See supra* note 44.

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investigate and is not limited to what the licensor actually knows or matters of which he has notice.[50] Under this draft it could be argued that any noncustomary term in a license that a reasonable licensor should have known would have been rejected by a reasonable licensee would not be enforceable, regardless of the licensor's actual state of knowledge. Thus, the 1996 NCCUSL Annual Meeting Draft of Article 2B both giveth and taketh away in comparison with the *Restatement (Second) of Contracts*. If a licensee uses a customary license, as judged by industry practices, the terms would be unassailable except for unconscionability. Conversely, if the license is not a customary one, it may be easier, in comparison with the *Restatement*, for a licensee to escape its terms.

On balance, however, the 1996 NCCUSL Annual Meeting Article 2B draft contained the narrowest formulation yet of the doctrine of reasonable expectations. It would leave it within the power of the information licensing industry to dictate the terms of form licenses. This not only provides far less protection for consumers than the Article 2-Keeton formulation, but it also provides less protection for consumers than section 211 of the *Restatement (Second) of Contracts*, differences that did not go unnoticed when the two versions were discussed in the committee of the whole proceedings of the 1996 Uniform Laws Conference.[51]

Although the differences in the drafts of Article 2 and 2B were discussed by the Uniform Law Commissioners at their annual meeting in the summer of 1996, no specific directions were given to the drafting committees on how to reconcile the differences.[52] It is fair to say, however, that a number of

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50. As used in the Restatements, the term "reason to know," which is very close to the language "has reason to believe" found in section 211(3) of the Restatement (Second) of Contracts, *see supra* note 23, differs in meaning from the term "should know." The former implies no duty of knowledge on the part of the actor whereas the latter implies that the actor owes another the duty of ascertaining the fact in question. *See* RESTATEMENT (SECOND) OF TORTS § 12 (1965)

51. Although the National Conference of Commissioners on Uniform State Laws records the discussion in the committee of the whole at the annual meetings, the transcript is not published. It is made available to the reporters, committee chairs, and others that need to review what transpired during the meeting and is on file at the national headquarters office in Chicago, Illinois. The author, who is a Commissioner on Uniform Laws from the State of Arizona, not only took part in the discussions but also reviewed the transcripts of the 1996 NCCUSL annual meeting.

52. Drafts of Conference acts must be discussed and considered section by section by the entire Conference at no fewer than two annual meetings before the Conference may decide by a vote of states whether to promulgate the draft as a Uniform Act. 1997-98 Reference Book, National Conference of Commissioners on Uniform State Laws 8. It is not unusual at a first reading for the participants to inquire about the meaning of the various provisions of drafts and

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Commissioners, as well as some of the Advisors, voiced their concerns—disparate as they were—and expressed their expectations that the drafting committees should continue their efforts to find a more appropriate formulation. In particular, serious reservations were expressed regarding the open-ended nature of the Keeton-type formulation of the doctrine of reasonable expectations in section 2-206 of Article 2. In fact, a motion was made to delete the section, but it failed on a voice vote.[53] In response to the concerns, the Reporters, Chairs, and members of both drafting committees—Article 2 and 2B—appeared to be in agreement that they would continue to strive for a formulation that would be more likely to achieve a consensus in the Conference and American Law Institute.[54]

B. The 1997 Drafting Efforts

1. American Law Institute 1997 Annual Meeting

The next occasion for there to be a general discussion of the drafting efforts regarding revisions to the Uniform Commercial Code came at the May 1997 annual meeting of the American Law Institute, at which time the latest drafts of the proposed revisions to Article 2[55] and the new article 2B[56] were presented to that body for discussion. The drafts of the two articles regarding the doctrine of reasonable expectations contained some very interesting developments as a result of the discussions at the 1996 annual meeting of NCCUSL and subsequent drafting committee meetings. As promulgated by the drafting committee on March 21, 1997,[57] Revised Article 2 contained three

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to suggest changes without formal motions which would require the drafting committees to make certain changes. It is felt that the drafting committees should be given the freedom to resolve matters of concern without being bound by specific suggestions. On the second reading, if it is to be the final reading, motions are often made from the floor to require the drafting committees to resolve matters of concern in a specific manner.

53. In the context of the debate in the committee of the whole, the motion probably was not intended to completely eliminate the doctrine of reasonable expectations from Article 2; rather it was mainly an attempt to the reject the Keeton-type formulation.

54. A consensus may have been reached on at least one point during the 1996 NCCUSL annual meeting. According to the notes of the Reporter for the Article 2B drafting committee, a motion to delete the doctrine of reasonable expectations in Article 2 "was defeated based in part on [the] Article 2 Drafting Committee assurances that Article 2 would use an objective test" for the doctrine, the test preferred by the Article 2B committee. *See* U.C.C. Article 2B, at 82 (ALI Discussion Draft, April 14, 1997).

55. U.C.C. Revised Article 2 (ALI Discussion Draft, April 14, 1997).

56. U.C.C. Article 2B (ALI Discussion Draft, April 14, 1997).

57. This draft was subsequently denominated as the American Law Institute Discussion Draft, dated April 14, 1997 and will be cited as such hereafter. *See supra* note 55.

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alternatives within section 2-206.[58] The first two alternatives, with some variations, essentially embodied the Keeton formulation whereas the third was taken from section 211(3) of the *Restatement (Second) of Contracts*. However,

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58. SECTION 2-206. CONSUMER CONTRACTS; STANDARD FORM RECORDS.

(a) In a consumer contract, if a consumer agrees to a record by authentication or affirmative conduct,

[Alternative A]

any non negotiated term that a reasonable consumer in a transaction of this type would not expect to be in the record is excluded from the contract.

[Alternative B]

any term of which the consumer is not expressly aware is excluded from the contract if a reasonable consumer in a transaction of this type would not expect to find that term in the record.

[Alternative C]

if the preparer of the record had reason to know that the consumer would not agree to the record if it knew of a term contained in the record, that term is excluded from the contract.

(b) Before excluding a term under subsection (a), the court, on motion of a party or its own motion, after affording the parties a reasonable and expeditious opportunity to present evidence on whether the term should be included or excluded from the contract, shall decide the question as a matter of law. Evidence as to whether a term would be expected by a reasonable consumer in a transaction of this type, includes:

(1) efforts by the party preparing the record to inform the consumer of the term, including:

(A) the setting and circumstances in which the form was presented to the consumer;

(B) whether the term was called to the consumer's attention, including by a prior course of dealing between the parties, if any; and

(C) the degree to which the seller, or any other person on the seller's behalf, publicized the terms of the type of sale involved, including the term in dispute; and

(2) facts from other sources that are relevant to the expectations of reasonable consumers, including:

(A) the nature, price, and description of the goods;

(B) the expectations of consumers in similar types of transactions; and

(C) usages, standards, and common practices with respect to goods of the same type or description.

(c) If the seller complies with other more specific requirements in this article for including terms in a consumer contract, this section does not exclude those terms.

U.C.C. Revised Article 2 (ALI Discussion Draft, April 14, 1997).

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in a memorandum dated April 1, 1997 the Reporter for the project explained to the members of the American Law Institute that certain substantive changes had been made at the most recent meeting of the drafting committee.[59] One of these changes involved section 2-206. The drafting committee had adopted the first alternative, with some amendments to it and other parts of the section, so that it would now read:

> SECTION 2-206. CONSUMER CONTRACTS; RECORDS.
>
> (a) In a consumer contract, if a consumer agrees to a record by authentication or affirmative conduct, any non-negotiated term that a reasonable consumer in a transaction of this type would not reasonably expect to be in the record is excluded from the contract, unless the consumer had knowledge of the term before agreement to the record.
>
> (b) Before excluding a term under subsection (a), the court, on motion of a party or its own motion, after affording the parties a reasonable and expeditious opportunity to present evidence on whether the term should be included or excluded from the contract, shall decide the question as a matter of law.
>
> (c) This section shall not operate to exclude an otherwise effective term disclaiming or modifying an implied warranty.[60]

Consequently, even though the draft that the ALI distributed to the members of the Institute for discussion at its annual meeting in May of 1997 contained three versions of the doctrine of reasonable expectations, the drafting committee was on record as favoring the broadest formulation of the three.

On the other hand, the drafting committee for Article 2B, in response to the discussion at the 1996 annual meeting of NCCUSL and subsequent committee meetings, deleted the safe harbor concept in section 2B-308(b)(1) that put the terms of licenses that conform to "customary industry practice" beyond the reach of the doctrine of reasonable expectations.[61] However, the committee retained the remaining language in section 2B-308(b)(1) which

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59. U.C.C. Revised Article 2, xxiii (ALI Discussion Draft, April 14, 1997).

60. *Id.* at xxiv-xxv.

61. *See supra* notes 44-47 and accompanying text.

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appeared in the 1996 NCCUSL Annual Meeting Draft.[62] The effect of these changes was to transform section 2B-308 into a section that adopted a formulation of the doctrine of reasonable expectations along the lines of that in section 211(3) of the *Restatement (Second) of Contracts*. Consequently, the draft of Article 2B that was presented for discussion at the annual meeting of the ALI in May of 1997 contained the following version of section 2B-308:

> SECTION 2B-308. MASS-MARKET LICENSES.
>
> (a) Except as otherwise provided in this section and Section 2B-309, a party adopts the terms of a mass-market license if the party agrees or manifests assent to the mass-market license before or in connection with the initial use of or access to the information.
>
> (b) Terms adopted under subsection (a) include all of the terms of the license without regard to the knowledge or understanding of individual terms by the party assenting to the form. However, except as otherwise provided in this section, a term [for which there was no opportunity to review before payment of the contract fee is not adopted and] does not become part of the contract if the term creates an obligation or imposes a limitation that:
>
> (1) the party proposing the form should know would cause an ordinary and reasonable person acquiring this type of information in the mass market to refuse the license if that party knew that the license contained the particular term; or
>
> (2) conflicts with the previously negotiated terms of agreement.....[63]

Nonetheless, even though the changes in Article 2B narrowed the gap between it and Article 2 to some extent, significant differences still remained between the two versions of the doctrine of reasonable expectations in the spring of 1997.

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62. *See supra* note 44 and accompanying text.

63. U.C.C. Article 2B, 81-82 (ALI Discussion Draft, April 14, 1997). The bracketed language in subsection (b) raises the issue whether the exclusionary terms of this section should be limited in effect to cases where the standard form was not made available to the licensee until after the purchase price was paid. *Id.* at 83.

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Although the Article 2B draft that was to be reviewed by the ALI discarded the idea of allowing licensors a safe harbor if they conformed to customary industry practices, it did not otherwise move significantly closer to the Keeton-type formulation contained in the contemporaneous draft of Revised Article 2 that also was to go before the ALI at its 1997 annual meeting. Article 2B retained the general approach found in the second *Restatement of Contracts*. Moreover, the drafters of section 2B-308 clearly intended to emphasize the differences between their formulation and the approach taken in Alternative A of section 2-206 of Revised Article 2. In fact, the Reporter's notes are unequivocal on the point that the drafters of section 2B-308 did not embrace the more expansive judicial interpretations of the doctrine of reasonable expectations under section 211(3) the *Restatement*, much less the Keeton-type formulation. Speaking with reference to subsection (b) of section 2B-308, the Reporter's notes state that:

> Subsection (b) parallels the Restatement test, but does not adopt the broad interpretation that some courts have placed on that proposal. ... [S]ome courts have confused the Restatement approach with a general authorization to review the terms of a standard form to determine whether, in the view of the court, the contract term should have been within the reasonable expectations of the recipient of the form and, ultimately, whether the term was appropriate in the context of the deal as viewed by the court. This, in effect, allows a court to rewrite the deal of the parties by excluding terms it thinks are not reasonable. This broad approach reflects case law in a number of states dealing with insurance contracts, but is neither appropriate in this commercial context, nor consistent with either the language of the Restatement, the apparent intent of the developers of the Restatement, or the language of this section. As applied outside of the arena of insurance contracts and divorced from the insurance law concepts that influence the test in that setting, a broad "reasonable expectations" test finds little support and is rejected here.[64]

64. U.C.C. Article 2B, Reporter's Notes, 83-84 (ALI Discussion Draft, April 14, 1997).

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The notes go on to state, after arguing that judicial interpretations of section 211(3) have gone beyond reasonable bounds, that this draft of section 2B-308 was intended to modify the *Restatement* formulation.[65]

The primary modification, to which the Reporter refers, is contained in paragraph (1) of subsection (b) of section 2B-308. In light of the mass market context, the Reporter's notes explain that this draft focuses on the perspective of the party proposing the form with respect to *an ordinary user* of the information.[66] In contrast, according to the Reporter, the *Restatement* permits a reference to the perception of the proposing party to the reactions of *the recipient* of the form.[67] The Article 2B drafters considered the *Restatement* approach unrealistic in the mass market situation since a one to one relationship creating an individualized perception is not what is contemplated by 2B-308.[68] The note goes on to explain that the latest draft of proposed subsection (b)(1) expressly connects the nature of the term to the refusal of the entire deal. The issue presented is not whether a term would fall within some general expectation, but whether the licensor "has reason to know that the term would be a 'deal breaker' in that it would so contradict the terms of the transaction or create oppressive conditions that would cause refusal of the proposed deal itself and in full."[69] Regardless of the merits of the Reporter's and drafting committee's interpretations of section 211(3) of the *Restatement*, it is abundantly clear that it was their intention to continue to reject the more liberal formulation of the doctrine of reasonable expectations that existed in Alternative A of section 2-206 of Revised Article 2.

As the 1997 ALI annual meeting approached, both the Revised Article 2 and Article 2B drafting committees appeared to be resolute in their respective approaches to the problem of enforcing unfairly surprising terms in form contracts. The respective drafts of Article 2 and 2B presented the members of the American Law Institute with an opportunity to compare and discuss two distinctly different formulations of the doctrine of reasonable expectations during the annual meeting of the Institute in 1997. Alternative A of section 2-

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65. *Id.* at 84.

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.* The Reporter's notes also indicate that this draft of 2B-308 made a second modification regarding the Restatement formulation of the doctrine of reasonable expectations in section 211(3). Subsection (c) of 2B-308 makes it clear that a term that would otherwise be excluded under subsection (b) will remain a binding term if the licensee is made aware of and assents to the term.

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206 essentially contained the Keeton formulation.[70] In comparison, Alternative C of section 2-206 and section 2B-308 embodied formulations of the doctrine that were based on comment *f* of section 211 of the *Restatement (Second) of Contracts*. The former approached the problem of enforcing unknown and surprising terms in form contracts from the perspective of a reasonable consumer, whereas the latter approached it from the perspective of the drafter. Something had to give, or at least it so appeared.

Because Revised Article 2 was the first of the two articles scheduled for discussion by the members of the ALI, the debate on the merits primarily focused on the differences between Alternative A and Alternative C of section 2-206.[71] As might be expected, this debate reflected the views of consumer advocates and those who use form contracts in their businesses. At the outset, it was recognized that form contracts were not only ubiquitous,[72] but that with the advent of electronic marketing the enforcement problem may become even more acute.[73] Nonetheless, some members of the ALI thought that even the adoption of a formulation based on section 211 of the *Restatement (Second) of Contracts* would be at odds with existing law under the Uniform Commercial Code because so few courts had ever embraced the doctrine of reasonable expectations in cases involving sales of good.[74] It was pointed out that, with very few exceptions, the cases actually applying the doctrine of reasonable expectations did not involve the UCC, but instead involved insurance contracts.[75] This fact led to the argument, which was the preferred position of business interests, that there was no need to make any reference to the doctrine in Revised Article 2.[76] According to these members, section 2-206 ought to be

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70. The only real difference between the Keeton formulation and Alternative A of section 2-206 was contained in subsection (b) where it clearly stated that the issue of the application of the doctrine is a question of law for the court, the propriety of which was also a subject of debate at the 1997 American Law Institute annual meeting. *See* 74 A.L.I. PROC. 75-80 (1997).

71. Although the debate focused on the alternatives contained in section 2-206 of Revised Article 2, the Reporters for Revised Article 2 and Article 2B both explained the respective sections dealing with the doctrine of reasonable expectations. The Reporter for Article 2B was very clear on the difference in approaches. *See* 74 A.L.I. PROC. 66 (1997). In addition, when discussing the merits of the alternative formulations in section 2-206, several members of the Institute indicated that they understood that the formulation in section 2B-308 was basically the same as the approach in Alternative C of section 2-206. *See id.* at 69-74.

72. *See id.* at 65.

73. *See id.* at 66.

74. *Id.* at 69-70, 73-74.

75. *See id.* at 73.

76. *See id.* at 70, 73.

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deleted.[77] On the other hand, if the section was to be retained, then Alternative C should be adopted instead of the broader formulation in Alternative A.[78] In addition, it was argued, in the event Alternative C were to be adopted, that the only type of term that should be ignored in a standard form contract is one that would have caused a reasonable customer, had the term been known, to reject the entire contract.[79] In other words, if section 2-206 was to be retained, it should follow the lead of section 2B-308 and be even more restrictive than some of the interpretations of *Restatement* section 211(3) in the insurance cases by using a "deal killer" standard.

In response, it was argued that Alternative A of Revised Article 2 was to be preferred because it would put the burden on the drafter to use terms that would not be surprising to a reasonable consumer or, in the alternative, to point out any unusual or questionable term so that the consumer would be aware of it.[80] This approach would best achieve an agreement to which both parties would most likely have assented, even though the contract was not read or completely understood at the time it was entered.[81] If an unusual term is included and not pointed out to the consumer, the drafter should understand that the term may not be enforceable and the risk of nonenforcement is appropriately place on the drafter, the person who is in control of the situation.[82] Moreover, according to those who favored Alternative A, the "deal breaker" standard is too stringent because it makes it much more difficult for consumers to attack a term in situations where they need the protection the most—situations where the need for the product is so great that a reasonable consumer would not reject the entire contract even though a particular term may be objectionable.[83]

At the conclusion of the debate on section 2-206 of Revised Article 2, what was characterized as a "straw vote" was taken to ascertain which formulation of the doctrine of reasonable expectations was most favored by the membership of the Institute.[84] Upon a show of hands, it was estimated that at least by a margin of two to one, or probably more, the Keeton-type formulation contained in Alternative A was favored in comparison with the *Restatement*

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77. *See id* at 70.

78. *See id.* at 70, 73-74.

79. *See id.* at 70, 73.

80. *Id.* at 71.

81. *Id.* at 71-72.

82. *Id.*

83. *Id.* at 72-73.

84. *Id.* at 74.

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formulation in Alternative C.[85] With regard to the show of hands, however, there was no indication whether the members of the Institute felt they were being asked merely to pass on the formulations for Revised Article 2 or instead to express a preference that would also dictate the formulation to be contained in Article 2B. In addition, when Article 2B was discussed the following day, there was no indication from the Chair or Reporter for that drafting committee whether they should be guided in any way in drafting section 2B-308 by the "straw vote" on section 2-206. The question of whether there should be a different formulation of the doctrine of reasonable expectations regarding mass-market licenses of information, much less whether it required an approach that was patterned after section 211(3) of the *Restatement (Second) of Contracts* and in particular the "deal killer" formulation, never arose. At best, the situation was left in an ambiguous state. With no definitive resolution of these issues at the ALI meeting in May, the next opportunity for debate and resolution would not occur until two months later at the annual meeting of the National Conference of Commissioners on Uniform State Laws in July of 1997.

2. Uniform Law Conference 1997 Annual Meeting

Based on the discussion and "straw vote" taken at the 1997 annual meeting of the American Law Institute, section 2-206 of Revised Article 2, along with some other minor changes, was redrafted to clearly adopt the Keeton-type formulation of the doctrine of reasonable expectations in Alternative A. As promulgated for discussion at the 1997 NCCUSL annual meeting, it now read:

> SECTION 2-206. CONSUMER CONTRACTS; RECORDS.
>
> (a) In a consumer contract, if a consumer agrees to a record, any non-negotiated term that a reasonable consumer in a transaction of this type would not reasonably expect to be in the record is excluded from the contract, unless the consumer had knowledge of the term before agreeing to the record.
>
> (b) Before deciding whether to exclude a term under subsection (a), the court, on motion of a party or its own motion, after affording the parties a reasonable and expeditious opportunity to present evidence on whether the term should be included or excluded from the contract, shall

85. *Id.* at 74-75.

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> decide whether the contract should be interpreted to exclude the term.
>
> (c) This section shall not operate to exclude an otherwise enforceable term disclaiming or modifying an implied warranty.[86]

Likewise, Section 2B-308 of Article 2B underwent some minor stylistic changes, but in substance the draft that was discussed at the 1997 ALI annual meeting essentially remained unchanged. It continued to embody a formulation based on section 211(3) of the *Restatement (Second) of Contracts*, employing the more stringent "deal breaker" standard.[87] However, in the interim both consumer and business interests became much more vocal and active in attacking various aspects, including sections 2-206 and 2B-308, of both drafting efforts.[88] Position papers were circulated to Commissioners outlining

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86. U.C.C. Revised Article 2 (1997 NCCUSL Annual Meeting Draft).

87. SECTION 2B-308. MASS-MARKET LICENSES.

> (a) Except as otherwise provided in this section and Section 2B-309, a party adopts the terms of a mass-market license if the party agrees, [including by] manifest[ing] assent, to the mass-market license before or in connection with the initial [performance] or use of or access to the information.
>
> (b) Terms adopted under subsection (a) include all of the terms of the license without regard to the knowledge or understanding of individual terms by the party assenting to the form. However, except as otherwise provided in this section, a term [for which there was no opportunity to review before payment of the contract fee is not adopted and] does not become part of the contract if [the party does not manifest assent to the particular term and] the term creates an obligation or imposes a limitation that:
>
> > (1) the party proposing the form should know would cause an ordinary reasonable person acquiring this type of information in the general mass market to refuse the license if that party knew that the license contained the particular term; or
> > (2) conflicts with the negotiated terms of the agreement.
> > . . . .

U.C.C. Article 2B (1997 Annual Meeting Draft).

88. For a particularly critical attack on the doctrine of reasonable expectations and its inclusion in Revised Article 2, see James J. White, *Form Contracts Under Revised Article 2*, 75 WASH U. L.Q. 315 (1997).

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arguments pro and con prior to and during the NCCUSL annual meeting.[89] It promised to be an interesting debate and it was.

When Revised Article 2 came up for discussion in the committee of the whole during the 1997 annual meeting of NCCUSL, it was no surprise that the positions taken at the recent ALI meeting were reiterated. On the other hand, the sentiment of the commissioners appeared to be running in the opposite direction of those expressed in the "straw vote" at the Institute meeting.[90] At the very least, those who saw no need for the section at all and those who opposed the open-ended nature of the current draft of section 2-206 were by far the most vocal in expressing their views. A potential show down between those taking polar positions, however, was avoided when a compromise was suggested. The suggestion consisted of a sentence to be inserted at the end of subsection (b) of section 2-206 as follows:

> The court may exclude the term under this section only if it finds that the term is bizarre or oppressive by industry standards or commercial practices, abrogates or substantially conflicts with other essential terms, eliminates the dominant purpose of the contract, or violates public policy because it conflicts with other consumer protection laws.

The suggested compromise was not offered as a formal motion to amend the draft of section 2-206; rather it was offered as a proposal to be studied and refined in hopes that it might gain a consensus among the members of the ALI and NCCUSL, if not the warring interests. To this end it was successful, as a number of Commissioners indicated that they preferred something akin to the compromise language. At best, the suggested language provided a basis upon which a consensus might be reached and, at worst, it forestalled a vote on the merits so that more thought could be given to the issue.

In fact, the suggested language offered something substantively different. First, it recognizes that form contracts actually provide benefits for consumers

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89. Most of the correspondence was in opposition to Revised Article 2, including Section 2-206. For example, one highly critical letter was signed by representatives from Caterpillar, Inc., Cooper Industries, Deere & Company, Hewlett-Packard Company, Motorola, Siemens Corporation, and Square D Company. Other correspondence criticizing Article 2 was received from the American Automobile Manufacturers Association, Association of International Automobile Manufacturers, Inc., Chamber of Commerce of the United States of America, Dresser Industries, Inc., and General Electric Company. One of the few letters that was generally supportive of Revised Article 2 and in particular Section 2-206 came from Consumers Union. Copies of these letters may be obtained from the author.

90. 74 A.L.I. PROC. 71-83 (1997).

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as well as business interests and that most of the time they do not contain unfairly surprising terms. It is convenient for consumers, as well as for businesses, to know that they can sign such agreements without having to study or even read them. It acknowledges that it is unrealistic to assume that most people will either read or understand many, if not most form contracts. It likewise acknowledges that many sales people are not qualified to explain the legal effect of the agreement even if questions were raised by a consumer. Basically, the proffered language creates a presumption in favor of enforceability. As long as business interests do not overreach or attempt to gain an unfair advantage, they can expect their form contracts to be honored by the courts. On the other hand, if a form contains a term that, when compared to reputable business practices, is questionable or so undermines the very purpose of the contract, it should be understood that it may be successfully challenged. In addition, and perhaps most importantly, the language does not take the perspective of the drafter or the consumer, but attempts to appeal to a neutral standard that is not overly burdensome to either party. Although it does not employ a "deal breaker" standard, in the final analysis the burden is on the consumer to convince the court that a particular term is so unfair that it should not be enforced unless it was brought to the attention of and agreed to by the consumer. At the very least, the suggested language appeared to be a step in the right direction by offering an improvement over the draft under consideration.

A number of commissioners indicated that they thought that the reasonable expectations formulation in section 2-206 was too devoid of substantive content to ever provide a meaningful guide for judicial application. It was noted that the American Law Institute had recently abandoned the reasonable consumer standard in drafting the portions of the *Restatement (Third) of Torts* dealing with strict liability for defectively designed products because it largely had failed as an efficacious test for resolving issues of liability in that area of the law. Arguably, a similar formulation in section 2-206 of the Uniform Commercial Code would fare no better. Consequently, for this and other reasons a number of commissioners indicated that they would vote against the present formulation and urged the Revised Article 2 drafting committee to pursue more of a middle ground. Apparently, there was enough interest to pursue further efforts to refine the compromise language or at least enough interest that no motion was offered or vote taken to accept or reject the existing approach in section 2-206. In short, there was more work to be done.

When Article 2B came to the floor, the issue regarding the appropriate formulation of the doctrine of reasonable expectations, which was also raised in section 2B-308, appeared to be defused pending future developments

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regarding section 2-206 of Revised Article 2. On the other hand, there was little indication that the Article 2B drafting committee had been persuaded by the earlier discussion of the doctrine of reasonable expectations in section 2-206 to change its position regarding the section 211 *Restatement* and "deal breaker" formulation embodied in section 2B-308. This apparent resoluteness continued in the face of strong sentiment that, unless there was some substantive need to do so, the language of Revised Article 2 and Article 2B should itself be uniform.[91]

3. Developments in the Fall of 1997.

After the 1997 annual meetings of the American Law Institute and National Conference of Commissioners on Uniform State Laws, the respective drafting committees proceeded with their work on Revised Article 2 and Article 2B. Meetings of the Revised Article 2 committee, however, were postponed until after the end of the year to give the Chair, Reporters, and others time to react to the suggestions and other matters that had occurred in connection with the discussions of the latest drafts at the most recent annual meetings of the sponsoring organizations. Since the strongest criticism was aimed at the proposed revisions to Article 2, it was felt that there needed to be more interchange with those affected and a greater effort to reach a consensus on some of the more difficult issues. With these needs in mind, the next meeting of the Revised Article 2 drafting committee was not scheduled until March of 1998. In addition, there was no immediate plan for Revised Article 2 even to be on the agenda of the next annual meeting of the ALI or NCCUSL in 1998. With the pressure off for the time being, no new drafts of Revised Article 2, including any revisions to section 2-206, were produced during the fall of 1997.

In contrast, the work of the Article 2B drafting committee, having been received much more favorably by those affected, proceeded apace. It not only was scheduled for further consideration by the ALI and NCCUSL at their next annual meetings, but with further work it was possible that it could receive final approval by these organizations in 1998. Yet, an unexpected change of mind occurred with regard to the doctrine of reasonable expectations during this period. The drafting committee voted at its September 1997 meeting to delete the doctrine of reasonable expectations in favor of a position previously

91. A motion was passed during the 1997 annual meeting of NCCUSL that required that the language of the various articles in the Uniform Commercial Code should be uniform when expressing the same concepts unless there was a substantive need to express it differently. In fact, a special committee was created to "harmonize" the language of the drafts of Articles 2, 2A, and 2B. U.C.C. Revised Article 2 (1997 NCCUSL Annual Meeting Draft).

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advocated by representatives of the American Bar Association.[92] This position, which was first reflected by relocating the subject of mass-market licenses to section 2B-208 in the November 1, 1997 draft,[93] classifies these licenses into two types based on whether the license is available to a potential licensee for review prior to payment. In the situation where the license is available for prior review, as a general rule,[94] a party manifesting assent[95] is bound by all the

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92. *See* U.C.C. § 2B-208, Reporter's Notes, n.1 (NCCUSL Committee Draft November 1, 1997).

93. SECTION 2B-208. MASS-MARKET LICENSES.

> (a) Except as otherwise provided Section 2B-209, a party adopts the terms of a mass-market license for purposes of Section 2B-207(a) if the party agrees, including by manifesting assent, to the license before or in connection with the initial performance or use of or access to the information. However, a term does not become part of the contract
>
> > (i) if it is unconscionable or
> > (ii) subject to Section 2B-301 with regard to parol or extrinsic evidence, if it conflicts with the negotiated terms of the agreement between the parties to the license.
>
> (b) If a party does not have the opportunity to review the terms of a mass-market license before becoming obligated to pay for the information and does not agree, including by manifest assent, to the license after having that opportunity, the party is entitled, on returning all copies of the information, to:
>
> > (i) refund of the consideration paid and cancellation of any obligation to pay for the information;
> > (ii) reimbursement of any reasonable expenses incurred in compliance with any reasonable instructions of the other party for return or destruction of the information or, in the absence of such instructions, reasonable expenses in connection with return of the information; and
> > (iii) compensation for any foreseeable harm caused to that information or system by the installed information and any reasonable expenses incurred in the restoration of the system to its condition prior to the installation, if the information must be installed in an information processing system to enable review of the license and the installation alters the system or information contained in the system.

U.C.C. Article 2B (NCCUSL Committee Draft, November 1, 1997).

94. Two exceptions are explicitly recognized for enforcing terms in a mass-market license: 1) unconscionability provides a limitation on what terms can be created in these contracts and 2) the form itself cannot alter negotiated terms reached by the parties to the license. *See id.* § 2B-208(a)(i) and (ii).

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terms in the license if payment is made before or in connection with the initial performance or use or access to the information.[96] However, in the situation where a party does not have an opportunity to review a mass-market license prior to payment, and therefore could not have assented, upon refusal[97] the party is entitled to a refund and any reasonable expenses in returning or destroying the information and certain consequential damages.[98] Whether this approach will carry the day remains to be seen, but it, at least for the time being, certainly has had two effects. It removes any pressure on the Article 2B committee to conform its position on reasonable expectations to that found in section 2-206 of Revised Article 2 and, as far as enforcement of form contracts is concerned, the focus, other than for the doctrine of unconscionability, is now limited to Revised Article 2.

4. Developments in the Spring of 1998

The first meeting of the Revised Article 2 drafting committee after the annual meetings of the ALI and NCCUSL in 1997 was scheduled for the weekend of March 6, 1998. In connection with this meeting, the Reporters produced still another draft of section 2-206, which, among other changes, again contained alternative provisions.[99] These provisions are set out below, with the italicized portions indicating changes from the draft that was discussed at the 1997 annual meeting of NCCUSL:

SECTION 2-206. CONSUMER CONTRACTS; RECORDS.

[Alternative A]

(a) In a consumer contract, if a consumer agrees to a record, any non-negotiated term that a reasonable consumer in a transaction of this type would not reasonably expect to be in the record is excluded from the contract, unless the consumer had knowledge of the term before agreeing to the record.

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95. There must be an affirmative act, such as a signature, initials, or electronically initiated response, to constitute assent. Mere retention of the information or license without objection is not a manifestation of assent. *See id.* § 2B-111.

96. *Id.* § 2B-208(a).

97. Apparently, under this draft it matters not why the potential licensee refuses the license.

98. *See* U.C.C. § 2B-208(b) (NCCUSL Committee Draft, November 1, 1997).

99. *See* U.C.C. Art. 2, § 2-206 (NCCUSL Committee Draft, March 1, 1998).

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(b) Before deciding whether to exclude a term under subsection (a), the court, on motion of a party or its own motion, *shall afford* the parties a reasonable and expeditious opportunity to present evidence on whether the term should be included or excluded from the contract. *The court may exclude a term under this section only if it finds that the term is bizarre or oppressive [harsh or "one-sided"] by industry standards or commercial practices, abrogates or substantially conflicts with other negotiated terms, eliminates the dominate purpose of the contract, or conflicts with other consumer protection laws.*

(c) This section shall not operate to exclude an otherwise enforceable term disclaiming or modifying an implied warranty.

[Alternative B]

(a) In a consumer contract, a consumer adopts the terms of a [standard form] record by manifesting assent to the record [2B-112] after having an opportunity to review. [2B-113]. However, a term does not become part of the contract if it is unconscionable or conflicts with any negotiated term of the agreement between the parties. [2B-208(a)]

(b) This section shall not operate to exclude an otherwise enforceable term disclaiming or modifying an implied warranty.[100]

According to the Reporters' notes,[101] it was clear that the Revised Article 2 drafting committee was no longer satisfied with the doctrine of reasonable expectations as it appeared in the July, 1997 draft.[102] Instead, a majority of the committee now appeared, at least in principle, to support the proposed amendment that had been suggested as a compromise at the 1997 NCCUSL annual meeting.[103] Other members, however, now appeared to favor a revision based on the new and most recent approach in Article 2B,[104] which would

100. *Id.* § 2-206 at 21.

101. *See id.*, n.1 at 21.

102. *See supra* note 86 and accompanying text.

103. *See* U.C.C. § 2-206, Reporters' Notes, n.1 at 21 (NCCUSL Committee Draft, March 1, 1998).

104. *See id.*

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eliminate any reference to the doctrine of reasonable expectations in Revised Article 2.[105] Consequently, the Reporters drafted section 2-206 in the alternative to facilitate discussion at the forthcoming March 1998 drafting committee meeting.[106]

Regarding the new draft of section 2-206, the italicized portion of subsection (b) of Alternative A contains a slightly edited version of the compromise language offered at the 1997 NCCUSL annual meeting, whereas Alternative B follows the new approach in Article 2B. "To sharpen debate," the Reporters summarized the position of the contending interests. Industry representatives claim that any version of section 2-206 is unnecessary because other state and federal law, as well as other provisions in Revised Article 2, provide sufficient protection for consumers.[107] In other words, business interests favor the Article 2B approach taken in Alternative B. Contrary to this position, "consumer representatives still favor section 2-206 as modified in Alternative A, rather than Alternative B".[108] Thus, the issues of whether to retain any reference to the doctrine of reasonable expectations in Revised Article 2 and, if so, what formulation it should take was squarely presented for debate at the next meeting of the drafting committee in March of 1998.

In a proposed agenda for the March 1998 Revised Article 2 drafting committee meeting, the Reporters, among other issues to be discussed, raised several questions regarding section 2-206.[109] The impact of the decision of the Article 2B drafting committee is evident in the first question, which raises the issue whether there is any need at all to refer to the doctrine of reasonable expectations in Revised Article 2. Although the current position of the Article 2 drafting committee is to retain the doctrine, the second question raises the possibility that the Revised Article 2 committee might change its mind and, if

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105. *See supra* note 92 and accompanying text.

106. *See* U.C.C. § 2-206, Reporters' Notes, 22 (NCCUSL Committee Draft, March 1, 1998).

107. *See id.*, n.2.

108. *See id.*

109. 1. Should 2-206 or a provision like it be in Revised Article 2? The Drafting Committee says yes.

2. If not, what should be done to provide adequate disclosure in consumer contracts? Is the judicial application of 2-105 coupled with state and federal consumer protection law sufficient?

3. If so, should Alternative A or Alternative B be adopted? The answer seems to depend upon the objective of 2-206, whether it is disclosure of terms or policing against "out of bounds" terms.

See Agenda prepared by Reporters for March 6-8, 1998, Revised Article 2 Drafting Committee meeting, *available at* <http://www.law.upenn.edu/library/ulc/ucc2/ucc2298m.htm>.

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so, what should be done to assure that consumers will be adequately informed about the terms of the sales contract. Were the Revised Article 2 committee to follow the Article 2B committee's lead in deleting the doctrine of reasonable expectations, would section 2-105 of Revised Article 2, which makes unconscionable terms unenforceable, when coupled with state and federal consumer protection laws suffice to protect consumers from surprisingly unfair contracts or terms? [110]

Depending on the answer to the latter question, the Reporters for Revised Article 2 inquire further whether Alternative A or Alternative B of section 2-206 of the March 1, 1998 draft should be adopted, and conclude by opining that the answer may depend on the purpose of section 2-206.[111] Is the objective of section 2-206 to encourage sellers to disclose unusual terms that may be regarded as unfair, and therefore subject to judicial nullification, absent assent by the consumer? Or, is it to guard against unfair terms, whether assented to or not? Presumably, the former objective lends support for Alternative A because it embodies a basic premise of the doctrine of reasonable expectations—absent assent, unfair terms may not be enforceable. In other words, a term may be unfair, but not so unfair that it should be judicially nullified regardless of assent. In comparison, under Alternative B, the policing of "out of bounds" terms would have to meet what could prove to be a more stringent test under the doctrine of unconscionability or that found in consumer protection statutes—the term has to be so unfair that it should always be disregarded, without regard to whether there was fully informed assent. [112] Although this distinction may be very subtle, it was clearly recognized and articulated by Judge Keeton when he first argued that a new doctrine, one closely related to but yet independent of the doctrine of unconscionability, was emerging under which courts were judicially regulating surprisingly unfair terms of insurance policies.[113] Essentially, it is this distinction that explains the difference in approaches taken by the Revised Article 2 and Article 2B committees in the spring of 1998, but it may be a while before a definitive decision on the subject is reached.

At the time this article was in the final stages of preparation, the Revised Article 2 drafting committee had met in March of 1998 and decided to retain the Alternative A approach set out in section 2-206 of the March 1, 1998

110. *See* U.C.C. § 2-105 (NCCUSL Committee Draft, March 1, 1998).

111. *See supra* note 109 and accompanying text.

112. *See supra* note 109.

113. *See* Keeton, *Rights At Variance: Part One, supra* note 5, at 964-65.

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draft.[114] However, despite the fact that the exact language of subsection (b) of section 2-206 had not been agreed upon and has yet to be formulated, the substance of the section, such as it existed, was transferred to section 2-105, the section on unconscionability. Future references, consequently, to the doctrine of reasonable expectations in Revised Article 2 may be found in section 2-105(b). Whether the juxtaposition of the two doctrines will affect the substance of either in future drafts remains to be seen, but for the present it appears that consumer advocates are enjoying some success. In the meantime, Article 2B is presently scheduled for final reading and approval by the Commissioners on Uniform Laws at their annual meeting in Cleveland, Ohio in July of 1998. Whether the American Law Institute will be in a position to approve Article 2B at its May 1998 is problematic, but there is a good chance that the work on this article will be completed by both organizations before the end of the year. On the other hand, Revised Article 2 is not scheduled to be reviewed by the ALI or NCCUSL at either of their annual meetings in 1998.

At this point, it would appear that there will be no reference to the doctrine of reasonable expectations in Article 2B, but there is a very good chance that it will remain in Revised Article 2. If this prediction proves correct, the doctrine could well be in a formulation that will fall between that originally articulated by Judge Keeton and that found in section 211(3) and comment *f* of the *Restatement (Second) of Contracts*. Only time, however, will tell and that time apparently will not come, at least, until 1999.

CONCLUSION

In the 1960s the American Law Institute was confronted with the fact that many, if not most, modern contracts were no longer negotiated between the parties. At best, only a few terms were actually agreed upon. Not only had negotiated agreements waned in the face of standardized forms, but it was commonly understood that most people—particularly consumers—would not bother to read, much less try to understand the terms in, these contracts. It could even be said without fear of any serious contradiction that most of those who utilized standardized forms in their businesses probably preferred that their customers not take the time to read the agreement. It was simply too inefficient to encourage their customers to do so.

Recognizing the realities of modern commercial practices, the Institute attempted to deal with the problem of enforcing surprisingly unfair terms in standard forms through a new provision in the *Restatement (Second) of*

114. *See supra* note 109 and accompanying text.

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Contracts—section 211—that has come to embody one of two competing formulations of the doctrine of reasonable expectations. At some point, the American Law Institute will undertake to draft a third edition of the *Restatement of Contracts.* When it does, it will be interesting to see what influence the debate regarding the doctrine of reasonable expectations during the process of revising Article 2 and drafting Article 2B of the Uniform Commercial Code may have in revisiting the formulation found it section 211(3) of the *Restatement (Second) of Contracts.* Of equal interest will be how much the case law involving contracts of insurance will impact any new formulation of the doctrine. Will the doctrine be that as originally formulated by Judge Keeton or will it bear more resemblance to the second *Restatement of Contracts*? Or, will there be more than one formulation—one for contracts in general and another for contracts of insurance? Even if the *Restatement Third* were to take such a two-pronged approach, it will still be interesting to observe the tug-of-war that is sure to take place as the various interests in the world of insurance compete to influence the outcome, an outcome that could be strongly influenced by efforts to revise the Uniform Commercial Code. My hope is that we will all still be around to participate in the debate. It should be fun.

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REASONABLE EXPECTATIONS REVISITED

*Mark C. Rahdert**

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* I. Herman Stern Professor of Law, Temple University. I wish to acknowledge the help of my research assistants, Jim Cosby and Rob Markoff. I also wish to thank my colleague Professor William Woodward, Jr., who provided me with several valuable insights regarding interconnections between insurance law and developments in modern contract law and theory. I wish to thank Temple University School of Law for generous financial support. Finally, I wish to thank Professors John F. Dobbyn of Villanova University School of Law, and Peter Nash Swisher of the University of Richmond School of Law, who organized and invited me to participate in the AALS Insurance Law Section meeting which served as the genesis for this symposium.

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INTRODUCTION

During the last three decades, few developments in insurance law have captured more attention than the doctrine of reasonable expectations. Owing its genesis to Professor (now Judge) Robert Keeton's seminal article, *Rights at Variance With Policy Provisions*,[1] the reasonable expectations doctrine enables courts to consider the "reasonable expectations of the insured" as an aid to insurance policy interpretation, and occasionally as a platform for guaranteeing the insured rights—including coverage—that the policy language itself does not provide. Keeton's argument regarding this principle was both empirical and prescriptive. Empirically, he detected the reasonable expectations doctrine lurking in many existing cases that purported merely to resolve policy ambiguities.[2] Because these so-called ambiguities were often more manufactured than real, and because the true animus for the court's decision seemed not to be so much a concern about policy clarity as a belief about policyholder assumptions regarding coverage, Keeton argued that in fact the courts were adjusting the policy provisions to match what they regarded as the reasonable expectations of the purchaser. Professor Keeton found this principle in operation across a wide range of insurance lines and policy interpretation questions, though most circumstances where he located the doctrine involved disputes between insurance companies and ordinary consumers.[3]

Prescriptively, Professor Keeton registered general support for this development, which he linked to the adhesive nature of insurance contracts, the virtually unbridled control over policy terms that insurers routinely exercise, and the inability of most insureds to understand the significance of technical language that insurance policies inevitably contain.[4] Keeton thus offered cogent reasons why the reasonable

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1. Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions,* 83 HARV. L. REV. 961 (1970) (Part II); *id.* at 1281 (1970) (Part II).

2. Keeton also saw the doctrine emerging in cases that purported to make equitable adjustments in the duties the policy imposed on the insured. *Id.* at 972-74.

3. Keeton, *supra* note 1, at 963-67.

4. Keeton, *supra* note 1, at 963-85. *See also* JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS section 11.3 (1994) (cataloging rationales for reasonable expectations principle).

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expectations doctrine made sense, and he encouraged courts to embrace it openly.[5]

With the imprimatur of one of America's most prominent and influential insurance law scholars behind it, the reasonable expectations idea has steadily gathered force. It has spread to become a key principle governing insurance policy interpretation in many, though by no means all, jurisdictions.[6] At the same time, however, judicial recognition of this concept has sparked persistent controversy regarding just how far the reasonable expectations idea should be carried, particularly in situations where honoring the insured's expectations would run contrary to the intent and clear import of policy language.[7]

Although controversy has not prevented the reasonable expectations concept from gaining ground, it has not subsided, and it has deterred several courts from embracing Professor Keeton's thesis.[8] Some courts have rejected the concept outright; others have vacillated between acceptance and rejection; still others have placed limitations on implementation of the concept that have prevented its full development.[9] Many judges still regard the reasonable expectations doctrine as little more than an excuse for improper judicial rewriting of the policy.[10]

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5. Keeton's position on the reasonable expectations doctrine has been further developed and elaborated in his treatise on insurance law. *See* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW 627-46 (student ed. 1988).

6. For a recent review of state court response to the reasonable expectations concept, see BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE Section 1.03[b] at 21-22 (1998).

7. *See, e.g.*, Conrad L. Squires, *A Skeptical Look at the Doctrine of Reasonable Expectations*, 6 FORUM 252 (1971); Stephen J. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461 (1989).

8. Most recently, Florida courts have decided not to follow the reasonable expectations doctrine. *See* Deni Associates of Fla., Inc. v. State Farm Fire & Cas. Ins. Co., 711 So.2d 1135 (Fla. 1998) (rejecting reasonable expectations doctrine because it would "rewrite the contract and the basis upon which the premiums are charged, and because applying the doctrine "can only lead to uncertainty and unnecessary litigation).

9. The judicial give and take on this issue is amply described in Jeffrey Stempel's article in this symposium. Jeffrey Stempel, *Unmet Expectations: Undue Restriction of the Reasonable Expectations Approach and the Misleading Mythology of Judicial Role*, 5 CONN. INS. L.J. 181, 210-45 (1998).

10. For example, the reasonable expectations doctrine was recently rejected by the Utah courts in Allen v. Prudential Prop. & Cas. Co, 839 P.2d 798 (Utah 1992), a case which prompted sharp judicial debate over the perceived virtues and vices of the reasonable expectations idea. For further discussion of this case, see Stempel, *supra* note 9, at 211.

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In 1986, I contributed to the growing body of scholarship[11] on this issue in an article entitled *Reasonable Expectations Reconsidered*,[12] which examined use of the reasonable expectations doctrine in insurance law. At that point, the concept was new enough to represent a fairly novel idea in the insurance field, but old enough to have undergone some significant transformation since it had first been advanced. I detected in recent developments growing opposition to what I termed the "strong form" of Professor Keeton's principle, but I defended the idea of imposing rights at variance with policy language, especially in cases where restrictions on coverage amounted to "naked preferences" by the insurer that interfered with the overriding objective of the insurance transaction as viewed from the standpoint of the insured.[13] I also offered a litany of suggestions as to

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11. For some of the leading academic commentary on this issue, see KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY (1986); KEETON & WIDISS, *supra* note 5, at 614-18 (1988); ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW section 25D at 106-11 (1987); Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531 (1996) (hereafter *Policy Interpretation*); Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151 (1981) (hereafter *Judge-Made Law*); Laurie Kindel Fett, Note, *The Reasonable Expectations Doctrine: An Alternative to Bending and Stretching Traditional Tools of Contract*, 18 WM. MITCHELL L. REV. 1113 (1992); James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. ST. L.J. 995 (1992); Robert E. Keeton, *Reasonable Expectations in the Second Decade*, 12 FORUM 275 (1976); Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L. J. 823 (1990); Spencer L. Kimball, *Distributing Risk: Insurance, Legal Theory, & Public Policy*, 19 CONN. L. REV. 311 (1987) (book review); William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267 (1986); Jeffrey W. Stempel, *Reassessing the "Sophisticated" Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807 (1993) (hereinafter *Reassessing the Sophisticated Policyholder Defense*); Peter Nash Swisher, *Judicial Interpretations of Insurance Contract Disputes: Toward a Realistic Middle Ground Approach*, 57 OHIO ST. L.J. 543 (1996) (hereinafter *A Middle Ground Approach*); Peter Nash Swisher, *Judicial Rationales in Insurance Law: Dusting Off the Formal for the Function*, 52 OHIO ST. L.J. 1037 (1991) (hereinafter *Judicial Rationales in Insurance*); Stephen J. Ware, Comment, *supra* note 7, at 1461.

12. Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323 (1986).

13. I borrowed the term "naked preferences" from an article on constitutional jurisprudence by Professor Sunstein. *Id.* at 379, citing Cass Sunstein, *Naked Preferences and the Constitution*, 84 COLUM. L. REV. 1639, 1695 (1984).

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how, in implementation, use of the reasonable expectations doctrine could be made clearer, more consistent, and perhaps more defensible.[14]

Another dozen years in the development of this doctrine have transpired, and it seems appropriate to revisit the issue, both to trace further developments and to reexamine some of the conceptual underpinnings that have made full-scale implementation of the reasonable expectations idea seem potentially explosive—to some of its critics perhaps even downright dangerous. In the main the doctrine remains very much alive. Indeed, it may be even growing in acceptance, at least in terms of courts' willingness to invoke it by name as a ground for decision. Nonetheless, the uncertainties and doubts that plagued implementation of the doctrine a dozen years ago still linger, and controversy continues to swirl about the concept, especially in its outer reaches. Curiously, in spite of its visibility, its wide use, and its endorsement by influential judges and scholars, the reasonable expectations principle's place in insurance law is by no means settled.

This article is not intended to be an exhaustive examination of the doctrine and its contours. Rather, my purpose is to explore the conundrum that a doctrine so relatively well established and well supported can, at the same time, remain so controversial and uncertain. In partial explanation of this curious phenomenon I offer two potentially significant ideas that emerged from my revisitation of the case law and scholarship on this subject.

1. To begin with, part of the difficulty with this doctrine is that it seems to mean so many different things. The reasonable expectations doctrine represents not a single concept but a bundle of related ideas. Beyond the weak and strong strains that I have previously described,[15] the reasonable expectations concept can be invoked in at least four different ways. Each of these different meanings addresses a separate set of policy concerns. Moreover, they range across a spectrum from close adherence to traditional policy interpretation techniques to sharp departure from them. Courts use the doctrine in these different ways, but they rarely distinguish clearly among them. I will briefly describe those four ways here and will treat each in greater detail later in the article.

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14. *Id.* at 382-86 (proposing five factors to be evaluated for purpose of identifying naked preferences in insurance: marketing practices; characteristics of typical insured; structure and format of the policy; comparison of included and excluded risks; and statutory and regulatory policy).

15. *See id.* at 335-36.

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For the most part, courts rely on the reasonable expectations of the insured (a) as an interpretive device for ascertaining the meaning of policy language. This use of the principle, which is by far the most common, fits comfortably within traditional precepts of insurance law and the common law tradition. It is closely aligned with what I call the "ambiguity principle," the time-honored invocation of the maxim *contra proferentem* that courts routinely and universally apply to interpret "ambiguous" insurance policy language. This use of the reasonable expectations concept as an interpretive device really should not be controversial.

On fewer occasions, but still fairly often, courts employ reasonable expectations (b) to adjust contract terms that, as applied to the insured's situation, would otherwise have an unfair or "unconscionable" effect, either because they would produce a result contrary to what the insured was led to believe, or because they would undercut a key benefit of the policy from the insured's perspective. While this idea might have been controversial thirty years ago, it really ought not to be so today. The limitation of unconscionable contractual provisions that are contrary to the expectations of one contracting party is one of the great legacies of the realist jurisprudence that swept contract law in the middle decades of this century. It was controversial at the time, but by now it is a relatively longstanding and accepted power of the courts that has put out fairly deep common-law roots. In the insurance context, it is also typically not a very big leap from traditional thinking, especially in the application of the ambiguity principle, because in most instances what makes the insured's expectation "reasonable" is that it rests on a *plausible* interpretation of the policy language that a casual review of policy language, even by a reasonably knowledgeable insured, would not dispel. Only "painstaking" study" of the policy language[16] aided by the technical expertise of the lawyer, judge or underwriting professional would ultimately yield a narrower interpretation. Thus, although the policy may not be ambiguous in a technical legal sense, it is at least confusing from the standpoint of the typical policyholder.

In judging the impact of this "unconscionability" version of the reasonable expectations principle, it is important to note that its implications for future coverage situations are reversible. Courts employing this version of the idea may be enforcing rights "at variance" with policy provisions, but they do so in a way that insurers can change in

16. *See* Keeton, *supra* note 1, at 967. For discussion of this aspect of the reasonable expectations idea, see Rahdert, *supra* note 12, at 335-36.

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future instances, either by modifying the policy language or structure to make the implications of restriction on coverage unavoidable to even the most casual and unsophisticated consumer (thus rendering any "expectation" to the contrary "unreasonable"), or by taking steps in the underwriting process to ensure that the limitations on coverage will be fully explained to the purchaser of the insurance. This version of the reasonable expectations idea thus takes on a dialectical character. Where underwriters draft policy terms that are too one-sided, courts correct the excesses and alert the insurers to the confused expectations they are creating; underwriters then have the option of redrafting or clarifying their position on coverage to dispel the insured's confusion.

On still fewer occasions, courts employ the reasonable expectations principle (c) to avoid enforcing policy language that, no matter how clearly expressed or fully explained, would defeat what the court believes are the essential objectives of the insurance policy. In these instances, which occur quite rarely, the language unambiguously fails to support the insured's interpretation, but in the court's judgment it is so completely at odds with the basic purpose the insurance transaction was intended to serve that enforcing it would work substantial injustice. The question whether courts should have the power to do this has remained controversial; how controversial it should be depends heavily on one's jurisprudential perspective toward contract adjudication, and the insurance-law facet of this question is part of a larger contract-law debate between formalists and functionalists, legal economists and consumer protectionists that has been raging for the last decade.[17] The fate of this version of the reasonable expectations idea is likely to hang in the balance of these contract-theory culture wars.

Finally, in what for emphasis I will term a "truly tiny trickle" of very, very rare instances (so rare that they approach zero), courts may invoke the reasonable expectations concept (d) to avoid policy limitations that would contravene important overriding public policies regarding assured

17. For discussions of this larger contract debate, *see generally* Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697 (1990); E. Allen Farnsworth, *Developments in Contract Law During the 1980's: The Top Ten*, 41 CASE W. RES. L. REV. 203 (1990); Jay M. Feinman, *Critical Approaches to Contract Law*, 30 UCLA L. REV. 829 (1991); Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 OR. L. REV. 1131 (1995); Edward L. Rubin, *The Nonjudicial Life of Contract: Beyond the Shadow of the Law*, 90 NW. U. L. REV. 107 (1995); William J. Woodward, Jr., *Clearing the Underbrush for Real-Life Contracting*, 24 J. LAW & SOCIAL INQUIRY ___ (1999) (forthcoming).

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compensation. In these cases, the court is not so much concerned with the dynamics of the arrangement between insurer and insured as it is with making the insurance "work" for the good of others who depend on it, or for the good of society.

Only the more aggressive uses of the reasonable expectations principle (particularly uses (c) and (d)) ought to stir sharp controversy. Given the infrequency with which these aggressive uses of the reasonable expectations idea occur, one is tempted to characterize the fight over them as something of a tempest in a teapot. The vast majority of reasonable expectations applications ought not to be perceived as threatening, in any substantial way, to either the traditions of insurance law adjudication or the ability of insurers to prescribe the limits of coverage for their policies.

2. Yet from another perspective the controversiality of the reasonable expectations principle seems well-deserved, because even its mildly aggressive applications challenge some of the most time-honored contract-law boilerplate on which much of the basic structure of insurance law depends. In my judgment, the baseline assumption that animates most modern American insurance law is that underwriters possess virtually unbridled discretion to determine and specify the risks they are willing to assume, and that the language they use to specify the risks—*including* its accumulated technical significance—ought to determine the rights and obligations of the parties. Since courts and commentators are, for the most part, quite unwilling to overhaul insurance law in its entirety or to rethink its most basic assumptions, they have found it difficult to reconcile any but the most tepid applications of the reasonable expectations idea with the other insurance law principles that routinely guide their decisions. The result is a continuing sense of instability about the role that reasonable expectations of the insured ought to play in insurance analysis.

The tension that the reasonable expectations principle generates is unlikely to go away, because the principle in its farther reaches depends on a different concept of contract interpretation and enforcement than that which inheres in most insurance policy construction. This difference, as Professor Swisher has persuasively argued, reflects the ongoing tension in American law between formal and functional approaches to adjudication.[18]

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18. *See* Swisher, *Judicial Rationales in Insurance Law*, *supra* note 11, at 1050-51. Professor Swisher's formal/substantive dichotomy actually cuts across all the different uses of the reasonable expectations principle I have identified. Even when a court takes the modest step of using the insured's reasonable expectations as a guide to discerning the meaning of policy language, it is to some extent acknowledging the fact that the policy is a contract of adhesion, the terms of which are determined unilaterally by the insurer. To this

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But it also reflects other deep-seated tensions in the law which I will try briefly to develop. These can be characterized roughly as involving two dichotomies: (a) private *versus* public law, and (b) contract as fixed bargain *versus* contract as ongoing legal relation.

Typically, courts treat insurance as the quintessence of a private, fixed bargain, whose terms have been integrated into a formal written instrument —the insurance policy—which determines the parties' respective rights and obligations.[19] That instrument supplies the "law of the bargain," and the court's job is simply to ascertain its meaning (using standard tools of contract interpretation) and to apply that meaning impartially to the facts. If the terms and their application are abundantly clear, the court should not flinch from enforcing them, even if they upset one party's expectations, however otherwise reasonable those expectations might be. This is done in order to give the parties themselves maximum control over the terms of their relationship, and to communicate clear directives to other contracting parties similarly situated.

When courts are motivated to use the reasonable expectations concept in one of its more aggressive manifestations, however, they tend to depart from this fairly static, private model of contract law to a more dynamic and flexible one that views the provisions of the contract as potentially subordinate to overriding policy and relational concerns. Under this model, while giving the parties substantial room for making their private economic choices, courts possess a residual power to intervene in limited circumstances to ensure that legal values other than contract freedom are also basically served. To lawyers and underwriters—and judges—steeped in traditional bargain notions of contract, this move to a different concept of the contractual undertaking seems particularly threatening.

I. FOUR VARIATIONS ON THE REASONABLE EXPECTATIONS THEME.

A. Ambiguity - the Objective of Policy Clarity

As Professor Keeton recognized, the seed of the reasonable expectations doctrine first germinated in the time-honored ambiguity principle of insurance policy interpretation. That principle holds that when a policy term is ambiguous, the court should adopt the interpretation that

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extent it is departing from the formal, Willistonian approach to contract construction, which at least in pure form would treat the parties' relative negotiating strength as irrelevant.

19. *See* J. APPLEMAN, INSURANCE LAW & PRACTICE § 7381, at 14-15 (1981); C. COUCH, CYCLOPEDIA OF INSURANCE LAW § 17:16, at 17 (1995).

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favors the insured.[20] A policy is ambiguous if, in a particular application,[21] it admits of more than one plausible interpretation, and the different plausible interpretations would have contrary effects on coverage, or other policyholder rights.[22] This rule is an insurance variation of the general contract-law doctrine of *contra proferentem*, a legal maxim with a noble common law pedigree. Versions of it can be found in both the First and Second Restatements of Contract,[23] as well as leading contracts and insurance law treatises.[24] It is bedrock law.[25]

The idea behind this principle is simple: since the insurer almost universally drafts the policy language, the insurer should assume the risk of its own imprecision. This rule, which applies broadly to policies of all types, serves the basic objective of encouraging *contract clarity*. It helps to ensure that the parties to the private financial arrangement the insurance policy represents know what they are talking about when they sign onto the contract. It also increases the prospect that there will be the mutuality of assent to contract terms that is the hallmark of the bargain theory of contract. Under this doctrine, as it applies to insurance, the insurer has full control over what the policy does and does not cover, but it is under a legal duty to communicate its decisions to the insured in language that does not allow misunderstanding. This principle says to the insurer, in effect,

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20. *See* Keeton, *supra* note 1, at 967. *See also* Rahdert, *supra* note 12, at 325-31, 335-36, for discussion of the ambiguity principle and its role in the reasonable expectation concept.

21. Like negligence, ambiguity does not exist "in the air." A policy provision is or is not ambiguous in terms of some particular application—a particular factual setting giving rise to a claim of coverage. It is perfectly possible, therefore, for a policy provision to be unambiguous and ambiguous at the same time—unambiguous with respect to many, perhaps even most, situations involving potential claims of coverage, but ambiguous with respect to some particular application. In the typical insurance policy, there are probably fairly few significant terms that are either completely ambiguous or completely unambiguous.

22. For a more elaborate discussion of the ambiguity principle in insurance law, *see* Rahdert, *supra* note 12, at 325-31.

23. *See* RESTATEMENT OF CONTRACTS § 236(d) (1932); RESTATEMENT (SECOND) OF CONTRACTS § 206 (1981).

24. *See* APPLEMAN, *supra* note 19, at §§ 7401,7402; COUCH, *supra* note 19, at § 22:14-29; KEETON & WIDISS, *supra* note 5, at 628-30; 4 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 621 (Jaeger ed., 1979).

25. For a discussion of *contra proferentem*'s use in insurance law, *see* OSTRAGER & NEWMAN, *supra* note 6, § 1.03[b] at 10-19.

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"Cover what you want. Exclude what you want. But make sure you do it clearly. Sloppy drafting could cost you something."[26]

Insurance law is rife with examples of the ambiguity principle in action.[27] Increasingly, it is also peppered with decisions linking the ambiguity principle with the concept of reasonable expectations. For purposes of illustration, I have selected a relatively recent example from the Minnesota courts. In *Grinnell Mutual Reinsurance Co. v. Wasmuth*,[28] the insured was a small-time insulation installer who had installed ureaformaldehyde insulation in a customer's home. Due allegedly to improper installation, the insulation emitted formaldehyde gases that caused the customer's home to become uninhabitable. The question before the court in a declaratory judgment action was whether the insulation installer's Comprehensive General Liability (CGL) policy precluded coverage under its so-called "pollution exclusion," a question which in turn depended on whether or not the emission of formaldehyde gas in this case was "sudden and accidental."[29] If it was sudden and accidental, the exclusion by its own terms did not apply and there was coverage.

The court in *Grinnell* concluded that in this particular setting the term "sudden" was ambiguous, and that its ambiguity "bolsters the lay person's reasonable expectation of coverage."[30] The court stressed that the liability-creating event involved "injuries to a single household as a result of negligent installation of building material."[31] While the term "sudden" might be unambiguously inapplicable in other situations (such as massive exposures to pollutants over long periods of time spanning several years, where the pollution occurred as a result of normal operations), here its meaning was unclear, requiring the court to resolve the uncertainty in favor of the ordinary insured's "reasonable" understanding that an event like this one would be covered.

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26. Professor Abraham has suggested that insurance law's use of the *contra proferentem* principle may actually involve a variety of perspectives, including a "strict liability" version that follows the principle as it is stated, and a "negligence" version that applies *contra proferentem* only in cases where the court finds that the ambiguity could have been anticipated and corrected. *See* Abraham, *Policy Interpretation*, *supra* note 11, at 537-544. The statement of the rule in the text is directed toward the "traditional" or "strict liability" version of the standard. For further discussion of these two variations in ambiguity analysis, see OSTRAGER & NEWMAN, *supra* note 6, at 43.

27. *See generally* Rahdert, *supra* note 12.

28. 432 N.W.2d 495 (Minn. App. 1989).

29. *Id.* at 501.

30. *Id.* at 500.

31. *See id.*

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Although one might dispute particular applications, few individuals would object in general to such garden-variety use of the rule of *contra proferentem*.[32] Indeed, the proposition that ambiguities should be resolved against the drafter seems to make a great deal of common sense. If you and I have a contract, and I stick ambiguous language in that contract, it seems only fair that I should pay for that ambiguity, not you. This seems particularly the case if you had no capacity whatsoever to influence the language that our contract used, you lacked sufficient understanding of the situation to realize that the language might be ambiguous, and even if you did detect ambiguity you had no bargaining power to insist on a less ambiguous alternative.

But in legal scholarship, nothing is immune from criticism, nor should it be. Professor Rappaport has raised an intriguing objection to the rule of *contra proferentem* in insurance law, arguing that even this mild principle of policy interpretation is a bad idea.[33] He argues that it tends to generate inefficient judicial interpretations of insurance policies, that it creates uncertainty, and that it makes insurance policies unduly complex and technical instruments, thus reducing the prospect of mutual comprehension and assent.[34] He also argues that it forces the insurer to charge higher premiums in order to guard against unexpected extensions of coverage, thus making insurance needlessly expensive.[35] Although Professor Rappaport's thesis is certainly provocative, I do not find his arguments persuasive, on either economic or fairness grounds. Let me briefly explain why.

First, let us take the viewpoint of legal economics. Let us assume that private contracting is generally an economically efficient means of

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32. Of course, the "pollution exclusion" has generated a good bit of controversy, but most of it has centered on coverage for more massive environmental harms. *See* KENNETH S. ABRAHAM, ENVIRONMENTAL LIABILITY INSURANCE LAW 153-58 (1991); Hollis M. Greenlaw, *The CGL Policy and the Pollution Exclusion Clause: Using the Drafting History to Raise the Interpretation Out of the Quagmire*, 23 COLUM. J.L. & SOC. PROBS. 233 (1990); Scott D. Marrs, *Pollution Exclusion Clauses: Validity and Applicability*, 26 TORT & INS. L.J. 662 (1991).

33. *See* Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171 (1995); David S. Miller, Note, *Insurance as Contract: The Argument for Abandoning the Ambiguity Doctrine*, 88 COLUM. L. REV. 1849 (1988).

34. *Id.* at 174-75.

35. *Id.*

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structuring voluntary individual commercial and financial arrangements.[36] Let us further assume that the economic advantages of private contracting extend to insurance. That means that as a society we generally want individuals to be able to enter into such private insurance contracts. We believe that, if left to their own devices, individuals are generally better able than governments to determine what kinds of insurance and how much of each kind they ought to buy, and we believe that private insurers are generally better able than governments to determine on what terms to offer their financial services.[37]

But the economic benefits of this process depend on the freedom of the parties to structure individual arrangements that are suitable to their mutual needs. That means, at a minimum, that they must be able to decide for themselves whether or not to enter such arrangements, and at what price; and, once the arrangement has been entered, they need to ensure mutual performance through some mechanism of enforcement. These preconditions in turn depend on the ability of the parties: 1) at least at some level, to actually bargain with one another,[38] (otherwise they will not

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36. *See* RICHARD POSNER, ECONOMIC ANALYSIS OF LAW section 4.1 at 89 (4th ed. 1992).

37. We do not, of course, always make these assumptions. Modern law often requires individuals to purchase insurance, specifies the terms of the insurance to be purchased, and so forth. I allude to a number of these situations in MARK C. RAHDERT, COVERING ACCIDENT COSTS: INSURANCE, LIABILITY, AND TORT REFORM 128 (1995). Indeed, even in such common forms of insurance as homeowners and auto insurance, underwriter choices regarding the terms of coverage may be substantially circumscribed by legislative requirements. In these circumstances, the analysis offered in text would not apply, but unless the underwriter had a choice regarding the terms in question, neither would the rule of *contra proferentem*.

38. Of course, in many contracts, including most insurance contracts, there is little real bargaining over contract language. These are the so-called contracts of adhesion. *See* Friedrich Kessler, *Contracts of Adhesion - Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1174 (1983). They cut an increasingly broad swath of the field of commercial arrangements, and have been dominant in insurance for at least a century. Their terms are prescribed entirely by one party, here the insurer, which permits no meaningful negotiation over the language by the other party, here the prospective insured.

But even in adhesion contracts there is often some bargaining, perhaps over price, perhaps over service. There is also usually a partial functional alternative to bargaining—the ability of the prospective purchaser to "shop" among several prospective contract partners, whose sense of competition with one another motivates them to offer satisfactory terms. *See id.* at 1225-29; Stempel, *Reassessing the Sophisticated Policyholder Defense*, *supra* note 11, at 856. I may not be able to make you offer me a particular contract term, but if I can get it from your competitor, and you either know or suspect that I may be

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be able to shape the arrangement to their economic needs); 2) voluntarily and intelligently to assent to the terms of their bargain (otherwise their participation will lack free will); and 3) to memorialize their mutual assent in some comprehensible and hence subsequently enforceable way (otherwise they will never be able to be sure what has been agreed, and they will lack the capacity to make the terms of their assent mutually binding). In other words, without bargaining we lose the benefits of economic competition; without assent we lose the benefits of voluntary undertaking; without a clear and comprehensible memorial we lose the benefits of mutuality and enforcement. Damage to any one of these preconditions interferes with the economic efficiency of the arrangement.

These preconditions (especially the second and third) cannot be achieved unless the terms of the bargain are expressed in clear and unambiguous language that the parties and any enforcing authority, such as courts or arbitrators, will interpret in essentially the same way. A couple of obvious examples drive home the point. If you and I are bargaining over widgets, we need to have a clear idea what a "widget" is. If I think widgets are a kind of mousetrap, while you think they are a kind of sewing machine, we are unlikely to arrive at an economically efficient contractual arrangement. Similarly, if we "agreed" on a price of "2000" for the widgets, but I (being from Japan) thought we meant yen and you (being from the United States) thought we meant dollars, our failure to arrive at a mutually understood price would make our arrangement a most

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shopping with your competitor, my shopping can put pressure on you to include that term as well, or at least to reflect the difference between what you are offering and what your competitor is offering in your price. If the competitor's terms are generally more desirable, the eventual cumulative effect of such shopping by a great many prospective purchasers will be to create enough pressure on you to change your terms to match those being offered elsewhere.

Of course, the argument I just made assumes that there is no collusion among prospective contracting sellers of the good or service in question regarding what terms to offer. If there is, and I can't get meaningfully different terms from a competitor, then there really is no room for even indirect bargaining of this sort. Unfortunately for free market theorists, that is precisely the case with most important lines of insurance, since explicitly collusive behavior in the drafting of insurance terms is legally permitted under federal antitrust laws by the McCarran-Ferguson Act, 15 U.S.C. § 1012, and is affirmatively fostered by the regulatory regimes of most states. *See* ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 50-68 (1987). One of the many reasons that insurance does not behave exactly like ordinary contracts is that often in insurance even these alternatives to open bargaining evaporate. Developing these arguments, however, would probably lead us to question the validity of an economic justification for private insurance, at least under the current regulatory structure.

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economically inefficient endeavor for at least one party to the contract. As every first-year contract student quickly learns, we need clear terms for such basic components of our bargain, or the whole undertaking will be a shambles.[39]

As a consequence, ambiguous drafting (that is, using contract terms that are ambiguous) is a harmful phenomenon that could potentially threaten the economic benefits that private contracting assumedly provides. Contract ambiguity, then, must be recognized as a "cost" of the process of private contracting, which must be minimized if the economic advantages of the process are to be maintained. Naturally, it falls to the courts to minimize that cost by adopting rules that either reduce or discourage such ambiguity. It comes as no surprise, then, that much of contract law, from the U.C.C. to various provisions of the Restatements of Contract, to the legislative, regulatory, and judicial principles of insurance law, quite properly is intended to serve that objective. So does form contracting, which ensures that carefully drafted language with an established, tested, and predictable meaning will be used in preference to terms that are improvised for the occasion and may contain lurking uncertainties.

But no matter how hard courts and legislatures—and form contractors —try, some loose language is going to slip through the cracks, get into the bargained-for contract, and end up as the basis for a legal dispute. Indeed, the process of form contracting, though it enhances certainty by using tested terms, may also enhance the prospect for ambiguity because its "one size fits most" language is virtually guaranteed not to "fit" in all situations. The "cost" of ambiguity is thus virtually certain to occur.

Now, as with any costs of a private activity, we must ask, who ought to bear those costs when they befall? In a perfectly competitive world where everyone had complete information and transaction costs were negligible, it arguably would not matter much where the costs were assigned, so long as the assignment was clear and the parties were free to reallocate it through bargaining.[40] But we do not live in anything very closely resembling that world, especially with respect to insurance.[41] In the highly imperfect world we do live in, the general answer is that the cost of any otherwise socially desirable activity should be borne by the party who is in

39. *See, e.g.*, E. ALLEN FARNSWORTH, CONTRACTS at 112 (definiteness), 677 (failure of basic assumption) (2d ed. 1990).

40. Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

41. Indeed, if we had all that perfect knowledge and so forth, there would never be any contract ambiguity.

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the best position to minimize it[42] —in other words, the party who can most cheaply avoid the particular cost in question.

In the context of ambiguous terms in insurance policies, that party is almost surely the insurer/drafter. A key factor in efficiently minimizing any cost is possessing information about its incidence and magnitude, as well as information about alternatives that might reduce the incidence and/or magnitude of the cost in question.[43] This is especially true where such information is costly and difficult to obtain and where processing it requires special expertise. A party that, by reason of its ordinary business activities, already possesses the information in question is in a much better position efficiently to avoid the cost than a party who must make the costly investment in information *ab initio*. In general, the insurer/drafter, because of its vast stores of statistical knowledge about risk, its expertise in processing such information, its frequent exposure to disputes over contract language, its knowledge of the relevant law, and its drafting sophistication—all of which it necessarily acquires as a function of its ordinary business activities—possesses far superior information about the likelihood that any term will be ambiguous in particular fact settings, the frequency with which such ambiguity-causing events are likely to arise, and the availability of means (such as more explicit contract language) for avoiding the ambiguity. To the extent that avoiding the ambiguity in question entails other costs (such as increasing the complexity of negotiation or generating other offsetting ambiguities in other potential factual settings), the insurer is also in a better position to possess or acquire that information, and to weigh the costs and benefits of alternative language against each other. Moreover, to the extent that the risks associated with ambiguity are uncertain, the insurer is in a better position to weigh the probable advantages of greater certainty against the costs of generating additional information.

Another key factor in minimizing cost is control: does the party in question have the authority or capacity, as well as the bargaining power, to

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42. Technically, we do not want the cost minimized, but rather *optimized*. If it would cost more to eliminate contract ambiguity than it would cost to leave it in the contract, we want the contracting parties to leave it in. In this context, the distinction between minimization and optimization does not alter judgments about which contracting party ought to bear the cost of ambiguity.

43. GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 312 (1970); FARNSWORTH, *supra* note 39, at 716, 723-24 (discussing roles of foreseeability and control in allocation of contract risks); POSNER, *supra* note 34, at 101-09 (discussing control and information as factors bearing on doctrines of mutual mistake, impossibility, and contracts as insurance).

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restructure the terms of the bargain in order to eliminate the ambiguity? Once again, the insurer, as the drafter of what is almost always a contract of adhesion, possesses superior control over the content of the policy. The insurer is largely free to pick the most desirable (meaning, in this context, the most economically efficient) contract language.[44] Thus, from the standpoint of both information and control, the insurer/drafter is unquestionably the cheapest ambiguity cost avoider for the overwhelming majority of situations involving potentially ambiguous insurance policy language. In order to provide the insurer with a proper incentive to select efficiently clear contract language, courts should require the insurer to bear the costs of ambiguity.[45]

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44. Of course, some insurance terms are prescribed by statute. In those cases, the insurer lacks direct control over potential ambiguity. But where this is the case, neither party has control over the ambiguity in question. The answer to this sort of ambiguity is not to eliminate the doctrine of *contra proferentem*, but to put pressure on the legislature either to change the prescribed term or to deregulate so that the insurer will do so. Given the characteristics of local politics on insurance matters, these results are more likely to be achieved by leaving the cost of ambiguity with the insurer, which has both resources and plenty of motivation to press for change, than they would be by transferring it to the policyholders.

45. Professor Abraham considers the possibility that courts should—and perhaps sometimes do—limit their invocation of *contra proferentem* to situations where the insurer can be considered "negligent" in using the ambiguous language in question, because it could/should have anticipated the risk of uncertainty and guarded against it by employing more precise language. Abraham, *Policy Interpretation*, *supra* note 11, at 534. Absent these circumstances, one can argue that resolving the ensuing coverage dispute against the insurer fails to serve the cause of contract clarity, because the ambiguity could not have been reasonably avoided. *Id.* at 538-39. Under this negligence-based reasoning there might be some circumstances in which the costs of ambiguity are not properly assessed against the insurer.

One objection to this approach, as Professor Abraham acknowledges, is that courts may find it exceedingly difficult to distinguish between reasonably avoidable and practically unavoidable ambiguities in insurance contracts. *Id.* at 543-44. To do so with any assurance would require a great deal of evidence about the drafting processes of the industry, and information about potentially ambiguous applications that may have been available to the drafters. Rather than incur these enormous costs, it arguably makes sense for courts to presume that ambiguity was avoidable. At a minimum, it would seem that the burden ought to fall on insurers to prove that it was not. Thus, if the concept of negligence is relevant, the doctrine of *res ipsa loquitur* ought to apply as well.

Another objection is that such an approach fails to make a strong case for assigning the cost of ambiguity to the other party (the insured), in cases where the insurer can prove that it acted with "due care." Placing the burden on the insured is virtually certain to do nothing to advance the cause of contract clarity, nor are there any other policies of insurance law that are likely to be generally served by routinely imposing the burden of uncertainty on the

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To this essentially economic justification, I would add a prudential justification grounded in concepts of fairness and personal responsibility. As Cardozo might have put it, opportunity is instinct with obligation. With the freedom insurers enjoy to structure policy language to suit their needs comes a responsibility to do so in terms that avoid uncertainty and potential misunderstanding from the standpoint of the insured. Just as lawyers should take responsibility for the quality of the legal documents they draft, so insurers should take responsibility for the quality of the instruments they create. At a minimum, they should not have the power to transfer the consequences of their own sloppiness upon others—their insureds—who are powerless to protect themselves from those potential consequences. More broadly, where uncertainty of policy language is an inevitable component of their business, they should treat it as a cost of business that is spread to all insureds through the premiums they charge, rather than visited on a single insured who falls victim to the lurking ambiguity.[46] To reach any other conclusion, in my opinion, requires one either to indulge the counterintuitive and counterfactual assumption that ambiguity in contract language is actually an economic benefit, not a cost; to ignore or discount the massive information costs the average insured would have to undertake in order to become an effective ambiguity-

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insured in such instances. The reason usually supplied for "letting the loss lie where it falls" in tort cases—avoiding expensive transfer costs—has no useful application here. The whole point of the insurance policy is to transfer the insured's loss, so that as between insurer and insured, the loss does not "fall" on anyone unless and until the court decides that it does, making the transaction costs of a lawsuit inevitable no matter where the loss is assigned.

There might be some exceptional cases where transferring the risk of uncertainty to the insured would make sense, but they are probably relatively rare. One possibility might be where the potential for ambiguity lies in an unusual factual application that the insurer would be unable to predict, but the insured has reason to know is likely to occur in his or her (or its) unique situation. Another possibility might be where preferring the insured's reasonable interpretation of the ambiguous language would produce a massive drain on the insurer's reserves, threatening its ability to provide coverage to other insureds. However, as to the former situation, unless the prospect of a factual anomaly is completely *sui generis*, the insurer should be able to protect against the risk by requiring representations or disclosures by the insured. And as to the latter situation, one should always bear in mind that responding to special cases (especially dire emergencies) by altering the general rules applicable to more ordinary situations usually runs the risk of serious overbreadth. It may be for this reason that courts applying the negligence approach—if in fact they do so—prefer, as Professor Abraham suggests, to do so in ways that avoid grafting explicit limitations on the general *contra proferentem* rule. *Id.* at 544.

46. *See* RAHDERT, COVERING ACCIDENT COSTS, *supra* note 37, at 32-33 (describing treatment of insurance as a "cost of business" in the context of tort liability).

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avoider; or to change the definition of ambiguity so that we are talking about some phenomenon other than the failure to state the bargain in terms that have only one plausible impact on coverage. At various points in his article, Professor Rappaport does all three of these things.[47]

If the rule of *contra proferentem* makes sense, then the ambiguity principle that arises from it also ought to make sense, at least as a default position. From that conclusion, it is not a very large leap to the inference that the "reasonable expectations of the insured" ought to be a relevant factor in the construction of the insurance contract language. How, after all, can we tell whether a term was ambiguous unless we first ascertain what each party to the contract reasonably thought it meant? In practice, this is more or less what has happened. Courts, in determining whether an ambiguity was present, naturally have inquired what the insured's expectations were regarding coverage, and whether those expectations seemed "reasonable" under the circumstances (with the "circumstances" including the language of the policy). If the language of the policy was sufficiently vague that it permitted a "reasonable expectation" of coverage despite the insurer's intention to restrict it, then it would follow that there was in fact more than one legitimate interpretation of the language in question, and hence, that the relevant policy language could be termed ambiguous.

Under this analysis, consideration of the reasonable expectations of the insured is simply one step in the process of determining whether the circumstances for invocation of the rule of *contra proferentem* exist. It is not much of a stretch to say, as many courts have, that the court's obligation in construing the policy language is to protect the reasonable

47. *See, e.g.,* Rappaport, *supra* note 33, at 193 (arguing that ambiguous terms are often "optimal"); *id.* at 208 (arguing that a defect in use of ambiguity principle is that it discourages policyholders from reading policy language); *id.* at 211 (treating "new" terms that lack accepted judicial meanings as functionally equivalent to ambiguous terms); *id.* at 217-218 (arguing that insurers will prefer clear over ambiguous language even without judicial oversight of contract clarity); *id.* at 220 (arguing that ambiguity is actually beneficial to consumers); *id.* at 226 (confusing ambiguity principle with judicial failure adequately to explain their invocation of it). In addition, Professor Rappaport never considers the possibility that ambiguous language might be beneficial from the insurer's perspective but not from the insured's perspective, that lack of coverage for the insured can entail significant economic costs, and that the policyholder lacks any means at all for avoiding policy ambiguity.

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expectations of the insured,[48] because this is likely to be the actual functional effect of enforcing the ambiguity principle in most instances.

As was true in 1986,[49] it is still true today that the vast majority of judicial references to the reasonable expectations of the insured go no farther than this. Most references to the "reasonable expectations of the insured" still come in the context of judicial inquiry into and resolution of insurance policy ambiguity.[50]

B. Unconscionability - the Objective of Policy Fairness

When Professor Keeton wrote his article in 1970, it was a relatively new and daring idea that courts, in addition to resolving ambiguity, might sometimes overrule or avoid the import of clear policy language on grounds that to enforce it would produce an unfair result. Courts had been doing so for decades, but generally without acknowledging that they were doing so.[51] It had been a principal objective of Karl Llewellyn's pathfinding legal realist scholarship to establish the proposition that courts possessed the power to disregard unconscionable contract terms, and Llewellyn had succeeded in importing some of his proposed reforms on the subject into the U.C.C.[52] Thus by 1970 the unconscionability doctrine, to which this branch of the reasonable expectations concept is unquestionably related, had gained a firm foothold in the law of sales.[53] But Llewellyn's ideas were slow to take hold in the more tradition-bound world of insurance law. Courts did employ a variety of doctrines to protect

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48. *See, e.g.*, Gray v. Zurich Ins. Co., 419 P.2d 168 (Cal. 1966); Society of Mount Carmel v. National Ben Franklin Ins. Co. of Ill., 682 N.E.2d 1180 (Ill. App. 1997) (applying California law); Jostens, Inc. v. Northfield Ins. Co., 527 N.W.2d 116 (Minn. App. 1995); Sparks v. St. Paul Ins. Co., 495 A.2d 406 (N.J. 1985).

49. Rahdert, *supra* note 12, at 353.

50. *See, e.g.*, OSTRAGER & NEWMAN, *supra* note 6, section 1.03[b] at 21.

51. Keeton, *supra* note 1, at 963.

52. *See* WILLIAM TWINING, KARL LLEWELLYN AND THE REALIST MOVEMENT (1973); Allen R. Kamp, *Uptown Act: A History of the Uniform Commercial Code: 1940-49*, 51 S.M.U. L. REV. 275 (1998); Arthur A. Leff, *Unconscionability and the Code: The Emperor's New Clause*, 115 U. PA. L. REV. 485 (1967); *cf.* Karl N. Llewellyn, *Across Sales on Horseback*, 52 HARV. L. REV. 725 (1939); Karl N. Llewellyn, *Book Review*, 52 HARV. L. REV. 700 (1939); Karl N. Llewellyn, *The Rule of Law in Our Case-Law of Contract*, 47 YALE L.J. 1243 (1938); Karl N. Llewellyn, *Through Title to Contract and a Bit Beyond*, 15 N.Y.U. L. REV. 159 (1938).

53. *See* M.P. Ellinghaus, *In Defense of Unconscionability*, 78 YALE L.J. 757 (1969); Arthur A. Leff, *Unconscionability and the Crowd—Consumers and the Common Law Tradition*, 31 U. PITT. L. REV. 349 (1970); John E. Murray, Jr., *Unconscionability: Unconscionability*, 31 U. PITT. L. REV. 1 (1969).

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policyholders from harsh terms and practices, but they resisted frankly asserting judicial power to restructure particular contractual arrangements in the name of fair dealing.[54]

Most of Keeton's arguments in favor of the reasonable expectations principle, and most of the arguments advanced by other proponents of the doctrine since then, have focused principally on this aspect of the reasonable expectations idea.[55] The arguments in favor of this approach are by now fairly familiar. They begin with the observation that insurance policies are examples *par excellence* of adhesion contracts. The terms of the contract are prescribed entirely by one party, which possesses such superior bargaining power that it can demand "adhesion" to the terms of the bargain on a take-it-or-leave-it basis.[56] In the insurance context, the insurer's extraordinary control over the terms of the bargain is even more pronounced than in the usual case of adhesion contracts. It is enhanced by vastly superior information about the nature and incidence of particular risks and the legal significance of language defining or excluding them, industry-wide standardization of contract terms, poor consumer understanding of the transaction, and deliberately cultivated high levels of consumer reliance. In these circumstances, the usual presuppositions that justify strict enforcement of contract terms in a negotiated arrangement are absent; hence, as Llewellyn was wont to say, "where the reason stops there stops the rule."[57] Since courts cannot depend on the usual practices of bargaining to produce a fair outcome, they must themselves police the fairness of the arrangement. One good way to do so is to insist that the *reasonable* expectations of the typical insurer-consumer are basically satisfied, regardless of what the policy itself provides.

The essential function of this facet of the reasonable expectations idea is to secure the basic *fairness* of policy terms and procedures. It is a broader doctrine than its contract-law unconscionability cousin, because it is not limited to cases of extreme one-sidedness. Besides cases of outright

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54. This is, to a significant degree, the essential thesis of Professor Keeton's *Rights at Variance* article. *See* Keeton, *supra* note 1.

55. Keeton, *supra* note 1, at 963-65. *See, e.g.*, JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS section 11.3 (1994); Abraham, *Judge-Made Law, supra* note 11, at 1153-55; Rahdert, *supra* note 12, at 324-30. For a criticism of this rationale, see Fischer, *supra* note 11, at 1008-1025.

56. For a comprehensive review of the characteristics of an adhesion contract, all of which apply to the vast majority of insurance transactions, see Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1174, 1177 (1983).

57. KARL LLEWELLYN, THE BRAMBLE BUSH 189 (1960 ed.) ("[T]he rule follows where the reason leads; [W]here the reason stops there stops the rule.")

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sharp practice (which in insurance are fortunately rare), this variation on the reasonable expectations theme involves courts in guarding against at least three kinds of potentially unfair situations: 1) "procedural" unfairness, in which insurer marketing practices (including sometimes the practices of agents subject to insurer control) lead the insured to expect coverage that the policy language (which the insured is fairly unlikely to read and even more unlikely to understand) actually purports to exclude; 2) "structural" unfairness, in which the complex structure and organization of the policy terms prevent even the most vigilant of ordinary insureds from understanding the restrictive scope of protection; and 3) "situational" unfairness, in which one-size-fits-most policy language that might well be fair and enforceable in many other contexts produces unacceptable restrictions on coverage or other rights when applied to the unique circumstances of a particular policyholder. These different varieties of unfairness are often interdependent. They blend into one another, and they frequently coincide.

A recent example that arguably illustrates all three of these types of unfairness is an Arizona case, *Gordinier v. Aetna Casualty & Surety Co.*[58] While married and living together, Tina and Shawn Gordinier purchased an automobile insurance policy from Aetna for their 1976 Buick. The policy listed both spouses as drivers, with Shawn identified as the principal (90%) driver of the Buick. About a year later, the couple separated and moved to separate residences. As part of their separation arrangement, Tina took over nearly exclusive use of the Buick; Shawn purchased a pickup truck for his use. Shawn, however, agreed as part of his support obligation to continue paying the premiums on the insurance policy for the Buick. In an effort to reflect their changed circumstances, the Gordiniers changed the listing of drivers on the insurance policy to show Tina as 90% driver of the Buick. They also added coverage for the truck, listing Shawn as 90% driver. They left Shawn as the named insured, since he was paying for the policy. Aetna charged premiums consistent with a policy fully covering two drivers of two vehicles.

Subsequently, Tina was seriously injured as a passenger in a motorcycle accident, which led eventually to her filing a claim for uninsured motorist benefits under the Aetna policy. Aetna denied coverage, however, because in order to receive uninsured motorist benefits under the terms of the policy, she had to be either the "named insured" or a "family member" of the named insured. Since Shawn was the named

58. 742 P.2d 277 (Ariz. 1987).

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insured, and since the policy defined a "family member" as "a resident of the same household" as the named insured, Tina failed to qualify under either definition, and thus was ineligible for underinsured motorist coverage. As the court summarized the situation, "although the record shows that premiums were calculated and paid for two drivers on two vehicles, Tina's coverage was less simply because Shawn, and not she, was listed as the named insured."[59]

In this situation, the limitation on coverage arose as a result of successive dealings (procedure) between the Gordiniers and Aetna that produced an unexpected result of reducing Tina's coverage. This occurred even though the Gordiniers had reason to believe that full coverage was being retained, and Aetna apparently never took any steps to clarify the reduced level of coverage that Tina would receive. This result, moreover, came as a surprise because the complex structure of the policy embedded a significant restriction in coverage in what seemed, from the policyholder's perspective, to be an innocuous and relatively insignificant definition of terms. The overall effect was to defeat one of the essential purposes of the transaction—the continuation of full coverage, including paid-for uninsured motorist coverage, for Tina as driver of the Buick. While the restriction in question (the narrow definitions of "named insured" and "family member") might make enforceable sense in other situations, it did not fit the Gordinier's particular circumstances.

Using a Restatement-based version of the reasonable expectations doctrine,[60] the Arizona Supreme Court determined that the lower courts had in erred in this case by rejecting a reasonable expectations argument simply because the language of the contract was not technically ambiguous. Observing that the language of the policy might be considered "unambiguous taken alone," the court nonetheless expressed "doubt that the average customer attempting to check on his or her rights could readily understand them," since the limitation on coverage depended on language "scattered over the policy." More importantly, the court viewed the restriction on coverage "resulting in disparate treatment of spouses" as one "that emasculates apparent coverage," and that "may well undercut the

59. *Id.* at 281.

60. In Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388 (Ariz. 1987), the Arizona Supreme Court fashioned a distinctive version of reasonable expectations analysis based on § 211 of the Restatement (Second) of Contracts. For discussion of the Restatement approach and Arizona's variation on it, *see* Henderson, *supra* note 11, at 844-853.

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purpose of the transaction or even the dickered deal between the parties."[61] Absent evidence that Aetna had called the limitation to the insured's attention, or had specifically negotiated about it with the insured, the Court concluded that the limitation on coverage for Tina would be unenforceable.[62]

Another recent example emphasizing the "structural" and perhaps the "situational" variants of unconscionability-based reasonable expectation analysis occurred in *Bromfeld v. Harleysville Insurance Companies.*[63] The case involved a question whether homeowner's insurance covered damage to the policyholder's home that occurred when a basement wall collapsed under stresses caused by melting snow. The policy, in one portion, extended coverage for damage to a building caused by "[w]eight of ice, snow or sleet," but in another section the policy excluded coverage for "pressure" caused by "water below the surface of the ground." The sections were dovetailed through a complex set of cross-references that required the reader to thumb back and forth through several pages of policy language. Because of a factual dispute about the exact cause of the damage, the court did not resolve the coverage dispute. But it did direct the lower court to honor the "reasonable expectations of the homeowner when he or she purchases a homeowner's policy," which the court interpreted to include an assumption "that he or she is covered by a comprehensive policy that will protect him or her from an unexpected event, such as a basement collapse."[64] Even if the specific cause for the building's collapse turned out not to be within a careful parsing of the policy's fairly complicated structure, the court directed the trial court to "look at the reasonable expectations of the average homeowner ... and whether the reasonable expectation of the insureds is that their homeowner's policy covers them for such a catastrophe."[65] Presumably, under this set of directives, it would be extremely unlikely that the lower court would end up denying coverage.

With nearly thirty years of accumulated hindsight, one is tempted to regard this unconscionability version of the reasonable expectations' principle as representing a fairly modest development. As its champion

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61. *Gordinier*, 742 P.2d at 284.

62. *Id.* at 285. The court remanded the case to permit Aetna an opportunity to present any evidence it might have that the Gordiniers actually were aware of the restrictions in coverage with respect to Tina.

63. 688 A.2d 1114 (N.J. App. 1997).

64. 688 A.2d at 1120.

65. *Id.* at 1123.

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Professor Keeton himself demonstrated, the doctrine is firmly rooted in both common law and longstanding judicial practice.[66] It grows naturally from the principles of legal realism that have enjoyed wide acceptance in our legal system for over half a century.[67] And it reflects the pro-consumer orientation that has animated much commercial law development in the post-World War II period of American law.[68] Just as importantly, it does not significantly challenge the primary assumption that the language of the insurance policy sets the terms of the bargain; rather, it treats that assumption as a basic guiding rule, to which, however, the objective of contract fairness may require occasional judicially crafted exceptions.

Yet the unconscionability variant of Professor Keeton's thesis has proven remarkably controversial. Some jurisdictions have refused to follow this approach, others have avoided addressing it, and more than a few commentators have opposed its adoption.[69] Boiled to their essence, the main objections to the unconscionability version of the reasonable expectations principle seem to be these: 1) a concern that use of the reasonable expectations idea will lead to undue judicial interference; 2) fear that it will generate unmanageable levels of uncertainty regarding the true scope of coverage under many standard insurance policy provisions; and 3) the possibility that the doctrine will drive up insurance premiums for all insureds since underwriters will be obliged to hedge against unanticipated judicial extensions of coverage.[70] There is some merit to each of these concerns, although in my view all three are overstated by the critics. Collectively they fail to justify rejection of the principle.

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66. Keeton, *supra* note 1, at 963-65, 974-77.

67. The connections between "functionalist" doctrines of insurance law, including the reasonable expectations principle, and the development of legal realism, are examined in Swisher, *Judicial Rationales in Insurance Law*, *supra* note 11, at 1040-41, 1050-54.

68. *See generally* ROBERT N. MAYER, THE CONSUMER MOVEMENT: GUARDIANS OF THE MARKETPLACE (1989).

69. For further discussion, including a detailed examination of recent judicial decisions, see Stempel, *supra* note 9, at 211.

70. *See, e.g.,* Fischer, *supra* note 11, at 999 (emphasizing dangers of uncertainty and inconsistency when courts use "context," including policyholder expectations, rather than "text" to resolve coverage disputes); Kimball, *supra* note 11, at 315 (stressing uncertainty and registering a preference for either legislative or administrative oversight instead of judicial intervention); Swisher, *A Middle Ground Approach*, *supra* note 11, at 635 (stating that reasonable expectations doctrine has been "justly criticized" for generating uncertainty by deviating from express contract terms and "for being applied by the courts in an inconsistent and uneven manner"); Ware, Comment, *supra* note 7, at 1486-88 (objecting to reasonable expectations doctrine on grounds of inconsistency and uncertainty); *cf.* Rahdert, *supra* note 12, at 364-65 (summarizing criticisms of reasonable expectations doctrine).

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Of these three arguments, the judicial interference argument is the least persuasive. It depends on unrealistic assumptions about private autonomy in contracting, and on an antiseptic view of the role that courts play in general in the enforcement of contracts. Courts mold and shape contracts in all kinds of ways that reach beyond the language of the agreement. They supply unwritten terms, like the obligation of good faith; they police restrictions on remedies; they employ equitable doctrines such as estoppel, reformation, and the like; they adjust obligations to account for unforeseen circumstances; they strike terms that are illegal or violate public policy; and so forth.[71] There is no more reason to suspect excessive judicial interference under the reasonable expectations principle than there is under many of these other extra-contractual legal doctrines.

Empirically, there is simply no credible evidence that judicial overreaching has occurred. Indeed, cases where courts, in the name of reasonable expectations of the insured, have gone sharply beyond the "landscape of risk"[72] defined by the policy terms are exceedingly rare. Although a theoretical potential for judicial overreaching arguably exists, the actual implementation of the reasonable expectations doctrine is more suggestive of judicial restraint.

What may be more significant than undue judicial interference is the prospect the reasonable expectations principle raises for judicial influence over the scope of coverage under the policy, particularly when one considers the role reasonable expectations may play in negotiation and settlement of insurance disputes rather than actual adjudication of controversies. The prospect that a court *might* invoke the reasonable expectations doctrine to shape the scope of coverage wrests from the insurer a significant degree of power over the outcome of coverage disputes, and thus creates pressure for settlement on terms more favorable to policyholders. It may also affect policy drafting, if underwriters consciously avoid placing some restrictions on coverage because of the perception that courts might override them in the name of protecting reasonable policyholder expectations. Insurers, accustomed to virtually

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71. Indeed, in a standard contract text or treatise, much of the discussion typically concerns the many ways in which courts impose extracontractual limitations on the parties' bargain. *See, e.g.*, FARNSWORTH, *supra* note 39, Chs. 2 (promissory estoppel and restitution), 4 (parties' status or capacity, regulation of the bargaining process, and regulation of substance), 5 (public policy), 7 (reformation), 9 (failure of a basic assumption, impracticability, frustration or mistake).

72. *See* Rahdert, *supra* note 12, at 381 & n. 253 (describing concept of "landscape of risk").

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complete control over all aspects of the insurance arrangement, find this potential for judicial intervention unsettling. From their perspective *any* such loss of control appears to be overreaching. Yet as I have previously argued, the implicit assumption that insurers *ought* to have unlimited authority to set policy terms vastly overstates the case for contractual freedom.[73] Indeed, it may well be that the reasonable expectations principle's greatest contribution to insurance law has been the prospect of judicial accountability that it creates, a prospect that deters insurers from pressing extreme interpretations of contract language and that generates at least a modicum of pressure in favor of designing coverage to satisfy consumer needs.

The potential for uncertainty may also be overestimated, but it is nonetheless a more trenchant criticism. One chief difficulty with fairness-based reasonable expectations thinking is that it is difficult to implement in a systematic and principled fashion.[74] Part of the problem is that in the insurance context "fair" and "unfair" policy provisions tend to look very much alike. Every coverage restriction is both "exculpatory" and "one-sided" in the sense that it unilaterally reduces the scope of the insurer's contract obligations. Consequently, every such term has at least the appearance of unfairness, especially in the context of a case (as they practically always are) where the excluded risk is the very one that befell the policyholder. Yet not every such restriction on coverage is unconscionable or unfair, even though it may substantially alter the degree of protection the policyholder enjoys under the policy. Indeed, it would be virtually impossible to have insurance at all without limitation of covered risks. How then does one discern fair from unfair coverage restrictions, or to turn the coin, reasonable from unreasonable expectations of coverage?

For the most part, the courts' response to this dilemma has been intuitive and highly discretionary. Few, if any, jurisdictions have developed useful criteria for making such a determination. Thus, it is not too difficult to summon examples of situations where courts have differed over the fairness *vel non* of particular policy terms. Courts often do not agree on what sorts of coverage a policyholder may reasonably expect from a particular kind of insurance.

In *Reasonable Expectations Reconsidered* I grappled at some length with this issue of uncertainty. I concluded that it was unnecessarily compounded by courts' tendency simply to announce what the reasonable

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73. *Id.* at 368-69.

74. *Id.* at 378-79.

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expectations of the insured are in a given situation, all too often without marshalling or appraising any evidence that would support their conclusion. In the end I offered a number of suggestions for dealing with this issue which I still generally endorse.[75] Collectively, they represent a proposal for more systematic method of addressing the expectations issue. No doubt, they represent little more than an opening gambit, and I imagine they could be substantially improved.[76] For present purposes, however, it is sufficient to observe that concerns about consistent application of the reasonable expectations concept can be alleviated to some extent by following something like the multi-step analytical framework I proposed.

The uncertainty objection is not limited, however, to a concern about inconsistent and haphazard application of the reasonable expectations concept across jurisdictions. After all, nearly every significant insurance-law question produces a rich variety of responses in different jurisdictions. At a more fundamental level, the uncertainty objection to the reasonable expectations concept rests on the basic proposition that predictability is an essential component of effective underwriting, and that legal doctrines like the reasonable expectations principle prevent its attainment. Insurers need to be able to define both included and excluded risks before they can measure their probability of occurrence and estimate the losses that are associated with them. If these estimates are inaccurate, underwriters will not be able to calculate appropriate premiums. Insurers faced with a great deal of legal uncertainty regarding what courts will and will not require them to cover will have difficulty assessing and evaluating covered risks.[77]

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75. *Id.* at 370-71.

76. In particular, I refrained in my proposals from specifying what weight courts ought to give to evidence it receives regarding the different aspects of the transaction it analyzes.

In addition to more systematic analysis by courts, it would be helpful in coverage disputes where the reasonable expectations principle is invoked if insurers could supply more information about the underwriting reasons for a given restriction on coverage, as well as the financial impact that would result if the interpretation of the policy advocated by the insured were to be generally applied. Where the policy provision in question serves an important function in the process of risk classification and assessment, and the interpretation advocated by the policyholder would substantially interfere with the underwriting process, courts ought in my view to be reluctant to proclaim that the insured's expectations of coverage were "reasonable." In such circumstances, the restrictive provision serves the essential function of defining the "landscape of risk" covered by the policy. On the other hand, where the policy provision in question restricts coverage without playing a demonstrably significant role in underwriting, the provision appears to function as a "naked preference" which ought not to be enforced. *See id.* at 374-80.

77. This has been a central theme of those advocating tort reform to stabilize liability insurance markets. *See, e.g.*, George L. Priest, *The Current Insurance Crisis and Modern*

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Faced with such a difficulty, the argument proceeds, insurers can protect their profitability only by charging artificially high premiums that hedge against expansive judicial interpretations of coverage.[78] From this perspective, judicial invocation of the reasonable expectations doctrine, at least where it deviates significantly from the familiar territory of the ambiguity rule, could introduce a destabilizing element in insurance law that will interfere with efficient insurer administration of risk. It could also prove costly for policyholders, who will end up paying higher premiums for coverage at the core of the policy because of the unpredictable prospect of elastic judicial policy interpretations at the margins.

These concerns would have considerable force if the unconscionability version of the reasonable expectations doctrine were an extremely common phenomenon, and/or if insurers had no meaningful form of response to its invocation. Fortunately, neither of these conditions exists. Cases where courts honor policyholders' expectations of coverage in the face of abundantly clear policy language to the contrary are very unusual. Moreover, the more prominent and plain the restrictive policy language, and the more effectively it is drawn to the insured's attention, the less likely it is that a court will find a contrary expectation of coverage to be *reasonable*. Indeed, several commentators, including Professor Keeton, have noted that the reasonable expectations principle actually protects *insurers* from *unreasonable* expectations in coverage, even in circumstances where invoking the maxim *contra proferentem* arguably would enable coverage.[79]

Insurers, in other words, have substantial means at their disposal to shape the "expectations" of their policyholders. They can use these means to prevent expectations of coverage that would be harmful to their efforts at sensible risk classification from forming. As long as the unconscionability version of the doctrine of reasonable expectations

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Tort Law, 96 YALE L.J. 1521 (1987). Their arguments have been applied by some commentators to issues of insurance policy interpretation. *See* Fischer, *supra* note 11, at 1020-25; *cf.* Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942, 955-61 (criticizing judicial interpretations of pollution exclusion in liability insurance policies because of their tendency to undermine rate-setting assumptions and thus to operate like a retrospective premium rebate). For further discussion of the need for predictability in insurance ratemaking, see RAHDERT, COVERING ACCIDENT COSTS, *supra* note 37, at 44-46, 138-41.

78. Kimball, *supra* note 11, at 314-16; Ware, Comment, *supra* note 7, at 1491-93.

79. *See* Keeton, *supra* note 1, at 969; Rahdert, *supra* note 12, at 369-70; Swisher, *supra* note 11, at 586.

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remains a relatively rare application, the concerns that have been registered about its potential effect on insurers seem overstated.[80]

C. Insurability - the Objective of Making Insurance Work

Sometimes—albeit very rarely—the reasonable expectations principle is invoked in circumstances where the court's main concern is not so much protecting the fairness of the insurer-insured relationship as it is determining what is necessary to make an insurance policy perform its intended function. Occasionally, courts discover that enforcing the insurance contract as written will deprive it of its essential value (or at least one major component of its value), not just to the policyholder before the court, but to most insureds who typically buy this kind of insurance. To make the insurance serve its purpose—*to make insurance "work"*—the court must override the restrictive import of specific policy language. When a court determines that this step is necessary, the reasonable expectations doctrine becomes a convenient means of justifying the court's action.

Cases of this type arise very seldom, and when they do, courts are often inclined to "cover their tracks" by stretching ambiguity and unconscionability arguments to reach the situation. Consequently, it is difficult to isolate any very clear recent examples. Nevertheless, a recent Wisconsin decision, *Wood v. American Family Mutual Ins. Co.*,[81] comes reasonably close to the mark.

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80. The reasonable expectations approach depends on the assumption that the average policyholder "expects" the rights or coverage in question. However, one could well imagine a justification for a "regulatory" approach to insurance policy interpretation that had nothing to do with the expectations of the insured. Indeed, one could mount a fairly persuasive argument that the entire idea of policyholder "expectations" is a bit fanciful, since most policyholders: 1) do not read their policies until long after they have been purchased, if at all; 2) have only vague and often dramatically erroneous ideas regarding the scope of coverage under typical lines of insurance; and 3) would not be able to comprehend many of the clearest and most routinely enforced policy provisions even if they did read them. See Jeffrey Thomas, *An Interdisciplinary Critique of the Reasonable Expectations Doctrine*, 5 CONN. INS. L.J. 295. Following this line of reasoning, one could conclude that policyholder "expectations" are essentially irrelevant, so that the courts should shape policyholder rights based more on what they "need" than on what they "expect." While this idea may have some attraction for scholars and theorists, it is my impression that it does not hold much appeal for courts.

81. 436 N.W.2d 594 (Wis. 1989). One aspect of the decision in *Wood*, involving interpretation of the Wisconsin "stacking" statute, was subsequently overruled in Matthiesen v. Continental Cas. Co., 532 N.W. 2d 729 (Wis. 1995). In that decision, however, the court specifically observed that "we do not overrule or limit language in

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Wood involved a question of underinsured motorist ("UIM") coverage in an auto insurance policy. One of the issues in the case was construction of a "reducing clause" that purported to reduce the amount of benefits payable under the UIM coverage by the amount the insured received from the underinsured driver's liability policy. This issue ultimately turned on the interpretation of the term "amounts payable" that appeared in the reducing clause. American Family Mutual claimed that this language should be interpreted to reduce the total amount of insurance available under the UIM clause by the amount received from the underinsured motorist's policy. Thus, under the insurer's interpretation, if an insured who sustained injuries worth $200,000 held $100,000 of UIM insurance and the underinsured motorist's carrier tendered policy limits of $25,000, the total amount available from the UIM carrier would be $100,000 - $25,000, or $75,000. In contrast Wood, the policyholder, argued that "amounts payable" should be interpreted to relate to the total amount of compensable damage the insured sustained. Under this interpretation, using the same illustration as above, since the insured's compensable damages exceeded $125,000, the UIM carrier would be responsible for the full $100,000 limits of coverage; funds available from the other motorists policy would reduce the obligation of the UIM carrier only in circumstances where the total compensable harm was less than the total available insurance under the two policies.

Using a blend of ambiguity and unconscionability-based reasonable expectations analysis, the court concluded that it should adopt the insured's interpretation of the reducing clause. In the process, it also took a significant step beyond limits of either of these variants of the reasonable expectations doctrine.[82] In the final analysis, the court did not place much weight on either ambiguity or fairness. It concluded that it should adopt the insured's interpretation of the contested language because it was more consistent with "the purpose of UIM coverage," which the court characterized as "to compensate the victim of an underinsured motorists's

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previous holdings of this court and the court of appeals that invalidated reducing clauses in UIM policies in part on the basis of the illusory nature of coverage." *Id.* at 733-34 (citing *Wood*, 436 N.W.2d 594). The portion of the *Wood* decision discussed here thus remains good law.

82. Indeed, it seems extremely unlikely that the typical auto insurance policyholder, even one who read the relevant policy language at the time s/he purchased the policy, would harbor any significant expectation one way or the other on such a question. In circumstances such as these, the notion of the insured's "reasonable expectation" becomes something of a legal fiction.

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negligence where the third party's liability limits are not adequate to fully compensate the victim for his or her injuries."[83] Beyond that, the court observed that the insurer's interpretation would effectively nullify a significant segment of purchased coverage:

> Accepting the [insurer's] position . . . . the [insurer] will never pay the policy limits of its UIM policies. For example, a policyholder purchases and pays a premium for UIM coverage with limits of $25,000. The insurance company would collect a premium for this coverage, but under no circumstances will the insured ever collect anything under that coverage. UIM coverage is effective where there is a tortfeasor with liability coverage inadequate in amount for the injuries caused [citation]. In Wisconsin, liability coverage currently cannot be issued for less than $25,000 [citation]. Therefore, because underinsurance is only effective where a tortfeasor has liability coverage which must be for at least $25,000 in Wisconsin and since, under the position the [insurer] urges us to adopt, recovery under UIM coverage is reduced by any amounts received from any liability policies, the insurance company will never have to pay out on a $25,000 UIM policy. Thus, *under the [insurer's] position, an underinsured liability limit is an illusion because an insured will never be entitled to recover up to that limit.*[84]

This analysis does not really depend on ambiguity in the policy language, the perceptions the ordinary insured would derive from a reading of the policy, or the expectations an insured would develop from his or her dealings with the insurer. Rather, it depends on the court's understanding of the role this particular kind of insurance is supposed to play, and the protection it is supposed to afford to the policyholder who purchases it. Fairness is a matter of concern here as well, but the issue is fairness to all

83. *Wood*, 436 N.W.2d at 600. This declaration of the purpose of UIM coverage was reaffirmed in Matthiesen v. Continental Cas. Co., 532 N.W.2d 729, 734 (Wis. 1995).

84. *Wood*, 436 N.W.2d at 600 (citations omitted, emphasis added).

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purchasers of this insurance, not just fairness to this particular insured in his or her particular situation.[85]

This kind of reasonable expectation analysis is extremely controversial, because it casts the court in a role that is very different from its customary posture in insurance disputes. The court is no longer umpire of the "bargain" that the insurer and insured have made. Instead, it has become an arbiter of what sort of bargain the parties *should* make—what terms are consistent with the overall purpose of their joint undertaking. In this way the court is taking on an oversight role with respect to the general character of insurance arrangements that is more akin to the role insurance commissioners and legislatures play. It is acting as a regulator of the business arrangement. It is setting insurance policy.

Objections to this kind of decisionmaking, to the extent they do not simply recapitulate the judicial overreaching, uncertainty and cost themes discussed above, tend toward separation-of-powers arguments. The problem is not simply that the court is interfering with the private autonomy of the parties' "bargain," but that it is taking on governmental oversight responsibilities that are better handled by the legislature, or perhaps by a legislatively authorized insurance commissioner.[86] In contrast to regulators from these other sectors, courts lack sufficient knowledge and/or accountability to warrant their taking on such a role.

I must admit that I have never understood this argument, at least as applied to a field so thoroughly steeped in common-law tradition as insurance. It reads into separation-of-powers analysis and makes restrictive assumptions about judicial power that do not belong in a common-law system. Common law courts *make* common law. They always have; it is one of the unique hallmarks of Anglo-American common

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85. Reduced to its essence, the court's "fairness" concern amounts to a belief that $100,000 worth of coverage ought, at least in some instances, actually to provide $100,000 worth of benefits.

86. *See* Kimball, *supra* note 11, at 315-316 (preferring legislative or administrative intervention over judicial intervention because the former is prospective and more predictable); Swisher, *Judicial Rationales in Insurance*, *supra* note 11, at 1056-57 (noting that "a Formalist judge" would argue that regulation of insurance terms should come "through the administrative action of the state insurance commissioner, who possesses properly delegated authority from the state legislature"); Ware, *supra* note 7, at 1489 (preferring legislative or administrative over judicial intervention). For a more extensive discussion of this criticism, see Stempel, *Unmet Expectations: Undue Restriction of the Reasonable Expectations Approach and the Misleading Mythology of Judicial Role*, *supra* note 9, at 265-72.

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law.[87] No doubt, legislatures have the power to mandate or prohibit particular coverage terms. No doubt, insurance commissioners have the power to review and approve or disapprove policy terms. But common-law courts also have long exercised a complementary authority to determine the meaning and application of insurance terms in order to effectuate the basic policies of insurance.

Indeed, courts are in a much better position than legislatures or insurance commissioners to pursue the policies of the reasonable expectations principle.[88] Courts are ideally situated to identify and evaluate the expectations of policyholders in particular situations, to ascertain the significance of policy language in those settings, and to assess the fairness of enforcing restrictive policy provisions in particular circumstances. Courts can "fine tune" insurance law and policy in ways that legislatures and administrators cannot. In any event, when courts do so they are exercising a common-law-making function that is evident throughout insurance law, as well as such related fields as contracts and torts. In this respect the reasonable expectations doctrine is not really unusual, although it may represent a more explicit invitation to judicial common-law policymaking than insurers are used to under most insurance-law doctrines.

D. Compensability - The Objective of Protecting Victims from Catastrophic Loss

Once in a very great while, a court takes an even greater step into the realm of policy and uses the reasonable expectations doctrine to protect the

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87. *See* RICHARD B. CAPPALLI, THE AMERICAN COMMON LAW METHOD 91-96 (1997). Professor Cappalli acknowledges that courts themselves often proclaim that they must defer to legislative authority, but he terms this a "specious argument":

> What is behind this blandishment "go to the legislature"? One possibility is that the argument is a clever decoy. The appearance of powerlessness appeases the court's conscience, assuages the blow to the plaintiff, and enhances the court's public image of subservience to the more democratic political branch. The cleverness, bordering on duplicity, stems from the court's full awareness, along with astute observers, that judges have full power, in the way of the common law, to remediate plaintiff's harm. But it has chosen, for unelucidated reasons, to favor defendant's case.

Id. at 95.

88. *See* Rahdert, *supra* note 12, at 341-42.

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interests of persons other than the insured. Insurance, of course, often vitally affects the interests of non-policyholders, such as family members, business partners, employees, customers, even strangers who suffer injury at the hands of the insured. These individuals also have an interest in how insurance policies are interpreted, and they may have "expectations"—probably not actual beliefs about coverage as much as reliance interests or identifiable needs for protection—regarding the scope of insurance rights under the policy. Their interests frequently coincide with the policyholder's interests, but not always. In extremely rare situations, a court may find that these third-party interests require protection from adverse policy language, and it may act to safeguard these third-party interests by invoking the doctrine of reasonable expectations. This use of the reasonable expectations concept has been most evident in the field of liability insurance, where the court typically pursues the objective of *protecting victims from catastrophic loss*.[89]

In the entire history of the reasonable expectations principle, the one case which stands out as an example of this kind of reasoning is *Keene Corp. v. Insurance Co. of North America*.[90] The case involved an insurance coverage dispute that grew out of the massive wave of asbestos litigation which hit the courts, and the insurance industry, in the 1970s and 1980s. Fairly early on, it became obvious that asbestos liability would strain, if not exhaust, nearly all legally available sources of compensation for asbestos victims, including the liability insurance that most asbestos manufacturers and installers had purchased during their years of operation. Most of the manufacturers had purchased substantial amounts of liability insurance for the period in question, but the carriers and policy limits often varied from year to year. Consequently, sharp disputes arose among the asbestos-manufacturing policyholders and their carriers regarding which policies were "on the risk" for particular claims, as well as the amount of liability coverage available from these policies. This dispute centered around the question of what aspect(s) of victims' contact with asbestos constituted "bodily injury" sufficient to trigger coverage under the fairly standard Comprehensive General Liability ("CGL") policy definitions of "occurrence" that most of the potentially applicable liability policies contained.

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89. Few commentators have directly addressed this particular facet of insurance policy interpretation. For a thoughtful critique of the connection between insurance policy interpretation and compensatory policies in contract and tort law, see Fischer, *supra* note 11, at 1059-61.

90. 667 F.2d 1034, 1041 (D.C. Cir., 1981), *cert. denied*, 455 U.S. 1107 (1982).

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Various insurers (each naturally seeking to minimize its own risk) and policyholders (each naturally seeking to maximize its overall insurance coverage) developed three competing definitions of "bodily injury." These came to be known as the exposure (inhalation of asbestos particles), exposure-in-residence (presence of embedded asbestos particles in the victim's lungs) and manifestation (appearance of symptoms of asbestos-related disease) theories.[91] The choice of one coverage theory over the others tended to push the liability either toward early (exposure), middle (exposure in residence) or later (manifestation) policy periods. Since most manufacturers had changed carriers and altered amounts of coverage on several occasions during many years of operation, the choice of one or another of these theories could have significant impact on the amount of insurance coverage available and the identity of the underwriters subject to the risk.[92]

One could treat this issue as requiring the interpretation of an ambiguous policy term, since the meaning of "bodily injury" as applied to the complex injury process of asbestos was unclear.[93] Some courts handled the determination of coverage in precisely that way. Those that did usually invoked the maxim *contra proferentem*, and then chose the definition of "bodily injury" which they believed maximized coverage for the insured.[94]

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91. For a detailed discussion of the asbestos coverage litigation, see Note, *Adjudicating Asbestos Insurance Liability: Alternatives to Contract Analysis*, 97 HARV. L. REV. 739, 740-43 (1984). *See also* Nicholas R. Andrea, Comment, *Exposure, Manifestation of Loss, Injury-In-Fact, Continuous Trigger: The Insurance Coverage Quagmire*, 21 PEPP. L. REV. 813 (1994); James M. Fischer, *Insurance Coverage for Mass Exposure Tort Claims: The Debate over the Appropriate Trigger Rule*, 45 DRAKE L. REV. 625 (1997); Lori J. Khan, Comment, *Untangling the Insurance Fibers in Asbestos Litigation: Toward A National Solution to the Asbestos Injury Crisis*, 68 TUL. L. REV. 195 (1993).

92. There were also complex related questions concerning what would happen in cases where claims triggered coverage under more than one policy, as well as how obligations for and costs of defense were to be allocated among carriers.

93. In most situations, exposure to an injury-causing agent, the presence of that agent in contact with bodily tissues, and the symptoms of injury (such as bleeding or damage to bodily organs and impairment of their function) happen almost simultaneously, so there would be no need to distinguish among them for purposes of defining bodily injury. What made the asbestos situation unusual was the extent to which these various components of an injury could be separated in time and space. Consequently, terminology which was perfectly clear for most circumstances acquired an unanticipated element of uncertainty when applied to the asbestos situation.

94. *See, e.g.*, Insurance Co. of North America v. Forty-Eight Insulations, 451 F. Supp. 1230, 1237-38 (E.D. Mich. 1978), *affirmed*, 633 F.2d 1212, 1221-22 (6th Cir. 1980), *clarified*, 657 F.2d 814 (6th Cir.), *cert. denied*, 454 U.S. 1109 (1981) (finding definition of "bodily injury" in CGL policies ambiguous and construing term against the drafter).

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In *Keene*, however, the court took a bold and controversial step beyond these decisions. Instead of picking and choosing *among* the contested theories of injury, the court, invoking the reasonable expectations doctrine, adopted them all, creating a fourth definition of bodily injury that came to be known as the "continuous injury" approach.[95] Under this approach any policy that had been in force from the time of the victim's first exposure, through exposure-in-residence, to the manifestation of disease would be potentially responsible to compensate the injured plaintiff. The effect of this decision was to massively increase the amount of insurance coverage available for satisfying most asbestos claims.

When it followed this approach, the *Keene* court surely did not imagine that Keene or any other asbestos manufacturer had actually *expected* coverage to be afforded on a continuous-injury basis, nor even that a policyholder reading the complex language of the policy would likely have drawn that inference. The court did not—and probably could not—maintain that failure to adopt this interpretation would work substantial injustice to the large and sophisticated corporate policyholder that had purchased the policy, no doubt with the aid of a professional risk management team and the advice of counsel. Nor could the court persuasively maintain that such an interpretation was necessary to make the insurance do its work. If anything, the CGL policies that had been issued to asbestos manufacturers and installers faced the prospect of being "overworked": coverage was likely to be exhausted long before the torrent of deserving asbestos claims subsided. Rather, what best explains the court's decision is that this approach would maximize the potential for each *victim* to secure meaningful compensation for his or her injuries. The policy interpretation was adopted to serve the purpose of victim protection, and the reasonable expectations principle became a convenient vehicle for expressing this judgment.

This sort of decision obviously takes the reasonable expectations principle a fair distance from its common-law ambiguity origins. Yet even such a decision implicitly acknowledges the power of the insurer to protect its interests through clear and precise drafting of contract language. What enabled the court to invoke the reasonable expectations principle was the failure of underwriters to anticipate the process of asbestos-related injury and disease. Had the underwriters who drafted the CGL language inserted, say, an unambiguous manifestation definition of bodily injury, the court

95. *See* Note, *Adjudicating Asbestos Insurance Liability: Alternatives to Contract Analysis*, 97 HARV. L. REV. 739, 739-43 (1984).

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surely would have enforced it. Only in matters left thus undetermined by the policy language did the court venture to take the interests of victims seeking assured compensation into account as a factor in setting the scope of coverage.

Nevertheless, *Keene* has been criticized as overbroad and unduly result-oriented,[96] and it has not been particularly influential outside the "toxic tort" context.[97] Because of the tidal-wave force of asbestos liability itself, with its multiple billions of dollars of risk, the *Keene* decision undeniably has had a powerful impact, but it has not sparked a revolution in insurance contract interpretation. At least for the foreseeable future, few other courts are likely to pursue the implications of the reasonable expectations concept quite so far.[98]

II. PRACTICAL AND THEORETICAL IMPLICATIONS

The previous discussion shows that the reasonable expectations principle is a multidimensional concept with a variety of potential applications that serve distinct policy objectives. Because the various strains of the principle are interrelated, they often overlap. In many instances, it is possible quite plausibly to characterize the issue for

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96. *See, e.g.*, Fischer, *supra* note 89, at 650-51 (summarizing objections to *Keene*'s continuous injury approach, particularly its linkage to the objective of "maximizing coverage"); Tung Yin, Comment, *Nailing Jello to a Wall: A Uniform Approach for Adjudicating Insurance Coverage Disputes in Products Liability Cases with Delayed Manifestation Injuries and Damages*, 83 CAL. L. REV. 1243 (1995). For judicial criticisms of *Keene, see* Abex Corp. v. Maryland Cas. Co., 790 F.2d 119, 126 (D.C. Cir. 1986) (applying New York law); Owens-Illinois, Inc. v. United Ins. Co., 650 A.2d 974, 985 (N.J. 1985).

97. It may well be that the *Keene* court was emboldened by the unique character of the coverage dispute in cases involving liability for asbestos-related injuries. With the solvency of large corporations, and access to compensation for thousands of victims at stake, it was apparent that any decision would have powerful reverberations for public policy. Moreover, one ought not to underestimate the *Keene* decision's significance. Many other toxic tort situations, including such prominent examples as lead poisoning, breast implant, and toxic waste litigation present liability insurance coverage issues comparable to those addressed in *Keene*, and the potential cost exposure in these cases, as in asbestos cases, is huge.

98. One other area where courts have arguably taken the need for compensating victims into account is uninsured motorist insurance, and particularly the issue of "stacking" benefits under multiple policies or policies covering multiple vehicles. *See* Fischer, *supra* note 91, at 647 n. 80; *cf.* Rusthoven v. Commercial Standard Ins. Co., 387 N.W.2d 642 (Minn. 1986) (allowing stacking of uninsured motorist coverage under a commercial vehicle policy covering 67 leased vehicles; using a combination of ambiguity and reasonable expectations analysis).

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decision as falling within more than one of the different categories I have described, or even occasionally all of them together.

This tendency of the reasonable expectations principle to convey multiple meanings, often at the same time, is a source of both strength and weakness. Most commentators to date, myself included, have emphasized the weaknesses, particularly the doctrine's tendency to generate uncertainty and inconsistency. In addition, the open texture and multiple meanings of the reasonable expectations concept render it vulnerable to the charge that it is a more radical concept than it actually is. But in significant respects the multidimensional character of the reasonable expectations principle is also a positive attribute. It makes the principle a flexible concept that is potentially adaptable to a variety of uses and situations.

Indeed, this versatility may partly explain the reasonable expectation principle's attraction for some courts. The principle's open texture gives it a vigorous common-law character, making it a handy tool in the common-law trade of insurance policy interpretation. In action, it allows courts to exercise substantial discretion to shape and reshape the reasonable expectations concept as they encounter new situations where it might potentially apply. It can be invoked aggressively, sparingly, or not at all, depending on what will in the court's judgment best serve the policies of insurance law in a particular case.

So why bother identifying the different variations on the theme? I will offer two answers to that question—one practical and one theoretical. They cut in different directions, but in my view they are not wholly inconsistent with one another.

On the practical side, isolating the different varieties of reasonable expectations analysis should help to put some of the controversy that has surrounded the doctrine into perspective. When critics attack the reasonable expectations idea, they often direct their attack at its more aggressive applications—what I have characterized as the "insurability" or the "compensability" variations of the doctrine.[99] As I have already observed, these variations represent the most controversial aspects of the doctrine, and to some degree they are more subject to criticism than their less daring relatives. But they are also unusual. Most of the time, when

99. *See, e.g.*, Kimball, *supra* note 11; Susan M. Popik & Carol D. Quackenbos, *Reasonable Expectations After Thirty Years: A Failed Doctrine*, 5 CONN. INS. L.J. 425, 433-38 (1998); Ware, *supra* note 7. The same is true of courts. *See, e.g.*, Sterling Merchandise Co. v. Hartford Ins. Co., 506 N.E.2d 1192, 1197 (Ohio Ct. App. 1986); Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d 798, 803 (Utah 1992).

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courts rely on the reasonable expectations idea they stop considerably short of these aggressive applications. To evaluate the entire doctrine in terms of its most unusual forms seems inappropriate. If most of the time courts using the doctrine stay quite close to the well-trodden path, it is both inaccurate and unfair to criticize them for running wildly through the woods. From this practical perspective, then, much of the controversy surrounding the reasonable expectations doctrine seems undeserved.

On the theoretical side, however, the reasonable expectations doctrine is indeed threatening, because in everything but its mildest form it challenges the basic assumptions underlying most of the boilerplate law of insurance.

When courts construe insurance policies, they typically treat the insurance policy as though it were just an ordinary contract[100] produced through bargaining (or at least a semblance of bargaining) between two individuals—the very essence of a private legal arrangement. In this private law sphere, the court's main duty is to use the language of the contract to discern "intentions" of the parties, and to enforce the obligations and limits to obligation that the language discloses, without much regard to the dynamics of the bargaining process which produced the language, and without much regard to whether that process of adjudication ends up favoring one side or the other.[101] To bend the contract to protect one side from the consequences of the bargain would, absent extraordinary intervening circumstances, smack of unseemly judicial partiality and might even erode the economic efficiency that such private contracting enables. From this perspective, inserting rights into the contract that are not written down there, or that may even have been specifically excluded, or altering one party's obligations from those that the contract language specifically discloses, simply because the other party "reasonably expected" the rights and obligations to be different from what is stated, is an abuse of judicial authority. It is, to put the matter bluntly, wrong.

But courts do not always behave as though they are simply arbitrating the results of a private negotiation. When courts intervene to alter the

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100. My contracts professor, Ellen Peters—who subsequently served with distinction as the Chief Justice of the Connecticut Supreme Court—liked to use the phrase "common garden-variety contract."

101. As with other adhesion contracts, these assumptions are largely fictional, but as with most other adhesion contracts, most of the time that does not seem to matter to courts. In all kinds of adhesion contracts, courts habitually enforce the terms of the contract as written, without paying much regard to the dynamics of the process that produced them. *See* Woodward, *supra* note 17, at ____.

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terms of the bargain, as they do under the stronger variants of the reasonable expectations principle, they start to act more like public law regulators, who are responsible for shaping private commercial relationships and individual transactions within those relationships in order to ensure that they serve overriding objectives of public policy.[102] For courts adjudicating insurance controversies, this is a new and sometimes disconcerting role.

Because insurance often has profound public implications, there are sometimes strong reasons for insisting that policies be structured to fit important policy objectives that transcend the particular insurer-insured arrangement. Indeed, insurance regulators and legislatures often specify quite particular contract terms for insurance policies, or prohibit others, in order to ensure that the policies do the job the regulators think they should, and to protect perceived public interests in assured compensation. A court which inserts a "reasonably expected" right into a policy that on its face omits or excludes that right acts in a similar, albeit more particularized fashion.

As a consequence, the reasonable expectation principle casts the court in a role that is different from, and to some extent inconsistent with, the usual assumptions of insurance law adjudication. This can be profoundly unsettling, because it raises serious doubts about the general validity of those usual assumptions. Once a court admits, in a reasonable expectations case, that an insurance contract bears virtually no resemblance to the classic "dickered deal" that symbolizes the presumed bargain of contract formalism, it can never again quite so comfortably settle back into the assumption that policy terms represent the product of mutual assent. It may still enforce the written terms of the bargain; it may even do so in circumstances where the impact on the policyholder is harsh. But if the court values candor and consistency it must justify enforcement of the policy terms as written on something other than the fiction that the policyholder knowingly and voluntarily consented to those terms. There must be some other reason than the parties' mutual "intent" for enforcing the language as written.[103]

Beyond this tension between public policy and private law lies another tension between the contract as an isolated transaction and the contract as an ongoing relationship. The impartial umpire stance tends to view the

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102. Rahdert, *supra* note 12, at 376-80.

103. This tension between the assumptions of an "objectivist" or "contractarian" model and the realities of modern form contracting is increasingly evident throughout contract law. *See* Mooney, *supra* note 17, at 1131-36, 1187-89; Woodward, *supra* note 17, at ___.

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contract that gives rise to the dispute as a discrete transaction, a one-time phenomenon. An insurance policy may be more complicated than most consumer purchases, in that the services being provided are harder to define and have a greater monetary significance, but like most such transactions, obtaining an insurance policy in this view represents a single, relatively isolated consumer decision among an array of alternative choices, based on features important to the consumer such as price, convenience, or service. If the contract does not turn out to the consumer's liking, s/he may make a different choice the next time such a purchase is required. Like buying clothes, or toothpaste, or theater tickets, or computer software, buying insurance is just one of the myriad contracts that define the life of the typical American consumer. Indeed, these days one can purchase an insurance policy over the telephone from a telemarketer, and pay for it with a credit card; one can probably even order insurance over the internet.

Obviously, however, most insurance contracts are not really like that, at least not in actual practice. In particular, most purchases of insurance are not isolated, relatively short-term, one-time phenomena. Rather, when policyholders buy insurance, they typically commit to a fairly complex long-term relationship with the insurer. A particular policy may involve only a relatively limited commitment, but most insureds will renew the arrangement with the same carrier again and again, year after year, unless and until a claim ripens into a legal dispute. The policy, moreover, calls for the performance of complicated responsibilities that are of great importance to the purchaser's welfare and security, such as legal representation, investment, and claims services. The insurance policy, thus, frequently reflects a larger long-term relationship between the parties.

In contracts dealing with complex ongoing relationships, courts sometimes subtly alter their approach to adjudication of disputes over particular terms.[104] The contract provision often becomes more of a starting point for determining the parties' rights and obligations, not an

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104. For discussions of relational theories of contract, *see, e.g.*, I. MACNEIL, THE NEW SOCIAL CONTRACT (1980); Jean Braucher, *Contract versus Contractarianism*, 47 WASH. & LEE L. REV. 697, 709-12 (1990); Jay M. Feinman, *The Significance of Contract Theory*, 58 U. CIN. L. REV. 1283, 1298-04 (1990); Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981); Stewart Macaulay, *An Empirical View of Contract*, 1985 WIS. L. REV. 465; Ian Macneil, *The Many Futures of Contracts*, 47 SO. CAL. L. REV. 691 (1974); Ian Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483; Steven R. Salbu, *The Decline of Contract as a Relationship Management Form*, 47 RUTGERS L. REV. 1271 (1995); Woodward, *supra* note 17, at ___.

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endpoint. Rights and obligations under the contract are less fixed, more fluid. They can and will be revised or restructured as the needs and demands of the relationship change. In such "relational contracts," the language of the contract is certainly a factor in ascertaining the rights and obligations of the parties, but its effect must be tempered by an adjudicator's understanding of the nature of the parties' relationship.[105] Arguably, the reasonable expectations principle introduces an element of this relational approach into the adjudication of insurance policy disputes.

The tension between these competing private/public and transactional/relational perspectives on contract interpretation is inherent in the reasonable expectations doctrine. It simply will not go away. The question then becomes how to manage it—which perspective to adopt in which situation(s). The difficulty of arriving at any coherent answer to that question perhaps best explains why courts are so wont to lapse into use of the notion of contract "ambiguity," where public policy and relational concerns can be slipped relatively unnoticed into the policy itself on the (often manufactured) ground that the language the parties chose was ambiguous on the question. This elides the competing perspectives into one, although it does so at the expense of judicial candor. But even when draped in an ambiguity disguise, the reasonable expectations principle has an unsettling effect, because it raises questions about the nature of the insurance arrangement that traditional insurance-law doctrines cannot answer.

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105. Factors that contract law theorists have identified in a relational contract which may temper the meaning and application of contract language include several that pertain to insurance: there may be either the prospect or past reality of significant duration to the relation; the exchange may include both easily measured quantities (such as compensation for loss of particular goods) as well as quantities not easily measured (such as the obligation of defense in a liability policy); there may be many individuals with varying individual and collective interests involved in the relation (for example an auto policy covering the insured, family members, passengers, and uninsured motorists); future cooperative behavior may be contemplated (for example, defense of a lawsuit in the case of liability insurance); the benefits are to be shared rather than wholly divided and allocated (as in the case of benefits under some life insurance policies); trouble is expected as a matter of course (usually true of insurance, which is about paying for trouble when it happens); and the parties know at the time of contracting that they cannot fully anticipate future developments that could alter the relation or the nature of contract rights (virtually always the case with insurance). *See* Woodward, *supra* note 17, at ___; *cf.* IAN MACNEIL, CONTRACT: EXCHANGE TRANSACTIONS AND RELATIONS 13 (2d ed. 1977).

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CONCLUSION

For the reasons that I have described, the controversy surrounding the reasonable expectations principle seems unlikely to abate as it moves into its fourth decade, yet the principle itself is equally unlikely to disappear. My own view has been and continues to be that the doctrine is considerably more valuable than its detractors suggest, that difficulties with its implementation can be successfully addressed, and that as practiced it represents a relatively modest reform. Nevertheless, I must acknowledge that the reasonable expectations principle does represent a very different vision of what Professor Robert Jerry has aptly termed the "soul" of insurance law.[106] Since this vision is also one that takes a measure of control over insurance transactions away from insurers and gives it to courts, the reasonable expectations principle is sure to encounter continued resistance.

106. Robert H. Jerry II, *Insurance, Contract, and the Doctrine of Reasonable Expectations*, 5 CONN. INS. L.J. 22, 55 (1998).

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THE DOCTRINE OF REASONABLE EXPECTATIONS IS INDISPENSABLE, IF WE ONLY KNEW WHAT FOR?

*James M. Fischer**

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INTRODUCTION

The Doctrine of Reasonable Expectations (DRE) is relatively young, but during its lifetime it has engendered spirited debate.[1] DRE creates *legal* rights of coverage at variance with the literal terms of the insurance contract, to build on Keeton's terminology.[2] Those rights exist independent of the contract itself, although they exist to redress the deficiencies inherent in the relationship that gave rise to the contract. DRE rests on the perceived desirability that social costs associated with losses be transferred and redistributed across society to reduce the impact of losses on individuals. On the one hand, we recognize that to effect the efficient transfer of these social costs to insurers' standardized agreements are desirable. On the other hand, as noted by Professor Henderson, the loss redistribution system must operate in a fair and equitable manner.[3] DRE is a methodology used to import "fairness" into the loss redistribution system and is thus counterpoised to the written contract by which the risk of loss is transferred from the policyholder to the carrier. In this sense, DRE may create a "contract" or "contract rights" neither party expressly acceded to in order to accomplish a redistribution of risk at variance with the risk distribution imposed by the contract terms themselves.[4]

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1. *See* Roger Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 823-24 nn.6-8 (1990) (hereinafter "Reasonable Expectations").

2. *See* Robert Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961 (1970) and 83 HARV. L. REV. 1281 (1970) (*passim*). Former professor, now District Judge, Robert Keeton's writings substantially influenced the treatment of DRE as an independent, stand alone doctrine. *See also* KENNETH ABRAHAM, INSURANCE LAW & REGULATION 47 (2d ed. 1995) (discussing Judge Keeton's contributions).

3. *See* Henderson, *supra* note 1, at 853:

> No insurance system can be fair and equitable where would-be insureds are deprived of the opportunity to participate intelligently in the system because of some obfuscating factor that is beyond their control. The principle of reasonable expectations emerged in recognition of the need to eliminate these barriers to intelligent participation. It has evolved over the past two decades into a doctrine that balances the needs of insureds against those of insurers, as it continues to further the overriding goal of fair and equitable allocation of costs of accidents and sickness in this society.

4. *See id.* at 823 n.5 (noting that many jurisdictions have provided insurance coverage to policyholders using DRE even though the unambiguous contract provisions would have denied coverage).

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DRE has generated a significant response from courts and commentators. This is surprising given what many consider to be its minor role as a decision influencing factor.[5] As several other contributors to this issue have noted, DRE, at least in the strong version proposed by Keeton, has been adopted in only a minority of jurisdictions; most jursidictions purport to limit their use of DRE to resolve disputes over the meaning of ambiguous policy language.[6] Ironically, given the origins and purpose of DRE, in those jurisdictions which use DRE only when insurance contract language is ambiguous, the result may be to benefit the carrier rather than the policyholder.[7]

The above caveats notwithstanding, DRE has had a profound influence both in our conception of what insurance law is and how insurance law is implemented in the courts. By encouraging courts to import notions of equity expressly into the evaluation of the carrier—policyholder relationship, coverage dispute resolution is subtly biased in favor of the individual policyholder, who presents a claim for indemnification for loss, and away from general concerns of efficient loss distribution, which tend to favor the carrier.[8] In addition, and accounting to some extent for what I believe to be DRE's influence, is what I would characterize as the compelling nature of the language used by Keeton to frame the doctrine. How could a court "interpret" the contract in a way other than to advance the "reasonable" expectations of the policyholder? The felicitous language used provides an incentive for courts to adopt coverage-favoring positions, if not expressly, then subconsciously. DRE provides doctrinal justification for a court's intuitive sense of what constitutes a right and just decision.

DRE has been influential in the resolution of insurance contract disputes and the development of insurance law, even if only indirectly.[9] Because DRE is a significant doctrine, it is important to assess whether, as implemented, DRE has been a help or a hindrance to the development of a coherent body of insurance law principles. In this regard, while I applaud the importation of equitable ideals into the resolution of carrier-policyholder coverage disputes, I believe the method used by Keeton has given rise to some counter-productive effects.

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5. Professor Kenneth Abraham's comment at AALS Insurance Law Section meeting (on file with author).

6. *See infra* text and accompanying notes 12-34.

7. *See infra* text and accompanying note 22.

8. These issues of efficiency and equity in the interpretation of insurance contracts are developed in KENNETH ABRAHAM, DISTRIBUTING RISK 31-36 (1986).

9. For example, in Gray v. Zurich Ins. Co., 419 P.2d 168, 169 (Cal. 1966), the court based its expansive construction of the carrier's duty to defend in part on DRE.

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Given the concession that the general direction DRE takes insurance law is good, is it simply quibbling to raise concern over the means selected to achieve those objectives? Should not the focus be on the merits rather than the implementation of DRE? I believe the answer is "no." Confusion or ambivalence over the meaning and method of implementing DRE reveals a structural weakness of the doctrine itself; namely, that DRE fails as a justification for the results it achieves. Confusion over the core values advanced by DRE leads to confusion over its proper implementation.[10] Moreover, uncertainty over the basic justification for DRE, which would direct DRE's implementation, leads to ironic contradictions in its application. For example, courts have refused to apply DRE to coverage claims by additional insureds and have limited DRE to the coverage claims of the policyholder who contracts directly with the carrier.[11] Uncertainty over the proper application of DRE thus leads to the Orwellian result where all insureds are equal, but some insured are more equal than others.

Part 2 of this paper identifies the two competing versions of DRE that have captured judicial and academic attention. Parts 3 through 6 discuss what I would characterize as the hollow center of DRE. Part 3 examines the amorphous quality of DRE, particularly its emphasis on reasonableness as the guiding standard for its application. Part 4 examines the failure of DRE, as implemented, to promote instrumental goals that insurance law may wish to advance. Parts 5 and 6 argue that DRE accomplishes little more than apply a label to a result reached and sugar-coat that result with a patina of doctrinal respectability. DRE is, in fact, little more than judicial expectations masquerading as policyholder expectations. Finally, this paper concludes with the suggestion that DRE should be jettisoned in favor of a more explicit

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10. *See* Bensalem Township v. Int'l Surplus Lines Ins. Co., 38 F.3d 1303, 1311 (3d Cir. 1994) (stating that "[f]aced [with prior Pennsylvania Supreme Court decisions], we are unable to draw any categorical distinction between the types of cases in which Pennsylvania courts will allow the reasonable expectations of the insured to defeat the unambiguous language of an insurance policy and those in which the courts will follow the general rule of adhering to the precise terms of the policy").

11. *See, e.g.,* City of Cedar Rapids v. Insurance Co. of N. Am., 562 N.W.2d 156 (Iowa 1997); *cf.* Barga v. Indiana Farmers Mut. Ins. Group, 687 N.E.2d 575, 578 (Ind. Ct. App. 1997) (refusing to construe ambiguity in favor of the injured party who is not the named insured and applying the Indiana rule that "the policy is construed from a neutral stance"); N.K.K. v. St. Paul Fire & Marine Ins. Co., 555 N.W.2d 21, 26 (Minn. Ct. App. 1996) (holding that policyholder's testimony that he understood that his policy did not cover professional acts that predated the policy period precluded finding coverage for a claim involving pre-policy acts).

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grounding of results on public policy and the recognition of insurance as a public good.

I. FORMS OF THE DOCTRINE OF REASONABLE EXPECTATIONS

DRE has both a strong and weak version. The strong version takes the view that a policyholder's reasonable expectations of coverage can trump plain and clear (*i.e.* unambiguous) policy language negating coverage.[12] The weak version of DRE holds that if policy language is ambiguous, *i.e.*, if that language is susceptible to more than one reasonable interpretation,[13] then the policyholder's reasonable expectations may be considered to determine which version of the ambiguous language should be adopted by the court.[14] Some jurisdictions appear to blend, or blur, the distinction between the strong and weak versions of DRE.[15] There are probably many iterations of DRE, some, no doubt, idiosyncratic. The jurisdiction body count is not important. The courts' receptivity to DRE, in any form, manifests the courts' basic concern that insurance contracts cannot be interpreted simply by applying the written language, but insurance contracts are necessarily subject to some extrinsic aids to assure a fair and just bargain.

Opponents of DRE focus their collective ire on the strong version; proponents of DRE focus their fury on the limitations contained in the weak version. Opponents of DRE complain that ignoring clear contractual language operates to create a bargain neither party would have accepted *ex ante*. In a

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12. *See* Parker v. Unum Life Ins. Co., 930 F. Supp. 1343, 1346 (D. Ariz. 1996):

> In limited situations, however, even an unambiguous term in standardized insurance contracts will not be enforced where the insured did not reasonably expect it, did not receive full and adequate notice, the insurer's activity created an objective impression of coverage, or the insurer induced the insured to reasonably believe that she had coverage.

(citation omitted); Henderson, *supra* note 1, at 823.

13. *See* Michael Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171 (1995).

14. *See* Dickins, M.D. v. Title Ins. Co. of Minn., 916 P.2d 435, 439 (Wash. Ct. App. 1996) (applying DRE requires that "there must be either an ambiguity or inconsistency between policy provisions. When this occurs, the provisions are to be interpreted in accordance with the reasonable expectations of the insured"). *Id.*

15. *See, e.g.*, Ross v. City of Minneapolis, 408 N.W.2d 910, 914 (Minn. Ct. App. 1987) (stating that the strong version of DRE may be used when the insurance contract contains "hidden exclusions").

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number of cases, courts have created coverage that probably would have been rejected by the policyholder *ex ante*.[16] The result of this, according to the critics, is that DRE requires rational carriers to provide and charge for more coverage than a policyholder would prefer *ex ante* in order to guard against having to provide coverage the policyholder desires *ex post*.[17]

Proponents of DRE, focusing on the weak version, contend that it is too limiting. They assume that policyholders do not read their policies until they have a claim or a coverage dispute with the carrier. Thus, a policyholder's beliefs regarding the scope of coverage provided by the policy, unless induced by the carrier,[18] can hardly have been formed *ex ante*. What a policyholder has not seen or read cannot induce a belief or expectation on the part of that policyholder. There is some empirical evidence, consistent with the general assumption, that policyholders neither read nor understand the written terms of their insurance policies.[19] That policyholders in general do not read their policies at the time of contract formation is surely the general assumption and understanding.

Under the weak version of DRE, it is the policyholder's reasonable expectations of coverage that control. In this context, the rule appears to be that the insurance contract will be construed as a reasonable carrier would (or should) have anticipated an objectively reasonable policyholder would construe the policy language. If the policy language is unambiguous, the carrier would expect policy language to control. Thus, if policy language is ambiguous, the carrier should expect the policyholder's reasonable expectations of coverage

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16. In *Vargas v. Insurance Co. of N. Am.*, 651 F.2d 838 (2d Cir. 1981) the policyholder actually rejected an endorsement that provided him with essentially the same coverage the court found he could reasonably expect under the policy. Was the policyholder prescient and thus knew the endorsement was surplusage because the court would find the basic policy provided the needed coverage?

17. *See* State Farm Fire & Cas. Co. v. Bongen, 925 P.2d 1042, 1047 (Alaska 1996) (noting that "most insureds develop an expectation that every loss will be covered . . ."). This is not to suggest that this expectation standing alone is sufficient. *See* Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388, 395 (Ariz. 1984) (stating that the policyholder's reasonable expectations must be filled by "something more than the fervent hope usually engendered by a loss").

18. This situation generates the greatest agreement that restrictive, unambiguous policy language should not be followed. In this context, however, the action sounds more in the tort of misrepresentation than in contract. Mallis v. Banker's Trust Co., 615 F.2d 68, 82 (2d Cir. 1980) (relying on alleged misrepresentations on the negotiability of unregistered stock by defendant's attorney was the proximate cause of plaintiff's loss); Restatement (Second) Torts §552 (1979).

19. *See* Jeffrey E. Thomas, *An Interdisciplinary Critique of the Reasonable Expectations Doctrine*, 5 CONN. INS. L.J. 295 (1998).

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to control.[20] This use of DRE can actually benefit the carrier since use of the weak version may ameliorate the traditional rule of *contra proferentum*, which is that ambiguity is construed against the drafter, here the carrier. If a policyholder would not have a reasonable expectation of coverage in any event, then the policy will not be construed in the policyholder's favor by use of a formal rule of construction.[21]

Ambiguity is usually found in structural defects in the format of the policy, the terminology used to define the scope of coverage, or the methods and practices of marketing the policies.[22] The structural defect may be in the thickness of the language, the smallness of the text (dense packing), or the juxtapositioning of companion provisions that make it difficult to determine what the actual coverage is.[23] Structural defects, complex terminology, and marketing practices are used by courts to support application of either the strong or weak version of DRE.

For proponents of DRE this weak version is illogical and inconsistent. Insurance contracts are rigorously construed by courts with the intent of

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20. Lebas Fashion Imports of USA v. ITT Hartford Ins. Group, 59 Cal. Rptr. 2d 36, 42 (Cal. Ct. App. 1996) (stating "[i]f contractual language is clear and explicit, it governs. On the other hand, '[i]f the terms of the promise are in any respect ambiguous or uncertain, it must be interpreted in the sense in which the promisor [carrier] believed, at the time of making it, that the promisee [policyholders] understood it") (citations omitted) [brackets added]; *cf.* Lincoln Tech. Inst. of Ariz. Inc. v. Federal Ins. Co., 927 F. Supp. 376, 379 (D. Ariz. 1994):

> [DRE] relieves an insured from certain standardized clauses of agreements which are not negotiated when the drafter has reason to believe that the insured would not have assented to the terms in question had he or she known of the terms.

Id. This concept is also found in THE RESTATEMENT (SECOND) OF CONTRACTS § 211 (1981). As Henderson noted, however, this formulation of DRE is structurally different from the view popularized by Keeton. Henderson, *supra* note 1, at 847 (noting that the Section 211 formulation requires "taking the perspective of the insurer").

21. *See, e.g.*, Bank of the West v. Superior Court, 833 P.2d 545, 552 (Cal. 1992) (noting that ambiguity will be construed against the carrier to provide coverage only when the policyholder has an objective reasonable expectation of coverage).

22. *See* Davenport Peters Co. v. Royal Globe Ins. Co., 490 F. Supp. 286, 291-92 (D. Mass. 1980) (Keeton, J) (noting the necessity about the "structure, content, manner of printing of the policy, or the methods and practices of marketing").

23. *See* North Bank v. Cincinnati Ins. Cos., 125 F.3d 983, 986 (6th Cir. 1997) (applying DRE to what the court characterized as "a studied ambiguity written into the [umbrella] policy by the [carrier]").

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protecting the policyholder by providing the maximum coverage possible.[24] The rules of construction developed to advance this goal are based on the complexity of policy language, the commercial role of insurance, the use of standardized contracts, and the inability of many policyholders to comprehend the detail or gross of what they have purchased.[25] In essence, judicial expectations regarding the proper contours of insurance law forces carriers to provide a consumer-safe and consumer-friendly package of coverage, much like product liability law encourages manufacturers to build and equip a reasonably safe vehicle consistent with so called "consumer expectations."[26] The proponents of DRE would argue that it is foolishly inconsistent[27] to erect a body of rules predicated in large part on the reality that policyholders neither read nor comprehend policy language *ex ante*, but then have coverage turn *ex post* on whether a particular provision was hidden or obscure.[28] Most courts

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24. This is a pervasive theme in insurance coverage decisions. *See, e.g.*, American Home Assurance Co. v. Ingeneri, 479 A.2d 897, 900 (Me. 1984) (holding that statutory provision addressing policyholder misrepresentations, which was written in the disjunctive ("or"), should be construed in the conjunctive ("and") in order to protect the policyholder). As written the statute would have allowed the carrier to maintain a misrepresentation defense under any one of the three factors described. As construed the carrier was required to satisfy all three factors to maintain a misrepresentation defense.

25. I developed these themes in James M. Fischer, *Why are Insurance Contracts Subject to Special Rules of Interpretation?: Text v. Context*, 24 ARIZ. ST. L.J. 995 (1992).

26. RESTATEMENT (SECOND) OF TORTS § 402A (1979) (stating that a defective product is one "dangerous beyond that which would be contemplated by the ordinary consumer who purchases it, with the ordinary knowledge common to the community as to its characteristics"). The consumer expectations test focuses on the hypothetical, reasonable consumer rather than the expectations of the particular plaintiff. Campbell v. General Motors Corp., 649 P.2d 224, 233 n.6 (Cal. 1982).

27. I believe a "foolish inconsistency" is at least as bad as a "foolish consistency." *Cf.* Ralph Waldo Emerson, *Self Reliance*, in Essays: First Series (1841): "[a] foolish consistency is the hobgoblin of little minds . . . ." *Id.*

28. This "inconsistency" is reflected in the inability of courts to develop a consensus on the issues of whether the insurer has a duty to explain policy terms, and whether an insured has a duty to read policy terms. Many courts state that the insured is under a duty to read the insurance policy. *See, e.g.*, Aetna Casualty & Sur. Co. v. Richmond, 143 Cal. Rptr. 75, 79 (Cal. Ct. App. 1977); Schoonover v. American Family Ins. Co., 572 N.E.2d 1258, 1264 (Ill. Ct. App. 1991); Twelve Knotts Ltd. Partnership v. Fireman's Fund Ins. Co., 589 A.2d 105, 113 (Md. 1991). Other courts, however, have held that the insured has no duty to read the policy. *See, e.g.*, Underwriters Ins. Co. v. Purdie, 193 Cal. Rptr. 248, 252-53 (Cal. Ct. App. 1983). Still others have qualified the duty to read the policy. *See, e.g.*, Fields v. Blue Shield of Cal., 209 Cal. Rptr. 781, 785 (Cal. Ct. App. 1985) (stating that a "duty to read is insufficient to bind insured to unusual or unfair language" in policy unless it is brought to insured's attention and explained); Floral Consultants, Ltd. v. Hanover Ins. Co., 470 N.E.2d 527, 529 (Ill. Ct. App. 1984) (stating that the duty to read does not operate as a bar to recovery in insured-agent

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today acknowledge that policy ambiguity cannot be addressed "abstractly" but only in the context of a definite event and claim.[29] Limiting DRE to a prior finding of ambiguity, and assuming a duty to read, requires policyholders to engage in an impossible task of imagining future possibilities to determine potential coverage ambiguities. Unless policyholders are expected to read their policies and be "deceived" or be "lulled into a false sense of security," the focusing on obscurity, hidden exclusions, and ambiguity is fruitless. And if reading policy language for ambiguity is a largely thankless task when the reading is to be done in the abstract, the weak version of DRE presents the policyholder with essentially a "catch 22" situation: Read what you can't understand to see if there is an ambiguity or obscure or hidden provision that you are unlikely to discern, and only if one exists will your reasonable expectations be considered.

The judicial response to this dialogue between the opponents and proponents of DRE has been to temporize. Some jurisdictions have expressly adopted the strong version of DRE, but many have not. Jurisdictions rejecting the strong version of DRE do not always use the unequivocal language that the proponents of DRE prefer and the opponents fear.[30] Likewise, jurisdictions,

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disputes). Similarly, courts have held that an insurer may be obliged to explain policy language to an insured, at least when the insurer knows that the insured is mistaken as to the existence of coverage. *See, e.g.,* Westrick v. State Farm Ins., 187 Cal. Rptr. 214, 219 (Cal. Ct. App. 1982). On the other hand, courts have held that the insured is "bound by clear and conspicuous provisions in the policy even if evidence suggests that the insured did not read or understand them." Sarchett v. Blue Shield of Cal., 729 P.2d 267, 276 (Cal. 1987).

29. Bank of the West v. Superior Court, 833 P.2d 545, 552 (Cal. 1992):

> In determining whether coverage is consistent with the objectively reasonable expectations of the insured, "the court must interpret the language in context, with regard to its intended function in the policy. This is because '*language in a contract* must be construed in the context of the instrument as a whole, and in the circumstances of that case, and *cannot be found to be ambiguous in the abstract.*'

Id. (citations omitted) [emphasis in original]; *see also* Hathaway v. Standard Mut. Ins. Co., 673 N.E.2d 725, 729 (Ill. Ct. App. 1996) (finding "latent" ambiguity in policy language based on the context in which the claim arose and public policy considerations).

30. The California Supreme Court, for example, adopted the weak version of in *Producers Dairy Delivery Co. v. Sentry Ins. Co.*, 718 P.2d 920, 924 (Cal. 1986) without expressly overruling earlier decisions adopting the strong version of DRE. This opening permitted a federal court to apply DRE absent a finding of ambiguity. Northern Assurance Co. of Am. v. Carr, 860 F.2d 934, 936 (9th Cir. 1988) (holding that DRE applied to obscure provision of insurance contract even though the provision was unambiguous).

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which reject the weak version of DRE in favor of the strong version, do not always use unequivocal language in so doing.[31]

All this evidences the great difficulty in defining with precision the exact impact of DRE on the current state of insurance coverage law. There are many insurance coverage decisions. The typical decision recites *both* that insurance contracts are like any other contract *and* that insurance contracts are subject to special rules of interpretation. In some decisions, a jurisdiction will expound on DRE expansively; in other decisions, DRE is viewed quite restrictively.[32] Often the inconsistencies are ignored,[33] perhaps studiously ignored for reasons of practicality, not principle.[34] This conjoining of contradictory themes

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31. *See, e.g.,* Atwater Creamery Co. v. Western Nat'l Mut. Ins. Co., 366 N.W.2d 271, 277 (Minn. 1985). This case is recognized for adopting the strong version of DRE. Subsequent Minnesota decisions have, however, limited *Atwater Creamery* to cases involving "hidden" exclusions. Kabanuk Diversified Inv., Inc. v. Credit Gen. Ins. Co., 553 N.W.2d 65, 72 (Minn. Ct. App. 1996).

32. *Compare* C&J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 177 (Iowa 1975) (holding that DRE applied regardless of the presence of an ambiguity), *with* Hickman v. IASD Health Services Corp., 572 N.W.2d 165 (Iowa Ct. App. 1997) (stating that it would apply DRE only when the policyholder could prove the following:

> (1) an ordinary lay person would misunderstand the policy's coverage or there are circumstances attributable to the insurer which foster coverage expectations; and (2) the exclusion is bizarre or oppressive; or (3) the exclusion eviscerates explicitly agreed to terms; or (4) the exclusion eliminates the dominant purpose of the transaction.

Id. at 167 (citation omitted).

33. For example. it is possible to trace a pathway through the Iowa decisions discussed in note 32 although, in my opinion, the reconciliation is more forced than natural. *See* Farm Bureau Mut. Ins. Co. v. Sandbulte, 302 N.W.2d 104, 112 (Iowa 1981). In other cases, the inconsistencies are ignored. *Compare* Producers Dairy Delivery Co. v. Sentry Ins. Co., 718 P.2d 920, 924 (Cal. 1986) (holding that DRE is applied only when "the policy language is found to be unclear"); *with* Wint v. Fidelity & Casualty Co. of New York, 507 P.2d 1383, 1388 (Cal. 1973) (stating that "there being no ambiguity with respect to the exclusion . . . it remains only for us to determine if under the language of the policy the insurer has led the *insured* reasonably to believe that a defense would be provided"); *but c.f.* Garcia v. Truck Ins. Exch., 682 P.2d 1100, 1106 (Cal. 1984) (stating that "[t]here remains, of course, the fundamental proposition that an insured is entitled to no less protection under an insurance policy than a person in his situation would reasonably expect"). I do not mean to suggest that the California decisions are irreconcilable, but there are certainly differences in emphasis and no reconciliation was made or even attempted.

34. Pittston Stevedoring Corp. v. Dellaventura, 544 F.2d 35, 49 (2d Cir. 1976), "We think its time to recognize . . . that there are two lines of Supreme Court decisions on this subject which are analytically in conflict, with the result that a court of appeals must choose the one

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confounds as much as it complicates analysis. It renders highly impressionistic any opinion whether DRE, in either its strong or weak version, is ascendant, in equipoise, or in disfavor.

II. THE AMBIGUITY OF THE DOCTRINE OF REASONABLE EXPECTATIONS

Reasonable expectations can arise from a variety of sources and DRE is rather imprecise as to what makes, gives rise to, or constitutes a reasonable expectation. DRE is also unclear as to when the expectations are to be gauged, *ex ante* or *ex post*. This lack of clarity as to the implementation of DRE is not surprising given the flex and play in decision making afforded by reasonableness standards. The problem arises, however, because the language of DRE suggests that courts should look at the policyholder's expectations, albeit those of objectively reasonable persons, and the decisional law occasionally supplements this approach by general discussions, unsupported by the record, in support of a finding that a reasonable person would expect, or not expect, coverage. For example, in *Loftis v. Vesta Companies*[35] the policyholder sought coverage under his collision insurance when his insured vehicle was damaged after striking a pothole in the road. The policy provided coverage for a "collision with another object." The question before the court was whether a "collision with a pothole" satisfied the policy language. The court concluded coverage existed. In part, the court relied on DRE, holding that "[a] contemporary over-the-road truck driver purchasing insurance would expect to have coverage for this type of occurrence."[36] This may or may not be true. The problem is that when presented as a factual observation, as DRE requires, the assertion is unsupported by competent evidence. How do we "know" what contemporary truck drivers expect? One would expect, at a minimum, competent survey evidence, such as that used in trademark litigation to measure consumer confusion. As Professor Thomas notes in his article,[37] if such evidence was obtained in a non-suggestive manner,[38] the answer might be contrary to the court's factual conclusion.

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it deems more appropriate for the case at hand." *Aff'd sub nom*, Northeast Marine Terminal Co. v. Caputo, 432 U.S. 249 (1977).

35. Loftis v. Vesta Companies, 686 N.E.2d 383 (Ill. Ct. App. 1997).

36. *Id.* at 385.

37. *See* Thomas, *supra* note 19 at 296.

38. For example, if the survey participants in the studies described by Professor Thomas were asked if pothole collisions constituted collision with an "object" their answers might be different from their answer to the question whether if they sustained damage to their vehicle after colliding with a pothole, would they expect the claim to be covered?

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Even when courts purport to look more exactly at the origins of a policyholder's reasonable expectations, the results are unsatisfying. For example, in *Haber v. St. Paul Guardian Ins. Co.*,[39] the issue was coverage for worker's compensation benefits for the policyholders' full-time, live-in housekeeper who was injured during the course of her housekeeping activities. The carrier contended that under the terms of the policy only employees who worked less than 40 hours per week or for whom coverage was required by state law were covered under the workers' compensation endorsement of the policy.[40] The policyholders argued that they were covered because (1) they had told their insurance producer when they acquired their policy that they were moving into a larger residence, (2) during a visit to the residence they had told the producer about the live-in housekeeper and where the housekeeper would be residing, and (3) the producer had said, after inspecting the residence, "I'm going to cover you."[41]

The court gave extensive credit to the policyholders' position that they desired "full coverage." The court noted the policyholders' testimony that they did not specifically seek a policy containing workers' compensation coverage.[42] The court discounted the importance of this concession given the larger, more general expectations of coverage the policyholders possessed, coupled with the ambiguity identified by the court in the endorsement as to who was a covered employee.[43] A policyholder's general expectation that all losses will be

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39. Haber v. St. Paul Guardian Ins. Co., 137 F.3d 691 (2d Cir. 1998) (applying New York law).

40. *See id.* at 694. The endorsement defined a covered employee as one for whom workers' compensation benefits must be provided under state law. The trial judge had found this reference created an ambiguity; the appellate court found that the trial court did not err on this point. *Id.* at 695-96. Courts have split on whether the policy's incorporation of a statutory definition creates an ambiguity. Most of the decisions have involved Financial Solvency Statutes where providing compensation to injured parties is the primary purpose of the legislation. Such a purpose also underlies Workers' Compensation legislation, although the point was not raised by the court in *Haber*.

41. *Id.* at 694.

42. *See id.* at 696-97; *compare* Murphy v. Kuhn, 682 N.E.2d 972 (N.Y. 1997):

> Generally, the law is reasonably settled on initial principles that insurance agents have a common-law duty to obtain requested coverage for their clients within a reasonable time or inform the client of the inability to do so; however, they have no continuing duty to advise, guide or direct a client to obtain additional coverage . . . .

Id. at 974; *see also infra* note 67.

43. *Haber, supra* note 39,137 F.3d at 697.

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covered is by itself insufficient to create a reasonable expectation of coverage;[44] nevertheless, under *Haber*, those general expectations are sufficient to create "reasonable" expectations of coverage, even as to uncommunicated insurance needs, if the carrier fails to exclude a possible interpretation of the policy language with a sufficient degree of particularity. This results even in situations when the producer (and the carrier) have no affirmative duty to delve into the policyholder's coverage needs. Holding that a policyholder can have an enforceable, reasonable expectation of coverage in the face of these contrary considerations and principles illustrates the extent to which DRE serves to create what the courts perceive to be a consumer-friendly and serviceable product.

It would be more accurate if courts and commentators addressed DRE as a legal "deux ex machina" designed to import public policy into private law. Indeed, this is largely true of many reasonableness standards.[45] Whether in tort or contract, reasonableness standards suggest a default rule that will apply to govern the parties' relationship. Usually this is due to the parties' silence, and language ambiguity may be seen as a form of silence, *i.e.* silence as to the level and degree of required specificity.

Ambiguity may be consciously included in a contract, for example, when the parties cannot resolve a particular issue, but prefer an agreement over deadlock. Given the absence of real bargaining, at least in the classical sense, in most insurance transactions, this type of "intended" ambiguity is unlikely to be present in most insurance contract disputes. The one-sidedness of the drafting process, coupled with the absence of bargaining over the terms of the contract, provides independent support for the broad preference for consumer expectations evidenced by DRE; the nullification of strategic advantage. Default rules operate largely under the premise that they mimic the bargain that the parties would have achieved had they thought about the matter. That assumption is largely illusory in consumer insurance transactions.[46] There is the perception that carriers will use their control of the pen to craft policy

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44. *See supra* note 17.

45. Larry Dimatteo, *The Counterpoise of Contracts: The Reasonable Person Standard and the Subjectivity of Judgment*, 48 S.C. L. REV. 293 (1997) (noting that "[t]he implication of society's rules of fairness and reasonableness is generally accomplished through the court's fabrication of the reasonable person. The reasonable person is the personification of contract law's externalities") *Id.*

46. Commercial insurance transactions may present a different case. Not surprisingly, some courts and commentators have suggested the difference is material and warrants a different application of DRE under the "sophisticated policyholder" concept. *See infra* notes 59-60 and accompanying text.

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positions that safeguard their interests to the detriment of policyholders.[47] DRE curbs this strategic advantage. There is, however, no connection between what the court is actually doing and what the court says it is doing: policyholder expectation, actual or hypothetical, form no part of the decision except in the broadest, most general sense, *i.e.* the policy should provide coverage for this loss because it is deemed socially good that it do so.

DRE's name does not really describe what it is or does, nor does DRE really focus on policyholder expectations. The reference to the objectively reasonable policyholder misses the mark, for the reference suggests that there are real expectations by a real policyholder. There are in fact no expectations, and no real policyholders whose expectations are plumbed by the legal equivalent of a "Vulcan mind-meld," except in the mind of those who resolve the disputes, which will be judges since the matter involves construction of the contract.[48] As so presented, DRE, unlike its common law counterpart—the reasonable person, is rarely a question for the trier-of-fact because there are no facts to find.

The expectations of the reasonable policyholder are not a fact-based inquiry; rather, DRE is a matter of public policy. The expectations of the reasonable policyholder are defined by the judge's perception of what constitutes a fair and just bargain. Since this perception becomes a controlling theme of policy interpretation, the necessary conclusion is that it is good public policy that the loss be redistributed in accordance with the judges' perception of fairness rather than the policy language.

This is not to suggest that "public policy" is a clearer standard or statement for discerning the content of a decisional norm than is a pure reasonableness standard.[49] The "meaning" of an insurance policy is not a discoverable fact of

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47. Within limits, that is both expected and as it should be. Contract law is largely based on self-interest, not altruism. Yet, no rule has ever beem pushed to its logical limit. The efficiency-equity antinomy reflects the notion that at some point a party's ability to prefer its own interest will be sublimated to what the courts identify as larger public values.

48. *See* Suarez v. Life Ins. Co. of North America, 254 Cal. Rptr. 377, 382 (Cal. Ct. App. 1988) (noting that "[a] party's reasonable expectation of coverage is a question of law not a question of fact"). It is unclear why "reasonableness" in this context is a bench issue, while reasonableness in other insurance contexts, such as bad faith and negligence in performing contractual obligations, is a jury issue. *See* Mowry v. Badger State Mut. Cas. Co., 385 N.W.2d 171, 181 (Wis. 1986).

49. *See* Lord Justice Burrough when asked to invalidate a contract on public policy grounds stated that public policy "is a very unruly horse, and once you get astride it you never know where it will carry you." Richardson v. Mellish, 130 Eng. Rep. 294, 303 (Comm. Pleas 1824). Other judges have expressed a more accepting role for public policy.

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nature. Meaning is largely determined by context and is often influenced by the pre-identification of what we want to find. The concepts of public policy and reasonableness are generally interchangeable in the context presented here.[50] That is not to say that public policy is never unreasonable, but no court would admit that it is. For courts, public policy is always reasonable. A public policy base for altering and modifying contract obligations is simply a more honest and accurate statement of what DRE does. Public policy creates coverage when a court believes it is fair, just, and reasonable to do so, notwithstanding the contrary position of the contract terms. A policyholder's expectations have nothing to do with the result, unless they happen to coincide with those of the court.

III. EXPECTATIONS FOR WHAT REASONS?

What do we want insurance law to encourage the parties to the insurance contract to do? The above question is really basic to any analysis of DRE, or any insurance law doctrine for that matter. DRE has become a basic component to analysis of the meaning of insurance contract terms; therefore, resolution of the relationship between DRE and any idealized version of insurance law will have systemic implications. If DRE is good, it must be because DRE instrumentally advances the ends that insurance law seeks to achieve. Within the area of the policyholder-carrier relationship that DRE affects, what are the ends or goals, at a pragmatic and functional rather than theoretical level, of insurance law?

A. Policyholder "Obligations"

Do we *really* want policyholders to read insurance contracts? The mantra that we do is frequently chanted by courts, but exceptions are common and it is difficult to state whether a "duty" to read the insurance contract exists or whether if it exists it is more honored by its non-observance than its application.[51] It is also doubtful that imposing such an obligation is really a

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> Public policy is the cornerstone—the foundation of all constitutions, statutes, and judicial decisions, and its latitude and longitude, its height and its depth, greater than any or all of them. If this be not true, whence came the first judicial decision on matter of public policy? There was no precedent for it, else it would not have been the first.

Pittsburg C, C & St. L.R. Co. v. Kinney, 115 N.E. 505, 507 (Ohio 1916).

50. *See* Randy Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269, 276-77 (1986) (noting definitional ambiguity of public policy and reasonableness).

51. *See supra* note 28.

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good idea, except perhaps for law schools whose admissions are declining and whose seats and coffers could be replenished by the demand for lawyers that vigorous enforcement of a "duty to read" obligation would entail.[52] Policyholders would have to retain experts to explain to them what they are duty bound to read.[53] This, of course, assumes that reading is not simply a useless formality but is designed to encourage comprehension. The whole point, however, of standardized contracts is to avoid the need for the policyholder to engage in a painstaking examination of the policy. Unless policy language is changeable or variable, and there is scant evidence that as to the standard terms it is, encouraging policyholders to read their insurance contracts would simply increase transaction costs for no purpose relative to the bargaining process. It is also questionable whether the incidental increase in consumer knowledge that employing an expert would engender is worth the cost. Thus, a version of DRE that discourages, excuses, or at least does not penalize a policyholder for not reading the policy, would not appear to violate or breach any norm or policy we would want insurance law to achieve or promote.

Do we want policyholders to describe in detail their coverage expectations and desires to carriers *before* the insurance contract is entered into by the parties? This seems to me to be a natural correlative of any duty to read. It is rather inefficient to ask policyholders to communicate dissatisfaction to the carrier at the conclusion of the contract formation process rather than at the outset.[54] A duty to read is most sensibly seen as a check to ensure that the written agreement reflects the reader's actual intent. In order for that process to be meaningful, "intent" and "agreement" should precede, not follow, memorialization.

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52. Bart Simpson: "Mr. Hutz, when I grow up I want to be a lawyer just like you."
Lionel Hutz: "Good for you, son. If there is one thing America needs, it's more lawyers."

The Simpsons: (Fox Television Broadcast).

53. I may be overstating this "demand" for legal services. Professor Thomas' data suggests that policyholders usually contact their insurance agent when they have a coverage question. *See* Thomas, *supra* note 19. But Professor Thomas' data predates the explosion in the lawyer population and the advent of legal advertising. In any event, it is difficult to go anywhere today and not meet a lawyer, or someone who is related to a lawyer and is ready to refer potential clients to their lawyer spouse, child, relative, friend, or neighbor.

54. This is possible since most policies permit the policyholder to cancel without penalty if done so within a certain number of days after receiving the policy. The normal course of events is for the carrier to provide the policy at the conclusion of the bargaining process.

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This issue of pre-contract disclosures has been indirectly addressed in the context of the law of misrepresentation as applied to insurance contracts. The dominant tendency has been that courts do not expect policyholders to say or disclose much voluntarily. The policyholder's role is passive not active. While policyholders must answer questions posed on the application honestly, it is less frequently insisted that they do so accurately.[55] It is only infrequently insisted that policyholders volunteer information not requested by the carrier, even if the policyholder knows the carrier would consider the information material to the risk.[56] The rationale for this rule is the identification of the carrier as the expert in risk allocation and hence the one who can be relied on to secure adequate underwriting information by posing to the policyholder questions in the application it deems material to deciding whether to accept the risk. Decisions imposing a requirement to volunteer information are generally limited to marine insurance, whose tradition leads to its rule regarding compelled disclosure.[57]

The law of misrepresentation evidences that the carrier's primary concern is over the acquisition of information relevant to assessing the underwriting risk for the coverage(s) the carrier's are willing to provide. Depending on the type and nature of coverage sought, the carrier and the policyholder may

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55. This is not to suggest that "intent" is an element of the carrier's misrepresentation defense, for in most jurisdictions it is not. *See* ROBERT JERRY, UNDERSTANDING INSURANCE LAW § 102, pp. 682-83 (2d ed. 1996). Disclosure by the policyholder of his awareness or knowledge of all the facts, however, is often required when the complaint is the policyholder's failure to disclose enough information. *Id.* § 103 pp. 697-702 (noting that the distinction between misrepresentation, on the one hand, and non-disclosure or concealment, on the other hand, is difficult to define).

56. *See* St. Paul Fire & Marine Ins. Co. v. Jacobson, 48 F.3d 778, 780-81 (4th Cir. 1995) (applying Virginia Law) (holding that policyholder has no affirmative duty to volunteer information in application; rather, the policyholder is only required to disclose information that is asked of him); *see also* Berger v. Manhattan Life Ins. Co., 805 F. Supp. 1097, 1103-04 (S.D.N.Y. 1992) (applying New York law); Waxse v. Reserve Life Ins. Co., 809 P.2d 533 (Kan. 1991).

57. *See* Stecker v. American Home Fire Assur. Co., 84 N.E.2d 797 (N.Y. 1949) (noting that "[i]n marine insurance, the insured is bound, although no inquiry be made, to disclose every fact material to the risk, within his knowledge") *id.* at 798-99. In *Stecker* the court refused to extend the principle to "inland marine" insurance. *Id.* at 800. There are occasional suggestions that a duty to volunteer extends to reinsurance. Compagnie de Reassurance d'Ile de France v. New England Reinsurance Corp., 944 F. Supp. 986, 994 (D. Mass. 1996) (discussing the role of the "utmost good faith" requirement in the context of reinsurance and noting its limited application).

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address the issue of underwriting risk directly in contract language.[58] Some policyholders are obviously sophisticated and able to identify the legal consequences associated with the use of particular contract language. Many policyholders are not. This ability differential has created its own set of problems, particularly whether doctrines such as DRE should be applied differently depending upon the sophistication of the policyholder.[59] I will assume for purposes of this paper that a decision not to recognize such a distinction is the preferable choice as being more consistent with the goal of giving standardized language a consistent construction which supports certainty in the law.[60] My reading of the law is that, aside from supplying data relevant to underwriting as requested by the carrier, the policyholder is neither encouraged nor expected to raise its coverage expectations directly with the carrier. I do not mean to suggest that a policyholder has no role here at all. Certainly the policyholder must express herself when it comes to the type of policy, *e.g.,* automobile, homeowners, or umbrella, as well as the policy limits. Beyond that the law is effectively silent, but this silence has a deeper meaning for it strongly suggests the absence of an obligation *ex ante*. *Ex ante* is where such a duty must be cited if focusing on policyholder expectations is to have any meaning. To the extent no duty exists, the inevitable conclusion is that the policyholder's expectations are essentially fictional insofar as the bargain is concerned.

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58. When this is done, the insurance contract is referred to as a "manuscript" policy, *i.e.* a policy not using standardize language. Koch Eng'g. Co., Inc. v. Gilbraltar Cas. Co., Inc., 878 F. Supp. 1286, 1288 (E.D. Mo. 1995) (refusing to apply the doctrine of *contra proferentum* (construction against the drafter) when the parties negotiated a manuscript policy "the mere title of which indicates that it was not an adhesion, preprinted contract but a policy negotiated by two equal parties on a level playing field") *id.*

59. *See* Reliance Ins. Co. v. Moessner, 121 F.3d 895, 904-05 (3d Cir. 1997) (predicting that Pennsylvania would not foreclose the use of DRE because of the fact that the policyholder was a sophisticated purchaser of insurance); *see generally* Jeffrey Stempel, *Reassessing the "Sophisticated Policyholder" Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807 (1993).

60. Often a manuscript policy will use the same language as standard form policies. *See* Maryland Cas. Co. v. W.R. Grace & Co., 794 F. Supp. 1206, 1210 (S.D.N.Y. 1991). In this context the court may minimize the fact that the policy is manuscript. *See* AIU Ins. Co. v. Superior Court, 799 P.2d 1253, 1265 (Cal. 1990) (applying the rule that ambiguities are construed against the drafter even though the policyholder and the carrier were both legally sophisticated and possessed substantial bargaining power unless the carrier demonstrated that the term(s) at issue "were actually negotiated or jointly drafted."). In addition, the court stated that even actual negotiation may not suffice when standard form contract language was adopted by the parties. *Id.* at 1266 n.9

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If one agrees with the above assertion that whether a policyholder reads the policy terms is largely irrelevant to application of legal rules interpreting standardized policy language, and that policyholder input for purposes of contract formation is neither required nor desired, then the basic concession must be that the conduct of policyholders *ex ante* should have little to do with the actual meaning of the insurance contract! If policyholders have no duty to volunteer information and if reading the policy is essentially useless, it is difficult to support use of policy structure or language complexity as a basis for determining reasonable expectations, or any expectations for that matter. Reliance on the presence of policy language ambiguity suggests a "gotcha" quality to law rather than a principled and candid decision making process. If the policy is not read until after the loss has been sustained, what difference does it make that the language is obtuse, obscure, hidden, or prolix? Why should one part of the bargain be emphasized over the other? Language complexity or policy structure cannot really influence policyholder expectations in a way that is relevant to determining what coverage the policy actually provides. If as courts say, contract construction is a question of law for the court, not a question of fact for the jury,[61] what the policyholder thinks the policy means is no more relevant than what the jury thinks the policy means. DRE as implemented, ignores this basic fact.

B. Carrier Obligations

The carrier is the logical choice as the party responsible for defining the scope of coverage provided by the insurance contract. Having the power to draft unilaterally the contract terms, the carrier will be subject to legal constraints to prevent carriers from drafting one-sided bargains that unduly favor the carrier vis à vis the policyholder.[62]

It is frequently urged or implied by courts that carriers should and could draft better policies.[63] Unfortunately, like the proverbial better mousetrap, the

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61. *See* Estate of Gotcha by Gotcha v. Shimon, 573 N.W.2d 218, 220 (Wis. Ct. App. 1997); Morgan v. American Farm Mut. Ins. Co., 534 N.W.2d 92, 99 (Iowa 1995); Castro v. Fireman's Fund Am. Life Ins. Co., 253 Cal. Rptr. 833, 835 (Cal. Ct. App. 1988). Because insurance contract construction is a question of law, appellate courts should review the issue *de novo*. *See* Boatner v. Atlantic Specialty Ins. Co., 115 F.3d 1248, 1251 (5th Cir. 1997). DRE's formulation leads some courts to state that a more deferential review of the trial court's decision is warranted. *See, e.g.*, Haber v. St. Paul Guardian Ins. Co., 137 F.3d 691, 697 (2d Cir. 1998), *supra* notes 39-44 and accompanying text (reviewing the trial court's application of DRE under the "clearly erroneous" standard).

62. *See* Fischer, *Text v. Context*, *supra* note 25, at 1003-05.

63. This is the reasoning behind the doctrine of *contra proferentum*. As the drafter of the policy, the carrier is identified as being in the better position to remove ambiguity from the

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better policy seems to lie beyond the abilities of mere mortals to create. Recent efforts to rewrite policies in "Plain English" have not been shown to improve comprehensibility. Stating that a policy has been written in "Plain English" is not a guarantee that it is readable as plain English. While DRE may have effected some changes in policy format and organization, it is difficult to discern any notable improvement in policy readability over the past 25 years. Insurance policies, even basic consumer-oriented products, such as automobile and residential coverages, remain complex contracts.

It may be urged that DRE is justified as a means of encouraging carriers to warn policyholders about coverage gaps, traps, and perhaps even coverage needs. Many of the DRE cases involve what courts have characterized as hidden or obscure policy terms and policy language, and in this context, application of DRE is functionally analogous to tort failure to warn cases.[64] Indeed, DRE as an equity-based concept, is somewhat analogous to warranty as a tort-contract hybrid, particularly when warranties are implied for public

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contract. *See* Krombach v. Mayflower Ins. Co., 827 S.W.2d 208, 210-11 (Mo. 1992); Peerless Ins. Co. v. Wells, 580 A.2d 485, 493-94 (Vt. 1990); *see also* McLean v. Continental Cas. Co., No. 95 Civ. 10415 HB, 1997 W.L. 566117 (S.D.N.Y. 1997) (noting that an award of attorney's fees to the policyholder will "act as an incentive to insurance companies to draft plain policy language in plain English and expressly delineate policy exclusions . . .") *id.* at *3 (citation omitted).

64. *See, e.g.*, Tower Ins. Co., Inc. v. Foster, No. C6-96-227, 1996 W.L. 410304 (Minn. Ct. App. July 23, 1996) (applying DRE to provide coverage for a loss which involved a newly acquired vehicle). The policy provided coverage for physical damage to newly acquired property provided the carrier was notified of the acquisition within 30 days. The policy did not, however, purport to provide liability coverage for newly acquired property. (Coverage was provided through an endorsement which applied only to physical injury to the property.) The carrier argued the policy language clearly provided no liability coverage when the policyholder was involved in an accident with his newly acquired property — a snowmobile. The court disagreed, treating the provision as a hidden trap for the policyholder:

> Nothing in the policies or endorsements warned Cich that he would not have liability coverage for a new snowmobile if he relied on the 30-day reporting provision in the physical damage endorsements. Instead, the hidden exclusion, coupled with the language in the newly-acquired property clauses stating that Tower would "cover" newly-acquired property and that newly- acquired property "shall be insured" by Westfield, created an ambiguity as to which coverages applied to the new snowmobile during the 30-day reporting period.

Id. at *2. This again reemphasizes the inherent and unresolved inconsistency between and the rule that carriers and producers have no general duty to advise policyholders about their coverage needs. Unwilling to acknowledge a blanket duty, courts sanction a backdoor route that reaches the same result.

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policy reasons.[65] I believe this approach leads to the same results as the "public goods" argument. Nevertheless, as I have noted in this paper, a duty to warn or advise cannot be seen as a valid justification for DRE . Use of DRE in this context to advance a duty to warn or advise is directly contrary to the position courts have accepted rejecting a direct duty of carriers to advise.[66] Courts have given several reasons for this rule. First, there is the concern that imposing an affirmative duty to advise insureds would absolve insureds of any need to exercise due care with respect to their financial needs. Second, courts would have a difficult time quantifying and limiting such disclosures. Third, such a duty would encourage creative recollections by insureds as to what they would have done if adequately advised.[67] These same concerns could be voiced when DRE is used.

It is possible to reconcile these two positions by limiting the advisory or warning function of DRE to extreme situations, such as when coverage is illusory because the policy coverage does not meet the basic needs of the policyholder. This is another area where DRE is frequently invoked, although similar results are invoked without explicit use of DRE.[68] DRE has not been limited to the illusory coverage situation. DRE is often applied when the policyholder could have purchased the very coverage he now claims he had all along. Given the dominance of the specific rule negating a general duty to warn or advise policyholders regarding coverage, it is difficult to discern why courts should indirectly impose a duty through DRE when courts have rejected that same duty when they have expressly considered the issue.

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65. I thank Tom Baker for this insight and his suggestion that the Iowa Supreme Court's decision in *C&J Fertilizer, Inc. v. Allied Mutual Ins. Co.*, 227 N.W.2d 169 (Iowa 1975) (finding that an insurance policy should be construed in the context of having an implied warranty of fitness to the purpose for which coverage was sought) better advances the equitable values underlying than does as implemented.

66. *See* Schultz Steel Co. v. Rowan-Wilson, Inc., 231 Cal. Rptr. 715, 719-20 (Cal. Ct. App. 1986) (holding that an insurer owes no general duty to advise the insured as to the most appropriate liability coverage); Szelenyi v. Morse, Payson & Noyes Ins., 594 A.2d 1092, 1094 (Me. 1991) (stating that absent a special agency relationship, the insurance agent owes no duty to inform the insured as to an appropriate scope and level of coverage); Wang v. Allstate Ins. Co., 592 A.2d 527, 532 (N.J. 1991) (concluding that an insurer or agent does not have a common law duty to advise an insured concerning coverage limits upon policy renewal).

67. *See* Mutual of Omaha Ins. Co. v. Russell, 402 F.2d 339, 345-46 (10th Cir. 1968), *cert. denied*, 394 U.S. 973 (1969); Nelson v. Davidson, 456 N.W.2d 343, 346 (Wis. 1990).

68. *See* Great N. Oil Co. v. St. Paul Fire & Marine Ins. Co., 189 N.W.2d 404, 407-09 (Minn. 1971) (refusing to allow carrier to claim defense of impairment of right of subrogation arising out of policyholder's release of tortfeasor where release was part of customary business practice of policyholder).

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IV. THE UNBEARABLE LIGHTNESS OF THE DOCTRINE OF REASONABLE EXPECTATIONS

As an explanation of an anticipated deeper reason for insurance law decisions, DRE's utility must be questioned. The critical focus of DRE is on the "policyholder's" reasonable expectations; yet, how "reasonable" expectations are defined, determined, or formed is not addressed by the doctrine. Reasonableness is an ubiquitous term in American law. Unfortunately, while reasonableness may be descriptive, it is of much lesser value when one attempts to be predictive.[69] To suggest that reasonableness is the standard is to concede that a real unifying theory remains to be discovered. Reasonableness commits us to case-by-case determinations based on the facts of each situation. Such a theory or approach is capacious enough to describe the world that is, but it fails to predict individual outcome.[70] DRE is like "good faith" in that it is devoid of either internal or external criteria that provide meaningful, predictive guidance.[71] When using DRE, the court and the parties are ultimately relegated to a totality of the circumstances approach that largely fails to distinguish relevant from irrelevant fact insofar as issue resolution is concerned.[72]

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69. This is conceded by the advocates of DRE. ROBERT KEETON & ALAN WIDISS, INSURANCE LAW § 6.3 at 633 & n.17 (Student ed. 1988) (noting that the formulation of DRE wherein courts will protect the reasonable expectations of policyholders regarding coverage, even though a careful review of policy language would indicate that those expectations are contrary to the express terms of the policy, "is too general to give precise guidance, and it is subject to being construed either too broadly or too narrowly unless it is read with an awareness of the way it has been applied by a particular court of last resort in the relevant jurisdiction").

70. We might compare situations where the parties can contract with greater awareness of the actual outcomes, for example, settlements of personal injury claims. When, however, fewer than all the parties settle but wish to foreclose future claims by non-settling parties, it is necessary that the settlement be in "good faith." This good faith requirement is essentially a reasonableness test, is fact-dependent, and resists predetermination by rule. This ambiguity in the legal test for a preclusive settlement encourages settling parties to seek judicial confirmation that the settlement is fair and reasonable as to the non-settling parties.

71. *See* Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 206, 215 (1968) (stating that neither criteria nor standards can be developed for resolving other than ad hoc, whether conduct violates a "good faith" standard); *cf.* ROBERT E. SCOTT & DOUGLAS L. LESLIE, CONTRACT LAW AND THEORY 512-14 (2d ed. 1993) (stating that the doctrine of unconscionability may operate to relieve a party of the obligations of an improvident bargain and that unconscionability is an elastic concept, hard to pin down, which includes notions of unfairness, oppression, and unfair surprise).

72. Steven Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 371-72 (1980).

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This dissonance between DRE's descriptive and predictive abilities explains some of the confusion over the influence the doctrine has in insurance law today. Invoking DRE provides support for any decision a court wishes to make in the specific coverage dispute at hand. Reasonableness approaches evoke adequate principles to stand on in support of the position taken, but not ones that get in the way of adopting any particular position a court wishes to reach. If it would be "reasonable" to expect coverage, then a court will hardly deny that which is reasonable, i.e., coverage. The converse is also true; coverage will not be found when it would be unreasonable to do so.[73] Such a doctrine, in the absence of choice-influencing factors which guide decision making, is trivial. Giving DRE its due, how much better informed about the decision-making process are we given that DRE's fundamental tenet is its observation that courts want to be reasonable? Can we predict whether or when a particular coverage position will be deemed reasonable or unreasonable? The answer is, usually, that we cannot.

What is reasonable is inherently a subjective determination that is the antithesis of rule-based decision making. Courts and commentators can look at the same policy language and come to different conclusions regarding whether a reasonable person would expect coverage. The fact is that DRE fails to inform us why a court found for the policyholder or the carrier. DRE is simply a label applied to the decision making process *after* the decision has been made. DRE tells us that the *court's* reasonable expectations of coverage will be recognized, but DRE does not inform us, other than by a general reference to policy format or language complexity, how those expectations are generated. Frankly, my intuitive sense of the situation is that expectations are formed by the judge's review of the record, but that is a difficult standard to apply or substantiate.

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73. *See* Farmers Ins. Exchange v. Knopp, 58 Cal. Rptr. 2d 331, 335 (1996) ("If an insured could not reasonably expect coverage, we do not construe ambiguous language in favor of coverage."), *relying on* Bank of the West v. Superior Court, 833 P.2d 545 (Cal. 1992); *see also* American Home Assur. Co. v. Stephens, 943 F. Supp. 703, 710 (S.D. Tex. 1996) (stating that a "finding of ambiguity cannot be based upon an unreasonable understanding of the policy language on the part of the insured").

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V. IS THE INSURANCE CONTRACT "CHOPPED LIVER"?

Words have a purpose.[74] The essential, fundamental difficulty in insurance contract interpretation is that we have not resolved how much weight should be given to the insurance contract language itself or how much policy language should be discounted to achieve a "fair" or "equitable" result. This may be a task that is beyond the capability of the legal system to resolve by a rule that will generate consensus as long as the view is held that both contract language and the equity of the situation are legitimate considerations for defining the carrier-policyholder relationship. The divergence of views and authorities is itself evidence that either approach will in some instances work an injustice and thus must be constrained by the other. Such a balancing approach necessarily resists a rule-based orientation.

Efforts to relate DRE to more refined factors that would provide a more calibrated and exacting balancing test are, I believe, also futile. For example, Llewellyn's concept of the "dickered deal" has been picked up by some courts as a justification for DRE.[75] Insofar as insurance contracts are concerned, Llewellyn's bifurcated contract, distinguishing between the "dickered deal" and the "supplementary boilerplate"[76] suggests a starting point. The preference for the dickered deal over the boilerplate reflects the willingness to invest more meaning into contractual terms the parties negotiated. Thus, typed terms or an endorsement are thought to have more likely influenced the decision to enter into the contract because the fact of typing or the fact of an endorsement evidences the parties' attention to that specific matter.[77]

In the context of most insurance transactions, the divide between the dickered deal and the boilerplate is hard to find. The declaration sheet is the dickered deal, while the rest of the policy is the supplementary material. Llewellyn tells us that the law's task is to determine which of the supplemental

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74. Chelsea Indus., Inc. v. Accuray Leasing Corp., 699 F.2d 58, 60 (1st Cir. 1983) ("The first principle is that there is a normal assumption that a business transaction is not meaningless and that words have a purpose").

75. Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388, 395 (Ariz. 1984), *relying on* KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS 370 (1960).

76. LLEWELLYN, *supra* note 75, at 371 (noting that "boiler-plate is assented to en bloc, 'unsight, unseen,'" the assumption being that "its terms are neither in the particular nor in the net manifestly unreasonable and unfair").

77. Ivy Nelson Grain Co. v. Commercial Union Ins. Co., 453 P.2d 587, 588-89 (N.M. 1969) (involving a typewritten addition to a policy which was countermanded by boilerplate, standard form language in the body of the policy; preference was given to the typewritten addition over the boilerplate).

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terms are reasonable and, thus, to be applied (or implied), and which terms are unreasonable and, thus, to be disregarded. This approach will most often lead to the entire policy being treated as boilerplate. This brings us back to the "reasonableness" standard from which we began. Moreover, in most insurance coverage disputes, the contest is not over a conflict between language on the declaration sheet and language in the boilerplate, but between language in different parts of the boilerplate[78] or simply the meaning of boilerplate language itself.[79]

Reliance solely on the written word is often unworkable,[80] but we stall when we attempt to move beyond the written word. This is largely due to the fear that disregarding the parties' memorialization of the bargain knows no stopping point and put us on the proverbial "slippery slope" while riding the "unruly horse." What is often ignored, however, is that reliance on "plain meaning" creates uncertainty just as the use of extrinsic aids does, although, concededly, probably not as much.

What does "plain meaning" mean? How much weight should a court give to contract structure? Do the parts stand alone[81] or are they to be harmonized?[82]

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78. *See, e.g.*, Weedo v. Stone-E-Brick, Inc., 405 A.2d 788, 795 (N.J. 1979) (involving a coverage dispute over a conflict between two exclusions in the standard CGL policy).

79. *See, e.g.*, Gray v. Zurich Ins. Co., 419 P.2d 168, 174 (Cal. 1966) (involving the interpretation of an exclusion for damage caused "intentionally by or at the direction of the insured").

80. Kenneth Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 531 (1996) (noting that "given the modern recognition that language is an inherently imperfect instrument for communicating meaning, insurance policy provisions are in a sense always ambiguous"). The problem is not unique to insurance contracts. Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 COLUM. L. REV. 1710, 1712 (1997):

> No contract can fully and unequivocally address every question that may arise regarding its performance or nonperformance. Disagreements about the scope and meaning of contracts are a major source of disputes and adjudication. The practical significance of the rules used to resolve these disputes, the rules of contract interpretation and supplementation, is therefore manifest.

81. Weedo v. Stone-E-Brick, Inc., 405 A.2d 788, 795 (N.J. 1979) (stating that "[e]ach exclusion is meant to be read with the insuring agreement, independently of every other exclusion. The exclusions should be read seriatim, not cumulatively"); *but cf.* Fresard v. Michigan Millers Mut. Ins. Co., 296 N.W.2d 112 (Mich. Ct. App. 1980), *aff'd by an equally divided court*, 327 N.W.2d 286 (Mich. 1982) (holding that same coverage provisions as before *Weedo* court were ambiguous when read in conjunction with one another).

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Does order of structure suggest priority of importance?[83] A "plain meaning" test introduces some discretion-based decision making just as surely as reliance on extrinsic aids. Under any approach we may develop, which attempts to balance the interests of the policyholder and the carrier will introduce uncertainty into insurance law due to the prevalence of case-by-case determination to resolve ambiguity and achieve expectations, which are largely individualistic and context specific.

This is not to deny that alternatives do not exist. For example, a test which focuses on the risk/premium ratio may be a more accurate measure of reasonable coverage in doubtful or hard cases. This might require the carrier to demonstrate a correlation between the premium charged the policyholder and the risk assumed.[84] By and large, however, carriers have failed to make this case when given the opportunity to do so by courts.[85] Whether this is due

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82. Buehner Block Co. v. UWC Assocs., 752 P.2d 892, 895 (Utah 1988) (noting that "it is axiomatic that a contract should be interpreted so as to harmonize all of its provisions and all of its terms, and all of its terms should be given effect if it is possible to do so"); *see also* Humphrey v. O'Connor, 940 P.2d 1015, 1018 (Colo. Ct. App. 1996); Reda v. Eastman Kodak Co., 649 N.Y.S.2d 555, 557 (N.Y. App. Div. 1996).

83. Coker v. Coker, 650 S.W.2d 391, 393 (Tex. 1983) (stating that in harmonizing the provisions of a contract, a court should favor terms stated earlier in the agreement over later terms); *cf.* Pierre Schlag, *Hiding the Ball*, 71 N.Y.U. L. REV. 1681, 1689 (1996) (observing that attempting to give the Constitution a "plain meaning" is subject to structural and organizational qualifications).

84. I raise this concept, which others have characterized as commercial reasonableness, simply as an option and fully appreciate its underdevelopment in the context of insurance law. For a fuller development, see Thomas Diamond & Howard Foss, *Proposed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: A Framework for Resolving the Mystery*, 47 HASTINGS L.J. 585 (1996) (arguing that a party breaches implied good faith obligations when his conduct is commercially unreasonable and defining commercial unreasonableness as (1) conduct the breaching party would know would cause material injury to the other party and is not necessary to avoid contractual injury to oneself or (2) the failure to use a less harsh alternative).

85. *See* Weinberg v. Dinger, 524 A.2d 366 (N.J. 1987). The *Weinberg* court abolished immunity of water companies for failure to maintain adequate water pressure but refused to extend rule to insurers pursuing subrogation claims. The court, however, expressly noted that its holding was without prejudice to the right of a fire insurance carrier to offer proof tending to demonstrate that any increase in water rates resulting from liability for subrogation would be substantially offset by reductions in fire insurance premiums. If such a relationship were established, the court stated that it would reconsider its refusal to grant fire insurance carriers subrogation rights. *See id.*at 378. No subsequent decision indicates that the carriers have attempted such a proof. Similar offers have been made in the area of subrogation. In *Travelers Indem. Co. v. Chumbley*, 394 S.W.2d 418, 425 (Mo. Ct. App. 1965) the court rejected the automobile insurer's claim that there was a correlation between medical payment subrogation rights and medical payment premiums. The court deemed persuasive the fact that not *all* insurers sought subrogation for claims paid on automobile medical payments coverage. The

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to cost considerations, lack of sufficiently precise data, or the undesirability of the results to a carrier's coverage position is unclear. The mere fact the carrier would have provided additional coverage at a higher price is not determinative absent a showing that the base rate is actuarially sound with respect to the carrier's coverage position and unsound with respect to the policyholder's coverage position.

The objective theory of contract and the use of standard form agreements increase the likelihood that parties will enter into contracts not fully understanding nor appreciating the scope and extent of the commitment made.[86] It is sufficiently accurate to suggest that in many cases we might as well accept that for the most part insurance contracts are essentially unavoidably ambiguous products. To return to an earlier example, is it clear that collision with a pothole while driving on the highway amounts to "collision with an object"? Plausible arguments can be made both ways; however, it is unrealistic to accept the ability to make plausible arguments as a justification for finding coverage. There is some limit to the extent to which the insurance contract can be written to account expressly for every possible contingency. The more specific and defined policy language becomes and the more nuanced the provisions between covered and non-covered event, the more complex and prolix the policy becomes. On the other hand, if the carrier seeks to use comprehensive language to limit or exclude risks from coverage, the greater the danger the court will treat the exclusion as overinclusive. For example, many jurisdictions have adopted the primary or efficient cause test to determine whether the cause of the loss was a covered or excluded event.[87] Some carriers have sought to enhance the scope of their policy's exclusions by providing that if an excluded event contributed to a loss, the loss is not covered even if the primary cause of the loss is a covered event. While some courts

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insurers' conduct negated this insurer's claim that allowing subrogation would "work a perceptible reduction in the premium charged for such coverage." *Id. Cf.* EDWIN W. PATTERSON, ESSENTIALS OF INSURANCE LAW, 151-52 (2d ed. 1957) (subrogation plays little or no role in rate-fixing citing as evidence the fact that there is no premium reduction in insuring secured creditors, where the subrogation rule has obvious value); *see also* ROBERT E. KEETON, BASIC INSURANCE LAW 172 (1960).

86. W. David Slawson, *The Futile Search for Principles for Default Rules*, 3 S. CAL. INTERDISC. L. J. 29, 38 (1993) (stating that "the objective theory of contracts . . . dictates that a contract shall have the meaning that a reasonable person would give it under the circumstances under which it was made, if he knew everything he should plus everything [he] actually knew").

87. *See* Garvey v. State Farm Fire & Cas. Co., 770 P.2d 704, 715 (Cal. 1989).

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accept the carriers' efforts to narrow coverage,[88] other courts have found the carriers' efforts to be ineffectual.[89]

Could a carrier include language in the policy specifically disclaiming or contracting around DRE? If the doctrine rests on actual, or even hypothetical expectations, I think a strong case can be made that such contractual language would be respected.[90] If, however, DRE rests on public policy grounds, particularly as a counterweight to carrier strategic bargaining, then there is less likelihood such language would be enforced.[91]

Focusing on the policyholder's expectations of coverage to determine whether contract language will be disregarded distracts from the fundamental issue before the court: should courts treat insurance as a public good? Identification of insurance as a public good necessarily limits the extent to which the product provider (here, the carrier) can control the terms and conditions under which the product is provided to consumers (here, the policyholders). It is frankly unrealistic to expect that in an era when courts have developed extensive tort liability regimes predicated on loss distribution concepts, those regimes will be backed up by shallow pockets. A liability system without a funding bank is a hollow system that will eventually be ignored because the investment (a lawsuit) fails to yield a satisfactory return (payment). The presence of insurance serves as an incentive to sue, just as its absence serves as a disincentive.[92]

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88. *See, e.g.*, State Farm Fire & Cas. Co. v. Bongen, 925 P.2d 1042, 1045 (Alaska 1996) (collecting decisions permitting carrier to contract out of primary cause test).

89. *See, e.g.*, Sentinel Assocs. v. Am. Mfrs. Mut. Ins. Co., 804 F. Supp. 815, 819 (Ed. Va. 1992) (Hirschmann), *aff'd* 30 F.3d 130 (4th Cir. 1994); Safeco Ins. Co. Of Am. v. Hirschman, 773 P.2d 413, 414-15 (Wash. 1989) (refusing to apply language which undermined the primary cause test).

90. *See* Northfield Ins. Co. v. Barlow, 983 F. Supp. 1376, 1379-80 (N.D. Fla. 1997) (suggesting but not deciding that parties to a marine insurance contract can contract around disclosure doctrine of *Uberrima Fidei*). Since *uberrimae fidei* exists for the benefit of the carrier, little reason exists not to permit contracting around the doctrine, at least to the extent the waiver would not include intentional misconduct (fraud).

91. *See* Howell v. State Farm Fire & Cas. Co., 267 Cal. Rptr. 708, 719 (Cal. Ct. App. 1990) (Barry-Deal, J. concurring) (noting that for the court to hold that a statutory provision is immutable, *i.e.*, not subject to alteration by private contracting, then the provision must be found to state the public policy of the jurisdiction).

92. *See* Manuel Ramos, *Legal and Law School Malpractice: Confessions of a Lawyer's Lawyer and Law Professor*, 57 OHIO ST. L.J. 863, 872-73 (1996) (stating that decision whether to sue lawyer for legal malpractice was largely determined by presence of E&O coverage). This argument, concededly, does not directly apply to first-party coverages. There is, however, a strong judicial tendency to match risk with insurance which I sketched in James Fischer, *The Presence of Insurance and The Legal Allocation of Risk*, 2 CONN. INS. L.J. 1 (1996). Loss

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Courts importing equitable consideration into the construction of the insurance contract should be more honest and candid regarding why courts are construing insurance contracts liberally in favor of coverage. Pretending that the analysis is driven by a legal rule based on a fictitious viewpoint, i.e., the policyholder's expectations, does little to enhance the acceptability of judicial decisions as reasoned efforts to resolve hard choices.

CONCLUSION: WHITHER THE DOCTRINE OF REASONABLE EXPECTATIONS?

If, as I suggest, DRE tells us so little about why courts decide coverage disputes the way they do, why is DRE so influential? There are several reasons for this. First, as noted previously, DRE is a utilitarian vessel that supplies a patina of respectability to the decision-making process. The "ad hoc" nature of the process is dressed up in the guise of decision-making by principle.

Second, DRE represents a successful effort to further leverage what I have characterized as a pro-policyholder tilt or bias that courts have used for most of this century in resolving coverage disputes.[93] The ability to disaggregate pro-coverage doctrines increases the likelihood that a court will find coverage under one of the sub-doctrines. The operative rule here is that the parts are greater than the whole. Recognition or creation of a coverage enhancing sub-doctrine, much like viral mutation, increases the chances that one form of the mutation will survive, live long, and prosper.

The primary deficiency that I see in DRE is the muting of decisional accountability. DRE is founded on public policy considerations, but the focus of DRE is to refract general public policy concerns through the lens of the policyholder's expectations. The problem is that what DRE does and what it purports to do are not in synchronization. The language of DRE suggests that the decisional result is the product of either the policyholder's expectations of coverage or the carrier's failure to address the policyholder's expectations in the insurance contract or during the bargaining process. DRE, as applied, largely reads explicit consideration of public policy out of the decisional calculus when public policy is, in fact, central to the result reached. As a consequence, readers of the decision are sent a misleading message as to the reasons for the decision. Moreover, decision makers themselves may be encouraged to ignore reasons and factors that suggest coverage should be found or denied in favor of the subtle siren sounds of policyholder expectations. If DRE, as a new legal principle, at one time needed to disguise

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distribution goals may be extended to first party coverages and as extended would support treating insurance as a public good in this context.

93. *See* Fischer, *Text v. Context, supra* note 25.

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itself in an old form to gain acceptability and judicial recognition,[94] that time has long passed. DRE needs to shed its disguise of policyholder expectations and sustain itself on its true grounding of insurance as a public good and the corollary that coverage decisions should be based on public policy.

Johann Geothe once remarked, "Everything has been thought of before, the difficulty is to think of it again." Computerized research has sapped Geothe's comment of much of its force. This Thirtieth Anniversary of DRE will replicate much of what was said on earlier anniversaries of Judge Keeton's seminal piece. While the praise, complaints, and analyses continue, we might ask what has thirty years of explicit thinking about DRE told us or taught us about its use? My own sense of the matter is that the inquiry has advanced very little beyond Keeton's initial paper. DRE lacks a doctrinal justification and a rigorous fleshing out so that the contours of the doctrine may be discernible in advance. Of the two the former is for me the greater flaw. The very nature of DRE probably resists calculable, rule orientation. To paraphrase Judge Andrews who fought a similar battle on another front, "it is all a matter of expediency."[95]

DRE permits courts to reach results that are fair, without explicitly resting fairness on public policy, which courts are hesitant to invoke. Yet, judicial expectations of coverage—for that is all that DRE is, or ever has been—necessarily rests on a judicial conception of a result that is fair and just. It is ironic that "fairness" and "justness" must hide beneath a veneer of policyholder expectations. Let DRE be freed from this anchor and sail, or sink, under its own weight. If we do so, then, perhaps at the Fortieth anniversary of DRE, its true merits will be discernible.

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94. *See* Leon Green, *Basic Concepts: Persons, Property, Relations*, 24 A.B.A.J. 65 (1938) (noting that new legal principles must often disguise themselves in old forms to gain acceptance).

95. Palsgraf v. Long Island R.R. Co., 162 N.E. 99, 104 (N.Y. 1928) (Andrews J., dissenting) (discussing issues of duty and proximate cause): "It is all a question of expediency. There are no fixed rules to govern our judgment. There are simply matters of which we may take account. . . This is rather rhetoric than law. There is in truth little to guide us other than common sense."

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UNMET EXPECTATIONS: UNDUE RESTRICTION OF THE REASONABLE EXPECTATIONS APPROACH AND THE MISLEADING MYTHOLOGY OF JUDICIAL ROLE

*Jeffrey W. Stempel**

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INTRODUCTION

In my contribution to this Symposium I want to try to site the reasonable expectations doctrine on the jurisprudential landscape generally, to revisit the emergence of the concept, and to assess the legal profession's reaction to reasonable expectations. By doing so, I hope to explain to some degree the doctrine's seemingly sudden emergence, attraction to academics but resistance from elements of bench and bar, early growth, subsequent retreat, current status, and continuing controversy.

In brief and oversimplified peroration, my thesis is that the reasonable expectations concept, although long a tacit, tidal pull on insurance coverage jurisprudence, has never really been fully utilized as an analytical tool and has not yet been fully deployed in a self-consciously thoughtful and comprehensive manner.

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In part, this unfortunate underuse of reasonable expectations thinking resulted from the manner in which the doctrine burst on the scene, with emphasis on the reasonable expectations concept as something creating rights "at variance" with the language of the insurance policy. Although the reasonable expectations approach of course does this in a relatively small segment of the case law, it has far more potential impact as a tool for addressing uncertain policy language and application, potential that has been underutilized due to overfixation on the role of reasonable expectations in overcoming clearly worded policy language and the attendant jurisprudential debate this has engendered.

A complete and open embrace of the pure version of the doctrine as enunciated in Judge Keeton's famous article—which expressly provides for finding coverage consistent with the objectively reasonable expectations of the policyholder even where those expectations are contradicted by apparently clear policy language[1]—is viewed by much of the legal and political mainstream as too inconsistent with the prevailing American paradigm of judicial restraint, strict construction of disputed texts, and minimal government involvement in market activity. Some of this resistance to reasonable expectations is the product of an unrealistic reification of the prevailing American politico-legal philosophy of judicial restraint. Some of the resistance results from legitimate concerns about judicial lawmaking less tethered to text (of insurance policies, contracts, statutes, treaties, or documents in general). But although excessively reified and deified, the judicial restraint paradigm is unlikely to shift significantly unless American society incurs radical change. The resilience of the judicial restraint construct is understandable in that, for the most part, it has proven sound and apt for the American system.

Properly seen, however, the reasonable expectations doctrine, even in its strong "rights at variance" form, is actually consistent with the prevailing jurisprudential ethos because of the context of insurance coverage. Determining the "correct" meaning of an insurance policy inevitably requires not only a sharp focus on policy text but also full consideration of the reasonable expectations of *both insurer and insured*, even where those expectations to some extent run counter to the text and certainly where text is unclear, insufficiently certain, or applied to unanticipated situations. Contrary to the assertions of some courts and commentators, strong judicial invocation of the reasonable expectations

1. Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part I*, 83 HARV. L. REV. 961, 967 (1970).

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concept poses no threat to separation of powers and little serious obstacle toward vindicating the intent of the parties to the insurance contract and the purpose of the insuring agreement.

Viewed comprehensively, the reasonable expectations of the parties to an insurance contract can be used not only to construe ambiguous policy text or to overcome clear text violative of the insured's reasonable expectations but also to serve as a check on absurd hyperliteral interpretations of policy text. In addition, the reasonable expectations approach can assist courts in determining whether policy provisions are ambiguous or whether "painstaking" study of the policy suggests a clear meaning for problematic text. All of these varieties of the reasonable expectations approach merit more frequent, more expansive, and more self-consciously reflective use by the courts.

I. HISTORICAL PERSPECTIVE

A. The "Birth" of the Reasonable Expectations Doctrine

The Reasonable Expectations "Doctrine" was not identified as a separate mode of insurance policy construction until Professor (now Judge) Robert Keeton's famous article, *Insurance Law Rights at Variance with Policy Provisions*.[2] But Keeton had humility. Although he came to describe the consideration of expectations as moving from an identifiable "principle" during the 1960s to a "doctrine" in the 1970s,[3] he did not label

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2. *Id.* In this first of two articles, Keeton addressed the degree to which three factors—objectively reasonable policyholder expectations, detrimental reliance, and unconscionability—combined to give policyholders rights beyond the text of the insurance policy. In Part II of his project, Keeton discussed the legal evolution away from rigorous judicial enforcement of warranty provisions in insurance policies, which also tended to give the policyholder rights "at variance" with the policy language in that warranty provisions had historically been strictly construed in favor of the insurer rather than the policyholder. The second article also discussed insurer reservation of rights and regulatory controls on policy language and insurer practices. *See* Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part Two*, 83 HARV. L. REV. 1281 (1970).

3. Writing six years later, Judge Keeton expressly labeled the expectations consideration a principle during the 1960s but that "[b]efore a decade has passed, a new doctrine of reasonable expectations was solidly established" in one state and nearly rooted in other states. *See* Robert E. Keeton, *Reasonable Expectations in the Second Decade*, 12 FORUM 275 (1976). Keeton further elaborated on the distinction between doctrine and principle:

> In the early years of the 1970s judicial support for a doctrine of reasonable expectations gradually increased.

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or describe this development as a rule of black letter law. Rather, Keeton examined judicial decisions and attempted to find a uniform explanation for cases that seemed to stretch or torture the notion of linguistic ambiguity. Keeton summarized his assessment in the now-famous words:

> objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations.[4]

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As an aid to understanding this development in insurance law, it may be useful to observe a distinction between what we might call a "principle" and a "doctrine" of honoring reasonable expectations. What has happened in the 1960s and 1970s is explicit judicial endorsement of a new ground of decision—a development connoted by the term "doctrine." The influence of the principle was apparent even earlier, and its influence during the 1960s and 1970s was considerably more pervasive than the applications of the doctrine.

Because we depend on language to express substantive distinctions, we are always in danger of mistaking semantics for deeper substance. Nevertheless, the distinction between a "principle" and a "doctrine" of reasonable expectations is one of deeper substance, however imprecisely it may be expressed by our linguistic usages.

Principles collide in a sense beyond doctrinal conflict. Doctrines are sets of explicit rules of decision—the outcomes of accommodation among competing principles. Conflicts among doctrines are imperfections yet to be worked out as the operational rules of the legal system evolve. The collision of principles, on the other hand, is a phenomenon that does not signal imperfection of the legal system but rather signals the underlying conflict of interest with which the legal system must grapple.

Id. at 276-77.

4. Keeton, *supra* note 1, at 967. In addition, the Keeton article posited additional principles creating policyholder rights beyond the terms of insurance policy text. According to Keeton:

> If the enforcement of a policy provision would defeat the reasonable expectations of the great majority of policyholders to whose claims it is relevant, it will not be enforced even against those who know of its restrictive terms.

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According to Keeton, expectations analysis was utilized by courts on occasion to go beyond the normal benefit accorded the policyholder when policy language was unclear (in which case any ambiguities in the policy are construed against the policyholder and in favor of the insured). When courts apply "pure" reasonable expectations theory, the court mandates coverage consistent with the policyholder's expectations even if relatively clear policy language is to the contrary.[5] With all due respect to the "creator" of the doctrine, I disagree with Keeton to an extent. Even today, courts use expectations analysis so gingerly that calling it a doctrine rather than a principle seems too much. In my view, consideration of the reasonable expectations of the parties, primarily the insured, is an *approach* or *method* of interpretation more akin to a principle than a doctrine. Keeton defines doctrine as a set of explicit "rules" for decision. As I read reasonable expectations cases, even those most often cited as

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Id. at 974.

> An insurer will not be permitted an unconscionable advantage in an insurance transaction even though the policyholder or other person whose interests are affected has manifested fully informed consent.

Id. at 963.

> A policyholder or other person intended to receive benefits under an insurance policy is entitled to redress against the insurer to the extent of detriment he suffers because he or another person justifiably relied upon an agent's representation incidental to his employment for the insurer.

Id. at 977-78.

Thus, although the Keeton article is best know for its identification of and formulation of the reasonable expectations principle, Keeton also identified the reasonable expectations approach as preventing even defenses of actual knowledge and noted the importance of unconscionability and detrimental reliance as grounds for recover under an adversely worded policy.

5. The rationale for the approach is based on several factors: complexity of policy language; standardization of policies; the adhesion nature of most insurance policies; the contracting process, in which insureds almost never see the full policy until after it is in force and seldom read it; and the need to protect unsophisticated or vulnerable insureds. *See* Keeton, *supra* note 1, at 963-85; JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS § 11.3 (1994); Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 324-30 (1986); Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151, 1153-55 (1981); Stephen J. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1463-64 (1989).

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trumpeting the doctrine,[6] the courts hardly seem to be decreeing a consistently all-powerful "rule". More often, one has the sense that the courts are invoking the equity considerations implicit in reasonable expectations analysis to decide an at least moderately difficult case. Often, one senses an almost apologetic tone by the courts rather than the handing down of a decision by "rule".

But Keeton is surely correct that in the wake of his article, courts and commentators expressly identified expectations analysis as something more than ordinary equitable interpretation, focusing on the rights-at-variance "brand" of the reasonable expectations doctrine and debating the extent to which policyholder expectations should be permitted to trump "clear" contract provisions. Before swiftly reviewing the history of reaction to the "reasonable expectations doctrine", it is worth emphasizing what many observers apparently failed to note or have forgotten: Keeton was not purporting to comment comprehensively on the role of party expectations in determining the meaning of insurance policies across-the-board. Rather, Keeton wrote about a number of instances in which the policyholder might enjoy rights "at variance" with the specific language of the insurance policy. Court-ordered coverage consistent with the policyholder's objectively reasonable expectations was simply one instance giving rise to what might be termed "extra-textual" policyholder rights. Keeton's article specifically identified two other significant instances creating such rights for the policyholder: (1) when the strictly applied policy language would create an unconscionable advantage for the insurer; and (2) where the insured had relied to its detriment on representations or conduct of the insurer.[7]

In short, Keeton's work, masterful and far-reaching as it was, had a relatively narrow focus: examination of situations giving rise to policyholder rights in addition to or in contravention of policy text. The use of "rights at variance" reasonable expectations was but one part of the project. Keeton did not purport to provide the definitive statement on the role of reasonable expectations analysis in general, although he noted that the expectations principle was used in ways other than contravention of adverse policy language.[8] Instead, Keeton focused on the relatively small

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6. *See infra* cases cited in nn.21 and 22,

7. *See* Keeton, *supra* note 1.

8. For example, Keeton suggested that reasonable expectations thinking has been used to limit the application of the contra proferentem principle (requiring ambiguous policy language to be resolved against the drafting insurance company) so as to prevent absurd results.

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set of cases where insureds recovered even in the face of quite clear policy language to the contrary and identified and named the unifying thread of these decisions as the reasonable expectations principle creating rights at variance in certain circumstances. Obviously, the expectations principle had potential application in other situations as well. Nonetheless, because of the impact of the celebrated article, academic commentary, litigation behavior, and the socio-legal climate of the past 30 years, the legal profession focused relentlessly on the propriety of applying expectations analysis to countermand clear policy language. Although the reasonable expectations principle is also invoked as a means of construing unclear language, this application of expectations analysis has received considerably less attention in the wake of Keeton's famous article.

> [I]t might be objected that resolving ambiguities against the insurer would sometimes be more favorable to the insured than would honoring reasonable expectations. For example, even though the contractual language was ambiguous, there might be no expectations at all, or the expectation might be unreasonable, thus defeating a claimed expansion of coverage beyond the letter of the contract. It seems likely, however, that, even though not often expressed, there has always been an implicit understanding that ambiguities, which in most cases might be resolved in more than just one or the other of two ways, would be resolved favorably to the insured's claim only if a reasonable person in his position would have expected coverage.

Id. at 969 (citations omitted).

However, cases such as Rusthoven v. Commercial Standard Ins. Co., 387 N.W.2d 642 (Minn. 1986) (finding policy insuring 67 vehicles ambiguous as to uninsured motorist policy limits, Court requires insurer to provide 67 times the $25,000 per vehicle UM limit, requiring coverage of $1.675 million) (discussed *infra* notes 251-57 and accompanying text), in which the Court cited this very passage, suggest that reasonable expectations may provide only modest restraint upon the more longstanding and expressly accepted contra proferentem doctrine. *See also* Foremost Ins. Co. v. Putzier, 627 P.2d 317 (Idaho 1981) (finding third-party liability policy sufficiently ambiguous to permit policyholder to obtain first-party benefits based on agent's statement that policyholder was "covered"); Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171 (1995) (criticizing ambiguity rule as unfairly mandating coverage from mere drafting imprecision where insured could not have reasonably expected coverage and suggesting unconscionability analysis as preferable approach).

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B. Surge, Decline and Uncertainty About Support for the Doctrine

1. A New Doctrine for Debate

After Judge Keeton's article, the judicial activity undertaken to aid insured now had a name. Several courts accepted Keeton's analysis and overtly declared themselves to be followers of the reasonable expectations approach.[9] But, "the expectations principle [was and] is being employed in varying situations and with varying justifications."[10] Many courts had difficulty embracing a concept that they regarded as turning too quickly away from the traditional contract law principles positing that contract language should be enforced as written if it is sufficiently clear. These courts were willing to consider policyholder expectations only if policy language was ambiguous.[11] Other courts were willing to utilize the Keeton form of reasonable expectations analysis to overcome clear text, but only where language favorable to insurers was complex, hidden, arguably

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9. *See* STEMPEL, *supra* note 5, §11.1 at 312; Rahdert, *supra* note 5, at 324, 345-55; Abraham, *supra* note 5, 1153 n.7 (finding more than 100 "opinions voicing the expectations principle" decided "both before and after Professor Keeton's article"); Note, *A Reasonable Approach to the Doctrine of Reasonable Expectations as Applied to Insurance Contracts*, 13 U. MICH. J. L. REF. 603 (1980) (collecting cases discussing reasonable expectations).

Again, for historical fairness, I should note that Keeton suggested that the doctrine was "solidly established" in New Jersey prior to publication of his article. *See* Keeton, *supra* note 3, at 275 (citing five New Jersey cases). However, even if one reads these cases as solidly reasonable expectations in orientation, as does Keeton, the caselaw here and elsewhere did not use reasonable expectations terminology until after appearance of the Keeton article.

10. Abraham, *supra* note 5, at 1153. *See also* Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO. ST. L. J. 823 (1990); STEMPEL, *supra* note 5, §11.1 at 313:

> Determining the exact status of the reasonable expectations school is difficult. In many states, court discussion is intermeshed with other insurance contract terminology. In other states, only lower courts have invoked the term, sometimes with different assessments or at least different actual use of the concept.

11. *See, e.g.*, Rodman v. State Farm Mut. Auto. Ins. Co., 208 N.W.2d 903, 908 (Iowa 1973)(expectations of policyholder considered only when layperson would not understand exclusion at issue or where insurer conduct created expectation of coverage).

But, as noted above, my view is that courts permitting policyholder expectations to assist in interpreting ambiguous language have failed to provide thorough analysis of the reach and application of the expectations principle. Most such decisions merely note that ambiguous terms must be construed consistently with the reasonable expectations of the parties and then render a decision without further discussion of party expectations and their basis.

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unfairly surprising, or where the insured was a consumer or small business.[12]

Courts have for decades and perhaps centuries been using the policyholder's understanding of the policy as a tool for resolving coverage disputes. However, the conventional wisdom held that these considerations only applied if the policy language at issue was unclear or unconscionable. Keeton both debunked this conventional wisdom and attempted to synthesize case law finding coverage despite policy language favorable to insurers denying coverage.[13] According to Keeton, these cases could not be solely explained by reference to traditional doctrines such as unconscionability, waiver, estoppel, or construction of ambiguities in favor of the policyholder. Rather, the common thread in these cases was the court's willingness to provide coverage consistent with the objectively reasonable expectations of the policyholder even if policy text read literally would foreclose coverage.

The Keeton thesis rapidly caught the attention of the academic community and a good deal of the judiciary and practicing bar as well.[14] Although assessments vary, observers consider at least a dozen states to have adopted the doctrine in the form articulated by Judge Keeton while more than half the states have invoked the reasonable expectations concept with favor.[15] Usually, however, the form of reasonable expectations applied is one in which "application of the reasonable expectations doctrine is typically limited to cases in which the policy is ambiguous and the mutual intent of the parties cannot be determined."[16]

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12. *See, e.g.*, Atwater Creamery Co. v. Western National Mutual Ins. Co., 366 N.W. 2d 271 (Minn. 1985), particularly as reinterpreted in Board of Regents of Univ. of Minn. v. Royal Ins. Co., 517 N.W. 2d 888 (Minn. 1994).

13. *See* Keeton, *supra* note 1, at 968-977 (1970).

14. *See* STEMPEL, *supra* note 5, Ch. 11; Henderson, *supra* note 10, at 823-24 nn.5-8 (listing significant commentary on Keeton analysis and noting adoption of approach by many state courts) (summarizing commentary and developments in the wake of Keeton article).

15. *See, e.g.*, Henderson, *supra* note 10, at 823 n.5 ("[a]s many as sixteen states may be viewed as having adopted the doctrine, but it is not clear whether every court intended to embrace the broadest formulation.").

16. *See* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE §1.03[b] at 21 (9th ed. 1998) (citing cases).

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2. The Scorecard in the States: Acceptance and Rejection of a Variety of Expectations Doctrines

After its rapid initial success, however, the Keeton doctrine was subject to limitation, retrenchment, and even reversal in many states.[17] Today, by the most liberal count of two leading commentators, 38 states "have recognized some variation of the reasonable expectations doctrine".[18]

Usually, commentators divide states into (1) those that have adopted reasonable expectations analysis supporting rights at variance with policy text as set forth by Keeton;[19] (2) those that utilize the reasonable expectations of the policyholder in interpreting ambiguous policy language,[20] and (3) those that have completely rejected the doctrine.[21] As noted above, some commentators make a blunter cut, classifying states as jurisdictions accepting or rejecting the approach.[22] A review of the cases

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17. *See generally* STEMPEL, *supra* note 5; Rahdert, *supra* note 5 (describing state court decisions reversing or limiting earlier application of reasonable expectations doctrine).

18. *See* OSTRAGER & NEWMAN, *supra* note 16, § 1.03[b] at 22.

19. *See* Rahdert, *supra* note 5 (dividing states according to strong and moderate versions of reasonable expectations doctrine as well as those that have rejected doctrine). *See, e.g.*, C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169 (Iowa 1975) (case very similar to *Atwater Creamery*; insurance policy covers theft with no visible marks despite express policy language requiring visible marks; reasonable expectations of policyholder overcome clear exclusionary language); Kievet v. Loyal Protective Life Ins. Co., 170 A.2d 22 (N.J. 1961) (requiring coverage notwithstanding exclusionary language due to policyholder expectations). The Minnesota case *Atwater Creamery Co. v. Western National Mut. Ins. Co.*, 366 N.W. 2d 271 (1985) is frequently viewed as a leading case adopting the pure Keetonesque version of the doctrine. *See* discussion *infra* notes 40-62 and accompanying text. However, *Atwater Creamery* is arguably more limited in that subsequent Minnesota decisions have emphasized that the reasonable expectations can trump clear policy language only where the language is hidden or unfairly surprising. *See infra* notes 55-62 and accompanying text.

20. *See* Rahdert, *supra* note 5, at 367. *See, e.g.*, Tonkovic v. State Farm Mut. Auto Ins. Co., 521 A. 2d 920 (Pa. 1987); Nile Valley Coop. Grain & Milling Co. v. Farmers Elevator Mut. Ins. Co., 193 N.W.2d 752 (Neb. 1972).

21. *See* Rahdert, *supra* note 5, at 369-71. *See, e.g.*, Northbrook Excess & Surplus Ins. Co. v. Proctor & Gamble Co., 924 F.2d 633, 639 n. 8 (7th Cir. 1991) (reasonable expectations doctrine "strongly rejected by Ohio Courts"); Allen v. Prudential Property & Cas. Ins. Co., 839 P. 2d 789, 803-06 (Utah 1992) (rejecting approach on jurisprudential grounds of excessively expanding court powers in unguided manner); Casey v. Highlands Ins. Co., 600 P. 2d 1387 (Idaho 1979)(denying coverage to policyholder after property loss from theft because of clarity of exclusion requiring visible marks).

22. *See, e.g.*, OSTRAGER & NEWMAN, *supra* note 16, § 1.03[b] (dividing states into those that "recognize the reasonable expectations doctrine" (citing decisions in Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, the District of Columbia,

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suggests somewhat more variety in the manner in which courts employ the reasonable expectations concept. Commentators listing up to 38 states as approving the reasonable expectations doctrine characterize the reasonable expectations approach too broadly. Reasonable expectations analysis takes several forms ranging on a continuum from use only as a near last-resort means of resolving ambiguous contract language (the version of the approach normally least helpful to policyholders) to use as a principle of insurance law that overrides clear and obvious policy language (the version of the approach that is normally most helpful to policyholders). There are logically several versions of the reasonable expectations approach:

> 1) Acceptance of the "pure" Keeton approach where policyholder expectations can win out over even clear policy text;
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> 2) Construction in favor of policyholder expectations where the arguably clear language is hidden, surprising, or would seem to contravene the essence of the insurance product in question;
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> 3) Use of reasonable expectations in what Professor Kenneth Abraham has referred to as "mandated coverage" cases—situations where the court tacitly seems to declare that a certain sort of policy must cover certain perils;[23]

Georgia, Hawaii, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Pennsylvania, Rhode Island, Texas, West Virginia, and Wisconsin) and those "that have rejected the reasonable expectations doctrine (citing decisions in Florida, Utah, Ohio, South Carolina, Washington, Illinois and Idaho)).

When the list of states recognizing the doctrine is assessed more closely, it appears that fewer than a dozen states have applied the Keeton doctrine in rights at variance form. Certainly, New York is not a rights at variance state even though it may have "recognized" the role of reasonable expectations in construing unclear policy language. Conversely, until the January 1998 decisions in *Deni Assocs. of Florida, Inc. v. State Farm Fire & Cas. Ins. Co.*, and *E.C. Fogg, III v. Florida Farm Bureau Mut. Ins. Co.*, 711 So.2d 1135 (Fla. 1998), it was not clear that Florida had definitively rejected the doctrine.

23. *See* Abraham, *supra* note 5, at 1162-63.

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> 4) Enforcement of the insurance contract in favor of the insured's expectations due to estoppel-like conduct by the insurer;
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> 5) Consideration of policyholder expectations in determining the proper construction to give to ambiguous language in dispute;
>
> 6) Rejection of any role for policyholder expectations;
>
> 7) In addition, as observed by the Keeton article, courts often use the reasonable expectations concept to avoid coverage where the insured, despite ambiguous or seemingly favorable language, is asserting a right to coverage that is unreasonable or at odds with basic insurance concepts such as fortuity, moral hazard, or adverse selection.[24]

As noted above, the number of jurisdictions that has adopted this "pure" version of the Keeton doctrine is relatively small, numbering approximately a half-dozen. It includes states generally regarded as more progressive and favorable to consumers and claimants: California;[25] New Jersey,[26] Pennsylvania,[27] and the District of Columbia.[28] Also appearing at

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24. *See* Keeton, *supra* note 1, at 969. Notions of reasonable expectations also are used to prevent unfair or fraudulent attempts to obtain coverage for intentionally caused injury, previously indemnified amounts, or recovery where the policyholder lacks an insurable interest in the subject matter of the policy. In these sorts of cases, the reasonable expectations doctrine can be seen as evenhanded as between insurers and policyholders, although courts usually describe the doctrine as one focusing on the reasonable expectations of the insured.

25. *See, e.g.*, Gray v. Zurich Ins. Co., 419 P. 2d 180 (Cal. 1966) (finding coverage for assault and battery claim under homeowner's policy despite clear intentional conduct exclusion). *But see* Bank of the West v. Superior Court, 833 P. 2d 545 (Cal. 1992) (apparently modifying doctrine narrowing range of policyholder expectations considered reasonable and suggesting inapplicability of the doctrine where exclusionary language is both clear and consistent with the purpose of the insurance policy).

26. *See, e.g.*, Kievet v. Loyal Protective Life Ins. Co., 170 A.2d 22 (N.J. 1961) (finding coverage for commercial activities under homeowner's policy despite clear business activities exclusion). Subsequent New Jersey decisions appear to have backed away from a broad form of the reasonable expectations doctrine to one requiring ambiguity, *see, e.g.*, DiOrio v. New Jersey Mfrs. Co., 398 A. 2d 1274, 1280-81 (N.J. 1979), but then returned to a stronger form of the doctrine consistent with the Keeton formulation. *See, e.g.*, Sparks v. St. Paul Ins. Co., 495 A.2d 406, 414-15 (N.J. 1985) (scope of coverage provided by text of lawyers' professional liability policy invalidated for failing to meet "objectively reasonable expectations" of

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least at one time to endorse the full dress form of the reasonable expectations doctrine are Hawaii,[29] Idaho,[30] Iowa,[31] Minnesota,[32] and Nevada.[33] Today, however, Idaho, Iowa, and Pennsylvania have since disapproved the pure reasonable expectations doctrine and instead appear

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policyholder; court declines to set forth criteria for assessing reasonableness of policyholder views). But, on the central issue of the case—the general validity of a claims-made form of commercial general liability (CGL) policy—the court rejected the argument that the claims-made form of trigger would violate the reasonable expectations of the insured. However, the particularly narrow form of claims-made coverage provided by the policy in question, which provided no retroactive coverage (understandably a concern for attorneys whose prior matters are all potential time bombs) was unenforceable because of its contravention of policyholder expectations. *See also* Morton Int'l v. General Accident Ins. Co., 629 A. 2d 831 (N.J. 1993) (construing "sudden and accidental" pollution exclusion not to preclude coverage for gradual pollution claims against insured due in part to manner in which the exclusion was characterized when amended in 1970s and degree to which policyholders would have reasonable expectation of coverage for unintended pollution).

27. *See, e.g.*, Collister v. Nationwide Life Ins. Co., 388 A. 2d 1346 (Pa. 1978) (ordering temporary coverage in conditional receipt case despite language restricting coverage unless applicant is deemed insurable by company); Hionis v. Northern Mut. Ins. Co., 327 A. 2d 363 (1974) (requiring that even clearly written exclusions be called to attention of applicant or policyholder if they are to be enforced). Subsequent Pennsylvania cases have backed away from the *Hionis* approach, *see* e.g., Standard Venetian Blind Co. v. American Empire Ins. Co., 469 A. 2d 563 (Pa. 1983), and suggest that Pennsylvania is now a "middle level" reasonable expectations state that uses the approach in combination with ambiguity analysis to resolve disputed and allegedly ambiguous language. *See* Tonkovic v. State Farm Mut. Auto Ins. Co., 521 A. 2d 920 (Pa. 1987).

28. *See, e.g.*, Owens-Illinois, Inc. v. Aetna Cas. & Sur. Co., 597 F. Supp. 1515 (D.D.C. 1984).

29. *See, e.g.*, Crawford v. Ranger Ins. Co., 653 F. 2d 1248 (9th Cir. 1981) (applying Hawaii law).

30. *See, e.g.*, Corgatelli v. Globe Life & Accident Ins. Co., 533 P.2d 737 (Idaho 1975) (providing coverage for partially separated shoulder under accident policy even though policy language required complete break or dislocation). However, in *Casey v. Highlands Ins. Co.*, 600 P. 2d 1387 (Idaho 1979) (denying coverage for burglary because of absence of visible marks of entry), the Idaho Supreme Court expressly rejected the reasonable expectations doctrine in any form and overruled *Corgatelli.*

31. *See, e.g.*, C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W. 2d 169 (Iowa 1975) (providing coverage for burglary loss with no visible marks despite policy language requiring visible marks of entry for coverage). *But see* Farm Bureau Mut. Ins. Co. v. Sandbulte, 302 N.W. 2d 104 (Iowa 1981) (moving away from pure reasonable expectations doctrine to requirement that policy language in question be ambiguous, bizarre, or oppressive to provide coverage based on policyholder expectations).

32. Atwater Creamery Co. v. Western Nat'l Mut. Ins. Co., 366 N.W. 2d 271 (Minn. 1985) (providing for coverage for burglary despite absence of visible marks of entry). *But see infra* notes 53-62 and accompanying text (describing subsequent developments in Minnesota).

33. *See, e.g.*, Farmers Ins. Exch. v. Young, 832 P. 2d 376 (Nev. 1992).

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to use expectations analysis only when contested policy language is ambiguous or otherwise problematic.[34] Minnesota does not require ambiguous language as a trigger for expectations analysis but does require that the exclusionary language at issue be in some way hidden or surprising to the policyholder.[35] New Jersey is seen by some commentators as similarly having moved from pure reasonable expectations analysis to expectations as a tool for resolving ambiguous language and then back again.[36]

3. Progress, Retrenchment, Stability

Within the first decade after Keeton's seminal article, the major four variants (acceptance, rejection, use only in response to hidden exclusions; use only for construing ambiguous language) of the "reasonable expectations doctrine" had already become known. On the whole, the 1970s can be seen as something of a "growth period" for the reasonable expectations doctrine. The doctrine, unnamed until Keeton's article, was widely discussed and utilized, with adoption in seemingly pure form in several states. In part this was undoubtedly because courts in some states merely began to name what they had been doing for some time. The 1980s continued to see growth in support for reasonable expectations analysis but also began to reveal some backpedaling by courts that had adopted the doctrine as well as less tendency in other states to embrace the reasonable expectations method. The cases of the 1990s suggest that the reasonable expectations "plebiscite" among the states is remaining relatively stable, with few states changing their respective positions on the doctrine.[37]

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34. *See supra* notes 27, 30, and 31.

35. *See infra* notes 40-62 and accompanying text.

36. *See* STEMPEL, *supra* note 5, § 11.4.4 at 348-49.

37. A Lexis search of caselaw in the 1970s reveals 36 cases citing to either the Keeton *Rights at Variance* article or discussion of the reasonable expectations principle in Keeton's insurance law treatise, ROBERT E. KEETON, BASIC TEXT ON INSURANCE LAW (1971). Prior to 1970, there is no express discussion of a reasonable expectations principle and no express suggestion that clear policy text could be overcome not only by unconscionability or actual estoppel but by policyholder expectations.

In the 1980s, 73 cases discuss the expectations principle and cite to one of the Keeton sources, with 61 cases doing so during the period from 1990 to the present. Those numbers increase to 89 and 75, respectively when citations to the Second Edition of the Keeton treatise, co-authored with Prof. Alan Widiss, is included. Although the 1980s and 1990s show more actual case use of the expectations principle, it remains accurate to view the 1970s as the period of doctrinal growth during which the reasonable expectations principle went from being undefined to being recognized as a "doctrine" and embraced by a significant number of courts.

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A classic example of relatively early embrace of the reasonable expectations doctrine is found in two cases involving burglary insurance. In *C & J Fertilizer, Inc. v. Allied Mutual Insurance Co.*.[38] The insured collected under a burglary policy even though the policy stated that "visible marks of entry" were required for coverage and no such visible marks were present. The court cited the Keeton article favorably and appeared to have embraced the "rights at variance" version of the reasonable expectations doctrine, although subsequently, Iowa courts stated that insured could not benefit from the reasonable expectations approach in the face of clear language unless the limitation on coverage was "bizarre or oppressive" or eliminated the dominant purpose of the insuring agreement.[39]

a. The Minnesota story: an illustration of the limited acceptance of the reasonable expectations concept through the stunted growth of the children of *Atwater Creamery*

Minnesota's response to reasonable expectations was slightly different but similarly enthusiastic in that Minnesota seemingly embraced reasonable expectations analysis, also in a burglary claim without visible marks as did the Iowa courts. In *Atwater Creamery Co. v. Western National Mutual Insurance Co.*,[40] the Minnesota Supreme Court examined a burglary insurance coverage dispute where the burglary lacked visible marks of entry, a type of coverage dispute that appears to test the receptiveness of state courts to the Keeton approach. This type of case prompted Iowa to adopt the doctrine[41] while Nebraska implicitly rejected it.[42] Idaho was so troubled that it decided the case in favor of the insurer

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38. 227 N.W. 2d 169 (Iowa 1975).

39. *See* Farm Bureau Mut. Ins. Co. v. Sandblute, 302 N.W.2d 104 (Iowa 1981).

40. 366 N.W.2d 271 (Minn. 1985).

41. *See* C. & J. Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169 (Iowa 1975).

42. *See* Cochran v. MFA Mut. Ins. Co. , 271 N.W.2d 331 (Neb. 1978) (finding no coverage for auto theft accomplished by "jiggle key" that left no scars on car). Although the Nebraska court rejected a pure version of reasonable expectations analysis in the auto theft case, *Cochran* did not reject use of policyholder expectations as a tool for construction. Like most states, Nebraska considers policyholder expectations in interpreting ambiguous insurance contracts. *See, e.g.*, Nile Valley Coop. Grain & Milling Co. v. Farmers Elevator Mut. Ins. Co., 193 N.W.2d 752 (Neb. 1972).

In *Cochran*, the Nebraska court viewed the "visible marks" standard as a not unconscionable definition of coverage rather than a surprising limitation on otherwise broad burglary coverage. It is worth noting, however, that in *Cochran*, the insured was a professional

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and expressly reversed earlier precedent adopting the pure form of the reasonable expectations doctrine.[43] In *Atwater Creamery*, Minnesota appeared to opt for the full-fledged version of the Keeton doctrine and found coverage notwithstanding that the "visible marks of entry" burglary definition was not literally satisfied.

The policyholder was a creamery and feed store in rural Minnesota. The policy definition of burglary read:

> [A covered theft is] the felonious abstraction of insured property (1) from within the premises by a person making felonious entry therein by actual force and violence, of which force and violence there are visible marks made by tools, explosives, electricity or chemicals upon or physical damage to, the exterior of the premises at the place of such entry, or . . . (3) from within the premises by a person making felonious exit therefrom by actual force and violence as evidence by visible marks made by tools, explosives, electricity or chemicals upon or physical damage to, the interior of the premises at the place of such exit.[44]

Chemicals worth more than $15,000 were stolen from the insured's warehouse, with the locks removed and the doors open (sufficiently to drive a truck into the warehouse). The policyholder admitted to not reading the policy. The insurance agent testified that he had "mentioned" the evidence of forced entry provision sometime during the sales or coverage period but was uncertain regarding the time. The *Atwater* court defined the issue as "whether the reasonable expectations of the insured as to coverage govern to defeat the literal language of the policy".[45] The Court noted that policy definition of burglary is different and more limited than the criminal statute's definition, a difference the Court regarded as

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locksmith, the policy's visible marks standard applied to thefts away from the policyholder's business premises but apparently not to on-premises thefts, and the physical evidence attending the loss was suspiciously neat. The insured's truck was stolen but recovered unharmed, with a jiggle key conveniently left in the ignition but the insured's tools conveniently missing. Expectations indeed!

43. *See* Casey v. Highlands Ins. Co., 600 P.2d 1387 (Idaho 1979) (reversing *Corgatelli v. Globe Life & Accident Ins. Co.*, 533 P.2d 737, 740-41 (Idaho 1975), which had adopted Keeton version of expectations doctrine to find health insurance coverage for rodeo cowboy notwithstanding exclusion.

44. 366 N.W.2d at 275.

45. *Id.*

germane to the insured's reasonable expectations in purchasing burglary insurance.[46]

The Court also assessed the insurer's purpose in writing a visible marks requirement into the policy.

> These purposes are two: to protect insurance companies from fraud by way of 'inside jobs' and to encourage insured to reasonably secure the premises. As long as the theft involved clearly neither an inside job nor the result of a lack of secured premises, some courts have simply held that the definition does not apply.
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> * * *
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> We are uncomfortable, however, with this analysis given the right of an insurer to limit the risk against which it will indemnify insured.
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> * * *
>
> The policy attempts to comprehensively define burglaries that are covered by it. In essence, this [purpose dominated interpretative] approach ignores the policy definition altogether and substitutes the court's or the statute's definition of burglary. This we decline to do, either via the conformity clause or by calling the policy definition merely one form of evidence of a burglary.[47]

The Court reviewed cases accepting or rejecting similar purpose-based approaches to interpreting insurance policies and found them too divorced from the actual policy language to be useful. However, the Court found no such infirmities with the Keeton doctrine. It noted that the burglary definition "constitutes a rather hidden exclusion from coverage"[48] and that exclusions are ordinarily strictly construed against the insurer. The Court then cited Keeton's article in the course of observing that the visible marks requirement is "surprisingly restrictive" and that "no one purchasing something called burglary insurance would expect coverage to exclude skilled burglaries that leave no visible marks of forcible entry or exit."[49]

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46. *Id.*
47. *Id.* at 276 (citations omitted).
48. *Id.*
49. *Id.*

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The Minnesota Court in *Atwater Creamery* cited favorably Iowa's *C & J Fertilizer, Inc. v. Allied Mutual Insurance Co.*.[50] But, more than the Iowa court, Minnesota emphasized the "hidden" or "surprising" nature of the visible marks exclusion. Despite this, *Atwater Creamery* also embraced the Keeton reasonable expectations concept in broad conceptual terms:

> The reasonable-expectations doctrine gives the court a standard by which to construe insurance contracts without having to rely on arbitrary rules which do not reflect real-life situations and without having to bend and stretch those rules to do justice in individual cases. As Professor Keeton points out, ambiguity in the language of the contract is not irrelevant under this standard but becomes a factor in determining the reasonable expectations of the insured, along with such factors as whether the insured was told of important but obscure conditions or exclusions and whether the particular provision in the contract at issue is an item known by the public generally. The doctrine does not automatically remove from the insured a responsibility to read the policy. It does, however, recognize that in certain instances, such as where major exclusions are hidden in the definitions section, the insured should be held only to reasonable knowledge of the literal terms and conditions. The insured may show what actual expectations he or she had, but the factfinder should determine whether those expectations were reasonable under the circumstances.
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> * * *
>
> In our view, the reasonable expectations doctrine does not automatically mandate either pro-insurer or pro-insured results. It does place a burden on insurance companies to communicate coverage and exclusions of policies accurately and clearly. It does require that expectations of coverage by the insured be reasonable under the circumstances. Neither of those requirements seems overly burdensome. Properly used, the doctrine will result in coverage in some cases and in no coverage and others.[51]

50. 227 N.W.2d 169 (Iowa 1975).

51. *Atwater Creamery*, 366 N.W.2d at 278.

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The Iowa decision in *C & J Fertilizer* and the Minnesota decision in *Atwater* represent perhaps as pure a self-conscious reference to and incorporation of scholarly theory or method as one finds in the messy real world of actual litigation. Not surprisingly, both *C & J Fertilizer* and *Atwater Creamery* have become well-known for this reason and has been reprinted at length in many of the leading insurance law case books as the paradigmatic example of the Keeton reasonable expectations doctrine in action.[52]

However, over the course of the ensuing decade, subsequent cases in Minnesota limited *Atwater Creamery* to only a moderate or limited version of reasonable expectations analysis, limiting the use of "rights at variance" expectations analysis to cases of hidden or deceptive policy language.[53] In *Board of Regents of the University of Minnesota v. Royal Insurance Co.*,[54] Minnesota Justices who had dissented from earlier reasonable expectations rulings effected a substantial change in the law, removing the remnants of the Keeton version of the reasonable expectations doctrine from *Atwater Creamery*. *Regents v. Royal*, authored by *Atwater* dissenter Justice John Simonett, involved the University of Minnesota which, having settled with

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52. *See, e.g.*, KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 53 (2d ed. 1995) (*Atwater Creamery* reproduced; also reprinted in original edition); EMERIC FISCHER & PETER N. SWISHER, PRINCIPLES OF INSURANCE LAW 570 (2d ed. 1994) (reprinting *C & J Fertilizer*); ALAN I. WIDISS, INSURANCE: MATERIALS ON FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES & REGULATORY ACTS 599, 614, 660 (1989) (reprinting *C & J Fertilizer* and discussing the case in notes); WILLIAM F. YOUNG & ERIC M. HOLMES, INSURANCE: CASES & MATERIALS 83 (2d ed. 1985) (reproducing *C & J Fertilizer*). *But see* KENNETH H. YORK, JOHN W. WHELEN & LEO P. MARTINEZ, CASES, MATERIALS & PROBLEMS ON GENERAL PRACTICE INSURANCE LAW (3d ed. 1994) (reprinting neither *Atwater Creamery* nor *C & J. Fertilizer*); SPENCER L. KIMBALL, CASES & MATERIALS ON INSURANCE LAW (1992) (same).

53. *See, e.g.*, Hubred v. Control Data Corp., 442 N.W.2d 308 (Minn. 1989) (reaffirming *Atwater* but finding against insured medical benefits claimant, quickly deeming an exclusion to be clear and also using reasonable expectations reasoning against the claimant); Minnesota Mining and Mfg. Co. v. Travelers Indem. Co., 457 N.W.2d 175 (Minn. 1990) (using a mixture of ambiguity and reasonable expectations analysis to find that environmental remission costs qualified as "damages" under a CGL, a determination that met with a strong dissent, as did *Atwater Creamery*). *But see* Eiynk v. Sabrowsky, 524 N.W.2d 297 (Minn. App. 1994) (expectations analysis precludes insurer from reducing coverage through added exclusion done as pro forma dispatch of boilerplate update of policy); Amatuzio v. United States Fire Ins. Co., 409 N.W.2d 278 (Minn. App. 1987) (policy endorsement providing coverage for FAA authorized "aerobatic flight, air shows or aerobatic competition" includes "air racing" and does not bar coverage where insurer knew of policyholder's participation in such events and failed to call the exclusionary language to the attention of the policyholder or utilize clearer language).

54. 517 N.W.2d 888 (Minn. 1994).

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asbestos suppliers for costs associated with asbestos abatement, sought to enforce the settlement against the insurers. Both primary and excess insurers raised the pollution exclusions of their respective policies. The primary policies contained the "standard 1973 Form pollution exclusion" barring coverage for pollutants discharged into the "atmosphere" unless the release was "sudden and accidental" while the excess carriers employed an "absolute" pollution applying to "real or personal property".

The *Regents v. Royal* Court sensibly concluded that a building's interior was not "atmosphere" within the meaning of the primary policy pollution exclusion but more problematically found the claim uncovered by the excess insurance policies because the excess exclusion applied not only to discharges into the atmosphere but also to any pollution of real property, forgoing any serious consideration of whether asbestos contamination of a building was really what insureds and ordinary contracting parties would envision when reading a "pollution" exclusion.[55] Although the language of the primary and excess policies clearly differs, the Court placed undue emphasis on the differing language despite purportedly adopting a contextual approach to insurance contract interpretation.[56]

By focusing so narrowly on whether the exclusion was spatially limited as an "indoor" or "outdoor" exclusion, the court overlooked the very real possibility that "pollution" itself is arguably an ambiguous term when applied to building injury claims. To restate: has an asbestos contaminated building been "polluted" or is its value reduced because the supplier used a defective material whose defect is its inadequacy, toxicity or other capacity for injury, as if the building were riddled with weak rivets about to release causing the building to sag? The *Regents v. Royal Court* does not really examine this issue of policy meaning but rather rushes to embrace the view that because asbestos is an irritant it must fit within a pollution exclusion that mentions irritants. But when we speak of a "sick" or problem building, we normally do not think of this as "pollution" so much as poor construction or materials.

Furthermore, *Regents v. Royal* also went out of its way to limit *Atwater Creamery* and to overrule the use of *Atwater*/Keeton style reasonable expectations analysis found in an intermediate state Court of Appeals case, *Grinnell Mutual Reinsurance Co. v. Wasmuth.*[57] *Grinnell* found coverage

55. *See id.* at 893.

56. *See id.* at 892-93.

57. 432 N.W.2d 495 (Minn. App. 1988).

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notwithstanding a pollution exclusion for a policyholder whose claim arose from formaldehyde fumes emitted by insulation material in the home, a seemingly sensible determination the *Regents v. Royal* Court viewed as troubling, stating:

> [t]he court of appeals [in *Wasmuth*] found insurance coverage, holding that an insured would not reasonably have expected its comprehensive general liability policy to exclude coverage for "unexpected damage due to installation of building materials in a home." The reasonable expectations test [of *Atwater Creamery*], however, has no place here, and the contrary ruling of Grinnell is overruled. In Atwater, we held that where major exclusions are hidden in the definitions section, the insured should be held only to reasonable knowledge of the literal terms and conditions." In the comprehensive general liability policy involved in this case, the pollution exclusion is plainly designated as such; consequently, the wording of the exclusion should be construed, if a claim of ambiguity is raised, in accordance with the usual rules of interpretation governing insurance contracts. The reasonable expectations test is not a license to ignore the pollution exclusion in this case nor to rewrite the exclusion solely to conform to a result that the insured might prefer.[58]

In a footnote, the *Regents v. Royal* Court moved to further restrict *Atwater*'s reach by emphasizing the "hidden or deceptive language" aspect of *Atwater* rather than the other portions of the opinion praising the Keeton version of the doctrine. *Regents v. Royal*'s cavalier treatment of expectations concerns is troubling. Surely insulation suppliers would expect that when sued for products liability claims, their CGL insurance policies will be available to protect against such lawsuits (absent, perhaps, a specific products liability exclusion). For example, a purveyor of fiberglass insulation that scratched the occupant (e.g., if the insulation were exposed in the attic), causing serious bleeding would be covered under the typical CGL. If instead, the occupant is injured by the fumes of formaldehyde insulation, it seems odd that this should be excluded from coverage even though this may literally be a release of an irritating

58. *Regents*, 517 N.W.2d at 891 (citations omitted).

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substance. Construing the pollution exclusion so broadly seriously shrinks available coverage, effectively transforming it into a specific risk policy rather than the all-risk CGL marketed to policyholders.

> Atwater Creamery presented a unique situation. Under the policy definition, there was no "burglary" on the insured's premises, even though admittedly a burglary had occurred and even though the policy was a "Mercantile Open Stock Burglary Policy" For there to be a burglary, the policy definition required that there be a burglar who left visible marks of a forcible entry or exit. If, as was the case in Atwater, the burglar is skillful enough to leave no marks, there is no "burglary." This "visible marks" qualification, we said in Atwater, was really a "hidden" or masked exclusion, impermissibly disguised within the definition section of the policy. The Iowa Supreme Court, it is interesting to note, has limited the application of its reasonable expectations doctrine to egregious situations similar to that in Atwater.[59]

Regents v. Royal narrows *Atwater* from an arguably pure Keeton reasonable expectations analysis to a moderate expectations jurisdiction that employs the concept as a means of interpreting ambiguous language or overcoming clear but furtive language restricting coverage. Effectively, Minnesota, like Iowa,[60] moved from being a "cutting edge" Keeton-style reasonable expectations jurisdiction in 1985 to a mainstream jurisdiction

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59. *Id.* at 891 n.4 (citing Atwater and AID (Mut.) Ins. v. Steffen, 423 N.W. 2d 189, 192 (Iowa 1988)). *Steffen* involved an insured's claim to have coverage for patent litigation expenses when customers refused to pay royalties, alleging the patents were worthless. Although the *Steffen* court does in dicta state that expectations analysis should be used only where coverage exclusions are hidden or bizarre, expectations analysis applied to the facts of *Steffen* case would have precluded coverage. The insureds were seeking to characterize as a "property damage" claim a business dispute that did not involve allegations that the Steffen brothers in fact caused bodily injury or property damage to others because of negligence. Consequently, they had no objectively reasonable expectation of coverage, a fact that alone would have supported the denial of coverage. Consequently, the facts of *Steffen* do not support the need for a hidden or bizarre provision to justify expectations analysis. In addition, it is difficult to determine what the *Regents v. Royal* Court used as its yardstick for measuring "egregious" circumstances.

60. *See supra* notes 21-29 and accompanying text.

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by 1994.[61] Ironically, the reasonable expectations concept in Minnesota today may possess greatest decisional strength when used against a policyholder to deem unreasonable an asserted expectation of coverage even though policy language is unclear or susceptible to being read against the insurer.[62]

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61. Cases since *Regents v. Royal* continue in this vein, as did a number of Court of Appeals decisions issued during the time period between *Atwater Creamery* and *Regents v. Royal*. *See, e.g.*, Johnson v. Schrunk, Nos. C5-95-970, C6-95-959, 1995 Minn. App. LEXIS 1093, 1995 WL 747907 (Minn. Ct. App. Aug. 22, 1995) (reasonable expectations analysis only apt where policy language is not clear); Farmers Union Oil Co. v. Mutual Serv. Ins. Co., 422 N.W.2d 530, 533 (Minn. Ct. App. 1988) (use of reasonable expectations doctrine requires either ambiguity or unconscionability); Home Mut. Ins. Co. v. Thalman, 387 N.W.2d 219 (Minn. Ct. App. 1986) (restrictions in text of farm liability policy ambiguous as to status of accident on dirt road adjoining farm; policy construed to provide coverage to meet policyholder's reasonable expectation of coverage for ordinary farming activity in vicinity of farm). In addition, federal cases applying Minnesota law also observed a retrenchment in the *Atwater Creamery* version of the doctrine. *See, e.g.*, St. Paul Fire & Marine Ins. Co. v. Federal Deposit Ins. Co., 765 F. Supp. 538, 548 (D. Minn. 1991) (reasonable expectations doctrine ordinarily not applicable where exclusionary language clear).

62. *See, e.g.*, Allstate Ins. Co. v. Steele, 74 F.3d 878 (8th Cir. 1996) (applying Minnesota law) (no coverage for sex abuse claim as this would rewrite clear exclusion for intentional acts; no reasonable expectation of coverage absent ambiguity or other factors negating clear language); Wicher Constr. Co. v. St. Paul Fire & Marine Ins. Co., 530 N.W.2d 1 (Minn. Ct. App. 1996) (construction contractor's all-risk property insurance policy does not provide business interruption coverage as this is a distinct type of risk normally insured through purchase of a separate endorsement or policy); Fluoroware, Inc. v. Chubb Group of Ins. Cos., 545 N.W.2d 678 (Minn. Ct. App. 1996) ("advertising injury" portion of liability policy does not provide coverage for patent infringement claim); Minnesota Mut. Fire & Cas. Ins. Co. v. Manderfeld, 482 N.W.2d 520, 525 (Minn. Ct. App. 1992) (court notes that policyholder was certified public accountant and suggests this level of training makes him more capable of understanding policy text and less able to utilize contra proferentem or reasonable expectations analysis); State Farm Ins. Cos. v. Seefeld, 472 N.W.2d 170 (Minn. Ct. App. 1991) (motor vehicle exclusion in mobile homeowner's policy applies to injuries arising out of use of trailer hauled behind jeep; policyholder had no reasonable expectation of coverage); Levin v. Aetna Cas. & Sur. Co., 465 N.W.2d 99 (Minn. Ct. App. 1991) (in case of fleet of vehicles, court distinguishes prominent prior precedent and finds per vehicle limit on coverage cannot be aggregated due to clarity of policy and policyholder's understanding of limits of coverage); Grossman v. American Family Mut. Ins. Co., 461 N.W.2d 489, 495 (Minn. Ct. App. 1990) (policyholder could not reasonably expect homeowner's policy to cover claims arising from business activity, both because of purpose and nature of policy at issue and because of text of business pursuits exclusion); Merseth v. State Farm Fire & Cas. Co., 390 N.W.2d 16, 18 (Minn. Ct. App. 1986) (policy exclusion of coverage for actions between insured sufficiently clear to set scope of policy and preclude reasonable expectation of coverage); Sicoli v. State Farm Mut. Auto. Ins. Co., 464 N.W.2d 300 (Minn. Ct. App. 1990) (loss of consortium claim not one constituting bodily injury as claim does not directly relate to physical damages and

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b. Diluted Doctrine in the 1990s

Minnesota and Iowa provide particularly good illustrations of states appearing to adopt the pure Keeton form of the reasonable expectations doctrine and then retreating to a more limited use of the concept. As Professor Rahdert chronicled in 1986, Idaho is another clear example of the doctrine's surge and decline, while Pennsylvania and New Jersey display embrace, wavery allegiance, and then seemingly renewed affection for the doctrine.[63] Professor Henderson writing in 1990 found a similar pattern in these and other states.[64]

Thus, the third decade of reasonable expectations began with a legal landscape that revealed a diluted doctrine in many states that had seemingly been more receptive to the full implications of the concept but then retreated to a weaker form of the expectations doctrine. Where the reasonable expectations doctrine was evaluated by states writing on a clean slate, the doctrine was accepted only in moderate form. For example, the Oklahoma Supreme Court in *Max True Plastering Co. v. United States*

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policyholder therefore had no reasonable expectation of coverage). *But see* State Farm Fire & Cas. v. Wicka, 474 N.W.2d 324 (Minn. 1991) (intentional act exclusion inapplicable where policyholder's mental illness prevents him from appreciating or controlling conduct and its effects on others); Minnesota Mut. Fire & Cas. Ins. Co. v. Manderfeld, 482 N.W.2d 520, 525 (Minn. Ct. App. 1992) (policy exclusion of coverage for actions between insured sufficiently clear to set scope of policy and preclude reasonable expectation of coverage). *See also* Vierkant v. Johnson, 543 N.W.2d 117 (Minn. Ct. App. 1996) (holding that a household exclusion in homeowner's policy is not hidden and that reasonable expectations analysis is therefore inapplicable). *Vierkant* also puts an unusual emphasis on the reasonable expectations doctrine. The Court focused on the portion of the Keeton formula that posited coverage consistent with reasonable expectations even though "painstaking" study of the policy would have negated those expectations. According to the *Vierkant* court, an unhidden policy provision does not require painstaking study and thus is not eligible for reasonable expectations treatment.

In addition, cases involving the respective rights of excess and primary carriers frequently focus on the operational assumptions of the insurance marketplace at least as much as on policy text. *See, e.g.*, American Hoist & Derrick Co. v. Employers of Wausau, 454 N.W.2d 462, 466 (Minn. Ct. App. 1990) (policyholder could not expect that excess insurers would "drop down" to take place of insolvent primary carriers as this violates common understanding of role and risk assigned to primary and excess carriers); Seaway Port Auth. of Duluth v. Midland Ins. Co., 430 N.W.2d 242, 248 (Minn. Ct. App. 1988) (same) ("[t]he excess insurer's risk of loss is based on the assumption that a predetermined amount of primary coverage will be exhausted before the excess insurer must pay. Imposing primary coverage on the excess insurer would 'transmogrify the excess policy into one guaranteeing the solvency of whatever primary insurer the insured might choose.'").

63. *See* Rahdert, *supra* note 5, at 353-67.

64. *See* Henderson, *supra* note 10.

Fidelity & Guaranty Co. "adopted" the reasonable expectations doctrine relatively recently.[65] The *Max True* court counted cases and concluded that the reasonable expectations doctrine had been accepted in some form in 36 states.[66] *Max True* cited four states expressly rejecting the doctrine.[67] This is consistent with the assessment of other commentators as well.[68]

However, as previously noted, the form of a reasonable expectations doctrine accepted by the courts can vary substantially. Although the *Max True* decision and legal newspapers reporting it might at first glance be read to suggest a court embracing the Keeton version of the doctrine, a close reading of the case shows that Oklahoma has in fact accepted only a modified version of reasonable expectations analysis, one that employs policyholder expectations as an interpretative tool only after the court deems the disputed policy language to be ambiguous. Similarly, as noted above a close parsing of the other reasonable expectations cases shows that at most only a handful of states currently follow the Keeton form of the doctrine.

One can seriously question whether a reasonable expectations jurisprudence that employs the expectations concept only after first determining that disputed policy analysis is ambiguous is anything new at all. It adds nothing to the policyholder's quiver of arguments for coverage beyond that already existing through the contra proferentem principle, although it perhaps provides insurers with a chance to avoid liability even when guilty of drafting ambiguous language.

4. Scholarly Reaction to Reasonable Expectations

Academic reaction to reasonable expectations reveals a similar pattern of embrace and then some backing away, although the doctrine continues to enjoy more support among scholars than among the courts. Throughout both the 1970s and 1980s, the reasonable expectations doctrine was the subject of considerable commentary.[69] Then-Professor and Dean Keeton

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65. *See* Max True Plastering Co. v. United States Fidelity & Guar., 912 P.2d 861 (Okla. 1996).

66. *See id.* at 863-64, n.5.

67. *See id.* at 864, n.6.

68. *See* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 1.03 (9th ed. 1997).

69. In addition to the sources already cited in this article, there were a number of shorter articles and student notes in the wake of Keeton's *Rights at Variance* article. *See, e.g.*. (listed in chronological order without regard to author or journal to illustrate the flow of commentary) Harry F. Perlet, *The Insurance Contract and the Doctrine of Reasonable Expectation*, 6 FORUM 116 (1971); Conrad L. Squires, *A Skeptical Look at the Doctrine of Reasonable*

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added his voice to the commentary, sounding a note of caution and restraint regarding characterization of his writings and application of the expectations approach.[70] Legal scholars tend to support the reasonable expectations approach,[71] although some have expressed misgivings[72] or

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Expectations, 6 FORUM 252 (1971); E. Neil Young, et al., *Insurance Contract Interpretation: Issues and Trends*, 625 INS. L.J. 71, 73, 78-81 (Feb. 1975) (reviewing approaches to insurance policy construction and identifying reasonable expectations doctrine as separate school of thought); Chad DeLuc, Note, *Insurance Contract and Policy—Doctrine of Reasonable Expectations Applied to Void a Crop Spraying Exclusion*, 53 N.D. L. REV. 613 (1977); Frank E. Gardner, *Reasonable Expectations: Evolution Completed or Revolution Begun?*, 669 INS. L.J. 573 (1978); Martin Kamarck, *Opening the Gate: The Steven Case and the Doctrine of Reasonable Expectations*, 29 HASTINGS L.J. 153 (1977); Note, *Common Law Alternatives to the Doctrine of Reasonable Expectations in the Construction of Insurance Contracts*, 57 N.Y.U. L. REV. 1175 (1982); Note, *The Reconstruction of Insurance Contracts Under the Doctrine of Reasonable Expectations*, 18 J. MARSHALL L. REV. 155 (1984); William C. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267 (1986); David L. Leitner, *Enforcing the Consumer's "Reasonable Expectations" in Interpreting Insurance Contracts: A Doctrine in Search of Coherent Defintion*, 38 FED'N. INS. & CORP. COUNS. Q. 379 (1988); Comment, *Decapitation to Cure Dandruff? The Scope of the Reasonable Expectations Doctrine of Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, 20 ARIZ. ST. L.J. 841 (1988).

70. *See* Robert E. Keeton, *Reasonable Expectations in the Second Decade*, 12 FORUM 275 (1972). Keeton described the expectations concept as more of a "principle" than a "doctrine," *id.* at 276-77, and noted the degree to which reasonable expectations analysis may often be interwoven with ambiguity analysis, waiver, equitable estoppel, and detrimental reliance. *Id.* at 278-79. He was careful to emphasize, however, that to be a distinct principle, a reasonable expectations approach must do something more than merely consider policyholder expectations while construing ambiguous language. *Id.* at 279-80. But regarding the degree to which the expectations approach should impact coverage decisions, Keeton suggested restraint in both objective and outcome:

> Both the fears and the claims generated by this new doctrine may easily be exaggerated. I do not mean to suggest that the changes are inconsequential. On the contrary, they may well be the early manifestations of very substantial changes indeed. The point is that they are not unprincipled changes, and they need not be, as some have feared, unbridled changes. Several precedents among the small body of cases already decided make the point that this new doctrine is no guarantee of victory for a plaintiff against the insurer, and may even be used affirmatively by an insurer in defense against claims that are beyond reasonable expectations. Surely, however, there will be instances of misapplication, as there are for any other doctrine that is entrusted to human beings for application.

Id. at 279-80 (footnotes omitted).

71. *See supra* notes 9, 52, and 69 (citing sources).

even attacked the doctrine.[73] Insurers and their counsel have largely been unrelenting in their opposition.[74]

In the 1990s, which I define as the "third decade" of the expectations principle,[75] industry attack and policyholder counsel's defense continues but the rush of attention given to the doctrine during the 1970s and 1980s seems to have abated. Although legal scholars have not focused on the doctrine as frequently or explicitly during the 1990s, major scholarly treatment continues to be given to the issue. One obvious example is Roger Henderson's *Reasonable Expectations After Two Decades*,[76] which has of course in part set the agenda for this Symposium. In addition, three very insightful articles that do not bill themselves as reasonable expectations scholarship strike very close to the heart of the continuing debate on the concept: Peter Swisher's *Dusting Off the Formal for the Function*[77] and *Looking for the Middle Ground*[78] as well as James Fischer's

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72. *See, e.g.*, STEMPEL, *supra* note 5, § 11.3 (outlining "justifications and criticisms" of the doctrine); Rahdert, *supra* note 5, at 336-45 (listing pro and con arguments regarding expectations approach).

73. *See, e.g.*, Ware, *supra* note 5; J.H. Baker, *From Sanctity of Contract to Reasonable Expectation, in* CURRENT LEGAL PROBLEMS 17, 23-24 (Lord Lloyd et al. eds. 1979):

> Now, if reasonable people in general want the law to protect reasonable expectations rather than the precise meaning of the formal words they have adopted, why should the law deny it to them?
>
> The most obvious answer to that question is that the law does not seek to cushion men against the ordinary buffets of life. Men are always having their expectations disappointed . . . Reasonableness may be a measure of conduct, but it is not a source of obligation.

74. *See, e.g.*, Perlet, *supra* note 69; Squires, *supra* note 69.

75. I see the 1990s as the third decade because of the 1970 publication of Keeton's *Rights at Variance* article, meaning that there have been three decades of self-conscious practitioner, judicial, and scholarly focus on the concept (i.e., the 1970s, the 1980s, and the 1990s). Prof. Henderson appeared to have a similar timeline in mind when in 1990, he wrote about reasonable expectations "after two decades". *See* Henderson, *supra* note 10, at 823-35. However, Judge Keeton apparently viewed the 1960s as the inaugural decade of discernable reasonable expectations activity by courts, thus making the 1970s the "second decade" about which he wrote in 1976. *See* Keeton, *Second Decade*, *supra* note 3, at 275-76 (citing 1960s cases as examples of reasonable expectations in "first decade").

76. Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823 (1990).

77. Peter Nash Swisher, *Judicial Rationales in Insurance Law: Dusting Off the Formal for the Function*, 52 OHIO ST. L.J. 1037 (1990).

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Text Versus Context[79] are extremely good examinations of the theory and practice of insurance policy interpretations that touch on the role of reasonable expectations analysis but do not directly defend or attack the Keeton approach.[80]

By the 1990s, there was relatively little expansion or change regarding judicial reaction to the reasonable expectations doctrine. Courts had by the 1990s either accepted the doctrine in its "pure" Keeton form, accepted a modified version of the doctrine, or rejected the approach. Although one can argue that the status of reasonable expectations remains as limited and uncertain in the third decade as it has been from the outset, Roger Henderson has persuasively argued that the penumbra of the Keeton definition of the doctrine has exerted a discernible influence on insurance coverage adjudication, which has mushroomed during the time since the Keeton article. In addition, comments about and arguments for and against reasonable expectations have become more sophisticated and precise. However, new developments continue to occur,[81] developments suggesting

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78. Peter Nash Swisher, *Judicial Interpretations of Insurance Contract Disputes: Toward a Realistic Middle Ground Approach*, 57 OHIO ST. L.J. 543 (1996).

79. James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation? Text Versus Context*, 24 ARIZ. ST. L.J. 995 (1992).

80. A particularly good student note written while the Minnesota courts were in the process of retreating from the Keeton form of the doctrine also examines the reasonable expectations doctrine and evaluates it favorably. *See* Laurie Kindel Fett, Note, *The Reasonable Expectations Doctrine: An Alternative to Bending and Stretching Traditional Tools of Contract Interpretation*, 18 WM. MITCHELL L. REV. 1113 (1992).

81. Despite the quarter century of reasonable expectations decisions, there remains some debate regarding a number of seemingly baseline technical or procedural aspects of the doctrine. For example, some courts and commentators dispute whether the reasonable expectations doctrine is objective or subjective. The appropriate standard for applying reasonable expectations analysis is an objective one that asks what the mythical, average, reasonable policyholder expected regarding coverage. The objective test was used by Judge Keeton in articulating the doctrine, has been endorsed by commentators, and is the choice of a clear majority of courts discussing the issue. *See, e.g.*, Atwater Creamery Co. v. Western Nat'l Mut. Ins. Co., 366 N.W.2d 271 (Minn. 1985). However, courts continue to exhibit confusion on this point. *See, e.g.*, State Farm Fire & Casualty Ins. Co. v. Deni Assocs., 678 So. 2d 397, 400-401 (Fla. Dist. Ct. App. 1996) (erroneously viewing reasonable expectations approach as premised on instant policyholder's subjective anticipation of coverage).

There also remains confusion as to whether the judicial inquiry should seek to determine a reasonable insured's expectations or the actual expectations of the policyholder. Consistent with the use of an objective standard in assessing the reasonableness of expectations is the axiom that the applicability of the doctrine will be assessed according to the objectively reasonable expectations of a policyholder in the position of the claimant insured. The individual policyholder's actual expectations are not the yardstick for applying reasonable

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that the expectations principle retains vitality while simultaneously being misunderstood and, in my view, insufficiently deployed. The most far-reaching implications of reasonable expectations analysis have been thwarted in favor of a not fully assessed judicial adoption of a middling form of the doctrine. In at least one recent case from a major jurisdiction (Florida), the state Supreme Court displayed surprising and unwarranted hostility to the reasonable expectations concept.

C. Continuing Controversy Over Reasonable Expectations: Developments in the Third Decade

The demise of the 1970s and 1980s "honeymoon" for reasonable expectations analysis is succinctly presented in the 1990s experiences of two states: Utah and Florida. Early in the third decade, Utah narrowly rejected reasonable expectations, in a battle of thorough opinions that expressly addressed the prudence of the reasonable expectations approach. In the latter portion of the third decade, Florida refused to even reflect

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expectations analysis. However, the actual expectations may be introduced by the policyholder as evidence of a reasonable understanding and presumably by the insurer as well for the same purpose if the actual expectations of the policyholder were in fact quite modest. Actual expectations may also of course to questions of estoppel.

Because reasonable expectations analysis uses an objective standard and because the cases are frequently litigated on the basis of uncontested documentary evidence or what might be termed legislative or social facts related to the purpose and function of the policy at issue and appropriate resolution of public policy factors, insurance policy meaning can often be resolved by the court as a matter of law. Nonetheless, the determination of what constitutes policyholder reasonable expectations is a question of fact. *See e.g.*, Wessman v. Massachusetts Mut. Life Ins. Co., 929 F.2d 402, 405 (8th Cir. 1991) (applying Minnesota Law); Atwater Creamery Co. v. Western Nat'l Mut. Ins. Co., 366 N.W.2d 271, 277-278 (Minn. 1985).

The role of expert testimony in reasonable expectations cases also remains unresolved. To the extent that a court's assessment of the meaning of a contract turns on the existence of certain facts or the inference to be drawn from certain facts, the court may take evidence and may be required to submit the issue to the jury. Where these evidentiary disputes involve the purpose and function of a policy, the role of the policy in risk management, custom and practice among insurers, or similar issues, expert testimony is clearly appropriate from underwriters, brokers, risk managers, and lawyers regarding the marketing and placement of contested policies. More problematic is the issue of whether legal experts may testify as to the parameters of reasonable expectation, treatment of the issue in other courts, benefits and detriments of applying a reasonable expectations doctrine, and so on. The test, like any other matter under the rules of evidence, would appear to simply be whether the court believes expert testimony will be helpful to the court and not misleading. Courts have wide discretion over this aspect of the case and may refuse legal experts altogether (on the theory that the court is already legally expert) or may employee them extensively to digest and assess case law as well as to speak to the practicalities of underwriting and risk management.

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upon the reasonable expectations of the parties in an opinion marked by linguistic literalism beyond the wildest strictures of William Safire[82] or Edwin Newman[83] and contractual formalism that would have made Joseph Beale[84] blush. A closer examination of developments in these states illustrates the competing views of reasonable expectations analysis and draws into sharp relief the frequent misunderstandings that have hindered the doctrine's development.

1. Mirroring the National Debate Over Reasonable Expectations, Utah Rejects The Keeton Doctrine and Hybrids

Perhaps the most comprehensive anti-reasonable expectations case to date is *Allen v. Prudential Property and Casualty Insurance Co.*.[85] In *Allen*, the policyholder held a homeowner's policy. When the Allens' two-year-old son was injured by a pot of boiling water spilled by Mrs. Allen, the Allens sought coverage for the son's liability claim against the parents. Prudential refused payment, citing the "household exclusion", a common provision in homeowner's policies that bars coverage for claims made against the policyholder by other members of the household. The exclusion is rather straightforward in language (excluding liability

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82. Safire, a speechwriter in the Nixon Administration and longtime *New York Times* columnist, contributes a weekly "On Language" column to the *New York Times Magazine* that regularly draws precise distinctions of word meaning and usage.

83. Newman, a longtime reporter and news anchor for NBC, wrote STRICTLY SPEAKING (1977) and A CIVIL TONGUE (1979), both bestsellers that criticized the slack and slouching word usage of modern society.

84. Beale, a professor at Harvard Law School during the early 20th Century "was a special target" of the legal realists. *See* BAILEY KUKLIN & JEFFREY W. STEMPEL, FOUNDATIONS OF THE LAW 153-54 (1994):

> Beale was a conflict of laws scholar who advocated the "lex loci delicti" theory under which the state in which an injury occurred provided the applicable substantive law for adjudicating the dispute—with no ifs, ands, or buts. Although the basic lex loci rule seems sensible as a presumption or consideration, Beale venerated it as an ironclad rule. For example, if a California plaintiff and a New York defendant crashed on a New Hampshire road, New Hampshire law would apply to all aspects of the case, even to questions of damages. Beale and his ultra-formalism thus became a lightning rod for the Realist's criticisms, and even their ridicule. Some members of the Yale Law faculty even penned a mocking poem about Beale and posted it in the faculty lounge.

85. 839 P.2d 798 (Utah 1992).

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coverage for bodily injury claims to the policyholder "or an 'insured'", which is defined in the policy as "you or residents of your household who are your relatives")[86] and serves an obvious purpose—the prevention of coverage for intra-family suits that may be collusive or in which the policyholder may lack the usual insured's incentive to cooperate in attempting to defeat the suit or minimize the damage award.

The Allens attempted to overcome the household exclusion by asserting that its presence in the policy disappointed their reasonable expectations. Because the household exclusion is so common and serves a readily understandable purpose as well as being rather clearly worded, the Utah Court could simply have decreed that the exclusion's enforcement did not violate the reasonable expectations of the policyholder.[87] However, the Court launched into an extensive discussion of the reasonable expectations doctrine, reviewing its genesis and development, criticizing its intellectual foundations, and refusing to incorporate it into Utah law.[88]

The *Allen* court dwelled on criticisms of the doctrine[89] and even utilized selected portions of case law endorsing the doctrine to build its case against reasonable expectations.[90] This initial portion of the *Allen*

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86. Homeowners Special Form 3, HO 00 03 04 91 (Insurance Services Offices, Inc. 1990), Definition 3(a) & Exclusion 2(f), *reprinted in* ALLIANCE OF AMERICAN INSURERS, THE INSURANCE PROFESSIONALS' POLICY KIT: A COLLECTION OF SAMPLE INSURANCE FORMS 23, 36 (1995-1996 Edition).

87. This was the basis for one of the dissenting opinions. *See infra* notes 110-116 and accompanying text.

88. 839 P.2d at 801-03.

89. *Id.* at 802 (noting criticisms of the doctrine not only in works critical of the doctrine such as Stephen J. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1467 (1989) but also as summarized in Roger C. Henderson, *The Doctrine of Reasonable Expectations After Two Decades*, 51 OHIO ST. L.J. 823 (1990); Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323 (1986); and William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267 (1986). The Henderson and Rahdert articles, however, are on the whole quite supportive of the reasonable expectations approach although they also collect contrary arguments).

90. *See, e.g., id.* at 803, n.6 ("as recognized by the Arizona Supreme Court, which has adopted one of the broadest versions of the reasonable expectations doctrine in the country, 'most insureds develop a 'reasonable expectation' that every loss will be covered by their policy" (citing Darner Motor Sales v. Universal Underwriters, 682 P. 2d 388, 395 (Ariz. 1984)).

Although this is sly rhetoric by the *Allen* majority, it is an intrinsically suspect statement. For example, even without reading the intentional act exclusion in a liability policy, the average insured is unlikely to expect coverage for a lawsuit arising out of the insured's intentional robbery at gunpoint of a third party. If instead, the *Darner* dicta cited by *Allen* means that in the nonobvious cases, policyholders holding comprehensive policies expect coverage, this

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majority opinion in the main attacks expectations analysis for existing in different forms for slightly different reasons in different courts.[91] In a nutshell, the *Allen* majority is criticizing expectations analysis as insufficiently rigorous because it is sometimes used to interpret ambiguous language, sometimes used to prevent adverse enforcement of standard form language, and sometimes used to introduce nontextual indicia of meaning into the contract construction analysis.[92] However, the Court does not explain exactly why this makes the expectations concept unfit for Utah jurisprudence. Certainly, the *Allen* court makes no case to suggest that expectations analysis is more inconsistent or less intellectually rigorous than other aspects of contract law (e.g., ambiguity analysis, which is used by courts in a variety of forms).[93]

The Court also noted in critical fashion that several states had accepted the expectations approach and later rejected or diluted the doctrine.[94] Of course, this observation is merely empirical: it fails to determine whether these other state courts were initially right to accept reasonable expectations or instead were later correct in rejecting or diluting the expectations approach. Although the *Allen* majority obviously supports the anti-reasonable expectations decisions, there is no persuasive argumentation against the doctrine at this juncture of the opinion. Rather, the implied criticisms of others are simply arrayed for the reader.

Later in the opinion, the *Allen* majority begins to give its actual reasons for opposing expectations analysis. One basis for opposition is the proposition that the reasonable expectations doctrine unnecessarily complicates the law without providing new benefit in light of the availability of other means of interpreting contracts and protecting policyholders.

> It is not clear why estoppel, waiver, unconscionability, breach of the implied duty of good faith and fair dealing, and the rule that ambiguous language is to be resolved against the drafter, for example, are insufficient to protect

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statement, if correct, suggests that reasonable expectations analysis may indeed be apt for many insurance disputes.

91. *See id.* at 801-3.

92. *See id.* at 801.

93. *See* STEMPEL, *supra* note 5 § 5.8 (1994) (identifying states as falling within strong, medium, and weak camps re aggressiveness invoking contra proferentum principle for the benefit of insured).

94. *See Allen*, 839 P.2d at 803 (citing Idaho, Iowa, New Jersey, and Pennsylvania as examples).

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> against overreaching insurers when applied on a case-by-case basis.[95]

However, in the case before it, the *Allen* majority gives only cursory treatment to the estoppel argument advanced by the Allens, who maintained that the agent who sold them the policy knew of their desire not to have claims by members of the household excluded from coverage. According to the court:

> To bring herself within the ambit of this version of the doctrine [estoppel-like coverage obligations through insurer conduct creating expectations], Allen makes the following argument: A year after she received the Prudential policy and two years before her son's accident, her husband met with the Prudential agent to increase the homeowner's policy's coverage because the family had just bought a trampoline. She alleges that her husband told the agent he wanted to make sure that "anyone" who was hurt on the trampoline would be covered. Thus, she argues, the agent knew or should have know that Mr. Allen expected the policy to cover the Allens' son. Allen further argues that the agent's failure to mention the existence of the exclusion when her husband made the statement "left the impression with Mr. Allen that his family was covered." She concludes, "[b]ecause of the agent's failure to meet his obligation at that stage, the insured's expectations were reasonable."[96]

Despite its statement elsewhere in the opinion that the reasonable expectations approach is unnecessary because estoppel and other doctrines exist, the *Allen* court never examines this at least plausible (if one accepts the policyholder's alleged version of events) argument on estoppel terms, instead preferring to argue that it is a newfangled reasonable expectations argument. By contrast, one of the dissenting opinions meets the Allens' reliance argument and rejects it strongly, finding it therefore unnecessary

95. *Id.* at 805-06 (footnotes omitted).

96. *Id.* at 803 (footnote omitted).

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for the Court to digress to an advisory opinion opposing the reasonable expectations doctrine.[97]

After characterizing the Allens' contention as seeking something more than coverage via estoppel or reliance, the Court then launches its most direct attack on the doctrine:

> In making this argument, Allen asks us to adopt a doctrine that considerably modifies the legislatively expressed public policy underlying the regulation of the insurance industry. The theory she advances essentially would allow a court to invalidate a clear provision of an insurance contract, even if the insured had not read it, if the finder of fact is convinced that the insurer's agent knew or should have known that the insured had expectations that contradicted the policy's language and that the agent created or helped to create those expectations. For the

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97. *See id.* at 809 and n.2 (Stewart, J., concurring):

> Nothing in [Mr. Allen's] statement even remotely suggests that the Allens sought to procure coverage for themselves and their children. Indeed, the statement indicates only that the Allens sought a typical homeowner's policy which would provide coverage for property damage, theft, and liability in the event they were sued.
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> * * *
>
> The agent's recommendation [to Mr. Allen] to build the fence [around the yard] and the Allen's compliance also indicate a concern only for liability for non-family members injured on the trampoline. In addition, the record indicates that plaintiff had health and medical insurance at the time of the accident and that she filed a claim against that insurance.
>
> There is no fact asserted in this case, even taking those facts in the light most favorable to plaintiff, that supports an inference that her expectations were objectively reasonable, and [the majority] cites none. Thus, [majority author] Justice Zimmerman erroneously proceeds on an inappropriate assumption in an effort to reject the reasonable expectations doctrine, without even attempting to define it. His failure to acknowledge that both Section 211 of the Restatement and Professor Keeton . . . require more than a subjective expectation to establish the reasonable expectations doctrine explains why this simple case has evolved into an unnecessarily protracted one.

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> reasons set forth below, we decline to make such a change in Utah law.[98]

Somehow, the seemingly garden variety estoppel, reliance, and contextual interpretation argument advanced by Allen (although perhaps unnecessarily labeled reasonable expectations by Allen) cannot be heard and decided by the Court without making new law—even though the prior existence of estoppel law and other construction doctrines makes the reasonable expectations doctrine unnecessary.

Without answering this contradiction, the *Allen* Court then reveals its concern over making new law by "recognizing" an additional reasonable expectations "problem": possible violation of separation of powers. The Court notes the existence of the state Insurance Code, which permits the state Insurance Department to promulgate rules regulating insurance. As part of this rulemaking and enforcement scheme:

> Preprinted policies for household insurance, such as the Prudential policy at issue in this case, must be filed with the commissioner. The commissioner may disapprove a preprinted policy at any time if it is found to be "inequitable, unfairly discriminatory, misleading, deceptive, obscure, or encourages misrepresentation." Thus, the validity of preprinted insurance contracts is premised on executive approval, a regulatory mechanism that the Wagner [Wagner v. Farmers insurance Exchange, 786 P. 2d 763 (Utah Ct. App. 1990)] version of the of the reasonable expectations doctrine would largely undermine.[99]

Lest one think the quoted passage is a non sequitur having no relation to the *Allen* dispute, the Court suggests that this Insurance Department power to approve or remove policy forms is in jeopardy if the Court either finds for the Allens on the estoppel claim or recognizes the reasonable expectations doctrine. According to the Court, "[o]ur prior case law demonstrates our tradition of deferring to the legislature on questions of general policy when considering the validity of insurance policies."[100] "Taken as a whole, [prior] cases show our unwillingness to alter

98. *Id.* at 804.
99. *Id.* at 804 (citations and footnotes omitted).
100. *Id.*

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fundamentally the terms of insurance policies in the absence of legislative direction. . . . Today, we again affirm the principle of deferring to legislative policy in considering the facial validity of insurance provision."[101]

Even when attempting in good faith to empathize with the *Allen* majority's view, one strains mightily to see any connection between policy form approval by the insurance commissioner and the meaning of that policy form in the context of a particular coverage dispute. The Allens were not asking to have the household exclusion invalidated as against public policy. Rather, they were seeking only to have the exclusion rendered unenforceable against *them* as a result of either (a) estoppel-like conduct attributable to the insurer; or (b) other factors showing that they had an objectively reasonable expectation that their policy covered liability claims by a member of the household. Regardless of whether the Allens' argument is persuasive, it is clear that ruling in their favor would in no way have invalidated the standard form policy at issue nor tread upon the Insurance Department's regulatory province.

Of course, even if ruling for the Allens would have required invalidating an exclusion, the *Allen* Court's view that this violates legislative supremacy and separation of powers is poppycock. First, the ordinarily proper characterization of a regulatory agency such as an insurance department is as an arm of the executive branch. The mere establishment of the department by a legislature and the passage by the legislature of laws implemented by the department hardly makes the department the equivalent of the legislature. Insurance departments are administrative arms of the executive branch of government—and courts are to a large extent in the business of ruling upon the legality of executive branch action (e.g., wiretaps, police arrest conduct, treatment of personnel, administration of schools, provision of services). Striking down even an entire year's worth of Insurance Department-approved policy forms would not exceed the scope of judicial power so long at the court had a basis for its action. Second, courts frequently use public policy and unconscionability as a basis for invalidating contract terms.[102] Ordinarily, this is not considered judicial activism violative of separation of powers.

Transplanting the *Allen* Court's reasoning to a hypothetical situation underscores the weakness of the rationale. If, for example, the Insurance Department had approved a life insurance policy form that expressly

101. *Id.* at 804, 805.

102. *See* STEMPEL, *supra* note 5, §7.1 (1994).

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designated the named beneficiary in mandatory language and indicated the policyholder's strong desire that this designation be undisturbed under any circumstances, a judicial decision invalidating recovery for the beneficiary who murdered the CQV would arguably run afoul of the "freedom of contract" and "separation of powers" ideology espoused by the *Allen* majority.

Yet most observers would indeed expect courts to refuse to apply contract language literally for the benefit of murderers (or arsonists, or defrauders). The more enlightened view of contract law has for more than a century found that contract text is not so sacrosanct that it must be applied literally even if the literal application of the words thwarts the intent of the contracting parties, the purpose of the instrument, or public policy. This is in essence the teaching of the famous New York case *Riggs v. Palmer*,[103] which refused to let a murdering heir inherit under a will.

At the time, *Riggs v. Palmer* was something of a departure from the formal "objective" theory of contract that is said to have dominated the era. But even in an era of supposedly strict formalism, the law recognized that inflexible literalism was not required by respect for contract text.[104] In THE NATURE OF THE JUDICIAL PROCESS,[105] then-Judge Benjamin Cardozo used *Riggs v. Palmer* as an illustration of the judiciary's need to sometimes choose among competing principles of decision. In *Riggs*, the court rejected decision based upon the force of contract text and even the force of statutory text (a state statute required disposition of property in accordance with a valid will and made no exception for any wrongdoing by the heir). According to Cardozo, the greater principle at work was decidedly nontextual and seeming nonformal: justice.[106]

But *Allen v. Prudential* seemingly bars Utah courts from engaging in the sort of common sense construction of any contract, including an insurance policy—or perhaps especially an insurance policy form that has been approved by the state insurance department. Under the rational of

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103. 22 N.E. 188 (N.Y. 1889).

104. *See* BAILEY KUKLIN & JEFFREY W. STEMPEL, FOUNDATIONS OF THE LAW: AN INTERDISCIPLINARY AND JUDICIAL PRIMER 149-50 (1994) (describing position of many leading lawyers, including Roscoe Pound, that murdering heir was entitled to recover under will but that *Riggs v. Palmer* represented strong strand of contrary thought that has come to dominate modern jurisprudence and that "legal formalism of the 19th century was less hidebound than often supposed").

105. BENJAMIN N. CARDOZO, THE NATURE OF THE JUDICIAL PROCESS (1921).

106. *Id.* at 41-53. *See also* NEIL DUXBURY, PATTERNS OF AMERICAN JURISPRUDENCE 217-220 (1995) (discussing this segment of Cardozo on *Riggs v. Palmer* as evidence of nonformal, nontextual, nonpositivist currents in American law).

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Allen, the life insurance policy's beneficiary designation is clear contract language regardless of the beneficiary's wrongful conduct. If the policyholder or the insurance company had intended to bar recovery due to such wrongful conduct, presumably this contingency would have been addressed in the policy text. With such language lacking, according to the *Allen* court, the judicial role is only to enforce the provision and not to take into account the reasonable expectations of the contracting parties.

Assessing the *Allen* court's notions of contract in this hypothetical context underscores the weakness of the reasoning of the decision. Surely fidelity to contract language and separation of powers does not require the type of hyperliteral contract interpretation that would permit murdering heirs and beneficiaries to recover. If this is what separation of powers requires, sign me up for government by judiciary. If this is freedom of contract, perhaps some shackling is in order. Because the household exclusion at issue in *Allen v. Prudential* is both clearly worded and sensible in light of the purpose of the homeowner's policy, the *Allen* opinion reads more reasonably than it deserves. Because the holding of the case is correct, the indefensibility of the dicta is not initially obvious.

Although the result in *Allen* is unexceptional, its rejection of reasonable expectations analysis is not only gratuitous but also betrays a rigidly unrealistic notion of contract law in theory and in operation. The truth is that contracting parties, even in complex form agreements, cannot possibly spell out all contingencies. Thus, enforcing even clear contract language may lead to results at odds with party intent, party expectations, or contract purpose, even if the results are not extreme enough to be labeled "absurd". In these instances, reasonable expectations analysis has an infrequent but vital role to play if contract law is to be rational and just.

To a limited extent, the *Allen* majority attempts to avoid completely painting itself into this textualist corner when it acknowledges that the court retains "authority to invalidate insurance provisions that are found contrary to public policy as expressed in the common law of contracts that has not been preempted by legislative enactment."[107] But does the Court mean this literally? Are any contract actions based on something other than the common law (e.g., legislation) immune from judicial review on grounds of public policy, unconscionability, waiver, estoppel, and the like? This seemingly cannot be true since the *Allen* decision in part rejects the reasonable expectations doctrine because of the existence of these other doctrines.

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107. *Allen*, 839 P. 2d at 805.

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In short, *Allen* reads like a civics lecture delivered by an unsophisticated schizophrenic. It says contradictory and inconsistent things but has a central, mistaken theme of confusing the work of other branches of government with the work of the courts, foolishly suggesting that courts lose interpretative authority merely because contracts in dispute before them have been approved for use in the state by the executive or legislative branch.[108] *Allen* takes a similarly unrealistic and excessively reverent view of judicial power vis-a-vis market forces, essentially concluding that the "freedom of contract" ethos requires courts to rebuke reasonable expectations analysis because it may undermine seemingly clear policy text which, the court simplistically assumes, surely reflects the volitional intent of the parties and the purpose of the agreement.[109]

Allen dissenter Justice Stewart correctly chides the majority for its wide-ranging advisory opinion inveighing against reasonable expectations:

> The facts of this case present nothing more than plaintiff's assertion that she had a subjective, uncommunicated, and otherwise unsupported expectation of coverage under the homeowner's insurance policy. Whether the reasonable expectations doctrine should be applied in some future case on different facts cannot be legitimately determined in this

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108. In an almost tangential observation, the *Allen* court criticizes the reasonable expectations doctrine because there is no clearly principled basis for applying it to insurance contracts but not other contracts. *See id.* at 806, n.17. But this observation is at least as much a brief for adopting reasonable expectations analysis for all contracts as it is a reason to refuse to recognize the concept for insurance policies or any other singular type of contract.

109. The *Allen* majority's rejection of the reasonable expectations principle on the basis that it is nontextual and forces courts into the business of contract revision logically implies that the *Allen* court rejects any nontextual basis for construing insurance policies or other contracts. However, as noted above, *Allen* also suggests that in some cases courts might have power to invoke concepts such as unconscionability and public policy to modify or refuse to enforce contract text.

It is not entirely clear why *Allen* would permit these nontextual bases for construction when it rejects the expectations principle. Presumably, unconscionability and public policy are acceptable while reasonable expectations analysis is not because the former notions have a longer history in contract law. But if the court's concern is the degree to which a nontextual basis for decision promotes judicial activism—which is what *Allen* states as its concern—the reasonable expectations principle is far less of a judicial power grab than the other doctrines. Objectively reasonable expectations are more linked to party intent and transaction purpose than are doctrines of unconscionability and public policy which (although not divorced from contract, context, and parties) are based more upon the judiciary's own collective opinions of fairness.

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> case, and the majority's attempt to foreclose reliance on that doctrine is simply inappropriate.[110]

Justice Stewart also criticized the majority's efforts to characterize the reasonable expectations doctrine as an unruly horse likely to ride roughshod over the whole of contract law:

> [The majority] describes the doctrine in only the most general terms, leaving the reader with the impression that the reasonable expectations doctrine would allow courts to engage in wholesale rewriting of insurance policies simply because an insured expected coverage.[111]

The Stewart dissent correctly characterizes the expectations analysis as "something of an extension" of "traditional principles of contract law" but "not an aberration."[112]

Regarding separation of powers and judicial legitimacy, Justice Stewart in dissent displayed a firmer grasp of practical reality and jurisprudential perspective than did the majority.

> [I]t is extremely farfetched for the majority to argue that pro forma administrative approval of thousands upon thousands of pages of forms somehow deprives the courts of the power to use the common law process of developing principles of fairness, justice, and equity.
>
> The insurance commissioner neither writes nor, more importantly, approves the forms. The fact that the commissioner has the power to disapprove a form in certain circumstances does not indicate "regulatory approval" of forms not disapproved. The majority's implication that the commissioner's review will guarantee fairness in the terms of a contract is misguided and wrong.

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110. 839 P.2d at 808. Later, the dissent added that: "the reasonable expectations doctrine may be essential to reaching a fair result in certain cases. It is not appropriate for this Court on this record to foreclose the application of some version of the doctrine in a later case on other facts." *Id.* at 811.

111. *Id.* at 810.

112. *Id.* *See supra* notes 17-39 and accompanying text (describing scope of reasonable expectations "doctrine").

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> Although the majority insists that we should always defer to legislative policy in construing insurance provisions, it never defines the legislative policy to which we should defer. The majority appears to be most concerned with freedom of contract. However, Utah Code Ann. § 31A-1-102 (1991) lists eleven other policies underlying the Insurance Code, including "to ensure that policyholders, claimants, and insurers are treated fairly and equitably."[113]

In a second dissent, Justice Durham went beyond criticism of the majority and forcefully advocated express adoption of the reasonable expectations doctrine as a necessary tool for the modern construction of contracts.[114] He cited the strong academic commentary supporting the doctrine and stressed the practical advantages of insurers vis-a-vis insured in contacting in for insurance coverage in the modern marketplace.

In sum, *Allen* reflects the obstacles that yet lay before the reasonable expectations approach in its continuing campaign for incorporation into mainstream insurance law—and for contract law as a whole. Although *Allen* is unusual in its express debate about reasonable expectations, the resistance of the *Allen* majority is reflected in the more cursory opinions rejecting or diluting the doctrine in many states.[115] More than a quarter-century after Keeton wrote, many judges and lawyers see expectations analysis as something subversive of the bedrock legal values of separation of powers and freedom of contract. Under these circumstances, the legal profession would be remiss in concluding, despite the case counting of treatises and articles,[116] that "we are all reasonable expectationists now".[117]

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113. *Allen*, 839 P.2d at 811, 812.

114. *See id.* at 812 (Durham, J., dissenting).

115. *See supra* notes 9-20 and accompanying text (describing rejection of expectations doctrine or requiring ambiguity as prerequisite to use of expectations analysis).

116. *See, e.g.*, OSTRAGER & NEWMAN, *supra* note 16, § 1.03[b] (listing 38 states as having "recognized" the reasonable expectations doctrine); Henderson, *supra* note 10, at 828-29 (identifying as many as 16 full-fledged reasonable expectations states and a roughly equal group of modified reasonable expectations states).

117. *See* WILLIAM TWINING, KARL LLEWELLYN AND THE REALIST MOVEMENT 382 (1973) (observing in comment upon the rise of the legal realism movement and its assimilation into the body of legal thought that "Realism is dead; we are all realists, now."). The sentiment has been echoed or invoked as a springboard for discussion by subsequent commentators, although division remains regarding the degree to which legal realism was either tacitly triumphant or

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2. Reasonable Expectations Comes to a Crossroad in Florida—and is driven into a ditch

a. A Long Run of Uncertainty

If a lawyer from another planet were to land on earth, the alien attorney would probably be surprised to learn that as we enter the third decade of self-conscious reasonable expectations doctrine several of the largest states lack extended evaluation of the expectations principle by the highest courts of the state in the 28 years since Keeton's famous article. For example, New York is often cited as states embracing the reasonable expectations doctrine, this is incorrect—at least to the extent that one means the pure Keeton doctrine.[118] If anything, most observers would

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merely housebroken by the legal establishment. *See, e.g.*, GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 100 (1982); Joseph Singer, *Legal Realism Now*, 76 CAL. L. REV. 467 (1988). No similar semi-consensus about the acceptance of "rights at variance" reasonable expectations analysis has emerged in legal literature.

118. For example, New York is an obviously important jurisdiction that has neither expressly accepted nor rejected the reasonable expectations doctrine—nor have New York courts engaged in any discussion of note regarding the jurisprudence of reasonable expectations. New York presents itself as a state following traditional contract principles, looking primarily to the language of the contract but eschewing hyperliteral application of text in favor of an interpretation that fulfills the purpose of the policy and the intent of the parties. *See, e.g.*, Newmont Mines, Ltd. v. Hanover Ins. Co., 784 F.2d 127, 136-37 (2d. Cir. 1986); Ace Wire & Cable Co., Inc. v. Aetna Cas. & Sur. Co., 457 N.E.2d 761 (N.Y. 1983). A contract is to be read as a whole, with courts attempting to give effect to all contract provisions if this can be done without violating other contract construction precepts. *See, e.g.*, Cruden v. Bank of New York, 957 F.2d 961 (2d Cir. 1992); W.W.W. Assocs. Inc. v. Giancontieri, 566 N.E.2d 639 (N.Y. 1990); Employers Commercial Union Ins. Co. v. Firemen's Fund Ins. Co., 384 N.E.2d 668 (N.Y. 1978) (entire contract to be construed may include binder, application, or other documents in addition to four corners of the policy per se). *See also* E. ALLAN FARNSWORTH, CONTRACTS §§ 7.8-7.14 (2d ed. 1991).

But despite this deference to text, New York courts have also repeatedly said that the intent of the parties is the touchstone for determining the meaning of a contract term. *See, e.g.*, Record Club of Am., Inc. v. United Artists Records, Inc., 890 F.2d 1264 (2d Cir. 1989) (applying New York law); W.W.W. Assocs. Inc. v. Giancontieri, 566 N.E.2d 639 (N.Y. 1990). Ordinarily, the best determinant of the parties' intent is the contract language, which will be given its plain and ordinary meaning so long as this does not lead to an absurd result or to a result clearly at odds with party intent or the purpose of the instrument. *See, e.g.*, Breed v. Ins. Co. of N. Am., 385 N.E.2d 1280 (N.Y. 1978). In addition, even crystal clear contract language will not be enforced if the contract term is unconscionable or violates a public policy of the state. *See, e.g.*, Kalisch-Jarcho, Inc. v. City of New York, 448 N.E.2d 413 (N.Y. 1983) (clear exculpatory clause will not apply to protect a party from willful or grossly negligent acts).

Where a disputed contract term is unclear, courts will attempt to resolve the ambiguity by examining the context of the transaction and probative extrinsic evidence, including the con-

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text, background, purpose, and function of the both the contract and the disputed term unless the text of the contract itself admits of only one reasonable interpretation that does not make for an absurd resolution of the dispute. In determining the proper meaning of a disputed contract term, the court favors construction that comports with the reasonable expectations of the policyholder. *See, e.g.*, J.A. Brundage Plumbing & Roto-Rooter, Inc. v. Massachusetts Bay Ins. Co., 818 F. Supp. 553, 556 (W.D.N.Y. 1993); Album Realty Corp. v. American Home Assurance Co., 607 N.E.2d 804 (N.Y. 1992); Ace Wire & Cable Co., v. Aetna Cas. & Sur. Co., 457 N.E.2d 761 (N.Y. 1983); Thomas J. Lipton, Inc. v. Liberty Mut. Ins. Co., 314 N.E.2d 37 (N.Y. 1974). Where these construction techniques fail to indicate contract meaning, the issue will be resolved against the party that drafted the unclear contract term and in favor of the non-drafter, an approach common to all states. *See* Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 531 (1996) ("The first principle of insurance law is captured by the maxim *contra proferentum*, which directs that ambiguities in a contract be interpreted "against the drafter," who is almost always the insurer.") (citations omitted).

Little v. Blue Cross of Western New York, Inc., 424 N.Y.S.2d 553 (N.Y. App. Div. 1980), summarizes New York law well on this point:

> The terms of a contract as a whole must be examined in determining the intent of the parties, and where the meaning of a policy of insurance is in doubt or is subject to more than one reasonable interpretation, all ambiguity must be resolved in favor of the policyholder and against the company which issued the policy; the reasonable expectation of the insured, from his reading of the policy, must control.

See also N.Y. JUR 2D *Insurance* § 706 at 100 (1988) ("[t]he meaning of coverage and exclusion provisions of a liability insurance policy is to be resolved in the light of the reasonable expectation and purpose of an ordinary businessman in making the contract of insurance. If an insurance company desires to limit its liability in a drastic manner it must express the limitation in language that will reasonably convey its meaning to an intelligent layman or person of ordinary business intelligence").

Thus, in essence, New York appears to be a middle level reasonable expectations state that utilizes the concept for construing ambiguous policy language but has not adopted the Keeton principle. Because reasonable constructions of the insured are always at least a part of the contra proferentem analysis, New York is one of those many states whose version of reasonable expectations is arguably no different than it was prior to Keeton's writing.

However, some courts applying New York law have on occasion endorsed the reasonable expectations doctrine in essentially "pure" form where policyholder expectations can overcome even clear and reasonable policy language negating coverage. *See, e.g.*, Fried v. North River Ins. Co., 710 F.2d 1022 (4th Cir. 1983); Board of Educ., Yonkers City Sch. Dist. v. CNA Ins. Co., 647 F. Supp. 1495 (S.D.N.Y. 1986), *aff'd*, 839 F.2d 14 (2d Cir. 1988); Champion Int'l Corp. v. Continental Cas. Co., 400 F. Supp. 978 (S.D.N.Y. 1975), *aff'd*, 546 F.2d 502 (2d Cir. 1976); Atlantic Cement Co., Inc. v. Fidelity & Cas. Co. of New York, 459 N.Y.S.2d 425 (1st Dept. 1983), *aff'd*, 471 N.E.2d 142 (N.Y. 1984); IQ Originals, Inc. v. Boston Old Colony Ins. Co., 447 N.Y.S.2d 174 (1st Dept. 1982), *aff'd*, 444 N.E.2d 1004 (N.Y. 1982); Riordan v. Auto Club of New York, Inc., 422 N.Y.S.2d 811 (N.Y. Sup. Ct. 1979). *See also* OSTRAGER & NEWMAN, *supra* note 16 § 103[b]. *But see* Moshiko, Inc. v. Seiger & Smith, Inc., 529 N.Y.S.

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probably regard the "expectations overcoming text" aspect of the doctrine as having been rejected in New York and California. More subtly, the influence of reasonable expectations analysis occurs frequently in these states and the reasonable expectations of the parties, particularly the policyholder, are given substantial consideration in resolving insurance coverage disputes.

For most of the three decades since the Keeton article, Florida has said even less about reasonable expectations than New York, artfully dodging an extended discussion of the concept for a quarter-century. Florida's avoidance of taking a stand on the reasonable expectations doctrine ended in early 1998 as the Court rejected expectations analysis in two cases involving the scope of the standard pollution exclusion contained in commercial general liability (CGL) policies. In *State Farm Fire & Casualty Insurance Co. v. Deni Associates of Florida, Inc. & Florida Farm Bureau Mutual Insurance Co. v. E.C. Fogg*,[119] an intermediate appellate court certified to the Florida Supreme Court the question:

> Where an ambiguity is shown to exist in a CGL policy, is the court limited to resolving the ambiguity in favor of coverage or may the court apply the doctrine of reasonable

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2d 284, 288 (1st Dept. 1988), *aff'd*, 529 N.E. 2d 420 (N.Y. 1988) (plain contract language controls and evidence of party expectation not effective to provide for different result).

A number of New York cases, despite refraining from any express analysis of the "reasonable expectations doctrine" per se, suggest that the concept affects judicial thinking on insurance coverage and may benefit either policyholders or insurers. *See, e.g.*, Michaels v. City of Buffalo, 651 N.E. 2d 1272 (N.Y. 1995) (third-party claimant was the estate of a decedent who had died, arguably because of a delay in transporting to hospital when first ambulance dispatched failed to start; coverage sought under its "business auto policy" that provided coverage for liability resulting from an "accident"; court held failure of the first ambulance to start was not an "accident" within the meaning of the policy even if it resulted from the ambulance company's failure to maintain the vehicle; finding in effect no reasonable policyholder expectation of coverage notwithstanding debatability of meaning of term "accident"); Moshiko, Inc. v. Seiger & Smith, Inc., 529 N.Y.S. 284 (1st Dept. 1988) (court refused to find an insurer obligated to provide first party water damage benefits for flooding that damaged its own goods; policy was a third-party liability policy, although it did not spell this out in the text of the policy; court found insured could not have reasonably expected first-party property coverage). *See also* In re Liquidation of Union Indem. Ins. Co. of New York, 674 N.E.2d 313 (N.Y. 1996) (court found reinsurance unavailable due to failure to disclose the insolvency of a reinsured, vindicating reasonable expectations of the reinsurer).

But despite all this, New York's highest court, the Court of Appeals, has yet to expressly assess and accept or reject the Keeton principle.

119. 678 So. 2d 397 (Fla. Dist. 1996).

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> expectations of the insured to resolve ambiguities in CGL policies?[120]

Prior to the Court's "answer" to this certified question, Florida law on reasonable expectations had been remarkably nondefinitive, but it was accurate to say that Florida never accepted the pure Keeton form of the doctrine. In fact, several intermediate appellate decisions expressly rejected the doctrine and leveled extensive criticism of the concept.[121] Similarly, Florida never really adopted a reasonable expectations doctrine for hidden, surprising, or unfair policy language. However, in cases involving hidden or nonobvious restrictions on coverage, Florida courts frequently found the oppressive language to be ambiguous or vitiated by other representations.[122] In general, Florida insurance coverage cases generally have followed the traditional approach to policy interpretation and accept the common precepts that: the meaning of a contract is a question of law;[123] the policy is to be read as a whole rather than focusing

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120. *Id.* at 404 (emphasis in original).

121. *See, e.g.*, State Farm Mut. Auto Ins. Co. v. Pridgen, 498 So.2d 1245 (Fla. 1986) (finding conversion exclusion to comprehensive coverage provisions of automobile insurance policy not to be ambiguous and failing to consider whether notwithstanding clarity of meaning of "conversion" (which was excluded) as contrasted to "theft" (which was covered), insured might have reasonably expected coverage for loss of automobile under circumstances of the case).

122. *See, e.g.*, Florida Farm Bureau Ins. Co. v. Birge, 659 So.2d 310 (Fla. Dist. Ct. App. 1994) (holding, over strong dissent, that absolute pollution exclusion does not bar coverage for damages caused by sewer backup notwithstanding obvious contaminant quality of loss).

> We agree with the trial judge that the policy was ambiguous. The average homeowner's examination of the insurance contract would not reveal the applicability of these exclusions to this type of disaster. Our conclusion is supported by the availability of clear and unambiguous language that the insurance company could have used to exclude damage resulting from a backup of raw sewage.

Id. at 311. *See also* Weldon v. All American Life Ins. Co., 605 So.2d 911, 915 (Fla..2d Dist. Ct. App. 1992) ("Since an insurer, as draftsman of the form policy, will not be allowed to use obscure terms to defeat the purpose for which a policy is purchased, the terms must be liberally construed in favor of coverage so that where two interpretations are available the one allowing greater indemnity will prevail."); Bunnell Medical Clinic, P.A. v. Barrera, 419 So.2d 681, 683 (Fla. Dist. Ct. App. 1982) (finding seemingly facially clear language to have "latent" ambiguity requiring use of extrinsic information to construe policy in favor of coverage).

123. *See* Jones v. Utica Mut. Ins. Co., 463 So.2d 1153 (Fla. 1985).

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on words in isolation, with effect given to all provisions if possible;[124] terms and phrases in an insurance policy are generally given their natural meaning as understood by a reasonable person in the position of the policyholder;[125] and where a policy term or provision is textually clear, it will be enforced as written accept where it will produce an absurd result or impose an unconscionable situation upon the policyholder.[126] When Florida courts find that policy language is clear, parol evidence (evidence of prior contract negotiations) and extrinsic evidence (other extratextual matter) are generally not admissible to vary or modify the textual terms.[127] Such evidence is available, however, in order to explain an unclear provision.[128] Florida law is unclear regarding whether the background and context of the insurance transaction is considered parol or extrinsic evidence that cannot be consulted absent facial ambiguity of the policy text. Where policy language is unclear and resort to extrinsic matter does not resolve the ambiguity, the dispute is resolved against the party that drafted the ambiguous language, usually the insurer.[129] Despite the failure of Florida courts to embrace the reasonable expectations doctrine, Florida courts have used the reasonable expectations concept in order to resolve thorny coverage issues and to protect the interests of both the policyholder[130] and the insurer.[131]

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124. *See* Excelsior Ins. Co. v. Pomona Park Bar & Package Store, 369 So.2d 938 (Fla. 1979).

125. *See* Weldon, 605 So.2d at 914-15; American Mfrs. Mut. Ins. Co. v. Horn, 353 So.2d 565 (Fla. Dist. Ct. App. 1977).

126. *See* Jefferson Ins. Co. of N.Y. v. Sea World of Florida, Inc., 586 So.2d 95 (Fla. Dist. Ct. App. 1991); United States Liab. Ins. Co. v. Bove, 347 So.2d 678 (Fla. Dist. Ct. App. 1977).

127. *See* Dimmitt Chevrolet, Inc. v. Southeastern Fidelity Ins. Corp., 636 So. 2d 700, 702-03 (Fla. 1993) (refusing to consider drafting history and statements to regulators as relevant to meaning of "sudden and accidental" pollution exclusion deemed textually unambiguous by Court) (reversing decision in Dimmitt Chevrolet, Inc. v. Southeastern Fidelity Ins. Corp., 1992 Fla. LEXIS 1599, *15-*21 (Fla. 1992) (finding drafting history and regulatory estoppel relevant to determine the meaning of "sudden and accidental" language)).

128. *See id.* at 705.

129. *See* State Farm Mut. Auto. Ins. Co. v. Pridgen, 498 So.2d 1245 (Fla. 1986); Excelsior Ins. Co. v. Pomona Park Bar & Package Store, 369 So.2d 938, 942 (Fla. 1979).

130. *See, e.g.*, Spengler v. State Farm Fire & Cas. Co., 568 So.2d 1293, 1294-95 (Fla. Dist. Ct. App. 1990) (intentional act exclusion in homeowner's policy not applicable to claim by policyholder's girlfriend who policyholder accidently shot when mistaking her for burglar); United States Fire Ins. Co. v. Pruess, 394 So. 2d 468 (Fla. Dist. Ct. App. 1981) (rental piloting exclusion not applicable to coverage claim arising from aircraft liability policy; court bases opinion on "more reasonable interpretation of the policy").

131. *See, e.g.*, Florida Farm Bureau Co. v. Hurtado, 587 So.2d 1314, 1318-20 (Fla. 1991) (refusing to "stack" uninsured motorist coverage for each car in a fleet of vehicles in

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b. The *Deni* and *Fogg* Cases

Deni & Associates, an architectural firm, was in the process of moving office equipment into new quarters when a blueprint machine was jostled or knocked over, spilling ammonia contained in the machine (ammonia is used as part of the process of making blueprints). The ammonia spill was serious enough to force evacuation of the building for six hours, breaking of a window for ventilation, and removal of affected carpeting. Other building tenants were evacuated, leading to claims against Deni. Citrus farmers Fogg, Lane & Clark retained a contractor to spray Ethion insecticide on the citrus grove. Using a helicopter, the sprayer went slightly wide of the mark, spraying two men on adjacent property, resulting in serious injuries to the bystanders and substantial personal injury claims against Fogg.

Both Deni and Fogg sought defense and indemnity under their respective Commercial General Liability policies, which generally cover personal injury claims but also contained an exclusion providing

> We do not insured for loss either consisting of, or directly and immediately caused by one or more of the following.
>
> * * *
>
> e. The presence, release, discharge or dispersal of pollutants, meaning any solid, liquid, gaseous or thermal irritant or contaminant, including vapor, soot, fumes, acids, alkalis, chemicals and waste, except as provided in the Pollution Clean Up and Removal Extension of Coverage.[132]

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order to reach large amount of coverage not set forth in policy limits); Excelsior Ins. Co. v. Pomona Park Bar & Package Store, 369 So.2d 938, 942 (Fla. 1979) (court construes general liability policy sold to liquor store not to provide dram shop liability coverage because of liquor liability exclusion, refusing to find exclusion ambiguous despite notion that policy sold to liquor store might be expected to cover liquor liability due in part to drastically higher exposure in dram shop actions, increase in exposure not reflected in premium charged).

Note that the *Hurtado* case reaches a result opposite that rendered in Minnesota, a state following almost the Keeton version of the doctrine. *See* Rusthoven v. Commercial Standard Ins. Co., 387 N.W.2d 642 (Minn. 1986), discussed *supra* notes 276-82 and accompanying text.

132. *Deni*, 678 So. 2d at 406 (Klein, J., dissenting) (quoting State Farm Policy issued to Deni Associates).

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The trial courts in both cases ruled that this "absolute" pollution exclusion was ambiguous as applied to the instant facts and granted summary judgment for the policyholders. The Fourth District Court of Appeal reversed.[133] Because of the relative youth of the absolute pollution exclusion (inserted into CGL policies since the mid-1980s), *Deni* and *Fogg* would have been noteworthy cases in any event. But *Deni* and *Fogg* take on considerably more significance in that the court expressly addressed the reasonable expectations doctrine in some detail, engaged in extensive discussion about the theory and practice of insurance coverage and placed the issue before the Florida Supreme Court.

i. Competing Theories of Policy Construction and Expectation

The trial court in *Deni* not only employed traditional ambiguity analysis but expressly hinged its decision upon "what a reasonable person in the position of the insured would have understood the word to mean".[134] In reversing, the majority of a sharply divided en banc Fourth District disagreed and after an extensive discussion found the pollution exclusion unambiguous and clearly applicable to the two coverage disputes. The majority concluded that the insured's reasonable expectations had no force where insurance policy language was clear. According to the court, ammonia and Ethion insecticide were clearly pollutants and the discharge or release of these pollutants had caused the underlying liability claims.

In particular, the *Deni* majority found reasonable expectations analysis to have no place in insurance coverage matters because it runs afoul of the objective theory of contract. To some extent, the *Deni* majority revived focus on a part of contract doctrine frequently overlooked—the notion that contract language must be given an objective and universally applicable meaning in order to prevent opportunistic post-dispute behavior by the parties. Quoting an older Florida case and Oliver Wendell Holmes, the majority observed:

> The [objective theory of contract] is probably best expressed by the late Justice Holmes in 'The Path of the Law', 10 Harvard Law Review 457, where it was stated in part that *"The making of a contract depends not on the agreement of two minds in one intention, but on the agreement of two sets*

133. *See id.* at 400.

134. *Id.* at 399.

> *of external signs—not on the parties having meant the same thing but on their having said the same thing."*[135]

From this, the *Deni* majority concluded—erroneously—that application of the reasonable expectations doctrine would make coverage turn on the *subjective* beliefs of litigant policyholder. In actuality, Keeton's reasonable expectations formula is quite clear that determination of the reasonableness of a coverage expectation is to be determined by an *objective* standard.[136] That is, the reasonableness of an expectation would turn on what the mythical reasonable person in the policyholder's position would expect, not upon an idiosyncratic notions of the policyholder involved in the dispute. Presumably, the *Deni* majority slid into this off-kilter view by contrasting the result it thought was dictated by the "objective" theory of contract and the result that would obtain under a reasonable expectations approach, thereby leading the *Deni* majority to erroneously conclude that anything supporting a result at odds with the court's view of the objectively literal meaning of the exclusion must rest on subjective grounds.

The Holmes view of an "objective theory of contract" has tended to fade into the background in American law even though it was never really rejected.[137] Holmes himself seemed considerably less confident about such objectively undebatable meaning of language when—twenty years after his law review article quoted with such assurance by the *Deni* majority—Justice Holmes penned the at least equally famous words:

> A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used.[138]

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135. *Id.* at 400 (quoting Gendzier v. Bielecki, 97 So.2d 604, 608 (Fla. 1957) (emphasis in *Deni*)).

136. *See* Keeton, *supra* note 1, at 967.

137. *See* GORDON D. SCHABER & CLAUDE D. ROHWER, CONTRACTS IN A NUTSHELL (3d ed. 1990) (describing modern approach under American Law Institutes RESTATEMENT (SECOND) OF CONTRACTS (1981) as having replaced the *First Restatement*'s "objective" theory of contract with emphasis on subjective intent of the parties).

138. *See* Towne v. Eisner, 245 U.S. 418, 425 (1918). *See also* NEIL DUXBURY, PATTERNS OF AMERICAN JURISPRUDENCE 34-46, 60 (1995) (Holmes exhibited elements of both formalism and anti-formalism, or realism in this thinking, even at time of writing THE COMMON LAW (1871) Holmes espoused mixture of views despite generally favoring objective standards and positive law); Symposium, *The Path of the Law 100 Years Later: Holmes' Influence on*

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The rarified version of the objective theory of contract has faded in large part because it presumes an unrealistic level of certainty as to the meaning of words. According to this mythology, agreement is widespread and easily reached regarding whether disputing parties "said the same thing." In contrast to the view of the early Holmes, Yale Law Professor Arthur Corbin wrote that "no word has one true and unalterable meaning".[139] As more recently put by a prominent contracts scholar writing in the Corbin tradition, "[t]he very concept of plain meaning finds scant support in semantics, where one of the cardinal teachings is the fallibility of language as a means of communication".[140] Furthermore, contract construction inherently involves more than simply extracting a linguistic definition from the contract language (even assuming reasonable readers were not in some disagreement over the semantic meaning of the words):

> [A]s part of the process of interpreting whether a contract was formed and, if so the scope of contractual obligation, legal decisionmakers mold obligations along socially desired lines. Interpretation cannot be neutral, but must be done from some point of view. [T]he law must supply a great deal of the content of contractual obligations. No matter how detailed, parties are in their planning, they will never plan for every contingency (nor is it necessarily desirable that the law encourage them to try to do so).

Modern Jurisprudence, 63 BROOK. L. REV. 1-278 (several Holmes scholars note eclectic nature of Holmes' views and evolution of Holmes' thinking over time, with observers often disagreeing about Holmes' thoughts and role); Richard A. Posner, *Foreword: Holmes*, 63 BROOK. L. REV. 7, 9-11 (1996) (Holmes was "buzzing hive" of ideas and his writings are not always consistent even though Holmes' basic philosophy did not change greatly during his career; "the Holmes of the opinions is more formalistic and positivistic, especially in contract cases and in matters of interpretation and stare decisis, than the Holmes of the book and the articles"). In a sense, the Holmes posited by Posner (based on the work of Prof. Thomas Grey) may reflect a general trait of American contract law, where legal scholarship is less textual and formalist than judicial decisions in contract disputes. *See infra* notes 200-225 and accompanying text (judiciary may act with excessive formalism and textualism, with accompanying rhetoric in order to minimize judicial burden in resolving cases and rendering opinions).

139. *See* 3 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 535 (1960).

140. E. Allan Farnsworth, *"Meaning" in the Law of Contracts*, 76 YALE L.J. 939, (1967).

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> Supplied terms reflect social views of the proper goals of contractual relations.[141]

Many, if not most, contemporary courts—in contrast to the Florida appellate court in *Deni*—appear more inclined to the Corbin perspective. As one court observed:

> In truth, language is inherently ambiguous. Nevertheless, over the centuries courts have developed a variety of interpretative tools to use in resolving the ambiguities that necessarily attach when written laws must be translated into legal decisions. The reliance of courts and litigants on claimed "plain meaning" usually represents a conscious disregard of evidence that would lead to an undesired result , and not the existence of true unambiguity. To translate the words [at issue in the case] into terms of meaning requires looking to all available interpretative tools and not simply relying on the false idol of "plain meaning."[142]

Professor E. Alan Farnsworth, the Reporter of the American Law Institute's RESTATEMENT (SECOND) OF CONTRACTS, takes a similar view:

> Indeed, it is questionable whether a word has a meaning at all when divorced from the circumstances in which it is used. Dictionary definitions may be of help in showing the general use of words, but they are not necessarily dispositive. . . . Often, the meaning attached to a word by the parties must be gleaned from its context, including all the circumstances of the transaction.[143]

Although the reasonable expectations principle has been inaccurately portrayed by its critics as a radical departure from settled contract doctrine, Keeton in essence has (as Utah Supreme Court Justice Stewart suggested

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141. Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697, 701 (1990).

142. *See* CORBIN *supra* note 139 § 535, at 16-19. *See also* E. ALAN FARNSWORTH, CONTRACTS §§ 7.7 - 7.9 (2d ed. 1991).

143. E. ALAN FARNSWORTH, CONTRACTS § 7.10 at 512 (2d ed. 1990) (footnotes omitted). *See also* Farnsworth, *supra* note 140 at 940-42.

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in his *Allen v. Prudential* dissent)[144] only refined and clarified modern contract law in the Corbin/Farnsworth mode. Under this vision of contract law, one that arguably has been dominant over formalism and literalism for several decades,[145] courts recognize the practical elusiveness of seeking an objectively agreed meaning of terms based only on words themselves. Writing outside the field of insurance law, Keeton observed:

> Differences in terminology sometimes interfere with communication. The risk of misunderstanding is especially high if writer and reader, or speaker and listener, are not alert to each other's usages. You can use a word or phrase with any meaning you choose to give it, but you cannot force others to understand it that way. Moreover, if you propose a meaning different from ordinary usage, the risk that others will misunderstand what you mean rises dramatically.[146]

A term like "pollution" and the pollution exclusion litigation of *Deni* and *Fogg* provides powerful support to Keeton's point.

The classic high version of "objective" approach[147] is therefore not helpful unless there is no room for doubt as to the meaning of a contract term, not only on paper but also as applied. If the term is really clear (e.g., "on or before July 1, 1997") there is no serious dispute as to the meaning of the term and we would all agree that the contract should be enforced as written rather than as conveniently misremembered by a party in breach (e.g., "you mean I don't have until July 15th to make payment?"). But in these cases of linguistic clarity, the objective theory of contract is almost a

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144. *See supra* notes 110-117 and accompanying text.

145. *See infra* notes 200-240 and accompanying text (discussing 20th century contract jurisprudence and consistency of reasonable expectations principle with modern contract law).

146. *See* ROBERT E. KEETON, JUDGING 66-67 (1990). Judge Keeton then defines terms he uses in the book in some detail as an aid to the reader. Even in long and detailed form contracts, such extensive effort at defining terms is seldom found or practically effective, particularly when much of the contracting memorialized by forms occurs quickly in conversation, phone call, and wire, without "painstaking" study of the definitions (or most other parts of the contract) prior to entry into an agreement.

147. However, a less lofty version of the objective theory of contract might well be helpful by attempting not only to interpret disputed language not only to vindicate the purpose of the agreement and the intent of the parties but also by seeking where possible to assign to contracts a meaning that is more universal, more objectively reasonable, and less idiosyncratic and subject to post hoc rationalization.

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trite truism. In a large array of cases, of course, even relatively clear language becomes unclear in application and is subject to reasonable dispute even if the term standing alone is not obviously ambiguous.

For example, a survey researcher asking laypersons on the street the meaning of "pollution" would probably find the respondents ready with a quick, succinct, firm, and relatively consistent response: pollution is degradation of the environment because of the introduction of polluting material into the environment. This widely held concept of pollution is in general quite clear but it provides relatively little guidance for determining whether a given CGL claim is covered or uncovered. Unless the court is willing to engage in sustained analysis of the meaning of a disputed term through consideration of connotative and contextual factors, party intent, policy purpose, and common sense, it is difficult to accept that words like the CGL "absolute" pollution exclusion can have an objectively certain meaning.

The objective view of contract must be reconciled first with the reality that some words have uncertain meanings due to a variety of factors. Prof. Farnsworth has broadly classified the categories of linguistic uncertainty as: (1) vagueness, (2) ambiguity of term; (3) ambiguity of syntax; and (4) ambiguity resulting from inconsistent or contradictory language.[148] Vague words are those not neatly bound but indicating only a general concept. For example, "the word green is vague as it shades into yellow at one extreme and into blue at the other, so that its applicability in marginal situations is uncertain.[149] An ambiguous provision in a contract is one that may have two distinct connotations. "Thus the word *light* is ambiguous when considered in the context of dark feathers."[150] The ambiguity may exist because the word itself is capable of different meanings: e.g., short tons or long tons? Canadian dollars or American dollars or Hong Kong dollars? which ship named "Peerless"?[151] Usually ambiguity of term can be resolved by reference to contract context. For example, a contract between two Americans in America involving the sale of an American-made product to be used in America probably contemplated payment in American dollars.

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148. *See* FARNSWORTH, CONTRACTS, *supra* note 143, § 7.8; Farnsworth, *supra* note 140.

149. *Id.*, § 7.8 at 498.

150. *See id.* §7.8 at 498 (footnote omitted).

151. *See id.*, § 8 at 498-99. The famous *Peerless* case is *Raffles v. Wichelhaus*, 159 Eng. Rep. 375 (Ex. 1964), which held that neither party was held to the other's concept of a particular ship *Peerless*. The case involved a classic example of mutual mistake.

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Ambiguity of syntax involves uncertainty created by the way otherwise clear words are put together. Something like the "sudden and accidental" pollution exclusion has been seen by some courts as evidencing both ambiguity of term ("sudden" has a dictionary definition meaning "unexpected" and one meaning "abrupt") and ambiguity of syntax (does the pairing of the two words indicate merely repetition or a requirement that coverage can exist only for discharges that are both unintentional and abrupt?). Ambiguity from inconsistent language takes place when one provision of a contract is arguably in conflict with another provision of the contract.[152] To this list, one might add ambiguity caused by shifting context and unexpected application of the policy to unforeseen circumstances, or what is often termed "latent" rather than "patent" ambiguity.

Even if one adheres to the objective theory of contract and finds no ambiguity in a term, or the syntax of the policy or conflicting provisions of a policy, there remains the issue of whether policyholder reasonable expectations might countermand clear policy language. Courts taking this view have insisted, as did the Keeton article, that those expectations be measured by an objective yardstick—adoption of the reasonable expectations doctrine does not make coverage turn on the policyholder's subjective state of mind. The *Deni* rejection of the reasonable expectations approach by the appellate court thus proceeds in large part based on what appears to be a misunderstanding of the doctrine.

The *Deni* Court of Appeals majority also applied a strict version of the traditional rule on extrinsic evidence—permitting consideration of extratextual matter only if a term is ambiguous. Because it saw the words "pollutant", and "release" as unambiguous, the *Deni* majority refused to consider the drafting history of the pollution exclusion, nontextual evidence of the intent and understanding of the parties, or the purpose of the pollution exclusion and the CGL policy.

The drafting history, if considered relevant, would of course have implications for the common understanding of the meaning of the absolute pollution exclusion. For example, there is an oft-quoted passage of an exchange before the Texas Insurance Department in which an industry representative states that the language of the exclusion was drafted with

152. *See infra* notes 276-82 and accompanying text (discussing *Rusthoven v. Commercial Standard Ins. Co.*, 387 N.W. 2d 642 (Min. 1986), which involved a portion of the policy setting uninsured motorist coverage at the maximum available per a single vehicle while another portion of the policy set the coverage limit as the sum of the individual vehicle UM coverage amounts).

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unrealistic breadth to ensure its effectiveness and that it would not be literally enforced against insured in cases where doing so would be inconsistent with basic understanding about the policy.[153] Similarly, the overall purpose and the customary use of liability insurance would seemingly be relevant to interpreting policy language in a given context. However, the *Deni* majority precluded consideration of this material since it found the pollution exclusion clear on its face.

The *Deni* majority, like Florida law generally, was unclear about whether background or contextual material is the type of parol or extrinsic evidence that is barred absent ambiguity. Presumably, the *Deni* majority believed so. However, the modern trend is to permit courts to consider extrinsic evidence as an aid to assessing whether the disputed language is ambiguous. In addition, contracts scholars such as Farnsworth differentiate background context from extrinsic evidence. For example, is it impermissible extrinsic evidence if the court appreciates that a contract was formed during wartime? Farnsworth would say no,[154] as would most courts.[155] Courts divide however, when the degree of contextual information expands. When contextual information becomes more peculiar to the disputing parties (e.g., how things were done in the past, what someone said, failure to object to an undertaking), this is generally regarded as extrinsic matter admissible only if contract language is facially ambiguous. However, most courts will consider usage in trade or course of

153. *See* STEMPEL, *supra* note 9, § T1.6, at 16-17 (Supp. 1998) (pp. 116-17 of the Supplement).

154. *See* FARNSWORTH, CONTRACTS, *supra* note 143, §§7.8-7.9.

155. *Id.* at §§ 7.12-7.13; GORDON D. SCHABER & CLAUDE D. ROHWER, CONTRACTS (3d ed. 1990) § 94 at 173 (Evidence is admissible to show the background and circumstances in which a contract was negotiated"); Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 542 (1996) (citing Pacific Gas & Elec. Co. v. G. W. Thomas Drayage & Rigging Co., 442 P. 2d 561 (Cal. 1968) (which considered extrinsic matter to determine whether contract text was ambiguous, as representative of modern majority trend)). *See also* AGFA-Gevaert, A.G. v. A.B. Dick Co., 879 F. 2d 1518, 1522 (7th Cir. 1989) (applying New York law) (noting prevalence of modern expanded use of extrinsic matter but noting New York's more traditional approach); Trident Center v. Connecticut Gen. Life Ins. Co., 847 F. 2d 564 (9th Cir. 1988) (following *Pacific Gas & Electric* as required precedent in federal case applying California law but Judge Alex Kozinski's majority opinion is highly critical of decision and largely urges return to purported more traditional doctrine permitting consideration of extrinsic matter only where contract language is facially ambiguous). *But see* SCHABER & ROHWER, *supra* note 155, §94 at 174 (*Pacific Gas & Electric* stands for proposition that extrinsic matter may be used only to argue for a meaning for which the contract language is "reasonable susceptible").

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dealing between the parties even though this is viewed by many courts as a type of "extrinsic" evidence.[156]

The Court of Appeals in *Deni* was clearly motivated by fears of judicial activism—stating that courts could not "rewrite" unambiguous contract language to reach a preferred result. Courts must be mindful not to "torture" policy language in favor of the insured.[157] Said the Court:

> When a policy clearly defines a term, however, it is error for the court to engage in further construction of the defined term under the rule of plain and ordinary meaning. The purpose of defining a contractual term is to make clear that the parties intend something in addition to the plain, ordinary meaning of the defined term. Hence, by finding an ambiguity in the general toxicity versus special toxicity rationale applied, the trial court has failed to give effect to the clear meaning of the actual exclusion defined in the policy. The court's construction has effectually created a limitation on the breadth of the exclusion and added a coverage that the insurer had clearly excluded.[158]

Despite its view of linguistic clarity and aversion to the reasonable expectations approach, the *Deni* majority opened the issue of reasonable expectations for the Florida Supreme Court:

> Nevertheless, we also recognize that CGL policies are widely and generally used in Florida. We perceived, as demonstrated by the two summary judgments reviewed in this decision, that there is an opinion in the bench and bar that these categorical exclusions of pollution coverage are

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156. *See* STEMPEL, *supra* note 5, § 3.2; FARNSWORTH, CONTRACTS, *supra* note 143, §§7.12-7.13. *See also* SCHABER & ROHWER, *supra* note 155, § 91 at 167 ("[t]he [parol evidence] rule does not preclude use of extrinsic evidence offered for the purpose of lending meaning to contract terms . . . . The use of extrinsic evidence to establish usage of trade, course of dealing or course of performance is not barred by the parol evidence rule. The reason the rule does not apply in the situations described is simply that they do not involve evidence of an extrinsic agreement offered for the purpose of adding to or modifying the terms of the writing. Course of performance, course of dealing and usage of trade are part of the parties agreement by implication. The are not the subject of any *extrinsic agreement* between the parties.") (emphasis added).

157. *See* Deni, 678 So. 2d at 401-3.

158. *Id.* at 403.

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> ambiguous. Therefore, to enable the supreme court itself to decide the issue of ambiguity and consider the/ doctrine of reasonable expectations, we certify the following question to the court:
>
> > *Where an ambiguity is shown to exist in a CGL policy, is the court limited to resolving the ambiguity in favor of coverage, or may the court apply the doctrine of reasonable expectations of the insured to resolve ambiguities in CGL policies?*[159]

The *Deni* majority acknowledged a role for "reasonable person" analysis in that Florida law follows the traditional rule of insurance contract interpretation "which requires that policy language be read as it would be understood by reasonable people, i.e., given its plain and ordinary meaning."[160]

In the Fourth District Court of Appeals decision, Judge Stone concurred in part and dissented in part in *Deni* and *Fogg*. Specifically, he voted in favor of Deni Associates (the architectural firm with the moving mishap) and concurred in the result only in denying coverage to Fogg for the errant insecticide spraying. In particular, Judge Stone was willing to examine the historical background and drafting history of the pollution exclusion and the purpose of the exclusion. The Stone view of language placed emphasis not only on the dictionary definition of a term but upon its connotative value:

> First, I would note that the term "pollution" is generally understood as referring to a more widespread exposure of the environment to a polluting substance than occurred here. In this case, the policy in question does not sufficiently alert the insured that this is not the case.[161]

In addition, Judge Stone argued for construing policy language according to reasonable expectations of the insured rather than deciding

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159. *Id.* at 403-404 (emphasis in original).
160. *Id.* at 401.
161. *Id.* at 404-05.

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policy meaning on the basis of dictionary or policy definitions alone. But the Stone dissent's interest in adopting a reasonable expectations approach was premised on the view that a more nuanced view of the absolute pollution exclusion would find it ambiguous as applied. Judge Stone did not argue for adoption of the pure Keeton doctrine of policyholder expectations trumping unambiguous policy language.

Judge Warner in the Court of Appeals concurred specially and in a short, somewhat cryptic opinion, appeared to argue for adoption of the Keeton version of reasonable expectations. Judge Warner also saw the reasonable expectations doctrine as a two-way street:

> It would seem to me that an insurer could argue successfully the reasonable expectations test to exclude coverage in circumstances where it has heretofore been construed in favor of the insured.[162]

Judge Klein concurred and dissented in part, finding the pollution exclusion clearly *not* to apply to preclude coverage in the *Deni* case.

> I, quite frankly, do not think that even State Farm intended this exclusion to leave its insured without coverage for the type of accident which occurred here. These insurance policies are not called comprehensive general liability policies for nothing. If they were intended to exclude liability for all the types of claims which the majority would exclude, there would be no reasonable certainty as to coverage, and insured would only discover their lack of coverage as everyday mishaps occurred.[163]

Notwithstanding that CGL policies are now "Commercial" General Liability policies, Judge Warner's position is supported by approximately half the key decisions in other states, which have mitigated the textual breadth of the absolute pollution exclusion according to the court's common sense view of what a CGL should reasonably cover.[164] In the

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162. *Id.* at 406.

163. *Id.*

164. *See id.* at 407 (citing cases). *See also* STEMPEL, *supra* note 5, §T1.6 (reviewing caselaw of "absolute" pollution exclusion and finding courts split between literal enforcement of broad exclusionary language and common sense view that every claim involving caustic material is not necessarily a "pollution" claim).

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alternative, Judge Warner saw the exclusion as ambiguous, in part because of the division of the courts on the issue.[165]

ii. Deni *and* Fogg *before the Florida Supreme Court Decision*

Deni and *Fogg* were argued before the Florida Supreme Court on Sept. 11, 1997.[166] Argument before what appears to be a closely divided Court further illustrates the difficulty of the absolute pollution exclusion and the potential utility of expectations analysis. Previous Florida decisions on pollution coverage set the stage for the *Deni* case and underscored the difficulty in predicting Florida's ultimate direction on reasonable expectations. In *Dimmitt Chevrolet, Inc. v. Southeastern Fidelity Ins. Corp.*,[167] the Florida Supreme Court at first utilized the drafting history of policy language to conclude that the former "sudden and accidental" pollution exclusion contained in CGLs prior to 1985 was ambiguous and provided coverage for gradual but unintentional pollution. In the second *Dimmitt* decision reconsidering the question, the Court found no ambiguity, refused to be influenced by the drafting history, and concluded that the term "sudden" required claims to have resulted from abrupt pollution as well as unintentional pollution in order to be covered under the old CGL language.[168]

The oral argument before the Florida Supreme Court placed in stark relief range of interpretations available for construing the CGL pollution exclusion. The insurance industry sought a broad and literal application of the absolute pollution exclusion. Recall that the exclusion applies to any "irritant" or "chemical" as well as to "smoke" and "soot" and "waste", terms obviously capable of a most broad reading, one that could place outside coverage any claim involving one of these substances, even if the claim was otherwise one of ordinary negligence. For example, an

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165. *See id.* at 407-08.

166. The insurers and their amici argued that the certified question should not be decided since the status of policyholder reasonable expectation in a dispute over ambiguous policy language was not germane to the actual case holding. Recall that the *Deni* majority held that the absolute pollution exclusion was not ambiguous, but that the certified question asks whether "the doctrine of reasonable expectations" may be applied to "resolve ambiguities" in CGL policies. As a matter of procedure and jurisprudence, the insurers appear to have a good point but not surpringly, the Supreme Court forged ahead to a rule on the cases.

167. Dimmitt Chevrolet, Inc. v. Southeastern Fidelity Ins. Corp., 1992 Fla. LEXIS 1599 (Sept. 3, 1992), *reversed*, 636 So. 2d 700 (Fla. 1993).

168. Dimmitt Chevrolet, Inc. v. Southeastern Fidelity Ins. Corp., 636 So. 2d 700 (Fla. 1993).

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automobile accident often results in the "release" or "discharge" of oil, gasoline, or radiator fluid. To the extent that the accident can be said to "consist of" the presence of these substances or in some way be "caused by" the release (such as when the gasoline becomes ignited after an accident), these claims would be excluded "pollution" claims under this approach to insurance policy construction.

Similarly, a by-now well-known hypothetical designed to test the application of the pollution exclusion asks whether a "slip-and-fall" claim against a grocer is excluded if the patron slips on spilled bleach rather than spilled ketchup.[169] At the *Deni/Fogg* oral argument, the Florida Supreme Court unveiled and pressed this hypothetical. Justice Ben Overton asked State Farm's counsel whether the pollution exclusion would bar a claim if a patron slipped on ammonia leaking from the Deni Associates blueprint machine. State Farm answered without hesitation that it regarded such a simple and traditional slip-and-fall claim as excluded because the absolute pollution exclusion was "intended to be broad."[170] Justice Overton pressed the point, asking with some incredulity whether slipping on soap was covered while slipping on ammonia was not. State Farm counsel continued to take the position that the ammonia slip-and-fall was excluded, prompting Justice Leander Shaw to ask whether in that case the CGL might be an "illusory contract" since it appeared to cover such ordinary negligence but then failed to when the negligence involved the spill and failure to mop up irritating chemicals.[171]

When Farm Bureau's counsel rose to argue *Fogg*, Justice Overton reiterated the slip-and-fall hypothetical. Farm Bureau argued that the slip claim was covered and not excluded because the injury was not caused by pollution but by wetness,[172] a less rigid and more reasonable response than that given by State Farm. Justice Harry Lee Anstead pounced on the

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169. This is the hypothetical asked by the Texas Insurance Commission at hearings on the absolute pollution exclusion. In response, an industry representative agreed it would be ludicrous to apply the proposed absolute pollution exclusion to bar the bleach slip claim when the ketchup slip claim was covered but he also admitted that a literal application of the exclusion would bring this result because "we [the insurance industry] overdrafted it". The insurer representative quickly suggested that responsible insurers would not attempt such literal enforcement of the exclusion. *See* STEMPEL, *supra* note 5, § T1.6 at 116-18 (Supp. 1997).

170. *Id.* (question of Hon. Ben Overton and Response of Elizabeth Russo, Esq.). State Farm counsel quickly added that it was unaware of any actual slip-and-fall case in which the pollution exclusion had been asserted as a defense and suggested that Court discussion of such a hypothetical would be in the nature of dicta or an advisory opinion.

171. *Id.* (question of Hon. Leander Shaw and Response of Elizabeth Russo, Esq.).

172. *Id.* (question of Hon. Ben Overton and Response of Bonita Kneeland, Esq.).

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inconsistency between the State Farm and Farm Bureau positions and asked Farm Bureau counsel why the conflict between the insurers on this point was not evidence of the ambiguity of the absolute pollution exclusion and "highly indicative of a serious problem".[173] Farm Bureau counsel dealt with the question as well as could be expected and suggested that the "toxic nature" of the injury should be the controlling factor in determining whether the pollution exclusion applied. Nonetheless, State Farm's absolutist position on the exclusion illustrates the problems inherent in reading the pollution exclusion broadly and literally in view of the many things defined as pollutants in the exclusion.

iii. The Surprisingly Superficial Supreme Court Decision

Despite the closeness of the prior *Dimmitt Chevrolet* decision regarding the former "sudden and accidental" pollution exclusion and the seemingly extreme inconsistent positions outlined by the insurers, the Supreme Court's January 1998 opinion in *Deni* and *Fogg* was a veritable valentine for the insurance industry and a surprise to any detached observer attending the oral argument. Despite the prospect that under at least State Farm's view of the absolute pollution exclusion, the grocery store slip-and-fall and other "ordinary" negligence claims incidentally involving irritants would be excluded from CGL coverage, the Court accepted the insurers' construction of the exclusion, denied coverage to Deni Associates and to Fogg, and rejected the reasonable expectations doctrine. The Court also refused to use ambiguity analysis, contextual construction, estoppel or unconscionability to limit the literal reach of the language of the absolute pollution exclusion.[174]

Equally surprisingly, the Supreme Court decision was overwhelmingly one-sided, with five Justices ruling in favor of State Farm over only the short dissents of Justice Theodore Wells and Justice Ben Overton, the author of the original pro-coverage *Dimmitt Chevrolet* opinion[175] and the principle dissenter when the Court reversed itself in *Dimmitt* to find no coverage for gradual pollution due to the qualified pollution exclusion

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173. *Id.* (question of Hon. Harry Lee Anstead and Response of Bonita Kneeland, Esq.).

174. *See* Deni Assocs. of Florida, Inc. v. State Farm Fire & Cas. Ins. Co. and E.C. Fogg, III v. Florida Farm Bureau Mutual Ins. Co., 711 So.2d 1135, 1137 (Fla. 1998).

175. *See* Dimmitt Chevrolet, Inc. v. Southeastern Fidelity Ins. Corp., 1992 Fla. LEXIS 1599 (Fla. Sept. 3, 1992) (finding "sudden and accidental" qualified pollution exclusion to bar coverage only for intentional pollution where damage expected).

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formerly found in CGL policies.[176] Justice Harding, who had allied with Overton in *Dimmitt Chevrolet*[177] did not join the limited dissent in favor of the small architectural firm with the spilled ammonia problem. In *Fogg*, the Court unanimously found no coverage for the botched crop spraying.

By contrast, as detailed above, the Court of Appeals decision featured split views, substantial discussion of contract law and the expectations approach, and a powerful dissent. By contrast, the *Deni* dissent was a comparative shrug of the shoulders, with Justice Wells merely adopting an intermediate court dissent by reference and suggesting support for a reasonable expectations approach but not endorsing the doctrine explicitly.[178]

The Court majority also presented a more streamlined opinion than had the intermediate court, thereby making its misunderstanding of the reasonable expectations doctrine less obvious than had the Court of Appeals[179] but also failing to discuss (much less refute) the reasonable expectations doctrine at any length. Said the Court:

> We [like the Court of Appeals majority] agree that the pollution exclusion clause is clear and unambiguous.[180]
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> * * *

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176. *See* Dimmitt Chevrolet, Inc. v. Southeastern Fidelity Ins. Corp., 636 So. 2d 700, 706 (Fla. 1993) (Overton, J., joined by Barkett and Harding, dissenting from decision holding that qualified pollution exclusion bars coverage unless pollution damage is unintentional and discharge is abrupt). *See also id.* at 711 (Overton, J., joined by Barkett and Harding, dissenting from denial of Dimmitt's motion for rehearing).

177. Fellow *Dimmitt Chevrolet* dissenter and Florida Supreme Court Justice Rosemary Barkett was subsequently appointed to the United States Court of Appeals for the Eleventh Circuit and was no longer on the Florida Court at the time of the *Deni* decision.

178. The entire concurrence and dissent of Justice Wells reads:

> I concur as to the spraying case involving Florida Farm Bureau. I dissent as to the case involving the printing machine. I adopt the well-reasoned dissent of Judge Klein in the district court's opinion. I believe to do otherwise allows the exclusion to swallow the coverage, rendering the policy to no longer be a comprehensive general liability policy as it was sold to be by State Farm.

Deni, 636 So.2d at 1141.

179. *Id*.at 1140 (referring to reasonable expectations doctrine as one that makes coverage turn on "insured's *subjective* expectations" (emphasis added) despite clear enunciation by Keeton that the issue is one of the policyholder's *objectively* reasonable expectations. *See supra* notes 4-10 and accompanying text.

180. *Id.* at 1137.

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> We cannot accept the conclusion reached by certain courts that because of its ambiguity the pollution exclusion clause only excludes environmental or industrial pollution.[181]
>
> * * *
>
> As a court, we cannot place limitations upon the plain language of a policy exclusion simply because we may think it should have been written that way. Moreover, unless we conclude that the policy language is ambiguous, it would be inappropriate for us to consider the arguments pertaining to the drafting history of the pollution exclusion clause.
>
> We also reject the argument that because the words "irritant" and "contaminant" are not defined, the policy exclusion is ambiguous [citing WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY UNABRIDGED (1981)].[182]
>
> * * *
>
> We also cannot agree [that consideration of material other than the face of the policy] can be justified as clarifying a latent ambiguity.[183]

As to the certified question, the Court was brief and dismissive:

> We decline to adopt the doctrine of reasonable expectations. There is no need for it if the policy provisions are ambiguous because in Florida ambiguities are construed against the insurer. To apply the doctrine to an unambiguous provision would be to rewrite the contract and the basis upon which the premiums are charged.
>
> * * *
>
> Construing insurance policies upon a determination as to whether the insured's subjective expectations are reasonable can only lead to uncertainty and unnecessary litigation.[184]

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181. *Id.*

182. *Id.* at 1139 (citation omitted).

183. *Id.*

184. *Id.* at 1140 (citing Allen v. Prudential Property & Cas. Ins. Co., 839 P. 2d 798, 803 (Utah 1992) (discussed *supra* notes 90-118 and accompanying text) for the proposition that there "is still great uncertainty as to the theoretical underpinnings of the doctrine, its scope, and the details of its application").

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The Court left open some room for coverage in any future case resembling the grocery store slip-and-fall alluded to at oral argument[185] and defended the logic of invoking the pollution exclusion in the instant case because ammonia and Ethion are both classified as pollutants by regulatory authorities.[186]

Deni and *Fogg* emphasize the retreat of reasonable expectations analysis perhaps even more than Utah's rejection of the doctrine in *Allen v. Prudential* and Oklahoma's acceptance of only the watered down version of the Keeton doctrine. In *Deni* and *Fogg*, the highest court of America's fourth largest state dismissed expectations analysis curtly and firmly despite a fact setting conducive to the doctrine's application. Compared to the welcoming embrace of expectations analysis in the 1970s, the 1990s reaction of the courts seems tantamount to deportation of the Keeton doctrine.

II. EXPLAINING RESTRICTIVE REACTION TO REASONABLE EXPECTATIONS

As the forgoing analysis demonstrates, courts in the "Third Decade" of what might be termed the "Reasonable Expectations Era" continue to expend substantial judicial energy disapproving expectations analysis and in the process embracing what many modern contracts scholars would view as a wooden and unrealistic view of contract meaning. In *Allen*, *Deni*, and *Fogg*, for example, it is as if the majority opinion authors so hate the reasonable expectations approach that they cannot see straight. In zeal to fend off expectations analysis, these courts may render decisions that do not accord with "traditional" contract principles[187] or overlook available avenues of case resolution that would not even require the court's sortie against the expectations doctrine.[188]

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185. Said the Court:

> We see no reason to address what might be the holding under certain hypothetical situations if we interpret the pollution exclusion clause as it is written because none of those facts are before us. Suffice it to say that insurance policies will not be construed to reach an absurd result.

Deni, 711 So. 2d at 1140.

186. *Id.*

187. *See supra* notes 150-187 and accompanying text (discussing *Deni* and *Fogg*).

188. *See supra* notes and accompanying text 120-150 (discussing *Allen*).

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But despite its failure to displace traditional contract analysis or to reconfigure insurance law generally, the Keeton doctrine can hardly be viewed as unsuccessful or marginal.[189] Since Keeton's 1970 article, the terms "reasonable expectations" and "reasonable expectations doctrine" have become an important part of the language of discussing insurance coverage. Casebooks regularly reproduce and discuss significant reasonable expectations decisions and raise questions about the doctrine.[190] Treatises note the doctrine and its variations and differing degrees of support in the states.[191] Legal periodicals, of course, contain substantial articles about the reasonable expectations concept,[192] as this Symposium demonstrates. The Keeton form of reasonable expectations analysis has arrived as a major consideration affecting insurance law or a competing school of thought—but it has not become the prevailing standard. The fundamental organizational principles about insurance law involve classic doctrine. Reasonable expectations thinking is applied to this framework rather than used to form the framework itself.

Prior to publication of the Keeton article in 1970, insurance coverage lawyers did not speak of a reasonable expectations methodology or approach, much less a "doctrine", although the reasonableness of the expectations and proffered interpretations of contracting parties was often a factor, frequently a decisive factor, in the resolution of contract and insurance disputes.[193] As is the case today, the reasonable expectations

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189. Again, to avoid misunderstanding, let me stress that Keeton did not intend the expectations concept to dramatically rework either insurance law or contract law. *See* Keeton, *Second Decade, supra* note 3, at 279-80.

190. *See, e.g.*, KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 47-65 (2d ed. 1995); YORK, ET AL., *supra* note 52; FISCHER & SWISHER, *supra* note 52, 570 (but barely mentioning reasonable expectations in discussing insurance contract interpretation that is more "functional" than formal); KIMBALL, *supra* note 52, at 8-10; ALAN I. WIDISS, INSURANCE: MATERIALS ON FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES & REGULATORY ACTS 595-715 (1989) (entire Chapter 6 devoted to "Rights at Variance with Insurance Policy Provisions"); YOUNG & HOLMES, *supra* note 52, at 72-91.

191. *See, e.g.*, OSTRAGER & NEWMAN, *supra* note 16, § 1.03; PETER J. KALIS, THOMAS R. REITER, POLICYHOLDER'S GUIDE TO THE LAW OF INSURANCE COVERAGE §§ 10.01, 20.04 (1997); EUGENE R. ANDERSON ET AL., INSURANCE COVERAGE LITIGATION § 2.7 (Giovanni Rodriguez, ed.)(1997); ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW § 25D (2d ed. 1996); ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES § 6.03 (3d ed. 1995); STEMPEL, *supra* note 5, at Ch. 11. *But see* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW Ch. 6 (2d ed. 1988) (130 pages devoted to "Rights at Variance").

192. *See supra* notes 5, 8-10, 69, 73, 77-80 (sources cited therein).

193. *See* FARNSWORTH, CONTRACTS, *supra* note 143, §§ 1.6, 7.16; Keeton, *Rights at Variance, supra* note 1, at 966-70. *See generally* Keeton, *Second Decade, supra* note 3.

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concept was used in a variety of ways in deciding coverage disputes even where there was no recognized effort to vindicate policyholder expectations as such. But prior to 1970, there were only a handful of cases that specifically focused on the reasonable expectations of the policyholder as a touchstone for determining coverage.[194] After 1970, hundreds of cases began addressing the reasonable expectations of the policyholder and dozens of cases self-consciously considered the Keeton thesis that objectively reasonable expectations could determine coverage despite the existence of clear policy language to the contrary.[195]

Thus, to a large extent, the legal profession's receipt of reasonable expectations thinking is a success story, evidenced by this Symposium as well. Since Keeton's famous article, lawyers, judges, and scholars dealing with insurance law must deal with reasonable expectations as both a principle and a doctrine, one recognized as a separate school of interpretative thought. But, the history of expectations analysis in actual cases also reflects distrust of the doctrine, dilution in its application, and even outright rejection as well as attack. To some extent, of course, any new proposal will encounter resistance. Furthermore, courts commonly apply different legal standards, particularly in insurance law, which is highly state-centered in its sources of authority.[196] But in my view, reaction to the reasonable expectations approach has been something more than ordinary resistance to change and variance in judicial opinion. Because the reasonable expectations approach simultaneously appears to be a significant challenge to conventional contract thinking and is mistakenly seen as a significant increase in judicial power, many elements

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194. *See* Keeton, *supra* note 3, at 275-77.

195. *See supra* notes 21 and 22 (noting cases using term "reasonable expectation(s)" and citing to Keeton's *Rights At Variance* article or treatise since 1970). A Lexis search for use of the term "reasonable expectations" alone in a case involving an insurance company reveals only 181 such entries prior to 1970. From 1970 to 1980, there were 878 such cases contained in the Lexis "Mega" database. During the 1980s, more than 1,000 such cases are contained in this database. Although the 1990s are not yet behind us, the so-called "third decade" of reasonable expectations has already produced more than 1,000 such cases. The Lexis search used was delimited by date and then used the search terms "Name (insurance or assurance or Lloyd's or property or casualty or life) and reasonable expectations".

Thus, although the expectations principle is not often discussed in the full light of the Keeton theory, the term is omnipresent in insurance litigation.

196. *See, e.g.*, STEMPEL, *supra* note 5, §§ T1.2, T1.6 (describing degree to which states split almost in half regarding meaning and application of "sudden and accidental" and "absolute" pollution exclusions, respectively).

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of the legal profession and the body politic have wrongly resisted use of expectations analysis in resolving insurance disputes.

Comparing the surge and partial decline of the expectations doctrine with intellectual reaction to philosophical and scientific concepts generally helps to explain the sometimes tortured path of expectations analysis. Deeper reflection on the meaning of contract and the scope of the judicial role further demonstrates that to a large extent the reasonable expectations doctrine has received the proverbial "bum rap" from its critics. Appreciating these factors augers for a wider role for expectations analysis for insurance adjudication. In particular, it is important to appreciate the nature of "regular" contract law, which suggests that a reasonable expectations approach is hardly as radical as commonly thought. In addition, a more realistic and sophisticated view of judicial power and proper judicial role augers in favor of expectations analysis rather than against it.

It is also worth noting that judicial and scholarly focus on Keeton's strong "rights at variance" form of the doctrine may have engendered sufficient "backlash" through the dilution or outright rejection of Keeton's concept as to hold expectations analysis at undue arm's length, limiting its use as an interpretative aid rather than a trump card over arguably clear but unexpected language.

A. Reasonable Expectations and the Hegelian Progression

The noted philosopher George Wilhelm Friedrich Hegel characterized the development of ideas as a process of thesis, antithesis, and synthesis.[197] Put simply, the process begins with existence of a dominant "thesis", an organizing principle, idea or theory. An alternative viewpoint or "antithesis" may be advanced that both gathers disciples and provokes response, even hostility, from adherents to the pre-existing thesis.[198] The

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197. *See* Peter Singer, *Hegel, in* THE ENCYCLOPEDIA OF PHILOSOPHY 339 (Paul Edwards ed. 1967) (summarizing Hegel's life, philosophy, and impact). Singer provides more extensive treatment in PETER SINGER, HEGEL (1983). *See also* MICHAEL INWOOD, A HEGEL DICTIONARY (1992); ROBERT SOLOMON, IN THE SPIRIT OF HEGEL (1983); CHARLES TAYLOR, HEGEL (1979). Hegel's most influential works are THE PHENOMENOLOGY OF MIND (1806) and THE SCIENCE OF LOGIC (1816). *See* Singer, ENCYCLOPEDIA, at 339. It was in THE PHENOMENOLOGY OF MIND (often translated as "Phenomenology of Spirit" because of the dual English translations frequently given to the German word "geist") that Hegel set forth his dialectical logic of "movement from thesis to antithesis to synthesis." *Id.* at 342 (emphasis in original).

198. According to one leading philosopher:

reaction leads to the promulgation of a counter-theory or a renewed shoring up of the school of thought attacked by the new theory. But if the new theory has sufficient intellectual force, it cannot be completely refuted or driven into submission by the antithesis. Yet the new theory cannot completely "conquer" the old theory or the antithesis triggered by the new theory. The relevant community—scientific, philosophical, political, social, or legal—eventually coalesces around a refined theory or construct that is a combination of the originally prevailing viewpoint, the new theory and its antithesis or the defense of the original viewpoint threatened by the new theory. The resulting "synthesis" is a new order or revised theory that holds sway for the moment but is subject to continuing dialectical revision.

The reasonable expectations doctrine resembles but does not quite duplicate the thesis-antithesis-synthesis pattern. As Judge Keeton demonstrated, case law prior to 1970 had been tacitly based in some cases on the reasonable expectations concept. But this basis of deciding cases was not self-consciously recognized as a distinct approach to coverage disputes until Keeton recognized and articulated the doctrine. Once this brooding omnipresence of insurance law had a formal name and physical embodiment, it immediately attracted attention.[199] It also attracted the devotees and critics one finds cleaving to new ideas.[200] In a sense, reasonable expectations thinking came on the scene as something of a perceived antithesis to the status quo insurance contract regime and a status quo counterattack quickly formed.[201]

> In dialectical logic, we start from a given position—as an example, we might take the customary ethics of ancient Greece. Then we find that this position contains within itself the seeds of its own destruction, in the form of an internal contradiction. The questioning of a Socrates leads eventually to the downfall of customary ethics, for example, and its replacement during the Reformation by a morality based on individual conscience alone. Yet this too is one-sided and unstable, and so we must move to a third position, the rational community. This third position combines the positive aspects of its two predecessors.

Singer, ENCYCLOPEDIA, *supra* note 197, at 342.

199. *See supra* notes 9-15, 69-80 (citing sources).

200. *See supra* notes 69-80 (citing sources defending and attacking reasonable expectations approach).

201. *See G.W.F. Hegel* entry in MS ENCARTA online encyclopedia (1997):

> The thesis, then, might be an idea or a historical movement. Such an idea or movement contains within itself incompleteness that gives rise to opposition, or an antithesis, a conflicting idea or movement. As a result of

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The pre-Keeton view of insurance law as merely contract law was sagging under the weight of its own contradictions of both application (courts were not enforcing policy language as written in all cases) and theoretical soundness (the insurance policy differed from "regular contracts" because of standardization, adhesion, marketing practices, complexity, and bargaining power of the parties). Thus, the Keeton reasonable expectations doctrine can be seen as the antithesis to pre-*Rights at Variance* insurance law.

I take some literary license to depart from a strict reading of Hegel and treat reasonable expectations as a thesis (rather than an antithesis) for illustration because it serves to underscore the hostility evoked by the doctrine in some quarters. The synthesis under either model is the same: the reasonable expectations concept is utilized, but not as fully as it should be, with many courts requiring ambiguity, hiddenness, or oppressiveness as a prerequisite for basing decision on the reasonable expectations of the policyholder. Also, the courts continue to undersell the frequency of their use of expectations analysis and either reject or reserve for rare instances decisions finding coverage expressly because of application of the Keeton form of rights at variance reasonable expectations doctrine. However, identifying some loose consensus in the ideological middle of the insurance law debate does not suggest that the status of the reasonable expectations approach is static.[202]

> the conflict, a third point of view arises, a synthesis, which overcomes the conflict by reconciling at a higher level the truth contained in both the thesis and the antithesis. This synthesis becomes a new thesis that generates another antithesis, giving rise to a new synthesis, and in such a fashion the process of intellectual or historical development is continually generated.

(quotation taken from 1997 WorldWideWeb version of *Encarta*). *See also* Singer, ENCYCLOPEDIA, *supra* note 197, at 342. *See also* Gustav E. Mueller, THE HEGEL LEGEND OF THESIS, ANTITHESIS, AND SYNTHESIS, 19 J. HIST. IDEAS 411, 411-414 (1958); Karl Popper, *What Is Dialectic?*, 49 MIND 403-26 (1940), *revised and reprinted* in KARL POPPER, CONJECTURES AND REFUTATIONS Ch. 15 (1963).

202. *See* H.B. Acton, *Hegel*, *in* THE ENCYCLOPEDIA OF PHILOSOPHY 435, 444 (1967):

> When Hegel was advocating the dialectical method, he had in mind a method in which oppositions, conflicts, tensions, and refutations were courted rather than avoided or evaded. Hegel was a student of the classical, laissez-faire economists who held that wealth would be maximized by the free play of competition. In this view, if traders and producers ceased to compete with one another, the whole level of

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B. Reasonable Expectations and Kuhn's Model of Paradigms

Also illuminating the saga of the reaction to Keeton's article is Thomas Kuhn's by-now well known theory of the development of new paradigms of science and the displacement of an old scientific paradigm with a new paradigm.[203] According to Kuhn, the shift takes place when the existing paradigm develops perceived deficiencies largely because it can not explain discordant phenomena.[204] The new paradigm arises as a result of attempts to explain the discrepancies, gathers "an enduring group of adherents away from competing modes" of thought in the area,[205] and eventually is recognized as providing a better organization and explanation of the discipline than did the former paradigm. At that point, a paradigm shift occurs and the new paradigm displaces the old, becoming recognized as the dominant school of thought in the field.[206] When the paradigm shift is complete, textbooks have been rewritten and curricula revised so that the new paradigm is presented as the established orthodoxy of the discipline, with the dethroned old paradigm ignored or described as a historical step on the road to truth, an errant view of the field, or (where the new

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> economic life would be lowered. General prosperity could be reached only at the expense of labor and anxiety. So it is, Hegel believed, with the categories of our thought, the systems of philosophers, and the forms of life and society. There is no tranquillity to be had by withdrawal and isolation. Our categories compete with one another, and out of their competition emerges something better than either of them could have accomplished alone. But it is not possible for the superior category to go into retirement, for without the spur of competition it would fall into decay.

203. *See* THOMAS S. KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS (2d ed. 1970).

204. *See id.* at 27-35, n.203. Although Keeton emphasized that his expectations approach was not a suggestion of displacing the prevailing paradigm of contract theory, one can appreciate the Kuhnian parallels. Kuhn posited that during a time of "normal science" or less controversial practicing of the status quo, the energy of professionals is directed toward achieving a better understanding of the existing paradigm (e.g., the major contract treatises of Williston and Corbin, the insurance works of Edwin Patterson and Robert Vance), gathering new data to enrich the prevailing paradigm (e.g., refined treatise writing and the contract and insurance articles of both scholarly law reviews and practitioner-oriented legal periodicals), and further articulation of theory as the prevailing school of thought is interpolated or extrapolated to new situations (e.g., the RESTATEMENT, additional articles and major court decisions).

205. *See* KUHN, *supra* note 203, at 17.

206. *See id.* at 17, 23.

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paradigm's dominance is not complete) a competing world view held by a minority of those practicing the discipline.[207]

Although there are of course differences of note, Kuhn's analysis of paradigm shifts can be applied to legal and political movements as well as to shifts in scientific thought.[208] The Keeton version of reasonable expectations doctrine has elements of both the Hegelian dialectical progression and the Kuhnian paradigm shift but fits neither model perfectly. As noted above, the Keeton "thesis" has not been completely incorporated into the law but neither has the "synthesis" of reasonable expectations compromise been coherently articulated or consistently applied throughout the law.

Using the Kuhn measurement, the Keeton doctrine clearly has not displaced the pre-existing paradigm of "ordinary" contract construction and the interpretation of insurance policies as a matter of "ordinary" contract law.[209] The major treatises and textbooks of insurance law have not come to present the Keeton doctrine as the primary organizing principle of insurance law. Rather, the principal texts of insurance law present the Keeton doctrine as an important development in insurance law thinking and a major aspect of insurance policy construction. In the main, however, the authoritative sources of insurance law describe the dominant paradigm as one based on standard operating principles of contract: construction of the insurance policy is based primarily on text, party intent, and overall purpose of the insuring agreement.[210] For most courts most of

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207. *See id.* at 52-91.

208. *See, e.g.*, Russell G. Pearce, *The Professionalism Paradigm Shift: Why Discarding Professional Ideology Will Improve the Conduct and Reputation of the Bar*, 70 N.Y.U. L. REV. 1229, 1230-33 (1995); Jeffrey W. Stempel, *New Paradigm, Normal Science, or Crumbling Contstruct? Trends in Adjudicatory Procedure and Litigation Reform*, 59 BROOK. L. REV. 659, 695-705 (1993); Steven L. Winter, *Indeterminacy and Incommensurability in Constitutional Law*, 78 CAL. L. REV. 1441, 1446, 1453-65 (1990).

209. *See supra* notes 203-08 and accompanying text.

210. As to casebooks, *see, e.g.*, KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 47-65 (2d ed. 1995) (reasonable expectations doctrine given significant attention, with cases reproduced, but as one variety of an array of interpretative approaches, YORK, ET AL., *supra* note 52, at 42-43 (focus in interpretive section of casebook is on ambiguity analysis, with slight mention of reasonable expectations); FISCHER & SWISHER, *supra* note 52 at 570 (reasonable expectations approach described as subset of functionalist interpretative method that stresses purpose of insurance more than formal text; major reasonable expectations case (*C & J Fertilizer*) reprinted in part, but authors tend to emphasize formal textual approach and ambiguity analysis); KIMBALL, *supra* note 52, at 8-10 (reasonable expectations discussed in passing but emphasis on text and ambiguity); WILLIAM F. YOUNG & ERIC M. HOLMES, INSURANCE: CASES & MATERIALS 72-91 (2d ed. 1985) (significant attention to reasonable

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the time, party intent and the purpose of the instrument will be deduced from the written policy. The reasonable expectations of the parties of course affect the resolution of these issues. However, it is not "typical" for coverage disputes to be resolved according to policyholder expectations analysis incorporated into these traditional indicia of contract meaning. Even rarer are reasonable expectations controlling when contradicted by policy text of significant clarity.[211]

C. Reasonable Expectations and Freedom of Contract

As noted above,[212] much of the criticism of expectations analysis, particularly the Keeton *Rights at Variance* form, asserts that the expectations approach violates a first principle of American law: freedom of contract.[213] However, as the courts and commentators embracing the doctrine have noted (and as Keeton observed in identifying the doctrine) insurance contracting is something less than the classical libertarian ideal of bargaining and custom-made voluntary agreement. To paraphrase

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expectations, with cases reproduced and noted but doctrine presented as minority strain amidst prevailing text and ambiguity approach).

Not surprisingly, the casebook that most centers organization and discussion around the reasonable expectations concept by Prof. Widiss, co-author of the Keeton treatise on insurance law. *See* WIDISS, *supra* note 52, 595-616 (containing a substantial chapter devoted to rights at variance with policy provisions a/k/a reasonable expectations).

As to treatises, *see, e.g.*, OSTRAGER & NEWMAN, *supra* note 16; PETER J. KALIS, THOMAS R. REITER, POLICYHOLDER'S GUIDE TO THE LAW OF INSURANCE COVERAGE (1997); EUGENE R. ANDERSON, ET AL., *supra* note 191; JERRY, *supra* note 191; WINDT, *supra* note 191; STEMPEL, *supra* note 5. All of these text devote significant mention to reasonable expectations, but only Ostrager & Newman, which gives the doctrine a subsection in its "interpretation" chapter and Stempel, which devotes a rather large Chapter 11 to the approach, can be regarded as emphasizing the reasonable expectations principle as such. *But see* KEETON & WIDISS, *supra* note 191, at Ch. 6 (providing prominent treatment of expectations approach as organizing principle of insurance law).

211. *See supra* notes 21-60 and accompanying text. In actual litigation, the same pattern repeats itself. The ordinary brief of counsel begins with and stresses the standard contract law means of interpreting a disputed policy. The Keeton form of the reasonable expectations doctrine is invoked, if at all, when the traditional contract modes of analysis are unilluminating or adverse to the client's position.

212. *See supra* notes 9-16, 69-80, 100-118, 160-180 and accompanying text (discussing cases rejecting reasonable expectations doctrine as an improper interference with freedom of contract).

213. Two sources making this argument at length and with considerable force are: Stephen J. Ware, *supra* note 5; J.H. Baker, *From Sanctity of Contract to Reasonable Expectation*, in CURRENT LEGAL PROBLEMS 1979 at 17, 23-24 (Lord Lloyd, et al., eds.) (1979).

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Stanley Fish, one might observe that there's no such thing as freedom of contract, and its a good thing, too.[214]

Fish in fact, addresses aspects of this legal debate over the sanctity of words and "freedom of contract" tangentially but revealingly:

> The law wishes to have a formal existence. This means, first of all, that the law does not wish to be absorbed by, or declared subordinate to, some other—nonlegal—structure of

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214. *See* STANLEY FISH, THERE'S NO SUCH THING AS FREEDOM OF SPEECH—AND IT'S A GOOD THING, TOO (1994). Speaking in a different but related context, Fish defended his defense of the prospect of the regulation of speech through campus "hate speech" regulations. "[My opponents have suggested that I am saying] let's abandon principles, or let's dispense with an open mind. But, in fact, I am not making a recommendation but declaring what I take to be an unavoidable truth. That truth is not that freedom of speech should be abridged but that freedom of speech is a conceptual impossibility because the condition of speech's being free in the first place is unrealizable." *Id.* at 115. Substitute "of contract" for "speech" and Fish's passage comes close to encapsulating my own views on contract law and insurance policy interpretation, suggesting that something other than a completely textualist/minimalist judicial role interpreting contracts is required.

Announcing the overall them of his book, which collects essays usually first published elsewhere, Fish states:

> I would expect that from many readers the most distressing thing about these essays will be the skepticism with which they view the invocation of high-sounding words and phrases like "reason," "merit," "fairness," "neutrality," "free speech," "color blind," "level playing field," and "tolerance." My argument is that when such words and phrases are invoked, it is almost always as part of an effort to deprive moral and legal problems of their histories so that merely formal calculations can then be performed on phenomena that have been flattened out and no longer have their real-world shape. An exemplary (it is a bad example) instance of this practice has just been provided for us by the Supreme Court in its recent (June 28, 1993) decision that the creation by the North Carolina legislature of two black majority districts may be unconstitutional because it smacks too much of "race consciousness." [The Court majority opinion's equating of this districting plan with partisan gerrymandering of the past] only emerges if one has forgotten or bracketed out everything about the past that makes the present an intelligible (and moral) response to it.
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> * * *
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> It is the willful disregard of history that is the object of critique in the pages that follow.

Id. at viii-ix.

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> concern; the law wishes, in a word, to be distinct, not something else.
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> In its long history, the law has perceived many threats to its autonomy, but two seem perennial: morality and interpretation.
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> [S]ome point of resistance to interpretation must be found, and that is why the doctrine of formalism has proved so attractive. Formalism is the thesis that it is possible to put down marks so self-sufficiently perspicuous that they repel interpretation; it is the thesis that one can write sentences in such a precision and simplicity that their meanings leap off the page in a way no one—no matter what his or her situation or point of view—can ignore; it is the thesis that one can devise procedures that are self-executing in the sense that their unfolding is independent of the differences between the agents who might set them in motion. In the presence (in the strong Derridean sense) of such a mark or sentence or procedure, the interpretive will is stopped short and is obliged to press its claims within the constraints provided by that which it cannot override. It must take the marks into account; it must respect the self-declaring reasons; it must follow the route laid down by the implacable procedures, and if it then wins it will have done so fairly, with justice, with reason.

Obviously then, formalism's appeal is a function of the number of problems it solves, or at least appears to solve: it provides the law with a palpable manifestation of its basic claim to be perdurable and general; that is, not shifting and changing, but standing as a point of reference in relation to which change can be assessed and controlled; it enables the law to hold contending substantive agendas at bay by establishing threshold requirements of procedure that force those agendas to assume a shape the system will recognize.[215]

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215. *See id.* at 141-43, n.214.

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Seen as part of this drive toward formalism and resistance to reasonable expectations analysis is better understood as something not exclusively part of contract or insurance law. Indeed, much of the debate regarding statutory and constitutional interpretation also mirrors this "text vs. context" debate. The general operating principle or thesis of American law largely remains reverence for the word, be it constitution, statute, or contract, a view supported not only by the law's continued affinity for formalism even after the Realist revolution but also by the prevailing fears of an unchecked judiciary. Armed with the notion that a textual focus limits unwarranted judicial activism and keeps the judiciary properly balanced against other government branches and market forces, courts strive to render textualist contract constructions. Faced with the counter-theory of reasonable expectations creating rights at variance with text, some elements of the profession have recoiled and resisted this antithesis or opposing paradigm. This explains a good deal of the opposition to the Keeton article and also reflects the mistaken thrust of Keeton's critics.

As Keeton and others have detailed, insurance contracts are standardized, are contracts of adhesion, are complex, are of necessity broadly worded and even "overdrafted" to cover a wide range of potential events, are almost never read prior to the transaction,[216] are seldom read afterward (unless a coverage dispute arises) and involve contracting parties frequently having wide disparities of expertise and bargaining power.[217] Consequently, a rigid view of the power of the dictionary definition of policy text seems misplaced in the insurance context, although one can argue, as Fish has, that such thinking is generally misplaced but dominant in law because it serves other needs of the system.

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216. Insurers have admitted to "overdrafting" policy language in order to cast an exclusionary net so wide that it can not be linguistically avoided—but have also stated that literal enforcement of such "overdrafted" exclusions was not intended by insurers where the claim did not fall within the purpose of the exclusions. *See, e.g.*, TEXAS STATE BOARD OF INSURANCE, TRANSCRIPT OF PROCEEDINGS: HEARING TO CONSIDER, DISCUSS, AND ACT ON COMMERCIAL GENERAL LIABILITY POLICY FORMS FILED BY THE INSURANCE SERVICES OFFICE, INC., Bd. Dkt. No. 1472, vol. I at 6-10 (Oct. 30, 1985) (excerpted in part in JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS, at 116-18 (Supp. 1998) (insurer representatives describe "absolute" pollution exclusion as "overdrafted" but state that insurers would not seek to deny coverage on all claims that only incidently involved an irritant or toxic substance)).

217. Much of this—but not all—holds true even where the policyholder is a large, wealthy, commercial and "sophisticated" insured. *See* Jeffrey W. Stempel, *Reassessing the "Sophisticated" Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807 (1993).

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However, the reasonable expectations principle hardly guts the generally textualist formality of contract and insurance law. Even in its strongest "rights at variance" form, the Keeton concept of expectations analysis places heavy emphasis on policy text and surrounding circumstances. The policyholder does not prevail, particularly when text is clear, unless contextual factors auger strongly in favor of the policyholder's understanding of the insurance coverage. Mere policyholder hope and whim is not enough to gain coverage. There must be an objectively reasonable expectation of coverage before the policyholder may prevail.

In addition, it is generally agreed that the use of standardized forms and the marketing mechanism of insurance facilitates the operation of the primary, excess, and reinsurance systems as well as providing economies of scale that should (at least in theory) lower the cost of insurance.[218] Thus, absence of total freedom of contract is not necessarily a bad thing. Usually, neither the insurer nor the policyholder can create a completely customized contract. Even so-called "manuscript" policies are much more the cutting and pasting of standard ISO terminology than they are any novel contract language independently generated by the parties.

Furthermore, to perhaps state the obvious, something less than total freedom of contract hardly means that the contracting process lacks all indicia of freedom. At a minimum, insurers and policyholders have the freedom not to contract with one another at all.[219] Usually, there is also considerable flexibility in seeking particular combinations of endorsements or coverage provisions at varying premiums. Despite standardization, there is usually opportunity for some comparison shopping, if the policyholder is willing to invest the resources in the search. For commercial policyholders or individuals with significant insurance needs, brokers and independent agents can be used to lower the search costs. Consequently, the insurance

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218. *See* STEMPEL, *supra* note 5, at §§ 10.1, 10.2 (delineating advantages of policy form standardization for insurers and policyholders).

219. Although this "freedom" is muted as a practical matter in many situations. For example, a prospective homeowner normally needs a bank loan to purchase the home. Only the very wealthy can avoid this. Most banks require homeowners insurance and title insurance as a condition of issuing the mortgage. Although the homebuyer is free to do some comparison shopping, seldom is the buyer free to dispense with insurance on the home altogether. For further evidence of "non-freedom" of contract, see W. David Slawson, *Standardization of Mass Contract: Lawful Fraud in California*, 47 S. CAL. L. REV. 1255 (1974) (law professor Slawson retells experience of buying home only to be presented at closing with standardized form documents that he had not had prior opportunity to read and was required to sign as a condition of completing sale).

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contracting environment can be accurately characterized as partially free or semi-free, with observers debating the degree of freedom. But, without doubt, the insurance contract market is far less than 100 percent free.[220]

Under these circumstances, it is hardly persuasive to attack the reasonable expectations doctrine as some sort of stiletto thrust into the breast of freedom. To a large extent, even the rhetoric of "freedom" of contract is misplaced. Although the terminology may be a useful device for appealing to judicial sympathies by evoking images of the Boston Tea Party, The Declaration of Independence, Valley Forge, and the Constitutional Convention, the rhetorical flourish attending "freedom of contract" debates obscures more than it illuminates. The point of a contract regime in a liberal democracy is to permit parties to arrange their affairs as they wish subject to other needs of the society and to ensure that parties are not privately coerced into involuntary arrangements and that parties may receive the aid of the law to enforce their contractual arrangements. The point is not to venerate contract text or dictionary definitions in and of themselves.

To use a perhaps-inflammatory example, we forbid slavery and the sale of slaves, although this clearly restricts the "freedom" of slave marketers and plantation owners to make such contracts.[221] Today, we recognize that attacking this sort of limitation of trade on freedom of contract grounds is revolting.[222] It is only slightly less obnoxious to suggest that courts lack

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220. Of course, assigning percentages of certainty as to a trait can be dangerously ludicrous by giving a false illusion of precision. *See, e.g.*, DAVID HALBERSTAM, THE BEST AND THE BRIGHTEST (1972) (describing former Defense Secretary Robert McNamara's seduction by such false certainty through essentially arbitrary assignment of numbers to issues; for example, McNamara would ask soldiers in the field to evaluate the safety (i.e., its friendliness to American troops) of a Vietnamese village on a scale of 1 to 10).

Notwithstanding this danger, my own impressionistic assessment is that the insurance contracting regime is perhaps 20 percent "free" for consumers and 50-60 percent "free" for commercial entities.

221. And, obnoxious as it may sound to modern ears, slavery was at least as much a commercial enterprise as it was a reflection of social norms. *See generally* HUGH THOMAS, THE SLAVE TRADE: THE STORY OF THE ATLANTIC SLAVE TRADE 1440-1870 (1997). One can also point to the slave trade not only as an example of the extreme results permitted under a "freedom of contract" regime but also to note that contract holds a central place in society largely because government enables this by establishing a policy favoring contracts and an infrastructure for enforcing them. For example, the governments of slave traders taxed slave trading as a substantial source of government revenue and used the coercive power of the state to protect slave brokers and owners and to hunt down or subdue rebellious slaves.

222. Although this was, of course, not always the social norm. From ancient times until the late 19th Century, slavery was considered something of a natural order and slavery as

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power to set aside unconscionable contract terms or to ensure that contract terms are accorded reasonable meaning where there is a mistake of drafting, an unanticipated development, or even where the drafting party may have intended an unreasonable meaning not shared by the party adhering to the drafter's form. Clothing such arguments in rhetorical garb better reserved for political conventions fails to improve the arguments against reasonable expectations interpretation.

Insurance contracting, even more than most modern contracting, is not totally free and perhaps not very free at all. Even in the non-insurance atmosphere, the government (legislatures and executive agencies in addition to courts) is widely regarded as having the power to void or refuse to enforce contract provisions that are illegal, unconscionable, or otherwise at odds with public policy.[223] In addition, human activity is generally widely regulated in modern society, with the operation of the insurance industry perhaps more regulated than most commercial activity this side of the securities and food & drug laws. Thus, the real world of contract and insurance is not one of unfettered discretion of the contracting parties.

The question then becomes: what should the law provide under these circumstances? One persuasive defense of the reasonable expectations doctrine is that it simply adds another interpretative tool for construing contracts so that courts are not required to completely strike from contracts terms that are unfair if read literally. Similarly, the reasonable expectations approach provides an alternative to simplistic application of a strong form of contra proferentem as well as allowing the courts a route other than simplistic enforcement policy text whose meaning is suspect or tending toward the absurd when applied literally to the context of the dispute.[224] Viewed from this realistic perspective, reasonable expectations analysis—even in its strongest "rights at variance" form—is not precluded by the legal system's treatment of contracting autonomy. Milder versions of expectations analysis as a tool for determining insurance policy meaning are perfectly consistent with the freedom of contract ethos. Accurate determination of contract meaning enhances party autonomy and the value of contract rather than diminishing it.

Furthermore, the expectations approach is well grounded in standard contract doctrine, although this seems frequently forgotten by courts and commentators resisting the reasonable expectations principle. A half-

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commerce was restricted largely only by the state's desire to obtain some a taxable share of the profits. *Id.* Ch. 2.

223. *See* STEMPEL, *supra* note 5, at § 7.1.

224. *See* Fett, *supra* note 80.

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century ago, Arthur Corbin listed as his first black letter pronouncement of the law of contracts that the "Main Purpose of Contract Law is the Realization of Reasonable Expectations Induced by Promises".[225] Corbin observed:

> The law does not attempt the realization of every expectation that has been induced by a promise; the expectation must be a reasonable one. Under no system of law that has ever existed are all promises enforceable. The expectation must be one that most people would have; and the promise must be one that most people would perform. This necessarily leads to a complexity in the law, to the construction of the various rules determining the circumstances under which a promise is said to be enforceable and those under which its performance will be excused.
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> reasonableness is no more absolute in character than is justice or morality.[226]

Thorny questions of course remain regarding whose expectations should control and in determining the actual content of expectations as well as the degree to which expectations are belied by or trumped by policy language and other factors surrounding a disputed term. But resolving those sorts of questions is the essence of adjudicative activity. By disputing this, the critics of expectations analysis are in reality arguing that comprehensive judicial construction of written instruments somehow violates freedom of contract. On the contrary, the existence of volitional contracting depends upon having a court system that can resolve the inevitably arising disputes over meaning by rendering decisions that do more than looking up the disputed term in a dictionary.

Unfortunately, however, even the best discussions of the reasonable expectations doctrine appear to have tacitly assumed that contract law outside of insurance is both highly textual and that textual meaning is rather clear and certain. Once this assumption is made (or unconsciously brought to the analysis at the outset), expectations analysis seems more of

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225. *See* CORBIN, THE LAW OF CONTRACTS, § 1 at 1 (1950) (one volume edition) (boldface in original).

226. *Id.* at 2.

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a departure and hence less legitimate. Reasonable expectations then becomes something of a "radical" doctrine that cannot be fully embraced by responsible judges. Courts taking this view then further exacerbate the practical problem of interpreting insurance policies by tending not to use expectations analysis in matters where there is no sufficiently clear text that can be "painstakingly studied" to determine the meaning of the policy. Meaning can only be derived from context and with a functional view of the policy in question and its intended purpose. Logically, the expectations of the parties would shed light on policy meaning just as this information would shed light on the meaning on non-insurance contracts. But this potential use of expectations analysis is truncated by adverse reaction to the "rights at variance" form of expectations analysis.

However, if contract law is properly understood historically and correctly as permitting substantial use of nontextual factors in resolving interpretative issues, the reasonable expectations principle crystallizes as an important but hardly radical addition to the collection of interpretative tools available to the courts. Although much contract law scholarship and precedent has stressed the textual and formal,[227] an at least equally weighty and persuasive body of case law and analysis has promoted the broader view more hospitable to the reasonable expectations doctrine.[228] As previously discussed,[229] the broader, functionalist view, frequently associated with Professors Corbin and Farnsworth, appears to have gained ascendancy in the years after World War II and culminating in the Second

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227. *See, e.g.*, SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACT (original ed. 1936; 4th ed. 1990 and supplements).

228. *See, e.g.*, FARNSWORTH, CONTRACTS, *supra* note 118; ARTHUR L. CORBIN, CORBIN ON CONTRACTS (1952) (One Volume Edition). Although frequently regarded as more formalist than Farnsworth, modern contracts scholars and treatise authors Calamari and Perillo appear to weigh in more on the Corbin/Farnsworth side of the debate and against Williston. *See* JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS, §47 (1970)(discussing "Standards of Interpretation", authors state there is no "'lawyers' Paradise'" where "'all words have a fixed, precisely ascertained meaning,'" *id.* at 89, setting off authors' perspective from those of evidence of evidence expert James Bradley Thayer, a Harvard Law faculty contemporary of contract law formalist Samuel Williston (citing JAMES BRADLEY THAYER, A PRELIMINARY TREATISE ON THE LAW OF EVIDENCE AT COMMON LAW 428-29 (1898)).

Although the theme of his study is largely that realism did not completely supplant formalism as the dominant paradigm in American legal thought, English scholar Neil Duxbury describes the American legal community as evolving during the 20th Century toward a less text-centered jurisprudence where "word-worship" was to a large extent attacked or even belitted. *See* DUXBURY, *supra* note 106, at 119-21.

229. *See supra* notes 215-225 and accompanying text.

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Restatement,[230] although the 1980s and 1990s have witnessed something of a formalist revival, particularly at the Supreme Court.[231] However, this formalist recidivism,[232] one largely decried by commentators,[233] hardly

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230. *See generally* RESTATEMENT (SECOND) CONTRACTS (1981); SCHABER & ROHWER, *supra* note 156, § 88 at 147 (authors of basic contract law text designed as primer and study aid for first-year law students state that "[o]ne purpose of contract law is to protect the reasonable expectations of persons who become parties to a bargain"). The Schaber & Rohwer view is in part premised on the work of earlier scholars who identified an "expectation interest" in contract performance. *See, e.g.*, LON FULLER & MELVIN ARON EISENBERG, BASIC CONTRACT LAW (5th ed. 1990); FRIEDRICH KESSLER, GRANT GILMORE & ANTHONY T. KRONMAN, CONTRACTS: CASES AND MATERIALS (3d ed. 19986). *See also supra* notes 215-225 and accompanying text.

In particular, Schaber & Rohwer observe that "[t]here is nothing wrong with 'plain meaning' and it may be a satisfactory answer to interpretations questions in some cases, but the problem may be more difficult than this expression indicates". SCHABER & ROHWER, *supra* note 155, at 148. They also note that even under the purportedly formalist/textualist views of Williston and the RESTATEMENT (FIRST), for which Williston served as Reporter, a number of nontextual factors were proferred as interpretative tools where the contract text at issue was not indisputably clear. *Id.* at 150-53. The approach of Corbin, Farnsworth, and the RESTATEMENT (SECOND) was more oriented to the parties actual and subjective meaning and did not seek an "objective" meaning for contract terms, as had Williston.

If this view is regarded as correctly summarizing the evolution of contract law in the 20th century, then the only real departure provided for insurance under the strong version of the Keeton "rights at variance" approach is that in cases of arguable unilateral mistake, where the policyholder has not read about or thought about portions of the policy language, the insurer's intended meaning will not control if this violates the insured's reasonable expectation. In fact, using the Keeton approach in these situations may be completely consistent with RESTATEMENT (SECOND) § 201(2)(b), which prevents one party's intended meaning from controlling if that party had "reason to know" that the other party may have had a different understanding, hardly a farfetched scenario in the context of insurance law.

231. *See* Jean Braucher, *The Afterlife of Contract*, 90 NW. U. L. REV. 49, 58-59 (1995) (viewing recent Supreme Court decisions as formalist and rendered as if Court was "blinded by a thick fog of free market rhetoric"); G. Richard Shell, *Contracts in the Modern Supreme Court*, 81 CAL. L. REV. 433 (1990) (finding Supreme Court contract cases of the 1980s governed by unrealistically rigid textualism, formalism, and insensitivity to pragmatic policy concerns). *See* Jeffrey W. Stempel, *Bootstrapping and Slouching Toward Gomorrah: Arbitral Infatuation and the Decline of Consent*, 62 BROOK. L. REV. 1381, 1412-17 (1996) (criticizing Court's interpretation of arbitration clauses in contracts as adopting erroneous view of objective meaning and reasonable reach of contract language).

232. Although the standard "story" of the march of 20th century American jurisprudence is of a trek away from formalism and toward functionalism, recent scholarship has persuasively argued that modern American legal thought has engaged in a protracted and probably perpetual tug-of-war between these schools of thought, but something considerably more complex than a "pendulum swing" alternating between periods of formalist and functionalist dominance. *See* DUXBURY, *supra* note 160, at 2-5 (1995). *See also id.* at 10 (realist revolt against formalism was "by no means as straightforward as some commentators have cared to suggest"); 21 (even

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suggests the absence of a place for expectations analysis at the contract law's figurative table.[234]

D. Reasonable Expectations and Reverence for Text

As previously discussed, courts and commentators rejecting the reasonable expectations approach frequently do so on the basis that consideration of party expectations undermines the predictability of a contract law regime premised on enforcing the contract as written rather than as understood.[235] But this perspective runs counter to the better reasoned views of contracts scholars such as Professors Corbin and Farnsworth and the assessment of the *Restatement*: the correct meaning of a contract term frequently cannot be determined by face of the term alone or even the term in the smaller context of the entire written instrument.[236] Often, courts must examine the larger context of extrinsic matter, background information, overall purpose, party intent, and even party expectations and public policy. Only then can the complex terms or terms at issue in unanticipated situations be aptly assessed.

Anti-expectations cases such as *Deni* and *Fogg*[237] ignore this truth in an almost simplistic manner, merely declaring that the meaning of the pollution exclusion is clear because the words "pollutant" or "irritant" can be looked up in a dictionary. The rallying cry of this jurisprudential perspective is that contract language must be given its "plain meaning" (and what could be more plain than a word that may be looked up in Webster's?) and that contract meaning can be decided based on the "four

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disciples of highly formalist 19th century Harvard Law Dean Christopher Columbus Langdell (such as Samuel Williston) found Landell's approach too narrow); 47 (progressive judges such as Benjamin Cardozo exhibited both formalist and functionalist traits); 55 (noting Harvard Law Dean Roscoe Pound's professed sociological jurisprudence attacking as "mechanical" jurisprudence the high formalism of Langdell); 60 (but both Pound and Oliver Wendell Holmes were both formalist and anti-formalist); 301-419 (modern "law and economics" movement has elements of both formalism and functionalism). *See also* FISH, *supra* note 214, at 156-68 (discussing "Contract's Two Stories" regarding nature and adequacy of consideration as example of ongoing tensions in the law).

233. See sources cited in previous note. *See generally*, *Symposium*, 90 NW. U. L. REV. 1 (1995) (variety of authors discuss aspects of Grant Gilmore's 1975 book, THE DEATH OF CONTRACT, with most authors criticizing Supreme Court's recent approach of rigid style textualism and formalism).

234. *See* SCHABER & ROHWER, *supra* note 155, § 6 at 11 ("[c]ontract law is concerned with protection of the reasonable expectations of the parties").

235. *See supra* notes 4-16, 21-22, 69-80 and accompanying text.

236. *See supra* notes 140-54 and accompanying text.

237. *See supra* notes 174-212 and accompanying text (discussing *Deni* and *Fogg* cases).

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corners" of the contract documents if the language used is sufficiently plain and clear.

A more sophisticated view of the four corners plain meaning rule is nicely stated by a jurist whose commitment to efficiency, predictability, party autonomy, and enforceable contract law is well-established. Judge Richard Posner, in *Agfa-Gevaert, A.G. v. A.B. Dick Co.*,[238] a commercial contract dispute, summarized:

> The black-letter substantive rule, sometimes called the "four corners" rule, is that if a written contract is clear "on its face"—that is, clear to someone who can read English but does not know the background of the contract—evidence may not be introduced to vary that apparent meaning. The practical effect is to confine the power to decide in such cases to the judge, for the issue of interpretation can be answered only one way. . . . [T]he four-corners rule has now pretty much yielded to a rule that "extrinsic" evidence may be introduced not only if the written contract is ambiguous on its face, but also to show that it is ambiguous.[239]

Applying this working definition of a four-corners plain meaning approach to insurance coverage immediately suggests the limited utility of the plain meaning textualist talisman. Many insurance policy provisions, even those routinely enforced by courts, simply are not clear unless one understands the nature of the insurance product and the background of the specific contract. Consider the pollution exclusion faced by the Florida Supreme Court in *Deni* and *Fogg*. The average reader of English perusing the exclusionary language can know what an irritant is, or what comprises smoke or soot—but when reading this language does the reader realize that policyholders will not receive liability coverage when a patron slips on the hypothetical blot of bleach? In a vacuum, the connotative value of the term "pollution" suggests something more despite the broad verbiage used by the insurance industry.

For the reader with background knowledge, i.e., the actual commercial policyholder, the meaning of the pollution exclusion becomes even more familiar. The insurer purchased coverage to obtain protection in the event of litigation over alleged business negligence. Under these circumstances,

238. 879 F. 2d 1518 (7th Cir. 1989) (applying New York law).

239. *Id.* at 1521 (citation omitted).

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would the reasonable reader poring over the four corners of the CGL and the pollution exclusion expect to be denied coverage when a blueprint machine tips over rather than catches fire or when a crop dusting plane sprays a bystander rather than crashing down upon him? My own preliminary reaction is that coverage should exist in this situation because of the nature of the CGL product. But even if my view is incorrect, refuting it would appear to require courts to do more than stare at the insurance policy and the dictionary in tandem.

The *Agfa-Gevaert* case from which the Posner quote is taken illustrates the practical limits of four-corners, plain meaning thought. In *Agfa*, the question was whether the contract between a manufacturer of paper copiers and a distributor was a "requirements" contract mandating that the distributor purchase all of its required copiers of that type from the manufacturer or whether the distributor was free to market the models of other manufacturers. The trial court found the contract language in dispute to unambiguously create a requirements contract. The Seventh Circuit unanimously found the contract unambiguously not to be a requirements contract. So much for the predictability, reliability, and certainty wrought by the four-corners plain meaning approach.

Furthermore, New York, identified in *Agfa* as the leading jurisdiction strongly supporting the traditional four corners approach resisting the intrusion of extrinsic evidence, frequently bases its insurance coverage decisions, at least implicitly and frequently explicitly, upon the objectively reasonable expectations of the parties reading the four corners of the policy in light of the context of the insurance contract.[240] Although not openly embracing rights at variance expectations analysis, the New York courts can be regarded as considering party expectations when interpreting insurance policies notwithstanding their professed allegiance to the four-corners plain meaning approach.

E. Reasonable Expectations and the Judicial Role

The pure *Rights at Variance* form of the reasonable expectations doctrine appears to be losing ground, or at least failing to gain ground since 1985,[241] although the doctrine appeared to be growing in popularity during the first 15 years after the Keeton article. Scholars observing this

240. *See supra* note 118 and accompanying text (discussing New York law).

241. The beginning of this trend was captured well in Prof. Mark Rahdert's excellent 1986 article. *See* Mark Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323 (1986) and discussion in the article of reasonable expectations developments in Iowa, Idaho, New Jersey, and Pennsylvania.

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trend have refrained from an extensive assessment of why these courts backtracked on the reasonable expectations doctrine and in particular eschewed a legally realist explanation for the change. For example, one might suggest that the retreat from the pure form of the reasonable expectations doctrine resulted from the increase in judicial conservatism during the 1980s and 1990s or the greater dominance of Republican Presidents and Governors in selecting judges. In my view, such an explanation, although perhaps sounding simplistically political, is partially correct.

The reasonable expectations doctrine is regarded (wrongly in my view) as overly liberal, result-oriented, and anti-free market anti-freedom of contract, and even at odds with the norm of judicial deference to the legislature.[242] Republican-appointed judges and conservative judges are generally reluctant to embrace a doctrine with this sort of image. But, as discussed in Part IV, the retreat from reasonable expectations or the reluctance to further embrace it stems from a more metapolitical aspect of our culture than the relative strengths of the political parties or their primary ideologies. Rather, the growth of reasonable expectations analysis has been pared to a large degree by the prevailing view that judges must generally be restrained strict constructionists who do as little as possible to interfere with textual instruments and markets.[243]

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242. *See, e.g.*, Stephen J. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461 (1989); J.H. Baker, *From Sanctity of Contract to Reasonable Expectation*, in CURRENT LEGAL PROBLEMS 1979 (Lord Lloyd, et al., eds.) at 17, 23-24 (1979); Harry F. Perlet, *The Insurance Contract and the Doctrine of Reasonable Expectation*, 6 FORUM 116 (1971); Conrad L. Squires, *A Skeptical Look at the Doctrine of Reasonable Expectations*, 6 FORUM 252 (1971); E. Neil Young, et al., *Insurance Contract Interpretation: Issues and Trends*, 625 INS. L.J. 71, 73, 78-81 (Feb. 1975) (reviewing approaches to insurance policy construction and identifying reasonable expectations doctrine as separate school of thought); Note, *Common Law Alternatives to the Doctrine of Reasonable Expectations in the Construction of Insurance Contracts*, 57 N.Y.U. L. REV. 1175 (1982); Note, *The Reconstruction of Insurance Contracts Under the Doctrine of Reasonable Expectations*, 18 J. MARSHALL L. REV. 155 (1984); William C. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267 (1986); David L. Leitner, *Enforcing the Consumer's "Reasonable Expectations" in Interpreting Insurance Contracts: A Doctrine in Search of Coherent Definition*, 38 FED'N. INS. & CORP. COUNS. Q. 379 (1988); Comment, *Decapitation to Cure Dandruff? The Scope of the Reasonable Expectations Doctrine of Darner Motor Sales, Inc. v. Universal Underwriters Insurance Co.*, 20 ARIZ. ST. L.J. 841 (1988).

243. *See* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW, Ch. III (1973)("Law and the Economy: 1776-1847") (discussing prevailing American view since colonial times that

"Judicial activism" has traditionally been frowned upon in the folklore of American jurisprudence.[244] Although this view has had greater strength since the 1968 election of Richard Nixon than it did during the 1930-1968 period,[245] the veneration of "judicial restraint" or "strict construction" is hardwired into our law, politics, and society.[246] Although there are of course exceptions to this "rule" and substantial but "hidden" chronic breaches of the rule, the American ethos of judging is one of constraint and frequent deference to other institutions (executive, legislative, private ordering, and to text:[247] the text of the Constitution created by the framers; the text of a statute enacted by Congress; or the text of a contract "bargained" for and executed by private parties.[248]

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courts should enforce contract language as written and generally avoid judicial interference with market activity).

244. *See generally* HENRY M. HART, JR. & ALBERT M. SACKS, THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW (William N. Eskridge, Jr. & Philip P. Frickey, eds.) (1994) (discussing notions of separation of powers, procedure, neutrality, prudence, suggesting that these favor judicial restraint; book focuses strongly on the other branches of government and on the relatively slow and steady change of common law doctrine. Courts are portrayed as having substantial authority over common law matters. Other lawmaking activity is to be approached by courts only with care so as not to intrude upon other policymakers).

245. Nixon made purported "judicial activism" of Warren Court a major target in his presidential campaign and promised to appoint only "strict constructionists" to the Supreme Court should a vacancy occur. *See* BOB WOODWARD & SCOTT ARMSTRONG, THE BRETHREN Introduction & Ch. 1 (1979). Although like any clever candidate, Nixon was not particularly specific in defining a "strict constructionist", he clearly was suggesting an appointee who focused on language (of the Constitution, a statute, a contract) rather than on other interpretative factors. Nixon won the election in 1968 and handily won re-election in 1972, suggesting that this perspective on judging and courts enjoyed substantial approval among the general public.

246. *See* HART & SACKS, *supra* note 244 (outlining relationship and co-equal power of executive, legislative, and judiciary).

247. *See* RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 9-12 (this "short history" of jurisprudence notes emergence of "legal positivism" in which law is defined as command of sovereign but with elements of natural law limiting range of sovereign's power). But Posner also notes the malleability of rules, pragmatic approaches (which he favors) and alternative centers of power in American law. *Id.* at 17. Although Posner endorses the progressive judging of, for example, Cardozo, Posner clearly favors a judicial approach in which change is incremental and initially rule-driven, with functional policy analysis used where black letter rules yield ready, sensible answers. *Id.* at 23-30, 32 (Posner labels his views on judging "boringly centrist").

248. *See* RICHARD A. POSNER, OVERCOMING LAW 109-110, 133, 134 (1995):

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Although this popular concept of judicial restraint obviously explains a good deal of the resistance to the reasonable expectations doctrine, there has been remarkably little serious reflection on exactly what it means to be a judge acting within the scope of properly limited judicial role. Many of the opinions rejecting the expectations doctrine on the ground that it is "judicial activism" fail to go beyond the surface of this shibboleth, the utterance of which alone is expected to convince the reader that expectations analysis must be bad if it entails judges doing anything more complex than reading an insurance policy and a dictionary in tandem.

As noted above, the notion of contract freedom has been rhetorically oversold.[249] Similarly, the notion that contracting parties, even the drafter, chose all words in a contract carefully and with a specific intent is hopelessly wrong much of the time. Consequently, for the reasons stated above, judicial scrutiny of contracts to ensure reasonable construction hardly seems like the conduct of a rogue judiciary intent on rampaging outside its boundaries to impose on litigants agreements they never made. Undoubtedly, parties losing a contract dispute will make such charges whenever an adjudication requires more performance than they were

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> [T]he appropriate role of the judge—his incentives and constraints, the balance he should seek to maintain between discretion and obeisance, between creativity and conformity, the conditions of judicial greatness, the sources of judicial wisdom, the twin shoals of usurpation and passivity—has occupied center stage in the drama of Anglo-American jurisprudence.
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> * * *
>
> Because there are so many ordinary judges, and because anti-intellectualism, democratic egalitarianism, and suspicion of officials run deep in the American soul, there is even a cult of ordinariness in judging. Exceptionally able judges arouse suspicion of having an "agenda" . . . .
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> * * *
>
> It is because judges play by the rules of the judicial game that legislatures can control judicial behavior, though not perfectly . . .
>
> * * *
>
> Traditional legal education and practice do tend to filter out of the profession, or at least the part of the profession from which most judges are appointed, persons radically uncomfortable with traditional legal roles, including that of the judge.

But "in our system the line between law and policy, the judging game and the legislating game, is blurred." *Id.* at 131. *See also*, RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE, Ch. 4 (1990) ("Legitimacy in Adjudication") (although not adhering to strongly rigid or formal notion of judicial restraint himself, Posner acknowledges general social and legal view favoring restraintist model).

249. *See supra* notes 214-233 and accompanying text.

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willing to give under their interpretation of the agreement. At most, however, a bad decision in this regard is just that: a bad decision. Construing a contract to require more than the losing party wanted to give is not judicial activism any more than it is judicial activism to construe an exclusion in an insurance policy more broadly than a policyholder wanted, thus eliminating coverage. An adjudicatory approach does not become uneven or quasi-legislative simply because the court uses additional factors to determine contract meaning.

In his other writings near the time of the *Rights At Variance* article, Judge Keeton shows an appreciation of this process and implicitly refutes cases like *Allen*, which suggest that courts may give only a certain interpretation to words contained in policies approved by the legislature. Rather than seeing courts as rebels seeking to overthrow the legislature, Keeton saw courts as flexible adjudicative institutions that would apply legislative commands to emerging or unforeseen situations and relieve the legislature of the burdensome and probably impractical duty of constantly updating and revisiting statutes and administrative rules.[250]

Thus, as discussed above, judicial use of expectations analysis does not violate the autonomy of contracting parties or their freedom to contract as they see fit subject to the already existing limits of illegality and unconscionability. To the extent that use of expectations analysis is attacked as judicial activism threatening separation of powers values, the criticisms of expectations analysis are even more misplaced. As discussed earlier in the article, even the *Allen* decision,[251] which attempts a tour de force against the reasonable expectations doctrine, fails to convince. In essence, *Allen* and similar cases argue that courts cannot apply reasonable expectations analysis to construe insurance policies because the policy forms were previously approved by insurance regulators, who must have intended the policy language to mean whatever the court construes the language to mean based on dictionary definitions or (at most) non-dictionary interpretative tools other than reasonable expectations.[252]

As discussed at length in my criticism of *Allen*,[253] the argument borders on the ridiculous. When regulators approve policy forms, they of course do so based on a generalized view of the coverage provided. But it is an

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250. ROBERT E. KEETON, VENTURING TO DO JUSTICE: REFORMING PRIVATE LAW 83-86 (1969)

251. *See* Allen v. Prudential Property & Cas. Ins. Co., 839 P. 2d 798, 803 (Utah 1992) (discussed *supra* notes 85-115 and accompanying text).

252. *See supra* notes 69-115 and accompanying text.

253. *See supra* notes 85-115 and accompanying text.

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inferential leap of infinite magnitude to take this fact and from it suggest that regulators have in mind for every word of every policy form approved an intended meaning and that the regulators would take umbrage if the courts were to subject language in approved policy forms to expectations analysis. Furthermore, refusing to apply expectations analysis to contract terms in forms approved by government regulators is judicial activism in reverse—judicial atrophy or even abdication—in that it attempts have agency employees (usually neither elected by the people or appointed by elected officials)[254] determine the meaning of contract terms. Even the most conservative politicians presumably agree that courts (and not executive branch employees or legislative aides) should be deciding contract disputes. Even where a statute enacted by the legislature defines terminology, courts must construe the definition as applied to an actual disputed insurance policy. If a judicial decision misconstrues the legislature's intended meaning, the legislature has ample opportunity to revise the provisions at issue and can even overrule the court's construction. Consequently, the reasonable expectations doctrine is perfectly consistent with the traditional judicial role and poses no threat to separation of powers or prevailing notions of judicial restraint.

Similarly, the expectations approach does not arrogate power to the judiciary when used in this manner. Recall that the "separation of powers/judicial activism" argument against the reasonable doctrine posits that policy text must be enforced as written because the policy text is embodied in forms approved by another branch of government, usually the state Insurance Department. The Department is normally an administrative agency of the Executive Branch of the state, although some Insurance Commissioners are elected in their own right. Sometimes legislation effectively mandates or authorizes particular policy language or provisions. Thus, runs the argument, any judicial use of any factor other than policy text is utilization of factors that have not been approved by the legislature. Or, if the text at issue is deemed "clear" according to dictionary criteria, the court may see itself (as did the *Allen* majority of the Utah Supreme Court) as rendering a decision not only outside the range of the other

254. Most review of proposed policy forms of necessity is done by employees of an insurance department and not by the insurance commissioner or even top aides. To the extent the commissioner gets involved, it will be to review the assessment of an employee, probably with considerable deference. Viewed this way, the *Allen* majority opinion is most indefensible in that it would require courts to limit their analysis of a contract term merely because the contract term was not prohibited by a civil service worker. This is judicial abdication every bit as lawless as any ultra vires judicial activism.

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branch's approval but in contravention of the views of another branch of government.[255]

As noted in the previous discussion of *Allen*, the "separation of powers" argument against reasonable expectations is unrealistic view of the practical operation of government regulation.[256] In the real world, government regulation is inconsistently and episodically imperfect. The regulators may be incompetent, ineffective, or even corrupt. By approving a policy form, the Insurance Commissioner does not simultaneously mandate that only a certain construction of the term applies or that dictionary construction of the term is required in future litigation.

At best, the regulatory agency approving insurance policy forms is scanning the policy and determining that the policy language, examined without reference to any actual dispute, seems noncontroversial. No serious observer of the regulatory process would suggest that in the ordinary case, the regulatory boy by approving a form has also given serious reflection to possible constructions of the policy in a variety of litigation contexts. On the contrary, it seems more likely that the regulatory agency is expecting that the courts will ensure that the form language of approved policies is applied in a manner that serves the intent and purpose of the parties and the insuring arrangement. When a court

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255. *See supra* notes 85-115 and accompanying text (discussing Allen v. Prudential Prop. & Cas. Ins. Co., 839 P. 2d 798 (Utah 1992)).

256. In a different context, Judge Ralph Winter in dissent criticized application of the mail fraud statute against a well-connected politician accused of dispensing patronage, finding that the majority's rationale that politically connected contracting deprived the citizens of honest government and the loyalty of elected officials to be "a legal standard which amounts to little more than the rhetoric of sixth grade civics classes." *See* United States v. Margiotta, 688 F. 2d 108, 139 (2nd Cir. 1982) (Winter, J., dissenting).

Regarding the mail fraud statute, I disagree. But the Supreme Court soon found Judge Winter's perspective persuasive. *See* McNally v. United States, 483 U.S. 350 (1987) (finding mail fraud statute did not reach a public officials "defrauding" of public of right to honest government). However, Congress had a different view, amending the statute with new section 18 U.S.C. § 1346 to overrule *McNally* by providing that a "'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services". The Court sustained application of the new provision. *See* Carpenter v. United States, 484 U.S. 19 (1987) (permitting mail fraud prosecution of government official involved in corrupt funneling of favors to political allies).

But whatever one's view of the merits of mail fraud, the point remains well-taken: simplistic notions of government can make for problematic construction of statutes or contracts. *See* Lawrence M. Solan, *Learning Our Limits: The Decline of Textualism in Statutory Cases*, 1997 WIS. L. REV. 235 (providing illustrations of inability of text-based approach to statutory interpretation fueled by formalistic notions of separation of powers to provide consistently sound construction of statutes at issue).

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provides the "correct" construction by using reasonable expectations as an aide, the court is not undermining the legislature or the executive: the court is helping the other branches to be more effective.

In a few instances, obviously significant or highly publicized policy form language (e.g., the use of a claims-made policy rather than an occurrence policy) may receive unusual attention from the regulatory body. But even in such instances, this greater scrutiny seldom results in a pronouncement by another branch of government as to the "meaning" of the policy term in litigation that was not even pending at the time the form language was approved for marketing in the state. Even if the insurance regulator had made such a finding, it is unclear that such a directive should be binding on the courts. As the old chestnut from *Marbury v. Madison* provides, it is emphatically the province of the judiciary to say what the law is.[257]

Similarly, within the core judicial mission of adjudicating private law disputes, it would seemingly violate separation of powers in a manner akin to a Bill of Attainder if a regulatory agency were to decree that the judiciary must render a given construction of a disputed contract term. To be sure, the agency's interpretation (if in fact the agency has actually made an interpretation) is entitled to substantial weight and perhaps even deference (if the agency has expertise or the legislature has committed such matters to the agency). But the notion that government regulators can bind courts to given constructions of contract language raises separation of powers problems far more severe than even the most aggressive judicial use of the reasonable expectations doctrine.

F. Assessing the Misguided Jurisprudential Resistance to Reasonable Expectations Analysis

In sum, more than two decades after the Keeton article, we continue to find uncertainty and division over the issue. Well-entrenched prior to the Keeton article was what might be termed the standard contract construction paradigm, which established the primacy of contract language, both as the legal content of the contract and the primary determinant of party intent. Against this bulwark, the suggestion that even clear contract text could be overcome by policyholder expectations has been unable to effect a paradigm shift. But, of course, Keeton did not purport to remake the contract law paradigm—only to refine its enunciation and application in a set subcategory of cases. Seen this way,

257. *See* Marbury v. Madison, 5 U.S. (1 Cranch) 137 (1803).

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the reasonable expectations doctrine was a new theory but not a competing paradigm.

However, despite the substantial contract law pedigree enjoyed by the expectations principle, courts and commentators have viewed it as somehow inconsistent with "normal" contract law. Several factors probably account for this:

- The long-standing and continuing tension in contract law between what might be termed the "Williston" and "Corbin" camps. Although the Corbin view may have enjoyed a period of relative dominance when Keeton wrote, Corbin's less text-reverent approach to interpretation never completely displaced the Williston camp's greater formalism in the manner of a Kuhnian paradigm shift.

- The comparative ascendancy of the Williston faction in the years since Keeton introduced the reasonable expectations doctrine. Although I continue to regard the Corbin view as having prevailed on the whole in the legal profession and in society, the textualism and formalism of the Williston school has made something of a comeback since the 1970s.

- The rise of textualism in the law generally, particularly renewed interest in textualism in statutory interpretation as popularized by Justice Antonin Scalia. Although this movement, like the Williston camp of contract law has or will ultimately lose out, it continues to enjoy substantial support and thus tends to color other fields of law.

- The rise of the law and economics movement, which has in tandem with textualism reinvigorated support for less limited judicial activity, greater deference to private ordering, the parol evidence rule, greater certainty, greater predictability, and greater efficiency in the law. The conventional wisdom—with which I disagree—posits that expectations analysis is inconsistent with these goals because it leads to results at odds with the

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insurers' understanding of the words chosen for the policy and makes outcomes turn too much on the self-interested averments of the policyholder.

- The influence of Chicago-school thinking, textualism, and contract formalism is perhaps most pronounced in the U.S. Supreme Court. Consequently, these countervailing influences pushing back rights at variance expectations analysis have enjoyed a bully and influential pulpit likely to have osmotic affect on other courts, even the state courts that are not bound to follow the Supreme Court on most matter of insurance law.

- The upswing of political conservatism since Keeton wrote. Although it would be too legal realist to suggest that a Republicanization of the judiciary has led to diluting or compromise of the reasonable expectations doctrine, it is largely correct to attribute greater support for textualism, Chicago-school economic analysis, and formalism to Republican judges.

Thus, factors that might be deemed external to insurance law and certainly to the reasonable expectations doctrine itself added to the normal reaction attending a significant new concept in a field of law. But apart from the politics of judicial appointment and public sentiment, expectations analysis would have generated antithesis and resistance from the dominant contract formalism paradigm under siege from the doctrine. But these factors intensified opposition to the expectations concept and forced greater dilution such as the requirement that a policy provision be (apparently textually) ambiguous before expectations analysis can be brought to bear on the issue. Similarly, these factors thwarted any hope that expectations analysis might be the paradigm shift that rewrites leading texts in the field (other than Judge Keeton's).

In the end, "freedom of contract" rhetoric, always strong in American law and society, became stronger after Keeton's seminal article. Because too many lawyers, judges, and scholars erroneously portray expectations analysis as undermining freedom of contract, there was sure to be some retreat from it during the 1980s and 1990s. In the hubbub, the opportunity to use expectations analysis to enhance party autonomy and choice through prudent use of expectations analysis has been lost.

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Left unanswered in the initial discussion of the Keeton doctrine was the question of exactly what contract construction process was to govern insurance coverage disputes and what role existed for reasonable expectations throughout this overarching model of contract interpretation. In addition, because of not only the traditional contract paradigm but also the historical paradigm of judicial restraint, courts have been reluctant to give a full hearing to the Keeton doctrine or a more comprehensive version of reasonable expectations thinking for fear of departing too greatly from the norm of judicial restraint.

It surely is not coincidence that the Keeton reasonable expectations formula was announced at a time of relatively ambitious if controversial expansion of the judicial role. It also cannot be mere coincidence that the largely successful counterattack on the Keeton application of expectations analysis paralleled a general upsurge in political conservatism in America and a retrenchment of the judicial role, complete with the onset of a different cast of more restrained judges deciding cases, often expressly aiming to reverse the perceived excesses of an earlier generation. At the same time, these events of the outside world were accompanied by and perhaps driven by a conservative counter-revolution in the academy, particularly the rise of the law and economics movement.[258] The law and economics analysis provided renewed philosophical support for the argument that social policy was best served by a legal regime weighted toward laissez faire freedom of contract,[259] a position that seemed to have been relegated to permanent minority status only a few years before in the wake of the New Deal, the ascendancy of the Corbin *Contracts* treatise,[260]

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258. *See* Edward L. Rubin, *The Nonjudicial Life of Contract: Beyond the Shadow of the Law*, 90 NW. U. L. REV. 107, 113 (1995) (viewing influence of law and economics writings, particularly those of Professor/Judge Richard Posner, as having influenced contract decisions toward greater focus on efficiency and wealth maximization rather than party intent). These and other forces were at work in effecting a retrenchment in the reach of civil litigation. *See* Jeffrey W. Stempel, *New Paradigm, Normal Science, or Crumbling Construct? Trends in Adjudicatory Procedure and Litigation Reform*, 59 BROOK. L. REV. 659, 661-95 (1993) (describing political forces affecting law during past thirty years).

259. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (4th ed. 1992).

260. *See* ARTHUR L. CORBIN, CORBIN ON CONTRACTS (1950) (One Volume Edition). The first half of the 20th Century featured a good deal of conflict between Yale Professor Corbin and Harvard Professor Samuel Williston, the author of the other leading treatise on contract law (SAMUEL WILLISTON, TREATISE ON THE LAW OF CONTRACTS (1st ed. 1920); To oversimplify a complex dispute, Williston was generally more of a formalist and textualist in matters of contract (though not so much as commonly thought) while Corbin was more of a legal realist favoring contract interpretation that focused on the purpose of the contract and the intent and expectations of the parties. *See* Jean Braucher, *The Afterlife of Contract*, 90 NW. U. L. REV.

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and an expanding notion of contract duty that one leading commentator termed the "death" of contract.[261]

As the law and economics school ascended in tandem with the Reagan Revolution, philosophical precepts that seemed outmoded only years before regained their status as irrefutable truths, ideals, and values of American polity—and legality. At the time Keeton's famous "rights at variance" articles were published, the libertarian construct was under attack and seemingly on the run. It is hard, for example, to imagine the anti-Vietnam War generation of the time accepting the view that real freedom of contract existed and that contract language needed to be strictly or literally embraced in order to protect the expectations of primary insurers, excess insurers, and reinsurers. But by the second decade after Keeton's articles, courts were regularly rejecting the Keeton doctrine with phrases suggesting that courts had no authority to disturb the "bargain" implicated in an insurance policy, in effect tacitly focusing on the expectations of the insurer. In the late 1960s and early 1970s, issues of justice, fairness, public safety, and equality were prominent: manufacturers were increasingly held strictly liable for product failures; liability was to be shouldered by the party in the most effective position to have avoided or spread the risk; discrimination was prohibited even if doing so created

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49, 58-60 (1995) (Williston regarded as being more conservative and having less support than Corbin but Williston more concerned with quality of bargain and consent than commonly supposed).

The conventional wisdom holds that Corbin won this battle for the hearts and minds of the legal profession. *See* E. ALAN FARNSWORTH, CONTRACTS Chs. 1-3 (2d ed. 1990) (describing modern contract law as emphasizing importance not only of text but also party intent, purpose of agreement, contract setting, party expectations, as well as knowing and voluntary consent of parties). In particular, *see id.* §1.9, at 31 n.3 (describing Williston's disagreement with provisions of Uniform Commercial Code supported by Corbin and legal realist Columbia Law Prof. Karl Llewellyn. However, since the 1970s, there has been a pronounced jurisprudential swing in favor of textualism and formalism, with a consequent diminution in the importance of other factors such as party expectations. *See* Braucher, *supra* at 60 (recent Supreme Court cases seem decided in "blinding fog of free market rhetoric); Edward L. Rubin, *The Nonjudicial Life of Contract: Beyond the Shadow of the Law*, 90 NW. U. L. REV. 107, 113 (1995) (contract law, because of law and economics influence, "took a massive wrong turn" during 1970s and 1980s in focusing too heavily on purported economic efficiency in interpretation); Shell, *supra* note 231.

261. *See* GRANT GILMORE, THE DEATH OF CONTRACT (1974); Robert A. Hillman, *The Triumph of Gilmore's The Death of Contract*, 90 NW. U. L. REV. 32 (1995) (suggesting that in response to Gilmore's critique that court decisions had effectively "killed" traditional contract doctrine through focus on extratextual factors, courts to some degree retreated and returned focus to traditional doctrinal factors).

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collateral costs for business. Viewed retrospectively, the Keeton project of identifying rights at variance seemed a part of this drive for justice and effective function.

The late 1970s and 1980s saw renewed support for reduced government regulation, business and contracting autonomy, and reduced aggregate costs despite the possible imposition of serious losses on individuals. In this climate, counter-reaction to the Keeton thesis and a generalized attack on reasonable expectations doctrine can hardly be viewed as a surprise. In light of the conservative swing on the federal and state bench, judicial retreat from the Keeton doctrine and acceptance of anti-reasonable expectations arguments can hardly be thought of as a surprise, either. In the third decade, there has not been any new shift in direction so much as there has been a continuation and stabilization of the modern version of traditional neo-classical contract doctrine perhaps made "kinder and gentler" as a result of some dissatisfaction with the excesses of conservatism and a partial comeback by progressive political forces. But like American politics and law generally this "synthesis" of the Keeton "thesis" and the insurer's "antithesis" has more in common with the traditional view of contract and insurance than it does the Keeton form of the reasonable expectations doctrine. Instead of Franklin Roosevelt, we have Bill Clinton. So much for counter-counter revolution.

Viewed with retrospective detachment, the Warren Court, the Civil Rights Movement, the Anti-Vietnam War Movement, the late 1960s and early 1970s (Hippies, Haight-Asbury, "Easy Rider" and all that) now most likely must be characterized as the clear exception rather than the rule. This period was one of unusual progressive ferment. Thereafter, these social forces receded before the more established social tide of ongoing commercial and political interests, who successfully re-established the hegemony of the neoclassical contract paradigm. But to some degree, the reassertion of the prior status quo was muted by the new wave of major coverage litigation involving long-tail latent injuries, mass product torts, and increasingly sophisticated legal talent deployed by both insurers and captives. Complex insurance problems were being litigated during the 1980s and 1990s, with increasingly sophisticated counsel for both policyholders and insurers marshalling an array of arguments, including of course the reasonable expectations doctrine.

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III. TAKING REASONABLE EXPECTATIONS SERIOUSLY—AND COMPREHENSIVELY: TOWARD A RECOGNIZED COMPREHENSIVE ROLE FOR REASONABLE EXPECTATIONS ANALYSIS IN RESOLVING INSURANCE COVERAGE DISPUTES

Courts addressing the reasonable expectations issue during the first, second, and third decades of the Keeton era have all tended to commit the same mistake—focusing on the Keeton reasonable expectations formula and the particular application of reasonable expectations analysis employed by Keeton in the article as though it were the only realm of insurance law where reasonable expectations were at issue.

Keeton wrote about insurance coverage that was "*at variance with*" the policy provisions. By definition, he was looking at coverage decisions that seemed to run counter to a fair reading of the policy text. In doing so, Keeton necessarily was not giving full consideration to the utility of expectations analysis that was not "at variance" with policy provisions. Because Keeton's article was deservedly celebrated and prominent, reasonable expectations analysis became indelibly associated with Keeton's deployment of reasonable expectations. Some expectations commentators and courts have addressed the reasonable expectations concept more comprehensively, observing the use of reasonable expectations thinking in a variety of cases.[262] However, most attention paid to reasonable expectations by courts and commentators has framed the issue as policyholder expectations vs. clear contract language, thus emphasizing the expectations approach as a trump card rather than an analytic tool.

For example, Professor Abraham's well-regarded and frequently cited article on reasonable expectations,[263] authored at the beginning of the second decade of the reasonable expectations era, focused almost exclusively on the Keeton formula and the cases posing stark conflict between expectations and clear policy language. Abraham further categorized and analyzed the Keeton formula cases as those reacting to insurer misbehavior and those involving "mandated coverage", a phenomenon he termed "Judge-Made Insurance". Even though Abraham largely endorsed the Keeton formula, his catchy term came to epitomize criticism of the Keeton doctrine—most likely because it resonated, perhaps unwittingly, with the prevailing American construct that courts do not "make" constitutional law, statutes, common law—or contracts. Rather,

262. *See, e.g.*, Henderson, *supra* note 10; Rahdert, *supra* note 5.

263. *See* Abraham, *supra* note 5.

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courts venerate the constitution, apply statutes, "find" common law, and construe contracts. A court that not only ventures widely in construing a contract but also finds the contract to create rights beyond the seemingly clear linguistic boundaries of the contract's text seems to observers to run afoul of the American ethos, making the court's activity seem somehow unprincipled.

As the history of more than a quarter-century of self-conscious reasonable expectations analysis suggests, the Keeton formula alone will probably never enjoy majority status nor can it ever comprise the entire role of reasonable expectations analysis in construing insurance policies and resolving insurance coverage disputes. As the third decade of reasonable expectations draws to a close, a more comprehensive and refined synthesis is necessary in order to establish a new (or at least modified) paradigm that can shoulder the burden imposed by the increasing frequency, complexity, and importance of insurance coverage litigation in the next century.

Rather than continue to debate the merits of the Keeton form of reasonable expectations or to argue over whether express consideration of the parties' reasonable expectations adds anything to traditional ambiguity analysis, courts should take a more comprehensive look at the role of policyholder and insurer expectations and the degree to which those expectations enhance the contextual base for interpreting insurance policies. The objectively reasonable expectations of both the policyholder and the insurer (and beneficiaries and other interested parties such as a lender or guarantor) should routinely be consulted in order to provide the background context (what English lawyers sometimes refer to as the "factual matrix") for determining the meaning of a disputed policy term. There is no compelling reason for courts to myopically focus only on policy text and to affirmatively avoid appreciating the connotation and context of the policy. Major indicators of such policy meaning are the objectively reasonable expectations of the parties and even the subjective expectations of the parties.

In many cases, consideration of expectations is of no moment. A term may be clear (e.g., "this policy covers your 1992 green Ford") both on its face and in terms of the expectations of all parties. In other cases, the use of expectations analysis may be valuable in determining whether policy language can or should be read literally. For example, does a policy term disclaiming coverage for anything "related to" the "release" of a "pollutant" bar coverage for a claim by a third party whose car skids on a puddle of oil negligently left on the road? In this latter case, courts

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unwilling to give literal application to such a broad exclusion should prefer to incorporate expectations into the analysis rather than arguing at length about the degree to which the text of the pollution exclusion should be read literally or is ambiguous. Further, if a state is unwilling to utilize expectations analysis, it is often left with a Hobson's Choice when reviewing policy language such as the absolute pollution exclusion: either the court reads the language literally and broadly, excluding far more than was ever intended by even the insurance industry; or it characterizes the exclusion as ambiguous and routinely rules against the insurer, even in cases that should not be covered in a rational system of insurance adjudication.

Because of the historical context of the Keeton reasonable expectations formula, the legal profession has essentially missed a sea of opportunity while quibbling over one wave of reasonable expectations controversy (the defensibility of invoking policyholder expectations to overcome the clear policy language). Even if the legal legitimacy of the Keeton approach is problematic under a regime of an objective theory of contract, there remains a wide array of cases that would greatly benefit from application of reasonable expectations thinking. But that application requires a general reassessment of the ground rules of contract meaning and interpretation.

The absolute pollution exclusion is an example of exactly the type of insurance policy provision for which courts should apply evenhanded reasonable expectations analysis not so much as a counterweight to clear text *but as a prerequisite to determining the meaning of words and the possible ambiguity of words.* Two recent cases provide good examples of proper use of this form of reasonable expectations analysis to resolve pollution exclusion controversies even though neither court emphasized the reasonable expectations aspects of its decisions.

In *Western Alliance Insurance Co. v. Gill*,[264] and *American States Insurance Co. v. Koloms*,[265] the Supreme Courts of Massachusetts and Illinois both determined that the absolute pollution exclusion does not bar coverage for claims related to negligence resulting in carbon monoxide poisoning simply because carbon monoxide is a dangerous gas and as such falls within the literal reach of the pollution exclusion, which on its face states that it excludes liability claims related to any "actual, alleged or threatened discharge, dispersal, release or escape of pollutants," with

264. 686 N.E. 2d 997 (Mass. 1997).
265. 687 N.E. 2d 72 (Ill. 1997).

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pollutants defined as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste."

The Illinois Court in *Koloms* faced a situation where the claim was against an insured landlord for failure to properly maintain a building furnace which emitted the CO fumes that caused the injuries resulting in the claim. Examining the background, history, and purpose of the exclusion, the *Koloms* Court determined that the exclusion—despite its broad literal language—was intended only to bar coverage for the traditional sort of waste discharge and diffuse contamination ordinarily thought of as pollution. Claims for the type of injuries traditionally arising from nonpolluting forms of insured negligence were not to be excluded. Hence, despite the linguistic breadth of the exclusion, the Illinois Court limited the reach of the exclusion in order to render a coverage determination the Court viewed as more consistent with the purpose of the CGL and the exclusion and the intent of the drafters.[266]

Citing *Koloms* and adopting similar reasoning, the Massachusetts Court stated that the absolute pollution exclusion "should not be reflexively applied to accidents arising during the course of normal business activities simply because they involve a 'discharge, dispersal, release or escape' of an 'irritant or contaminant.'"[267] Following this analysis and confronted with a claim by a restaurant patron who suffered carbon monoxide poisoning as a result of poor ventilation at the restaurant, the *Gill* Court found coverage not to be thwarted by the exclusion or the contaminant's role in bringing about the injury. In short, *Gill* and *Koloms* demonstrate the usefulness of reasonable expectations thinking in fairly resolving a thorny interpretative problem that has to date divided the state courts and required millions in litigation expenditures.

This use of background context expectations would be applied as part of the process of determining whether language is clear or ambiguous—and whether language should be read literally (even hyperliterally) or with greater breadth. Courts would generally, however, consider not only the dictionary definition of words, but also their connotative value, particularly the connotative value in light of the purpose of the contract, the setting of the contract, and the identity of the parties to the contract. If assessment of both text and context does not provide a clear meaning for the disputed term, the expectations of and consequences to both insurer and

266. *See id.*

267. *Western Alliance Ins. Co.*, 686 N.E. 2d 997, 999 (Mass. 1997).

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policyholder become an important factor in deciding whether to give the benefit of the doubt to the policyholder or to the insurer.

Weighed along with those expectations would also be other indicia of contract meaning such as:

- The overall purpose of the contract and whether a particular interpretation of the disputed term better serves that purpose;
- The identity of the drafter;
- The degree of ambiguity and whether the ambiguity was inevitable or was the result of poor drafting that could have been improved;
- Whether the term is unconscionable, unfair, or surprising if construed in a particular manner;
- Any classic "parol" or "extrinsic" evidence (and, despite frequent confusion, the two terms are not strictly synonymous) that illuminates the parties' intent or specific subjective expectations (not to be confused with the objectively reasonable expectations that will be used as part of the background context to help assess the meaning of the four corners of the policy).
- Any factors supporting promissory or equitable estoppel against one or more of the parties.

To the extent that this sort of comprehensive inquiry does not resolve the issue, a court should be permitted to make an express consideration of public policy issues (qua public policy issues) and whether those considerations compel a particular construction in close cases. Factors to consider would include not only the perceived need for defense and indemnity by the policyholder but also the impact on insurance markets. Issues of solvency, notice, and stability should be permitted consideration by the court—but only in the closest cases where standard contract principles fail to bring resolution. Given the power held by insurers over contract language and structure, public policy issues affecting the insurer or the insurance industry should not be given significant consideration

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unless the more traditional interpretative factors listed above fail to resolve the dispute. In short, the reasonable expectations of the parties should be expressly recognized as one of the by-now-conventional contract principles utilized by courts in deciding contract disputes, particularly insurance policy coverage actions.

A particularly instructive case example where consideration of reasonable expectations properly played an important overarching (but unfortunately under-appreciated) role comes ironically from a jurisdiction that has never self-consciously accepted the Keeton doctrine. In *Lachs v. Fidelity & Casualty Co. of New York*, the Court of Appeals was required to determine whether benefits would be paid on a "flight insurance" policy purchased by machine at the airport by a passenger moments before she boarded a plane destined for a fatal crash. [268] The policy provided that it covered only flights on "scheduled" airlines. The policyholder died flying what the insurer considered a "non-scheduled" airline. The *Lachs* decision can be explained both on ambiguity grounds and on reasonable expectations grounds even though the term "scheduled" airline has a technical meaning to those in the trade. On the whole, the more comprehensive, expectations-oriented approach provides a more convincing rationale and satisfying justification for the court's holding.

Because of the surrounding circumstances in *Lachs*—the background or extrinsic evidence so to speak—New York's highest court was unwilling to permit the insurer to invoke the technical meaning of a disputed term, irrespective of its clarity, where this would run counter to the reasonable expectations of the policyholder who thought that he had purchased flight insurance for the flight he was about to board. Although the focus of the court's analysis is the manner in which the decedent Lachs would have interpreted this context (buying "flight insurance" right in front of an airline counter and presuming that the flight he took on that airline or at that gate was covered by such flight insurance), it is clear that the court thought that any objectively reasonable airport patron would have reacted as did Lachs—there was no slouching toward subjectivity that might imperil the actuarial soundness of the flight insurance risk pool because of the deeply felt but bizarre views of a particular policyholder or class of policyholders. The flight insurance bought by Lachs was enforced to meet the expectations of the insurer's intended customers: reasonable fliers like Lachs.

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268. 120 N.E.2d 216 (N.Y. 1954).

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In this regard, *Lachs* is consistent with other cases tacitly applying expectations analysis as a general principle of insurance contract construction rather than as a rationale for overcoming clear policy language. Rather than endorsing policyholder expectations as a trump card over policy language, many courts can be viewed as applying a broader and more subtle reasonable expectations doctrine that resists policy construction inconsistent with the reasonable expectations of the policyholder in light of the nature of the coverage purchased. As one court observed a half-century before the Keeton article:

> We are construing a policy of insurance and we are not bound by the niceties of definition that might otherwise be proper. When a builder takes out builders' risk insurance, delivers his materials on the ground, and does some manifest act evidencing his intention to incorporate them into a building, and when there is and can be no dispute about his intention, it would be a harsh rule to require that he should protect himself by a general open policy on stock in order to cover a loss sustained before he had actually joined one timber to another. It was reasonable for the insured to believe that it had covered the risk of loss by fire of its materials when it took out the policy in suit. The ordinary builder would agree with the plaintiff's [policyholder's] witness that 'the building of the boat starts just as soon as you start getting that material ready,' and that such a construction of the policy expresses the fair and reasonable understanding of the risk.[269]

A similar approach was taken by a federal court applying Minnesota law in *Tower Insurance Co. v. Judge*,[270] where inebriated teenagers played a fatal practical joke on their drunk, sleeping friend, accidentally electrocuting him while trying to shock him awake with a wire from a nearby light switch. There was no dispute that the boys did not subjectively intend harm to the decedent but the recklessness of their conduct led to criminal charges, to which they pleaded no contest. The insurer attempted to deny coverage under both the intentional act and the criminal act provisions of the policy. The court rejected both arguments,

269. *See* Ira S. Bushey & Sons v. American Ins. Co., 142 N.E. 340, 342 (N.Y. 1923).
270. 840 F. Supp. 679 (D. Minn. 1993).

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finding that although the criminal act exclusion was literally applicable if one assumed the state could have proved reckless homicide (there had been a no contest plea, which lacks the preclusive effect of the guilty plea) since it required only recklessness and not intent to injure. One might consider the criminal act exclusion "overdrafted" in that insurers need only to exclude intentional efforts to cause damage but generally agree to cover policyholders for negligence. That the negligence leads to criminal charges has little to do with underwriting imperatives. Despite the literal textual applicability of the criminal act exclusion, the *Tower* Court found coverage, stating

> application of the criminal act exclusion to the facts of this case would violate the reasonable expectations of the Balsters, the insureds. It is objectively reasonable to expect that the criminal act exclusion would not apply unless bodily injury was the reasonably expected result of the act.[271]
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> * * *
>
> In short, although the criminal act exclusion interpreted as [the insurer] intended, would proscribe coverage, this Court finds that the exclusion is unenforceable in this case. Ambiguity is not a condition precedent to application of the reasonable expectations doctrine. The facts of this case present a situation for which people classically seek insurance coverage, and the Court concludes that a denial of coverage would conflict with the reasonable expectations of the insureds.[272]

Other cases applying Minnesota law (the applicable law in *Tower*) have implicitly taken a similar view of the utility of expectations analysis and have in many cases found in favor of the insurer and against coverage even though policy language in dispute could be characterized as something less than clear.[273]

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271. *Id.* at 692. The *Tower* court cited with approval a similar New York decision, *Allstate Ins. Co. v. Zuk*, 574 N.E. 2d 1035 (N.Y. 1991), which found coverage despite the insured's guilty plea to second degree manslaughter arising from an accidental shotgun discharge that killed a friend.

272. *Tower*, 840 F. Supp. at 692-93 (citations and footnotes omitted).

273. *See, e.g.:*

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Anderson v. AMCO Ins. Co., 541 N.W.2d 8, 11 (Minn. Ct. App. 1995) (denying no-fault auto policy medical benefits for policyholder's "panic attacks" in the absence of physical injury. Policyholder "offers no support for her final argument that members of the public assume all necessary medical care is covered by their policies. Given that policies invariably contain exclusions and limitations on coverage, the assumption would seem unwarranted. While appellant may indeed have expected that her no-fault policy, despite its language, would cover losses resulting form her panic attacks, there is no evidence that her expectation was reasonable. . . . given the language of appellant's policy, any expectation that it would provide coverage was unreasonable.").

National Union Fire Ins. Co. v. Gates, 530 N.W.2d 223 (Minn. Ct. App. 1995) (despite third-party claim of negligence included with sex abuse claim, policyholder objectively would know that sexual abuse claims are intentional and uncovered and policyholder could thus have no expectation of coverage).

Illinois Farmers Ins. Co. v. Coppa, 494 N.W. 2d 503 (Minn. Ct. App. 1993) (no reasonable expectation of liability coverage under homeowner's policy insuring policyholder premises where claim arose from use of all-terrain vehicle on adjacent property that was not owned by the policyholder).

Centennial Ins. Co. v. Zylberberg, 422 N.W. 2d 18 (Minn. Ct. App. 1988) (claimant could not obtain coverage when not named in policy; claimant thus had no reasonable expectation of coverage; adding unnamed driver to policy as additional insured would constitute reformation of the policy rather than interpretation).

Independent Sch. Dist. No. 197 v. Accident & Cas. Co. of Winterthur, 525 N.W.2d 600 (Minn. Ct. App. 1995) (pollution exclusion stating that it applies to "all operations" of policyholder other than oil and gas operations precluded reasonable expectation of coverage for asbestos-related contamination).

Mikulay v. Home Indem. Co., 449 N.W.2d 464 (Minn. Ct. App. 1989) (no expectations of coverage for vehicles for which no premium was paid).

See also Minnesota Mut. Fire & Cas. Ins. Co. v. Manderfeld, 482 N.W.2d 521, 525 (Minn. Ct. App. 1992) (also suggesting that policy language that is clear without painstaking study can not be overcome by reasonable expectations analysis). This view is not consistent with the original reasonable expectations doctrine, which in context used the words "painstaking study" to refer to clear text rather than the degree of effort required to locate, examine, and comprehend the text.

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As the forgoing discussion suggests, the reasonable expectations concept has substantial utility even if not asserted in its full form of overcoming explicit policy provisions. Reasonable expectations thinking can be used by courts to provide a more nuanced approach to contract interpretation than the traditionally crude two-step of consulting the dictionary and invoking contra proferentem where dictionary definitions are deemed ambiguous. Reasonable expectations analysis provides both a check against absurd hyperliteralism (e.g., the slip-and-fall claim excluded because the slippery liquid on the floor falls within the technical linguistic reach of the policy definition of "pollutant") and an alternative to routinely ruling against the insurer whenever the language is something less than inarguably clear. Similarly, the reasonable expectations concept can be significantly more sensible than traditional contra proferentem in calibrating the amount of coverage or other relief available to the policyholder.

For example, in *Rusthoven v. Commercial Standard Insurance Co.*,[274] decided by the Minnesota Supreme Court only a year after it had embraced the reasonable expectations doctrine in *Atwater Creamery*,[275] the Court required an insurer to provide up to $1,675,000 in uninsured motorist coverage where a truck driver was forced off the road by a "phantom" or "miss-and-run" driver. However, the insurance policy in question provides for uninsured motorist coverage of $25,000 "each person." But the policy also contained a provision stating that "[i]f there is more than one covered auto our limit of liability for any one accident is the sum of the limits applicable to each covered auto."[276] The policy under which the injured truck driver was a named insured covered 67 rigs in the fleet of the driver's employer, with premiums based on the employer's gross receipts.[277]

Seizing upon the inconsistency, the *Rusthoven* court noted the obvious contextual ambiguity (provision X of the policy contradicted by provision Y of the policy) and proceeded to apply the contra proferentem principle against the insurer that drafted the policy.[278] However, the Minnesota Court was well aware of its recent adoption of the reasonable expectations doctrine and, citing *Atwater Creamery* as well as the famous Keeton article and first edition of the Keeton hornbook, stated the "result of such a

274. 387 N.W.2d 642 (Minn. 1986).

275. Atwater Creamery Co. v. Western National Mut. Ins. Co., 366 N.W.2d 271 (Minn. 1985) (discussed *supra* notes 40-70 and accompanying text).

276. *Rusthoven*, 387 N.W.2d at 643.

277. *Id.*

278. *Id.* at 644-45.

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[contra proferentem] construction, however, must not be beyond the reasonable expectations of the insured."[279] Remarkably, the Court did not even tarry before finding this rather enormous and unusual uninsured motorist limit to be reasonable.

Nonetheless, one reasonable person, Professor Kenneth Abraham, obviously has qualms with the Court's assessment. After reproducing *Rusthoven* in his casebook, Abraham follows with notes that ask:

> 1. *A Tall Stack.* Did it make sense for the court to rule that the policy provided $1,675,000 of coverage (there were 67 covered autos, yielding coverage of $25,000 per auto multiplied by 67) when the premiums paid were based on the gross receipts of the plaintiff's employer rather than the number of vehicles insured?
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> 2. . . . It seems unlikely that a lay person reading the policy in *Rusthoven* could have determined that the endorsements contradicted each other, and even less likely that Rusthoven's employer expected that it had purchased and paid for over a million dollars worth of uninsured motorist coverage for each of its employees. Should these facts have affected the result in the case? Having determined that the endorsements in the policy were contradictory, did the court have any alternative to allowing the stacking of 67 limits of liability?[280]

Despite the conventional wisdom that courts construing contract provisions must pick one of the alternative meanings proffered by the disputants, the reasonable expectations approach provides not only a useful method for selecting from alternatives but also the possibility of escaping extreme alternatives. In *Rusthoven*, it seems that uninsured motorist limits of $25,000 are too low. But certainly limits of $1.675 million seems to high absent evidence of similarly high premium payments or other bases for creating such an expectation other than mere conflict of policy

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279. *Id.* (citing Atwater Creamery Co. v. Western National Mut. Ins. Co., 366 N.W. 2d 271 (Minn. 1985)), Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 969 (1970); ROBERT E. KEETON, BASIC TEXT ON INSURANCE LAW § 6.3(a)(1971)).

280. *See* KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION: CASES AND MATERIALS 47 (2d ed. 1995)

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provisions. The court could have decreed a UM limit consistent with the "extra" uninsured motorist protection ordinarily purchased by policyholders when offered the specific option. By common practice in most states, this appears to be $100,000/person and $300,000 per accident. Because Rusthoven's employer was a commercial entity that probably faced greater exposure to claims, 100/300 may be too low. But $1.675 million?

Of course, in suggesting this alternative rather than the simple erring in favor of the policyholder performed by the Minnesota Supreme Court, I may in essence be advocating a form of reformation that fits the expectations of the parties. However, reformation is a long-accepted doctrine of contract law. So are the doctrines of impossibility and commercial impracticability. Making disputed contracts make sense is not inconsistent with the judicial role in contract adjudication. Reasonable expectations analysis can be a powerful tool for helping courts make sense of the provisions and, if necessary to render a construction of the contract that erects a different meaning of the term at issue than any of those advocated by the parties.

Although reasonable expectations analysis obviously need not become a regular route to contract reformation, it has this potential. This is a useful attribute if not overused. Although some undoubtedly would label this erroneous judicial rewriting of the contract, I disagree. The conventional wisdom—that policy meaning must be linguistically anchored in text—is bound to be erroneous in many instances. Sometimes the contract language is chosen without any anticipation of its application to unforeseen future events (e.g., CERCLA remediation costs, substantial gradual but unintentional pollution, long-tail insidious disease and product liability claims). Sometimes contract drafters make mistakes (e.g., adding an endorsement to a policy without realizing it contradicts language in the body of the policy). Unless one is prepared to ruthlessly impose strict liability on the contract drafter and hold against the insurer in every case of mistaken or insufficiently prescient contract drafting, reasonable expectations construction provides a sound alternative, even where the result is not completely consistent with policy text—or runs counter to policy text in some significant way. *Rusthoven* provides a good example of the missed opportunities of reasonable expectations doctrine. In view of the linguistic uncertainty provided by the policy, the Minnesota Supreme Court could seemingly have reached a more reasonable construction without depriving the policyholder of an expected benefit or giving a financial windfall to the insurer. But even though expressly recognizing

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this potential, the Court timidly granted near absolute deference to the ambiguity tiebreaker. Cases like *Rusthoven* suggest that even express embrace of the expectations doctrine raises no serious threat of rampaging judicial activism. More likely is the problem of excessive judicial apathy.

Furthermore, consideration of the bilateral (or even multilateral) reasonable expectations of the parties can reveal whether the text is clear under the circumstances or in fact is ambiguous and in need of nontextual resolution. Similarly, the reasonable expectations polestar can serve to advise those applying the Keeton methodology as to whether the "painstaking" study of the policy provisions provides clear guidance. To some extent, there has always been a hidden circularity in the Keeton formula, which states that policyholder expectations control even thought a "painstaking" look at the policy would have negated the expectations. But which is chicken and which is egg? Does a painstaking review of the policy language not require the reader to check the text against:

- the background of the contracting arrangement;
- the purpose of the transaction;
- the implicit and expressed intent of the parties;
- including behavior and oral statements (assuming the absence of a clear integration and "entire agreement" clause seeking to exclude parol evidence);
- as well the parties' prior course of dealing;
- customary trade or technical connotation of the terms;
- common sense; and (of course)
- the party's expectations.

In short, does the notion of a "painstaking" study of the policy provisions not imply more than simply staring back and forth at the four corners of the policy and the four corners of a dictionary? Undoubtedly, many insurance policy provisions are susceptible to such "four corners" certainty, either because of the clarity attending the word itself or the clause at issue or because these words become clear when the policy is read as a whole. Often, however, this sort of clarity of meaning can only be achieved by considering the extratextual factors described above, all of which tend to combine in forming the objectively reasonable expectations of the parties. To escape the trap of the policy meaning only what the literal definitions of the policy words provide, a reasonable expectations analysis would seemingly need to be part of the painstaking analysis that leads to a correct understanding of the policy.

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In a sense, then, the conventional approach that refuses to consider reasonable expectations (or any extrinsic matter) unless the disputed term is ambiguous on its face has it backwards. Ambiguity can only be accurately determined to exist or not exist after the relevant nontextual factors are considered as well. "Pollution" may mean something in setting 1 and something quite different in setting 2. Consequently, it is not surprising that courts generally have moved away from the traditional rule and permit nontextual matter to assist the court in determining whether text is ambiguous.[281]

Viewed from this perspective, use of the expectations inquiry to assess text is not anti-textual but rather seeks to give the text its correct meaning rather than to crucify it on the cross of hyper-literalism. Similarly, expectations analysis does not denigrate the intent of the parties or the purpose of the contract. Rather, the expectations inquiry seeks to vindicate party intent and contract purpose. Consequently—and contrary to much of the traditional wisdom—the expectations approach serves the concepts of freedom of contract and market transaction.

But what about the smaller universe of cases where the disputed policy text, when read literally, is clear and the impact is not absurd? In those cases, where painstaking review of the policy does reveal a text precluding coverage, at least as a matter of text, does the reasonable expectations doctrine have a role to play in the third decade? The answer, of course, is resoundingly affirmative. In the cases already identified by Judge Keeton—unfair surprise or unconscionable advantage—an objective expectations assessment serves to inform the court as to what is fair and conscionable and thus fills the "gap" created by unenforceable text in a principled way.

The harder question is whether expectations analysis should be permitted where the painstakingly studied clear text does not produce an absurd or unconscionable result surprising the policyholder. Although the question is close, the strong form of the Keeton reasonable expectations doctrine can be applied without doing violence to the traditional American notion of judicial restraint. First, the insurance policy with text that disappoints the policyholders' expectations is not fulfilling its intended purpose, unless the court is willing to conclude that the only recognizable purpose is revenue to the insurer. The insurance policy is in essence a product or good sold to the policyholder. When the product falls

281. *See* Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531 (1996).

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substantially short of policyholder expectations, it has failed in its purpose unless expectations analysis is used to bring the written product in line with the marketed product and the use for which the policy was sold. To the extent premiums paid reflect more extensive rather than less extensive coverage, use of reasonable expectations analysis is legitimate because it permits the judiciary to bring the application of the product more in line with its seeming coverage and prevents the insurer from enjoying an unfair financial windfall that can result when the insurer charges Cadillac premiums but only delivers a Volkswagen Beetle. However, to be consistent, insureds must suffer the consequences when this expectations analysis brings different results. In other words, proper application of the expectations principle should prevent policyholders from paying VW Bug premiums and getting Cadillac coverage in return.

If the courts are too reverent toward text and too hesitant to utilize "rights at variance" reasonable expectations, the courts becoming accomplices in enforcing illusory "bargains." Although the standardized insurance form contract does not easily fit within the historical bargain theory,[282] it can be said that in purchasing the form policy (and perhaps a relatively customized pack of endorsements), the policyholder has "bargained" for a certain level of coverage, protection, and financial security. Even where the policy text might have altered such a bargain, the policyholder should not suffer. At some point, the Anglo-American reverence for text is required to yield to the greater systemic desire that contracts be enforced so as to meet the intent of the parties. Similarly, the insurer has committed to a given level of protection against fortuitous events in return for a calculated premium. Except when expectations analysis is inapposite, the insurer's bargain should also be respected rather than routinely undermined because the insurer did a suboptimal job of drafting policy language.

CONCLUSION

Properly viewed, then, the reasonable expectations doctrine, even the strong form of the doctrine that "overpowers" the ostensible meaning of contract language, is not the sort of radical judicial arrogation of power that should make judges tremor at the thought of its invocation. Nor

282. *See* Edward A. Dauer, *Contracts of Adhesion in Light of the Bargain Hypothesis*, 5 AKRON L. REV. 1 (1972) (noting that standard form contracting does not meet bargain model of contract formation and that methods of interpretation developed for traditional contracts with bargained-for terms may be inapt for interpreting disputed standardized contracts).

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should courts require that problematic policy language be hidden or deceptive before being willing to construe the disputed text in a manner vindicating the policyholder's objectively reasonable expectations (or the actual subjective expectations created by the insurer, but that is another issue). Even where the arguably more persuasive linguistic meaning of disputed policy text augers in favor of the insurer, a constellation of other factors—perhaps most importantly reasonable expectations—may counsel construction favoring the policyholder. When this occurs, courts should not shrink from the task of vindicating reasonable expectations simply because of the longstanding rhetoric and misplaced iconography of judicial restraint.

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AN INTERDISCIPLINARY CRITIQUE OF THE REASONABLE EXPECTATIONS DOCTRINE

*Jeffrey E. Thomas**

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INTRODUCTION

It has been nearly 30 years since the doctrine of reasonable expectations was first recognized in Insurance Law.[1] During this time, the doctrine has reached a certain level of maturity.[2] Nevertheless, as recently as this year it has been observed that "there is still great uncertainty as to the theoretical underpinnings of the doctrine, its scope and the details of its application."[3] The purpose of this article is to use work done in other disciplines to help explore some of the theoretical underpinnings of the doctrine.

The reasonable expectations doctrine is built on assumptions about the way people, in particular unsophisticated insureds,[4] buy insurance. It assumes that in the process of buying insurance, insureds develop specific expectations about what will be covered by their policies.[5] Research done generally in consumer psychology, and specifically about insureds' perceptions and buying behaviors, casts serious doubts on these assumptions. Although not conclusive, that research tends to show that average consumers generally do not develop the kinds of expectations assumed by judges applying the reasonable expectations doctrine.[6] If those assumptions are eliminated, the reasonable expectations doctrine is less theoretically justified and becomes arbitrary in its application. At the same time, however, this research shows that insureds are easy targets for insurers, and therefore some type of protective doctrine like reasonable expectations may be justified.

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1. The formal articulation of the doctrine, in its modern form, is generally traced back to Judge, then Professor, Keeton's seminal article, Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961 (1970). *See, e.g.*, 2 ERIC MILLS HOLMES & MARK S. RHODES, HOLMES' APPLEMAN ON INSURANCE, 2D § 8.6, at 416 (1996) [hereinafter APPLEMAN 2D]; Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 825 (1990); Laurie Kindel Fett, Comment, *The Reasonable Expectations Doctrine: An Alternative to Bending and Stretching Traditional Tools of Contract Interpretation*, 18 WM. MITCHELL L. REV. 1113, 1122-23 (1992).

2. *See* Henderson, *supra* note 1, at 853.

3. Deni Assocs. of Florida, Inc. v. State Farm Fire & Cas. Ins. Co., 711 So. 2d 1135, 1140 (Fla. 1998) (quoting Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d 798, 803 (Utah 1992)).

4. The reasonable expectations doctrine has generally been used to protect the unsophisticated insured. *See* ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 143 (2d ed. 1996); Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151, 1154 (1981). However, there is some support for extending the doctrine to at least a limited extent to sophisticated insureds. *See, e.g.*, Reliance Ins. Co. v. Moessner, 121 F.3d 895, 905-06 (3d Cir. 1997).

5. *See infra* Part I.B.

6. *See infra* Part II.

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This critique begins by outlining the contours of the reasonable expectations doctrine and the assumptions that underlie it. Part II then tests those assumptions against research from consumer psychology and against survey data collected from insureds. Part III reassesses the reasonable expectations doctrine in light of the problematical nature of its assumptions. General conclusions and areas for further research are identified in Part IV.

I. THE REASONABLE EXPECTATION ASSUMPTIONS

In order to identify and articulate the assumptions that underlie the reasonable expectations doctrine, we must begin with the doctrine itself. The reasonable expectations doctrine is explored in detail elsewhere in the literature and in this Symposium, but a brief description of the contours of the doctrine will set the stage for identifying basic assumptions. Although there are substantial doctrinal uncertainties, there is enough commonality to identify two of the fundamental assumptions.

A. Contours of the Reasonable Expectations Doctrine

Reasonable expectations evolved as a doctrine to protect insureds. Its roots began, by and large, in consumer-oriented decisions of the 1960s.[7] Courts were concerned about the inherent inequality of bargaining power between insurers and insureds reflected in the use of adhesion contracts which were difficult to understand and not generally delivered until after the transaction.[8] Judicial authority was used in an effort to equalize the bargaining power.[9] In so doing, however, the courts stretched existing legal doctrine to the point that some of their decisions seemed unprincipled.[10] Judge Keeton, then a law professor, observed in his seminal article[11] that, in fact, the courts were

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7. *See* Abraham, *supra* note 4, at 1153; *see also* Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 327 (1986).

8. *See* Rahdert, *supra* note 7, at 336-43; *see also* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINE AND COMMERCIAL PRACTICES § 6.3(a)(4), at 634-36 (Student ed. 1988). For a good analysis of this issue by a court, see Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388, 394 (Ariz. 1984). One commentator noted that insurance contracts "may be more adhesive than most other commercial contracts." William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267, 270 (1986).

9. *See* Rahdert, *supra* note 7, at 327; *see also* Mayhew, *supra* note 8, at 272.

10. *See* KEETON & WIDISS, *supra* note 8, § 6.3(a)(3), at 632; Mayhew, *supra* note 8, at 268.

11. *See* Keeton, *supra* note 1.

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simply protecting the reasonable expectations of the insureds.[12] Keeton's observation formalized the doctrine[13] and fostered its adoption and growth.[14]

Keeton originally recognized reasonable expectations as more of a principle to explain case law developments rather than a doctrinal rule to be followed. He articulated the principal this way:

> The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations.[15]

This principal "points in the direction insurance law appears to be moving," but was considered by Keeton to be "too general to serve as a guide from which particularized decision can be derived."[16] Nevertheless, this broad "principal" has been adopted as the doctrinal rule for reasonable expectations in a number of jurisdictions.[17]

Although some commentators have maintained that this principal has led to the development of a doctrinal "core,"[18] the doctrine cannot be reduced to a single, monolithic rule.[19] Courts in different jurisdictions have taken a variety of approaches to the doctrine.[20] These approaches may be classified along a continuum between the strongest and weakest forms of the doctrine.[21] The strongest, most aggressive form of the doctrine is consistent with Keeton's principal and allows the protection of reasonable expectations in spite of

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12. *See* Keeton, *supra* note 1, at 973; *see also* KEETON & WIDISS, *supra* note 8, § 6.3(a)(3), at 632.

13. *See* Fett, *supra* note 1, at 1122-23; *see also* APPLEMAN 2D, *supra* note 1, § 8.6, at 416 (modern doctrine of reasonable expectations was "introduced" by Keeton); Henderson, *supra* note 1, at 826.

14. *See* Rahdert, *supra* note 7, at 333; *see also* Mayhew, *supra* note 8, at 276, 279.

15. Keeton, *supra* note 1, at 967.

16. *Id.*

17. The reasonable expectations "principal" articulated by Keeton has been quoted in hundreds of cases. In some jurisdictions the quote is used as a doctrinal rule of decision for reasonable expectations. *See, e.g.*, Regional Bank of Colorado v. St. Paul Fire & Marine Ins. Co., 35 F.3d 494 (10th Cir. 1994); Bering Strait Sch. Dist. v. RLI Ins. Co., 873 P.2d 1292 (Alaska 1994); Transamerica Ins. Co. v. Royle, 656 P.2d 820 (Mont. 1983); Grimes v. Concord Gen. Mut. Ins. Co., 422 A.2d 1312 (N.H. 1980).

18. *See* Henderson, *supra* note 1, at 852; *see also* JERRY, *supra* note 4, at 143.

19. *See* Abraham, *supra* note 4, at 1153; Rahdert, *supra* note 7, at 367; *see also* ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 6.03, at 291 (1988).

20. *See* JERRY, *supra* note 4, at 141-43.

21. *See* Rahdert, *supra* note 7, at 367; *see also*, Stephen J. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1467 (1989).

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express policy language to the contrary.[22] The weakest version of the doctrine uses it as a rule of construction to resolve ambiguities. The ambiguous term or phrase is to be construed in accordance with the insured's reasonable expectations.[23]

This doctrinal uncertainty is further complicated by absence of doctrinal refinement or identification of salient factors.[24] The reasonable expectations doctrine is often invoked as a kind of "mantra" to justify the desired outcome, but without the support of much explicit legal analysis.[25] As a result, one of the major Insurance Law Treatises has concluded that the doctrine is "an equitable process of judicial interpretation" that considers "the surrounding circumstances" and "public policy and fair treatment."[26] In light of the absence of doctrinal factors, it is therefore not surprising that the doctrine is criticized for being inconsistently applied[27] and for being uncertain and unpredictable.[28]

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22. *See, e.g.*, Reliance Ins. Co. v. Moessner, 121 F.3d 895 (3rd Cir. 1997); State Farm Mut. Auto. Ins. Co. v. Falness, 39 F.3d 966 (9th Cir. 1994); Regional Bank of Colorado v. St. Paul Fire and Marine Ins. Co., 35 F.3d 494 (10th Cir. 1994); Bering Strait Sch. Dist. v. RLI Ins. Co., 873 P.2d 1292 (Alaska 1994); Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388 (Ariz. 1984); Clark-Peterson Co. v. Independent Ins. Assocs., 492 N.W.2d 675 (Iowa 1992); Transamerica Ins. Co. v. Royle, 565 P.2d 820 (Mont. 1983); Atwood v. Hartford Accident & Indem. Co., 365 A.2d 744 (N.H. 1976); Sparks v. St. Paul Ins. Co., 495 A.2d 406 (N.J. 1985); West Virginia v. Janicki, 422 S.E.2d 822 (W. Va. 1992).

23. *See, e.g.*, Carly v. Lumberman's Mutual Casualty Co., 521 A.2d 1053 (Conn. App. Ct. 1987); Eli Lilly & Co. v. Home Ins. Co., 482 N.E.2d 467 (Ind. 1985); Allstate Ins. Co. v. Elwell, 513 A.2d 269 (Me. 1986); Rodriguez v. General Accident Ins. Co., 808 S.W.2d 379 (Mo. 1991) (en banc); Kracl v. Aetna Cas. & Sur. Co., 374 N.W.2d 40 (Neb. 1985); National Union Fire Ins. Co. v. Reno's Executive Air Inc., 682 P.2d 1380 (Nev. 1984); Max True Plastering Co. v. United States Fidelity & Guar. Co., 912 P.2d 861 (Okla. 1996).

24. Professor Rahdert has noted that "courts have only scratched the surface in identifying factors other than the policy language that must be considered before a court can decide what expectations are reasonable enough to be honored." Rahdert, *supra* note 7, at 367-68.

25. *See* Rahdert, *supra* note 7, at 353 & n. 110; *see also* Abraham, *supra* note 4, at 1153-54. For examples of such cases, see Regional Bank of Colorado v. St. Paul Fire & Marine Ins. Co., 35 F.3d 494 (10th Cir. 1994); Smith v. Auto-Owners Ins. Co., 500 So. 2d 1042 (Ala. 1986); Stordahl v. Gov't Employees Ins. Co., 564 P.2d 63 (Alaska 1977); State Farm Mut. Auto. Ins. Co. v. Dimmer, 773 P.2d 1012 (Ariz. Ct. App. 1988); Corgatelli v. Globe Life & Accident Ins. Co., 533 P.2d 737 (Idaho 1975); Clark-Peterson Co. v. Independent Ins. Assocs., 492 N.W.2d 675 (Iowa 1992); State Farm Mut. Auto. Ins. Co. v. Mastbaum, 748 P.2d 1042 (Utah 1987).

26. APPLEMAN 2D, *supra* note 1, § 8.6, at 417.

27. *See, e.g.*, Abraham, *supra* note 4, at 1153; Fett, *supra* note 1, at 1115.

28. *See, e.g.*, Rahdert, *supra* note 7, at 370-72; Ware, *supra* note 21, at 1489. *See also* Deni Assocs. of Florida, Inc. v. State Farm Fire & Cas. Ins. Co.,711 So. 2d 1135, 1140 (Fla. 1998) (quoting Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d 798, 803 (Utah 1992)).

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B. Assumptions About Insureds Implicit in the Doctrine

Notwithstanding this doctrinal uncertainty, the various forms of the reasonable expectations doctrine make common assumptions about the behavior of insureds. Regardless of the doctrinal variation, the focus is always on the *expectation* of the insured. This corresponds with the expectation interest protected by contract law generally. The main purpose of the law of contracts is to protect "the reasonable expectations that have been induced by the making of a promise."[29] This expectation is the hoped for, or expected, benefit of the bargain.[30] Because it is the expected benefit that is protected, contract damages are measured by the value of the expectation.[31]

By focusing on the insured's expectation, the doctrine of reasonable expectations makes two fundamental assumptions: first, that the insured does in fact develop specific and identifiable expectations[32] when purchasing insurance; and second, that these expectations are based on the rational evaluation[33] of information and priorities reflected by the purchasing decision. These assumptions correlate with the assumptions underlying contract law generally. The archetypal contract is the exchange of promises, for consideration, arrived at through rational, self-interested bargaining, and memorialized in a written agreement. The parties to such a contract enter into the agreement because of a specific and identifiable expected benefit (the "expectation"). This benefit is the result of rational negotiations during which the parties assess the available information and their priorities (the "reasonableness" of the expectation). The agreement reached then reflects assent to an exchange considered mutually beneficial (a "meeting of the minds").

Ironically, even though the reasonable expectations doctrine assumes an insured has specific expectations and undertakes rational evaluation, it explicitly rejects the archetypical contract as a descriptive paradigm for

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29. *See* 1 JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 1.1, at 2 (Rev. ed. 1993) [hereinafter CORBIN ON CONTRACTS].

30. *See* BLACK'S LAW DICTIONARY 576 (6th ed. 1990) (defining "expectancy" as "that which is expected or hoped for").

31. *See* CORBIN ON CONTRACTS, *supra* note 29, § 1.1, at 5.

32. The qualifiers "specific" and "identifiable" are somewhat ambiguous, but they are not intended to be used with great precision. The point I am trying to make is a general one. I maintain that the reasonable expectations doctrine assumes that insureds develop quite specific expectations regarding coverage for particular scenarios, as contrasted with a more generalized belief that the insurance provided some kind of protection.

33. The phrase "rational evaluation" may convey some unintended connotations. Here, I use the phrase simply to mean that the insured makes a conscious and deliberate evaluation of the available information and personal priorities when making a purchasing decision.

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insurance. The reasonable expectations doctrine is based on the premise that insurance policies *are not* the result of the archetypal bargaining.[34] One court described the typical insurance transaction:

> An insurance agreement such as the ordinary fire policy in issue here is not a contract arrived at by negotiation between the parties. The insured is given no choice regarding terms and condition of coverage which are contained on forms which the insured seldom sees before purchase of the policy, which often are difficult to understand, and which usually are neither read nor expected to be read by either the person who sells the policy or the person who buys it.[35]

The court concluded: "The rules pertaining to the enforcement of the 'bargain' made by the parties evolved at a time when the parties negotiated an insurance contract; they have little or no relevance to the present methods of transacting most insurance business."[36]

Although the reasonable expectations doctrine rejects the archetypal contract as descriptive of the typical insurance transaction, the doctrine nevertheless accepts the bargaining paradigm represented by the archetypal contract. The doctrine accepts the premise that the insured has entered into a bargain in purchasing insurance, and simply relaxes the interpretive rules to determine the insured's perceived benefit of the bargain. It makes the text of the agreement less important and puts greater emphasis on the circumstances. But by looking for the insured's benefit of the bargain, or the "reasonable expectations" of the insured, the object of the interpretive enterprise is still the same. The reasonable expectations doctrine therefore makes the same assumptions as the bargaining paradigm, that the insured had specific and identifiable expectations based on a rational evaluation of the circumstances.

These assumptions are reflected in the Iowa Supreme Court's analysis in the leading case of *C & J Fertilizer, Inc. v. Allied Mutual Insurance Co.*[37] In

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34. Professor Rahdert describes the policy rationale underlying the reasonable expectations doctrine as based on the adhesive nature of the contract, the risk of unconscionability, and the likelihood of extracontractual reliance. *See* Rahdert, *supra* note 7, at 336-37. Each of these concerns distinguishes the insurance policy from the archetypal contract negotiated at arms-length and memorialized in a manuscripted contract. For a more complete description and discussion of these policy concerns, *see id.* at 337-45.

35. Zuckerman v. Transamerica Ins. Co., 650 P.2d 441, 446 (Ariz. 1982).

36. *Id.*

37. 227 N.W.2d 169 (Iowa 1975). The importance of this case was explained by Professor Henderson. *See* Henderson, *supra* note 1, at 843-46.

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that case the insured, an unsophisticated small businessman,[38] sought coverage under a Broadform Storekeeper's Policy for a burglary. The policy covered burglary losses, but the definition of burglary required "visible marks . . . or physical damage to, the exterior of the premises."[39] Although there were tire marks visible in the driveway and physical damage to an interior door that had been forced open, there were no visible marks or physical damage to the exterior of the building. It appeared that the burglars had entered through a plexiglass door which could be forced open without leaving visible marks or physical damage.[40] The court applied the reasonable expectations doctrine and held that the claim was covered in spite of the fact that it did not meet the specific definition of burglary in the policy.[41]

In reaching this conclusion, the court tried to reconstruct the expectation of the insured based on the bargain struck at the time he purchased the policy. The court noted the evidence of a conversation at the time of the inspection of the premises before policy was issued. The insured was told during that conversation that "there had to be visible evidence of burglary."[42] This conversation, however, did not explicitly tell the insured that the evidence had to be visible marks or physical damage to the *exterior* of the building. In fact, there was no evidence that the insured was informed of that requirement until after the loss.[43] From this evidence the court concluded that the "negotiation was for . . . the insurer's promise 'To pay for loss by burglary'. . . so long as it was not "an 'inside job.'"[44] "But there was nothing relating to the negotiations" which would have led the insured "to reasonably anticipate . . . another exclusion denying coverage when, no mater how extensive the proof of a third-party burglary, no marks were left on the exterior of the premises."[45] In addition, the definition was not the common or legal definition of burglary. Under these circumstances, the court concluded: "The most plaintiff might have reasonably anticipated was a policy requirement of visual evidence (abundant here) indicating the burglary was an 'outside' not an 'inside' job."[46]

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38. The insured was technically a corporation, but the president of the corporation was "a 37-year-old farmer with a high school education." *Id.* at 172.

39. *Id.* at 171.

40. *See id.*

41. *See id.* at 177. The Court also held that there would be coverage under two alternative grounds, implied warranty and unconscionability. *See id.* at 177-81.

42. *Id.* at 171.

43. *See id.* 173.

44. *Id.* at 176-77.

45. *Id.* at 177.

46. *Id.*

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In the course of this reconstruction, the court assumed that the insured had a specific and identifiable expectation regarding burglary coverage. It was not just a general expectation of coverage for burglaries, but was specific enough to understand that coverage required visual evidence (though not on the exterior of the building).[47] The court also assumed that this expectation was developed by a rational evaluation of the circumstances. The court made a logical inference that because the requirement for visible marks on the exterior was not explicitly disclosed, was not read by the insured, and was not within the common understanding of the term burglary, it was not within the expectation of the insured.[48]

These assumptions are also reflected in one of the most explicit tests for reasonable expectations, the one based on section 211 of the *Restatement (Second) of Contracts*.[49] Section 211 of the Restatement addresses standardized agreements. It was considered a "codification" of the reasonable expectations doctrine in Arizona,[50] and has been said to embody the "core set of rules" for reasonable expectations.[51] Subsection (3) of the *Restatement* provides: "Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement."[52] This test tries to reconstruct a party's expectation in an explicit bargaining context. A term is to be excluded if an insured *would not have accepted the term* had it been disclosed prior to the purchase. Thus, this test assumes that the insured acts rationally in the insurance transaction, and that the insured would not have accepted the offending term if it was disclosed. It also implicitly assumes the

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47. As will be discussed below, this level of specificity does not seem very likely in light of the way insureds buy insurance. *See infra* Part II.

48. Another good illustration of these assumptions can be seen in the case of State Farm Mut. Auto. Ins. Co. v. Bogart, 717 P.2d 449 (Ariz. 1986). That case concerned the interpretation of an escape clause for non-owned automobile coverage. The court found that the reasonable expectations doctrine justified coverage in spite of the escape clause. In reaching this conclusion, the court reasoned: "the more rational assumption would be that the average person who purchases non-owned automobile liability insurance with limits of $200,000 would reasonably expect to be covered in that amount. . . ." *Id.* at 455. Thus, the court assumed that the insured had a specific expectation when he purchased the insurance, and that his expectation could be determined by assuming he was rational.

49. RESTATEMENT (SECOND) OF CONTRACTS § 211 (1981).

50. Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388, 396 (Ariz. 1984). Subsequent opinions have noted that *Darner* "adopted" section 211 for the reasonable expectations doctrine. *See, e.g.*, Gordinier v. Aetna Cas. & Sur. Co., 742 P.2d 277, 283 (Ariz. 1987); State Farm Mutual Auto. Ins. Co. v. Bogart, 717 P.2d 449, 455-56 (Ariz. 1986); Pruett v. Farmers Ins. Co., 857 P.2d 1301, 1306 (Ariz. Ct. App. 1993).

51. Henderson, *supra* note 1, at 852.

52. RESTATEMENT (SECOND) OF CONTRACTS § 211 (1981).

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converse, that based on what was actually disclosed, the insured forms a specific and identifiable expectation.

A somewhat less bargaining-oriented test is based on misinforming the insured, but that test still reflects the assumptions of specific expectations and rational evaluation. This test proposes that "the insured's expectations are reasonable when the insurer has created a misleading impression about coverage."[53] Because this test focuses more on information than assent, it does not rely as heavily on an assumption of bargaining as does the *Restatement.* Nevertheless, it assumes both that the insured has specific expectations and that the insured will use rational evaluation. For there to be a "misleading impression about coverage," the insured must make a rational evaluation of the information available, and then develop a fairly specific "impression" (or expectation).[54]

Although this discussion has not considered the entire panoply of reasonable expectations theories, it has shown, from several different perspectives, that the reasonable expectations doctrine assumes that insureds have specific expectations and make rational evaluations. Those assumptions are related to the assumptions underlying the paradigm for thinking about contracts generally. Although the reasonable expectations doctrine distinguishes insurance from the archetypal contract, it works within the general paradigm in an attempt to adjust the bargaining to account for the limitations of using standardized forms. Because the doctrine operated within the general bargaining paradigm, the underlying assumptions have not been tested. We now turn to research from non-legal sources to assess the validity of these assumptions.

II. ASSESSING THE ASSUMPTIONS

Consumer psychology research and surveys of insureds cast doubt on both the assumption of specific expectations and the assumption of rational

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53. APPLEMAN 2D, *supra* note 1, § 8.6, at 420. This statement of the rule is based on Professor Abraham's explication of the reasonable expectations doctrine in his article. *See* Abraham, *supra* note 4, and his book, KENNETH S. ABRAHAM, DISTRIBUTING RISK 101-132 (1986). *See* APPLEMAN 2D, *supra* note 1, § 8.6, at 420 n. 79.

54. Although he does not try to provide a "test" for the reasonable expectations doctrine, Professor Jerry's articulation of the "factors" to be considered likewise focuses on information and implicitly makes the same assumptions. He identifies three factors: (1) the insured's subjective expectation, (2) the insurer's knowledge or reason to know of such an expectation, and (3) the extent to which a reasonable effort could have confirmed (or not confirmed) the expectation. *See* JERRY, *supra* note 4, at 145-47. Each of these factors assumes that the insured has a specific expectation, and the third factor assumes that the expectation is shaped by rational evaluation of information and circumstances.

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evaluation. Consumers generally do not undertake a rational evaluation of their buying options, and the related costs and benefits, prior to making purchases. This tends to be confirmed by empirical survey data regarding how insureds make their purchasing decisions. Moreover, the empirical data tends to show that insureds often do not have specific expectations regarding coverage. As a general matter, insureds rely on their agents to advise them on coverage, and many times do not have a correct understanding of the most basic coverages provided by their policies. We will begin by analyzing the rational evaluation assumption, and then will consider the extent to which insureds have specific expectations.

A. Do Insureds Rationally Evaluate Insurance Options?

It has been widely assumed that consumers make rational evaluations in making purchasing decisions.[55] This assumption is not surprising; after all, those who are studying consumer behavior are themselves undertaking a rational evaluation, so it would be natural to assume that other consumers make rational evaluations as well. Consumer psychology research, however, has shown that this assumption overstates reality. "Consumer research conducted over the last decade or so suggests strongly that consumers have a very limited capacity for receiving and using information; that they do not as a rule undertake rational, comparative evaluations of brands on the basis of their attributes or make final judgment among brands on the basis of such outputs of complex information processing as attitudes and intentions."[56]

Although the assumption is overstated, some consumers are more rational about their purchasing decisions than others. Two models of consumer buying behavior are at opposite ends of the spectrum: the "cognitive consumer" and the "uninvolved" consumer.[57] The cognitive consumer makes a rational evaluation of the purchasing decision. The cognitive consumer actively solicits information by shopping and research, and then evaluates the available

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55. *See* GORDON R. FOXALL & RONALD E. GOLDSMITH, CONSUMER PSYCHOLOGY FOR MARKETING 27-28 (1994). For some specific models that make this assumption, see *infra* note 58.

56. *See* FOXALL & GOLDSMITH, *supra* note 55, at 31. A good example of this failure to make rational decisions is consumers' non-use of nutritional information regarding foods. One study concluded that "the vast majority of consumers neither use nor comprehend nutrition information in arriving at food purchase decisions." *Id.* (quoting J. Jacoby et al, *Consumer Use and Comprehension of Nutrition Information*, 4 J. CONSUMER RES. 119 (1977)).

57. *See id.* at 27-31. Professor Foxall explores the evolution of consumer behavior paradigms in another book. *See* GORDON R. FOXALL, CONSUMER CHOICE (1983).

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information against his or her priorities to make the best possible purchase.[58] The cognitive consumer generally has the following characteristics:

- Receives information from the environment (advertising, etc.);
- Interprets the information according to experience and personal values;
- Searches for additional information;
- Evaluates competing brands;
- Makes a conscious decision to purchase based on the information and evaluation;
- Reevaluates decision based on satisfaction; and
- Stores reevaluated information for future reference.[59]

The uninvolved consumer is to a large extent the opposite of the cognitive consumer. Uninvolved consumers make much less use of information, and

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58. These kinds of assumptions were commonly reflected in the major consumer behavior theories developed in the 1960s and 70s. *See, e.g.*, JAMES R. BETTMAN, AN INFORMATION PROCESSING THEORY OF CONSUMER CHOICE (1979); JOHN A. HOWARD & JAGDISH N. SHETH, THE THEORY OF BUYER BEHAVIOR (1969); MODELS OF BUYER BEHAVIOR: CONCEPTUAL, QUALITATIVE AND EMPIRICAL (Jagdish N. Sheth, ed., 1974); FRANCESCO M. NICOSIA, CONSUMER DECISION PROCESSES: MARKETING AND ADVERTISING IMPLICATIONS (1966); James F. Engel, *The Study of Human Behavior, in* CONSUMER BEHAVIOR: SELECTED READINGS 2 (James F. Engel ed., 1968). Such assumptions continue with modern theories as well. *See, e.g.*, William R. Dillon, *Building Consumer Behavior Models with LISREL: Issues in Applications, in* PERSPECTIVES ON METHODOLOGY IN CONSUMER RESEARCH (David Birnberg & Richard J. Lutz eds., 1986); Blair R. Sheppard et al, *A Theory of Reasoned Action: A Meta-Analysis of Past Research with Recommendations for Modifications and Future Research*, 15 J. CONSUMER RES. 325 (1988). Some of the more modern theories, however, are beginning to take non-rational factors into account. *See id.* at 340 (suggesting the need to account for, among other things, choice situations).

A good illustration of these assumptions can be seen in examples used in developing these theories. For instance, one example of a washing machine purchase assumes the buyer makes rational choices about the features, makes brand selection based on information in *Consumer Reports*, does comparative price shopping, and ultimately purchases from a slightly more expensive retailer because of the longer warranty. *See* BETTMAN, *supra*, at 14-15; *see also* Engel, *supra*, at 14-16 (using examples of the decision to remodel a kitchen and to buy a pound of coffee). These assumptions do not describe the typical buyer's actual behavior. *See* William L. Willkie & Peter R. Dickson, *Shopping for Appliances: Consumers' Strategies and Patterns of Information Search, in* PERSPECTIVES IN CONSUMER BEHAVIOR 1 (Harold H. Kassarjian & Thomas S. Robertson eds., 1991); *see also infra* note 60.

59. This summary is based on a similar summary by Foxall and Goldsmith. *See* FOXALL & GOLDSMITH, *supra* note 55, at 28. I have simplified it to avoid some of the psychological terminology.

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instead tend to rely on situational factors.[60] The model of the uninvolved consumer has the following characteristics:

- Uses far less information;
- Bases decisions on something other than pre-purchase, rational processing of information;
- Uses trial purchasing to evaluate brands;
- Exhibits multipurchasing within groups of acceptable brands; and
- Is influenced mainly by situational factors.[61]

As a general matter, "[i]t is recognized that most consumer decisions do not follow an extended, detailed decision process, but instead can be characterized as low involvement."[62] This low-involvement approach is taken by many consumers even when making relatively important purchasing

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60. *See id.* at 29-30. The notion of a low-involvement consumer is generally traced to the work of Professor Krugman, who studied the effect of television advertising on consumers. *See* Herbert E. Krugman, *The Impact of Television Advertising: Learning without Involvement*, 29 PUB. OPINION Q. 349 (1965). For additional work on low-involvement consumers, see David H. Furse et al., *A Typology of Individual Search Strategies Among Purchasers of New Automobiles*, 10 J. CONSUMER RES. 417 (1984); John L. Lastovicka & David M. Gardner, *Low Involvement Versus High Involvement Cognitive Structures, in* 5 ADVANCES IN CONSUMER RESEARCH 87 (1978); Richard W. Olshavsky & Donald H. Granbois, *Consumer Decision Making—Fact or Fiction*, 6 J. CONSUMER RES. 93 (1979); Thomas S. Robertson, *Low Commitment Consumer Behavior*, 16 J. ADVERTISING RES. 19 (1976); Willkie & Dickson, *supra* note 58; Judith Lynne Zaichkowski, *Measuring the Involvement Construct*, 12 J. CONSUMER RES. 341 (1985). Other research does not address "low involvement" directly, but does show that non-rational factors have a significant bearing on purchasing decisions. *See, e.g.*, Peter H. Block et al., *Consumer Search: an Extended Framework*, 13 J. CONSUMER RES. 119 (1986); Elizabeth C. Hirschman, *Cognitive Processes in Experiential Consumer Behavior, in* RESEARCH IN CONSUMER BEHAVIOR 67 (Jagdish N. Sheth ed., 1985). Professor Foxall analyzed the effects of such research on the paradigmatic approach to consumer behavior in his book CONSUMER CHOICE. *See* FOXALL, *supra* note 57.

For examples of research on situational factors, see FOXALL, *supra* note 57, at 86-97; Ellen C. Garbarino & Julie A. Edell, *Cognitive Effort, Affect & Choice*, 24 J. CONSUMER RES. 147 (1997); Robert A. Mittelstaedt & Robert E. Stassen, *Shopping Behavior and Retail Merchandising Strategies*, 21 J. BUS. RES. 243 (1990); C. Whan Park et al., *The Effects of Situational Factors on In-Store Grocery Shopping Behavior: the Role of Store Environment and Time Available for Shopping*, 15 J. CONSUMER RES. 422 (1989); Sigurd Villads Troye, *Situationist Theory and Consumer Behavior, in* RESEARCH IN CONSUMER BEHAVIOR 285 (Jagdish N. Sheth ed., 1985); William Weitzel et al., *The Influence of Employee Perceptions of Customer Service on Retail Store Sales*, 65 J. RETAILING 27 (1989).

61. This summary is based on a simplified version of a similar summary by Foxall and Goldsmith. *See* FOXALL & GOLDSMITH, *supra* note 55, at 30.

62. *Id.* at 44.

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decisions.[63] One reason that consumers fail to make rational decisions is that situational factors (for example the break-down of an appliance or a move to a new home) make consumers less inclined to gather and utilize information.[64] Another reason is that consumers find it convenient to rely on reputable sales people to make informational choices for them.[65]

The average, unsophisticated insured tends to fit the low-involvement model, and therefore does not undertake a rational evaluation when making insurance purchasing decisions. Although some insureds may rationally evaluate their insurance options, surveys show that most purchasers of homeowners and automobile insurance do not. Most fail to actively gather information or make comparative decisions about insurance products, and tend to rely instead on their agents or other situational factors. Survey data regarding homeowners and automobile insurance was used because those kinds of insurance are most commonly purchased by unsophisticated insureds, the archetype of the person the reasonable expectations doctrine is supposed to protect,[66] and because that data is available.[67] The data demonstrates that most insureds are low-involvement consumers because they do not actively "shop around" for insurance, and because they tend to rely on informal and situational information.

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63. There are "numerous studies indicating that consumers drastically limit their search for information about durable produces like furniture and cars, and services such as those of general practitioners." *Id.* at 31. One study of consumer purchasing behavior of domestic appliances found "most consumers for domestic appliances visit a single store, fail to consult advertising, use restricted price information, consider only one make, and employ perceptions of the manufacturer's reputation and packaging rather than make evaluations of the product/service attributes to arrive at judgments of quality." *Id.*; *see also* Willkie & Dickson, *supra* note 58. For additional studies on consumers' failure to make rational assessments, see Olshavsky & Granbois, *supra* note 60; Willkie & Dickson, *supra*.

64. *See* FOXALL & GOLDSMITH, *supra* note 55, at 34; *see also* Willkie & Dickson, *supra* note 58, at 21-2.

65. *See* FOXALL & GOLDSMITH, *supra* note 55, at 34.

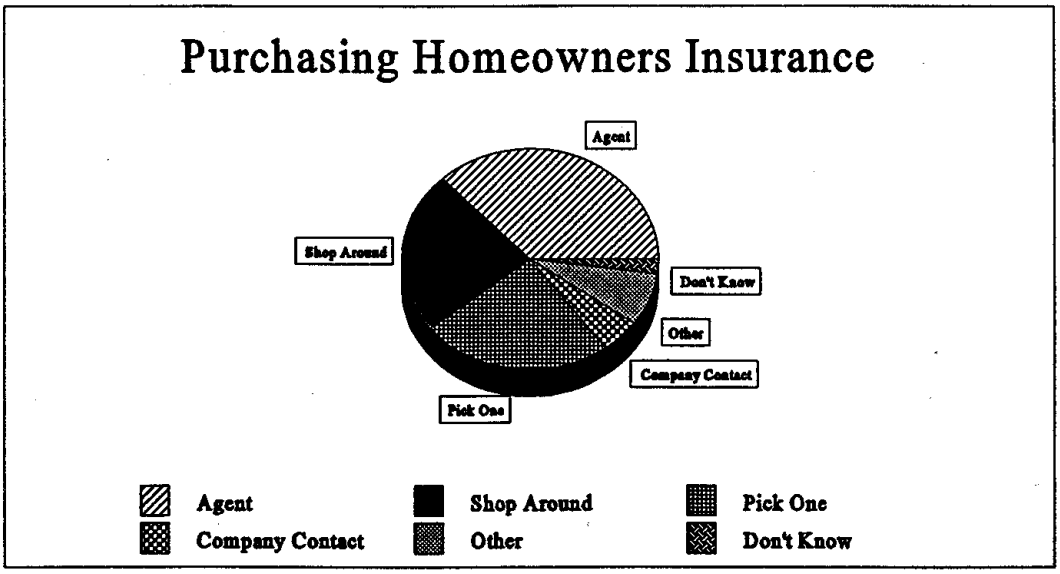
66. *See supra* note 4.

67. One of the admitted weaknesses of using homeowners and automobile insurance data is that the insureds do not really have any choice about whether they purchase such insurance. Automobile insurance is required as a condition to driving in most states, *see* JERRY, *supra* note 4, at 849, and most lenders will require homeowners insurance as a condition of financing the purchase of a home. Because insureds are "forced" (in a sense) to buy such insurance, they may be less likely to make cognitive choices about it than if they consciously chose to buy it. On the other hand, the very fact that such insurance is required is what causes so many unsophisticated insureds to buy it. Moreover, the fact that insureds do not "choose" to buy such insurance is another reason to provide some additional protection against possible manipulation by the insurance industry.

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1. Most Insureds Do Not "Shop Around" for Insurance

Purchasers of homeowners insurance make little effort to gather and analyze comparative information about insurance options. The most common approach to buying insurance is to let the agent select the insurer, which is the way 37% of insureds selected their homeowners insurer.[68] This is consistent with the low-involvement consumer's tendency to rely on sales people to assess information for them. Only 24% of insureds would "shop around and chose from among several companies."[69] Another 24% of insureds pick the insurer at the beginning of the process.[70] The relative proportion of those who shopped for insurance is represented by the following chart:[71]



The data for the purchasing of automobile insurance is consistent with the homeowners data, although purchasers of automobile insurance tend to shop a little more. Like homeowners, most purchasers of automobile insurance, 34%, also rely on their insurance agent to select the insurer.[72] The proportion

68. *See* INSURANCE RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 1995 32-33 (1995) [hereinafter PAM 1995]. The study was conducted by Roper Starch Worldwide, Inc., from a representative sample of U.S. households. In-home interviews were conducted of 1,997 Americans age 18 or older between June 17 and June 24, 1995. *See id.* at 1. A more complete description of the sampling methodology is contained in an appendix to the report. *See id.* at 93. Another appendix contains a sample of the survey used. *See id.* at 79-92.

69. *See id.*, at 33 fig.2-28.

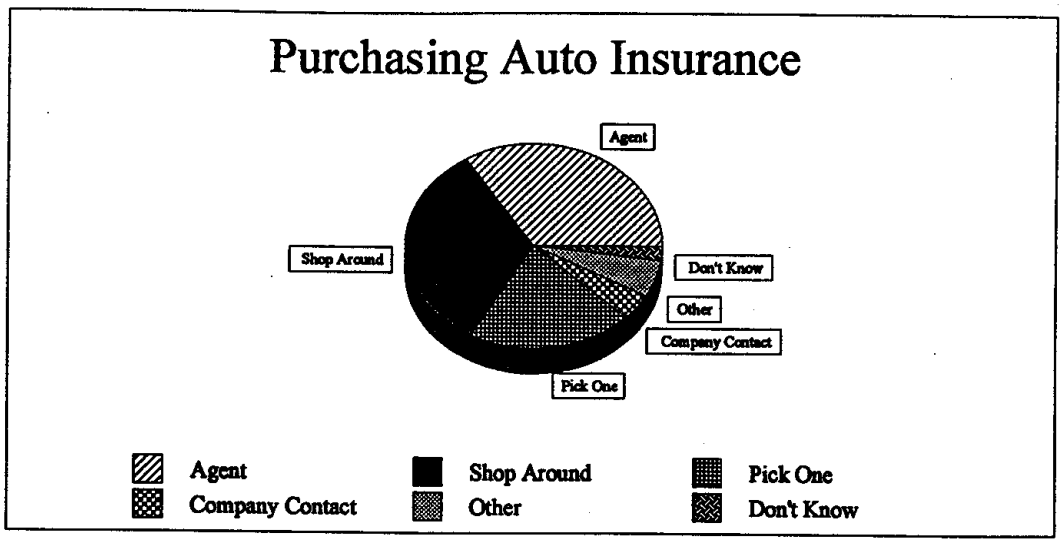
70. *See id.*

71. This chart is based on data contained in Fig. 2-28 of the study. *See id.*

72. *See id.* at 16.

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of purchasers who shop around, however, is very close, at 33%.[73] Another 21% of auto insurance purchasers decide on the company at the beginning of the process.[74] The relative proportion of those who shop for auto insurance is represented in the following chart:[75]



Although the figures of those who "shop around" for insurance represent a significant number of insureds, though still clearly a minority (24% of homeowners and 33% of auto insureds), activity that constitutes "shopping around" is quite broadly defined. It included such actions as being contacted by an insurer, asking a friend or relative for advice about insurance, and checking one's insurance against information in the media or pamphlets.[76] Thus, a significant number of those who "shopped around" for insurance may nonetheless be low-involvement consumers, just slightly more involved than most.

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73. *See id.*

74. *See id.*

75. This chart is based on data contained in Fig. 2-8 of the study. *See id.*

76. *See id.* at 13 fig.2-5 (auto insurance), 29 fig.2-25 (homeowners). The data concerning shopping activity is not directly correlated to the proportion of those who "shopped around." These were the factors used in questions about what kind of shopping activity the respondent had conducted during the previous year, and the proportion that engaged in such activity is not exactly the same as the number who shopped around. There were 21% of homeowners who engaged in shopping activity in the previous year (vs. 24% who "shopped around") while 31% of auto insureds did so (compared to 33% who "shopped around"). However, by using these factors in the survey, it at least signaled to respondents that this activity amounted to "shopping around." Moreover, although the figures are not the same, they are fairly close.

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Once an insured has purchased insurance for the first time, the turnover rate is relatively low. Insureds tend to stay with their original choice for long periods of time. Of homeowners insureds, about 49% had not shopped for insurance in more than 10 years, with some 24% of them indicating that they had *never* shopped for insurance after the original purchase.[77] Of auto insureds, 37% had not shopped for insurance in more than 10 years, with 21% indicating they had never shopped after the initial purchase.[78] Although these figures may reflect a high degree of satisfaction with the product and services provided by the present insured,[79] they are also consistent with the low-involvement model. Characteristic of the cognitive consumer is the continual collection and reassessment of data. The low involvement consumer tends to utilize trial purchasing, and so long as he or she is reasonably satisfied, will stay with that product.

2. Insureds Rely on Informal and Situational Information

When insureds do collect information about insurance, they tend to rely on informal and situational information. On average, insureds consult two sources of information about insurance.[80] The most widely used source of information is people the insureds know, or what might be called "word of mouth." That was a source of information for 51% of homeowners insureds,[81] and for 54% of auto insureds.[82] When assessing the value of that source of information, 95% of homeowners using that source rated it as very or somewhat valuable,[83] while 94% of auto insureds gave it that rating.[84] Although other people may provide some helpful information about insurance, that information is likely to be based on the individual's perceptions and experiences and is unlikely to be representative of the experience of many insureds. Reliance on this information therefore is more consistent with the low-involvement model than the cognitive model.

Consistent with the tendency of insureds to rely on their agents to select their insurance, the second most widely used source of information was

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77. These figures may not be exact because they are based on a bar graph. *See id.* at 30 fig.2-26. The report does not give specific the specific numbers.

78. *See id.* at 14 fig.2-6.

79. Some 92% of homeowners reported being very satisfied or fairly satisfied with their insurance company. *See id.* at 36. The figures are similar for auto insureds. Some 88% reported being very satisfied or fairly satisfied. *See id.* at 19.

80. For homeowners, see *id.* at 32. For auto insurance purchasers, the average is 2.1 sources. *See id.* at 15.

81. *See id.* at 31 fig.2-27.

82. *See id.* at 15 fig.2-7.

83. *See id.* at 31 fig.2-27.

84. *See id.* at 15 fig.2-7.

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insurance agents. They were identified as a source of information by 45% of homeowners[85] and by 42% of auto insureds.[86] The information provided by agents was considered to be very valuable or somewhat valuable by 94% of those homeowners using that source,[87] and by 95% of auto insureds using that source.[88] Although rated as having about the same value as word-of-mouth, agents are probably a more reliable source of information, assuming they are "independent" agents,[89] because they are more likely to have comparative information that represents a wider scope of experience. Agents, however, are trying to sell insurance. They are generally paid on commission, which creates an incentive to provide information that will sell insurance. Consequently, the information from agents seems likely to be self-serving, at least to some extent, and therefore is not as objective as other information. Moreover, by relying on the agent the insured is acting consistently with the low-involvement model. The insured lets the agent make the informational choices in the same way as the low-involvement consumer relies on sales people.

The remaining sources of information include some that would be used by cognitive consumers, but none of those sources of information is used with nearly the frequency of word-of-mouth or agents. The following table summarizes the other sources of information and the proportion of insureds who used them.[90] (Keep in mind that the average insured uses two sources.)

85. *See id.* at 31 fig.2-27.

86. *See id.* at 15 fig.2-7.

87. *See id.* at 31 fig.2-27.

88. *See id.* at 15 fig.2-7.

89. This assumption seems reasonable in light of the wording of the question. Respondents were asked to identify the method they used to select their insurer from a list which included "have an agent who selected the company." *Id.* at 82.

90. The homeowners information is based on Fig. 2-27 in PAM 1995. *Id.* at 31. The auto insured information is based on Fig. 2-7 in the same publication. *See id.* at 15.

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Sources of Information	Home	Auto
Insurer Literature	23%	19%
Insurer Advertising	15%	14%
Consumer Organization Information	11%	13%
Yellow Pages	11%	9%
Home or Auto Lenders	11%	6%
Television	6%	8%
Stories in Magazines or Booklets	5%	5%
Toll-free Telephone Call	4%	5%
State Government Information	3%	3%
PC On-line Services	2%	2%
Some Other Source	9%	8%
Don't Know or Did Not Answer	17%	22%

What is most remarkable about this data is the extremely low use of information that would seem to be the most reliable from the standpoint of a rational evaluation. A cognitive consumer would likely consult sources of neutral and comprehensive information, such as that from consumer organizations or state regulators. At least some of that information is relatively accessible. For example, the magazine *Consumer Reports* regularly includes articles on insurance purchasing.[91] Yet consumer information was consulted by only 11% of homeowners and only 13% of auto insureds. Those who consulted consumer information rated it highly. 89% of homeowners and 92% of auto insureds rated consumer organization information as very or somewhat valuable,[92] which is higher than the rating for insurer information.[93] Even so,

91. *See, e.g., Homeowners Insurance: Do You Have the Right Coverage?*, CONSUMER REP., Sept. 1997, at 62; *A Guide to Auto Insurance*, CONSUMER REP., Oct. 1995, at 638.

92. For homeowners, see PAM 1995, *supra* note 68, at 31 fig.2-27. For auto insureds, see *id.* at 15 fig.2-7.

93. Insurer literature and advertising were considered very or somewhat valuable by 85% and 79% of homeowners who used those sources. *See id.* at 31 fig.2-27. Of auto insureds using insurer literature and advertising, 85% and 75% found them to be very or somewhat valuable sources of information. *Id.* at 15 fig.2-7.

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consumer information, at 89% and 92%, was still not considered as valuable as word-of-mouth and information from agents, both at 94% and 95%.

Even fewer insureds, only 3%, contacted state regulators, another potential source of reliable, unbiased and comprehensive information. The regulators have fairly general supervisory responsibility over the insurance industry, and they often are recipients of consumer complaints. In addition, regulators consistently collect a variety of data about insurance companies, including financial information, and are therefore, in a position to have reliable and comprehensive information. Nevertheless, of the few insureds that actually used state government information, only 75% of homeowners and 79% of auto insureds rated that information as very or somewhat valuable.[94] This is the same or lower than the value ratings given to insurer advertising. 79% of homeowners and 75% of auto insureds rated advertising as a very or somewhat valuable source of information.[95]

The more widely-used remaining sources of information are consistent with the low-involvement consumer. After word-of-mouth and agents, the next most commonly used sources of information are insurer literature (23% of homeowners and 19% of auto insureds) and advertising (15% of homeowners and 14% of auto insureds). That information is likely to be readily available as part of the sales process, and therefore to a certain extent is a situational factor. Such information is promotional in nature, and therefore not objective or very reliable. Another example of a situational factor is the reliance by some insureds on information from lenders (used by 11% of homeowners and 6% of auto insureds). When the insured purchases a home or car, insurance is needed, so some insureds simply ask for a recommendation from the person from whom the other purchase was made.

One sizable group of insureds, but still a minority, decided on their insurance company *prior* to the purchasing decision (24% of homeowners[96] and 21% of auto insureds[97]). Although that decision could be based on a rational evaluation of insurers, the data shows that those insureds also tend to use informal and situational information. Consistent with the data discussed so far, the most common source of information used to select an insurance company was word-of-mouth in the form of advice from friends or relatives. That was a source of information for 37% of homeowners[98] and 45% of auto

94. For homeowners, see *id.* at 31 fig.2-27. For auto insureds, see *id.* at 15 fig.2-7.
95. For homeowners, see *id.* at 31 fig.2-27. For auto insureds, see *id.* at 15 fig.2-7.
96. *See id.* at 33 fig.2-28.
97. *See id.* at 16 fig.2-8.
98. *See id.* at 35 fig.2-31.

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insureds.[99] The other information sources are generally consistent with the data discussed above. A table summarizing the sources of information for selection of an insurer follows:[100]

Source of Information - *Selecting Insurer in Advance of Purchase*	**Home**	**Auto**
Familiar or Respected Name or Reputation	24%	22%
Parents Insurer	19%	10%
Had Other Insurance with Company	9%	13%
Media	3%	7%
Consumer Organization Information	2%	3%
State Government Information	2%	1%
Advertising	6%	8%
Other	14%	9%
Don't Know or No Answer	4%	3%

Again, insureds made little use of sources of neutral and comprehensive information. Only 4% used information from either consumer organizations or state governments. Although perception of an insurer's reputation could be the result of a rational evaluation of information, it seems more likely to be based on a more generalized perception based on disparate and diffuse sources of information such as advertising, conversations with others, media coverage, etc. This is supported by the relatively strong showing of express situational

99. *See id.* at 19 fig.2-11.

100. The homeowners information is based on Fig. 2-31 in PAM 1995. *See id.* at 35. The auto insured information is based on Fig. 2-11 in the same publication. *See id.* at 19.

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factors such as the choice of the parents' insurer or the insurer who already provided other insurance.

This data tends to show that the typical insured fits the low-involvement model much better than the cognitive consumer model. Although there may be individual insureds who rationally evaluate their insurance purchasing options and the available information, the *average* insured does not. Most insureds do not actively shop for insurance, but instead let their agent pick the company for them or pre-select a company based on informal and situational information. To the extent that the average insured does consider and process information in making the purchasing decision, that information tends to come from informal and situational sources. Insureds heavily rely on word-of-mouth and their agents in making purchasing decisions, and rely more on biased sources of information, such as company materials and advertising, than on the least biased and comprehensive sources of information, such as that from consumer organizations and state regulators. It therefore seems doubtful that the average or reasonable insured will develop "expectations" through the rational process implicitly assumed by the courts applying the reasonable expectations doctrine. Up to this point the analysis has focused on whether insureds undertake rational evaluations during the purchasing process generally. We now turn to an analysis of the more narrow question of whether typical insureds develop specific and identifiable expectations of coverage.

B. Do Insureds Have Specific and Identifiable Expectations?

It is obvious that insureds must have *some* expectation of coverage, or they would not pay insurance premiums. The more pertinent question, however, is how specific and identifiable are those expectations. The reasonable expectations doctrine assumes than an insured's expectation develops to a high level of specificity. As discussed above, the doctrine assumes that an insured's expectation is sufficiently specific to draw distinctions between a burglary with visible signs of an outside job, and a more narrow definition of burglary requiring evidence of forced entry or damage on the *exterior* of the building.[101] Similarly, the doctrine assumes that expectations are so clearly defined that a change in information about what is covered would cause the insured to reject the insurance policy,[102] or at least would affect the insured's understanding of the coverage.[103] The specificity of the insureds' expectation will be evaluated

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101. *See supra* text accompanying notes 38-48.

102. This is the essence of the RESTATEMENT (SECOND) OF CONTRACTS approach to reasonable expectations. *See supra* text accompanying notes 49-52.

103. This is the misunderstanding test. *See supra* text accompanying notes 53-54.

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in the context of insurance coverage for particular claims because that is the most common use of the reasonable expectations doctrine.[104]

The way insureds purchase insurance makes it questionable whether insureds have developed specific or identifiable expectations regarding particular claims. Insureds in the normal course of purchasing insurance do not even "shop around" for insurance, let alone consider the specific scenarios of possible coverage. When they do gather information, it tends to be from sources that will provide little reliable coverage information. Advice from friends and relatives, the most widely used and regarded source of information, is unlikely to provide a basis for specific expectations of coverage. At the same time, the sources of information that are most likely to provide comprehensive and unbiased information, consumer organizations and state regulators, are used by a relatively small number of insureds.

1. Insureds are Unlikely to Develop Specific Expectations from Interaction with Their Agents

One purchasing practice, the reliance on agents, on first examination, seems a possible way for insureds to develop specific expectations of coverage, but on closer examination the data provides little support for that conclusion.[105] The data above shows that agents are extremely important to the sale of homeowners and auto insurance. Many insured's rely on the agent to select the insurer, and, next to word-of-mouth, agents are the most commonly used, and highly regarded source of information. In addition, insureds rely on their agents to determine the scope of the coverage provided under their policies. When insureds have questions about what is covered under their policies, 77% said they turn to their agents, while another 8% turn to the insurance company.[106] Only 11% turn to the policy itself.[107] Furthermore, insureds are

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104. *See* Rahdert, *supra* note 7, at 351 & n.101.

105. The use of insurance company literature or advertising also might be considered possible sources for insureds to develop specific expectations. Only a minority of insureds, however, used these sources of information. Insurer literature was used by 23% of homeowners and 19% of auto insureds, while advertising was used by 15% of homeowners and 14% of auto insureds. *See supra* table accompanying note 90. Moreover, this information seems likely to represent coverage in a more general way because of its promotional nature. This argument is addressed below in the context of representations by agents. *See infra* text accompanying notes 109-111.

106. *See* J. DAVID CUMMINS ET AL., CONSUMER ATTITUDES TOWARD AUTO AND HOMEOWNERS INSURANCE 240 (1974). Admittedly, this data is quite old, but more recent data was not found. In addition, this data comes from the era when the reasonable expectations doctrine was being recognized and applied. For a description of the study's methodology, see *id.* at 3-9.

107. *See id.* at 240.

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generally satisfied about the explanations they get regarding coverage at the time that they purchase insurance. The following table summarizes the satisfaction data:[108]

Degree of Satisfaction with Agent's Explanation of Coverages	Home	Auto
Completely Satisfactory	73%	70%
Only Partially Satisfactory	15%	17%
Hardly Satisfactory at All	5%	8%
Not Sure	7%	5%

Although this high level of satisfaction might lead one to conclude that agents are providing a thorough explanation of policy coverages, which could lead to specific and identifiable expectations, that conclusion is not compelled by the data. It seems unlikely that the average insured who relies on informal and situational information would want a detailed explanation of coverage. Thus, the study analyzing this survey data concluded, "[I]t is possible, and probably quite likely, that [insureds] do not desire an extensive explanation of their coverage from their agent at the time they buy insurance, and hence they have no reason not to be completely satisfied when asked to rate his explanation."[109]

In addition, there are possible motivations for the agent to give more generalized explanations of coverage. An agent's primary motivation is to sell insurance, and more generalized information may be more effective as a sales tool than specific coverage details. At the very least, the more generalized information gives the agent greater flexibility. It allows the agent to promote the most profitable insurance by using sales "puffing" without making any express misrepresentations. It also allows flexibility in explaining a denial of coverage. Although coverage may have been described broadly in general terms, the specific coverage for a particular claim may nonetheless be excluded. In contrast, an agent who makes a specific representation of coverage which turns out to be incorrect, runs the risk of losing a customer[110] or even being sued for malpractice or misrepresentation.[111]

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108. This table is based on a table found *id.* at 28.

109. *Id.* at 31.

110. Of insureds who felt they had been unfairly treated in a loss settlement, 17% responded by changing agents. 40% complained to the company, 34% changed companies, and

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The possibility of a more generic explanation of coverage also is supported by agents' failure to inform insureds of alternative insurance policies. Of homeowners, 39% were not told by their agent of the availability of different homeowners insurance policies.[112] Where a significant number of agents do not even tell insureds about competing policy forms, it seems unlikely that they would explain the particular details of the policy purchased. This behavior would be consistent with the sales-motivation; the agent may be giving the insured just enough information to make the sale. Moreover, there is a strong correlation between the agent telling the insured about alternative insurance and the level of satisfaction of the policy explanation. When those who found their agent's explanation as "hardly satisfactory at all" are considered, 67% of them were not told of alternative homeowners policies.[113] Thus, the survey data seems to show that insureds are satisfied when they are told about the general types of coverages available, for example the standard homeowners policy versus the "deluxe" edition.[114]

2. Insureds Generally Misunderstand Basic Coverages and Exclusions

Whether agents provide specific coverage explanations is addressed more directly by data concerning the insureds' understanding of their insurance coverage. If agents were providing specific coverage explanations, one would expect insureds to have at least an elementary understanding of basic coverages and exclusions. A 1989 survey, however, found that "there seems to be quite a bit of confusion about coverage for perils typically covered as well as perils not covered in a homeowner's insurance policy."[115] Thus, it seems likely that

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7% contacted the state regulators. *See id.* at 199 tbl.7.3. Although the insured may seem more likely to change companies than to change agents, that might assume that the insured believed the source of the problem was the company, not the agent. If the agent has made a representation of coverage that turns out to be wrong, the insured could be more likely to blame the agent.

111. *See generally* 16A JOHN ALAN APPLEMAN & JEAN APPLEMAN, INSURANCE LAW & PRACTICE §§ 8831, 8837 (1981).

112. *See* CUMMINS ET AL., *supra* note 106, at 32.

113. *See id.*

114. In explaining alternative policies, agents may give specific coverage information about the differences in those policies. As the above analysis shows, however, that information is likely to be fairly general, which tends to be confirmed by the insureds' misunderstanding of basic coverages and exclusions, as shown in the following section. *See infra* Part II.B.2

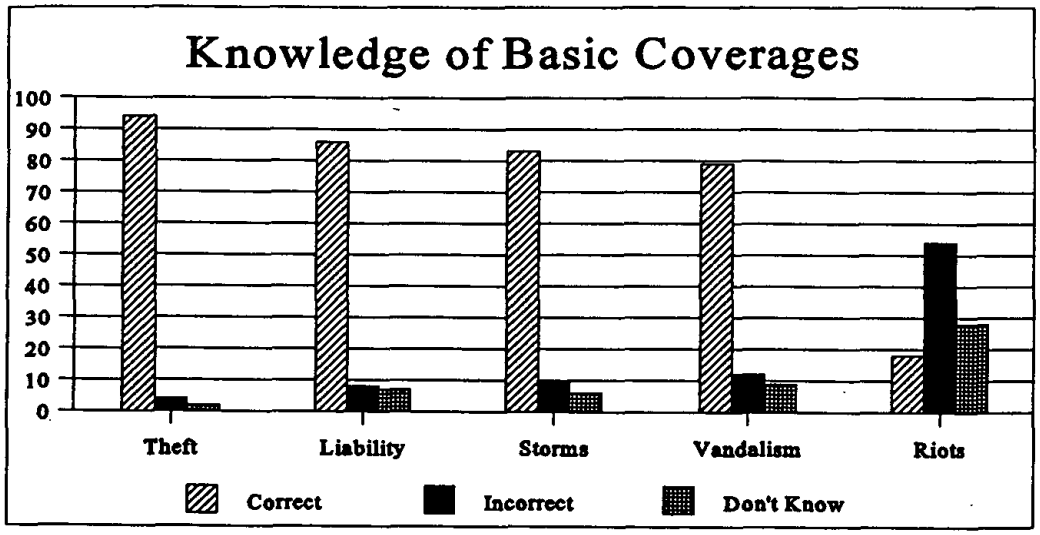
115. ALL-INDUSTRY RESEARCH ADVISORY COUNCIL, PUBLIC ATTITUDE MONITOR 1989: A SURVEY OF PUBLIC ATTITUDES ON AUTO INSURANCE RATES, SEAT BELTS, ATTORNEY ADVERTISING, HOMEOWNER'S INSURANCE, AND INSURANCE CLAIM FRAUD 15 (1989) [hereinafter PAM 1989]. The survey was conducted by the Roper Organization, Inc., of 1,484 adults age 18 or over. Interviews were conducted in-home between May 20-25 and May 30-June 10,

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either the agents are not providing detailed explanations of coverage, or insureds do not comprehend or remember the agents' explanations. In either event, because insureds misunderstand the most basic coverages and exclusions, it seems unlikely that they would develop specific expectations about particular claims.

The study asked survey recipients about eleven different perils addressed by typical homeowners insurance: fires, theft, liability for bodily injury or property damage, storms, vandalism, riots, floods, earthquakes, mudslides, nuclear accidents, and deterioration due to age or wear and tear. Of these eleven, the first six (fires, theft, liability for bodily injury or property damage, storms, vandalism and riots) are typically covered by homeowners insurance. The next three (floods, earthquakes and mudslides) are typically excluded, but supplemental insurance can be purchased by endorsement for earthquakes and mudslides, and the flood coverage is sometimes available through a federal flood program marketed through private agents. The last two perils (nuclear accident and deterioration due to age or wear and tear) are typically excluded and cannot be altered through endorsement.[116]

Although insureds knew that their homeowners policies covered losses caused by fire[117] (which is really the heart of the homeowners coverage), there was significant misunderstanding about other standard coverages. The following chart summarizes the knowledge of the insureds regarding the other six standard coverages:[118]



1989. *Id.* at 1. A copy of the survey is included with the study as Appendix 1, *see id.* at 20-23, and the methodology is described in Appendix 2, *see id.* at 24.

116. *See id.* at 13.

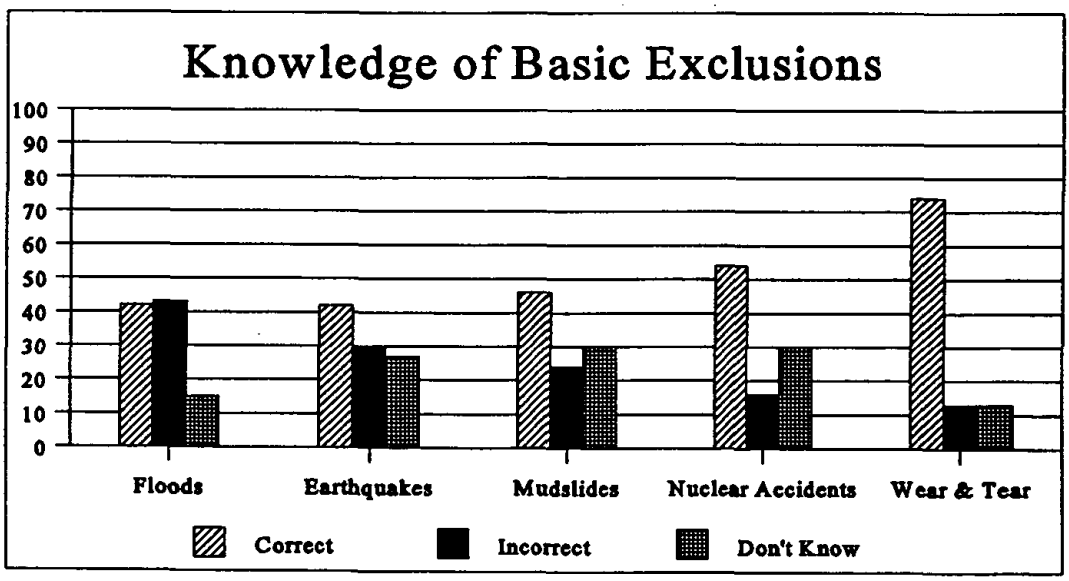
117. 99% of those asked reported that property damage caused by fire would be covered under their homeowners or renters policy. *See id.* at 14 tbl.17.

118. This chart is based on data provided in Table 17. *See id.*

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Most of the insureds knew that theft, liability, storms and vandalism were covered. Nevertheless, there were still significant numbers of insureds who did not know. For example, 8% of insureds thought that they would *not* be covered for liability for injury or property damage, and another 7% were unsure.[119] While this is not a large proportion of insureds, it is significant that so many insureds do not have a correct understanding of even the most basic and primary coverages provided by the policy. There are similar numbers of insureds who did not think damages caused by storms (10%) or vandalism (12%) were covered, or were unsure about those perils (6% for storms and 9% for vandalism).[120] For riots, the majority of insureds (54%) *incorrectly* thought there was no coverage under their homeowners policies, and another 28% were unsure.[121] Only 18% of insureds correctly answered that damages caused by riots would be covered.[122]

As might be expected, insureds had even greater misunderstanding of standard exclusions contained in homeowners insurance. There was substantial uncertainty as to whether damages caused by floods or earthquakes were covered, and significant uncertainty as to mudslides, nuclear accidents and deterioration due to age or wear and tear. The following chart summarizes the survey results regarding exclusions:[123]



119. *See id.*
120. *See id.*
121. *See id.*
122. *See id.*
123. This chart is based on data provided in Table 17. *See id.*

This data shows that insureds are more likely than not to *incorrectly* assume damages due to floods were covered, and nearly as likely to *incorrectly* assume that damages due to earthquakes were covered. Moreover, once those who were unsure about coverage are combined with those who answered incorrectly, *less than half of insureds* knew that these perils were excluded. Some of this uncertainty is undoubtedly due to the fact that supplemental coverage is available for both floods and earthquakes, but that only partially explains the uncertainty. Although some people purchase supplemental coverage, those numbers are substantially less than the proportion incorrectly assuming there was coverage.[124] Moreover, the fact that separate coverage is purchased by some insureds should indicate that agents have told insureds about the separately available coverage, which should inform them that such perils are not covered under the basic homeowners policy.

Perhaps just as significant is evidence that many insureds incorrectly assume coverage for nuclear accidents and deterioration due to age or wear and tear. Although only a minority of insureds make this mistake, it is a substantial minority. Only 54% of insureds correctly understood that nuclear accidents were excluded.[125] 16% thought that damages from a nuclear accidents were covered, while another 30% of insureds were unsure, for a total of 46%.[126] This exclusion has been a fundamental and irrevocable part of the homeowners policy for many years. The exclusion for wear and tear is even more fundamental; it reflects an essential premise of insurance law that only *fortuitous* losses are insured.[127] Yet 13% of insureds thought that damages due to deterioration or wear and tear were covered, and *another* 13% did not know whether such damages were covered, making a total of 26% of insureds that misunderstood one of the most basic exclusions in the homeowners policy.[128]

This data tends to undermine the assumption that insureds consistently develop specific expectations regarding insurance coverage. It shows a divergent range of expectations about the most basic coverages and exclusions, which were considered at a high level of generality. Respondents were not asked about specific claims, but only the more general question, "[w]hich of the following types of property damage or loss do you think would be paid for under your homeowner's or renter's policy?"[129] If insureds do not develop

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124. Only about 1 in 8 (or 12.5%) of homeowners buy flood insurance, and only 1 in 4 buy earthquake insurance in the high-risk state of California, so it is unlikely that much larger percentages incorrectly assumed they had purchased such coverage. *See id.*

125. *See id.*

126. *See id.*

127. *See* KEETON & WIDISS, *supra* note 8, § 5.3(a), at 475.

128. *See* PAM 1989, *supra* note 115, at 14 tbl.17.

129. *Id.* at 22.

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consistent expectations about general coverages and exclusions, it seems unlikely that the average insured would develop specific expectations of coverage regarding particular claims.

This data also tends to rebut the conclusion that agents provide detailed explanations of policy coverages. The information provided by agents does not educate insureds as to the most basic coverages and exclusions contained in the homeowners insurance policy. Although it is possible that the agents provided adequate information, and that insureds simply forgot or were confused, the information did not create consistent expectations among average insureds. If average insureds do not have consistent expectations about the basics of their insurance, it seems unlikely that they would develop more specific and identifiable expectations as to particular claims.

The lack of specific expectations is also supported by insureds' understanding of the role of the insurance policy's text. Even though insureds say they are generally satisfied with the explanation of coverage provided by their agents, they nonetheless believe that the text of the policy will ultimately be used against them when they submit a claim. In the same survey in which insured's approved of agents' explanations of coverage, 82% of them agreed with the statement, "If you don't look at the fine print when you buy an auto or homeowners insurance policy, you are likely to find you are not covered in an emergency."[130] Therefore, even if insureds expect coverage in a general sense, when it comes to the particulars of a claim, insureds expect that the text of the policy will be used to exclude their claims.

The research analyzed in Part II tends to undermine the assumptions that insureds form specific expectations for coverage or that they rationally evaluate their insurance options. The average insured exhibits the characteristics of a low-involvement consumer by failing to do comparative shopping and by relying on informal and situational information. Not surprisingly, the information used by insureds results in a misunderstanding of general coverages and exclusions. It therefore is unlikely that the average insured makes a rational evaluation of insurance options or develops specific expectations of coverage for particular claims. This research, of course, only

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130. CUMMINS, ET AL., *supra* note 95, at 134. I recognize that this data is old, but it was gathered in the same study in which insureds approved of agents' explanations. Therefore, even though it is old, it provides a basis for inferring the level of generality of those explanations. In addition, parts of the study are supported by later survey data. The insureds' reliance on agents for information and decisionmaking was confirmed in the 1995 PAM study. *See supra* notes 68, 72, and 85-88, and accompanying text. The likelihood that the agents provide only general information was corroborated by the 1989 study showing that many insureds do not understanding even the most basic coverages and exclusions, let alone how a more marginal claim would be handled. *See supra* notes 115-29 and accompanying text.

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addresses the "average" insured because it is based on the answers and behaviors of a representative sample of insureds. As a result, it is possible that an *individual* insured may undertake a rational evaluation and develop a specific expectation of coverage. But this research tends to show that such an insured would be an exception. On the whole, the data tends to show that the bargaining assumptions are not supported as to the typical insured.

III. REASSESSMENT OF REASONABLE EXPECTATIONS DOCTRINE

Because the reasonable expectations doctrine is based on incorrect assumptions, it needs to be reassessed. Although incorrect assumptions could be a basis for rejecting the doctrine entirely, it may be possible to reformulate the doctrine to accommodate more accurate underlying assumptions. Moreover, even if the doctrine is based on incorrect assumptions, it nevertheless may be normatively justified if it provides appropriate protection for insurance consumers. The research reviewed in this article confirms that consumers need some form of protection. Not only do they have less power and expertise than the insurers (the traditional assumption of unequal bargaining power), they do not even use the bargaining power they have. Insureds do not "bargain" for insurance; they rely on agents, informal and unreliable information, and situational factors. Insurers undoubtedly have some sense of this from their marketing research, and market their insurance to take advantage of these behaviors.[131]

The question therefore is not *whether* insureds need protection, but whether the reasonable expectations doctrine is an *appropriate way* to provide consumer protection. On the one hand, because the reasonable expectations doctrine allows the courts to ignore express policy language, it is "a powerful regulatory tool" that can protect consumers.[132] On the other hand, this "powerful tool" affords courts substantial discretion,[133] which could be used arbitrarily. If insureds do not have specific expectations and do not even

131. One example of this is the insurers' extensive use of non-specific advertising. Rather than advertising prices, coverages, or claims practices, insurers tend to promote their products with generic slogans and representations (e.g. "Like a good neighbor . . .," "You're in safe hands . . . ," "Get a piece of the rock . . .," etc.). Such advertising tries to influence general perceptions and attitudes rather than providing specific information for a rational evaluation.

132. *See* JERRY, *supra* note 4, at 147.

133. *See supra* note 26. Professor Jerry summarizes this aspect of the doctrine nicely: "Although the contours of the doctrine of reasonable expectations are explicable, the fact remains that courts have considerable discretion when applying the doctrine. The tradeoff for tolerating this discretion and the equity that comes with it is some degree of unpredictability in outcomes." JERRY, *supra* note 4, at 147.

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rationally assess insurance information, efforts to "find" those reasonable expectations often will be futile. The courts' determination of "reasonable expectations" therefore, in many cases, is a fiction that allows them to impose their own view of fairness. This might be acceptable if courts could determine "fairness" in some objective, consistent way, but one's view of fairness is greatly influenced by individual experience and perspective.

It is possible that the arbitrariness to the doctrine could be eliminated by making adjustments to the assumptions and the doctrine. One possible adjustment would be to narrow the doctrine to those situations involving *actual* reasonable expectations of *individual* insureds, rather than *assuming* that the typical insured has such expectations. Another possible adjustment is in the other direction. Instead of narrowing the doctrine to account for more specific factual circumstances, the doctrine might be narrowed towards greater generalization, so as to protect the *generalized* expectations of insureds instead of the *specific* expectations assumed in many court decisions. After exploring the arbitariness of the doctrine when separated from its underlying assumptions, this part will briefly consider each of these two options.

A. The Arbitrariness of the Reasonable Expectations Doctrine when Separated from its Assumptions.

The arbitrary nature of the reasonable expectations doctrine when the underlying assumptions are removed can be illustrated by returning to the case decided by the Iowa Supreme Court concerning the definition of burglary.[134] *C & J Fertilizers, Inc. v. Allied Mutual Insurance Co.*,[135] is a relatively strong case for the application of the doctrine (with its assumptions) because the insured appeared to be acting rationally and seemed to have a specific expectation regarding burglary coverage.[136] The insured and his agent had discussed the burglary coverage prior to the issuance of the policy. During that conversation, the agent told the insured that burglary coverage required "visible evidence of burglary."[137] This evidence, along with the general understanding of the term "burglary,"[138] led the court to conclude that, "[t]he most plaintiff might have reasonably anticipated was a policy requirement of visual evidence (abundant here) indicating the burglary was an 'outside' not an 'inside' job."[139]

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134. *See supra* text accompanying notes 38-48.

135. 227 N.W.2d 169 (Iowa 1975).

136. Many, perhaps most, courts make a finding about reasonable expectations with little or no evidence of the insured's actual expectation. *See supra* note 25.

137. *C & J Fertilizers*, 227 N.W.2d at 171.

138. *See id.* at 177.

139. *Id.*

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Although this conclusion seems logical enough, it may be arbitrary when considered in light of the realities of how insureds purchase insurance. As a general matter, insureds do not rationally assess coverage or develop specific expectations of coverage. In light of the research discussed above, the insured in this case may not have had the specific expectation assumed by the court. Although the insured had at least a generalized expectation of burglary coverage, which was limited by the knowledge that some burglaries (i.e. "inside" jobs) were not covered, it seems unlikely that the expectation was specific enough to address the particular factual scenario of the case. The insured probably never considered whether there would be coverage for a burglary in which there was internal evidence, but none on the exterior of the building. It is therefore doubtful whether the insured thought about his coverage in the kind of detail that would have led to a specific expectation of coverage for this scenario.

It may be that the court implicitly concluded that even if the insured did not think about this specific scenario, a logical extrapolation of the circumstances showed a reasonable expectation of coverage. The court seemed to assume that if the insured had been questioned about this particular scenario at the time he purchased the insurance, he would have logically concluded that it was covered. But most insureds do not rationally assess their coverage when buying insurance. They tend to rely on their agents and on other informal and situational information. Many insureds do not correctly understand even the most basic coverages and exclusions in their policies. Instead, when they have a question about the scope of their insurance coverage, they tend to simply ask their agent whether it is covered. It therefore seems just as likely, or perhaps even more so, that if the insured had been questioned about this scenario at the time he purchased his insurance, he would have been *unsure* about whether it was covered. If he would have been unsure, he did not have a specific expectation of coverage. Enforcing such a concocted "expectation" under such circumstances would be arbitrary.

Moreover, the court incorrectly assumed that a more complete disclosure of the burglary coverage would have altered the transaction. It implicitly assumed, consistent with the rational evaluation assumption, that the insured would have refused to buy the insurance if he had known that the visible evidence of burglary had to be on the *exterior* of the building.[140] This

140. This refers to the commentary from the RESTATEMENT (SECOND) OF CONTRACTS (in draft form) that provided a party "does not assent to a term if the other party has reason to believe that the adhering party would not have accepted the agreement if he had known that the agreement contained the particular term." *Id.* at 176. It then analyzes the "negotiations" of the parties to determine the agreement to which the parties assented. *See id.*

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bargaining assumption is inconsistent with the fundamental premise of the reasonable expectations doctrine which states that insurance policies are contracts of adhesion, and therefore do not provide any *choice* of provisions for the insured.[141] In addition, this assumption is inconsistent with the way insureds buy insurance. The typical insured relies on informal, subjective information and situational factors, and is unlikely to be concerned about the specific details of coverage for particular scenarios. Therefore, as one court concluded, it could be just as likely that the insured would have purchased the policy even if he had been told *exactly* what was required for a burglary loss to be covered.[142]

This example is not meant to prove the inherent shortcomings of the reasonable expectations doctrine, but simply illustrates the problems that arise in even a relatively strong case once the doctrine is separated from its assumptions. When the assumptions of rational evaluation and specific expectation are eliminated, the reasonable expectations doctrine has so little remaining content that it allows courts to reach whatever result they choose. In light of the research data, the court in *C & J Fertilizer* could have concluded that the insured did not have a reasonable expectation for coverage. Therefore, the reasonable expectations doctrine did not *compel* the court's holding, but simply provided the rationale. Although this might be viewed as an acceptable result in *C & J Fertilizer* because there was evidence of the insured's expectation, most courts invoke the reasonable expectations doctrine without such evidence, and in many cases even without any explicit analysis of the insured's expectations.[143] As a result, the application of the reasonable expectations doctrine is arbitrary in many cases once the doctrine is separated from its assumptions.

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141. As Professor Henderson noted, "The requirement of visible marks of entry for burglary and similar coverages was not a rare provision in the insurance world. Insurers had begun to employ such a provision because of the ease with which an insured could assert a burglary claim absent such a provision and to distinguish it from other coverages that provided for employee dishonesty and mysterious disappearance." Henderson, *supra* note 1, at 849 n. 127.

142. *See* Sterling Merchandise Co. v. Hartford Ins. Co., 506 N.E.2d 1192, 1197 (Ohio Ct. App. 1986). In that case, the policy required "visible marks made by tools, explosives, electricity, gas or chemicals upon the exterior" of the safe for coverage to apply. *Id.* at 1195. In finding that there was no coverage, the court found that there was "no indication that underwriters had any reason to believe that [the insured] would not have assented to the provision." *Id.* at 1198. The court also found that there were other facts that made *C & J Fertilizer* distinguishable. *See id.* at 1197.

143. *See supra* note 23, and accompanying text.

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B. The Possible Narrowing of the Reasonable Expectations Doctrine

One possible way to avoid the arbitrary application of the reasonable expectations doctrine is to tailor the doctrine and its assumptions to better fit the realities of insurance purchasing. Even though the average insured does not appear to rationally evaluate insurance options or develop specific expectations of coverage, it is possible that an *individual* insured might do so. In addition, the research tends to show that the average insured does have at least a generalized expectation for coverage. These assumptions, which are more modest than those which presently underlie the doctrine, would require a narrowing of the doctrine. We now consider adjusting the reasonable expectations for these more modest assumptions.

1. Tailoring the Doctrine to the Expectations of Individual Insureds

The foregoing analysis of *C & J Fertilizer* treated the insured as a "typical" insured, and extrapolated his individual expectations from the research about insureds generally. It is possible, however, that he was *not* an average insured. It is possible that he did, in fact, develop the individual expectations of coverage inferred by the court from the circumstances. After all, he apparently cared enough about his burglary coverage that he and his agent discussed the topic prior to his purchasing the insurance. It is also possible that he cared enough about that coverage that he might have purchased a different policy[144] with a more liberal definition (assuming that there was one available).[145]

If the insured in *C & J Fertilizer* undertook a rational evaluation and formed a specific expectation, that might justify a modified reasonable expectations doctrine. Instead of *assuming* that insureds act rationally and

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144. Although this is possible, there was no evidence in the record to support that conclusion. Moreover, the fact that the insured did not read the definition of burglary in the policy, tends to show that the insured did not care enough about the burglary coverage to have changed policies based on the definition. *See C & J Fertilizer*, 227 N.W.2d at 172. If he was concerned enough to change policies based on the definition, one might expect him to have looked at the definition. This failure to read the policy is consistent with the behavior of most insureds.

This issue raises another problem. The after-the-fact reconstruction of what the insured would have done raises a host of possible permutations which are difficult to fully analyze. For example, assuming that another policy would have had a different definition of burglary, it might also have included other less-favorable provisions, or might have been significantly more expensive, or might have been offered by an insurance company that subsequently became insolvent.

145. *See* Henderson, *supra* note 1, at 849, n. 127.

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develop specific expectations, the doctrine might require *proof* of the insured's expectation. Some facts in *C & J Fertilizer* support such a finding, perhaps enough to support a factual inference of an actual expectation. This approach to the reasonable expectations doctrine, however, would be a substantial alteration of way the doctrine is applied because most courts perform little factual or legal analysis of an insured's expectations,[146] although there is some authority which could support this more narrow view.[147]

One problem with this approach is that it may encourage insureds to simply develop after-the-fact expectations for coverage. As some courts have noted, insureds may have the tendency to "develop a 'reasonable expectation' that every loss will be covered."[148] This tendency is illustrated by *State Farm Mutual Automobile Insurance Co. v. Dimmer*.[149] In that case the Arizona Court of Appeals held that household exclusion (which excludes liability coverage for any suit brought by a member of the same household as the insured) was unenforceable under the reasonable expectations doctrine.[150] In support of his motion for summary judgment, Mr. Dimmer provided an affidavit to set forth a factual basis for a reasonable expectations finding. In his affidavit he testified that his "understanding of the coverage . . . was that [his] wife would be covered to the same extent as any other person," and that if he had "known that there was any question of [his] wife not being insured to the same extent as any other person, [he] certainly would have sought a different insurance

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146. *See supra* note 23.

147. Professor Jerry, for instance, notes that one of the factors that appears to affect the application of the reasonable expectations doctrine is "the extent to which an insured actually, subjectively expects coverage." JERRY, *supra* note 4, at 145. In addition, the courts in Arizona have recognized the reasonable expectations doctrine can apply "[w]here some activity reasonably attributable to the insurer has induced a particular insured reasonably to believe that he has coverage, although such coverage is expressly an unambiguously denied by the policy." Gordinier v. Aetna Cas. & Sur. Co., 742 P.2d 277, 284 (Ariz. 1987). *See also* Mayhew, *supra* note 8, at 289; Gary L. Birnbaum et al, *Standardized Agreement and the Parol Evidence Rule: Defining and Applying the Expectations Principle*, 26 Ariz. L. Rev. 793, 834 (1984).

Professor Henderson argues that this approach seems to be "an anomoly" in the doctrine because it includes situations "covered by orthodox doctrines" such as "waiver, estoppel, or election" or "reformation." Henderson, *supra* note 1, at 851. Professor Mayhew maintains that the reasonable expectation doctrine would make such cases easier to prove than under the orthodox doctrines, but concedes that "the differences . . . are not as great as they may seem." Mayhew, *supra* note 8, at 294.

148. Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388, 395 (Ariz. 1984); *see also* Max True Plastering Co. v. United States Fidelity & Guar. Co., 912 P.2d 861, 868 (Okla. 1996).

149. *See* State Farm Mut. Auto. Ins. Co. v. Dimmer, 773 P.2d 1012 (Ariz. Ct. App. 1988).

150. *See id.* at 1019.

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policy."[151] Although the court did not rely on this evidence, it found a reasonable person's reading of the policy resulted in a reasonable expectation of coverage for Mr. Dimmer.[152]

This conclusion and Mr. Dimmer's testimony seem dubious in light of the consumer research and empirical data. It is unlikely that he would have considered the scenario in which he injured his wife, and then she sued him for damages. Most insureds make purchasing decisions with informal and situational information that is unlikely to give them specific expectations for particular claims. To the extent that insureds consider coverage information, it is likely too general in nature. Moreover, many insureds do not understand even the basic coverages and exclusions, let alone exclusions that have specialized applications such as the household exclusion. That exclusion only applies to the limited circumstance in which one family member brings a lawsuit against another for bodily injury. The record tends to show that Mr. Dimmer's experience was consistent with that of the average insured. He purchased his policy from an agent, who explained the general coverages Mr. Dimmer should have, but his agent "never detailed the facts and situations in which the policy coverages would and would not apply."[153] Mr. Dimmer never asked for such information. It therefore seems unlikely that he had a specific expectation that a claim brought by his wife against him would be covered.

Moreover, his affidavit shows that, consistent with the typical insured, Mr. Dimmer did not understand the basics of his auto policy, let alone the workings of the household exclusion.[154] The issue in dispute was whether the claim made against him by his wife was covered under the liability provisions of the policy.[155] The insurer argued that Mr. Dimmer was not covered as the defendant because of the household exclusion. Mr. Dimmer's testimony, however, did not go to his expectation of his *own* coverage, but concerned his expectation of his *wife's coverage.*[156] He apparently confused his third-party liability coverage with first-party coverage for his wife.

This basic misunderstanding, combined with the evidence of a more general description of coverage provided at the time of the purchase, makes it quite unlikely that Mr. Dimmer had a specific expectation of coverage for his

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151. *Id.* at 1015.

152. *See id.* at 1019-20.

153. *Id.* at 1014.

154. This fact is all the more remarkable in light of the fact that the affidavit was presumably prepared with the advice of counsel.

155. *See Dimmer*, 773 P.2d at 1015.

156. In fact, if his wife was not covered under the policy the claim would have been covered. For her to not be covered, she would have to not be a named insured and would have to not reside in the same household. *See id.* (quoting the household exclusion).

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wife's claim. The possibility that he would injure his wife in an automobile accident and, further, that she would sue him seems far-removed from kinds of considerations normally involved in the insurance transaction. Furthermore, even assuming that Mr. Dimmer might have considered those possibilities, it seems unlikely that specific disclosure of the household exclusion would have caused Mr. Dimmer to purchase a different auto policy, especially since any other auto policy probably would have a household exclusion as well. Because this application of the reasonable expectations doctrine to the household exclusion strains credulity, it is not surprising that the "vast majority of cases . . . have held that household exclusions or analogous exclusions are enforceable with respect to policy amounts in excess of the statutory minimum."[157] Thus, the research shows that the court's conclusion in *Dimmer* was not well-supported, and that, to a certain extent, insureds' expectations will be shaped by their ability to use those expectations after-the-fact to recover.

2. Tailoring the Doctrine to the More Generalized Expectations of Typical Insureds

Instead of tailoring the reasonable expectations doctrine to protect the expectations of specific individual insureds, the doctrine might be narrowed in the opposite direction so as to protect the more generalized expectations of the typical insured. This modified doctrine would apply only if the offending provision was sufficiently broad that it undermined the insured's generalized expectation of coverage.[158] This version of the doctrine would be consistent with one of the earliest lines of reasonable expectations cases finding temporary life insurance coverage based on the payment of the initial premium in spite of language in the conditional receipt that would have precluded coverage.[159] Applying the doctrine in that situation is more consistent with the

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157. State Farm Mut. Auto. Ins. Co. v. Mastbaum, 748 P.2d 1042, 1043-44 (Utah 1987) (citing cases). Because of mandatory insurance laws, however, most jurisdictions have found that the household exclusion is invalid as to the minimum amount required under those laws. For a general discussion of the household exclusion, see JERRY, *supra* note 4, at 889-92.

158. This is consistent with the approach of the RESTATEMENT (SECOND) OF CONTRACTS. In the commentary to section 211, the *Restatement* provides that "[r]eason to believe [that the other party would not have assented, which would make the standardized provision unenforceable] may be inferred from the fact that the term is bizarre or oppressive, from the fact that it eviscerates the non-standard terms explicitly agreed to, or from the fact that it eliminates the dominant purpose of the transaction." RESTATEMENT (SECOND) OF CONTRACTS § 211, cmt. f (1981).

159. *See, e.g.*, Puritan Life Ins. Co. v. Guess, 598 P.2d 900 (Alaska 1979); Smith v. Westland Life Ins. Co., 539 P.2d 433 (Cal. 1975); Prudential Ins. Co. v. Lamme, 425 P.2d 346 (Nev. 1967); Allen v. Metropolitan Life Ins. Co., 208 A.2d 638 (N.J. 1965); Collister v.

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realities of insurance purchasing. When the insured makes the initial premium payment, he or she has a generalized expectation that the policy coverage is in force. Although the insured may not have the specific expectations about particular conditions for coverage or the possible exclusions, it seems likely that the insured was induced to make the premium payment by the general expectation that such a payment would make the policy effective.

Another Iowa case illustrates the operation of this modified version of the reasonable expectations doctrine. In *Clark-Peterson Co. v. Independent Insurance Associates, Ltd.*,[160] the insured had purchased a contractor's umbrella liability policy. The insured sought coverage under the policy for an employment discrimination claim. The policy contained exclusions for intentional acts and for discrimination by or at the direction of the insured, which the court found applicable.[161] Nevertheless, the court found coverage under the doctrine of reasonable expectations. The court found that the insurance policy purported to provide coverage for discrimination claims, but that the provisions relied upon by the insurer "effectively gut[ted] the discrimination coverage."[162] Because the exclusion "eviserate[d] the discrimination coverage explicitly agreed to," the reasonable expectations doctrine justified finding coverage in spite of the exclusions.[163]

This modified version of the reasonable expectations doctrine might be more consistent with the way people purchase insurance. By focusing on whether the offending provision *eviscerates* coverage which had been agreed to, this version addresses expectations at a higher level of generality. The focus is not so much on the specific circumstances of the particular claim, but rather on the general coverage agreed to, and whether the offending provision completely undermines that coverage. Of course, because this version requires the complete evisceration of coverage, it would apply to a significantly smaller number of cases.[164]

Nationwide Life Ins. Co., 388 A.2d 1346 (Pa. 1978). This line of cases includes one of the earliest cases using a reasonable expectations analysis, although the doctrinal basis for the opinion is the application of the doctrine of contra proferentum. *See* Gaunt v. John Hancock Mut. Life Ins. Co., 160 F.2d 599 (2d Cir. 1947); *see also* Mayhew, *supra* note 8, at 273.

These conditional receipt cases were significant to the recognition and evolution of the reasonable expectations doctrine. *See* Keeton, *supra* note 1, at 970-71 & n.17; *see also* Abraham, *supra* note 4, at 1160-62.

160. *See* Clark-Peterson Co., Inc. v. Independent Ins. Assoc. Ltd., 492 N.W.2d 675 (Iowa 1992).

161. *See id.* at 676-77.

162. *Id.* at 678.

163. *Id.* at 679.

164. The requirement for evisceration of the policy coverage may make the reasonable expectations doctrine unnecessary and redundant with other protective doctrines. For example,

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This discussion of possible modifications of the reasonable expectations doctrine illustrates two ways the shortcomings of the present assumptions might be addressed. There might be other ways as well. This article does not specifically advocate for any particular solution. The main point is that the present bargaining assumptions are flawed, and that future research should address the weaknesses in those assumptions in some fashion.

CONCLUSIONS AND DIRECTIONS FOR FUTURE RESEARCH

This critique has shown that the reasonable expectations doctrine rests on dubious assumptions. The consumer research and empirical data tends to show that insureds do not rationally evaluate insurance information or arrive at specific expectations of coverage. However, further empirical research is needed. Although the data casts doubt on the bargaining assumptions underlying the reasonable expectations doctrine, it does not directly test those assumptions. In addition, some data may actually support the assumptions. The data shows, for instance, that insureds rely on insurance agents in making a purchasing decision,[165] and that most insureds are relatively satisfied with the way their agents explain their coverage.[166] Therefore, it is possible that agents perform the rational evaluation for insureds, or that they provide coverage explanations that could result in specific expectations. A careful review of the data makes it seem unlikely that agents perform in this manner,[167] but it would be useful to have more direct empirical evidence on the role of agents. Similarly, although the data on insurance buying tends to show that insureds do not consider coverage in their purchasing decision,[168] it would also be useful to have more direct evidence on that issue.

This critique has also shown that insureds are at least theoretically in need of protection from the effects of unequal bargaining.[169] The consumer research and empirical data tends to show that insureds do not actively bargain for insurance products. As a result, not only are insureds in an inferior bargaining position, but, because of reliance on informal information and situational

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a provision that eviscerates the dominant purpose of the transaction, or the agreed to terms, might be held invalid under the doctrine of unconscionability. *Cf. C & J Fertilizer, Inc.*, 227 N.W.2d at 179-81 (applying the unconscionability doctrine to the definition of burglary found to be inconsistent with the reasonable expectations of the insured). For a basic outline of the requirements for unconscionability, see RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981).

165. *See supra* text accompanying notes 68 & 72.

166. *See supra* text and table accompanying note 108.

167. *See supra* text accompanying notes 109-114.

168. *See supra* Part II.

169. *See supra* text accompanying note 131.

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factors, they make little use of the bargaining power they have. The absence of bargaining, however, may not necessarily reflect widespread unfairness in applying insurance coverage. As a general matter, the vast majority of insureds are very satisfied or fairly satisfied with their insurers,[170] and most appear to be satisfied with the way claims are adjusted.[171] The cases that end up in litigation may therefore represent only the marginal cases. An empirical investigation into the actual need for legal protection of insureds against unfair policy terms (or the unfair application of those terms) would therefore be useful.

Assuming that the need for protection of insureds is real, not just theoretical, it may be that the reasonable expectations doctrine should be reformulated somewhat more narrowly to account for the realities of the insurance marketplace. Two possible modifications are to narrow the doctrine to those cases in which the insured's reasonable expectation has been proven, or, alternatively, to narrow the doctrine to those cases in which the offending term would undermine the insured's generalized expectation for coverage. Future research concerning the evolution of the reasonable expectations doctrine should consider the relationship between the doctrine and its underlying assumptions.

This critique also may call into question the broader interpretive paradigm used for insurance policies. The bargaining assumptions underlying the reasonable expectations doctrine may extend to the entire canon of interpretive rules. The paradigm therefore might need to be reassessed in light of the realities of the insurance market. An important consideration for this reassessment, however, would be the extent to which the lack or bargaining by unsophisticated consumers extends to more sophisticated business insureds. If a significant portion of insureds do bargain for their insurance, an interpretative paradigm built on the bargaining assumption may be justified. On the other hand, if most insureds do not bargain for their insurance, the interpretive paradigm might need to be reformulated to bring the interpretive canon in line with the realities of the marketplace.

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170. *See supra* note 75.

171. A 1993 survey found that 87% of auto insureds expected that their insurance company would settle their claim fairly, and 81% expected that another insurance company (of, for instance, another driver) would settle the claim fairly. *See* INSURANCE RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 1993, at 8, & fig.2-3 (1993). The survey methodology and questionnaire are contained in appendices to the report. *See id.* at 39-55.

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WHY COURTS ENFORCE INSURANCE POLICYHOLDERS' OBJECTIVELY REASONABLE EXPECTATIONS OF INSURANCE COVERAGE

Eugene R. Anderson and James J. Fournier***

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INTRODUCTION: CURBING INSURANCE INDUSTRY CONTROL AND DOMINATION

Much in the business of insurance focuses on control. The insurance industry has traditionally made great efforts to control the development of insurance statutes and case law, the outcome of insurance litigation, the resources and recourses available to insurance policyholders. The insurance industry exploits the tremendous imbalance in information, financial resources and litigation experience between insurance companies and policyholders. Insurance industry control over state insurance regulators is notorious.[1] More insidious and less well recognized is the insurance industry control over purchasers of insurance. A telling and dramatic example of seller domination over the buyer is the fact that

1. Insurance industry efforts to clip the wings of their regulators are front page news. *See* Scot J. Paltrow, *The Converted: How Insurance Firms Beat Back an Effort for Stricter Controls*, WALL ST. J., Feb. 5, 1998, at A1 (discussing how the insurance companies curbed the National Association of Insurance Commissioners' efforts to regulate areas which were "getting short shrift in the underfunded state insurance departments"); *see also* Scot J. Paltrow, *Indiana's Regulators Have Little Budget or Clout; Conflicts at the Capitol*, WALL ST. J., Jan. 14, 1998, at A1 (describing the dangerous effects of chronic underfunding at Indiana's Insurance Department and the bond between state insurance regulators and the insurance industry).

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insurance buyers (risk managers) consider themselves to be part of the "insurance industry."[2]

The insurance industry efforts to control are designed to, and do, maximize premiums and limit—post-loss—the insurance coverage which a policyholder has purchased. Breaching insurance policies is incredibly profitable for insurance companies. After years of premium payments (and then only after a claim is made), policyholders all too often are shocked to discover that the insurance coverage they *thought* they had purchased is illusory.

By virtue of the way the insurance industry operates, the remedies available to a policyholder who has been denied insurance coverage may be narrower than otherwise under contract law. The common law has historically favored the party breaching a contract. When one party says "Sue me," the other party, if it seeks to enforce the contract, is going to suffer an economic loss. Time, trouble, distraction and legal fees are rarely compensated.[3] Even the minor penalty of having the aggrieved party take its business elsewhere does not apply to insurance policyholders. An insurance product cannot be replaced with another insurance product after a loss.

Courts increasingly recognize that traditional contract law principles do not adequately compensate a policyholder who has been wrongfully denied insurance coverage. Courts apply the reasonable expectations doctrine as one way to minimize insurance industry control and to more fully protect the policyholder's rights as the purchaser of an insurance product. Since the doctrine is founded in objective rather than subjective expectations, its application does not depend upon the idiosyncracies of

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2. Stephen M. Wilder, Incoming RIMS President, Vice President, Risk Management, The Walt Disney Company, Inaugural Address to 35th Risk and Insurance Management Society Annual Conference and Exhibition (April 14, 1997). Mr. Wilder concluded his speech by asking RIMS members to "each accept the challenge and take personal responsibility to make [the insurance industry] better."

3. The New Jersey Supreme Court recently took a new look at the inadequacies of traditional contract law in a non-insurance case. *See* Sons of Thunder v. Borden, Inc., 690 A.2d 575 (N.J. 1997). The New Jersey Supreme Court held that a company can be liable for bad faith damages even though the company had complied with the terms of the contract. The Court reinstated a jury award of approximately one year's worth of additional profits for the breach of the implied covenant of good faith, reversing a lower court finding that the right to terminate the contract could not be eliminated by an implied covenant of good faith and fair dealing. *See also*, Dean Starkman, *Jury's Award of $738,000 in Claims Contract Case is Upheld*, WALL ST. J., Mar. 13, 1997, at B13.

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individual policyholders. The reasonable expectations doctrine gives policyholders the insurance coverage they thought they had purchased.

The reasonable expectations doctrine is perhaps the best known area of insurance law which the insurance industry cannot *control*. In a small way, the doctrine takes away from insurance companies the power to control insurance policy drafting and insurance law.

I. THE ORIGINS AND UNDERPINNINGS OF THE REASONABLE EXPECTATIONS DOCTRINE

The formulation of the reasonable expectations doctrine was set forth by Professor (now Judge) Keeton in a 1970 law review article:

> The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored *even though painstaking study of the policy provisions would have negated those expectations.*[4]

The doctrine of reasonable expectations is a relatively new addition to the body of insurance law.[5] It is not, however, a surprising departure from established legal principles. The reasonable expectations doctrine is an outgrowth of modern contract theory and is rooted in several well established principles of common law. As one commentator has noted, Professor Keeton 'discovered' the doctrine "in the more traditional doctrines with which lawyers are more familiar and comfortable."[6] In

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4. Robert Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 and 1281 (part 2) (1970) (emphasis added).

5. Professors Widiss and Keeton write that courts in the early 1960s began to "clearly and explicitly employ[ ] the doctrine of honoring reasonable expectations." *See* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES AND COMMERCIAL PRACTICES § 6.3(a)(3), at 632 (Practitioners ed. 1988).

6. ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 25D, at 144 (2d ed. 1996). Professor Jerry explained the common law origins of the reasonable expectations doctrine:

> When the insured's expectation is created by some kind of ambiguity or vagueness in the policy language, syntax, or organization, something like the *doctrine of contra proferentem* . . . is operating. When the insured's expectation comes from some assertion by an agent of the insurer or through the insurer's advertising, something like the *doctrine*

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Professor Keeton's words, the reasonable expectations doctrine simply recognizes the broad principle underlying the "congeries of doctrines" comprising the rules of insurance policy interpretation.[7]

The reasonable expectations doctrine is an objective rule—that is, it protects the *reasonable* expectations of insurance coverage that *most* policyholders would hold—not subjective beliefs and not idiosyncratic policyholders:

> The key to understanding the role played by the expectations principle . . . [is] that the *objectively* reasonable expectations of the policyholder as to coverage will be honored, notwithstanding contrary policy language. The requirement that the expectations be objectively reasonable is significant . . . because objectively reasonable expectations are those that are likely to be held by the majority of policyholders.[8]

> *of misrepresentation or deceit* is operating. When the insured's expectation is grounded in an assumption that coverage for the loss in question would exist given the amount of premium charged, something like the *doctrine of unconscionability* is operating. When the insured's expectation is part and parcel of the insured's sudden surprise and dismay at the absence of coverage, something like the *doctrine of mistake* is operating. When the insured's expectation comes from the insurer's invitation to the insured to place trust in the insurer that the insured's coverage needs will be satisfactorily met, something like an *estoppel or reliance theory* is operating.

Id. at 144-45 (emphasis added) (footnotes omitted).

7. *See* KEETON, INSURANCE LAW: BASIC TEXT 351 (1971); Keeton, *Reasonable Expectations in the Second Decade*, 12 FORUM 275 (1976).

8. Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 559 (1994) (footnote omitted). Professor Abraham analogized the objective focus of the doctrine of reasonable expectations to two of the doctrine's common law ancestors:

> Thus, the expectations principle does for policyholders as a group what waiver and estoppel did for the individual policyholder-plaintiff: it affords them coverage under policy provisions that are reasonably clear under the circumstances, but not sufficiently clear, or at least not sufficiently obvious, to definitively communicate their meaning to the ordinary policyholder.

Id.

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An objective standard has limits. As Professor Corbin points out:

> As usually understood, the 'objective theory' is based upon a great illusion—the illusion that words, either singly or in combination, have a 'meaning' that is independent of the persons who use them. It is crudely supposed that words have a 'true', or 'legal,' meaning (described as 'objective'), one that all persons of whatever race, origin, or education are bound to know . . . . As a good dictionary shows, all words have been used by men to convey a variety of meanings, variable with time, place and circumstance. The cheaper and more incomplete the dictionary, and the more parochial and limited the linguistic education and experience of a man, the more firmly fixed is the illusion of 'an objective meaning' and the more positive its assertion as the truth.[9]

It is perhaps because of this fundamental shortcoming that the "objectivist" view of contract has generally been replaced by a subjective view of contract.[10] Under the subjective approach:

> [A]ll relevant extrinsic evidence is admissible on the issue of meaning including evidence of subjective intention and what the parties said to each other with respect to meaning. This is true even if there is an integration and there is no ambiguity.[11]

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9. 1 ARTHUR CORBIN, CORBIN ON CONTRACTS §106, at 474 (1963).

10. *See, e.g.,* Jeffrey W. Stempel, *Unmet Expectations: Undue Restriction of the Reasonable Expectations Approach and the Misleading Mythology of Judicial Role*, Symposium Draft, at 70, (citing GORDON D. SCHABER & CLAUDE D. ROHWER, CONTRACTS IN A NUTSHELL (3d. ed. 1990) (noting that the Restatement (Second) of Contracts adopted the subjective theory of contract and superseded the First Restatement's "objective" approach)).

11. JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS §3-12, at 171 (3d ed. 1987) *citing* 3 CORBIN § 542; Corbin, *The Interpretation of Words and the Parol Evidence Rule*, 50 CORNELL L.Q. 161, 189 (1965); RESTATEMENT (SECOND) OF CONTRACTS § 201, cmt c, and § 212, cmt. b and U.C.C. § 2-202, cmt 1(a) (additional citations omitted). As another contract law scholar noted:

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That the reasonable expectations doctrine is rooted in the "objectively" reasonable expectations of the policyholder reveals that the doctrine is not—and was not intended to be—a radical departure from *traditional* contract law. The reasonable expectations doctrine remains consistent with the rule that "the terms of a contract are to be interpreted and their legal effects determined as a whole."[12] The reasonable expectations doctrine can be viewed as modernizing the objective standard of contract interpretation so that particular problems of insurance, such as relying on standard form insurance policies, are not ignored. Application of the reasonable expectations doctrine ensures that an insurance policy will not be interpreted in a factual vacuum.[13] The insurance industry argues that application of the reasonable expectations doctrine will encourage policyholders to seek their "post-loss" subjective expectations. This is not true. As an objective rule, the fundamental purpose of the reasonable expectations doctrine is to enforce the terms of the original bargain, not to create new "fairer" deals as the court sees fit.[14] This goal coincides with the aims of traditional contract law.

> The very concept of plain meaning finds scant support in semantics, where one of the cardinal teachings is the fallibility of language as a means of communication.

E. Allan Farnsworth, *'Meaning' In the Law of Contracts*, 76 YALE L.J. 939 (1967). *See also* E. ALLAN FARNSWORTH, CONTRACTS, § 7.10, at 512 (2d ed. 1990) (noting that "it is questionable whether a word has a meaning at all when divorced from the circumstances in which it is used").

12. 3 CORBIN § 549, at 183.

13. *See, e.g.*, Glidden v. Farmers Auto. Ins. Ass'n, 312 N.E.2d 247, 250 (Ill. 1974), (citing Jensen v. New Amsterdam Ins. Co., 213 N.E.2d 141 (Ill. App. Ct. 1965)):

> An insurance policy is not to be interpreted in a factual vacuum; it is issued under given factual circumstances. What at first blush might appear unambiguous in the insurance contract might not be such in the particular factual setting in which the contract was issued.

14. A more accurate criticism is that application of the doctrine will result in tailoring insurance coverage to the reasonable expectations of the judiciary, which is a very frequent common law phenomenon. Insurance policies are interpreted as a reasonable lay person or ordinary purchaser of insurance would understand them. *See* 1 EUGENE R. ANDERSON, ET AL., INSURANCE COVERAGE LITIGATION § 2.5, at 62-63 (Aspen 1997) (listing cases). Insurance policies are not always interpreted according to a layperson's or an average policyholder's understanding because interpretations of insurance policies are governed by two dubious legal rules that severely restrict policyholders' claims. The first is that questions of insurance policy interpretation are for judges—not juries. The judiciary

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The reasonable expectations doctrine is commonly thought of as an extension of the doctrine of *contra proferentem*.[15] Under the doctrine of *contra proferentem*, ambiguities are to be construed against the drafter.[16] In insurance law, it has long been established that ambiguities are to be construed against the insurance company.[17] The purpose of the reasonable expectations doctrine is to provide protection which goes beyond the doctrine of *contra proferentem*. While the doctrine of *contra proferentem* can only be applied if the insurance policy contains an ambiguity,[18] the

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zealously guards its self-assumed role as the arbiter of what insurance policies mean. This means that insurance coverage is determined in large measure by the idiosyncracies of judges. The result is that the rules are rules of individuals and not rules of law. The second legal rule is that judges determine what an "ordinary" purchaser of insurance would understand. Almost by definition, judges are not "ordinary." In most other areas of the law, we have juries to determine what is "ordinary." After the fire, everyone knows that kerosene should not be stored near a propane water heater. The real question is whether *before* the fire, could it have been "ordinary" to store kerosene by the water heater? Judges and juries (if given the opportunity) would most likely often differ in their reasoning and conclusions. Judges engage in "post-claim" underwriting as do insurance companies.

15. *See* PETER J. KALIS, ET AL., POLICYHOLDERS GUIDE TO THE LAW OF INSURANCE COVERAGE § 20.04, at 20-6 (1st ed. 1997) (Mr. Kalis represents policyholders in insurance coverage disputes); 1 EUGENE R. ANDERSON, ET AL., INSURANCE COVERAGE LITIGATION § 2.7, at 73-76 (Aspen 1997).

16. *See* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 1.03[b][1], at 13-14 (7th ed. 1994) (listing cases) (Ostrager and Newman are attorneys who regularly represent insurance companies in insurance coverage disputes.) The term *contra proferentem* comes from the Latin phrase *verba chartarum fortius accipiuntur contra proferentem*. 3 A. CORBIN, CORBIN ON CONTRACTS § 559 (2d ed. 1960). The term is defined to mean "against the party who proffers or puts forward a thing." BLACK'S LAW DICTIONARY 393 (4th ed. 1951).

17. *See* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 1.03[b][1], at 13-14 (7th ed. 1994) (quoting Liverpool & London & Globe Ins. Co. v. Kearney, 180 U.S. 132, 136 (1901)) ("[T]he general rule . . . is . . . that where a policy of insurance is so framed to leave room for two constructions, the words used should be interpreted most strongly against the insurer" (cases in accord omitted)).

18. Under the doctrine of *contra proferentem*, a term is generally considered to be ambiguous if it is "fairly susceptible to two different reasonable interpretations." *See* PETER J. KALIS, ET AL., POLICYHOLDERS GUIDE TO THE LAW OF INSURANCE COVERAGE §20.07, at 20-13 and 20-14 (1st ed. 1997) (listing cases and authorities); 1 EUGENE R. ANDERSON, ET AL., INSURANCE COVERAGE LITIGATION § 2.2, at 49 (1st ed. 1997) (a term is patently ambiguous if it is susceptible on its face to more than one reasonable interpretation). An ambiguous term is often a term which is clear until it is applied to a particular set of facts. For example, in Bird v. St. Paul Fire and Marine Ins. Co., 120 N.E. 86 (N.Y. 1918), a fire started in some freight cars loaded with explosives. There was an explosion, causing another fire which in turn caused a much larger explosion. The last explosion caused a concussion in the air which damaged the policyholder's boat, lying in the harbor about one

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Keeton formulation of the reasonable expectations doctrine recognizes that a reasonable expectation of insurance coverage can exist *without* an ambiguity in the policy:

> While ambiguities may be highly relevant in determining the reasonable expectations of the insured, nevertheless the invocation and application of the doctrine does not

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thousand feet away. The policyholder owned a fire insurance policy and sought insurance coverage under the terms of the policy. Justice Cardozo, writing for the high court of New York, held that there was no insurance coverage. The decision, though discussing the meaning of proximate cause, sets forth the proper standard to determine whether a genuine ambiguity exists:

> We must put ourselves in the place of the average owner whose boat or building is damaged by the concussion of a distant explosion, let us say a mile away. Some glassware in his pantry is thrown down and broken. It would probably never occur to him that within the meaning of his policy of insurance, he had suffered loss by fire. A philosopher or lawyer might persuade him that he had, but he would not believe it until they told him.

Bird, 120 N.E. at 87. Thus:

> There is no use in arguing that distance ought not to count, if life and experience tells us that it does. *The question is not what men ought to think of as a cause. The question is what they do think of as a cause.*

Id. (emphasis added).

In determining whether a term is ambiguous, many courts consider whether dictionaries provide differing definitions for the same term or whether other courts have reached contrary meanings for the same term. Differing judicial interpretations may either establish an ambiguity or be evidence of an ambiguity. *See* PETER KALIS, ET AL., POLICYHOLDERS GUIDE TO THE LAW OF INSURANCE COVERAGE § 20.07, at 20-13 and 20-14 (1st ed. 1997) (listing cases). For examples listed therein, *see, e.g.*, Crawford v. Prudential Ins. Co., 783 P.2d 900, 908 (Kan. 1989) ("reported cases are in conflict, the trial judge and the Court of Appeals reached different conclusions and the justices of this court [disagree]. Under such circumstances, the clause is, by definition, ambiguous and must be interpreted in favor of the insured"); New Castle County v. Hartford Acc. & Indem. Co., 933 F.2d 1162, 1198 (3rd Cir. 1991), cert. denied, 507 U.S. 1030 (1993) ("That so many learned jurists throughout the nation differ on the construction of this phrase, is, in our view, additional proof that the phrase admits of two reasonable constructions;" "our dictionaries, like the district court's, define 'sudden' both with and without a temporal element, thus lending considerable weight to the County's assertion that either interpretation is reasonable").

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> depend for its existence upon the presence of ambiguities.[19]

Requiring an ambiguity in the policy language *before* applying the reasonable expectations doctrine would render the doctrine a mere redundancy of *contra proferentem*:

> If the doctrine of reasonable expectations is limited to ambiguous contracts, it is not a doctrine at all; it is nothing more than the traditional rule that ambiguous contracts be interpreted against the drafter. Only if courts discard the fiction that consumers read form language, unambiguous or otherwise, will contracting parties realize their reasonable expectations.[20]

Certainly, insurance policy terms often are ambiguous. But relying on "ambiguity" as a threshold to invoke the reasonable expectations doctrine is dangerous. Doing so invites insurance companies "to keep rewriting until the provisions, although possibly unfair, are acceptably unambiguous."[21]

The Restatement (Second) of Contracts contains a model version of the reasonable expectations doctrine which does not require an ambiguity in the policy. It states that with respect to standard-form[22] contracts:

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19. COUCH ON INSURANCE 3d § 22:11, at 22-25 (Lee R. Russ & Thomas F. Segalla, eds., 1995). Some jurisdictions, however, do require an ambiguity in the policy language before applying the doctrine of reasonable expectations.

20. M. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. MIAMI L. REV. 1263, 1281 (1993).

21. Karl Llewellyn, *Book Review*, 52 HARV. L. REV. 700, 701 (1939) (reviewing O. PRAUSNITZ, THE STANDARDIZATION OF COMMERCIAL CONTRACTS IN ENGLISH AND CONTINENTAL LAW (1937)).

22. RESTATEMENT (SECOND) OF CONTRACTS subsection (1) specifically states:

> (1) Except as stated in Subsection (3), where a party to an agreement signs or otherwise manifests assent to a writing and has reason to believe that like writings are regularly used to embody terms of agreements of the same type, he adopts the writing as an integrated agreement with respect to the terms included in the writing.

RESTATEMENT (SECOND) OF CONTRACTS § 211 (1979).

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> (2) Such a writing is interpreted wherever reasonable as treating alike all those similarly situated, without regard to their knowledge or understanding of the standard terms of the writing. (3) *Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement.*[23]

Under the Restatement version of the reasonable expectations doctrine, terms "beyond the range of reasonable expectations" are not enforceable against the adhering party.[24] Terms are considered to be "beyond the range of reasonable expectations" when "the other party has reason to believe that the adhering party would not have accepted . . . had [the party] known that the agreement contained the particular term."[25] This would include a term which is "bizarre or oppressive," "eviscerates the nonstandard terms explicitly agreed to," or "eliminates the dominant purpose of the transaction." The Restatement version of the reasonable expectations doctrine has been specifically adopted by the Arizona Supreme Court.[26]

II. REINFORCING THE 'KNOW THY POLICYHOLDER' RULE

The origin of the reasonable expectations doctrine can be traced to Lord Mansfield, the father of insurance law. Many years ago, he wrote:

> Every under-writer is presumed to be acquainted with the practice of the trade he insures, and that whether it is recently established, or not. If he does not know it, he ought to inform himself. It is no matter if the usage has only been for a year.[27]

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23. *Id.*

24. RESTATEMENT (SECOND) OF CONTRACTS § 211, cmt. f, (1979).

25. *Id.*

26. *See* Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388 (Ariz. 1984). For a discussion of the application of the Restatement version of the reasonable expectations doctrine, *see* Amy D. Cubbage, Note, *The Interaction of the Doctrine of Reasonable Expectations and Ambiguity in Drafting: The Development of the Kentucky Formulation*, 85 KY. L.J. 435 (Winter 1996/1997).

27. Noble v. Kennoway, 2 Doug. 511, 513 (K.B. 1780). The principle that the insurance company is presumed to know the business of its policyholder is well established

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Lord Mansfield's holding is consistent with the view that an insurance company is expected to know the policyholder's objectively reasonable expectations of insurance coverage and to sell a policy suitable for the policyholder's needs. Courts have held that insurance companies selling an insurance policy which specifically excludes insurance coverage for the policyholder's essential activities or business are required to provide insurance coverage.[28]

In *Lachs v. Fidelity & Casualty Co.*,[29] the high court of New York rejected insurance company arguments to bar insurance coverage under a

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and was adopted by the United States Supreme Court in Buck & Hedrick v. Chesapeake Ins. Co., 26 U.S. (1 Pet.) 151 (1828):

> [A] knowledge . . . of the course and incidents of the trade on which they insure, and the established import of the terms, used in their contract; must necessarily be imputed to underwriters.

(citing Pelly v. Royal Exch. Ass'n., (1 Burrows 341) (1757) (Mansfield, C.J.)). *See also* Hazard's Adm'r v. New England Marine Ins. Co., 33 U.S. (8 Pet.) 557, 582 (1834) ("The underwriters are presumed to know the usages of foreign ports to which insured vessels are destined; also the usages of trade, and the political condition of foreign nations"); Clark v. Manufacturer's Ins. Co., 49 U.S. (8 How.) 235, 248 (1850) ("The insurer must be presumed to know what is material in the course of any particular trade"); Globe & Rutgers Fire Ins. Co. v. Indiana Reduction Co., 113 N.E. 425, 429 (Ind. App. Ct. 1916) ("The law charges insurance companies with the duty of informing themselves as to the usages of the particular business insured and a knowledge of such usage on the part of such company will be presumed"); Hazelton v. Manhattan Ins. Co., 12 F. 159, 162 (N.D. Ill. 1882), *quoting* Lord Mansfield in Pelly v. Royal Exch. Ass'n Co., 1 Burrows 341 (1757) ("The underwriter must adjust himself to the custom of the trade which he insured . . . '[a]nd in general what is usually done . . . [in such trade] is understood to be referred to by every policy, and to make a part of it as much as if it was expressed.'" For more recent examples, *see* Contractors Realty Co., Inc. v. Ins. Co. of N. Am., 469 F. Supp. 1287, 1295 (S.D.N.Y. 1979), (insurance companies were "charged with knowledge" of "the course and incidents of the [policyholder's] trade"); Anne Quinn Corp. v. American Mfrs. Mut. Ins. Co., 369 F. Supp. 1312, 1315 (S.D.N.Y. 1973), *aff'd* 505 F.2d 727 (2d Cir. 1974) ("no misrepresentation or breach of duty of good faith where plaintiff failed to disclose a trade practice that was equally open to [the knowledge of] both parties"); Compagnie de Reassurance d'Ile de France v. New England Reins. Corp., 57 F.3d 56, 76-77 (1st Cir. 1995), *cert. denied*, 516 U.S. 1009 (1995) (reinsurance companies presumed to know the business of their policyholder).

28. *See* Howard Ende, Eugene R. Anderson and Susannah Crego, *Liability Insurance: A Primer for College and University Counsel*, 23 J.C. & U. L. 609, 663-68 (1997). *See, e.g.*, Globe & Rutgers Fire Ins. Co. v. Indiana Reduction Co., 113 N.E. 425, 428 (Ind. App. Ct. 1916); American States Ins. Co. v. Kiger, 662 N.E.2d 945 (Ind. 1996), *reh'g denied* (May 31, 1996).

29. 118 N.E.2d 555, 556-57 (N.Y. 1954).

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flight insurance policy which excluded insurance coverage for non-scheduled flights. The insurance was purchased from a vending machine located in front of a ticket counter which sold tickets for non-scheduled flights.

In *American States Insurance Co. v. Kiger*,[30] the Indiana Supreme Court rejected insurance company arguments that a polluters' exclusion barred insurance coverage for gasoline contamination at a gasoline station.

In *NI West, Inc. v. Louis Usdin Co.*,[31] the court refused to apply the so-called "absolute" polluters' exclusion to damages arising out of the policyholder's recycling business because the insurance company knew that the policyholder was a recycling company.

In *Bentz v. Mutual Fire, Marine, & Inland Insurance Co.*,[32] the court held that where the policyholder's business was pesticide application and the insurance company was aware of the nature of the business, the insurance policy was intended to cover the policyholder's "normal operations."

In *West American Insurance Co. v. Tufco Flooring East, Inc.*[33] the court rejected the insurance company's denial of insurance coverage for damages caused by toxic fumes emitted by a flooring company in the normal course of business. To deny insurance coverage "would be allowing an insurance company to accept premiums for a commercial liability policy and then to hide behind ambiguities in the policy and deny coverage for good faith claims that arise during the course of the insured's normal business activity. Such an interpretation would constitute the height of unfairness."[34]

In *S.E.A., Inc. v. Dunning-Lathrop Associates*,[35] the court refused to give effect to a pollution exclusion contained in a Specialty Errors and Omissions Liability insurance policy issued to a company that performed environmental assessments. The court held that if the exclusion did apply, the policyholder "would have little, if any, coverage for the activities essential to its business, and the policy's coverage would be illusory. The absurdity of this result also undermines defendant's argument. . . ."

These decisions indicate the relationship between the suitability principle and the doctrine of reasonable expectations: Courts—without

30. 662 N.E.2d 945 (Ind. 1996).
31. 106 B.R. 372 (D.N.J. 1989).
32. 575 A.2d 795 (Md. 1990).
33. 409 S.E.2d 692 (N.C. Ct. App. 1991).
34. *Id.* at 697.
35. No. 93CVH09-6556 (Ohio Ct. C.P., Franklin Cty, July 30, 1996).

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specifically invoking the reasonable expectations doctrine—have rejected insurance companies' arguments contrary to a policyholder's "objectively reasonable" expectations of insurance coverage. The relationship between the suitability principle and the reasonable expectations doctrine was articulated by an insurance industry official as follows:

> *Insurance must be suitable to the needs of the insured regardless of the policy language.* The doctrine of suitability is being used more often in an attempt to reach a just and equitable result. . .The courts will continue to find reasons to cover these areas where the insured had a right to expect insurance to apply. The doctrine of suitability is their standard.[36]

In re Technology for Energy, Corp.[37] provides another expression of the tie between the reasonable expectations doctrine and the suitability principle. In that case, the court held that even where the insurance policy is unambiguous, proof of a usage of trade is admissible as "a backdrop against which the parties understood their rights and duties under the contract":[38]

> [E]very usage of a particular trade, which is so well settled or is generally known that all persons engaged in that trade may be fairly considered as contracting with reference to it, is considered to form part of every policy, designed to protect against risks in such trade.[39]

Insurance companies have long acknowledged that they understand the responsibility to sell insurance coverage suitable for their policyholders'

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36. Thomas F. Sheehan, *Beware of the Broad Form Excess or Umbrella Excess Policies*, 22 CPCU ANNALS 165, 174 (1969) (footnote omitted) (discussing Gerhardt v. Continental Ins. Cos., 225 A.2d 328 (N.J. 1966) (refusing to apply workers' compensation exclusion in homeowner's policy because the exclusion was buried in a mass of language and the homeowner was entitled to expect a policy that provided insurance coverage for all homeowner's hazards)). Mr. Sheehan was Assistant Vice President of American States Insurance Company.

37. 123 B.R. 979 (Bankr. E.D.Tenn. 1991).

38. *Id.* at 989.

39. *Id.*, *quoting* Cramer & King Co. v. National Sur. Co., 134 A. 771, 772-73 (N.J. 1926). *See also* Compagnie De Reassurance d'Ile de France v. New England Reinsurance Corp., 57 F.3d 56, 76-77 (1st Cir.), *cert. denied*, 116 S. Ct. 564 (1995).

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specific needs. One Aetna advertisement[40] proclaimed that "Aetna Casualty Knows the Chemical Industry."[41] Thirty years later, Aetna advertised an expanded promise:

> There are people who know your business as well as you do. They have to. They're Independent Agents who represent Aetna. They know the shoe business. They know the construction business. They know the car business. They know *your* business. They know dozens of businesses as well as they know their own. You see, more than 10,000 agents have been taught at the Aetna Institute. There they learn how to understand your needs, analyze risk, and give you a policy that's just perfect for you.[42]

One CNA Insurance Companies advertisement promised that "CNA knows the scrap industry and it shows in every phase of our ISIS Program."[43] CNA touted "CNA and the scrap metal industry . . . a proud partnership. Since 1968, CNA has been privileged to work with hundreds of individual scrap metal processors nationwide covered under business insurance programs we developed especially for your industry. . . ."[44] Over a decade later, CNA went to great lengths to explain that it thoroughly understood the specific needs of a myriad of different policyholders:

> 'What does an insurance company really know about your business?' A good company knows more than you might think. About your business, your people, equipment and inventory. To properly tailor your coverage, they should thoroughly understand your needs . . . CNA protects tens of thousands of businesses, large and small.[45]

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40. Advertisements may be incorporated into the terms of the insurance policy and can be used to establish a fiduciary duty owed by the insurance company to the policyholder. *See* discussion at Section VIII below.

41. Aetna advertisement, THE NAT'L INS. BUYER, May 1962, at 31.

42. Aetna advertisement, NEW YORK TIMES MAG., Oct. 31, 1993, at 42-43; NAT'L UNDERWRITER, Oct. 19, 1992, at 30-31 (emphasis in original).

43. CNA advertisement, RECYCLING TODAY, Sept. 1980; SCRAP AGE, Sept. 1980, at 27.

44. CNA advertisement, SCRAP AGE, Aug. 1979, at 31.

45. CNA advertisement, WALL ST. J., Feb. 10, 1992, at B6.

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Sentry Insurance Company circulated a series of advertisements which pledged that at Sentry, "We understand the risks, because we understand the business." The advertisements pledged that Sentry had "taken the time to learn" the equipment manufacturing,[46] wholesaling[47] and food processing[48] industries. Sentry later emphasized that it understood the precise needs of its policyholders:

> By paying close attention to the details of your business, we can design insurance or service programs geared precisely to your needs.
>
> . . . .
>
> And when you work with us, you're not working with a faceless voice on the telephone. You get the personal attention of an account executive who knows your business inside and out.
>
> If you'd like to see the benefits of working with people who understand your business, give our business a call . . . .[49]

Courts, without specifically invoking the reasonable expectations doctrine, will often enforce a policyholder's claim of insurance coverage despite a clearly drafted exclusion in the policy to the contrary. Courts often refuse to enforce ordinance or law exclusions which exclude insurance coverage for the costs of repairing or rebuilding a damaged structure according to ordinances or building codes not in force when the structure was originally erected[50] or when the insurance policy was

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46. Sentry advertisement, BUS. INS., May 10, 1982, at 15.

47. Sentry advertisement, BUS. INS., Feb. 18, 1985.

48. Sentry advertisement, BUS. INS., Apr. 19, 1982, at 43.

49. Sentry advertisement, BUS. INS., Apr. 22, 1985.

50. *See, e.g.*, Hugh L. Wood, Jr., *Comment: The Insurance Fallout Following Hurricane Andrew: Whether Insurance Companies Are Legally Obligated To Pay For Building Code Upgrades Despite The 'Ordinance or Law' Exclusion Contained in Most Homeowners Policies*, 48 U. MIAMI L. REV. 949 (1994). The comment discusses insurance companies' invocation of ordinance or law exclusions against thousands of Florida homeowners following Hurricane Andrew, and focuses on the importance of enforcing the homeowners' objectively reasonable expectations of insurance coverage. At least three thousand homeowners could not obtain building permits to rebuild their homes following Hurricane Andrew because the homes were below federal flood levels. *See id.* at 954. Rebuilding the homes to comply with federal flood guidelines required that they be elevated

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purchased.[51] Courts often refuse to enforce unambiguous exclusions in renewal policies which were not specifically called to the policyholder's attention at the time the renewal was sent.[52]

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several feet—at a cost of tens of thousands of dollars per home. *See id.* at 955. Many insurance companies refused to pay for the costs of raising the homes, citing the ordinance or law exclusion. Homeowners buying homeowners insurance have an objectively reasonable expectation that a home destroyed by a hurricane will be replaced by another home:

> Insurance companies, relying on the Ordinance or Law exclusion, offer to settle claims for the amount of the actual damage only; they disregard both elevation costs and the fact that the home cannot be rebuilt until it is elevated. Therefore, although claims are paid, insureds do not receive what they thought they would get: a functional home. They find they do not own what they thought they purchased: a policy that would cover the cost of repairing their homes to a functional condition. It is this expectation that forms the basis of the "reasonable expectation" doctrine.

Id. at 954-55.

51. *See, e.g.*, Bering Strait School Dist. v. RLI Ins. Co., 873 P.2d 1292 (Alaska 1994); Hart v. North British & Mercantile Ins. Co., 162 So. 177 (La. 1935); Stahlberg v. Travelers Indem. Co., 568 S.W.2d 79 (Mo. App. 1978); Unified School Dist. No. 285 v. St. Paul Fire and Marine Ins. Co., 627 P.2d 1147 (Kan. App. 2d 1981), *overruled on other grounds*, 666 P.2d 676 (Kan. 1983); Garnett v. Transamerica Ins. Servs., 800 P.2d 656 (Idaho 1990); Starczewski v. Unigard Ins. Group, 810 P.2d 58 (Wash. App. 1991); Farmers Union Mut. Ins. Co. v. Oakland, 825 P.2d 554 (Mont. 1992); Sentinel Mgmt. v. Aetna Cas. and Sur. Co., 563 N.W.2d 296 (Minn. 1997); Hertog v. Milwaukee Mut. Ins. Co., 415 N.W.2d 370 (Minn. 1987).

52. Davis v. United Services Automobile Association, 223 Cal. App. 3d 1322, 1332 (1990); Fields v. Blue Shield of California, 163 Cal. App. 3d 570, 579, 209 Cal. Rptr. 781 (1985); Pennsylvania Millers Mut. Ins. Co. v. Dunlap, 264 S.E.2d 483 (Ga. App. 1980); Canadian Universal Ins. Co., Ltd. v. Fire Watch, Inc., 258 N.W.2d 570 (Minn. 1977); Campbell v. Ins. Serv. Agency, 424 N.W.2d 785 (Minn. 1988); Duane Wolff Agency, Inc. v. Northshore Marine, Inc., 463 N.W.2d 562 (Minn. 1990); Industro Motive Corp. v. Morris Agency, Inc., 256 N.W.2d 607, 609 (Mich. App. 1977); Bauman v. Royal Indem. Co., 174 A.2d 585, 590-91 (N.J. 1961); Woodlawn Fraternal Lodge v. Commercial Union Ins. Co., 510 So. 2d 162, 164 (Ala. 1987); Horace Mann Ins. Co. v. Jackson, No. CX-97-175, 1997 Minn. App. LEXIS 1005 (Minn. Ct. App. Sept. 2, 1997); Whiteside v. New Castle Mut. Ins. Co., 595 F. Supp. 1096, 1099 (D. Del. 1984); Mosten Mgmt. Co., Inc. v. Zurich-American Ins. Group, No. C 89-3475 SBA, 1992 U.S. Dist. LEXIS 13593 (N.D. Cal. June 19, 1992); Giles v. St. Paul Fire and Marine Ins. Co., 405 F. Supp 719 (N.D. Ala. 1975); Taylor v. Omaha Property and Cas. Ins. Co., 739 F. Supp. 1069 (E.D. Va. 1990); Koski v. Allstate Ins. Co., 539 N.W.2d 561 (Mich. App. 1995), *rev'd on other grounds*, 572 N.W.2d 636 (Mich. 1998); Aetna Ins. Co. v. Lythgoe, 618 P.2d 1057 (Wyo. 1980); Tower Ins. Co. v. Judge, 840 F. Supp. 679 (D. Minn. 1993); Frendreis v. Blue Cross Blue Shield of Michigan,

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In construing insurance policy language, courts look to the purpose for which the insurance coverage was obtained in order to determine whether it was suitable for the policyholder's activities.[53] The reasonable expectations doctrine continues this approach.

III. THE DIFFERENT APPROACHES TO APPLYING THE REASONABLE EXPECTATIONS DOCTRINE

Courts have adopted three general variations of the reasonable expectations doctrine: (1) restricting the doctrine of reasonable expectations to ambiguous terms only; (2) applying the doctrine to determine whether "fine print" unfairly limits the policyholder's more prominent reasonable expectations, and; (3) looking to the "whole transaction" to determine whether the policyholder's reasonable expectations have been negated.[54] The doctrine of reasonable expectations may also be properly invoked where the premium charged does not truly reflect "the actual scope of the risk that the policy provisions define."[55] In

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873 F. Supp. 1153 (N.D. Ill. 1995); North River Ins. Co. v. Young, 453 S.E.2d 205, 209-10 (N.C. Ct. App. 1995); Defiance Metal Prods. Inc. v. Cincinnati Ins. Co., No. 4-94-18, 1995 Ohio App. LEXIS 3075 (Ohio Ct. App. July 19, 1995); Lexington Ins. Co. v. Devaney, No. 93-16284, 1995 U.S. App. LEXIS 4976 (9th Cir. Mar. 9, 1995); Allstate Ins. Co. v. Fibus, 855 F.2d 660 (9th Cir. 1988); Oregon Mut. Ins. Co. v. Hollopeter, 447 P.2d 391 (Or. 1968).

53. *See* Champion Int'l Corp. v. Continental Cas. Co., 546 F.2d 502 (2d Cir. 1976).

54. Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1467-75 (Fall 1989).

55. ROBERT E. KEETON AND ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINE AND COMMERCIAL PRACTICES §6.3(a)(1), at 627-28 (Practitioner's ed. 1988) (quoting Vargas v. Insurance Co. of N. Am., 651 F.2d 838, 841 (2d Cir. 1981). In *Vargas*, the insurance company argued that insurance coverage was properly denied where the policyholder's plane crashed beyond the territorial limits "unambiguously" set forth in the policy. The court found:

> The fact that coverage of the entire Caribbean, including the ocean areas, cost only an additional fifty dollars undermines the argument that substantial additional risks are involved. Moreover, INA offers no evidence that over-water flights between covered locations are more dangerous than flights over points . . . expressly covered by the policy and that include vast mountain ranges, lakes, deserts, and urban centers with heavy air traffic. Common sense and experience contradict INA's assertion that over-water flights add materially to these explicitly covered risks.

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effect, "[c]onstruing an insurance policy to protect the insured's 'reasonable expectations' means different things to different courts."[56]

Some courts hold that the reasonable expectations of the policyholder will be invoked only if there is an ambiguity in the policy—effectively blending the doctrine of reasonable expectations with the doctrine of *contra proferentem*.[57]

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56. Ware, *supra* note 54, at 1466.

57. The following is a non-exhaustive list of courts which have recognized *some variation* of the reasonable expectations doctrine:

> Alabama: Travelers Ins. Co. v. Jones, 529 So. 2d 234, 239 (Ala. 1988); Lambert v. Liberty Mut. Ins. Co., 331 So. 2d 260 (Ala. 1976).
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> Alaska: Stewart-Smith Haidinger v. Avi-Truck, Inc., 682 P.2d 1108 (Alaska 1986); U.S. Fire Ins. Co. v. Clover, 600 P.2d 1 (Alaska 1979); Puritan Life Ins. Co. v. Guess, 598 P.2d 900 (Alaska 1979); Stordahl v. Government Employees Ins. Co., 564 P.2d 63 (Alaska 1977); INA Life Ins. Co. v. Brundin, 533 P.2d 236 (Alaska 1975); National Indem. Co. v. Flesher, 469 P.2d 360 (Alaska 1970).
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> Arizona: Gordinier v. Aetna Cas. & Sur. Co., 742 P.2d 277 (1987); Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388 (1984); Zuckerman v. Transamerica Ins. Co., 650 P.2d 441 (1982), Mason v. State Farm Mut. Auto. Ins. Co., 714 P.2d 441 (Ariz. App. Ct. 1985); Cain v. Aetna Life Ins. Co., 659 P.2d 133 (Ariz. App. Ct. 1983).
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> California: Hanson v. Prudential Ins. Co., 772 F.2d 580 (9th Cir. 1985), *modified and reh'g denied en banc*, 783 F.2d 762 (9th Cir. 1985 & 1986); Continental Cas. Co. v. City of Richmond, 763 F.2d 1076 (9th Cir. 1985); McLaughlin v. Connecticut Gen. Life Ins. Co., 565 F. Supp. 434 (N.D. Cal. 1983); Wilson v. Insurance Co. of N. Am., 453 F. Supp. 732 (N.D. Cal. 1978); AIU Ins. Co. v. Superior Court (FMC Corp.), 51 Cal. 3d 807, 799 P.2d 1253 (1990) (en banc); Smith v. Westland Life Ins. Co., 539 P.2d 433 (1975); Gyler v. Mission Ins. Co., 514 P.2d 1219 (1973).
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> Colorado: Davis v. M.L.G. Corp., 712 P.2d 985 (Colo. 1986).
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> Delaware: Del Collo v. Houston, Civ. No. 83C-JA-121, slip op. (Del. Super. Ct. 1986); Steigler v. Insurance Co. of N. Am., 384 A.2d 398 (Del. 1978).
>
> District of Columbia: Owens-Illinois, Inc. v. Aetna Cas. & Sur. Co., 597 F. Supp. 1515 (D.D.C. 1984).

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Georgia: Macon Light House Revival Center, Inc. v. Continental Ins. Co., 651 F. Supp. 417 (M.D. Ga. 1987); Southeastern Fire Ins. Co. v. Heard, 626 F. Supp. 476 (N.D. Ga. 1985).

Hawaii: Crawford v. Ranger Ins. Co., 653 F.2d 1248 (9th Cir. 1981); Okada v. MGIC Indem. Corp., 608 F. Supp. 383 (D. Haw. 1985), *aff'd in part and rev'd in part*, 795 F.2d 1450 (9th Cir. 1986), *amended*, 823 F.2d 276 (9th Cir. 1987); Fortune v. Wong, 702 P.2d 299 (Haw. 1985).

Indiana: Eli Lilly & Co. v. Home Ins. Co., 794 F.2d 710 (D.C. Cir. 1986), *cert. denied*, 479 U.S. 1060 (1987).

Iowa: Grinnell Mutual Reins. Co. v. Voeltz, 431 N.W.2d 783, 786 (Iowa 1988); Farm Bureau Mut. Ins. Co. v. Sandbulte, 302 N.W.2d 104 (Iowa 1981); Gibson v. Milwaukee Mut. Ins. Co., 265 N.W.2d 742 (Iowa 1978); Steinbach v. Continental Western Ins. Co., 237 N.W.2d 780 (Iowa 1976); C&J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169 (Iowa 1975); City of Cedar Rapids v. Insurance Co. of N. Am., 562 N.W.2d 156 (Iowa 1997); Global Aviation Ins. Mgrs. v. Lees, 368 N.W.2d 209 (Iowa Ct. App. 1985).

Kansas: Dronge v. Monarch Ins. Co., 511 F. Supp. 1 (D. Kan. 1979).

Kentucky: Woodson v. Manhattan Life Ins. Co., 743 S.W.2d 835, 839 (Ky. 1987); Ohio Cas. Ins. Co. v. Stanfield, 581 S.W.2d 555 (Ky. 1979).

Louisiana: Louisiana Ins. Guar. Ass'n v. Interstate Fire & Cas. Co., 630 So. 2d 759 (La. 1994); Breland v. Schilling, 550 So. 2d 609 (La. 1989).

Maine: Peerless Ins. Co. v. Brennon, 564 A.2d 383 (Me. 1989); Baybutt Constr. Corp. v. Commercial Union Ins. Co., 455 A.2d 914 (Me. 1983).

Massachusetts: Davenport Peters Co. v. Royal Globe Ins. Co., 490 F. Supp. 286 (D. Mass. 1980); Home Indem. Ins. Co. v. Merchants Distribs., Inc., 483 N.E.2d 1099 (1985); Bond Bros. v. Robinson, 471 N.E.2d 1332 (1984). *But see* Jefferson Ins. Co. v. City of Holyoke, 503 N.E.2d 474, 478, *review denied*, 506 N.E.2d 146 (1987) (reasonable expectations doctrine "does not appear to have been explicitly adopted in Massachusetts").

Michigan: Crowell v. Federal Life & Cas. Co., 247 N.W.2d 503 (1976); Fresard v. Michigan Millers Mut. Ins. Co., 296 N.W.2d 112 (1980), *aff'd*, 327 N.W.2d 286 (1982).

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Minnesota: Auto-Owners Ins. Co. v. Jensen, 667 F.2d 714, 721 (8th Cir. 1981); Atwater Creamery Co. v. Western Nat'l Mut. Ins. Co., 366 N.W.2d 271, 278-79 (Minn. 1985); Arndt v. American Family Mut. Ins. Co., 380 N.W.2d 885 (Minn. Ct. App. 1985), *aff'd in part and rev'd in part*, 394 N.W.2d 791 (Minn. 1986).

Mississippi: Brown v. Blue Cross & Blue Shield, Inc., 427 So. 2d 139 (Miss. 1983).

Missouri: Wright v. Newman, 598 F. Supp. 1178 (W.D. Mo. 1984), *aff'd*, 767 F.2d 460 (8th Cir. 1985); Katz Drug Co. v. Commercial Standard Ins. Co., 647 S.W.2d 831 (Mo. Ct. App. 1983).

Montana: Transamerica Ins. Co. v. Royle, 656 P.2d 820 (1983).

Nebraska: Kracl v. Aetna Cas. & Sur. Co., 374 N.W.2d 40, 44 (Neb. 1985); Nile Valley Coop. Grain Milling Co. v. Farmers Elevator Mut. Ins. Co., 193 N.W.2d 752 (Neb. 1972).

Nevada: Farmers Ins. Exch. v. Young, 832 P.2d 376 (1992); National Union Fire Ins. Co. v. Caesars Palace Hotel & Casino, 792 P.2d 1129 (1990) (per curiam); National Union Fire Ins. Co. v. Reno's Executive Air, Inc., 682 P.2d 1380, 1383 (1984); Prudential Ins. Co. v. Lamme, 425 P.2d 346 (1967); Sullivan v. Dairyland Iris. Co., 649 P.2d 1357 (1982) (per curiam); Catania v. State Farm Life Ins. Co., 598 P.2d 631 (1979).

New Hampshire: Great Lakes Container Corp. v. Nation Union Fire Ins. Co., 727 F.2d 30, 34 (1st Cir. 1984); Commercial Union Assur. Co. v. Aetna Cas. & Sur. Co., 455 F. Supp. 1190 (N.H. 1978); Town of Epping v. St. Paul Fire Marine Ins. Co., 444 A.2d 496 (1982); Atwood v. Hartford Accident & Indem. Co., 365 A.2d 744 (1976).

New Jersey: Van Orman v. American Ins. Co., 680 F.2d 301 (3d Cir. 1982); McNeilab, Inc. v. North River Ins. Co., 645 F. Supp. 525 (D.N.J. 1986), *aff'd without opinion*, 831 F.2d 287 (3d Cir. 1987); Meier v. New Jersey Life Ins. Co., 503 A.2d 862 (1986); Sparks v. St. Paul Ins. Co., 495 A.2d 406 (1985); Gerhardt v. Continental Ins. Cos., 225 A.2d 328 (1966); Kievet v. Loyal Protective Life Ins. Co., 170 A.2d 22 (1961); Lerhroff v. Aetna Cas. & Sur. Co., 638 A.2d 889 (N.J. Super. Ct. App. Div. 1994).

New Mexico: Woodmen Accident & Life Ins. Co. v. Bryant, 784 F.2d 1052 (10th Cir. 1986); Konnick v. Farmers Ins. Co., 703 P.2d 889 (1985); Pribble v. Aetna Life Ins. Co., 501 P.2d 255 (1972); Read v. Western Farm Bureau Mut. Ins. Co., 563 P.2d 1162 (Ct. App. 1977).

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New York: Fried v. North River Ins. Co., 710 F.2d 1022 (4th Cir. 1983); Board of Educ., Yonkers City School Dist. v. CNA Ins. Co., 647 F. Supp. 1495 (S.D.N.Y. 1986), *aff'd*, 839 F.2d 14 (2d Cir. 1988); Champion Int'l Corp. v. Continental Cas. Co., 400 F. Supp. 978 (S.D.N.Y. 1975), *aff'd*, 546 F.2d 502 (2d Cir. 1976), *cert. denied*, 434 U.S. 819 (1977); Atlantic Cement Co. v. Fidelity & Cas. Co., 91 A.D.2d 412 (N.Y.S. 1st Dept. 1983), *aff'd*, 63 N.Y.2d 798, 471 N.E.2d 142 (1984); I Q Originals, Inc. v. Boston Old Colony Ins. Co., 85 A.D.2d 21 (N.Y.S. 1st Dep't.), *aff'd*, 444 N.E.2d 1004 (N.Y. 1982).

North Carolina: Great Am. Ins. Co. v. C.G. Tate Constr. Co., 279 S.E.2d 769 (1981).

North Dakota: Mills v. Agrichemical Aviation, Inc., 250 N.W.2d 663 (N.D. 1977); Walle Mut. Ins. Co. v. Sweeney, 419 N.W.2d 176 (N.D. 1988).

Pennsylvania: Tonkovic v. State Farm Mut. Auto. Ins. Co., 521 A.2d 920 (1987); Collister v. Nationwide Life Ins. Co., 388 A.2d 1346 (1978), *cert. denied*, 439 U.S. 1089 (1979); *cf.* Standard Venetian Blind Co. v. American Empire Ins. Co., 469 A.2d 563 (1983); Beckham v. Travelers Ins. Co., 225 A.2d 532 (1967); Gdovic v. Catholic Knights of St. George, 453 A.2d 1040 (1982).

Rhode Island: Gleason v. Merchants Mut. Ins. Co., 589 F. Supp. 1474 (D.R.I. 1984); American Universal Ins. Co. v. Russell, 490 A.2d 60 (R.I. 1985); Elliott Leases Cars, Inc. v. Quigley, 373 A.2d 810 (R.I. 1977).

Texas: Fritz v. Old Am. Ins. Co., 354 F. Supp. 514 (S.D. Tex. 1973).

West Virginia: National Mut. Ins. Co. v. McMahon & Sons, Inc., 356 S.E.2d 488, 495-96 (W. Va. 1987).

Wisconsin: Lund v. American Motorists Ins. Co., 619 F. Supp. 1535 (W.D. Wis. 1985), *aff'd in part and rev'd in part*, 797 F.2d 544 (7th Cir. 1986); Gross v. Lloyd's of London Ins. Co., 121 Wis. 2d 78, 358 N.W.2d 266 (1984).

See 1 EUGENE R. ANDERSON, ET AL., INSURANCE COVERAGE LITIGATION §2.7, at 68-69 (Aspen 1997); BARRY R. OSTRAGER AND THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES §1.03[b][2][B], at 21-24 (7th ed. 1994). For an excellent discussion of many of these cases, as well as an analysis of specific jurisdictions and a comparison of how courts have interpreted Professor Keeton's doctrine, see Roger C. Henderson, *The Doctrine*

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The Florida Supreme Court recently revealed a grave misunderstanding of the reasonable expectations doctrine in *Deni v. State Farm Fire & Cas. Ins. Co.*[58] The decision was based on two companion cases dealing with the terms of a so-called "absolute" pollution exclusion in a comprehensive general liability policy. The Supreme Court of Florida refused to invoke the reasonable expectations doctrine:

> We decline to adopt the doctrine of reasonable expectations.[ ] There is no need for it if the policy provisions are ambiguous because in Florida ambiguities are construed against the insurer. To apply the doctrine to an unambiguous provision would be to rewrite the contract and the basis upon which the premiums are charged . . . 'The reasonable expectation doctrine requires a court to rewrite an insurance contract which does not meet popular expectations. Such rewriting is done regardless of the bargain entered into by the parties to the contract.'[59]

It appears that the *Deni* court assumed (there being no discussion on the point) that policyholders and insurance companies actually "bargain" over the terms of the standard form insurance policies.[60] It also appears that the *Deni* court misunderstood whether the reasonable expectations doctrine is an objective or subjective rule. The court first correctly noted that "[u]nder this doctrine, the insured's expectations as to the scope of coverage is upheld provided that such expectations are objectively reasonable."[61] Two paragraphs later, the court stated that "[c]onstruing insurance policies upon a determination as to whether the insured's *subjective* expectations are reasonable can only lead to uncertainty and unnecessary litigation."[62] The *Deni* court does not clarify nor reconcile these conflicting understandings of the doctrine. That the *Deni* court did not understand that the reasonable expectations doctrine is an objective

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of Reasonable Expectations In Insurance Law After Two Decades, 51 OHIO ST. L.J. 823 (1990).

58. 711 So. 2d 1135 (Fla. 1998).

59. *Id.* at 1140 (footnote and internal citation/parentheses omitted).

60. *See* discussion of the limitations of standard form policy language and contracts of adhesion at Section V, below.

61. *Deni*, 711 So.2d at 1140.

62. *Id.*

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rule is certain to have an important impact on how the doctrine is interpreted by future courts.

The *Deni* court relied on *Max True Plastering Co v. United States Fidelity and Guaranty Co.*[63] for the proposition that most states require an ambiguity before invoking the reasonable expectations doctrine.[64] This is a fundamental misreading of the *Max True* decision. *Max True* stands for the proposition that:

> Under the reasonable expectations doctrine, the *objectively* reasonable expectations of applicants, insureds and intended beneficiaries concerning the terms of insurance contracts are honored even though painstaking study of the policy provisions might have negated those expectations. We find that the reasonable expectations doctrine *may* apply to the construction of ambiguous insurance contracts *or to contracts containing exclusions which are masked by technical or obscure language or which are hidden in policy provisions.*[65]

The *Max True* decision hardly limits application of the reasonable expectations doctrine to ambiguous policy language. The *Max True* decision adopted, and did not reject, the reasonable expectations doctrine. In support of its decision, the *Max True* court cited cases which had and *had not* limited application of the doctrine to ambiguous policy language.[66] Even the cases which the *Max True* court cited for the proposition that the reasonable expectation doctrine is applicable to ambiguous language do not *require* an ambiguity in order to apply the doctrine.[67] The *Max True* court also understood that the terms of insurance policies are not bargained for by policyholders:

> Insurance contracts are contracts of adhesion because of the uneven bargaining positions of the parties. The doctrine of reasonable expectations has evolved as an

63. 912 P.2d 861 (Okla. 1996).
64. *See Deni*, 711 So.2d at 1140.
65. 912 P.2d 861, 862 (Okla. 1996)(emphasis added).
66. *See id.* at 864, n.5., 868, nn. 35-36.
67. *See id.* at 868, n.35.

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> interpretive tool to aid courts in discerning the intention of the parties bound by adhesion contracts.[68]

The *Deni* court's decision relies heavily on a broad misreading of the *Max True* decision. The decision in *Deni v. State Farm Fire & Cas. Ins. Co.* is simply incorrect.

Max True is an example of the "whole transaction" version of the reasonable expectations doctrine. The "whole transaction" version of the reasonable expectations doctrine reflects the doctrine as it was originally set forth by Professor Keeton. This version evaluates both the objectively reasonable expectations of the policyholder according to the language and structure of the policy (the fine print approach) *and* evaluates the "marketing patterns and general practices" of the insurance company.[69] Courts following the "whole transaction" approach recognize that merely reviewing the policy language is insufficient to determine the scope of insurance coverage a policyholder reasonably believed it had bought.[70]

IV. STANDARDIZED FORM LANGUAGE SUPPORTS ENFORCING THE REASONABLE EXPECTATIONS OF THE POLICYHOLDER

During the early days of Lloyd's Coffee House in the sixteenth and seventeenth centuries, merchant shipowners seeking insurance coverage, and the underwriters willing to provide it, entered into transactions with relatively equal bargaining power.[71] Not only were most merchant policyholders at least as wealthy as the underwriters, but it was not uncommon for the policyholder to prepare the insurance policy and submit it to the underwriters, who would then agree to underwrite a specific dollar amount.[72] In this respect, the policyholder's expectations of insurance coverage "were at least as accurately described as those of the insurer(s)."[73]

Times have changed. Today, standard form insurance policies are drafted:

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68. *Id.* at 864.

69. Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1472-73 (Fall 1989) (quoting Keeton, 83 HARV. L. REV., at 973). *See* discussion of insurance company advertising at Section VIII, below.

70. *See id.*

71. *See* WIDISS, *supra* note 55 at 627-28.

72. *See id.*

73. *Id.*

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> with the aid of skillful and highly paid legal talent, from which no deviation desired by an applicant will be permitted. The established underwriter is magnificently qualified to understand and protect its own selfish interests. In contrast, the applicant is a shorn lamb driven to accept whatever contract may be offered on a "take-it-or-leave-it" basis if he wishes insurance protection.[74]

The classic model of freely negotiated agreements is "far removed from the reality of the business of insurance."[75] Even insurance companies have acknowledged the futility of determining a policyholder's reasonable expectations of coverage based on the language of the insurance policy alone:

> Because of the way the insurance industry operates, most of the relevant policy language is found in standardized insuring forms, drafted by insurance associations or bureaus, and used industry-wide. Thus, questions of intent may be addressed on a standardized basis. Predictably, there will be precious little evidence of the negotiation of individual policies. The primary evidence of the intent of the parties drafting the contracts, and their expectations about the scope of coverage, will be obtained through document productions from key industry wide organizations, and depositions of their personnel.[76]

It makes no sense to rely on contract remedies when even insurance companies believe that extrinsic evidence—not the policies themselves—is the best way to determine a policyholder's expectations of insurance coverage.

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74. SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS §900, at 19-20 (3d ed. W. Jaeger 1973).

75. ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW §25C, at 139 (2d ed. 1996).

76. Travelers' Reply Memorandum in Support of Coordination; In Opposition to GAF's Motion of Separate Hearing, and Exhibits in Support Thereof at 7-8 (filed Jan. 2, 1981), Armstrong Cork Co. v. Aetna Cas. & Sur. Co. (Cal. Super. Ct., Los Angeles County) (No. C315367).

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The modern standard form insurance policy has long been recognized as the "archetypal 'adhesion' contract:"[77] One commentator has set forth the seven qualities that "define a model 'contract of adhesion.'"[78] Most standard form insurance policies possess all of the following characteristics, often to a high degree:

> (1) The document whose legal validity is at issue is a printed form that contains many terms and clearly purports to be a contract.
>
> (2) The form has been drafted by, or on behalf of, one party to the transaction.
>
> (3) The drafting party participates in numerous transactions of the type represented by the form and enters into these transactions as a matter of routine.
>
> (4) The form is presented to the adhering party with the representation that, except perhaps for a few identified items (such as the price term), the drafting party will enter into the transaction only on the terms contained in the document. This representation may be explicit or may be implicit in the situation, but it is understood by the adherent.
>
> (5) After the parties have dickered over whatever terms are open to bargaining, the document is signed by the adherent.

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77. *See* Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1464 (1989). For an extensive discussion on insurance policies as contracts of adhesion, *see* 1 EUGENE R. ANDERSON, ET AL., INSURANCE COVERAGE LITIGATION §2.1, at 45-48 (Aspen 1997). The term was coined nearly a century ago by a French commentator. *See* R. SALEILLES, DE LA DECLARATION DE VOLONTE §89, at 229-30 (1901) (translated in Edwin W. Patterson, *The Interpretation and Construction of Contracts*, 64 COLUM. L. REV. 833, 856 (1964)). In the United States, the term was first used in an insurance coverage case. *See* Bekken v. Equitable Life Assurance Soc'y, 293 N.W. 200, 212 (N.D. 1940).

78. T.D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1177 (1983).

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> (6) The adhering party enters into few transactions of the type represented by the form—few, at least, in comparison with the drafting party.
>
> (7) The principal obligation of the adhering party in the transaction considered as a whole is the payment of money.[79]

With standard form policies and contracts of adhesion, there is no freedom of contract. As one commentator noted:

> Freedom of contract enables enterprisers to legislate by contract and, what is even more important, to legislate in a substantially authoritarian manner without using the appearance of authoritarian forms. Standard contracts in particular could thus become effective instruments in the hands of powerful industrial and commercial overlords enabling them to impose a new feudal order of their own making upon a vast host of vassals.[80]

The insurance companies, not an activist judiciary or renegade policyholders, have destroyed the freedom to contract. The reasonable expectations doctrine attempts to re-inject—not remove—a limited amount of freedom to contract. Under standard form policy language, that freedom was never there.

The reasonable expectations doctrine does not require that an insurance policy state in *literal terms* the insurance coverage that a policyholder has come to reasonably expect.[81] Rather, the doctrine is based in part on the understanding that most policyholders do not draft, negotiate, or assent to the specific provisions in standard-form insurance

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79. *Id.* at 1177.

80. Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM L. REV. 629, 640 (1943).

81. *See, e.g.*, Storms v. United States Fidelity & Guar. Co., 338 A.2d 578, 580 (N.H. 1978).

> If a policy is so constructed that a reasonable man in the position of the insured would not attempt to read it, the insured's reasonable expectations will not be delimited by the policy language, regardless of the clarity of the particular phrase among the Augean stable of print.

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policies.[82] In nearly all cases, if the policyholder has assented to anything, it is only to the general scope or type of insurance coverage provided by the policy, the premium, or the amount of the policy limits. Most policyholders do not see their policies until long after they have purchased insurance coverage. That most policyholders do not read their policies after they receive them is nearly universally accepted:

> [T]he adhering party is in practice unlikely to have read the standard terms before signing the document and is unlikely to have understood them if he has read them. Virtually every scholar who has written about contracts of adhesion has accepted the truth of this assertion, and the few empirical studies that have been done have agreed.[83]

Virtually no one expects the policyholder to have read or understood the language of a standard form insurance policy:[84]

> [a] party who makes regular use of a standardized form of agreement does not ordinarily expect his customers to understand or even to read the standard terms. . . .

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82. *See, e.g.*, Atwater Creamery Co. v. Western Nat'l Mut. Ins. Co., 366 N.W.2d 271, 277 (Minn. 1985) ("[t]he doctrine of protecting the reasonable expectations of the insured is closely related to the doctrine of contracts of adhesion").

83. T.D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1179 (1983). *See also* KEETON, INSURANCE LAW: BASIC TEXT 352 (1971); C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 174 (Iowa 1975) (citing 7 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS §906B (3d ed. 1959) ("where the document . . . delivered to him is a contract of insurance the majority rule is that the insured is not bound to know its contents")); Atwater Creamery Co. v. Western Nat'l Mut. Ins. Co., 366 N.W.2d 271, 278 (Minn. 1985) ("in certain instances . . . the insured should be held only to reasonable knowledge of the literal terms and conditions"); 3 A. CORBIN, CORBIN ON CONTRACTS §559 (1964) ("[o]ne who applies for an insurance policy ... may not even read the policy, the number of its terms and the fineness of its print being such as to discourage him"); Note, *Unconscionable Contracts: The Uniform Commercial Code*, 45 IOWA L. REV. 843, 844 (1960) ("[i]t is probably a safe assertion that most involved standardized form contracts are never read by the party who 'adheres' to them. In such situations, the proponent of the form is free to dictate terms most advantageous to himself").

84. *See, e.g.*, W. David Slawson, *The New Meaning of Contract: The Transformation of Contracts Law By Standard Forms*, 46 U. PITT L. REV. 21, 26 (1984) ("[U]nder the conditions of modern contracting buyers are not reasonably expected even to read the forms before they become bound.").

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> Customers do not in fact ordinarily understand or even read the standard terms.[85]

The typical method of selling insurance reveals that the insurance industry understands very little is gained by having the policyholder read the insurance policy:

> Insurance agents and consumers usually discuss the consumer's broad insurance needs and whether the insurer can satisfy those needs at an acceptable price. Discussion is usually limited to the few terms that are inserted into blanks in the contract. The insurer does not expect the insured to understand all the terms and usually makes no attempt to explain them. Exclusions and limitations, as well as most other "boilerplate" provisions, are not discussed.[86]

Insurance companies know, or should know, that it is pointless for policyholders to negotiate standard form language, since insurance company "[e]mployees regularly using a form often have only a limited understanding of its terms and limited authority to vary them."[87]

Arguments that the reasonable expectations doctrine should apply to both the policyholder and the insurance company miss the point that there is only one adhering party in the policyholder-insurance company relationship. The insurance company is the drafter of the standard form language. The insurance company offered the policy on a take-it-or-leave it basis. The insurance company has years of experience in drafting similar policies. The insurance company is presumed to have set forth its reasonable expectations within the policy. The point of the reasonable expectations doctrine is to ensure that the objectively reasonable expectations of the adhering party, the policyholder, have not been trampled upon by the drafter of the instrument.

But the insurance industry wants to have their cake and eat it too. Nearly all insurance companies use identical standard form language drafted by the Insurance Services Office, Inc. ("ISO"). This is why most

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85. RESTATEMENT (SECOND) OF CONTRACTS §211 cmt. b (1979).

86. William Mark Lashner, *A Common Law Alternative to the Doctrine of Reasonable Expectations in the Construction of Insurance Contracts*, 57 N.Y.U. L. REV. 1175, 1180-81 (1982) (footnotes omitted).

87. RESTATEMENT (SECOND) OF CONTRACTS §211 cmt. b (1979).

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insurance policies are identical, and why, except for perhaps negotiating the premium to be paid, "shopping around" for different insurance coverage is futile.[88] Though aware of the inherent limitations of standard form language, insurance companies tout the benefits of its use:

> For the insurance system to function, insurers need to be able to predict their insureds' potential losses based upon known categories of risks . . . That is why policies are written on standard forms. Standardization enables ISO [Insurance Services, Inc.] to track the claims experience of the defined coverages nationwide which in turn enables insurers to set realistic premiums and reserves. This is possible only if the words have the same meaning in New York and Washington as they do in California. Standardization also promotes the consumer interest by providing well-defined coverages which permit insureds to know what they are buying and to evaluate it comparatively.[89]

The benefit of using standardized language is that it increases commercial efficiency by reducing, or eliminating, the time and expense of bargaining.[90] Requiring unnegotiable standard form language to be read—especially the language contained in a standard form insurance policy—

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88. The insurance industry's exemption from antitrust regulation allows different insurance companies to use identical policy language. Congress exempted the insurance industry from antitrust regulation in the McCarran-Ferguson Insurance Regulation Act, 15 United States Code Annotated §§1011-1015 (1945). *See* discussion of the McCarran-Ferguson Act and the resulting information imbalance at Section VIII(C)(1), below.

89. Real Parties in Interest's [Industrial Indemnity Company and Industrial Insurance Company of Hawaii, Ltd.] Opening Brief on the Merits at 36-37, Bank of the West v. Superior Court, 833 P.2d 545 (Cal. 1992), (No. S019556). *See also* Eugene R. Anderson, Catherine M. Ward, and John P. Winsbro, *Environmental Insurance Coverage In New Jersey: A Tale of Two Stories*, 24 RUTGERS L.J. 83 (1992) (reviewing the development of the pollution exclusion and the invocation of regulatory estoppel to prohibit insurance companies from adopting positions contrary to insurance company representations made when regulations were proposed).

90. *See* E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 4.26 (2d. ed. 1990); RESTATEMENT (SECOND) OF CONTRACTS §211 cmt. c. (1979)(discussing the benefits of using standardized language).

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would produce the opposite result and obliterate the benefits of standardization.[91]

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91. This is especially true with insurance policy standard form language. Consider the opening language and exclusions in a typical ISO-approved comprehensive general liability policy:

> Section I - Coverages
> Coverage A. Bodily Injury and Property Damage Liability
>
> 1. Insuring Agreement
>
> a. We will pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies. No other obligation or liability to pay sums or perform acts or services is covered unless explicitly provided for under SUPPLEMENTARY PAYMENTS—COVERAGES A AND B. This insurance does not apply to 'bodily injury' or 'property damage' which occurred before the Retroactive Date, if any, shown in the Declarations or which occurs after the policy period. The 'bodily injury' or 'property damage' must be caused by an 'occurrence.' The 'occurrence' must take place in the 'coverage territory.' We will have the right and duty to defend any 'suit' seeking those damages.
>
> . . . .
>
> 2. Exclusions
>
> This insurance does not apply to:
>
> a. 'Bodily injury' or 'property damage' expected or intended from the standpoint of the insured. The exclusion does not apply to 'bodily injury' resulting from the use of reasonable force to protect persons or property.
>
> b. 'Bodily injury' or 'property damage' for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages:
>
> 1. Assumed in a contract or agreement that is an 'insured contract;' or
>
> 2. That the insured would have in the absence of the contract or agreement.

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In short, reading or understanding the complicated standard form policy language in order to alter it is not possible. And if it were possible, doing so would defeat the benefits of using standardized forms. Yet the problems with securing policyholder expectations under standard form insurance policies is not a new phenomenon. Over fifty years ago one commentator noted:

> [T]he insurance policy has become overloaded with warranties, representations, conditions and exceptions, and other restrictive provisions, besides which tend to take on highly technical and treacherous characteristics. . . . It has been often said that if all the provisions of the modern insurance policy were literally enforced no policyholder could recover a penny. This is an overstatement, but suggestive.[92]

That standard form insurance agreements and boilerplate are particularly subject to hidden meanings and confusion has been succinctly noted by the courts: "Although insurers have had over a hundred years to hone their policies into forms that would not ferry the unwary reader on a trip through Wonderland, they regrettably have not seen fit to do so."[93]

Insurance companies have refused to remedy the situation on their own. Despite the century to clarify their policies, insurance companies use standard form language as a sword against policyholders:

> Ambiguity and incomprehensibility seem to be the favorite tools of the insurance trade in drafting policies. Most are a virtually impenetrable thicket of incomprehensible verbosity. It seems that insurers generally are attempting to convince the customer when selling the policy that

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Commercial General Liability Coverage Form CG 00 01 01 96, p.1 (Copyright, Insurance Services Office, Inc., 1994), set forth in YOUR GUIDE TO THE ISO COMMERCIAL LINES POLICIES, Appendix B, at B-2 (6th ed. 1996).

The above-quoted policy contains 12 additional exclusions and 6 additional sections. Requiring a policyholder to read this language, much less understand it prior to purchasing insurance coverage, would defeat the purpose of using standardized language. It certainly does not make matters clearer.

92. WILLIAM REYNOLDS VANCE, CASES ON INSURANCE 211-12 (3d ed. 1940).

93. Storms v. United States Fidelity & Guar. Co., 338 A.2d 578, 580 (N.H. 1978).

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> everything is covered and convince the court when a claim is made that nothing is covered. The miracle of it all is that the English language can be subjected to such abuse and still remain an instrument of communication. But, until such time as courts generally weary of the task we have just experienced and strike down the entire practice, we feel that we must run with the pack and attempt to construe that which may well be impossible of construction.[94]

Another factor compounds the limitations of standard form contracts of adhesion: insurance is often an involuntary purchase. It is impossible to buy a home, operate a business or drive a car without some form of insurance. Insurance companies have a captive market, yet are allowed to sell their product via a non-negotiable contract of adhesion. In a business that is not subject to federal regulation and is governed by state laws drafted by the insurance industry itself, it is too much to rely on boilerplate language and traditional contract remedies. Policyholders have only the courts to rely upon for relief when their insurance sellers "run for cover rather than coverage."[95] The judiciary is an especially important gatekeeper in a society where the decision to buy insurance is no longer voluntary.

The reasonable expectations doctrine is not necessarily limited to fulfilling the policyholder's objectively reasonable expectations of insurance coverage. Insurance coverage affects a broad spectrum of individual, governmental and corporate interests.[96] Insurance protects not only policyholders, but also injured parties, neighbors, the community, creditors and employees.[97] One insurance textbook described the far-reaching effects of insurance like this:

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94. South Carolina Ins. Co. v. Fidelity and Guar. Ins. Underwriters, 489 S.E.2d 200, 206 (S.C. 1997) (quoting Universal Underwriters Ins. Co. v. Travelers Ins. Co., 451 S.W.2d 616, 622-23 (Ky. Ct. App. 1970)).

95. Sandoz, Inc. v. Employers Liab. Assurance Corp., 554 F. Supp. 257, 258 (D.N.J. 1983).

96. *See* James R. Stirn, *Environmental Risks Challenge Re Capabilities*, NAT'L UNDERWRITER, June 19, 1989, at 42, 45.

97. Eugene R. Anderson, Richard C. Tuttle and Susannah Crego, *Draconian Forfeitures of Insurance: Commonplace, Indefensible, And Unnecessary*, 65 FORDHAM L. REV. 825, 829 (1996) (citing Charles A. McAlear, *The Emperor's Old Clothes; Business Insurance and the Risk Retention Act*, BEST'S REV., Feb. 1989, at 22-23).

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> [I]n addition to eliminating or reducing the financial uncertainty of risks to individuals and businesses, insurance benefits society by paying for losses, providing funds for investments, controlling losses, supporting credit, allocating resources, and satisfying legal and business requirements.[98]

By acknowledging that insurance protects the public-at-large as well as the policyholder, the insurance industry implicitly recognizes that the *failure* of insurance to insure also affects many more than the policyholder who purchased the policy. The reasonable expectations doctrine provides society as well as the policyholder with a layer of protection for a required purchase with non-negotiable terms and far-reaching effects.

V. THE FALLACY OF THE SOPHISTICATED POLICYHOLDER

Insurance companies and their lawyers have strenuously argued that the doctrines of reasonable expectations and *contra proferentem* should not apply when a claim is made by a so-called "sophisticated" policyholder.[99] So-called "sophisticated" policyholders have been defined by one pro-insurance commentator as commercial policyholders whose "business insurance policies . . . are typically negotiated (and often drafted) on behalf of the insured by sophisticated brokers, risk managers and/or counsel. . ."[100] This argument, and the facts upon which it rests, are pure fabrication.

The first obvious problem with the sophisticated policyholder argument is that standard form insurance policies contain no "sophisticated" policyholder exclusion, although nothing prevents the insurance industry from drafting one.[101] That a "sophisticated" policyholder exclusion does not exist is strong evidence that insurance companies never intended to treat commercial and individual policyholders

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98. JAMES J. MARKHAM ET AL., THE CLAIMS ENVIRONMENT 2 (1st ed. 1993).

99. *See, e.g.*, Barry R. Ostrager and David W. Ichel, *Should the Business Insurance Policy Be Construed Against the Insurer? Another Look at the Reasonable Expectations Doctrine*, 33 FED'N INS. COUNS. Q. 273 (1983).

100. *See* BARRY R. OSTRAGER AND BARRY R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES §1.03[c], at 26 (7th ed. 1994).

101. *See* Carl A. Salisbury, *Pollution Liability Insurance Coverage, The Standard-Form Pollution Exclusion, and The Insurance Industry: A Case Study In Collective Amnesia*, 21 ENVTL. L. 357, 362-63 (1991).

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differently. In fact, insurance companies apparently have no specific criteria to determine what constitutes a "sophisticated" policyholder. One insurance company argued (unsuccessfully) that a policyholder who had graduated from business school was a sophisticated policyholder.[102] The slippery slope character of the "sophisticated" policyholder argument is self-evident.

Holding commercial policyholders to a higher standard based on nebulous factors such as size or wealth "suggests that big companies ought to receive less insurance coverage than small companies, notwithstanding that big companies pay big premiums for their coverage."[103] The size or wealth of a commercial policyholder has nothing to do with its understanding of the language in its insurance policy. One court contrasted the policyholder's purported "sophistication" to the insurance industry's typical business practices:

> In transactions involving sophisticated and unsophisticated insureds alike, the insured has a right to expect that [it] will receive something of comparable value in return for the premium paid, yet the courts have recognized that the insured can be forced by the insurer to rely upon the oral representations of the insurance agent. The control exercised by insurers is especially problematic when the insured, whether sophisticated or not, does not receive the actual insurance policy until after offering to buy insurance and paying the first premium . . . . Moreover, when the insured does not know or have reason to know of the existence of an unfavorable provision, then the insured lacks the ability to negotiate a more favorable insurance policy, and its sophistication or putative bargaining power is meaningless.[104]

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102. *See* Brotherhood Mut. Ins. Co. v. Roseth, 532 N.E.2d 354 (Ill. App. Ct. 1988).

103. Carl A. Salisbury, *Pollution Liability Insurance Coverage, The Standard-Form Pollution Exclusion, And The Insurance Industry: A Case Study In Collective Amnesia*, 21 ENVTL. L. 357, 362 (1991).

104. Reliance Ins. Co. v. Moessner, 121 F.3d 895, 905 (3rd Cir. 1997)(internal citations and quotations omitted) (quoting Collister v. Nationwide Life Ins. Co., 388 A.2d 1346, 1353 (Pa. 1978) and citing Robert Keeton, *Insurance Law Rights at Variance With Policy Provisions*, 83 HARV. L. REV. 961, 968 (1970) and Zuckerman v. Transamerica Ins. Co., 650 P.2d 441 (Ariz. 1982)).

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The court was cognizant that the reasonable expectations doctrine was "adopted to combat the effects of the relatively unequal bargaining power exercised by insurer and insured."[105] Nevertheless, it reversed the district court's finding that the policyholder's expectation of insurance coverage was "irrelevant as a matter of law because of [the policyholder's] status as a sophisticated purchaser of insurance."[106]

The truth is that America's largest corporations purchase standard form policy language just like everybody else.[107] In fact, most large commercial policyholders do not purchase "manuscript" policies, and policies which insurance companies purport to be manuscript policies are often no more than a typewritten version of the standard form language.[108] A policy based on standard-form language, whether sold to a multinational corporation or a residential homeowner, is offered on a take-it-or-leave-it basis.[109] Even large commercial policyholders who work with brokers are only paying to have *segments* of yet more standard-form language *assembled*—terms are rarely rewritten. As the Illinois Supreme Court commented: "The insurance industry is powerful and closely knit. . . . Any insured, whether large and sophisticated or not, must enter into a contract

105. Reliance Ins. Co. v. Moessner, 121 F.3d 895, 904 (3rd Cir. 1997).

106. *Id.*

107. *See* David B. Goodwin, *Disputing Insurance Coverage Disputes*, 43 STAN. L. REV. 779, 796-97 (1991) (listing examples of cases involving large policyholders with policies containing unvaried standard form language. Among others, the article cites Eli Lilly & Co. v. Home Ins. Co., 764 F.2d 876, 879 (D.C. Cir. 1985)(policyholders' 242 policies issued over the course of 29 years by different insurance companies contained functionally identical definitions of "injury" and "occurrence"); In re Asbestos Ins. Coverage Cases, Judicial Coordination Proceeding No. 1072, Statement of Decision Concerning Phase III Issues, slip. op. at 1-3, 14 (Cal. Super. Ct. Jan. 24, 1990)(insurance agreement, injury and occurrence language is "functionally identical" for policies issued by dozens of insurance companies to several large policyholders).

108. *See* David B. Goodwin, *Disputing Insurance Coverage Disputes*, 43 STAN. L. REV. 779, 796 n.100 (1991) (quoting Wondie Russel, Barry S. Levin & Celia M. Jackson, *Insurance Policy Construction and the Non Sequitur of the "Sophisticated Insured,"* 3 ENVTL. CLAIMS J. 3, 16-17 (1990)).

109. *See* Melody A. Hamel, Comment, *The 1970 Pollution Exclusion in Comprehensive General Liability Policies: Reasons For Interpretations in Favor of Coverage in 1996 and Beyond*, 34 DUQ. L. REV. 1083, 1111 (1996)(arguing that the non-competitive nature of the market for pollution insurance coverage justifies application of the doctrines of *contra proferentem* and reasonable expectations, even where the policyholder is "sophisticated").

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with an insurer which is written according to the insurer's pleasure by the insurer."[110]

Other courts have come to the same conclusion. The Washington Supreme Court in *Boeing Co. v. Aetna Casualty and Surety Co.* held that:

> [O]n the facts of this case, it is questionable whether these standard rules of construction are no less applicable merely because the insured is itself a corporate giant. The critical fact remains that the policy in question is a standard form policy prepared by the company's experts, with language selected by the insurer. The specific language in question was not negotiated, therefore, it is irrelevant that some corporations have company counsel. *Additionally, this standard form policy has been issued to big and small businesses throughout the state. Therefore it would be incongruous for the court to apply different rules of construction based on the policyholder because once the court construes the standard form coverage clause as a matter of law, the court's construction will bind policyholders throughout the state regardless of the size of their business.*[111]

Similarly, the California Supreme Court in *AIU Insurance Co. v. Superior Court* held that the mere fact a policyholder possessed "both legal sophistication and substantial bargaining power" "has little bearing on the construction of the specific [standard-form] policy language in question here."[112] Insurance companies simply have no reason to believe that policyholders sophisticated in building automobiles, manufacturing chemicals or flying airplanes are equally sophisticated about insurance:

> The particular sophisticated commercial entities involved in this case were in different businesses. [The policyholders] may have been knowledgeable about their own businesses, aviation, and security, respectively, but

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110. Outboard Marine Corp. v. Liberty Mut. Ins. Co., 607 N.E.2d 1204, 1218 (Ill. 1992).

111. Boeing Co. v. Aetna Cas. and Sur. Co., 784 P.2d 507, 514 (Wash. 1990) (emphasis added). *See also* EUGENE R. ANDERSON, ET AL., INSURANCE COVERAGE LITIGATION §2.15, at 101 (Aspen 1997).

112. AIU Ins. Co. v. Superior Court (FMC Corp.), 799 P.2d 1253, 1266 (Cal. 1990).

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> not necessarily insurance. Though they may have possessed some degree of generic business sophistication, it would be nonetheless reasonable for a jury to infer that both relied extensively on the superior expertise of [the insurance company].[113]

In addition, large commercial policyholders do not negotiate policy terms for economic reasons created by the insurance company. The economic reasons for not negotiating standard form language were succinctly set forth by one commentator:

> The reality is that sophisticated insureds normally devote their "bargaining power resources" to obtaining higher limits of liability or coverage for a broader range of risks than to negotiating specific policy language. After all, when insurance carriers use non-standard language, the carrier is unable to use pooled risk rating information and therefore must charge a higher premium to compensate for the increased risk. Sophisticated insureds thus rarely will find that the cost of purchasing non-standardized policies makes financial sense.[114]

There is no reason why large commercial policyholders should be compelled to negotiate their policy language; the very purpose of the regulatory process is to approve standard-form language "so that the state can negotiate with the insurance industry on behalf of policyholders who never get that chance."[115] To force a policyholder with deep pockets to undertake the same responsibilities is a purely opportunistic argument.

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113. United States v. Brennan, 938 F. Supp. 1111, 1121, (E.D.N.Y. 1996), *appeal pending*.

114. David B. Goodwin, *Disputing Insurance Coverage Disputes*, 43 STAN. L. REV. 779, 797 (1991)(footnotes omitted).

115. Melody A. Hamel, Comment, *The 1970 Pollution Exclusion in Comprehensive General Liability Policies: Reasons For Interpretations in Favor of Coverage in 1996 and Beyond*, 34 DUQ. L. REV. 1083, 1112 (Summer 1996) (quoting Morton Int'l, Inc. v. General Accident Ins. Co., 629 A.2d 831, 848 (N.J. 1993), *cert. denied*, 114 S. Ct. 2764 (1994)):

> The insurance industry's presentation and characterization of the standard pollution-exclusion clause to state regulators constituted virtually the only opportunity for arms length bargaining by interests

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The "sophisticated" policyholder argument suffers from an additional flaw: at what point, exactly, does an "ordinary" policyholder become a "sophisticated" policyholder? Policyholders may not have been "sophisticated" decades ago when the policies were purchased. Or they may not have been "sophisticated" when insurance coverage under those policies was triggered.[116] Moreover, insurance companies 'standing in the shoes of a policyholder' have forcefully argued that the "sophisticated" policyholder argument is meritless. So said:

CNA Casualty of California:

> [T]he level of sophistication of the insured is irrelevant when the policies are standard form policies slapped together without any negotiation as to their terms.[117]

Travelers Insurance Co.:

> Significantly, regardless of the sophistication of the insured, the [plaintiff insurance company's] policy is a printed *form* policy prepared by the carrier without the possibility of negotiation or modification by the assured. (129a). It follows therefore that an ambiguity which permits an interpretation of either coverage or noncoverage must be resolved as coverage in favor of the insured . . . .[118]

Travelers continued:

> [T]he form policy was selected and prepared by [the plaintiff insurance company]. It must suffer the consequence of the carelessness of its own draftsmanship. If there exists a possibility of an interpretation by

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adverse to the industry, insureds having virtually no choice at all but to purchase the industry-wide standard CGL policy.

116. *See* David B. Goodwin, *Disputing Insurance Coverage Disputes*, 43 STAN. L. REV. 779, 798 n.5 (1991).

117. Reply Brief of Respondent CNA Casualty of California in Reply to Appellants Seaboard Surety Company and Insurance Company of North America and Opening Brief of Cross-Appellant CNA Casualty of California at 20 (filed Aug. 16, 1984), CNA of California Cas. v. Seaboard Sur. Co., 222 Cal. Rptr. 276 (Cal. Ct. App. 1986) (No. 761572).

118. Brief for Defendant-Appellee Travelers Ins. Co. at 22, First State Underwriters Agency of New England Reinsurance Corp. v. Travelers Ins. Co., *rev'd and remanded*, 803 F.2d 1308 (3d Cir. 1986) (Nos. 85-5104, 85-5341).

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> providing coverage from the viewpoint of the reasonable expectations of the insured, the court must conclude that coverage exists.[119]

Continental Casualty Co.:

> [T]he California Supreme Court has recently and unanimously held that even where the policyholder is sophisticated (even to the extent of operating a subsidiary that drafted CGL policies identical to those at issue in the case), the usual rule of interpreting ambiguities in favor of the policyholder applies where standard form policy language is involved.[120]

Again from *Continental Casualty Co.*:

> The [defendant insurance company] recognizes . . . that any ambiguities in an insurance policy should be construed strictly against the insurer and in favor of the insured . . . [but] argues that the rule should not be applied in this case because [the policyholder] is a 'sophisticated' corporate entity . . . . [I]n this case there is ample evidence on the record that [the policyholder] would have had very limited bargaining power in obtaining the [defendant insurance company's] policy because few general liability carriers were willing to write the sort of coverage sought by [the policyholder].[121]

The court accepted Continental's argument. Commercial Union Insurance Company then relied upon the favorable decision to argue against the "sophisticated" policyholder:

Commercial Union:

> [Commercial Union, citing Continental Cas. v. Canadian Universal Ins. Co.] follows the general rule that the

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119. *Id.* at 23.

120. Plaintiff Metropolitan's Memorandum of Points and Authorities in Opposition to Defendant CalFarm's Motion for Summary Judgment at 11 (dated May 22, 1991), Metropolitan Life Ins. Co. v. Calfarm Ins. Co. (Cal. Super. Ct.) (No. 419329-8) (citing AIU Ins. Co. v. Superior Court, 51 Cal. 3d 807, 815, 823-24 (1990)).

121. Brief for Plaintiff-Appellee Continental Cas. Co. at 12-13, Continental Cas. Co. v. Canadian Universal Ins. Co., 924 F.2d 370 (1st Cir. 1991) (Nos. 90-1406, 90-1491).

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> 'sophisticated insured' (or equal bargaining power) exception does not apply when the insured, no matter how large or 'sophisticated', has no actual participation in drafting the contract language.[122]

Hartford Life Insurance Co.:

> The [defendant insurance company] made the superficial comment that Hartford's argument . . . is 'perhaps a bit shameful to be made by a major insurance company.' Hartford, however, is not, and never has been, involved in the title insurance business. Its normal practice of requiring title insurance of its real estate investments and relying on the expertise of the title insurance companies is no different from a labor lawyer seeking the advice of a tax lawyer with regard to his personal income tax problems, or a medical general practitioner referring his wife to a gynecologist.[123]

Despite their arguments, insurance companies treat large commercial and individual policyholders similarly in another respect: like the individual policyholder, the "sophisticated" policyholder does not receive the policy until weeks or months after the premium has been paid.

VI. THE REASONABLE EXPECTATIONS DOCTRINE AND CONTRACT LAW: WHAT MAKES INSURANCE POLICIES DIFFERENT FROM OTHER PRODUCTS

Traditional contract law provides an incentive for insurance companies to breach the insurance policies they sell to policyholders:

> The traditional goal of the law of contract remedies has not been compulsion of the promisor [e.g. the insurance company] to perform but compensation of the promisee

122. Brief of Appellant Commercial Union Ins. Co. at 39, Commercial Union Ins. Co. v. Walbrook Ins. Co., 7 F.3d 1046 (1st Cir. 1993) (No. 92-2415) (citing Continental Cas. Co. v. Canadian Universal Ins. Co., 924 F.2d 370, 375 (1st Cir. 1991)).

123. Reply Brief of Appellant Hartford Ins. Co. at 11, Hartford Life Ins. Co. v. Title Guar. Co., 520 F.2d 1170 (D.C. Cir. 1975) (Nos. 74-1451, 74-1461).

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> [e.g., the policyholder] for the loss resulting from the breach.[124]

But insurance is different. The Supreme Court of Delaware explained:

> Insurance is different . . . . Unlike other contracts, the insured has no ability to 'cover' if the insurer refuses without justification to pay a claim. Insurance contracts are like many other contracts in that one party (the insured) renders performance first (by paying premiums) and then awaits the counter-performance in the event of a claim. Insurance is different, however, if the insurer breaches by refusing to render the counter-performance. In a typical contract, the non-breaching party can replace the performance of the breaching party by paying the then-prevailing market price for the counter-performance. With insurance this is simply not possible. This feature of insurance contracts distinguishes them from other contracts. . . .[125]

A. Why Opportunistic Breach Has No Place In Insurance Law

Under contract law, an opportunistic breach is efficient "when it creates sufficient benefit such that promisor [the insurance company] can compensate promisee [the policyholder] fully and still be better off by breaching than by performing and leaving one party better off and no one worse off."[126] This is never true in cases involving a wrongful denial of insurance coverage. Commentators have recognized that opportunistic breach by insurance companies against their policyholders is especially inappropriate, because contract law remedies cannot truly "make whole" a policyholder wrongfully denied insurance coverage:

> The law wishes to prevent what Richard Posner calls 'opportunistic breach' or breach designed to take

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124. RESTATEMENT (SECOND) OF CONTRACTS, Introductory note, Ch. 16, at 100 (1979).

125. E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 447 (Del. 1996). The court also noted that these differences justified "the availability of punitive damages for breach in limited circumstances." *Id.* Note that *Pressman* is not an insurance case.

126. *See* David W. Barnes, *The Meaning of Value in Contract Damages And Contract Theory*, 46 AM. U.L. REV. 1, 3 (1996).

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> advantage of the vulnerable promisee. . . . Ordinarily the law limits recovery to expectation damages in order to foster efficient breaches. But insurance contracts are perceived differently. Insurance is far from the market ideals of complete information and no transaction costs. Opportunistic breaches are especially likely, and traditional damage rules do not sufficiently deter them. Additionally, it is the very nature of the insurance contract that payment is to be made automatically without the need for a lawsuit. As one court summarized it:
>
> > The benefit contracted for by an insured under the terms of a policy is the availability of money promptly upon the occurrence of a particular event. When an insurer refuses unreasonably to make a payment of the benefit due, or when the insurer does not pay promptly, it deprives the insured of the essence of the bargain. The insured bargained for prompt payment, not a right of action against the insurer.[127]

Also consider that insurance transactions are completed sequentially, with the policyholder first paying the premium, in exchange for the insurance company's promise to provide insurance coverage in the future.

> Sequencing has many advantages, but it creates an unfortunate incentive. Having received its benefit from the bargain, the party who is to perform last may be tempted to renege on its obligations. Law and economics scholars often describe the conduct of a reneging party in these situations as 'opportunistic.' The reneging party,

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127. Mark Pennington, *Punitive Damages For Breach of Contract: A Core Sample From The Last Ten Years*, 42 ARK. L. REV. 31, 54 (1989). The second portion of the quote above is taken from a decision which was later vacated. *See* discussion at Section VIII(C)(2), below, discussing routine *vacatur* of decisions by insurance companies. Kanne v. Connecticut Gen. Life Ins. Co., 607 F. Supp. 899, 907 (C.D. Cal. 1985), *aff'd in part and rev'd in part*, 819 F.2d 204 (9th Cir. 1986), *op. withdrawn, reh'g granted*, 823 F.2d 284 (9th Cir. 1987), *vacated*, 859 F.2d 96 (9th Cir. 1988), *cert. denied*, 492 U.S. 906 (1989).

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> perceiving an opportunity to increase its gain, yields to temptation and refuses to perform.[128]

The leading text in law and economics defines the economic value of something as "how much someone is willing to pay for it or, if he has it already, how much money he demands for parting with it."[129] Unlike a contract, to a policyholder, an insurance policy is not a widget and it is not simply a contract to pay money. It is a product.[130] It is peace of mind and

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128. G. Richard Bell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward A New Cause of Action*, 44 VAND. L. REV. 221, 222 (1991) (footnote omitted; arguing that pre-contractual opportunism should be recognized by courts and regulated).

129. *See* David W. Barnes, *The Meaning of Value in Contract Damages And Contract Theory*, 46 AM. U.L. REV. 1, 2 (Oct. 1996) (quoting RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 31 (4th ed. 1992)).

130. An insurance policy is a product, not a mere contract right. Courts and insurance companies have referred to insurance policies as products. *See, e.g.*, U.S. Healthcare v. Blue Cross, 898 F.2d 914, 917 (3d Cir. 1990); Omega Nat'l Ins. Co. v. Marquardt, 799 P.2d 235 (Wash. 1990) (upholding state insurance commissioner's rule aimed at "banishing certain offensive insurance products from the state marketplace" because the policies were "inherently unfair to insurance purchasers"); State Farm Mut. Auto. Ins. Co. v. Wyoming Ins. Dep't, 793 P.2d 1008, 1016 (Wyo. 1990) (insurance policyholders are "purchasers of the product"); New Mexico Life Ins. Guar. Ass'n v. Quinn & Co., 809 P.2d 1278, 1284 (N.M. 1991); National Claims Assoc. v. Division of Employment, 786 P.2d 495, 498 (Colo. Ct. App. 1989); C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 178 (Iowa 1975); Batton v. Tennessee Farmers Mut. Ins. Co., 736 P.2d 2, 5-6 (Ariz. 1987) (en banc). *See also* Letter from Allstate agent to policyholder (Apr. 24, 1995) (on file with the authors); Special Notice from Aetna Life & Casualty to Aetna policyholders (ed. 11-88) (on file with the authors); INSURANCE AND REINSURANCE TRENDS (Dec. 1994) at 10.

Because insurance policies are products, some courts have also recognized implied warranties in the sale of an insurance policy. *See, e.g.*, Carper v. State Farm Mut. Ins. Co., 758 F.2d 337 (8th Cir. 1985) (theory of implied warranty for a particular purpose focuses on the circumstances present at the time the insurance policy is sold). The Supreme Court of Iowa has held that a standard form insurance policy was subject to the implied warranty of fitness for its intended purpose. *C & J Fertilizer, supra.* Similarly, the Supreme Court of Arizona has held that selling an insurance policy is no different than selling a product. *Batton, supra.* The recognition of an implied warranty of fitness in the sale of an insurance policy was summarized by a Missouri court as follows:

> Although implied warranties of fitness for intended purpose have traditionally been attached only to sales of tangible products, there is no reason why they should not be attached to "sales of promises" as well. Whether a product is tangible or intangible, its creator ordinarily has reason to know of the purposes for which the buyer intends to use it,

an expectation that the policyholder is protected. It is an obligation backed by a fiduciary duty and a duty of good faith by the insurance company which sold the policyholder the insurance coverage.[131] All of these concepts are promoted by insurance companies.[132]

Opportunistic breach, however, is wholly inconsistent with the purposes of insurance. An insurance company that breaches its promise to provide insurance coverage can *only* leave a policyholder worse off than if the promise were fulfilled. A policyholder can *never* win when an insurance company opts for an opportunistic breach.[133] Moreover, unlike

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> and buyers ordinarily rely on the creator's skill or judgment in furnishing it.

Estrin Constr. Co. v. Aetna Cas. & Sur. Co., 612 S.W.2d 413, 424 n.10 (Mo. Ct. App. 1981) (quoting W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 546-47 (1971)).

131. For an argument that insurance companies do not owe policyholders a fiduciary duty, see William T. Barker et al., *Is an Insurer a Fiduciary to Its Insureds?*, 25 TORT & INS. L.J. 1 (1989); William T. Barker, *Fiduciary Duty, R.I.P.*, 6 BAD FAITH L. REV. 107 (1990). Mr. Barker regularly represents insurance companies.

132. *See* discussion at Section VI(C), *infra*, concerning insurance companies' fiduciary duties and duty of good faith and fair dealing. *See also* Section VII, below, concerning the effects of insurance company advertising.

133. *See, e.g.*, West Am. Ins. Co. v. Freeman, 46 Cal. App. 4th 1476 (Cal. Ct. App. 1st Dist. 1995), *rev. granted*, 907 P.2d 1323 (Cal. 1995), *rev. dismissed*, 927 P.2d 1172 (Cal. 1996), *rev. denied*, No. S049306, 1997 Cal. LEXIS 649 (Cal. Feb. 5, 1997), *cert. denied*, __ U.S. __, 117 S.Ct. 1695 (1997). Note that the appellate decision was superseded by the California Supreme Court's grant of review and that publication has not been reinstated. *See* Cal. Rules of Court 976, 977. In this case, the policyholder, a contractor, was sued for alleged construction defects. The position of the policyholder's insurance company was that if the policyholder refused to accept the proposed settlement, the policyholder would be responsible for any settlement or judgment which exceeded the proposed settlement amount and responsible for any additional legal fees incurred in his defense. The insurance company never attempted to exonerate the policyholder or to join the parties more likely to be at fault because it wanted to minimize its expenses. This was despite expert testimony from five witnesses who each had concluded that the policyholder was not at fault for any defects, and despite the policyholder's desire to clear his name. Trial testimony also indicated that since the insurance company's greatest expense was usually attorneys fees, the insurance company had made a "policy" decision to seek reimbursement from policyholders in cases where the insurance company had been required to pay for *Cumis* counsel.

After the policyholder agreed to settle because "he could not afford to take on the insurance company," the insurance company sued *him* to recover the amount of the settlement and for the legal fees it had incurred in the policyholder's "defense." The policyholder counterclaimed, claiming breach of contract and breach of the duty of good faith and fair dealing. In all, the policyholder incurred over $320,000 in legal fees. He lost

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an insurance company, it is impossible for a policyholder to opt for an opportunistic breach. The policyholder has nothing tangible—only a promise from the insurance company that it will provide insurance coverage—and an assurance of peace of mind. The insurance company already has the policyholder's premium dollars. If the premium is not paid, the insurance is cancelled.

Unlike other products, or contracts generally, breach of an insurance policy does not involve a third party vying for what the insurance company has already promised to sell to the policyholder—the policyholder's insurance coverage. Rather, the insurance company merely wants to hold on to the policyholder's money for as long as it can.[134] In a February 1985 letter to shareholders, Chairman Warren Buffet of Berkshire Hathaway, Inc., the corporate parent to several insurance companies, recognized the obligations and unique qualities of an insurance company:

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his business and his assets. He had already paid more than $60,000 in premiums to the insurance company for his liability insurance. There was evidence that the insurance company may have lied about the destruction of its documents.

A jury awarded the policyholder $12 million in punitive damages against the insurance company. In affirming the award, a California appellate court held that "the award was based on the reprehensibility of [the insurance company's] conduct toward [the policyholder] and its failure to accord [the policyholder] the consideration to which he was entitled." The appellate court accorded great weight to the trial court's findings:

> [T]he conduct of the insurance company in this case was egregious . . . [the insurance company's claims adjuster] somehow seemed to determine that he wasn't going to cover this claim, and that he would do what he wanted despite the evidence to the contrary. He exhibited an absolute total disregard for [the policyholder's] rights under the contract, and for his rights as a person to be treated decently.

134. *See* Mark Pennington, *Punitive Damages For Breach of Contract: A Core Sample From The Last Ten Years*, 42 ARK. L. REV. 31, 54 (1989):

> With regard to claims for small amounts of money, the insurance company has some incentive to refuse payment because little likelihood exists that the claimant will pursue the claim. As for large claims, the insurance company may find it profitable to delay payment as long as possible to keep for itself the time value of the amount due. Finally, prolonged delays in payment may make the insured more willing to settle for less than the amount due, particularly if the insured is financially desperate.

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> The buyer of insurance receives only a promise in exchange for his cash. The value of that promise should be appraised against the possibility of adversity, not prosperity. At a minimum, the promise should appear able to withstand a prolonged combination of depressed financial markets and exceptionally unfavorable underwriting results.[135]

No less than a textbook used to train insurance company personnel has emphasized that an insurance policy is more than a mere contract right:

> Notwithstanding the often stated opinion that the insurance contract is affected with a public interest, insurers often view their policies as simple contractual obligations between parties. While an insurance policy does represent a contractual commitment, *the attitudes of the general public, the legislatures, and the courts make clear that the insurance agreement is viewed as having broader ramifications than a mere contract.* The public has a definite interest in the reliability of the insurance product. Insurance involves an obligation that affects the public interest as well as the policyholder and therefore is necessarily subject to certain restrictions.[136]

Insurance companies owe their policyholders a long term obligation. Unfortunately, contract damage rules create incentives for parties to breach when the subject matter of the contract can be devoted to a more valuable use.

Insurance companies litigation abilities, when combined with policyholders' financial vulnerability and strict enforcement of contract law, virtually guarantee an insurance company victory against an aggrieved policyholder. Exploiting policyholders' financial vulnerability can be a lucrative business. An insurance company is a financial colossus with unmatched resources and expertise in insurance coverage litigation.[137] In

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135. Letter from Warren Buffet, Chairman of Berkshire Hathaway Inc., to the shareholders of Berkshire Hathaway Inc. at 9 (Feb. 25, 1985) (on file with the authors).

136. 1 LORIMER ET AL., THE LEGAL ENVIRONMENT OF INSURANCE 37-38 (3d ed. 1987) (emphasis added).

137. THE FACT BOOK 1998: PROPERTY/CASUALTY INSURANCE FACTS 5 (Insurance Information Institute 1998) (the insurance industry "[a]ltogether . . . has responsibility for

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stark contrast to the typical policyholder's experience, litigation is the bread and butter of insurance companies. In large part, litigation *is* their business. Insurance companies now admit that they are waging a "war" against policyholders.[138] In this "war," insurance companies are "institutional litigants." Insurance companies boast that they have filed "tens of thousands of briefs across the country in a number of courts and in a vast variety of contexts" against their policyholders.[139] According to the former president of the Alliance of American Insurers, "[t]he liability system is fuel for the insurance engine."[140] Claims exceeding $10 million are seldom resolved without litigation.[141] In fact, the insurance industry admits that it spends over $1 billion a year battling their policyholders in court.[142] This insurance industry strategy of insurance nullification by

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assets totalling $3.1 trillion at the end of 1996. The property/casualty segment of the business is responsible for assets totalling $802.3 billion at the close of 1996"). *See also* HOUSE SUBCOMMITTEE, 1030 CONG., A WORLD VIEW OF INSURANCE INSOLVENCY REGULATION III (Comm. Print 1994) (describing insurance as "a $2.3 trillion financial industry...").

138. *See, e.g.,* Memorandum of Law of CNA in Support of Motion To Strike Amended Counterclaims, Cross-Claims and Third-Party Complaint of General Battery at 1, Continental Cas. Co. v. General Battery Corp., No. 93C-11-008, 1994 WL 682320 (Del. Super.). The CNA Insurance Group is comprised of approximately forty-seven insurance companies. *See* BEST'S INSURANCE REPORTS: PROPERTY-CASUALTY UNITED STATES (1997 ed.).

139. *See* Brief and Appendix of Amicus Curiae Insurance Environmental Litigation Association (IELA) in Support of Continental Insurance Company, Aetna Casualty and Surety Company and Fireman's Fund Insurance Company of Newark, N.J. at 25, n.21, County of Columbia v. Continental Ins. Co., 595 N.Y.S.2d 988 (App. Div. 3d Dep't 1993) (No. 65588).

140. Franklin Nutter, *Search for Stability: Industry Must Solve Problems that Undermine a Stable Market*, BUS. INS., June 17, 1985, at 21.

141. *See* Richard A. Archer, *Preparing For A 'Mega-Loss'*, BUS. INS., Oct. 10, 1994, at 23. Mr. Archer is the retired deputy chairman of Jardine Insurance Brokers, Inc. *See also* L. Brenner, *The Polluted Open Box*, CORP. FIN., June/July 1995 at 34, 35 ("No matter what the policy language, if there's a significant seven-digit claim, it's not going to be covered [by the policyholder's insurance company]."); *See also* Eugene R. Anderson, et al., *Insurance Nullification By Litigation*, RISK MGMT., Apr. 1994 at 46.

142. *See* Brief of Amicus Curiae American Ins. Assoc. at 3, Affiliated FM Ins. Co. v. Constitution Reinsurance Corp., 626 N.E.2d 878 (Mass. 1994) (No. SJC-06165); Leslie Schism, *Tight-Fisted Insurers Fight Their Customers To Limit Big Awards*, WALL ST. J., Oct. 15, 1996, at A1. Moreover, the $1 billion figure includes only what the insurance industry spends on property and casualty insurance litigation. When life and health insurance litigation expenditures are added, "the legal costs of coverage battles with policyholders may far exceed $1 billion[.]" Robert H. Gettlin, *Fighting The Client*, BEST'S REV. P/C, Feb. 1997, at 49, 50.

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litigation has not escaped the attention of the courts.[143] As the Chairman of Dow Corning has said, "it has become standard procedure for some insurance companies to procrastinate and dispute rather than honor policies with companies that become embroiled in litigation."[144] Insurance industry trade associations regularly file anti-policyholder briefs, and the insurance industry even has a trade association devoted solely to anti-policyholder litigation.[145]

Litigation costs for policyholders, potentially enormous to begin with, and are even more heightened because lawyers representing policyholders must "reinvent wheels." Insurance companies, on the other hand, with vast experience in litigating against policyholders, can simply reuse some of their "tens of thousands" of briefs. National Casualty summarized the reality of litigating an insurance company as follows: "It is preferable to litigate multi-insurer coverage disputes between insurers than it is between insurers and insureds, who often lack the resources to wage these disputes."[146] Indeed, as Liberty Mutual Insurance Company recognized:

> [the policyholder] is likely not as familiar with litigation and claims evaluation and disposition as is the insurance company . . . . [T]he insurer is a professional defender of lawsuits . . . . Unlike the insured, an [insurance company] is not a novice as to matters involving litigation.[147]

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143. *See, e.g.,* Miller v. Fluharty, 500 S.E. 2d 310, 318, n.10 (W. Va. 1997) (noting that the disparity of bargaining power between an insurance company and its policyholder "is apparent in the fact that insurance companies spend over $1 billion annually in litigation battles against policyholders") (citing Eugene R. Anderson and Joshua Gold, *Recoverability of Corporate Counsel Fees in Insurance Coverage Disputes*, 20 AM. J. TR. ADV. 1, 3 n.5 (1996)).

144. Richard Hazleton, *The Tort Monster That Ate Dow Corning*, WALL ST. J., May 17, 1995, at A21.

145. *See* IELA Amicus Curiae Brief, *supra* note 139. The IELA is a group of the approximately twenty largest insurance companies which have banded together to regularly assist each other—and other large insurance companies—in litigating against policyholders. Even the largest corporate policyholders cannot match this combined insurance industry might.

146. Reply Brief of Petitioner National Casualty Company at 9, National Cas. Co. v. Great Southwest Fire Ins. Co., 833 P.2d 741 (Colo. 1992) (No. 91 SC 562).

147. Liberty Mutual Insurance Company's Memorandum in Support of Motion for Partial Summary Judgment at 7, National Union Ins. Co. v. Liberty Mut. Ins. Co., 696 F. Supp. 1099 (E.D. La. 1988) (No. 86-2000). Liberty Mutual has been sanctioned for being a "major league team" in the game of "hardball litigation." *See* Adolph Coors Co. v. American Ins. Co., 164 F.R.D. 507, 509 (D. Colo. 1993).

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The nature of the insurance business is clear: "The insurance company is in no hurry. It has the money. It has your premium. It has an army of lawyers."[148]

Opportunistic breach should have absolutely no place in insurance law. Unfortunately, contract law *promotes*, not discourages, opportunistic breach.[149] The reasonable expectations doctrine, by going beyond traditional contract analysis and the language of the policy, enables courts to fully compensate a policyholder for all of the damage caused by a wrongful denial of insurance coverage.

B. Insurance Industry and Judicial Recognition That Insurance Companies Are Fiduciaries

Permitting insurance companies to opportunistically breach their insurance policies is particularly unfair in light of the fiduciary duty insurance companies owe their policyholders. Who says insurance companies owe their policyholders a fiduciary duty?:

Fireman's Fund does:

> An insurer stands in a fiduciary relationship to its insured; when an insurer chooses his interest over the interests of his insured his actions are indeed 'intentional and deliberate' . . . and when a case can be settled with no personal liability to said insured, [failure to do so] has the 'character of outrage frequently associated with crime'.[150]

Continental Casualty does:

> It has been held that an insurer who issues a [comprehensive general liability policy] is under a

148. Herb Denenberg, *How Insurance Companies Avoid Payment of Claims*, READING EAGLE, May 26, 1995, at A12. Mr. Denenberg is a former Commissioner of Insurance for Pennsylvania and Professor of Insurance at the Wharton School of the University of Pennsylvania.

149. David W. Barnes, *The Meaning of Value in Contract Damages And Contract Theory*, 46 AM. U. L. REV. 1, 2 (1996).

150. Civil Action—Cross Petition for Certification and Brief in Opposition to Defendant-Appellant Petition for Certification at 13, Fireman's Fund Ins. Co. v. Security Ins. Co. of Hartford, 367 A.2d 864, 866 (N.J. 1976) (No. 1, 223) (court finding that the insurance company acted "in disregard to its acknowledged fiduciary duty to its insured").

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fiduciary duty to look after the interests of the insured as well as its own interests.[151]

Continental Insurance Company does:

Representing the insured is clearly a 'fiduciary' situation, especially in view of the fact that improper conduct by the insurer could expose the insured to liability beyond the amount of his insurance protection.[152]

National Union (an AIG company) does:

Underlying all forms of insurance is a fiduciary duty to some extent simply because of the insurer's expertise in the area of its business. In the public liability area the fiduciary duties are heavier because the insurance company is an expert in the litigation arena in all parts of the country since it has thousands of cases nationwide and trained personnel to handle them.[153]

Liberty Mutual does:

[T]he cases have readily acknowledged that the insurer-insured relationship gives rise to a fiduciary duty.[154]

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151. Continental Casualty Company's Memorandum of Law For Trial at 27 (filed Sept. 11, 1990) Continental Cas. Co. v. Great Am. Ins. Co., No. 86-C-3938, 1990 U.S. Dist LEXIS 12807 (N.D. Ill. Sept. 28, 1990). *See also* Continental Cas. Co. v. Great Am. Ins. Co., 711 F. Supp. 1475, 1481-82 (N.D. Ill. 1989) (in earlier related decision, court rejected Great American's request for summary judgment on the issue of the duty of good faith and fair dealing; issue of bad faith departure from company or industry custom was question for jury in light of evidence that Great American had previously involved itself in defense and settlement of claims, though not contractually obligated to do so).

152. Memorandum in Opposition to Plaintiff's Cross-motion to Dismiss Defendants' First and Second Defenses and Plaintiff's Request For Leave to Further Amend its Amended Complaint at 9-10, New York Univ. v. Continental Ins. Co., 209 A.D.2d 231 (N.Y. Sup. Ct. 1994) (No. 11627/92), *rev'd*, 662 N.E.2d 763 (N.Y. 1995).

153. Memorandum in Opposition To Columbia Cas. Co. Motion For Summary Judgment at 18, Columbia Cas. Co. v. National Union Fire Ins. Co. of Pittsburgh, Pa., (E.D. Pa. 1989) (No. 89-3506).

154. Memorandum of Law in Support of Plaintiff's Response at 6, Liberty Mut. Ins. Co. v. Paper Mfrs. Co., 753 F. Supp. 156 (E.D. Pa. 1990) (No. 90-3787).

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Home does:

> [A]n insurer is in a fiduciary relationship to its insured.[155]

St. Paul Fire and Casualty does:

> St. Paul owes a fiduciary duty to [the plaintiff]. We don't contest that . . . . We owe a fiduciary duty to every one of our policyholders . . . .[156]

Hartford does:

> The standard which attaches to the insurer-insured relationship is fiduciary in nature. . . . [G]reat weight must be placed upon the character of an insurance policy as a contract of adhesion . . . which the insurer, as the dominant party, must honor as a fiduciary. . . .[157]

Insurance companies often argue for a fiduciary duty when suing *their* insurance company, e.g., an excess, umbrella or co-insurance company. In the process, the insurance company may make two points. For example:

American Centennial:

> The primary carrier owes to the excess carrier the same fiduciary obligation which the primary insurer owes to its insured.[158]

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155. Defendant's Requested Jury Instructions, Defendant's Proposed Instruction No. 2, Georgetown Realty, Inc. v. Home Ins. Co., (Oregon Cir. Ct., Multnomah Cty.) (No. A8708-05098).

156. Motion For Summary Judgment Hearing, Transcript at 24, Richland Valley Prods. v. St. Paul Fire & Cas. Co. (Wis. Cir. Ct.) (No. 92CV149), *rev'd*, 548 N.W.2d 127 (Wis. Ct. App. 1996) (No. 94-1837).

157. Brief and Volume I of Appendix of Plaintiff-Appellant, Hartford Accident & Indem. Co. at 11-12, Hartford Accident & Indem. Co. v. Aetna Life & Cas. Ins. Co., (N.J. Super. Ct. App. Div.) (No. A-1595-82T2), *aff'd*, 483 A.2d 402 (N.J. 1984) (quoting Griggs v. Bertram, 443 A.2d 163, 173 (N.J. 1982)).

158. Application for Writ of Error of American Centennial Ins. Co. and First State Ins. Co. at 20, American Centennial Ins. Co. v. Canal Ins. Co., 843 S.W.2d 480 (Tex. 1992) (No. D-1213).

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Hartford Steam Boiler perhaps best explained the reason for recognizing a fiduciary duty:

> The essence of a fiduciary relationship is that the fiduciary agrees to act as his principal's alter ego rather than to assume the standard arm's length stance of traders in a market. Hence the principal is not armed with the usual wariness that one has in dealing with strangers; he trusts the fiduciary to deal with him as frankly as though he would deal with himself—he has bought candor.[159]

These are merely a few examples. They are not, however, sporadically made assertions. Here is Hartford, again, arguing that *its* insurance company owes it a fiduciary duty:

> The primary carrier owes the excess carrier the same fiduciary obligation which the primary insurer owes its insured, namely, a duty to proceed in good faith and in the exercise of honest discretion, the violation of which exposes the primary carrier to liability beyond its policy limits.[160]

Here is Liberty Mutual, again, making the same argument in a different case:

> When determining whether an insurer breached its duty to its insured . . . the appropriate standards to employ are described by cases involving the very issue at hand, i.e., the fiduciary duty of an insurer to act with the utmost good faith in its handling of the claims against the insured.[161]

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159. Memorandum of Law Re Motion to Compel at 64 (filed Nov. 29, 1994), Hartford Steam Boiler Inspection and Ins. Co. v. Industrial Risk Insurers, No. CV-94-705105, 1994 Conn. Super LEXIS 3088 (Conn. Super. Ct. Dec. 7, 1994) (quoting United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985).

160. Brief of Plaintiff-Respondent at 11, Hartford Accident & Indem. Co. v. Michigan Mut. Ins. Co., 463 N.E.2d 608, 610 (N.Y. 1984) (citations omitted).

161. Appellant's Reply Brief at 9-10, General Star Nat'l Ins. Co. v. Liberty Mut. Ins. Co., 960 F.2d 377 (3rd Cir. 1992) (No. 91-1497) (contrary to excess insurance company's arguments, finding no evidence of dishonesty by primary insurance company to policyholder).

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Again as well, National Union:

> [L]egal authorities have declared the relation of insured and insurer to be fiduciary and to require of the parties the utmost good faith in their dealings . . . . Whenever a contract is in its essential nature intrinsically fiduciary, the utmost good faith and fullest disclosure of material facts are required from the parties . . . . Any concealment of a material fact known to a party would necessarily be fraudulent. The most familiar and illustrative example of such contracts is that of insurance.[162]

Insurance companies clearly understand the fiduciary duties owed to their policyholders. So do the courts.[163] Allowing insurance companies to

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162. Defendant National Union Fire Ins. Co. of Pittsburgh, Pa.'s Reply Memorandum in Support of its Motion for Summary Judgment at 23, In re: Cardinal Industries, Inc. (S.D. Ohio) (No. C-2-94-254) (internal quotations and citation omitted).

163. *See* United States v. Brennan, 938 F. Supp. 1111 (E.D.N.Y 1996), appeal pending:

> Broadly stated, a fiduciary relationship is one founded upon trust or confidence reposed by one person in the integrity and fidelity of another. It is said that the relationship exists in all cases in which influence has been acquired and betrayed. The rule embraces both technical fiduciary relations and those informal relations which exist whenever one man trusts in, and relies upon, another. . . .

Id. at 1120.

The *Brennan* court rejected insurance company arguments that an insurance company owes no fiduciary duty to a "sophisticated" policyholder. *Id.* at 1121. *See also* 2 EUGENE R. ANDERSON, ET AL., INSURANCE COVERAGE LITIGATION § 11.6, at 16-18 (Aspen 1997); Randy Papetti, Note, *The Insurer's Duty of Good Faith in the Context of Litigation*, 60 GEO. WASH. L. REV. 1931, 1933 at n.10 (1992) (Mr. Papetti generally supports positions regularly advocated by the insurance industry); Gibson v. Western Fire Ins. Co., 682 P.2d 725, 730 (Mont. 1984) (citation omitted); Stetler v. Fosha, 809 F. Supp. 1409, 1422 (D. Kan. 1992), *aff'd without op.*, 7 F.3d 1045 (10th Cir. 1993); Village of Morrisville Water & Light Dep't v. United States Fidelity & Guar. Co., 775 F. Supp. 718, 734 (D. Vt. 1991); Corrado Bros. v. Twin City Fire Ins. Co., 562 A.2d 1188, 1192 (Del. 1989) (insurance company-policyholder relationship is analogous to fiduciary relationship) *aff'g* No. Cov. A.

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85C-MY-7, 1988 WL 25373 (Del. Super. Mar. 16, 1988); Florida Farm Bureau Mut. Ins. Co. v. Rice, 393 So. 2d 552, 555 (Fla. Dist. Ct. App. 1980); Illinois Masonic Med. Ctr. v. Turegum Ins. Co., 522 N.E.2d 611, 613 (Ill. App. Ct. 1988); Pareti v. Sentry Indem. Co., 536 So. 2d 417, 423 (La. 1988); Fireman's Fund Ins. Co. v. Continental Ins. Co., 519 A.2d 202, 204 (Md. 1987); Lisiewski v. Countrywide Ins. Co., 255 N.W.2d 714, 717 (Mich. Ct. App. 1977); Varnal v. Weathers, 619 S.W.2d 825, 828 (Mo. Ct. App. 1981); Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 323 A.2d 495, 504 (N.J. 1974). *But see* Rawlings v. Apodaca, 726 P.2d 565, 571 (Ariz. 1985) ("[A]lthough the insured is entitled to expect that the insurer will be 'on his side'. . . we do not go so far as to hold that the insurer is a fiduciary.").

In the claims handling environment, it is very clear that insurance companies owe their policyholders a fiduciary duty. *See* Allstate Ins. Co. v. American Transit Ins. Co., 977 F. Supp. 197 (E.D.N.Y. 1997) (primary insurance company owes fiduciary duties to an excess insurance company); Hartford Accident & Indem. Co. v. Commercial Union Ins. Co., 772 F. Supp. 741 (E.D.N.Y. 1991) (same); Employers Mut. Cas. Co. v. Key Pharms., No. 91 Civ. 1630, 1992 U.S. Dist. LEXIS 11091 (S.D.N.Y. July, 27 1992) (excess insurance company could not withhold from the policyholder documents regarding the underlying litigation and settlement; issue was not "privity or the lack of privity, but defendants' fiduciary obligations"); Highlands Ins. Co. v. National Union Fire Ins. Co., 27 F.3d 1027 (5th Cir. 1994) (insurance company which sold primary policy owed its excess insurance company the same fiduciary obligation it owed its policyholders); Royal Globe Ins. Co. v. Chock Full O' Nuts Corp., 86 A.D.2d 315 (N.Y. App. Div. 1982) (policyholder allowed to maintain breach of fiduciary duty counterclaim for alleged breach of contract and negligence in handling claims under workers' compensation and employers liability policies); United Nat'l Ins. Co. v. Waterfront N.Y. Realty, 948 F. Supp. 263 (S.D.N.Y. 1996) (insurance company's fiduciary duty to the policyholder requires that the insurance company's loyalty be undivided); New York v. Blank, No. 88-CV-163, 1991 U.S. Dist. LEXIS 14582, at *27 (N.D.N.Y. Oct. 10, 1991), *aff'd in relevant part*, 27 F.3d 783 (2d Cir. 1994) (court agreed with policyholders' observation that "the Insurers' efforts in these summary judgment motions to in effect prove its insureds' liability in the underlying action may be a breach of their fiduciary obligations to their insureds" (quoting Hartford Accident & Indem. v. Michigan Mut. Ins. Co., 93 A.D.2d 337, 340-41 (N.Y. App. Div. 1983), *aff'd*, 463 N.E.2d 608 (N.Y. 1984)); Fireman's Fund Ins. Co. v. Security Ins. Co., 367 A.2d 864 (N.J. 1976) (holding that primary insurance company's failure to settle was in "disregard of its acknowledged fiduciary duty to its insured"); Dornberger v. Metropolitan Life Ins. Co., 961 F. Supp. 506 (S.D.N.Y. 1997) (basis for the fiduciary obligation is quite clear in the litigation context and that under the right circumstances, the relationship between the insurance company and policyholder in non-litigation environment may be imbued with elements of trust and confidence to create a fiduciary duty); Zurich Ins. Co. v. State Farm Mut. Auto. Ins. Co., 137 A.D.2d 401 (N.Y. App. Div. 1988) (primary insurance company owes the same fiduciary obligation to its excess insurance company as it owes to its policyholder); Argonaut Ins. Co. v. Hartford Accident & Indem. Ins. Co., 687 F. Supp. 911 (S.D.N.Y. 1988) (same); Myers v. Ambassador Ins. Co., Inc., 508 A.2d 689, 691 (Vt. 1986) ("[t]he insurer's fiduciary duty to act in good faith when handling a claim against the insured obligates it to take the insured's interests into account."); Ampower Semiconductor Corp. v. American Motorists Ins. Co., 159 A.D.2d 268, 522 N.Y.S.2d 269 (N.Y. App. Div.

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opportunistically breach their insurance policies makes a mockery of insurance companies' fiduciary duties—duties which they openly acknowledge. By acknowledging their fiduciary duties to policyholders, insurance companies admit that their responsibilities to their policyholders go far beyond the letter of the policy. The reasonable expectations doctrine enforces this insurance company admission.

C. Opportunistic Breach Conflicts With Insurance Companies' Duty of Good Faith and Fair Dealing

Insurance companies owe policyholders a duty of good faith and fair dealing. The duty of good faith and fair dealing implicitly requires insurance companies to be fair and honest with their policyholders:[164]

> The duty of good faith and fair dealing that an insurer owes an insured obligates the insurer to refrain from (1) engaging in unfounded refusals to pay policy proceeds, (2) causing unfounded delay in making payment, (3) deceiving the insured, and (4) exercising any unfair advantage to pressure an insured into settlement of the insured's claim.[165]

At least one insurance company has echoed these points in its internal claims manual, stating the "most positive way to [meet the duty of good faith] is to look for coverage in . . . policies, and not to look for ways to deny coverage."[166] Thus:

> In considering coverage questions, the policyholder should be given the benefit of any reasonable doubt. Our goal is to find coverage whenever possible, not ways to avoid our

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1990) (by breaching its fiduciary duty to deal with its policyholder with the utmost good faith, insurance company could not take advantage of its own wrongdoing); *But see* Goshen v. Mutual Life Ins. Co., No. 600466/95-006, 1997 N.Y. Misc. LEXIS 486 (N.Y. Sup. Ct. Oct. 24, 1997) ("Although a fiduciary relationship may exist between an insurance company and its insured once the insurer is called upon to provide a defense to its insured in the context of a liability claim . . ., in general, a contract of insurance does not otherwise create a fiduciary relationship between the parties."(citations omitted)).

164. 16A J. APPLEMAN, INSURANCE LAW AND PRACTICE §8878 (Pocket Part 1994), at 12.

165. *Id.*

166. Travelers Liability Coverage Manual §16.0. *See also* JAMES J. MARKHAM ET AL., THE CLAIMS ENVIRONMENT 274 (1993).

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> obligations. Our dealings with claimants must be conducted fairly, courteously, and honestly.[167]

Insurance companies do not dispute that policyholders are owed an implied duty of good faith and fair dealing under any insurance policy.[168] In fact, some of the most succinct definitions of good faith come not from the courts or from learned treatises, but from the insurance companies themselves. For example, Continental Casualty has stated:

> Insurance is an agreement whereby parties give valuable consideration for protection from and indemnification against loss, damage, injury, or liability. As servants of the public, insurance companies are held to the universally high standard of 'good faith.'[169]

Continental further explained:

> If the insurer is motivated by selfish purpose or by the desire to protect its own interests at the expense of its insured's interest, bad faith exists, even though the insurer's actions were not actually dishonest or fraudulent.[170]

Similarly, Century Indemnity has stated that :

> Good conscience and fair dealing require that the insurer not pursue a course which is advantageous to itself while disadvantageous to its policyholder.[171]

Aetna has also long acknowledged the insurance industry's duty of good faith and fair dealing:

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167. Claim Department, Travelers Insurance Companies, Property Claims: I-General Information (1987).

168. *See* BARRY R. OSTRAGER AND BARRY R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES 429 (7th ed. 1994).

169. Plaintiff's Memorandum of Law For Trial at 1 (filed Sept. 11, 1990), Continental Cas. Co. v. Great Am. Ins. Co., No. 86-C-3938, 1990 U.S. Dist. Lexis 12807 (N.D. Ill. Sept. 28, 1990).

170. *Id.* at 13.

171. *See* Appellant's Reply Brief at 20, Century Indem. Co. v. Truck Ins. Exch. of the Farmers Ins. Group, 887 P.2d 455 (Wash. Ct. App. 1995) (No. 13141-6-III).

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> Over-riding all policy provisions is the insurance relationship existing by reason of the liability contract which imposes upon the company the obligation to act in good faith and in the interests of the insured in the defense and settlement of claims.[172]

Hartford probably said it best:

> [O]ur Supreme Court has recently and emphatically held an insurer to the high standards of a fiduciary: In approaching the inquiry, great weight must be placed upon the character of an insurance policy as a contract of adhesion. It is equally important to emphasize that `[a]n insurance contract is preeminently one of the utmost good faith.'[173]

Enforcing the reasonable expectations doctrine honors insurance companies self-recognized duty of good faith and fair dealing. Failure to enforce the doctrine—in light of the insurance industry's own recognition of this duty—would render the duty of good faith and fair dealing a nullity.

VII. REASONABLE EXPECTATIONS OF INSURANCE COVERAGE AND INSURANCE COMPANY ADVERTISING

The "whole transaction" version of the reasonable expectations doctrine suggests that "marketing patterns and general practices" of the insurance company can influence a policyholder's reasonable expectation of insurance coverage:[174] "an insured can have reasonable expectations of coverage that arise from some source *other* than the policy language itself,

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172. George W. Katz, *Why the New Liability Policy?Part III*, INS. ADVOC., Oct. 8, 1966, at 14; *see also* Lia B. Royle, *Insurance Company Bad Faith Refusal To Settle*, MEALEY'S LITIG. REP., Feb. 15, 1996, at 1.

173. Brief and Volume I of Appendix of Plaintiff-Appellant Hartford Accident & Indem. Co. at 12, Hartford Accident & Indem. Co. v. Aetna Life & Cas. Ins. Co., (N.J. Super. Ct. App. Div. 1992) (No. A-1595-82T2).

174. *See* Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1472-75 (1989). *See* Section III, *supra*, discussing Professor Keeton's "whole transaction" formulation of the reasonable expectations doctrine.

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and that such an extrinsic expectation can be powerful enough to override any policy provisions no matter how clear."[175]

Insurance companies' advertisements often *create* their policyholders' reasonable expectations of insurance coverage[176] and contribute to the fiduciary relationship between the insurance company and the policyholder.[177] Courts around the country have found that insurance company advertisements tell people what to expect from insurance:

> Allstate's slogan "You're in Good Hands," Travelers' motto of protection "Under the Umbrella," and Fireman's Fund symbolic protection beneath the "Fireman's Hat," exemplify the industry's own efforts to portray itself as a repository of the public trust . . . . It is noteworthy that the insurance company involved in this appeal promotes itself in national advertisements with the slogan, "Like a good neighbor, State Farm is there."[178]

The unfortunate truth is that insurance companies do the opposite of what they promised when they cultivated the policyholder's trust and expectations of insurance coverage: "[t]he insurer's promise to the insured to 'simplify his life,' to put him 'in good hands,' to back him with 'a piece of the rock' or to be 'on his side' hardly suggest that the insurer will abandon the insured in his time of need."[179]

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175. Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 335 (1986). The article provides a good comparison of the differences between the reasonable expectations doctrine and traditional contract law principles.

176. *See, e.g.*, Thomas M. Reiter & John K. Baillie, *Better Late Than Never: Holding Liability Insurers To Their Bargain Regarding Coverage for Unforeseen, Gradual Pollution Under Pennsylvania Law*, 5 DICK. J. ENVTL. L. POL. 1, 40 (1996).

177. Older decisions which refused to recognize a fiduciary relationship between the insurance company and its policyholder are "out of step with current concepts . . . [and] particularly . . . outmoded when television advertising repeatedly refers to the 'good hands' of the insurer or how it is 'like a good neighbor', implying an ability to place trust and reliance upon the broad shoulders of the kindly company." 12 J. APPLEMAN, INSURANCE LAW & PRACTICE §7004 (1981). *Cf.* Dornberger v. Metropolitan Life Ins. Co., 961 F. Supp. 506, 547 n.39 (S.D.N.Y. 1997).

178. State Farm Fire & Cas. Co. v. Nicholson, 777 P.2d 1152, 1156 n.6 (Alaska 1989) (quoting Russell H. McMains, *Bad Faith Claims Handling—New Frontiers: A Multi-state Cause of Action in Search of a Home*, 53 J. AIR L. & COM. 901, 904 (1988) (recognizing the insurance company duty of good faith in first-party cases).

179. D'Ambrosio v. Pennsylvania Nat'l Mut. Cas. Ins. Co., 431 A.2d 966, 972 (Pa. 1981) (Larsen, J., dissenting), Romano v. Nationwide Mut. Fire Ins. Co, 646 A.2d 1228 (Pa.

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Abandon the policyholder in his time of need is exactly what insurance companies frequently do. When this happens, an insurance policy is not a shield, a safe hand, a kindly neighbor or a rock. Not only does this abandonment violate the policyholder's reasonable expectations of insurance coverage, but it violates the policyholder's fundamental expectation of peace of mind which insurance is meant to provide:

> That insurers sell their product as being not only an agreement to indemnify the insured for certain kinds of loss but also to relieve the purchaser from anxiety concerning all aspects of claims is readily apparent in our society. One cannot watch televised entertainment for very long without being exposed to commercials for the sale of insurance which, for example, indicate that the purchaser will be in 'good hands,' that he will have the assistance of a troop of mounted cavalry, that he [will have] 'a piece of the rock,' or 'like a good neighbor' the insurer will be there. As such advertisements reflect, the relationship between insurer and insured does not merely concern indemnity for money loss.[180]

The reasonable expectations doctrine protects policyholders who believe what an insurance company tells it—whether or not those statements are found in the policy. In fact, courts have found that insurance company advertising reveals that the insurance industry itself recognizes that the insurance relationship is more than the company's promise to pay certain claims when forced to do so:

> Advertising programs portraying customers as being 'in good hands' or dealing with a 'good neighbor' emphasize a special type of relationship between the insured and

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Super. Ct. 1994), Continental Cas. Co. v. Diversified Indus., Inc., 884 F. Supp. 937 (E.D. Pa. 1995). *See also* Irion v. Prudential Ins. Co., 765 F. Supp. 337, 338 n.2 (N.D. Tex. 1991), *rev'd*, 964 F.2d 463 (5th Cir. 1992) ("Plaintiff, at the inducement of Prudential, got herself a 'piece of the rock,' and now that its time for the insurance company to pay, Prudential wants to take its rocks and go home."); Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claim Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1396-97 (1994).

180. Andrew Jackson Life Ins. Co. v. Williams, 566 So.2d 1172, 1175 n.5 (Miss. 1990) (quoting Farris v. United States Fidelity & Guar. Co., 284 Or. 453, 479 n.4, 587 P.2d 1015, 1028 n.4 (Or. 1978) (Lent, J., dissenting)).

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> insurer—one in which trust, confidence and peace of mind have some part . . . . We hold therefore that one of the benefits that flow from the insurance contract is the insured's expectation that his insurance company will not wrongfully deprive him of the very security for which he bargained or expose him to catastrophe from which he sought protection.[181]

Courts have also found that advertising brochures may create a reasonable expectation of insurance coverage.[182]

VIII. THE NATURE OF THE INSURANCE BUSINESS: USING THE REASONABLE EXPECTATIONS DOCTRINE TO LEVEL THE PLAYING FIELD

A. The Imbalance in Bargaining Power Between the Insurance Company and the Policyholder

The doctrine of reasonable expectations helps protect policyholders from the effects of the tremendous disparity in bargaining power between the insurance companies and policyholders. Many courts have recognized that "the bargaining power of an insurance carrier vis-a-vis the bargaining power of the policyholder is disparate in the extreme."[183] As noted by the Supreme Court of California:

> [T]he relationship of insurer and insured is inherently unbalanced; the adhesive nature of insurance contracts places the insurer in a superior bargaining position. The availability of punitive damages is thus compatible with recognition of insurers' underlying public obligations and reflects an attempt to restore balance in the contractual relationship.[184]

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181. Rawlings v. Apodaca, 726 P.2d 565, 571 n.3 (Ariz. 1986). *See also* Alice E. Graham, *Use of Advertising Materials To Determine Insurance Coverage*, DEF. COUNS. J., July 1990, at 332 (reviewing cases which have found insurance coverage based on advertising materials).

182. *See e.g.,* Dobosz v. State Farm Fire & Cas. Co., 458 N.E.2d 611 (Ill. App. 3d 1983).

183. Hayseeds, Inc. v. State Farm Fire & Cas., 352 S.E.2d 73, 77 (W. Va. 1986).

184. Egan v. Mutual of Omaha Ins. Co., 620 P.2d 141, 146 (Cal. 1979) (citations omitted). *See also* McCullough v. Golden Rule Ins. Co., 789 P.2d 855, 856 (Wyo. 1990).

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The Supreme Court of Oklahoma held:

> Of particular importance is the delicate position of the insured after a loss is incurred: The very risks insured against presuppose that if and when a claim is made, the insured will be disabled and in strait financial circumstances and, therefore, particularly vulnerable to oppressive tactics on the part of an economically powerful entity.[185]

Similarly, the Supreme Court of Arizona stated:

> The special nature of an insurance contract has been recognized by courts and legislatures for many years. . . . An insurance policy is not obtained for commercial advantage; it is obtained as protection against calamity. In securing the reasonable expectations of the insured under the insurance policy there is usually an unequal bargaining position between the insured and the insurance company . . . . Often the insured is in an especially vulnerable economic position when such a calamity loss occurs. The whole purpose of insurance is defeated if an insurance company can refuse or fail, without justification, to pay a valid claim.[186]

One California court captured the essence of what motivates all too many insurance companies to deny insurance coverage:

> [A] lot of people who regarded themselves as rather powerful got together and [rode] roughshod over [the policyholder] because they viewed him as someone who was powerless and unable to fight back.[187]

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185. Buzzard v. Farmers Ins. Co., 824 P.2d 1105, 1109 (Okla. 1991) (quoting Fletcher v. Western Nat'l Life Ins., 10 Cal. App. 3d 376, 404 (1970)).

186. Noble v. National Am. Life Ins. Co., 624 P.2d 866, 867-68 (Ariz. 1981).

187. *See* West Am. Ins. Co. v. Freeman, 44 Cal. Rptr. 2d 555, 564 (Cal. Ct. App. 1st Dist. 1995).

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The stark reality is that "[a]ll that an insurance company has to sell is its promise to pay. Yet, all other things being equal, the better an insurance company is at avoiding that promise, the more money it makes."[188] Enforcing a policyholder's reasonable expectations of insurance coverage makes it less likely insurance companies will exploit their superior bargaining and financial position.

B. Insurance Companies Profit From Litigation

Insurance companies may violate a policyholder's reasonable expectations of coverage for purely financial reasons. This is because insurance companies profit by prolonging a coverage dispute rather than paying a claim—even when they know the claim is valid.

The practicalities and economics of denying insurance coverage weigh heavily in favor of insurance companies.[189] First, insurance companies earn investment income—a profit—during an insurance coverage dispute with a policyholder. This is done by continuing to invest the policyholder's premiums and the reserves for the duration of the dispute. Second, insurance companies are bulk purchasers of legal services; they incur proportionately lower litigation costs than their policyholders, and can reuse work product from case to case. This is particularly true in the property and casualty insurance industry, where the approximately twenty largest insurance companies have banded together to form the Insurance Environmental Litigation Association ("IELA"). These factors, combined with the insurance industry's tremendous collective resources and litigation experience, allow insurance companies to wage wars of attrition against individual policyholders who litigate an insurance dispute once in a lifetime. This war-making ability, along with a policyholder's often critical need for money after a loss, drives policyholders to settle cases for less than their merit. Enforcing the reasonable expectations doctrine prevents insurance companies from hiding behind a contract:

> [T]he money-for-promise arrangement makes delay a powerful strategic tool insurance companies can use against claimants, a tool that under the prevailing application of contract damages doctrine is nearly cost

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188. Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claim Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1401 (1994).

189. *See* Eugene R. Anderson, et al., *Insurance Nullification By Litigation*, RISK MGMT., Apr. 1994, at 46; Eugene R. Anderson, *Is Something Wrong With Claims Handling? Plaintiff: Insurers Profit From Delay, Litigation*, CLAIMS, Apr. 1995, at 33.

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> free. *In a state adhering to traditional insurance contract damages limitations and an intent-based bad faith standard, an insurance company with a weak, but colorable, defense to a claim will almost never have to pay more in real dollars than was owed at the time the claim was presented.*[190]

Securing the insurance coverage the policyholder reasonably expected is plainly a "mild mannered" tool.[191] Courts realize that the business of insurance is "different" from other businesses. The truth is that unless an insurance company is confronted with enforcement of the policyholder's reasonable expectations of insurance coverage or the prospect of damages well in *excess* of the policy limits,[192] it may have no incentive to honor its obligations under the insurance policy:

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190. *See* Tom Baker, *Constructing the Insurance Relationship; Sales Stories, Claim Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1430 (1994) (citation omitted) (emphasis added). *See also* Garnett v. Transamerica Ins. Servs, 800 P.2d 656, 666 (Idaho 1990).

191. *See, e.g.*, Atwater Creamery Co. v. Western Nat'l Ins. Co., 366 N.W.2d 271, 278 (Minn. 1985):

> [T]he reasonable-expectations doctrine does not automatically mandate either pro-insurer or pro-insured results. It does place a burden on insurance companies to communicate coverage and exclusions of policies accurately and clearly. It does require that expectations of coverage by the insured be reasonable under the circumstances. Neither of those requirements seems overly burdensome.

192. In addition to enforcing their reasonable expectations, policyholders have attempted to level the playing field by making it less profitable and far riskier for insurance companies to breach their insurance policies by seeking, and getting, punitive damages. The threat of punitive damages adds an element of unpredictability to the insurance company's potential liability. Even insurance companies recognize that punitive damages should be used to deter insurance company bad faith: "[p]unitive damages must be awarded to deter this type of action in the future. A simple judicial test will serve this purpose: If the court finds that an insurer made a determination not to settle within the policy limits based on its own self-interest, punitive damages will be awarded."

Civil Action—Cross Petition for Certification and Brief in Opposition to Defendant-Appellant Petition for Certification at 13, 16, Fireman's Fund Ins. Co. v. Security Ins. Co. of Hartford, 367 A.2d 864 (N.J. 1976).

The same insurance company, Fireman's Fund, also argued:

> Insurance companies must realize the importance of settlement within policy limits and should realize the impact their decisions must have

> Unlike most other commercial actors fighting for supremacy in a world where possession is nine-tenths of the law, insurers always have the nine-tenths advantage: They hold the money. Consequently, insurers always get to "play the float" in any dispute. Even where the judicial system acts rapidly and efficiently to provide compensation to wronged policyholders, the carrier may find it made money by delaying payment of the claim. If its investments have been good, it may even have made enough to cover any prejudgment interest, costs, or consequential damage award, or counsel fees collected by the policyholder.[193]

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upon their insured. This court should establish the rule that punitive damages are to be awarded whenever the court finds that an insurance company made its decision regarding settlement based on its own interest as opposed to the interests of its insured.

Id. at 13.

Lawyers who regularly represent insurance companies have also recognized that without punitive damages, insurance companies "had nothing to lose by wrongfully denying claims or coercing unfair settlements." James A. McGuire & Kristin Dodge McMahon, *Issues For Excess Insurer Counsel In Bad Faith And Excess Liability Cases*, 62 DEF. COUNS. J. 337 (1995). *See also* James A. McGuire & Kristin Dodge McMahon, *Bad Faith, Excess Liability And Extracontractual Damages: Counsel For The Excess Carrier Looks At The Issues*, 72 U. DET. MERCY L. REV. 49 (1994).

The financial realities of insurance coverage and the need for punitive damages was explained by no less than a standard textbook of the insurance industry: "When an insurance company fails to pay claims it owes or engages in other wrongful practices, contractual damages are inadequate. It is hardly a penalty to require an insurer to pay the insured what it owed all along." JAMES J. MARKHAM, ET AL., THE CLAIMS ENVIRONMENT 274 (1993). The quoted textbook is a comprehensive text used to train insurance company personnel in claims handling practices and is part of the required materials for students preparing to obtain the professional designation of Chartered Property and Casualty Underwriter ("CPCU"). Thus, candidates for the highest professional status in the business of insurance are taught that contractual damages alone are inadequate.

The consensus among policyholders, insurance companies and insurance company lawyers is clear: The nature of the relationship between policyholders and insurance company makes it all too easy for insurance companies to simply say "NO." Awarding punitive damages, in addition to enforcing the policyholder's reasonable expectations of insurance coverage, provide an additional means to curb insurance company opportunistic breach.

193. JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS: LAW AND STRATEGY FOR INSURERS AND POLICYHOLDERS § 19.3, at 466-67 (1994).

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Ironically, the possibility of damages in excess of the policy limits most often arises in litigation between insurance companies, not policyholders.[194]

C. Insurance Companies Profit From The Information Imbalance

1. The Public Relations Campaign

"Insurance is far from the market ideals of complete information."[195] The imbalance in information and resources between insurance companies and policyholders creates a disparity in the abilities of each side to organize effectively. Insurance companies take advantage of the resulting policyholder ignorance of how the insurance industry works. Only the insurance companies and some of the state insurance departments have a relatively complete understanding of the insurance industry.

The insurance industry is not competitive because Congress exempted the industry from federal antitrust regulation by the McCarran-Ferguson Act. The move towards insurance industry exemption from antitrust regulation began in 1944, when the United States Supreme Court rejected insurance company arguments that insurance was not commerce. The Court held that Congress could properly apply federal antitrust statutes to the insurance industry.[196] As one noted commentator tells it:

> This decision sent shivers down the spines of insurance company executives, who feared the prospect of federal agencies, particularly the Federal Trade Commission, interfering with the insurers' cozy relationships with the state insurance commissioners. The insurance industry

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194. *See generally*, PAT MAGARICK, EXCESS LIABILITY, §§ 17.02, 17.06 (1996). In particular, insurance companies which have sold a policyholder excess liability coverage attempt to reduce their ultimate costs by settling a policyholder's claim after the primary insurance company has refused to do so. The policyholder then assigns its rights under the primary policy to the excess insurance company. By stepping into the shoes of the policyholder, excess insurance companies can bring a bad faith claim against primary insurance companies which wrongfully refuse to settle a claim and expose the policyholder or excess insurance company to a judgment exceeding the primary policy's limits.

195. E.I. DuPont De Nemours & Co. v. Pressman, 679 A.2d 436 (Del. 1996) (quoting Mark Pennington, *Punitive Damages for Breach of Contract: A Core Sample from the Decisions of the Last Ten Years*, 42 ARK. L. REV. 31, 54 (1989)).

196. *See* STEPHEN S. ASHLEY, BAD FAITH ACTIONS: LIABILITY AND DAMAGES § 9:02 at 4 (1996). The United States Supreme Court decision was United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).

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> devised an ingenious plan to head off federal regulation. It persuaded Congress to introduce legislation, known as the McCarran-Ferguson Act, which provided a three year moratorium on federal regulation of the insurance industry. At the expiration of the moratorium the federal regulators could then assert their authority only over those aspects of the insurance industry not regulated by the states. This moratorium gave the insurance commissioners the opportunity, through the National Association of Insurance Commissioners (NAIC), to draft model legislation intended to preempt the entire field of insurance industry regulation and thus protect the commissioners' turf from Federal Trade Commission encroachment.[197]

The "ingenious plan" has crippled policyholders ever since and represented a powerful victory for the insurance industry. The effects of antitrust exemption support the arguments that contract damages are inadequate for opportunistic breach of insurance policies. The insurance industry's exemption from federal anti-trust regulation gives insurance companies a tremendous litigation and organizational advantage. Exemption from antitrust regulation allows insurance companies to exchange vast amounts of allegedly confidential insurance industry information and documents. Policyholders are deprived of this same information and those same documents.

The information imbalance impacts the decisions of state regulatory agencies. For example, the New York State Insurance Department currently makes decisions and rulings from information provided solely by the insurance industry. Even if given the opportunity, policyholders do not have the resources to present a full actuarial or legal case to the New York State Insurance Department. There is no advocate for policyholders before the state insurance departments.[198] Insurance companies, on the other hand, can and do hire staffs of attorneys, economists, researchers, and actuaries. In fact, insurance companies hire more attorneys than any other

197. *Id.*(footnotes omitted).

198. Texas is the only state with a pro-policyholder watchdog—The Office of Public Insurance Counsel of the State of Texas (OPIC). The New York Task Force on Insurance has also suggested creating such an office.

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industry in the United States.[199] According to one influential insurance industry source: "Of course, the insurance industry is fortunate in having at its disposal a veritable army of qualified experts in a dizzying number of disciplines."[200] Policyholders are not so fortunate.

Two of the largest trade associations representing insurance companies, the American Insurance Association ("AIA") and the Alliance of American Insurers ("AAI"), both regularly file "friend of the court" briefs on behalf of insurance companies in insurance litigation cases. Two other groups, the Insurance Services Office, Inc. ("ISO")[201] and the National Association of Independent Insurers ("NAII") gather and analyze information for the insurance industry. The information provided by ISO and the NAII is available to insurance companies, but not to policyholders or the public. Members of the insurance industry are able to hone their skills through a myriad of advanced training and educational seminars.[202]

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199. *See* Zan Hale, *Want a Job? Call An Insurance Company; Insurers Dominate The List Again*, CORP. LEGAL TIMES, Aug. 1995, at 1. *See also* Angela Ward, *The Big Just Keep Getting Bigger; Doing More With . . . . More*, CORP. LEGAL TIMES, Aug. 1996, at 1.

200. Bill Thorness, *The Explosive Nature of Evidence*, CLAIMS, June 1997, at 8. Mr. Thorness is the editor of CLAIMS.

201. The Insurance Services Office, Inc. ("ISO") is a national non-profit corporation that gathers, stores and disseminates statistical information to insurance regulators as required by law and to insurance companies for their use. ISO drafts and assists insurance companies in implementing insurance coverage programs and defining insurance coverage risks faced by policyholders. ISO also distributes industry-wide advisories regarding insurance rates and rules to participating property and casualty insurance companies. *See Insurance Services Office In a Competitive Marketplace: ISO's Role Within the Property/Casualty Insurance Industry*, Insurance Services Office, Inc., June 1987, at 2, 3. ISO drafted the 1985 revisions to the Comprehensive General Liability policy, including the so-called 'absolute' pollution exclusion. Predecessors of ISO include the Mutual Insurance Rating Bureau (MIRB); the National Bureau of Casualty Underwriters (NBCU), and the Insurance Rating Board (IRB)(NBCU's successor). These groups jointly drafted the 1965 and 1973 revisions to the occurrence based Comprehensive General Liability policies and the 'sudden and accidental' polluter's exclusion introduced in 1970. *See* John A. MacDonald, *Decades of Deceit: The Insurance Industry Incursion into the Regulatory and Judicial Systems*, COVERAGE, Nov./Dec. 1997, at 2 n.3.

202. *See* Mikel M. Benton, *Adjusters See Moderate Progress In New RPA Program*, CLAIMS, Feb. 1998, at 58 (discussing a newly designated program designed "to enhance the knowledge, stature and reputation of people working in the claims handling industry."); V.P. "Champ" Codding Jr., *State-By-State Requirements For Adjusters and Appraisers, Charting Credentials For Handling Claims: Charting Credentials For Handling Claims*, CLAIMS, Feb. 1998, at 42, 44 (discussing the various licensing requirements of adjusters and appraisers employed by insurance companies or independently and noting that several states require continuing educational training); *Ninth Annual Directory of Education Resources*,

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Policyholders, who have not made a career out of insurance, seldom have the time or the opportunity to become even remotely familiar with the most basic tricks and techniques of the insurance industry. The insurance industry effectively controls the NAIC.[203]

There is no organization specifically devoted to representing policyholders' interests in insurance coverage actions.[204] Yet there are major national organizations specifically devoted to the legal defense of insurance companies: the American Insurance Association, the Alliance of American Insurers, the Defense Research Institute, the Insurance Environmental Litigation Association and the Federation of Insurance and Corporate Counsel. While the American Bar Association has two committees largely committed to insurance coverage matters, both are overwhelmingly dominated by insurance company lawyers. By contrast, policyholders—aside from the FBI and the Justice Department, neither of which particularly "caters" to policyholders—have virtually none.

The National Association of Insurance Commissioners ("NAIC") generally excludes policyholders from its meetings and studies. At NAIC conventions, there are thousands of insurance brokers and insurance company representatives but only four or five consumer-policyholder

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CLAIMS, Feb. 1998, at 50 (listing over 40 schools which provide insurance training of every sort for members of the insurance industry).

203. *See* Paltrow, *supra* at note 1, at 1.

204. One policyholder organization is United Policyholders. United Policyholders is a non-profit corporation dedicated to educating policyholders on their rights and duties under their insurance policies. Specifically, United Policyholders engages in charitable and educational activities by promoting greater public understanding of insurance issues and policyholder rights. United Policyholders' activities include distributing written materials, filing *amicus* briefs and responding to requests for information from individuals, elected officials, and governmental entities.

United Policyholders was founded in 1991 as a § 501(c)(3) non-profit corporation organized under the laws of the State of California, funded by donations and grants and staffed exclusively by volunteers. United Policyholders' first major project was working with over a thousand victims of a devastating October 1991 firestorm in the Oakland/Berkeley, California hills, to help them understand their policies and receive prompt, fair insurance claim settlements. Since that time, United Policyholders has conducted educational meetings and workshops on insurance issues in Florida, Texas, and throughout California. Much of United Policyholders' work takes place in communities that have been hit by natural disasters, such as hurricanes, wildfires, earthquakes, and floods, which give rise to large numbers of insurance claims and results in consumer confusion and frustration. United Policyholders receives frequent invitations to testify at legislative and other public hearings, and to participate in regulatory proceedings on rate and policy issues.

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representatives. It is virtually impossible for a policyholder representative to get into an NAIC convention.

Insurance companies can play a hand in determining who the state insurance department singles out for regulatory scrutiny.[205] Equally concerning to policyholders is that most state insurance commissioners come from the insurance industry and leave their government office in order to return to the industry (by accepting an offer of high-level employment with an insurance company at a much higher salary).[206] The

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205. *See, e.g.*, Peter S. Canellos, *Insurance Fraud Case Attacks Mass. System*, BOSTON GLOBE, Jan. 11, 1998, at A1. According to the article, while the investigative bureaus of some states accept contributions from industries to offset the cost of prosecuting their cases, those states allegedly "keep their investigative bureaus under the control of public officials—not industry representatives." *Id.*

Massachusetts' Insurance Fraud Bureau, for example, is funded by the industry and *privately* run, allowing insurance companies to "buy themselves a special Division of [the attorney general's] office—thereby directing more attention toward cases of special interest to them." *Id.* This argument was made by the attorney for a law office facing an insurance fraud prosecution. The defendants argued that the state attorney general had "surrendered part of his prosecutorial discretion" by accepting more than $1 million from insurance industry sources to fund the state's insurance fraud division. A trial court judge ruled that the attorney general's office could proceed with the prosecution and upheld the state law that allowed for the private funding of the fraud bureau. Gary V. Murray, *Ellises to Appeal Ruling that Case May Proceed*, TELEGRAM & GAZETTE (Worcester, Ma.), Aug. 4, 1998, at B1.

206. *See* Walter Updegrave, *Stacking the Deck*, MONEY, Aug. 1996, at 50, 52 (characterizing this unfortunate phenomenon as a revolving door to the insurance industry); L.H. Otis, *Pa. Regulator Named*, NAT'L UNDERWRITER P/C ed., Aug. 4, 1997, at 7 (reporting that Pennsylvania's insurance commissioner was returning to Reliance Insurance Company, her former employer, and that she was to be replaced by the vice-president and general counsel of Provident Mutual Life Insurance Company). The "revolving door" at the top at state insurance departments widens the information imbalance between the insurance companies and its policyholders by seriously questioning whether protecting policyholders or a potential employer is the primary concern of the state insurance department. *See, e.g.*, Robert H. Gettlin, *An Elder Statesman Moves On*, BEST'S REV. P/C ed. (Sept. 1997):

> Insurance commissioners live in two worlds. They're charged with protecting consumer interests, but they're also responsible for maintaining a healthy insurance market and keeping profitable companies in the state. Commissioners tack back and forth between these twin duties. A state regulator may promote one role over the other, but can never fully escape the natural tensions of the job.

The article goes on to note that Maine's retiring superintendent of insurance, who had held his post for five years, was "one of the grizzled veterans of the profession." *Id.* According

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revolving door between the insurance industry private sector and state insurance departments, and the ability of the insurance industry to influence legislators, increases the information and organizational imbalance between policyholders and insurance companies.

2. Buying And Lying

A significant force in perpetuating the information imbalance is the ability of insurance companies to simply buy away adverse legal decisions—one of the best examples of the insurance industry's tremendous influence over the development of insurance law and the courts.[207] Through the frequent use of *vacatur*,[208] insurance companies have paid big money to wipe out case law contrary to their interests.[209] In this way, insurance companies are able to erase the 'bad' decisions while retaining the 'good' ones. The insurance companies then relitigate the same issues with a deck increasingly stacked in their favor. Insurance companies repeatedly offer settlements with policyholders conditioned upon the courts vacating and withdrawing earlier rulings.[210] These mechanisms eradicate pro-policyholder case law and enables insurance companies to shape insurance law—even after losing important cases.

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to the article, of the fifty-five sitting commissioners, only six had been at their posts longer. As of September 1997, ten insurance commissioners had resigned in 1997.

207. *See* Eugene R. Anderson & James J. Fournier, *Insurance Companies Buy Legal Decisions—and Then Lie To Courts and Policyholders About It*, THE ADVOC., Sept./Oct. 1997, at 22.

208. Although the legal term for this practice is "vacatur," the practice is also known by another name—"buying and lying." Buying and lying refers to a common practice of insurance companies of vacating and depublishing undesirable decisions by offering claimants attractive settlements, after the insurance company has litigated and often after the court has written its opinion. The practice of buying and lying operates by preventing the creation of "bad" law for the insurance industry or preventing policyholders from appealing decisions favorable to the insurance industry. The practice is firmly established. *See* Jill E. Fisch, *The Vanishing Precedent: Eduardo Meets Vacatur*, 70 NOTRE DAME L. REV. 325, 356 and n.135 (1994).

209. *See* Eva M. Rodriguez, *Legal Sleight of Hand: Vacatur Policy Challenged In Supreme Court Appeal*, TEX. LAW., May 17, 1993, at 1, 34. *See also* Saundra Torry, *It's Magical History Tour At 'Vacatur Center,'* WASH. POST, Mar. 10, 1997, at 7; Susan Dominus, *Reviving Dead Rulings On The Web*, AM. L. TECH, Spring 1997, at 24.

210. *See, e.g.*, Round Rock Plaza Venture v. Maryland Ins. Co., No. 03-95-00108-CV, 1996 Tex. App. LEXIS 581 (Tex. Ct. App. Feb. 14, 1996); Circle "C" Ranch Co. v. St. Paul Fire & Marine Ins. Co., No. 3-91-388-CV, 1993 Tex. App. LEXIS 1291 (Tex. Ct. App. May 5, 1993), *withdrawn*, 1993 Tex. App. LEXIS 1827 (Tex. Ct. App. May 19, 1993); Bankers Trust Co. v. Hartford Accident & Indem. Co., 518 F. Supp. 371 (S.D.N.Y. 1981), *vacated* 621 F. Supp. 685 (1981).

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According to one insurance industry source, fifty percent of the pro-policyholder judicial decisions are wiped off the law books by the insurance industry.[211] Contrary to insurance company assertions, the true "majority of the courts" is not on the law books.[212] Reported court decisions do not accurately reflect insurance law:

> [V]acatur becomes an important litigation tool, particularly for institutional litigators who must return to court many times with the same arguments. When a court

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211. Philip Carrizosa, *Making the Law Disappear: Appellate Lawyers Are Learning to Exploit the Supreme Court's Willingness to Depublish Opinions*, CAL. LAW., Sept. 1989, at 65. *See also* Wendy R. Leibowitz, *'Dog' Cases Get Around on the 'Net*, NAT'L L.J., Oct. 14, 1996, at A11; Paul M. Barrett, *Critics Say that Deep-Pocketed Clients Benefit From Vacated Court Judgments*, WALL ST. J., Sept. 24, 1996, at B15 (securities fraud judgment vacated). However, it is not easy to determine after the fact the frequency or number of valuable decisions courts have vacated. This is because when a decision is vacated prior to publication, there is nothing written and nothing of which to inform the public. Even if the decision is published, the West reporting system and the on-line reporting services (LEXIS and WESTLAW) allow courts to withdraw vacated opinions from publication. Unless a copy has been saved, the only traces that the decision ever existed may be a cryptic three line statement indicating that the decision has been vacated.

212. *See id.*; *see also* Oklahoma Radio Assocs. v. Federal Deposit Ins. Corp., 3 F.3d 1436, 1444 (10th Cir. 1993) ("A policy permitting litigants to use the settlement process as a means of obtaining the withdrawal of favorable precedents is fraught with the potential for abuse."); National Union Fire Ins. Co. v. Seafirst Corp., 891 F.2d 762 (9th Cir. 1989) (denying joint post-settlement motion to vacate where vacatur would have preclusive effect on other parties involved in the litigation); Memorial Hosp. of Iowa County, Inc. v. United States Dept. of Health & Human Serv., 862 F.2d 1299, 1300 (7th Cir. 1988) (explaining why the Seventh Circuit routinely rejects requests to vacate opinions: "[A]n opinion is a public act of the government, which may not be expunged by private agreement. History cannot be rewritten. There is no common law writ of erasure."); Aetna Cas. & Sur. Co. v. Home Ins. Co., 882 F. Supp. 1355, 1356 (S.D.N.Y. 1995) ("[V]acatur . . . would allow a party with a deep pocket to eliminate an unreviewable precedent it dislikes simply by agreeing to a sufficiently lucrative settlement to obtain its adversary's cooperation in a motion to vacate. We do not consider this a proper use of the judicial system.") (quoting Manufacturers Hanover Trust Co. v Yanakas, 11 F.3d 381 (2d Cir. 1993)); Benavides v. Jackson Nat'l Life Ins. Co., 820 F. Supp. 1284, 1289 (D. Colo. 1993) (noting that failure to acknowledge genuine legal precedents in insurance law means that "[t]he case law becomes what the party with the greatest resources wishes it to be. Economic prowess purchases more persuasive power than the marketplace of ideas and sound reasoning combined. Vacatur allows wealthy litigants to become, in effect, editors of their own treatises on the subjects which concern them. We have no kind words for such a practice. We can imagine few practices condoned by the judicial system that would have a less salutary effect on both the reality [and] the perception of its integrity.").

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> rejects the arguments of institutional litigators such as [the defendant], an insurance company, the institutions are dealt a crippling blow not only in the case at bar but in future litigation. Vacatur allows disappointed litigators effectively to rewrite history. Vacatur allows them to control the direction and content of the jurisprudence—to weed out the negative precedent and preserve the positive—and create an artificially weighty and one-sided estimate of what comprises "the case law."[213]

Insurance companies also settle with policyholders when insurance companies win. This is done to prevent policyholders from appealing a decision favorable to the insurance company, thereby foreclosing any chance of reversal and allowing the entire insurance industry to cite the decision as positive precedent.[214]

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213. Benavides v. Jackson Nat'l Life Ins. Co., 820 F. Supp. 1284, 1289 (D. Colo. 1993).

214. This happened in *Travelers Insurance Co. v. Ross Electric of Washington, Inc.* ("Ross Electric"), 685 F.Supp. 742 (W.D. Wash. 1988), *overruled by* Boeing Co. v. Aetna Cas. & Sur. Co., 784 P.2d 507 (Wash. 1991), a case involving the critically contested issue of whether CERCLA mandated environmental cleanup costs are damages covered under a standard CGL policy. The federal district court for the Western District of Washington ruled in favor of the insurance company and found that cleanup costs were not covered as damages under the CGL policy. Yet at the time Travelers and Ross Electric entered the settlement agreement, Travelers knew that two Washington state trial level judges had ruled the other way in two unpublished opinions. *See* Roger Parloff, *Rigging the Common Law*, AM. LAW., Mar. 1992, at 74, 77. Moreover, the judge in *Ross Electric* had told the parties that he wished to reconsider his opinion in light of those decisions. *See* Parloff, at 77. According to the attorney for Ross Electric, following these developments, Travelers decided to pay "a substantial amount to freeze the decision as precedent." *Id.* It was not until *two years later* that the Washington Supreme Court in Boeing Co. v. Aetna Casualty & Surety Co. ("Boeing") halted insurance company defendants from "primarily" relying on the *Ross Electric* decision. The *Boeing* court rejected the case, holding that the *Ross Electric* decision had incorrectly applied Washington law and had been decided without the benefit of the reasoning of the only Washington court to have addressed the issue in question. Boeing Co. v. Aetna Cas. & Sur. Co., 784 P.2d 507, 515 (Wash. 1991) (discussing how the defendant insurance companies' primary reliance on Travelers Insurance Co. v. Ross Electric of Washington, Inc. was erroneous based on Travelers misapplication of Washington law). Nonetheless, the strategy was an insurance industry success while it lasted: Until *Ross Electric* was rejected by *Boeing*, the decision was cited at least a dozen times by other courts. *See Payoffs by Insurance Companies To Make Court Decisions Disappear Thwarted By Law Firm's Website*, PR NEWSWIRE ASS'N, Apr. 17, 1997.

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Attorneys representing the insurance industry claim that vacatur supports settlement.[215] Nothing could be further from the truth. As many courts and commentators have been quick to point out, an insurance company that wishes to avoid an adverse precedent need only settle before a decision is rendered.[216] Vacating judgments at the appellate court level does not foster settlement at the trial court level—it does the opposite.[217] "Vacatur is simply not efficient judicial resource management."[218] Or perhaps even more to the point: "[W]hen the proposed savings can be realized only at the cost of increasing the vulnerability of the judicial system to manipulation, we view the investment as unsound.[219] Parties which litigate only to negotiate on appeal and then vacate an adverse decision are only seeking an "advisory opinion" from the court, wasting precious judicial resources in the process.[220] "The public's interest is in settlement before all the work is done."[221]

The power to routinely vacate decisions is tremendous. In insurance coverage litigation, legal precedents are worth far more than the sum in dispute. This is because most insurance policies sold in the United States follow a nearly universally standardized format dictated by the insurance industry. Thus, the same issues tend to re-emerge. The result is that almost every state court decision, though binding only in one state, adds to the "weight of authority" concerning the interpretation of insurance policies. This circumstance gives the insurance industry a very strong interest in erasing pro-policyholder insurance coverage decisions.[222]

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215. *See* Saundra Torry, *When Decisions Are Written In Disappearing Ink*, WASH. POST, July 25, 1994, at F7.

216. Memorial Hosp. of Iowa County, Inc. v. United States Dep't of Health & Human Serv., 862 F.2d 1299, 1302 (7th Cir. 1988).

217. Stolz v. American Int'l Life Assurance Co., 922 F. Supp. 435, 437 (W.D. Wash. 1996).

218. Benavides v. Jackson Nat'l Life Ins. Co., 820 F. Supp. 1284, 1288 (D. Colo. 1993). (noting that post-settlement vacatur provides "no incentive for early settlement," encourages litigants to "roll the dice" and takes the view that vacatur encourages settlement "empirically unsupported" and contrary to the court's experience).

219. *See* Manufacturers Hanover Trust Co. v. Yanakas, 11 F.3d 381, 385 (2d Cir. 1993).

220. Stolz v. American Int'l Life Assurance Co., 922 F. Supp. 435, 436 (W.D. Wash. 1996).

221. *See* Mancinelli v. Int'l Bus. Machs. Corp., 95 F.3d 799, 800-801 (9th Cir. 1996)(Kleinfeld, J., dissenting).

222. Anderson Kill & Olick has a website devoted to the publication of judicial decisions that have been wiped off the law books. <http://www.andersonkill.com>.

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The classic "sale" of pro-policyholder case law occurred in 1981 when Hartford Accident & Indemnity Company ("Hartford"), a member of the Hartford Insurance Group, paid $200,000 to expunge from the case books the decision of United States District Court Judge Morris Lasker in *Bankers Trust Co. v. Hartford Accident & Indemnity Co.*[223] In *Bankers Trust*, Judge Lasker granted Bankers Trust's motion for summary judgment, holding that it was entitled to insurance coverage from Hartford for cleanup costs incurred in removing oil from its property. Nearly four months later, Judge Lasker signed an order vacating his earlier decision. Judge Lasker indicated that he took this action to allow Hartford to submit additional materials to the court, after which Judge Lasker would "determine Bankers' motion for summary judgment *de novo*." But Hartford had actually reached a settlement with Bankers Trust whereby Hartford would pay Bankers Trust $2.3 million—about $200,000 more than the amount Bankers Trust had sought in its complaint—with the provision that Judge Lasker vacate his earlier opinion.[224]

Similarly, in *Circle "C" Ranch Co. v. St. Paul Fire & Marine Insurance Co.*, a Texas appellate court decided in favor of the policyholder on a long-awaited decision interpreting the polluter's exclusion in a standard-form general liability policy.[225] The decision was the first time a Texas appellate court had addressed the issue. Pursuant to a settlement agreement, however, St. Paul paid Circle "C" $300,000, and both parties requested the court to vacate its decision. The decision was vacated within two weeks. Although Circle "C" received $300,000, the indemnity amount due from St. Paul had been only $5,000, which together with the $81,000

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223. Bankers Trust Co. v. Hartford Accident & Indem. Co., 518 F. Supp. 371 (S.D.N.Y.), *vacated*, 621 F. Supp. 685 (1981). *See also* Roger Parloff, *Rigging the Common Law*, AM. LAW., Mar. 1992 at 74, 78.

224. It is telling that Hartford's 'arrangement' did not come to light until 7 years later when it surfaced in another case involving Hartford. In Intel v. Hartford Accident & Indemnity Co., 692 F. Supp. 1171, 1192 (N.D. Cal. 1988), *aff'd in part, rev'd in part*, 952 F.2d 1551 (9th Cir. 1991), Hartford tried to use the very same arguments that had been rejected by Judge Lasker 7 years prior, arguing that *Bankers Trust* had no application to the present facts since it had been vacated. Hartford's duplicity was exposed when Intel produced an affidavit from an attorney involved in the *Bankers Trust* which revealed the real story in *Bankers Trust*. The court in Intel took notice of the 'sound guiding analysis' of *Banker's Trust* and upheld insurance coverage for Intel's environmental liability. *See Intel*, 692 F. Supp. at 1192.

225. Circle "C" Ranch Co. v. St. Paul Fire & Marine Ins. Co., No. 3-91-388-CV, 1993 Tex. App. LEXIS 1291 (Tex. Ct. App. May 5, 1993), *withdrawn*, 1993 Tex. App. LEXIS 1827 (Tex. Ct. App. May 19, 1993). *See also* Janet Elliott, *For 300K, Environmental Test Case Evaporates*, TEX. LAW., May 31, 1993, at 1.

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in attorneys fees, gave Circle "C" a total claim of $86,000. Thus, the price for the decision in Circle "C" was about the same as it was in Bankers Trust—$200,000.

In *U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership*, 513 U.S. 18 (1994) (*"Bonner Mall"*), the United States Supreme Court held that vacatur is an "extraordinary remedy" which must take account of the public interest: "Judicial precedents are presumptively correct and valuable to the legal community as a whole. They are not merely the property of private litigants and should stand unless a court concludes that the public interest would be served by a vacatur."[226]

Nor was it lost on the Court that:

> [W]hile the availability of vacatur may facilitate settlement after the judgment . . . it may deter settlement at an earlier stage. Some litigants, at least, may think it worthwhile to roll the dice rather than settle . . . if, but only if, an unfavorable outcome can be washed away by a settlement-related vacatur. [227]

Thus, the Court held that absent "exceptional" circumstances, "settlement does not justify vacatur of a judgment under review."[228] Moreover, the Court held that exceptional circumstances does not include the mere fact that a settlement agreement provides for vacatur.

But make no mistake—the insurance company campaign continues. Despite the seeming precision of the language in *Bonner Mall*, litigants routinely seek to avoid the Supreme Court's edict and state courts continue to legitimize buying and lying.[229] Judges are simply unable to contend with the insurance industry practice of wiping the common law off the books. In one example, a Texas court imposed a $2 million sanction on AIU Insurance Company, an AIG company, for its "systematic and pervasive discovery abuses," finding that AIG had violated two court orders requiring the insurance company to produce (1) claims files; (2)

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226. 513 U.S. 18 (1994) (quoting Izumi Seimitsu Kogyo Kabushiki Kaisha v. U.S. Philips Corp., 510 U.S. 27, 40 (1993)(Stevens, J., dissenting)).

227. *Id.* at 21 (Stevens, J., dissenting).

228. *Id.*

229. At least one state court has held that *Bonner Mall* "is not binding precedent because the issue decided was one of federal procedural law" and as such "does not apply to state courts' application of state procedural law." Panterra Corp. v. American Dairy Queen, 908 S.W.2d 300, 301 (Tex. Ct. App. 1995).

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claims manuals; (3) policy forms; (4) drafting history; (5) "lost" insurance policies; (6) diaries and notes of claims handlers; and (7) company produced training manuals.[230] One week later, the order was vacated, forever erasing any trace of AIG's misconduct.[231] In another variation of buying and lying, National Union Fire Insurance Company, another AIG company, was found liable for punitive damages for failing to pay its defense counsel after a case had been settled:

> By threatening unwarranted fee disputes, carriers such as National Union try first to pressure law firms to violate their duty of undivided loyalty to their clients, the insureds, and thus to interfere with the insureds right to control the litigation. Whether or not that works, such carriers build up payables to the law firms, knowing the firms cannot reasonably withdraw, and then, using economic leverage and the 'indemnify the client' device, seek to get a big discount.[232]

Cases can disappear even before a decision has been rendered or a settlement has been reached. In a "disappearing docket" case involving Gold Medal Insurance Co. (a captive insurance company) and National Union Fire Insurance Company, the entire docket seemingly vanished. Although a business journal reported that National Union had filed a

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230. *See* Bristol-Myers Squibb v. AIU Ins. Co., No. A-0145,672 (Tex. Dist. Ct. Apr. 29, 1997)(order granting plaintiffs' motion for sanctions). *See also* Dan Lonkevich, *Texas Judge Hits AIG With $2M Sanction*, NAT'L UNDERWRITER, May 12, 1997, at 41.

231. *See* Bristol-Myers Squibb v. AIU Ins. Co., No. A-0145,672 (Tex. Dist. Ct. May 7, 1997)(order vacating sanctions), reported in MEALEY'S LITIG. REP.: INS., May 20, 1997, at G-1.

232. In re: The Arbitration of Seltzer Caplan Wilkins & McMahon, P.C. v. Shapell, No. 684799 at 44 (Cal. Nov. 25, 1996). The arbitrator found that punitive damages were required because National Union acted in "conscious disregard" of the law firm's rights by denying their claim, while, among other things, (1) never reviewing the case file; (2) never reading any report accompanying the billing statements at issue; (3) never communicating with the law firm regarding their work in the case; (4) "completely" ignoring the National Union Claims Manual; and (5) similarly creating fee disputes with other law firms. *See id.* at 42-3. In sum, "[t]his type of conduct by National Union . . . is a deliberate and calculated invasion of the sanctity of the attorney-client relationship . . . Public policy requires a message be sent to the industry. The message is punitive damages." *Id.* at 44-5. *See also* David Rubenstein, *Insurer Pays Plenty For Haggling Over Legal Bills*, CORP. LEG. TIMES, June 1997, at 1. The insurance company refusing to pay its lawyers, National Union Fire Insurance Company is one of the AIG companies.

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declaratory judgment action, and that U.S. District Court Judge John F. Keenan had denied a General Mills motion to move the case,[233] a search of the public records turned up nothing. Why? The case now appears on the official court docket as "*A.B.C. v. D.E.F.*"[234] Clearly, National Union is afraid that policyholders will discover positions it takes on the interpretation of standard-form insurance policy language and use them against it in subsequent litigation.

Needless to say, lawyers and policyholders should not rely on exclusively on the lawbooks when prosecuting any insurance coverage action. Buying and lying gives insurance companies the ability to control the judiciary. The reasonable expectations doctrine, on the other hand, does the opposite by stripping insurance companies of their tools of control. The reasonable expectations doctrine, by assisting policyholders to achieve the benefit of their bargain, is diametrically opposed to the legal and litigation control insurance companies have attempted to erect.

3. Arbitration

The information imbalance is further worsened by the insurance industry preference to arbitrate insurance coverage disputes. Arbitrator decisions usually do not result in written opinions explaining the reasoning behind a ruling. Because arbitrations are closed proceedings, unlike court cases which are usually public, the insurance companies are able to exchange information about arbitration proceedings with each other.[235] The policyholder has no such ability to do so.[236]

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233. *See* David Rubenstein, *Why General Mills is Suing Its Own Captive Insurance Co.*, U.S. BUS. LITIG., Feb. 1997, at 1.

234. A.B.C. v. D.E.F., No. 96-CV-1950 (S.D.N.Y. filed Mar. 18, 1996). Interestingly, the lawyers representing the captive insurance company are lawyers who also regularly represent National Union Fire Insurance Co. and other American International Group insurance companies.

235. In court cases as well, insurance companies frequently request, and obtain, secrecy orders.

236. Arbitration holds numerous potential pitfalls for the policyholder. As the Supreme Court of California noted with regard to a mandatory arbitration provision:

> [Kaiser's] arbitration program is designed, written, mandated and administered by Kaiser. In regard to the latter, Kaiser collects funds from claimants and holds and disburses them as necessary to pay the neutral arbitrator and expenses approved by him or her. It monitors administrative matters pertinent to the progress of each case including, for example, the identity and dates of appointment of arbitrators. It does not, however, employ or contract with any independent person or entity

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Insurance companies, but not policyholders, can keep track of arbitrators' decisions—and arbitrators know it. A pro-policyholder arbitrator can easily be "blackballed" by insurance companies. Arbitrators are in the business of arbitrating. They know that the insurance industry is their major source of business. To keep the business coming, arbitrators must maintain a pro-insurance company position a high percentage of the time.[237]

Most courts hold that arbitration provisions are usually enforceable—even those contained in contracts of adhesion such as insurance policies.[238]

> to provide such administrative services, or any oversight or evaluation of the arbitration program or its performance. Rather, administrative functions are performed by outside counsel retained to defend Kaiser in an adversarial capacity. The fact that Kaiser has designed and administers its arbitration program from an adversarial perspective is not disclosed to Kaiser members or subscribers.

Engalla v. Permanente Medical Group, 938 P.2d 903, 909 (Cal. 1997). "[Further,] the selection [of the so-called "neutral" arbitrator] is made by defense counsel after consultation with the Kaiser medical-legal department. Kaiser has never relinquished control over this selection decision." *Id.* at 911.

237. One article summarized these problems in the context of securities arbitration, another industry-wide, industry-dominated arbitration system very similar to the system established for insurance arbitration:

> The industry asserts that it is better for the customer to have an individual knowledgeable about the workings of the market sitting in judgment of fraud claims. But the public suspects that an industry arbitrator will have difficulty determining impartially whether another firm engaged in fraudulent activity . . . . And will that industry arbitrator have the courage to render a multimillion-dollar award, including punitive damages, against another member of the Wall Street Club? An industry arbiter who does that risks being blackballed by the industry in his career and in future cases.

See Theodore G. Eppenstein & Madelaine Eppenstein, *An Arbitration Albatross*, N.Y. TIMES, June 8, 1997, at F12.

A Massachusetts federal district court decision held that a securities brokerage firm could not force a former employee to arbitrate her sexual harassment claim against the brokerage firm. The court expressed that it was "deeply troubled" by the "structural bias" in the New York Stock Exchange's arbitration system. *See* Margaret A. Jacobs, *Judge Finds Merrill Lynch Can't Force Ex-Consultant to Arbitrate Bias Claim*, WALL ST. J., Jan. 27, 1998, at B8. The structural biases of the securities and insurance industries are very similar.

238. *See* Worldwide Ins. Group v. Klopp, 603 A.2d 788 (Del. 1992).

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Many states strongly favor arbitration as a matter of public policy, typically holding that "contracts providing for . . . arbitration[ ] are valid, enforceable and irrevocable, save upon such grounds as exist in law or in equity for the revocation of any other type of contract."[239]

Very few recent cases have broken away from the near-universal enforcement of arbitration clauses. The California Court of Appeals recently held that an arbitration clause in a "contract of adhesion" was unconscionable and unenforceable.[240] The court's holding is quite favorable to the proposition that arbitration clauses contained in contracts of adhesion, such as insurance policies, should not be enforced. Another California appellate court recently held that a decision in a private nonjudicial arbitration cannot be used to collaterally estop a party to the arbitration from relitigating the issue in a subsequent action.[241]

In *Thiokol Corporation v. Certain Underwriters at Lloyd's of London*, a Utah federal district court refused to enforce the arbitration clause found

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239. Ice City, Inc. v. Insurance Co. of N. Am., 314 A.2d 236, 240 (Pa. 1974). *See also* Moses H. Cone Mem'l Hospital v. Mercury Const. Corp., 460 U.S. 1, 24-25 (1983); Continental Cas. Co. v. Gezon, No. 94-1767, 1994 U.S. Dist. LEXIS 7190 (E.D. Pa. May 26, 1994); Federal Kemper Ins. Co. v. Reager, 810 F. Supp. 150 (E.D. Pa. 1992); Travelers Indem. Co. v. Greenfield, No. 88-6845, 1990 U.S. Dist. LEXIS 498 (E.D. Pa. Jan. 18, 1990); Johnson v. Pennsylvania Nat'l Ins. Cos., 594 A.2d 296, 299-300 (Pa. 1991); Brennan v. General Accid. Fire & Life Assur. Corp., Ltd., 574 A.2d at 299. As an example of the power of "public policy" preferences, the court in *Johnson* held that although arbitration is a creature of contract, and although the third party beneficiary had signed no contract with the defendant insurance company, the third party beneficiary was still bound by the arbitration clause contained in the insurance policy which she sought to enforce. *Johnson*, 594 A.2d 296, 299. *See also* WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 19-13, at 328 (5th ed. Supp. 1997); Schaefer v. Allstate Ins. Co., 590 N.E.2d 1242, 1245-46 (Ohio 1992)(noting the Ohio Supreme Court's "strong public policy favoring arbitration," listing cases and providing in depth discussion of the "meaning" of arbitration; prohibiting any agreement between parties to non-binding arbitration). *But see* Nationwide Mut. Ins. Co. v. Marsh, 472 N.E.2d 1061, 1063-64 (1984) (Sweeney, J., concurring) (cited by *Schaefer*, 590 N.E.2d at 1248); noting that endorsement in insurance policy binder which allows insurance company to escape binding result in arbitration is contrary to public policy strongly favoring final and binding arbitration).

Some states "limit the availability of arbitration to knowledgeable commercial parties." *See, e.g.*, Rashid v. Schenck Constr. Co., 438 S.E.2d 543, 547 (W. Va. 1993); Copley v. NCR Corp., 394 S.E.2d 751, 755 (W. Va. 1990); Barber v. Union Carbide Corp., 304 S.E.2d 353, 356-58 (W. Va. 1983); Board of Educ. v. Miller, 236 S.E.2d 439, 444-45 (W. Va. 1977).

240. *See* Stirlen v. Supercuts, Inc., 60 Cal. Rptr. 138 (Cal. Ct. App. 1997), *rev. denied*, No. S059176, 1997 Cal. LEXIS 1973 (Cal. Apr. 16, 1997).

241. *See* Vandenberg v. Superior Court, 69 Cal. Rptr. 2d 511 (Cal. Ct. App. 1997), *rev. granted*, 953 P.2d 158 (Cal. 1998).

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in a Lloyd's policy.[242] The court held that the arbitration clause conflicted with a service of suit clause within the same policy which required the underwriters to submit to any jurisdiction of the policyholder's choosing in the United States. The court found the arbitration clause ambiguous and resolved the conflict by enforcing the more specific service of suit clause, which allows policyholders to file claims in courts of law in the United States.[243]

The Missouri Court of Appeals came to the same conclusion as the *Thiokol* Court in *Transit Casualty Co. v. Certain Underwriters at Lloyd's of London,*[244] holding that the receivers of an insolvent insurance company were not required to arbitrate a dispute with the insolvent insurance company's reinsurance companies because the reinsurance agreements contained both a service of suit clause and an arbitration clause. The court rejected insurance company arguments for arbitration. The court applied the basic rule of contract construction that a more specific clause (here the service of suit clause) nullifies a more general clause. The court also based its holding on the principle that ambiguous clauses are to be construed against the drafter.

Arbitration, in general, is a very unfavorable forum for policyholders.[245] The insurance industry arbitration system is part of the information imbalance exploited by insurance companies and restrained by application of the reasonable expectations doctrine.

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242. Thiokol Corp. v. Certain Underwriters at Lloyd's of London, No. 1:96-CV-028 B, slip op., 1997 U.S. Dist. LEXIS 8264 (N.D. Utah May 6, 1997). Anderson Kill & Olick served as co-counsel to the Thiokol Corporation with the firm of Wood Quinn and Crapo, L.C. The decision is on file with the authors.

243. *Id.*, slip op. at 7-8.

244. Transit Cas. Co. v. Certain Underwriters at Lloyd's of London, 963 S.W. 2d 392 (Mo. Ct. App. 1998).

245. *See* Barry Meier, *In Fine Print, Customers Lose Ability To Sue*, N.Y. TIMES, Mar. 10, 1997, at A1; David Garfield Roland, *Arbitration—A Good Idea That Does Not Work*, INS. ADVOC., June 8, 1996, at 23; Roger Parloff, *Kaiser Arbitration: Waiting For Judge Godot?*, AM. LAW., July 1996, at 84; Lorelie S. Masters, *Arbitration Clauses In Liability Policies: A Ticket To Ride?*, JOHN LINER REV., Winter 1996, at 33; Margaret A. Jacobs, *Policies Requiring Arbitration Challenged*, WALL ST. J., Oct. 16, 1995, at B5; Eugene R. Anderson & Paul Liben, *The Perfect Insurance Or The Perfect Crime*, METRO. CORP. COUNS., Jan. 1995; *Editorials: Surprise Packages*, N.J. LAW., Apr. 7, 1997, at 6.

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IX. FRAUD: IS INSURANCE A DEFECTIVE PRODUCT?

Insurance industry employees and executives are indoctrinated with the philosophy that insurance is good and that policyholders, claimants and lawyers are bad. According to the insurance industry, nearly 50% of policyholders are actual or potential crooks.[246] One recent article, written by the President of the Insurance Information Institute,[247] finds that the perpetrators of insurance fraud are . . . "for the most part, the people we live and work among—our neighbors. . . ."[248] Moreover, the "rampant" corruption of otherwise honest, "seemingly law-abiding people" is something that those in the insurance industry "have known for some time."[249] Insurance company claims adjusters view themselves as underpaid, overworked vigilantes protecting an unappreciative American public from a horde of thieving, conniving robbers intent on pillage and plunder.

In order to deal with the insurance system, one must accept the fact that insurance company adjusters believe what they say they believe. They may be wrong, but they think they are right and must be dealt with on that basis. It goes without saying that there are crooked policyholders and

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246. *See* Brief on the Merits of Amicus Curiae American Council of Life Insurance in Supports of Petitioner at 13, n.4 (dated April 2, 1996), West Am. Ins. Co. v. Freeman, 46 Cal. App. 4th 1476 (1st Dist. 1995), *rev. granted*, 907 P.2d 1323 (Cal. 1995), *rev. dismissed*, 927 P.2d 1172 (1996), *rev. denied*, No S049306, 1997 Cal. LEXIS 649 (Cal. Feb. 5, 1997), *cert. denied*, 117 S. Ct. 1695 (U.S. 1997). The American Council of Life Insurance states:

> Although fraud by the insured is not an issue in this case, it is of great concern to first-party insurers such as life and property-casualty insurance companies. Shockingly, nearly half of the individuals who responded to a recent survey reported that they were willing to engage in insurance fraud.

See also Foppert, *Waging War Against Fraud*, BEST'S REV. P/C, Mar. 1, 1994, at 44; Brian Cox, *Michigan Bill Would Crack Down On Insurance Crime*, NAT'L UNDERWRITER, May 15, 1995, at 7; *Insurance Crime Is Big Money Industry*, INS. ADVOCATE, Nov. 12, 1994, at 12 (executive for American Alliance of Insurers noting the "public's seeming tolerance and indifference towards" insurance fraud); Phil Zinkewicz, *The Signs And Smells Of Insurance Fraud*, INS. ADVOC., Jan. 21, 1995, at 6.

247. The Insurance Information Institute is one of the insurance industry associations involved in the fight against insurance fraud.

248. Gordon Stewart, *Criminals Aren't To Blame For All Insurance Crime*, BEST'S REV., June 1997, at 94.

249. *Id.*

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crooked claimants and there are crooked lawyers,[250] but there are also crooked insurance companies.[251]

Is the insurance industry selling matches to arsonists? Fifty percent of the people who go to church do not steal from the collection plate and 50% of the people who go to the market do not shoplift. The fault may not be with the premium-paying policyholders. The fault may be with the insurance product. Any other product which turned its customers into anti-social cheats and thieves would be condemned and banned from the market.

The insurance product damages policyholders and others in many ways. First, if the insurance industry is to be believed, insurance corrupts. Second, this corruption then justifies corruption on the part of insurance company adjusters who engage in corrupt claims-handling tactics. When insurance executives, underwriters, adjusters and insurance lawyers believe that their policyholders and beneficiaries are cheats, the entire insurance mechanism is askew. Forcing policyholders to cheat or to be treated as cheats is counterculture in the United States. The insurance system brings out the worst in people involved in insurance claims handling; the system encourages and may even demand "padding" by policyholders and other beneficiaries. Insurance company vigilantes do

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250. An insurance company anti-policyholder litigation association argued to the New Jersey Supreme Court that New Jersey automobile insurance policyholders should get less insurance coverage than policyholders in other states because a "gang" of lawyers in California ran an insurance scam. *See* Brief of the Insurance Environmental Litigation Association As Amicus Curiae at 13, Trustees of Princeton Univ. v. Aetna Cas. & Sur. Co., 293 N.J. Super 296, 680 A.2d 783 (App. Div. 1996), *appeal granted*, 147 N.J. 574, 688 A.2d 1050 (1997). This case settled pending appeal.

251. *See* United States v. Brennan, 938 F. Supp. 1111 (E.D.N.Y. 1996); Michael Schachner, *USAU, Exec Found Guilty Of Fraud In Allocation*, BUS. INS., July 8, 1996, at 1; *Big Aviation Insurer, Former Head Brennan Convicted Of Fraud*, WALL ST. J., July 2, 1996, at B2; Adam Bryant & Barry Meier, *Taking A Hard Line Amid The Wreckage*, N.Y. TIMES, Oct. 6, 1996, §3, at 1.

See also Moleski v. Molin, No. 2ND 1995 (Pa. Commw. Ct.). In this case, a Pennsylvania judge found the CEO of Corporate Life Insurance Company liable for $139.7 million in compensatory damages and $1 million in punitive damages for looting the company's assets over the course of three years, pushing the company $210 million into the red. *See Verdicts and Settlements*, NAT'L L.J., Apr. 21, 1997, at A8.

Larry P. Schiffer & Vanessa L. Sutter, *If You Can't Pay the Fine, Don't Do . . .*, BEST'S REV. P/C ed., Dec. 1997, at 73 (discussing how the Federal Insurance Crimes Act, passed by Congress in 1994, is being used to prosecute wrongdoing by insurance companies and insurance company executives). A conviction under the Federal Insurance Crimes Act, as with any other federal criminal statute, requires that the sentencing judge follow the Federal Sentencing Guidelines Manual. *Id.* at 74.

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battle against the dishonest hordes and in the process develop a mentality that permits a "little deception and a little dishonesty." Since the end is noble, the means can be ignoble.[252]

The insurance product sold *to policyholders* to protect policyholders and the public is *not* the same product sold by the insurance company *to the courts*. Broad promises are made at the point of sale and fine print is delivered when a loss happens. Nearly every word in every insurance policy has a precise meaning. But all too often, the plain meaning of those words, whether common or technical, is far afield from the meaning attributed to them by insurance companies in insurance coverage disputes. Compounding the injury (and expense) are the legal theories spun by insurance law professors, insurance company lawyers, industry representatives and judges which complicate what should otherwise be a straightforward issue: If tens of thousands of automobile tires exploded, every judge in the United States would know the tires were defective and would not listen to any nonsense from law professors about the economics and theory of automobile tires and the automobile industry. A new car which requires judicial intervention is, by definition, defective. Automobile manufacturers are not permitted to sell lemonade and deliver lemons. Policyholders buy protection, not a ticket to the courthouse. The massive amount of insurance coverage litigation indicates that something is terribly wrong with the insurance product and that it has yet to be fixed.

There are very few organizations or associations, other than the FBI and the Justice Department's National Level Insurance Fraud Working Group, to combat fraud perpetrated by insurance companies against their policyholders. Contrast that with the numerous associations and organizations created—primarily by the insurance industry—at the

252. Policyholders and claimants are alleged to steal $120 billion a year from insurance companies. *See Insurance Fraud: The Quiet Catastrophe*, 1996, at 8 (a report prepared by Conning Insurance Research & Publications). Given the insurance companies' sophistication, it seems reasonable to assume that insurance companies steal at least that much from the public. *See also The "Other Cost of Fraud*, CLAIMS, Nov. 1997, at 10 (discussing a report from the Insurance Research Council in Wheaton, Illinois). According to the Insurance Research Council report, insurance companies spent $650 million in anti-fraud efforts, up from $200 million spent in 1992. *Id.* The IRC researchers noted that the $650 million figure was probably low because it did not include indirect internal expenses and assessments paid to state fraud bureaus. *Id.* The IRC study also found that 76% of insurance companies have special investigation units (SIU's). *Id.* Another article noted that 32 states have insurance fraud bureaus and that 13 other states are considering measures to establish or strengthen an existing fraud bureau. *See Coalition Reports Legislative Fraud Bureau Action*, WORKERS' COMP. EXECUTIVE, June 25, 1997.

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national and state levels to combat insurance fraud by policyholders, claimants and others.[253] As is known so far, there are no insurance

253. Following is a list of insurance industry associations and organizations which assist in the fight against insurance fraud by policyholders and other claimants:

1. Alliance of American Insurers (drafter a model state insurance fraud statute);

2. American Insurance Association (AIA);

3. American Insurance Services Group (AISG) (compiles data on claims to create comprehensive fraud database);

4. Coalition To Reduce Auto Fraud And Theft (CRAFT);

5. Independent Insurance Agents of America (IIAA);

6. Insurance Committee For Arson Control;

7. Insurance Fraud Bureau of Massachusetts ("industry backed") (*Fraud Investigators See Rise In Staged Accidents*, J. OF COM., June 21, 1994, at 7A);

8. Insurance Fraud Investigation and Management Committee (serves insurance industry claims management and managers of anti-fraud programs);

9. Insurance Information Institute (III);

10. Insurance Institute of America (IIA);

11. Insurance Research Council (IRC);

12. Insurance Services Office, Inc. (ISO);

13. International Association of Arson Investigators (IAAI);

14. International Association of Auto Theft Investigators (IAATI);

15. International Association of Defense Counsel;

16. International Association of Insurance Fraud Agencies, Inc.;

17. International Association of Insurance Fraud Bureaus (IAIFB);

18. International Association of Special Investigative Units (IASIU);

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industry sponsored fraud units designated to ferret out fraud committed by insurance companies against policyholders. Contrast this with the many insurance companies which have set up within their ranks special

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19. International Claim Association (ICA);

20. Loss Executives Association (LEA);

21. National Association of Independent Insurance Adjustors (NAIIA)

22. National Association of Independent Insurance Brokers (NAIIB);

23. National Association of Independent Insurers (NAII);

24. National Association of Insurance Commissioners (working group is looking into a model to stop insurance agents from making ridiculous promises regarding insurance policies (mainly life insurance policies));

25. National Association of Mutual Insurance Companies (NAMIC);

26. National Council Against Health Fraud (NCAHF);

27. National Council On Compensation Insurance (NCCI);

28. National Crime Information Center (NCIC);

29. National Fire Protection Association (NFPA);

30. National Fraud Advisory Council ("launched" by NCCI, Inc. (National Council On Compensation Insurance, Inc.));

31. National Health-Care Anti-Fraud Association;

32. National Insurance Crime Bureau (NICB);

33. New York Board Of Fire Underwriters (NYBFU);

34. Special Investigations Academy (set up by NICB to train fraud investigation techniques to SIU investigators, claims adjustors and managers from NICB member companies); and

35. Workers Compensation Research Institute (WCRI).

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insurance fraud investigation unit, commonly referred to as Special Investigation Units or SIUs.[254]

One conclusion from all of this crime and corruption is that insurance is a defective product. "We have actually designed an industry for the purpose of a con man."[255]

Most of the problem is with the insurance product and not with the customer. But rather than take responsibility for a defective product, many insurance companies have decided to blame the frequent victims of insurance fraud—their policyholders. John G. DiLiberto, president and chief executive officer of the National Insurance Crime Bureau, warned insurance companies that they are "in a shootout with the con men."[256] This says that the people who pay the premiums and who are the beneficiaries of insurance are evil.

Many observers have recognized the business of insurance to be a perfect vehicle for fraud. One FBI agent has commented that: "[I]nsurance is attractive to con artists because it is based on a simple premise: Pay me now and I promise to pay you later. The fraud often goes undetected longest with hard-to-place risks because the premiums are high and liabilities long-tailed."[257]

A study on insurance company insolvencies conducted by the FBI discovered that: "[t]he business of insurance is uniquely suited to abuse by mismanagement and fraud. The very nature of insurance, which involves the payment of money in the present in exchange for a promise to pay costs associated with some future event which may or may not occur, is a con artist's dream."[258]

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254. CNA, Royal Ins. Co., Zurich and Fireman's Fund set up special claims service groups to investigate complex and potentially fraudulent claims. These companies will also sell their services to other insurance companies. *See* Robert G. Knowles, *Fraud Can't Be Stopped, But It Can Be Contained*, NAT'L UNDERWRITER, Sept. 11, 1995, at 15. Royal & Sun Alliance Insurance Group, PLC has established Investigative Resources Global of Charlotte, N.C. and USF&G has established Nemax Claim Services, Inc., both SIUs. *See* Anne Colden, *Small Insurers That Need Gumshoes To Fight Fraud Turn To Bigger Rivals*, WALL ST. J., Feb. 24, 1997, at B9C.

255. Statement by Trevor H. Jones, chairman of Insurance Security Services, Ltd., a London-based insurance consulting company. Deborah Shalowitz Cowans, *Insurance Fraud By Design*, BUS. INS., Sept. 25, 1995, at 24.

256. Stephanie D. Esters, *Insurers Urged to Unite in "Shootout With Con Men"*, NAT'L UNDERWRITER, Sept. 16, 1996, at 6.

257. Marilyn Ostermiller, *Paper Chase*, BEST'S REV. P/C, Sept. 1997, at 40, 41.

258. Economic Crimes Unit White-Collar Crimes Section, Federal Bureau of Investigation, *Insurance Company Insolvency Study* (1991). *See* Alfred G. Haggerty, *FBI Steps Up Campaign Against Insurance Fraud*, NAT'L UNDERWRITER, Oct. 11, 1993, at 1.

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According to one Assistant United States Attorney, "dishonest people are moving from other industries into the insurance industry."[259] The National Association of Insurance Commissioners has also recognized that insurance is "uniquely suited" for abuse and that "insurance lends itself all too readily to fraud:"[260]

> The business of insurance is uniquely suited to abuse by mismanagement and fraud. Making believable promises is a stock item in every con man's bag of tricks. The prepayment of large, often vast, sums of money with few restrictions lends itself naturally to monumental wasting of assets through greed, incompetence, and dereliction of duty. This combination of easy money based on easy promises makes the insurance industry an irresistible target for financial knaves and buccaneers.[261]

Given the potential for fraud and abuse acknowledged by law enforcement agencies and insurance companies themselves, contract remedies are insufficient to protect policyholders from unscrupulous conduct in an alien, and potentially hostile, business environment.

CONCLUSION

In the past, insurance policies were treated as contracts. Today, more and more they are treated like products. When Professor Keeton wrote his famous articles, there were few remedies for opportunistic breach of contract. Today, contract law and insurance law are in evolution. Policyholders seeking insurance coverage are not limited to the literal terms—often hidden or unclear—of their policies.

The reasonable expectations doctrine protects policyholders from the inadequacy of contract remedies and the temptations of opportunistic breach. By going beyond the written language of the policy, the doctrine attempts to fully fulfill a policyholder's objectively reasonable

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259. *Haggerty* at 1.

260. Brief of Amicus Curiae National Association of Insurance Commissioners Supporting Respondent at 4 (filed Oct. 12, 1995), Prometheus Funding Corp. v. Merchants Home Delivery Servs., Inc., 50 F.3d 1486 (9th Cir.).

261. *Id.* at 4 (quoting "Failed Promises: Insurance Company Insolvencies," STAFF OF HOUSE COMMITTEE ON ENERGY AND COMMERCE, 101ST CONG. 2D SESS., (Comm. Print 101-P 1990)).

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expectations of insurance coverage. This approach is supported by the unique nature of the insurance product and the business of insurance.

It cannot be ignored that the insurance companies are in the best position to address a policyholder's reasonable expectations of insurance coverage. Striving for clarity in policy language, openness in sales negotiations and fair claims handling reduces the risk that the insurance company will fail to satisfy the reasonable expectations of their policyholder.[262] Disclosure of potential gaps in insurance coverage should occur at the point of sale rather than after a claim is made. Policyholders genuinely apprised of the extent of their insurance coverage from the outset are less likely to feel abused and abandoned by their insurance company when a claim is denied. Correspondingly, insurance companies' willingness to share this type of information should proceed at speeds greater than slow, stop and reverse. By training their agents and employees to honor the duty of good faith and fair dealing, insurance companies ultimately save money for the policyholder and themselves. Such conduct engenders good will and trust. It is simply good business.

262. *See* ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 25D, at 147 (2d ed. 1996).

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REASONABLE EXPECTATIONS AFTER THIRTY YEARS: A FAILED DOCTRINE

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INTRODUCTION

Despite optimistic predictions from some quarters,[1] the reasonable expectations doctrine[2] has not developed into a coherent, principled body of law that can be used to interpret insurance policies with a reasonable degree of certainty in the outcome. Rather, the problems that have plagued the developing doctrine from the start, such as its indefinite contours and the lack of objectivity and predictability in its application,[3] have persisted.[4] With the

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1. Looking back after 20 years, Professor Roger Henderson expressed the belief that the doctrine had evolved to the point that "its jurisprudential core . . . consist[s] of rules that provide sufficient guidelines for its application" and predicted that "any confusion over the nature of the doctrine itself will rapidly dissipate." Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO L.J. 823, 825, 838 (1990); *accord* Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d 798, 816 (Utah 1992) ("Although I acknowledge certain difficulties with the reasonable expectations doctrine, I view such problems as grounds for refinement of its content and care in its application, not for exclusion of its use.").

2. The reasonable expectations doctrine "was initially formulated by Professor, now Judge, Robert Keeton as an overarching set of principles to assist in explaining the results of disparate insurance law decisions that appeared to be based on a number of different rationales." Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d at 801.

3. Since Professor Keeton's seminal article identifying a doctrine of "reasonable expectations," Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part One*, 83 HARV. L. REV. 961, 967 (1970) (hereinafter KEETON, PART ONE); Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part Two*, 83 HARV. L. REV. 1281 (1970), the doctrine has generated extensive debate in the academic community. *See* Bensalem Township v. International Surplus Lines Ins. Co., 38 F.3d 1303, 1311 (3d Cir. 1994) ("Since Professor Keeton's article, a considerable number of trees have been sacrificed in the name of reasonable expectations as the academic community has debated what reasonable expectations means, which courts have adopted the doctrine, and whether it is desirable for them to have done so."); Peter Nash Swisher, *Judicial Interpretations of Insurance Contract Disputes: Toward a Realistic Middle Ground Approach*, 57 OHIO ST. L.J. 543, 553 nn.29-30 (1996) (listing articles supporting and criticizing the reasonable expectations doctrine).

Even commentators advocating the use of some form of the doctrine have noted a myriad of difficulties in its scope and application. *See, e.g.*, HENDERSON, *supra* note 1, at 823 ("Even after two decades, there still seems to exist a great deal of uncertainty as to the doctrinal content and when the principle may be invoked, including most of the jurisdictions that have professed to have adopted it."); Mark Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 392 (1986) ("The difficulties with the reasonable expectations concept, though real, do not outweigh its usefulness to the point that the principle should be abandoned.").

4. A survey of recent decisions shows judicial criticism in much the same vein as in the earlier decisions. *See, e.g.*, Nielsen v. O'Reilly, 848 P.2d 664, 667 (Utah 1992) (noting that "substantial uncertainty surrounds 'the theoretical underpinnings of the doctrine, its scope, and the details of its application'") (quoting Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d at 803 ("[A] number of states have struggled with the doctrine's scope, leaving a trail of inconsistent decisions and creating an obviously uncertain future for the doctrine in those states.")).

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benefit of hindsight, it seems clear that the problems are inherent in the doctrine itself, and thus will not work themselves out over time.

This article examines the several variations of the doctrine that have evolved over the last three decades, pointing out along the way some of the more blatant inconsistencies among, and even within, these variations. It does not attempt to provide a comprehensive survey of the many cases across the country that, in the author's view, have improperly invoked the doctrine in an effort to reach a desired result. Rather, it highlights the problem by example in order to demonstrate the critical point: that the absence of any real doctrinal standards has resulted in such inconsistent and unpredictable results that the ultimate effect of the doctrine can only be to increase premiums or restrict coverage, all to the detriment of the very people the doctrine was intended to protect.

I. WILL THE REAL REASONABLE EXPECTATIONS DOCTRINE PLEASE STAND UP?

From the beginning, there has been a striking lack of agreement among the courts and commentators as to what the reasonable expectations doctrine is, how it should be applied, or when it should be invoked.[5] According to Professor Keeton's oft-quoted formulation: "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."[6] This principle, Professor Keeton believed, would explain the results in a number of insurance cases that did not fit neatly into established doctrines generally invoked in cases involving "rights at variance" with contract provisions, i.e., cases in which there was no other way to justify relieving one contracting party from the literal terms of the contract.[7] What began as a description soon became a rule of law, and courts since 1970 have frequently invoked the "reasonable expectations doctrine" as a rationale for refusing to enforce a variety of contract terms. But despite the apparent simplicity of Professor Keeton's words, courts seeking to apply them have created a patchwork of rules that are

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5. *See supra*, notes 3-4. *See also* Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1466-67 (1989) ("Construing an insurance policy to protect the insured's 'reasonable expectations' means different things to different courts. . . . [The various versions of the doctrine] form a rough continuum from purported adherence to the policy's language to open disregard of the written contract.").

6. KEETON, PART ONE, *supra* note 3, at 967.

7. HENDERSON, *supra* note 1, at 823, 825.

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impossible to harmonize and, in many instances, virtually unrecognizable as the progeny of Professor Keeton's formulation.

Fundamental to Professor Keeton's analysis is the notion that the challenged provision, while apparent upon a "painstaking study" of the policy language, is "inconsistent with the reasonable expectations of a policyholder having an ordinary degree of familiarity with the type of coverage involved."[8] Stated differently, "[A]s a prerequisite to the applicability of [the reasonable expectations] doctrine, the insured must . . . show that 'the policy is such that an ordinary layperson would misunderstand its coverage.'"[9]

Yet many courts purporting to embrace the doctrine simply ignore the key adjective "painstaking" and allow the purportedly reasonable expectations of the insured to override the express terms of the policy even when the most *cursory* examination of the policy would have "negated" any alleged expectations of coverage.[10] Applying this "unqualified" version of the doctrine, a court may invalidate an exclusion that is both clearly stated and prominently placed based simply on the court's determination that the insured expected something different.[11] Whatever else is so, this approach puts the court in the paternalistic role of rewriting the contract for the insured and overriding the insured's apparent judgment that the contract was worthwhile as written.

Other courts hew more closely to Professor Keeton's original definition and give greater weight to the word "painstaking."[12] These courts take the

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8. KEETON, PART ONE, *supra* note 3, at 968.

9. Lemars Mut. Ins. Co. v. Joffer, 574 N.W.2d 303, 311 (Iowa 1998) (quoting Benavides v. J.C. Penney Life Ins. Co., 539 N.W.2d 352, 357 (Iowa 1995)).

10. For example, in Hamilton v. Allstate Insurance Co., 789 S.W.2d 751, 752-53 (Ky. 1990), the court was called upon to determine the validity of an "anti-stacking" clause in an automobile liability policy, which provided that the insured's payment of an additional premium for another car under the policy did not allow the insured to aggregate or "stack" the two policy limits in the event of an accident involving one of the cars. Despite acknowledging that the provision was both unambiguous and prominently placed, the court invoked the reasonable expectations doctrine to invalidate the provision. According to the court, "Under the doctrine of reasonable expectations, we have held that when one has bought and paid for an item of insurance coverage, he may reasonably expect it to be provided." *See also* Regional Bank of Colo. v. St. Paul Fire & Marine Ins. Co., 35 F.3d 494, 497-98 (10th Cir. 1994) (voiding absolute pollution exclusion in CGL policy: "Regardless of the ambiguity, or lack thereof . . . the public has a right to expect that they will receive something of comparable value in return for the premium paid.").

11. The various means by which the courts determine what a particular insured's objectively reasonable expectations are, and the problems accompanying such a determination, are discussed *infra* Part III.C.

12. *See, e.g.*, Minnesota Mut. Fire & Cas. Co. v. Manderfield, 482 N.W.2d 521, 524 (Minn. Ct. App. 1992) (upholding household exclusion in homeowners policy: "We find no

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language and format of the policy into account in determining whether the insured's expectations of coverage are objectively reasonable. Theoretically at least, a court applying this variation of the doctrine will not invalidate an otherwise clear and unambiguous policy provision unless it is "hidden" in some manner, such as by fine print or inconspicuous placement in the policy.[13] Thus, in contrast to courts applying the unqualified version of the doctrine, courts applying this "prominence" - based variation must satisfy themselves that at least a casual inspection of the policy would not have alerted the insured to the provision at issue.[14]

A third iteration of the reasonable expectations doctrine is even further afield from its doctrinal underpinnings. Under this variation, the court will invoke the doctrine to nullify a policy provision only if the challenged provision is ambiguous.[15] Courts applying an "ambiguity" - based version of the doctrine have apparently abandoned the doctrine as a rule of substantive law altogether, treating it instead as a rule of construction analogous to—indeed, virtually indistinguishable from—the *contra proferentem* doctrine.[16]

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reason to believe that [the insured] could not read the policy and understand the exclusion provision without the need for 'painstaking' study."); *see also* RAHDERT, *supra* note 3, at 335 (Some courts' "heavy emphasis on 'painstaking' . . . means that expectations derived from sources other than at least a cursory review of the policy are not reasonable and should not be honored in the face of unambiguous contrary policy language.").

13. *See, e.g.*, Chu v. Allianz Life Ins. Co., 980 F. Supp. 1086, 1092 (N.D. Cal. 1997) (to be enforceable, exclusion must be "positioned in a place and printed in a form which will attract the reader's attention"); Lehroff v. Aetna Cas. & Sur. Co., 638 A.2d 889, 892 (N.J. 1994) ("Reasonable expectations of coverage raised by the declaration page cannot be contradicted by the policy's boilerplate unless the declaration page itself clearly so warns the insured.").

14. *See, e.g.*, Chu v. Allianz Life Ins. Co., 980 F. Supp. at 1092 ("Courts have invalidated exclusions as not conspicuous where not in a section labeled exclusions and placed on an overcrowded page . . . or in a section labeled 'General Limitations' but in a dense pack format . . . or hidden in a subsequent section of the policy bearing no clear relationship to the insuring clause and concealed in fine print."); Vierkant v. AMCO Ins. Co., 543 N.W.2d 117, 121 (Minn. Ct. App. 1996) (refusing to invalidate exclusion where it was neither hidden nor ambiguous and there was no evidence the insured was unable to read the policy).

15. *See, e.g.*, Commerce & Indus. Ins. Co. v. Valero Terrestrial Corp., No. 95-1875, 1996 U.S. App. LEXIS 10320, at *9 (4th Cir. May 6, 1996) ("[U]nder West Virginia law . . . the doctrine of reasonable expectations applies only where the policy terms are ambiguous"); Continental Cas. Co. v. City of Richmond, 763 F.2d 1076, 1080 (9th Cir. 1985) (reasonable expectations doctrine "is applicable only when the policy language is found to be unclear"); *see also* WARE, *supra* note 5, at 1468 n.32 (listing nine other states that have adopted this approach).

16. The maxim of *contra proferentem* — "against the drafter" — is a rule of contract construction that provides that a contract will be interpreted most strictly against the party that drafted it. Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 531 (1996). As a general rule, therefore, any ambiguity in an insurance contract is

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This formulation is thus fundamentally at odds with Professor Keeton's basic conception, which plainly contemplated that in appropriate circumstances, the insured's reasonable expectations should prevail despite unambiguous policy language.[17]

Finally, some courts have combined the second and third variations to create a hybrid version of the reasonable expectations doctrine, which may be invoked to override a contract term if the provision is either "hidden" or ambiguous.[18]

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construed against the insurer. *See, e.g.*, Donaldson v. Urban Land Interests, Inc., 564 N.W.2d 728, 731 (Wis. 1997) ("Under the doctrine of contra proferentem, ambiguities in a policy's terms are to be resolved in favor of coverage, while coverage exclusion clauses are narrowly construed against the insurer."). Courts and commentators have noted that the ambiguity-based variation of the reasonable expectations doctrine is in reality *contra proferentem* by another name. *See, e.g.*, Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d 798, 807 (Utah 1992) (citing HENDERSON, *supra* note 1, at 827) ("It is doubtful whether application of [the ambiguity-based] version of the reasonable expectations doctrine can be distinguished from, or adds anything to, the application of the canon of construction resolving ambiguities against the drafter and reforming the contract accordingly.").

17. *See* McHugh v. United Service Automobile Ass'n No. 97-35019, 1998 U.S. App. LEXIS 24272, at *15 (9th Cir. Sept. 29, 1998). After all, no amount of "painstaking study" will enable an insured to divine the proper meaning of policy language that is, by definition, "capable of two constructions, both of which are reasonable." Chu v. Allianz Life Ins. Co., 980 F. Supp. at 1089. The problems associated with a court's determination that a policy provision is ambiguous are discussed *infra* Part III.B.

18. *See, e.g.*, Max True Plastering Co. v. United States Fidelity & Guar. Co., 912 P.2d 861 (Okla. 1996) (requiring either a finding of ambiguity or a determination that the exclusions were "masked by technical or obscure language or . . . hidden in a policy's provisions"); *see also* RAHDERT, *supra* note 3, at 335-36 (distinguishing between "weaker" and "stronger" versions of the reasonable expectations doctrine: "weaker" version encompasses expectation of coverage caused by ambiguous or "hidden" policy provisions; "stronger" version allows reasonable expectation of coverage to be honored despite lack of ambiguity if expectation was created by "some source other than the policy language itself"). Because of the conceptual differences and practical consequences of these variations of the doctrine, the author believes they should be analyzed separately—a view shared by other commentators as well. *See* WARE, *supra* note 5, at 1467.

Some courts, of course, have rejected the doctrine altogether on various grounds, including that existing equitable doctrines provide sufficient protection or that there is insufficient justification to depart from the usual rules that apply to all contracts. *See, e.g.*, Constitution State Ins. Co. v. Iso-Tex, Inc., 62 F.3d 405, 410 n.4 (5th Cir. 1995) ("Texas law does not recognize coverage because of 'reasonable expectation' of the insured."); Nielsen v. O'Reilly, 848 P.2d 664, 667 (Utah 1992) ("This court, however, has never adopted any version of the [reasonable expectations] doctrine."); Findlay v. United Pacific Ins. Co., 917 P.2d 116, 121 (Wash. 1996) ("The 'reasonable expectations' doctrine has never been adopted in Washington, and there is no reasonable expectation that no exemptions to coverage exist.").

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II. CONSUMERS CANNOT AFFORD THE PRICE OF PROFESSOR KEETON'S FORMULA

Although it might be tempting to assume that abandoning the reasonable expectations doctrine would be a boon to insurance carriers, such an assumption would be entirely too facile. The reality is that judicial invalidation of policy language based on a court's view of an insured's alleged reasonably expectations is as serious a threat to the insurance-buying public as it is to the insurance industry.

Insurance is a conduit, not a cornucopia. In its most basic (albeit grossly oversimplified) form, it is a risk-spreading mechanism by which many people pay a relatively small amount of money so that a smaller number of people will receive a larger amount of money in the event of certain defined contingencies. This mechanism depends for its success on the insurer's ability (1) to calculate its anticipated losses relatively accurately, and (2) to set premiums at a level low enough to enable large numbers of people to buy insurance but high enough to ensure that sufficient funds will be available to cover those losses when they occur. In order to do either of these things, insurers must be able to predict *in advance and with reasonable certainty* how the policy terms will be interpreted.[19] As one commentator has described it:

> No principles are more deeply ingrained in the minds of underwriters than the selection of risk and the determination of premium. Insurers must know with certainty that contract language will be judicially respected. Absent such certainty, only the most cavalier insurer would attempt to write business.[20]

When the courts invalidate unambiguous exclusions, the insurance industry's ability to calculate and manage risk is severely impaired.[21] The

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19. *See, e.g.*, Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d at 808 ("The insurance company certainly considers the household exclusion when calculating its risk under a homeowner's policy. The result is a relatively low premium when compared with premiums for higher risk coverage, such as medical and health insurance.").

20. Michael E. Bragg, *Concurrent Causation and the Art of Policy Drafting: New Perils for Property Insurers*, 20 FORUM 385 (Spring 1985).

21. As one court put it, it is "imperative that the provisions of insurance policies which are clearly and definitely set forth in appropriate language, and upon which the calculations of the company are based, should be maintained unimpaired by loose and ill-considered judicial interpretation [under the reasonable expectations doctrine.]" Max True Plastering Co. v. United States Fidelity & Guar. Co., 912 P.2d 861, 870 (Okla. 1996).

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insurers' only alternative to this uncertainty is to hedge their bets by increasing premiums[22] or restricting coverage.[23]

It is not just the direct costs that create the problem. When the courts allow the insured to invoke the reasonable expectations doctrine as a basis for defeating an unambiguous policy provision, transactions costs—especially the cost of litigation—increase as well. The reason is simple: If every policy provision is potentially subject to invalidation on reasonable expectations grounds, an insured whose claim is denied has a tremendous incentive to challenge any claim denial, whether or not he or she in fact had an expectation of coverage. Due to the fact-intensive nature of the inquiry, the parties are forced to engage in prolonged and expensive litigation in an effort to ascertain the insured's reasonable expectations with regard to coverage, a dubious enterprise at best.[24] Thus, rather than a speedy resolution based on the plain meaning of the policy, the determination of coverage turns into a full-scale trial.[25] Here again, the ultimate loser is the insurance-buying public as these increased costs are passed along to insureds in the form of higher premiums.

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22. "If we were to extend the coverage of the Hartford policies in this case, by some strained interpretation, to find potential coverage for the situation presented by this [loss], we would be doing no favors to the consumers of homeowners and excess insurance policies. Ordinary insureds would have to bear the expense of the increased premiums necessitated by the expansion of their insurers' potential liabilities." Hartford Fire Ins. Co. v. Superior Court, 142 Cal. App. 3d 406, 414, 191 Cal. Rptr. 37, 42 (1983); *accord* Garvey v. State Farm Fire & Cas. Co., 770 P.2d 704, 711 (Cal. 1989); *see also* Nation v. State Farm Ins. Co., 880 P.2d 877, 889 (Okla. 1994) (Opala, J., concurring) (observing that majority's invalidation of household exclusion in automobile liability policy is no "victory for consumers" because expanded coverage "would doubtless be passed on to all affected consumers in the form of higher premiums"); Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d at 808 (enforcing household exclusion in homeowner's policy: "If an insurer provided bodily injury coverage in a homeowner's policy for those living on the insured premises, the likelihood of covered injuries would increase and the insurer would assess a higher premium based on the increased risk.").

23. Safeco Ins. Co. v. Hirschmann, 773 P.2d 413, 427 (Wash. 1989) (Callow, J., dissenting) (criticizing majority for invalidating unambiguous language in an "all-risk" homeowner's policy: "The insurance industry's ability to segregate and manage risk will be severely impaired. Insurance purchasers may be required to choose between high premiums or foregoing 'all-risk coverage' entirely."); BRAGG, *supra* note 20, at 391 ("The traditional response of insurers upon discovering that their contract language is not being interpreted by the courts as the drafters intended is to rewrite the language.").

24. *See infra* Part III.C.

25. As the Pennsylvania Supreme Court has noted, "[b]y focusing on what was and was not said at the time of contract formation rather than on the parties' writing, [the reasonable expectations doctrine] makes the question of the scope of insurance coverage in any given case depend upon how a fact-finder resolves questions of credibility. Such a process, apart from the obvious uncertainty of its results, unnecessarily delays the resolution of controversy, adding

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III. UNPREDICTABLE, UNPRINICIPLED, AND UNCERTAIN: A TRILOGY OF PROBLEMS

A. Problem No. 1: Ad Hoc Judicial Lawmaking

One of the chief vices of the reasonable expectations doctrine is that it turns every court into a mini-legislature, with the power to fashion public policy by invalidating contract terms it believes to be unfair or inappropriate. Not surprisingly, this tendency is seen most often in states that have adopted the unqualified variation of the doctrine, which may be invoked in the absence of any finding that the challenged policy provision is inconspicuous or ambiguous. The unqualified version of the doctrine is intended not only to level the playing field between insurers and their policyholders but also to fill a perceived gap in the protections otherwise afforded by doctrines such as unconscionability, ambiguity, and adhesion.[27] Thus, courts unable to find any other means of providing insurance coverage will turn to the reasonable expectations doctrine to ensure a source of funding for victims of tragic circumstances who might otherwise find themselves without financial resources.

In *Lewis v. West American Insurance Co.*,[28] for example, the Kentucky Supreme Court was called upon to determine the validity of a "household exclusion" in an automobile liability insurance policy.[29] In that case, a nine-year old child was brain damaged in a car accident that killed her mother, who was the owner and operator of the insured vehicle. The mother's policy contained a household exclusion that clearly and unambiguously excluded coverage for the child's injuries.[30] Confronted with these tragic facts, the court refused to enforce the limiting language , even though Kentucky case law had

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unwanted costs to the cost of procuring insurance." Standard Venetian Blind Co. v. American Empire Ins. Co., 469 A.2d 563, 567 (Pa. 1983).

27. *See, e.g.,* Max True Plastering Co. v. United States Fidelity & Guar. Co., 912 P.2d at 864 (the reasonable expectations doctrine "developed in part because established equitable doctrines were inadequate . . . ."); Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d 798, 805 (Utah 1992) ("[T]he reasonable expectations doctrine has been urged because of the supposed inadequacy of the existing equitable doctrines available to courts confronted with overreaching insurers.").

28. 927 S.W.2d 829 (Ky. 1996).

29. The household exclusion, also known as the "family exclusion," is a standard provision in virtually all automobile liability policies and typically precludes coverage for bodily injury to the named insured and relatives of the named insured who are residents of the same household.

30. 927 S.W.2d at 830.

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previously upheld such exclusions.[31] Instead, the court divined a reasonable expectation of coverage based on its own, unaided conclusion that, despite what their insurance policies may say, insureds expect that "their family members [will] receive comparable protection to that afforded to unknown third persons . . . ."[32]

As a further basis for nullifying the household exclusion in *Lewis*, the Kentucky Supreme Court pronounced its view that public policy required "that innocent victims of another's negligence" receive "fair compensation."[33] Accordingly, under the principle that a court may declare void a contract that is "against public policy," the court invalidated the household exclusion.[34] In so holding, the court rejected as inadequate the competing interest served by the exclusion: to allow insurers to offer reasonably priced policies based upon their ability to exclude from coverage "high risk collusive claims."[35] To justify this departure from settled case law, the court noted that public policy is "dynamic, flexible and fully capable of adapting to new situations . . . to permit our institutions to better serve the needs of our citizens."[36]

As the concurring and dissenting justices pointed out, the *Lewis* majority's approach is rife with problems. For one, except in rare cases, courts should not declare a contractual provision void as against public policy in the absence of

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31. Although the majority avoided acknowledging that it was overruling prior Kentucky decisional law, it clearly did, as both the concurring and dissenting opinions pointed out. *Id.* at 837 (Lambert, J., concurring); *id.* (Stephens, J. dissenting).

32. *Id.* at 833. Not coincidentally, the court noted that the effect of such exclusions was to deny insurance protection to "innocent children". *Id.*

Similar sentiments prompted the dissent in Forbau v. Aetna Life Ins., 876 S.W.2d 132 (Tex. 1994) (Doggett, J., dissenting). In that case, a clear and unambiguous provision limited medical expense benefits to one year after the group employer terminated the policy. Pursuant to this provision, Aetna discontinued benefits to Amy Miller, a permanently disabled teenager, and she brought suit. Following a jury trial, the trial court rendered judgment in favor of Amy, which was reversed by the Texas Court of Appeals. The Texas Supreme Court affirmed the court of appeals. Although conceding that the termination of benefits provision was clear and unambiguous, the dissent argued that the coverage limitation should not be enforced in order to ensure compensation to someone in need:

> Amy Miller, a young quadriplegic, now leaves this court with nothing — without any of the means that a judge and jury in Lubbock, Texas thought essential to meeting her lifetime medical needs over the course of her now bleak future.

Id. at 136.

33. Lewis v. West American Ins. Co., 927 S.W.2d at 836.

34. *Id.*

35. *Id.* at 834.

36. *Id.* at 835.

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a specific legislative mandate.[37] In this case, despite ample opportunity to do so, the Kentucky Legislature had never prohibited household exclusions.[38] Nonetheless, the *Lewis* majority took it upon itself "to adjust economic relations to achieve its view of economic fairness with what seems to be too little regard for the role of the legislative branch and for this Court's prior decisions."[39] And although the majority couched its opinion in sweeping generalities about serving the needs of its citizens, it thereby sacrificed the interests of a larger segment of the public: other policyholders who will eventually carry the load in the form of higher premiums or restricted coverage.[40]

Similarly, in *Nation v. State Farm Insurance Co.*,[41] the Oklahoma Supreme Court held that household exclusions in automobile liability policies are unenforceable as against public policy. Remarkably, in reaching its decision, the court relied on a statute that expressly *allowed* insurers to exclude designated persons from coverage if agreed to by the insured in a separate endorsement.[42] To compound matters, in a prior opinion, the same court had upheld household and named insured exclusions, declaring that the purpose of the statute was to compel motor vehicle owners to maintain minimum amounts of liability insurance, not to dictate policy terms.[43]

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37. *Id.* at 837; *see also* Aerojet Gen. Corp. v. Transport Indem. Co., 48 P.2d 909, 932 (Cal. 1997) (rejecting lower court's reliance on "fairness" as basis for disregarding plain meaning of CGL policy so as to prevent insurer from allocating defense costs to insured; "[a]s a general matter at least, we do not add to, take away from, or otherwise modify a contract for 'public policy considerations.'").

38. Lewis v. West American Ins. Co., 927 S.W.2d at 837 (Lambert, J., concurring).

39. *Id.*

40. This is generally the price of *ad hoc* judicial lawmaking. As the commentators have observed: "Judicial, as distinguished from legislative, intervention renders costs quite unpredictable and makes insurers fearful, tightening the market... Legislative intervention can destroy a market, too. Yet recurring judicial activism . . . can have an even more disruptive effect. Whereas legislative intervention is prospective, judicial intervention has a retroactive effect. This creates greater uncertainty, giving insurers no opportunity to react in a timely fashion to the changes in the legal environment." WARE, *supra* note 5, at 1489 (quoting Spencer L. Kimball, Book Review, 19 CONN. L. REV. 311, 322 (1987) (reviewing KENNETH S. ABRAHAM, DISTINGUISHING RISK).

41. 880 P.2d 877, 890 (Okla. 1994) (per curiam).

42. Although the majority did not acknowledge this fact, a concurring justice pointed out that "the [Financial Responsibility] Act — presumably the source for [the majority's] perceived public policy mandate — expressly allows exclusions by agreement." *Id.* at 890 (Summers, J., concurring). The purpose of allowing exclusions of designated individuals from coverage is to "enabl[e] individual insureds to keep their insurance rates at an acceptable level" and reflects a legislative judgment to balance competing interests. *Id.*

43. *Id.* at 889.

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One would assume that a doctrine allegedly based on some sort of objective expectation—applicable by definition to all "reasonable" insureds—would be construed more or less identically by all courts, thus providing a measure of certainty to the interpretive process. After all, if the highest courts of Kentucky and Oklahoma find the household exclusion so repugnant to public policy that it cannot be applied as a matter of law, surely one would expect that other courts addressing the exclusion should react similarly.

Of course, that is not the case. Many other states have held there is no public policy impediment whatever to the household exclusion.[44] Indeed, since 1970, the exclusion has been specifically authorized by the California legislature.[45] Ironically, the very concerns dismissed by the Kentucky's Supreme Court as unworthy of serious consideration—the possibility of fraud and collusion among insureds and the attendant increase in insurance premiums—were the primary reasons that led the California Legislature to enact the statute.[46]

There is no denying the benefit of the reasonable expectations doctrine to the individual policyholder in those cases where it is invoked to override a contractual limitation on coverage. Despite that benefit, however, the ultimate cost to the insurance-buying public as a whole is simply too great. As one dissenting justice stated in challenging the majority's refusal to enforce a landslide exclusion in a flood insurance policy:

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44. For example, the household exclusion has withstood public policy challenges in Alabama (*see* Hutcheson v. Alabama Farm Bureau Mut. Cas. Ins. Co., 435 So. 2d 734, 737 (Ala. 1983)); California (*see* Farmers Ins. Exch. v. Cocking, 629 P.2d 1 (Cal. 1981)); Colorado (*see* Allstate Ins. Co. v. Feghali, 814 P.2d 863, 866-67 (Colo. 1991)); Florida (*see* Amica Mut. Ins. Co. v. Wells, 507 So. 2d 750, 752 (Fla. Dist. Ct. App. 1987)); Georgia (*see* Stepho v. Allstate Ins. Co., 383 S.E.2d 665, 667 (Ga. 1987)); Illinois (*see* Severs v. Country Mut. Ins. Co., 434 N.E.2d 290, 292 (Ill. 1982)); Indiana (*see* Transamerica Ins. Co. v. Henry, 563 N.E.2d 1265, 1268-69 (Ind. 1990)); Iowa (*see* Walker v. American Family Mut. Ins. Co., 340 N.W.2d 599, 603 (Iowa 1983)); Massachusetts (*see* Hahn v. Berkshire Mut. Ins. Co., 547 N.E.2d 1144, 1145 (Mass. App. Ct. 1989)); Minnesota (*see* American Family Ins. Co. v. Ryan, 330 N.W.2d 113, 115 (Minn. 1983)); Pennsylvania (*see* Paiano v. Home Ins. Co., 385 A.2d 460, 462 (Pa. Super. 1978)); and Rhode Island (*see* Faraj v. Allstate Ins. Co., 486 A.2d 582, 588 (R.I. 1984)).

For a listing of jurisdictions that have nullified household exclusions, *see* Nation v. State Farm Ins. Co., 880 P.2d at 886 (Opala, J., concurring).

45. *See* Cal. Ins. Code §11580.1(c)(5) (West 1998), *as construed in* Farmers Ins. Exch. v. Cocking, 629 P.2d 1, 2 (1981).

46. "The primary basis underlying the use of this exclusion . . . 'is to prevent suspect inter-family legal actions which may not be truly adversary and over which the insurer has little or no control. Such an exclusion is a natural target for the insurer's protection from collusive assertions of liability.'" Farmers Ins. Exch. v. Cocking, 629 P.2d at 4.

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> Although what befell plaintiffs was unquestionably a disaster, disallowing recovery under an insurance policy that plainly does not cover their loss is entirely reasonable and just. It is not unconscionable to require an insured to read the terms of the contract, and it is not unconscionable to deny coverage when the insured has not bought coverage for the particular kind of disaster that occurred. . . . [T]he opposite result is what would be unconscionable. Others who have purchased flood insurance must pay for the claim in the form of increased premiums. Purchasers of flood insurance agree to share only the risk of flood, not any of the many other risks for which other forms of insurance are designed.[47]

There is a cost to the system as well. As one commentator aptly put it, "[s]ocial goals should be achieved in ways other than cross-subsidization within the insurance system, which works badly enough as a pure market system without being burdened with solving the ills of the world at the same time."[48]

In any event, wealth transfers such as this should be imposed by the legislature rather than the courts, because "the legislative alternative would do less harm to the values protected by freedom of contract and the rule of law."[49]

B. Problem No. 2: Policy Reconstruction in the Guise of Construction

Although it would seem that the ambiguity-based variation of the reasonable expectations doctrine ought to afford greater protection to the insurer, the reality is that it does not. As even Professor Keeton recognized, the unavoidably subjective nature of determining whether a policy provision is amenable to two or more reasonable interpretations is itself subject to considerable judicial manipulation.[50] Indeed, courts around the country have

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47. McHugh v. United Service Automobile Assn., No. 97-35019, 1998 U.S. App. LEXIS 24272, at *31 (9th Cir. Sept. 29, 1998) (Graber, J., dissenting).

48. KIMBALL, *supra* note 40, at 322. Another commentator agrees, criticizing the reasonable expectations doctrine as a "coerced wealth transfer" mechanism, i.e., a way of "forc[ing] some people to provide others with insurance that they could not have obtained through auslander transactions in the market" by means of a judicially imposed "tax" on insurers and, ultimately, other policyholders. WARE, *supra* note 5, at 1492.

49. WARE, *supra* note 5, at 1493.

50. *See* KEETON, PART ONE, *supra* note 3, at 972 ("The conclusion is inescapable that courts have sometimes invented ambiguity where none existed, then resolving [sic] the invented ambiguity contrary to the plainly expressed terms of the contract document."); ABRAHAM, *supra*

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had no difficulty conjuring an ambiguity when necessary to enable them to disregard the plain meaning of an insurance policy and thus to achieve a predetermined outcome.[51] As a dissenting justice recently stated, in condemning this practice:

> What we have here is not a case of contract construction. It is, rather, a case of contract reconstruction. As such, it is thimblerigging, pure and simple. It also indicates the depths to which a court will go to achieve a desired result. If any principle can be derived from this ruling, it is that words have no meaning.[52]

Just a few examples should suffice to make the point. In Minnesota, a trial court ruled that a minor injured in a snowmobile accident was covered by a homeowner's policy, despite the policy's exclusion of coverage for injuries resulting from the operation or use of a motor vehicle.[53] "Motor vehicle" was defined in the policy as "a motorized land vehicle, including a trailer, semi-trailer or motorized bicycle," or "any other motorized land vehicle designed for recreational use off public roads."[54] The lower court held that this definition was ambiguous and did not encompass snowmobiles for two reasons: (1) snowmobiles travel on snow or ice as opposed to "land," and (2) a snowmobile is not limited to recreational use, but may also be used for transportation or hauling.[55] The appellate court reversed, noting among other things that snowmobiles are included in the listing of "recreational motor vehicles" under state statutes.[56]

In *Federal Ins. Co. v. Stroh Brewing Co.*,[57] a wholesale distributor sued a beer manufacturer for antitrust violations, alleging that the manufacturer's

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note 16, at 538-39 ("The formulation [for determining ambiguity] presupposes something like an 'I know it when I see it' or 'I know what the ordinary reader would understand' test, aided perhaps by some other aged maxims of interpretation.").

51. *See* KEETON, PART ONE, *supra* note 3, at 972; *see also* Dodson v. St. Paul Ins. Co., 812 P.2d 372, 376 (Okla. 1991) ("We cannot agree with a construction which isolates and stretches one contractual provision, creating an ambiguity, and then entirely neutralizes two provisions . . . .").

52. American States Ins. Co. v. Koloms, 687 N.E.2d 72, 82 (Ill. 1997) (Heiple, J., dissenting).

53. *See* Christie v. Illinois Farmers Ins. Co., No. C4-98-134, 1998 Minn. App. LEXIS 711, at *3-5 (June 23, 1998).

54. *Id.* at *3.

55. *Id.* at *4-5.

56. *Id.*

57. 127 F.3d 563 (7th Cir. 1997).

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volume discounts constituted price discrimination against smaller distributors. The manufacturer's standard form business liability umbrella policy provided coverage for liability arising from "personal injury," defined to include "false arrest, malicious prosecution, libel, slander, invasion of privacy, humiliation or discrimination."[58] Although conceding that most people would understand the word "discrimination" to mean unfavorable treatment based on race or gender, the majority nevertheless held that the term was ambiguous. The court thus found coverage by concluding, with essentially no analysis, that this *particular* insured would reasonably expect the term to cover price discrimination suits, since such suits are common in the beer industry.[59]

This reasoning and result are ludicrous.[60] As the dissent correctly noted, both the current usage of the word "discrimination" and its placement in the policy with the term "humiliation" made plain that the term was intended to cover claims involving prejudicial or unfavorable treatment of "persons on the basis of some personal characteristic, such as race, age, sex, handicap, or nationality—not the pricing of one's products in a manner injurious to competition."[61] Given this reality, combined with the fact that insurance coverage is not typically provided for antitrust damages and that such claims are brought relatively frequently, it was highly unlikely the insured actually "expected" its liability policy to afford coverage for this kind of claim. To the contrary,

> the more plausible assumption . . . is that the parties would have addressed the issue of antitrust coverage in a more direct manner if they had in fact intended to do so. One would expect recurring claims to be addressed with a certain degree of precision and clarity. Relying upon the placement of the phrase "humiliation or discrimination" in the "Personal Injury" section of the policy is a highly unusual, if not obtuse, means of indemnifying one's company against antitrust suits of this nature.[62]

In yet another example, a "Peeping Tom" husband surreptitiously videotaped the family's Danish au pair while she was taking a shower.[63] When

58. *Id.* at 565.
59. *Id.* at 567.
60. *See id.* at 570 (Flaum, J., dissenting).
61. *Id.* at 572.
62. *Id.* at 573.
63. Bailer v. Erie Ins. Co., 687 A.2d 1375 (Md. 1997).

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the au pair discovered the tape, she sued for invasion of privacy. The family's personal catastrophe liability insurance policy provided coverage for "personal injury," this time defined to include bodily injury, libel, slander, defamation, false arrest, malicious prosecution, invasion of privacy or "humiliation caused by any of these."[64] Based on a specific exclusion for personal injury "expected or intended" by the insured, the insurer declined to defend or indemnify the insured.

In an analysis that can most charitably be described as tortured, the Maryland Court of Appeals held that the au pair's suit was within the scope of coverage. First analyzing the phrase "invasion of privacy," the court concluded that a reasonable insured would interpret the phrase to refer to the tort of "unreasonable intrusion upon the seclusion of another."[65] The court next undertook a lengthy analysis of somewhat ambiguous Maryland case law regarding this tort, and concluded that the tort can only be committed intentionally. Having made this decision, the court then held that the "expected or intended" exclusion had to be invalidated, because it rendered coverage for "intrusion upon seclusion" illusory and thus rendered the policy ambiguous.[66]

The dissent disagreed with the majority's threshold conclusion that the tort required intent and therefore rejected its conclusion that the exclusion could not be reconciled with the basic personal injury coverage.[67] More to the point here, its analysis of the issue demonstrates the absurdity of the majority's assumptions as to the insured's reasonable expectations:

> The majority's construction further presumes that a "reasonable" policy purchaser is sufficiently knowledgeable of the law of torts to understand that an intrusion upon seclusion can only be committed intentionally and that, as a result, the inclusion of coverage for invasion of privacy supersedes the policy's intentional injury exclusion clause . . . . The express language of the policy is a better aid to construction than assumptions about a reasonable person who is ignorant of the variations of invasion of privacy, some of which may be committed unintentionally, but who does know

64. *Id.* at 1377.

65. *Id.* at 1380.

66. As the majority put it, "If the exclusion totally swallows the insuring provision, the provisions are completely contradictory. That is the grossest form of ambiguity . . . ." *Id.* at 1380-81.

67. *Id.* at 1385-86 (Chasanow, J., dissenting).

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> what [the majority] reveals for the first time in the instant case, that the unreasonable invasion of seclusion form of invasion of privacy can only be committed intentionally.[68]

C. Problem No. 3: Expectations in the Eye of the Beholder

There is yet another crucial element of the reasonable expectations doctrine that is subject to exploitation by judges inclined to indulge a bias against insurers[69] or who for some other reason seek to provide coverage where none exists under the policy: the manner in which the court determines, *after* a coverage dispute has arisen, what the reasonable expectations of the insured were *prior* to that dispute. After all, "most insureds develop a 'reasonable expectation' that every loss will be covered by their policy. Therefore, the reasonable expectation concept must be limited by something more than the fervent hope usually engendered by loss."[70]

How the courts go about determining an insured's reasonable expectations often depends on which variation of the doctrine the court employs—and again reveals the intractable problems inherent in a doctrine that looks far beyond the language of the contract to determine how it will be interpreted. Indeed, the courts cannot even agree on whether the threshold determination is a question of law or a question of fact.[71]

Under the unqualified version of the doctrine, courts often simply divine what coverage "the average person" or theoretical group of "consumers" would expect the policy to provide without the benefit of any extrinsic evidence on

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68. *Id.* at 1387.

69. Although some courts and commentators maintain that the reasonable expectations doctrine is neutral, that is, neither pro-insured nor pro-insurer, *see, e.g.*, Max True Plastering Co. v. United States Fidelity & Guar. Co., 912 P.2d 861, 869 (Okla. 1996) ("the doctrine does not mandate either a pro-insurer or pro-insured result because only reasonable expectations of coverage are warranted"), others acknowledge that, in at least some of its forms, it "tilts insurance disputes in favor of the insured," *see also* KEETON, PART ONE, *supra* note 3, at 972 (when the courts strain to find ambiguity, it "not only causes confusion and uncertainty about the effective scope of judicial regulation of [insurance] contract terms but also creates an impression of unprincipled judicial prejudice against insurers"); WARE, *supra* note 5, at 1461.

70. Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388, 390 (Ariz. 1984); *accord* State Farm Fire & Cas. Co. v. Bongen, 925 P.2d 1042, 1047 (Alaska 1996); Millar v. State Farm Fire & Cas. Co., 804 P.2d 822, 826 (Ariz. 1990).

71. *Compare* Christie v. Illinois Farmers Ins. Co., 580 N.W.2d 507 (Minn. Ct. App. 1998) (question of law), *with* Wessman v. Massachusetts Mut. Life Ins. Co., 929 F.2d 402 (8th Cir. 1991) (question of fact).

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the subject.[72] However, unless an insured claims not to have read the policy at all before buying it (a fact which, even if true, generally may not be used as a basis for avoiding contractual terms[73]), most insureds would be hard-pressed to admit they had an expectation of coverage that was directly contrary to a clear and prominently placed policy provision.[74] It is difficult to avoid the suspicion in such cases that the court's refusal to enforce the policy as written has nothing to do with the insured's "reasonable expectations" of coverage, and everything to do with the court's judicial expectations of "reasonableness."

There is a somewhat greater degree of objectivity to the inquiry under the prominence-based variation of the doctrine. In these instances, the courts tend to determine the insured's reasonable expectations as to coverage primarily from an examination of the overall format of the policy.[75] So, for example, if the challenged provision does not appear sufficiently close to the beginning of the policy,[76] or if the headings in the policy give a misleadingly expansive impression of coverage,[77] the court may disregard it.

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72. *See, e.g.*, Lewis v. West American Ins. Co., 927 S.W.2d 829, 833 (Ky. 1996) (refusing to enforce unambiguous household exclusion because buyers of automobile insurance "expect their family members to receive comparable protection to that afforded to unknown third persons . . ."); Sparks v. St. Paul Ins. Co., 495 A.2d 406, 414 (N.J. 1985) (unambiguous provision will be enforced only if it conforms to "public expectations" about insurance coverage); In re Unum Life Ins. Co., 647 A.2d 708, 713 (Vt. 1994) (voiding clear exclusion in life insurance policy precluding coverage for insureds with pre-existing AIDS or cancer, because, in the court's view, consumers expect to receive coverage unless they commit suicide). Ironically, at least one court has applied a "reasonable layman" standard to determine the reasonable expectations of an *attorney*—insured under a professional liability policy. *See* Bodell v. Walbrook, 119 F.3d 1411 (9th Cir. 1997).

73. As a general rule, acceptance of the policy without objection binds the insured, "and he cannot thereafter complain that he did not read it or know its terms." Aetna Cas. & Sur. Co. v. Richmond, 76 Cal. App. 3d 645, 652, 143 Cal. Rptr. 75, 79 (1977).

74. As other courts have noted in refusing to invoke the reasonable expectations doctrine to invalidate clear and conspicuous provisions, "expectations which are contrary to a clear exclusion from coverage are not 'objectively reasonable.'" Stutzman v. Safeco Ins. Co., 945 P.2d 32, 37 (Mont. 1997); *accord* Frain v. Keystone Ins., 640 A.2d 1352, 1354 (Pa. 1994) ("[A]n insured may not complain that his or her reasonable expectations were frustrated by policy limitations which are clear and unambiguous.").

75. *See, e.g.*, State Farm v. Falness, 39 F.3d 966, 968 (9th Cir. 1994) (inquiry into insured's reasonable expectations "involves an analysis of the format and clarity of the policy, as well as the circumstances of its acquisition and issuance"); Gray v. Zurich Ins. Co., 419 P.2d 168, 174 (Cal. 1966) (en banc) (refusing to enforce limitation on duty to defend that "is not 'conspicuous' since it appears only after a long and complicated page of fine print, and is itself in fine print"); Lehroff v. Aetna Cas. & Sur. Co., 638 A.2d 889, 892 (N.J. 1994) ("Reasonable expectations of coverage raised by the declaration page cannot be contradicted by the policy's boilerplate unless the declaration page itself clearly so warns the insured.").

76. *See, e.g.*, State Farm v. Falness, 39 F.3d at 967 (holding that named insured exclusion on page 6 of 18-page automobile liability policy was unenforceable because insufficiently

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As with the unqualified version of the doctrine, those courts that purport to determine the insured's reasonable expectations without considering extrinsic evidence[78] may rewrite the policy to provide coverage even though the insured was well aware of and understood the coverage limitations.[79] Other courts, applying a more rigorous standard, require evidence of some conduct by the carrier, such as a misrepresentation about the scope of coverage or a failure to point out an obscure exclusion, that created an actual, i.e., subjective-expectation of coverage on the part of the insured.[80] Of course, the downside of this latter approach is that it often hinges on a credibility contest, which itself causes protracted litigation and greater uncertainty in the outcome.[81]

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conspicuous); *see also* Chu v. Allianz Life Ins. Co., 980 F. Supp. 1086, 1093 (N.D. Cal. 1997) ("Courts have invalidated exclusions where not in a section labeled exclusions and placed on an overcrowded page.").

77. *See, e.g.*, Forbau v. Aetna Life Ins. Co., 876 S.W.2d 132 (1994) (Doggett, J., dissenting) (although group accident and health insurance policy restricted coverage for medical expenses to one year after the policy was terminated by employer, where heading on policy referred to "comprehensive" medical benefits and application form described coverage for medical benefits as "unlimited," insured could reasonably expect coverage for all expenses resulting from injury that occurred while policy in force).

78. Relevant extrinsic evidence could include testimony from the parties as to the meaning they attached to the disputed provision, *see* Nygard v. Western Nat'l Ins. Co., No. C8-97-1163, 1998 Minn. App. LEXIS 36, at *4-5 (January 13, 1998), its drafting history, *see* Montrose Chem. Corp. v. Admiral Ins. Co., 913 P.2d 878, 887 (Cal. 1995) (en banc), or representations the parties made about it, *see, e.g.*, Morton Int'l Inc. v. General Accident Ins. Co. of America, 629 A.2d 831, 847-48 (N.J. 1993) (representations made to state regulatory authorities).

79. *See, e.g.*, State Farm v. Falness, 39 F.3d at 967 ("[T]he reasonable expectations doctrine applies even in the absence of proof of promises or misrepresentations by an insurance agent").

80. *See, e.g.*, Reliance Ins. Co. v. Moessner, 121 F.3d 895, 903-04 (3d Cir. 1997) (if the insured requests specific insurance coverage, and the insurer unilaterally changes the coverage provided without telling the insured, the insured's "reasonable expectation" that it had obtained the requested coverage will prevail over the clear language of the policy); Bensalem Township v. International Surplus Lines Ins. Co., 38 F.3d 1303, 1308-09 (3d Cir. 1994) (even though exclusion for claims related to prior or pending litigation was clear, insured allowed to take discovery on whether insurer added exclusion after renewal and failed to call it to insured's attention or misled insured by telling it claims would be covered despite exclusion); Grinnel Mut. Reins. Co. v. Voeltz, 431 N.W.2d 783, 786 (Iowa 1988) (rejecting application of doctrine to clear policy language "unless there are other circumstances attributable to the insurer which caused such expectations"); Minnesota Mut. Fire & Cas. Ins. Co. v. Manderfield, 483 N.W.2d 521, 524 (Minn. Ct. App. 1992) (factors such as "whether the insured was told of important, but obscure, conditions or exclusions and whether the particular provision in the contract at issue is an item known by the public generally").

81. *See, e.g.*, Standard Venetian Blind Co. v. American Empire Ins. Co., 469 A.2d 563, 567 (Pa. 1983) ("By focusing on what was and was not said at the time of contract formation rather than on the parties' writing, [the reasonable expectations doctrine] makes the question

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Courts applying the ambiguity-based version of the doctrine take three different approaches to determining the insured's reasonable expectations. In some states, the only question is whether the challenged provision is ambiguous; once that determination is made, the inquiry ends and coverage follows more or less automatically.[82] This approach is especially troublesome when a court declares a policy provision to be ambiguous not because the exclusion is unclear in the context of the specific circumstances of the case before it, but instead because the court can imagine *other* scenarios in which applying the literal language of the exclusion might lead to absurd results.[83]

A second group of states goes further and inquires into the specific circumstances of the case. Even when a policy provision is found to be ambiguous, courts applying this approach will find coverage only if a reasonable insured would have expected the policy to provide coverage under those specific circumstances.[84]

A third group of states applies an even more objective standard. Courts in these jurisdictions will interpret the policy to include coverage only if they determine that a majority of policyholders would choose to purchase such

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of the scope of insurance coverage in any given case depend on how a fact finder resolves questions of credibility. Such a process, apart from the obvious uncertainty of its results, unnecessarily delays the resolution of the controversy, adding unwanted costs to the cost of procuring insurance.").

82. *See* ABRAHAM, *supra* note 16, at 566. Abraham dubs this approach the "penalty standard," pursuant to which "a finding for the policyholder follows automatically from a finding of linguistic ambiguity, however defined." *Id.* Thus, the insurer is penalized for employing unclear language, irrespective of whether it is objectively reasonable to expect coverage under the specific circumstances. For a good illustration of this approach, see Federal Ins. Co. v. Stroh Brewing Co., 127 F.3d 563 (7th Cir. 1997), *supra* text accompanying notes 56-61.

83. *See, e.g.,* American States Ins. Co. v. Koloms, 687 N.E.2d 72, 77 (Ill. 1977) (commercial landlord insured under CGL policy sued by tenants injured by carbon monoxide fumes emitted by defective furnace; absolute pollution exclusion not enforced because definition of pollutant as "any solid, liquid, gaseous . . . irritant or contaminant . . ." was overbroad and could apply to any normally harmless substance to which someone had an allergic reaction); *accord* Regional Bank of Colo. v. St. Paul Fire & Marine Ins. Co., 35 F.3d 494, 498 (10th Cir. 1994) (same).

84. *See, e.g.*, Haber v. St. Paul Guardian Life Ins. Co., 137 F.3d 691, 697 (2d Cir. 1998) ("If an ambiguity arises that cannot be resolved by examining the parties' intentions, then the ambiguous language should be construed in accordance with the reasonable expectations of the insured when he entered into the contract."); Robert E. Keeton & Alan I. Widiss, INSURANCE LAW § 6.3(a)(2) (1988) (ambiguities should "be resolved favorably to the insured's claim only if a reasonable person in the insured's position would have expected coverage"). Some courts have expressed skepticism about the worth of an insured's assertion where that is the only evidence supporting his claim that he believed an ambiguous clause provided coverage. *See, e.g.*, Nygard v. Western Nat'l Ins. Co., 1998 Minn. App. LEXIS 36, at *4-5 (January 13, 1998).

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coverage if it were offered at an actuarially fair price.[85] Although on its face fairer to the carrier, this last approach—requiring expert testimony, market surveys, and actuarial studies—necessarily increases the cost and length of litigation, to the benefit of no one but the lawyers and their experts.[86]

IV. AN EMERGING DOCTRINE OF IMPUTED EXPECTATIONS?

As troublesome as the prior examples may be, they pale in comparison to the Supreme Court of New Jersey's opinion in *Morton v. General Accident Insurance Co.*[87] In that case, the court was called upon to determine, among other things, whether the "sudden and accidental" pollution exclusions[88] in a variety of commercial general liability policies precluded coverage for government-mandated cleanup costs incurred by the insured in remediating pollution caused by forty years of discharging mercury into an estuary. The court held that the exclusions would not be given effect, in part because of alleged misstatements as to the scope and effect of the exclusionary language by the insurance carriers to the New Jersey state regulatory authorities when the exclusion was initially presented for approval in 1970.[89] In so holding, the

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85. Abraham calls this approach the "majoritarian standard." *See* ABRAHAM, *supra* note 16, at 547-49. He cites as an example of this approach, Owens-Illinois, Inc. v. United Ins. Co., 650 A.2d 974 (N.J. 1994), in which the policyholder asked the court to require successive insurers to assume joint and several responsibility for the insured's asbestos-related liabilities. The court held that the policies were ambiguous as to the method of allocating coverage and referred the case to a special master to determine what coverage the policyholders would have selected had they been given a choice.

86. *See* ABRAHAM, *supra* note 16, at 566 ("Notwithstanding the greater normative appeal of a majoritarian standard, however, it would be extremely undesirable to require or even permit an ordinary interpretive dispute to be encumbered by evidence from experts, market surveys, and the like, regarding policyholder coverage preferences.").

87. 629 A.2d 831 (N.J. 1993).

88. A typical form of this exclusion, also called the "qualified" pollution exclusion, provides as follows:

> This insurance does not apply . . . to bodily injury or property damage arising out of the discharge, dispersal, release or escape of smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials or other irritants, contaminants or pollutants into or upon land, the atmosphere or any water course or body of water; but this exclusion does not apply if such discharge, dispersal, release or escape is sudden and accidental.

Id. at 836.

89. *Id.* at 851.

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court invoked the *reasonable expectations of the regulators* to invalidate the exclusion:

> We are fully satisfied that if given literal effect, the standard clause's widespread inclusion in CGL policies would limit coverage for pollution damage to so great an extent that the industry's representation of the standard clause's effect, in its presentation to New Jersey and other state insurance regulatory agencies, would have been grossly misleading. . . .[90]

Because, in the court's view, "the typical commercial insured may have had little, if any, awareness that the terms of CGL coverage had been changed, much less any 'objectively-reasonable expectation' of the scope of the new coverage," the court simply "imputed" the "reasonable expectations" of the New Jersey insurance regulatory authorities to the insureds and, on that basis, wrote the exclusion out of the policy.[91]

The New Jersey Supreme Court is hardly alone in refusing to give effect to the qualified pollution exclusion.[92] But that is not the point. The point is how the court got to that result: by recognizing an entirely new theory of policy invalidation based on the "reasonable expectations" of a *third party*—and a third party with whom the insured has no connection whatever.

While it is would be easy to dismiss the *Morton* court's analysis as a solution in search of a theory, its implications are too disturbing to ignore. As this article is being written, insurers are presenting to insurance regulators around the country a variety of policy provisions designed to exclude liability for "Y2K" losses.[93] These potential losses and related litigation expense, which result from computers' inability to process the year date "2000," are

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90. *Id.* at 847.

91. *Id.* at 875.

92. To the contrary, the scope and application of such exclusions has been among the "most hotly litigated insurance coverage questions of the late 1980s and early 1990s." Jeffrey W. Stempel, INTERPRETATION OF INSURANCE CONTRACTS: LAW AND STRATEGY FOR INSURERS AND POLICYHOLDERS 825 (1994), *quoted in* Center for Creative Studies v. Aetna Life & Cas. Co., 871 F. Supp. 941, 943 (E.D. Mich. 1994).

93. The "Y2K" or "Year 2000" problem, also known as "The Millennium Bug," results from the use of two-digit codes to identify the years in date fields in computer programs. Begun in the 1950s and 1960s as a means of saving space in (then) costly computer memory, the practice persisted in many cases well into the 1990s. The fear is that when the last two digits of the year change from "99" to "00," programs containing the two-digit date fields will malfunction, resulting in massive business interruption and other serious global consequences.

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predicted to run as high as a trillion dollars or more[94]—some two and one-half times the combined reserves of all North American property and casualty insurers.[95] While the true magnitude of the Y2K problem may be uncertain, one thing is not: insureds and insurers are sure to do battle over the validity of the Y2K exclusions. Given the potential magnitude of the problem, it is easy to see that even a passing nod to a *Morton*-like analysis could bankrupt the property/casualty industry. And while the chances of that happening may be remote, the real problem is that there is no way to predict whether, or when, it might.

V. THE REASONABLE EXPECTATIONS DOCTRINE IS UNNECESSARY IN LIGHT OF EXISTING EQUITABLE REMEDIES

It is a fundamental principle of contract law that the best indication of the intent of the parties to a contract is the language of the contract itself and that, in most circumstances, that alone should guide the interpretive process. This is no less true for insurance policies than any other kind of contract.[96]

There will always, of course, be circumstances in which a determination of the parties' intent cannot be made from the language of the policy alone. In those instances, the existing rules of contract interpretation, such as waiver,[97] estoppel,[98] unconscionability,[99] and *contra proferentem*,[100] are all that is

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94. *Insurers' Reserves Thin for Coming Y2K Woes*, J. COM., Sept. 17, 1998, at 16, available in LEXIS, Insure Library, Curnws File.

95. *Id.*

96. As even courts applying the reasonable expectations doctrine concede, "in most cases, the language of the insurance policy will provide the best indication of the content of the parties' reasonable expectations." *See, e.g.*, Reliance Ins. Co. v. Moessner, 121 F.3d 895, 905 (3d Cir. 1997).

97. Waiver generally is defined as the voluntary and intentional relinquishment of a known right. *See, e.g.*, Services Holding Co., Inc. v. Transamerica Occidental Life Ins. Co., 883 P.2d 435, 443 (Ariz. Ct. App. 1994); 16B Appleman, INSURANCE LAW & PRACTICE 9081 (1981). Courts have found waiver of policy provisions that would otherwise defeat coverage where, for example, a liability insurer, with knowledge of a ground of noncoverage under the policy, nonetheless assumes the defense of its insured without reserving its rights to contest coverage later. *See, e.g.*, Miller v. Elite Ins. Co., 100 Cal. App. 3d 739, 754, 161 Cal. Rptr. 322, 330 (1980).

98. Equitable estoppel generally has four elements: (1) the false representation or concealment of a material fact with actual or constructive knowledge of the truth; (2) the party asserting estoppel did not know or could not discover the truth; (3) the false representation or concealment was made with the intent that it be relied upon; and (4) the person to whom the representation was made or from whom the facts were concealed relied and acted upon the representation or concealment to his prejudice. *See, e.g.*, Miller v. Elite Ins. Co., 100 Cal. App.

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necessary to interpret the contract—and even to protect insureds from overreaching insurers.[101] Applicable to all contracts, these equitable principles do not suffer from the same infirmities as the reasonable expectations doctrine and are thus preferable to that doctrine, with its unavoidable vagaries and uncertainties.

For example, waiver and estoppel rely for their application on the actual dealings between the insured and the insurer.[102] Thus, courts cannot invoke these doctrines to create coverage unless the insurer has actively misled the insured or otherwise done something affirmatively to create an expectation of coverage.[103] Accordingly, waiver and estoppel avoid the nebulous inquiry into the "reasonable expectations" of "objective" policyholders, and do not give courts the excessive latitude afforded under the reasonable expectations doctrine.[104]

3d at 754, 161 Cal. Rptr. At 330; Wells v. United States Life Ins. Co., 804 P.2d 333, 336 (Idaho Ct. App. 1991).

99. As one court has held, to nullify a contractual provision as "unconscionable," it must "shock the conscience and confound the judgment of any man of common sense." California Grocers Ass'n v. Bank of America, 22 Cal. App. 4th 205, 215, 27 Cal. Rptr. 2d 396, 402 (1994).

100. Like the ambiguity-based variation of the reasonable expectations doctrine, this maxim of construction should not automatically result in a finding of coverage. Rather, an ambiguous provision should be interpreted in a way that is objectively reasonable in light of the remaining terms of the contract and other relevant circumstances.

101. In at least one state, the courts have expressly relied on the adequacy of these other equitable doctrines as a ground for rejecting the reasonable expectations doctrine. *See, e.g.*, Allen v. Prudential Property & Cas. Ins. Co., 839 P.2d 798, 805 (Utah 1992) ("[W]e note that the reasonable expectations doctrine has been urged because of the supposed inadequacy of the existing equitable doctrines available to courts confronted with overreaching insurers. . . . The difficulty with this logic is that no such inadequacy has been shown to exist in Utah.").

102. *See* ABRAHAM, *supra* note 16, at 559 (recognizing that waiver and estoppel "focus on specific factual interactions between particular policyholders and their insurers").

103. Some courts do not allow waiver and estoppel to create coverage even when the insurer's conduct induced the insured's mistaken, but reasonable, belief that there was coverage. *See, e.g.*, Manneck v. Lawyers Title Ins. Corp., 28 Cal. App. 4th 1294, 1303, 33 Cal. Rptr. 2d 771, 777 (1994) ("The rule is well-established that the doctrines of implied waiver and estoppel, based upon the conduct or action of the insurer, are not available to bring within the coverage of a policy risks not covered by its terms, or risks expressly excluded therefrom . . . ."); Nationwide Mut. Ins. Co. v. Hockessin Constr., Inc., No. 93C-03-179-SCD, 1996 Del. Super. LEXIS 263, at *12 (May 15, 1996) ("It is fundamental, however, that neither waiver nor estoppel may be used by an insured to create an insurance contract that does not otherwise exist"). A court recently expressed the view, however, that the modern trend is to allow waiver and estoppel to expand the scope of coverage beyond the terms of the policy as written. *See* Peoples Bank & Trust Co. v. Aetna Cas. & Sur. Co., 113 F.3d 629, 637-38 (6th Cir. 1997).

104. Courts adopting a more restrictive view of waiver and estoppel will not apply these doctrines unless the party seeking to assert the estoppel did not know and could not have

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Similarly, unlike the vague expressions of "public policy" invoked under the reasonable expectations doctrine to invalidate clear policy language, the "unconscionability" doctrine—which requires a contractual provision to be shockingly unfair or unjust to be unenforceable—is more rigorous, and thus less subject to abuse by result-oriented courts.[105] Finally, although *contra proferentem* can be manipulated in the same way that the similar ambiguity-based version of the reasonable expectations doctrine can,[106] at least it does not fall prey to the worst excesses of the doctrine.

CONCLUSION

It is not enough to say that the lack of certainty and uniformity reflected in the reasonable expectations doctrine are inherent in the nature of the judicial process. Different approaches among judges may be an unavoidable fact of litigation life, but the hazy contours of the doctrine make it particularly subject to abuse. A few years ago, the Court of Appeals for the Ninth Circuit had occasion to consider California's now defunct tort of bad-faith denial of a contract. In his concurring opinion, Judge Alex Kozinski had this to say:

> In inventing the tort of bad faith denial of a contract, . . . the California Supreme Court has created a cause of action so nebulous in outline and so unpredictable in application that it more resembles a brick thrown from a third story window than a rule of law.[107]

Unfortunately, the same may be said of the reasonable expectations doctrine. Despite thirty years of effort, neither courts nor commentators have been able to provide a real analytic framework for the doctrine. The inescapable conclusion may be that it is just not possible to do so—and that perhaps it is time to stop trying.

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discovered the truth. Thus, for example, an insured cannot successfully claim estoppel by pointing to a false representation by an agent that a particular risk was covered under the policy, if reading the policy would have alerted the insured to the fact of noncoverage. *See, e.g.*, Aetna Cas. & Sur. Co. v. Richmond, 76 Cal. App. 3d 645, 652, 143 Cal. Rptr. 75, 79 (1977) (estoppel does not absolve insured of duty to read policy).

105. As one court has stated, the unconscionability standard is "more specific, more exacting, and more demanding than an 'unreasonableness' standard . . . ." California Grocers Ass'n v. Bank of America, 22 Cal. App. 4th at 215, 27 Cal. Rptr. 2d at 402.

106. *See* discussion *supra* Part III.B.

107. Oki America, Inc. v. Microtech Int'l, Inc., 872 F.2d 312, 315 (9th Cir. 1988) (Kozinski, J., concurring).

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THE DOCTRINE OF REASONABLE EXPECTATIONS IN CALIFORNIA: A JUDGE'S VIEW

*H. Walter Croskey**

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INTRODUCTION[1]

In the construction and interpretation of insurance policy provisions, California has long recognized the significance of an insured's reasonable expectations.[2] A policy's provisions "must be construed so as to give the insured the protection which he *reasonably had a right to expect*, and to that end doubts, ambiguities, and uncertainties arising out of the language used in the policy must be resolved in his favor."[3]

However, in 1990 California adopted a new analytical approach to ambiguity resolution which had as its clear purpose the construction and interpretation of insurance contracts in the same manner as all other contracts, and involved a refinement of the reasonable expectations doctrine which altered its application.[4] In the leading cases of *AIU Insurance Co. v. Superior Court ("AIU")*[5] and *Bank of the West v. Superior Court ("Bank of the West")*,[6] the California Supreme Court applied standard statutory contract interpretation rules to the disputed provisions of a liability policy and required a three-step, rather than the existing two-step, analysis to be utilized in the construction of policy language. This analysis shifted the emphasis away from simply a search for *ambiguity* and directed it to a standard of policy construction which was governed by *context*. This had the effect (and perhaps reflected the

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1. The purpose of this article is to provide a broad overview of how California has changed its application of the doctrine of reasonable expectations. I have chosen to focus on California principally for three reasons. First, I am most familiar with its law and practice and, given my perspective as an active judicial officer, such a restricted examination seems prudent. Second, California insurance jurisprudence has considerable influence on that of other jurisdictions. Other states may or may not choose to follow California's example on a particular issue or principle, but they certainly note and examine what California does. Finally, California's new approach to its use and application of the doctrine is indeed significant.

2. Coast Mut. Bldg.-Loan Assn. v. Security Title Ins. & Guar. Co., 57 P.2d 1392, 1393-94 (Cal. Ct. App. 1936).

3. *Id.* at 1393 (emphasis added).

4. California cases have applied the doctrine of reasonable expectations in such diverse contexts as insurance policy contract formation, *see* Smith v. Westland Life Ins. Co., 539 P.2d 433, 439-42 (Cal. 1975), recognition of coverage after policy termination, *see* Gyler v. Mission Ins. Co., 514 P.2d 1219, 1220-21 (Cal. 1973), and limitations on an insurer's ultimate liability for payment of the entire cost of defending an action against its insured which asserts both covered and noncovered claims, *see* Buss v. Superior Court, 939 P.2d 766, 774-75 (Cal. 1997). However, the doctrine's most significant application has been in the context of the scope of policy coverage and the definition, interpretation and construction of policy terms.

5. 799 P.2d 1253 (Cal. 1990).

6. 833 P.2d 545 (Cal. 1992).

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purpose) of resolving claims of policy ambiguity in favor of coverage *only* when the insured's expectations were *objectively* reasonable in the *context* of the entire policy, the circumstances of the case, and common sense. While it was not immediately appreciated, these decisions represented a significant change in the way California courts were to construe and interpret policies of insurance.

I. THE EARLY PRO-INSURED APPROACH TO AMBIGUITY RESOLUTION

Prior to *AIU,* California courts applied a special rule to insurance provisions which were found to be ambiguous. This rule was summarized in *Continental Casualty Co. v. Phoenix Construction Co.*:[7]

> It is elementary in insurance law that any ambiguity or uncertainty in an insurance policy is to be resolved against the insurer. If *semantically permissible*, the contract will be given such construction as will fairly achieve its object of securing indemnity to the insured for the losses to which the insurance relates. If the insurer uses language which is uncertain any reasonable doubt will be resolved against it; if the doubt relates to extent or fact of coverage, whether as to peril insured against, the amount of liability or the person or persons protected, the language will be understood in its most inclusive sense, for the benefit of the insured.[8]

This broad and expansive principle of policy construction was decidedly pro-insured and was repeatedly endorsed by the California Supreme Court prior to 1990.[9]

The purpose of this special rule of construction was to protect the insured's *reasonable expectation* of coverage in those circumstances where the insurer-drafter controlled the language of the policy.[10] This protection

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7. 296 P.2d 801 (Cal. 1956).

8. *Id.* at 809-10 (citations omitted) (italics added).

9. *See, e.g.,* Gray v. Zurich Ins. Co., 419 P.2d 168, 171 n.3 (Cal. 1966); Crane v. State Farm Fire & Cas. Co., 485 P.2d 1129, 1130-31 (Cal. 1971); Harris v. Glens Falls Ins. Co., 493 P.2d 861, 862-63; Insurance Co. of N. Am. v. Sam Harris Constr. Co., 583 P.2d 1335, 1336-38 (Cal. 1978); Reserve Ins. Co. v. Pisciotta, 640 P.2d 764, 767-68 (Cal. 1982); White v. Western Title Ins. Co., 710 P.2d 309, 313-14 (Cal. 1985).

10. *See* Reserve Ins. Co. v. Pisciotta, 640 P.2d at 767-68.

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is necessary, noted the court in *Gray v. Zurich Insurance Co.*,[11] because of the adhesive nature of the standardized insurance contract.

> [A] contract entered into between two parties of unequal bargaining strength, expressed in the language of a standardized contract, written by the more powerful bargainer to meet its own needs, and offered to the weaker party on a 'take it or leave it basis' carries some consequences that extend beyond orthodox implications. Obligations arising from such a contract inure not alone from the consensual transaction but from the relationship of the parties.
>
> Although courts have long followed the basic precept that they would look to the words of the contract to find the meaning which the parties expected from them, they have also applied the doctrine of the adhesion contract to insurance policies, holding that in view of the disparate bargaining status of the parties [the court] must ascertain that meaning of the contract which the insured would reasonably expect.[12]

Thus, prior to 1990, California viewed the reasonable expectations doctrine as a rationale for the application of a broad, pro-insured principle of ambiguity resolution. If it were "*semantically permissible*" to recognize a construction or interpretation of a disputed policy term which favored coverage or precluded application of an exclusion, then the court would adopt it; indeed, it was bound by substantial precedent to do so. A few examples from pre-1990 decisions by the California Supreme Court will illustrate the point.

In *Steven v. Fidelity & Casualty Co.*[13] a policy of flight life insurance (purchased from a vending machine) was held to be payable upon the death of the insured while flying on a non-scheduled airline even though the policy clearly stated that it was not for "Travel on Other Than Scheduled Air Carriers" and the only policy reference to substituted transportation was to emergency *ground* transportation necessitated by "interruption or temporary suspension" of a scheduled airline's service. This result was

11. 419 P.2d 168 (Cal. 1966).
12. *Id.* at 171-72 (footnotes omitted).
13. 377 P.2d 284 (Cal. 1962).

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justified by what the court perceived as the reasonable expectations of a traveler purchasing a policy to cover a *complete* trip. "Since his contract covered the *trip*, he would not contemplate a hiatus in coverage; he bargained for protection for the whole, not part of, the trip."[14] When, on the return leg of his trip, the scheduled airplane suffered mechanical difficulties and his flight was canceled, the insured accepted the airline's offer to book him on a non-scheduled airline in order to reach his next destination on time. The court held that the insured could reasonably expect that his policy would nonetheless provide coverage:

> [a] reasonable person, having bought his ticket for a fixed itinerary, and thus having at the moment of purchase of the policy gained insurance protection for the whole trip, would normally expect that if a flight were interrupted by breakdown or other causes, his coverage would apply to substitute transportation for the same flight.[15]

The *Steven* court made it clear that the ambiguity of the term "substitute conveyances" would not be decided under the rule of *expressio unius est exclusio alterius*, but rather, *for reasons of public policy*, under the rule that *all* ambiguities in an insurance policy are construed against the drafter.[16] The court further noted that there was also an ambiguity as to the term "scheduled air carrier." The court made it clear that in such a case, " 'The burden . . . is on the [insurer] to establish that the words and expressions used not only are susceptible of the construction sought by [the insurer] but that it is the *only* construction which may fairly be placed on them.' "[17]

In *Gray v. Zurich Insurance Co.*,[18] an insured had sued his insurer for failing to defend him from a complaint which alleged that he had committed an assault. The court noted that the policy's promise to "defend any . . . suit against the insured alleging . . . bodily injury," even though the allegations of the suit were groundless, false or fraudulent, was so broad in its sweep as to lead the insured reasonably to expect a defense of *any* suit

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14. *Id.* at 288.

15. *Id.* at 288-89.

16. *Id.* at 288-90.

17. *Id.* at 298 (citations omitted) (quoting Lachs v. Fidelity & Cas. Co., 118 N.E.2d 555, 559 (N.Y. 1954).

18. 419 P.2d 168 (Cal. 1966).

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regardless of its merit or cause.[19] The intentional acts exclusion relied upon by the insurer was both unclear and inconspicuous.

The court held that:

> [s]ince *we must resolve uncertainties in favor of the insured* and interpret the policy provisions *according to the layman's reasonable expectations,* and since the effect of the exclusionary clause is neither conspicuous, plain, nor clear, we hold that in the present case the policy provides for an obligation to defend and that such obligation is independent of the indemnification coverage.[20]

On such reasoning, the court imposed a duty of defense on the insurer even though it might have no obligation to indemnify the insured for any damages that might be awarded in the underlying action.

In *Crane v. State Farm Fire & Casualty Co.*,[21] the court refused to enforce a business pursuits exclusion in a homeowner's policy and thus there was coverage for a claim asserted against the insured homeowner arising out of an injury to a child for whom she was being paid to provide care. The "business pursuits" exclusion had an exception which provided that it did not apply to activities which were "ordinarily incident to nonbusiness pursuits."[22] The court concluded that this exception was ambiguous.

> In analyzing the extent of the exclusion, our boundaries are the rules to be applied in the interpretation of insurance policies. *Any ambiguity or uncertainty* in an insurance policy is to be resolved against the insurer. *If semantically permissible*, the contract will be given such construction as *will fairly achieve its manifest object of securing indemnity* to the insured for the losses to which the insurance relates. *Any reasonable doubt as to uncertain language will be resolved against the insurer* whether that

19. *Id.* at 174.
20. *Id.* at 174-75 (emphasis added) (footnote omitted).
21. 485 P.2d 1129 (Cal. 1971).
22. *Id.* at 1131.

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> doubt relates to the peril insured against or other relevant matters.[23]

Since the insured was caring for the injured child along with her own children, the exception could semantically be given a meaning which would permit the characterization that such care, even though for compensation, was *incidental* to her regular non-business home care activities.

Insurance Co. of North America v. Sam Harris Construction Co.[24] was a case where the court was faced with a coverage dispute arising from an airplane crash which occurred two days after the insured had sold the airplane to the plaintiff and canceled its liability policy. The plaintiff sued the insured claiming negligent repair and maintenance of the aircraft had caused it to crash. A special coverage provision in the canceled policy protected against liability "arising out of the . . . *maintenance* . . . of the aircraft," but coverage was limited to "occurrences or accidents" which happened during the policy period, although neither word was defined.[25] The court held that the meaning of the two words had to be ascertained by reference to the insured's reasonable expectation of coverage.[26] Applying the general rule on the construction of ambiguities in insurance policies, the court held that since the term "occurrence" *could* refer to the negligent repairs implicitly referred to in the special coverage provision (i.e., it was "semantically permissible" to do so), it would be so construed and therefore there was an "occurrence" within the policy period and the insurer had a duty to defend.[27]

In *Reserve Insurance Co. v. Pisciotta*, [28] the insured's liability policy had a "family member" exclusion and when the insured's stepson was injured in a boating accident the question arose as to whether a claim by the stepson was precluded. The court concluded that the word "family," which was not defined, was ambiguous as it might or might not be construed to include the stepson. Applying the principle that if "*semantically permissible,*" the policy will be construed so as to provide

23. *Id.* at 1130 (emphasis added).
24. 583 P.2d 1335 (Cal. 1978).
25. *See id.* at 1336.
26. *See id.*
27. *See id.* at 1337.
28. 640 P.2d 764 (Cal. 1982).

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coverage and thus protect the insured's reasonable expectations, the court concluded that the exclusion did not apply.[29]

In *White v. Western Title Insurance Co.*[30] the issue of construction concerned an exclusion in a policy of title insurance which excluded interests of a type which were ordinarily not recorded, including: "(a) [u]npatented mining claims; (b) reservations or exceptions in patents or in Acts authorizing the issuance thereof; (c) *water rights, claims or title to water.*"[31] The insurer had failed to disclose multiple *recorded* water easements affecting the property purchased by the insured. Western Title relied on the aforesaid exclusion to deny liability under the policy. However, the insuring clause of the policy had purported to insure a "fee" interest free from any defect in title or any lien or encumbrance on title, subject to the exclusions. The court concluded that California's broad, pro-insured rules of policy construction required coverage of water rights shown in public records within the scope of an ordinary title search.

> In determining what benefits or duties an insurer owes [its] insured pursuant to a contract of title insurance, the court may not look to the words of the policy alone, but must also consider the reasonable expectations of the public and the insured as to the type of service which the insurance entity holds itself out as ready to offer. Stated in another fashion, the provisions of the policy, "*must be construed so as to give the insured the protection which he reasonably had a right to expect. . . .*"[32]

The court concluded that coverage of claims of *record* was in accord with the purpose of the type of title policy which was involved. Thus, an insured could not reasonably expect coverage against unrecorded claims, but he certainly could reasonably expect that there had been a competent search of the records, and that all interests of record had been discovered and disclosed and agreed to protect him against any undisclosed interests. "Nothing in the policy makes it clear that there may be interests of record undisclosed by the policy yet excluded from coverage."[33]

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29. *See id.* at 769-70.

30. 710 P.2d 309 (Cal. 1985).

31. *Id.* at 311.

32. *Id.* at 314 (quoting Gray v. Zurich Ins. Co., 419 P.2d 168, 172, n.7 (Cal. 1966) (emphasis in original) (citations omitted)).

33. *Id.* at 314.

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This broad, pro-insured treatment of policy ambiguity probably justified the conclusion of those commentators[34] expressing the view that California was among those states which had recognized Professor Keeton's thesis that: "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though *painstaking study* of the policy provisions would have negated those expectations."[35] As the several decisions noted above illustrate, California's standard of *semantic permissibility* for resolving ambiguous policy language disputes in favor of coverage came very close to meeting Professor Keeton's thesis. However, it seems clear from most of the decisions that a predicate ambiguity was first required to be established.[36]

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34. *See, e.g.*, Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 827-28 (1990).

35. Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970) (emphasis added).

36. Whatever the favorable treatment given insureds with respect to ambiguous policy language, California still adhered to the basic principle that clear and unambiguous policy language would be enforced. *See, e.g.*, Searle v. Allstate Life Ins. Co., 696 P.2d 1308, 1315 (Cal. 1985) (a life insurance policy's exclusion of liability if death resulted from "suicide, whether sane or insane" had to be construed to include a suicide committed by an insane person). In order to apply the rule resolving *all* ambiguities against the insurer, a court had to first conclude that the policy language was ambiguous or unclear. *See* Producers Dairy Delivery Co. v. Sentry Ins. Co., 718 P.2d 920, 924 (Cal. 1986). A policy term was deemed ambiguous when it was capable of two or more constructions, both of which were reasonable. This was and is a question of law to be determined by the court from reading the policy terms in their ordinary sense and without adoption of a strained interpretation. *Id.* at 924-25. If no ambiguity is present and the plain language of the policy permits only one interpretation, then it is to be followed, irrespective of any contrary expectations by the insured. In this sense then, California did not follow Professor Keeton's thesis.

It also should be noted, however, that since 1968 the demonstration of the presence of an ambiguity in contractual provisions may be accomplished in California by reliance upon matters extraneous to the contract even though the questioned language appears, on its face, to be clear and unambiguous. Thus, a party seeking to raise the specter of an ambiguity may have an easier task in California than in other jurisdictions which adhere to a more traditional view of the parol evidence rule. In order to demonstrate the existence of an ambiguity, a party may rely on evidence extraneous to the contract to prove a meaning to which the language of the instrument is *reasonably susceptible*. Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co., 442 P.2d 641, 644 (Cal. 1968) (emphasis added). While this rule applies to the construction of contracts generally, it is not clear whether it may be applied to insurance contracts. *See infra* note 72 and accompanying text. What is clear, however, is that a finding of an ambiguity in policy language cannot be based upon an unreasonable characterization or understanding of extraneous evidence by an insured. *See Producers Dairy* 718 P.2d at 925.

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II. THE SEA CHANGE BROUGHT ABOUT BY THE *AIU* DECISION

In its 1990 decision in *AIU*,[37] and more explicitly in its decision two years later in *Bank of the West*,[38] the California Supreme Court made a substantial change in its approach to this issue. In *AIU*, the court was faced with the question of whether comprehensive general liability policies covered any costs the insured might become obligated to pay as the result of injunctive relief or the reimbursement of cleanup and other response costs ordered in suits against the insured brought by governmental agencies under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA")[39] and related state and federal environmental laws. The policies involved in *AIU* generally promised to provide coverage to the insured for all sums which the insured shall become legally obligated to pay *as damages* because of covered property damage or by reason of liability imposed by law for damages, including direct or consequential expenses defined by the term "ultimate net loss."[40] The court essentially had no trouble with the policy terms "legally obligated" or "because of property damage." It concluded that these terms were not ambiguous and did apply to the type of costs imposed on the insured. The real problem arose with the meaning of the term "damages."

In what amounted to a departure from the previous practice of applying special rules to insurance contracts, the *AIU* court held that the rules of construction which should be applied are those found in California statutes dealing with the interpretation of contracts *generally*. "The mutual intention of the parties at the time the contract is formed governs interpretation."[41] "Such intent is to be inferred, if possible, solely from the written provisions of the contract."[42] The "clear and explicit" meaning of these provisions, interpreted in their "ordinary and popular sense," unless "used by the parties in a technical sense or a special meaning is given to them by usage,"[43] will control judicial interpretation.[44] "Thus, if the

37. 799 P.2d 1253 (Cal. 1990).

38. 833 P.2d 545 (Cal. 1992).

39. *See* 42 U.S.C.A. § 4601 *et seq.* (1995).

40. As the *AIU* court put it, the questions which it had to determine were "whether (i) any adverse orders issued in those suits will 'legally obligate' [the insured] to pay such costs, (ii) the costs will constitute 'damages' or 'ultimate net loss,' and (iii) such costs will be incurred because of 'property damage.' Only if all three conditions are fulfilled will the insurers' duty to provide coverage arise under the policies." *AIU*, 799 P.2d at 1261.

41. *Id.* at 1264, *citing* CAL. CIV. CODE § 1636 (West 1985).

42. *Id.* at 1264, *citing* CAL. CIV. CODE § 1639 (West 1985).

43. *Id.* at 1264, *citing* CAL. CIV. CODE § 1644 (West 1985).

44. *Id.* at 1264, *citing* CAL. CIV. CODE § 1638 (West 1985).

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meaning a layperson would ascribe to contract language is not ambiguous, then that meaning should be applied."[45] "If an ambiguity still remains after applying these rules, then it is resolved by interpreting the ambiguous provisions in the sense the promisor (i.e., the insurer) believed the promisee (i.e., the insured) understood them at the time of formation."[46] "If the application of that rule does not resolve the ambiguity, then the ambiguous language is to be construed against the party who caused the uncertainty to exist."[47] Ordinarily, this party would be the insurer. However, the *AIU* court cautioned that "where the policyholder does not suffer from lack of legal sophistication or a relative lack of bargaining power, and where it is clear that an insurance policy was actually negotiated and jointly drafted, we need not go so far in protecting the insured from ambiguous or highly technical drafting."[48]

This was a significant restatement of California insurance law. For the first time, nothing was said about relying upon any "*semantically permissible*" meaning of disputed policy language in order to find coverage. Rather, a new *three-step* analytical process was recognized and applied to resolve the ambiguity surrounding the term "damages" as used in the commercial general liability policies under review.[49]

The court noted that the environmental statutes

> [a]uthorize alternative remedies—injunction and reimbursement—that are relatively interchangeable in a way perhaps not foreseen by the parties at the time they entered the CGL policies .... The policies necessarily present some ambiguity in light of statutory schemes that by their very operation tend to eliminate the formal distinction between compensation paid to an aggrieved party and sums expended by the insured under compulsion of injunction .... To the extent that policy language is ambiguous in light of the way environmental statutes

45. *See id.*

46. *Id.* at 1264, *citing* CAL. CIV. CODE § 1649 (West 1985).

47. *Id.* at 1264, *citing* CAL. CIV. CODE § 1654 (West 1985).

48. *Id.* at 1265.

49. The term "commercial general liability" (sometimes indicated by the shorthand acronym "CGL") is the term currently utilized by insurers to describe policies previously characterized as "*comprehensive* general liability" policies.

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> authorize relief, our goal remains to protect the *objectively* reasonable expectations of the insured.[50]

The *AIU* court concluded that the ambiguity arising from the undefined term "damages" was resolved by construing it in accordance with the insured's objectively reasonable expectations that the policies provided coverage.[51] After an extended analysis, the court concluded that an insured's reasonable expectations would extend to both reimbursement of response costs[52] and the cost of compliance with injunctive orders.[53]

Perhaps because the court found in favor of coverage, the full significance of the *AIU* decision was not immediately recognized or

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50. *AIU*, 799 P.2d at 1268-69 (emphasis added).

51. The burdens imposed by CERCLA and similar state statutes involve the creation of a new statutory liability which had not existed when the policies were originally written. The *AIU* court discussed the impact of this circumstance upon the "expectations" of the insured: "Although our focus is the expectations of the insured at the time the policy is made, this emphasis does not preclude coverage of forms of liability—such as those at issue here—created after the formation of the policy. Because the policies in question here are 'comprehensive,' it was within the insured's reasonable expectation that new types of statutory liability would be covered, as long as they were within the ambit of the language used in the coverage provision. As one court has pointed out, failure to cover new liabilities would create a 'discordant result, for it would mean that where courts enlarge liability during the effective period of a liability policy, an insured who contracted for complete coverage of a possible risk would be left without coverage because the scope of the risk had been enlarged by decisional law.' Travelers Ins. Co. v. Industrial Indem. Co. 18 Cal. App. 3d 628, 632, 96 Cal. Rptr. 191 (1971). The same is true when legislatures create entirely new forms of liability. The sole relevant inquiry in determining whether such types of liability are covered is whether, in view of the reasonable expectations of the insured, policy language can be interpreted to embrace the liability that may accrue under new statutory schemes." *AIU*, 799 P.2d at 1264-65 n.8 (quoting Travelers Ins. Co. v. Industrial Indem. Co., 96 Cal. Rptr. at 194).

52. "The ordinary, nontechnical meaning of 'damages,' as stated by statute and dictionaries and used by the courts in related contexts, encompasses reimbursement of response costs. The agencies' expenditure of federal funds to investigate and initiate cleanup of hazardous waste constitutes 'loss' or 'detriment.' Furthermore, reimbursement by responsible parties is monetary 'compensation' for such loss." *Id.* at 1269.

53. "It is unlikely . . . that the parties to CGL policies intended to cover reimbursement of response costs but not the costs of injunctive relief, at least where the latter costs are incurred—generally at a lower total cost—for exactly the same purposes addressed through governmental expenditure of response costs . . . Under CERCLA and similar statutes, injunctive relief and reimbursement of response costs serve substantially the same purpose. For this reason, we find CGL policy language is ambiguous as applied to remedial and mitigative costs incurred pursuant to injunction under CERCLA and similar statutes, and therefore must be construed in favor of coverage to satisfy the reasonable expectations of the insured." *Id.* at 1276, 1278.

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appreciated by the bench and bar.[54] This all changed in 1992 when the court decided the *Bank of the West* case. The issue presented there was whether a CGL policy covered a claim for "unfair competition" based upon a California statute which proscribed any illegal, unfair or fraudulent conduct. The insured bank had been sued for inadequate customer disclosures and use of illegal terms in automobile financing documents. However, the unfair competition statute allowed only limited remedies: restitution and/or injunction; no damages were recoverable. The policy provided coverage only for "damages" the insured was required to pay for injury arising out of "unfair competition" in the course of "advertising activities." Contending that the promised coverage did not extend to the claims asserted against the bank, the insurer filed suit for a declaratory judgment that no coverage existed.

The bank argued that the term "*unfair competition,*" as used in its policy, reasonably could be construed to apply to the statutory definition of that term as well as to the more commonly understood "common law" tort.[55] Therefore, the bank concluded, because the term was susceptible to

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54. Indeed, in a number of cases, the lower appellate courts continued to recite and apply the old discarded "semantically permissible" standard. *See* Mardirossian v. Superior Court, 64 Cal. Rptr. 2d 468, 472 (Cal. Ct. App. 1997); Smigielski v. Aetna Cas. & Sur. Co., 285 Cal. Rptr. 898, 899 (Cal. Ct. App. 1991); Rosenberg v. First State Ins. Co., 280 Cal. Rptr. 388, 391 (Cal. Ct. App. 1991); Demonet Indus. v. Transamerica Ins. Co., 278 Cal. Rptr. 178, 180 (Cal. Ct. App. 1991). However, when these decisions were called to the attention of the Supreme Court by petition for review they were "Ordered Not Published" or, in the vernacular term utilized in California, "depublished." *See* Cal. Rules of Court, Rule 976(c)(2). Under California law, this means that such decisions will not be printed in the official volumes of Court of Appeal opinions and cannot be cited as authority. *See* Cal. Rules of Court, Rule 977. In another case, the California Supreme Court granted review and ultimately issued its own opinion. *See* Montrose Chem. Corp. v. Admiral Ins. Co., 913 P.2d 878 (Cal. 1995). In that opinion, the court did not repeat the California Court of Appeal's recitation of the old rule. However, in three other cases the court recited the old rule, but either did not find any ambiguity and had no occasion to apply it, *see* Denny's Inc. v. Chicago Ins. Co., 286 Cal. Rptr. 507, 510-11 (Cal. Ct. App. 1991); Span Inc. v. Associated Internat. Ins. Co., 277 Cal. Rptr. 828, 833-835) (Cal. Ct. App. 1991), or despite such recitation, the court applied the *AIU/Bank of the West* three-step analysis. *See* Desai v. Farmers Ins. Exch., 55 Cal. Rptr. 2d 276, 279-80 (Cal. Ct. App. 1996). Finally, one case, decided less than 30 days after *Bank of the West* was filed, appears to have not only recited but also applied the old rule. *See* National Auto. & Cas. Ins. Co. v. Underwood, 11 Cal. Rptr. 2d 316, 319-20 (Cal. Ct. App. 1992). However, no review by the Supreme Court was sought and that court did not have occasion to consider the case.

55. The common law tort of unfair competition is generally thought to be synonymous with the act of 'passing off' one's goods as those of another. The tort developed as an equitable remedy against the wrongful exploitation of trade names and common law trademarks that were not otherwise entitled to legal protection. *See generally* CALLMAN,

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at least two reasonable interpretations, it was ambiguous and should be construed against the insurer. Prior to the *AIU* decision, this argument certainly would have carried the day. However, the *Bank of the West* court rejected it in language which clearly marked California's new departure in policy construction, underscored the proposition that insurance contracts would not require rules of construction different from those applied to contracts generally, and directly applied the *three-step analysis* outlined in *AIU.*

As explained by the *Bank of the West* court, the insured bank sought to invoke the *contra proferentem* rule of construction without recognizing that insurance policies are just like other contracts in that ordinary rules of contractual interpretation apply. Applying the rules summarized in *AIU* will require more than a simple search for ambiguity.[56] The court summarized *AIU's* three-step analysis which is to be applied:

> If contractual language is clear and explicit, it governs. [Step 1] On the other hand, '[i]f the terms of a promise are in any respect ambiguous or uncertain, it must be interpreted in the sense in which the promisor believed, at the time of making it, that the promisee understood it.' This rule, as applied to a promise of coverage in an insurance policy, protects not the subjective beliefs of the insurer but, rather, '*the objectively reasonable expectations of the insured.*' [Step 2] *Only* if this rule does not resolve the ambiguity do we then resolve it against the insurer. [Step 3]."[57]

Thus, when a court is faced with a policy construction issue the critical question to be determined is whether the insured's claim of coverage is *consistent* with the insured's *objectively* reasonable expectations.[58] In order to make this determination, the court will be required to interpret the language in the *context* of the entire policy and the intended function in that policy of the specific language claimed to be ambiguous. This is so because "'*language in a contract* must be construed in the context of that

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UNFAIR COMPETITION, TRADEMARKS & MONOPOLIES §§ 2.01-2.03 (4th ed. 1981); *Bank of the West*, 833 P.2d at 551.

56. *See id.* at 551-52.

57. *Id.* at 552 (citations omitted) (emphasis added).

58. *See id.* at 552.

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instrument as a whole, and in the circumstances of that case, and *cannot be found to be ambiguous in the abstract.*'"[59]

In applying this analysis to the case before it, the *Bank of the West* court recognized that, under California law, it was certainly plausible to argue that the term "unfair competition" referred not only to its common law meaning but also to the far broader concept recognized under the statute.[60]

> As the Bank correctly observes, policy terms must be read in their 'ordinary and popular sense,' and definitions of 'unfair competition' in standard dictionaries generally include acts that harm the public as well as acts that harm competitors only. One dictionary, for example, defines 'unfair competition' as 'business competition effected by an act that is deceptive and in effect a fraud on the public or that otherwise violates the legal and equitable rights of a competitor or the public.'[61] While the foregoing argument is probably correct as a matter of abstract philology, it is defective as a matter of policy interpretation *because it disregards the context.* The policy does not purport to cover 'unfair competition' in the abstract; instead, it covers '*damages*' for 'advertising injury' caused by 'unfair competition.' Read in this context, the term 'unfair competition' can only refer to a civil wrong that can support an award of damages.[62]

Since, as already noted, statutory "unfair competition" allowed no remedy for "damages," the policy's promise of coverage for "unfair competition" could not extend to the statutory claim asserted against the Bank. In reaching this result, the *Bank of the West* court made it clear that it was no longer enough to find an abstract ambiguity; most certainly, "semantic permissibility" would not be the test. In order to conclude that an ambiguity existed which would be construed against an insurer, it was

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59. *Id.* at 552 (quoting Producers Dairy Delivery Co. v. Sentry Ins. Co., 718 P.2d 920, 927 n.7 (Cal. 1996).

60. *See* CAL. BUS. & PROF. CODE, § 17200 (West 1985).

61. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2494 (unabridged ed. 1961); *cf.* RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1549 (unabridged ed. 1979) (giving "unfair competition" as a synonym for "unfair practices").

62. *Bank of the West*, 833 P.2d at 552 (citations omitted) (italics added).

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necessary first to determine whether the coverage under the policy which would result from such a construction was consistent with the insured's *objectively reasonable expectations.*[63] In order to do this, the disputed policy language had to be examined *in context* with regard to its intended function in the policy.[64] This requires a consideration of the policy as a whole, the circumstances of the case in which the claim arises, and "common sense."[65]

It probably does not matter whether this examination is made in connection with the first step of the *AIU* analytical approach or the second.[66] The objectively reasonable expectations of the insured and the analysis required to determine those expectations, may be relevant to either of the following two questions: (1) whether the disputed policy language is, *in context,* free from ambiguity and has a plain and clear meaning to a layperson, or (2) in what sense did the insurer believe the insured understood that policy language at the time the policy was issued. Whenever raised, however, what is important to remember is that a claimed ambiguity in the policy cannot be resolved without a determination of the insured's objectively reasonable expectations.[67]

While *Bank of the West* confirmed and formalized a significant departure from prior practice, the opinion itself reflects no particular recognition of its own significance or ultimate impact. The court did not acknowledge that the three-step analysis originally described in *AIU* was a meaningful departure from the approach to ambiguity resolution endorsed in its own earlier opinions. Moreover, apparently as a result of this outwardly seamless evolution, there was no rationale articulated justifying that departure other than obedience to the statutory command that "[a]ll contracts, whether public or private, are to be interpreted by the same rules . . . ."[68] However, this statute had been the law in California since 1872 and no notice was taken nor was an explanation provided by the *Bank of the West* court with respect to why the statute would henceforth be applied to contracts of insurance when, prior to 1990, that had not been the case.

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63. *See* Cooper Companies v. Transcontinental Ins. Co., 37 Cal. Rptr. 2d 508, 515 (Cal. Ct. App. 1995).

64. *See Bank of the West*, 833 P.2d at 552.

65. *See id.*

66. *See Cooper Companies*, 37 Cal. Rptr. 2d at 515.

67. *See id. See also* ACL Technologies, Inc. v. Northbrook Prop. & Cas. Ins. Co., 22 Cal. Rptr. 2d 206, 213 (Cal. Ct. App. 1993).

68. CAL. CIV. CODE § 1635 (West 1985).

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This new primacy of "context" for resolving ambiguities by determining the objectively reasonable expectations of the insured has been recognized and applied in numerous cases since *AIU* and *Bank of the West* were decided. In each of those cases the insured's *objectively* reasonable expectation has been critical to either the recognition or rejection of coverage. In each of the following examples the court rejected a particular construction of policy language based upon its conclusion that such a result was *not* consistent with the insured's *objectively* reasonable expectations. In most of these cases, it is likely that there would have been a different result under the pre-*AIU* standard.

In a case where an employer was sued for "damages" in a civil action for employment discrimination and wrongful discharge, the defense was tendered to the employer's workers' compensation carrier. The policy had promised coverage for "compensation benefits" and a defense for "any claim, proceeding or suit . . . . for benefits payable by this insurance."[69] While ambiguous, the promise to defend could have no *objectively* reasonable construction other "than providing coverage solely for workers' compensation benefits, or claims, proceedings, or suits for such benefits, and not for civil suits for damages."[70] Considering the *context* of the entire policy, the employer policyholder could have no objectively reasonable expectation of a defense to its terminated employee's civil action for "damages."

In the context of a policy's pollution exclusion, the meaning of the word "sudden" (as utilized in the standard exception which precludes application of the exclusion to toxic discharges which are "sudden and accidental") cannot be determined except in conjunction with the word "accident." When examined in that "context," the word "sudden" necessarily must involve a temporal element; otherwise, it would have no meaning separate and independent of "accidental."[71]

In a policy which provided coverage for injuries arising from "libel, slander, defamation of character, *humiliation* or invasion of privacy," the meaning of the word "humiliation" could not be determined outside of the

69. La Jolla Beach & Tennis Club, Inc. v. Industrial Indem. Co., 884 P.2d 1048, 1057 (Cal. 1994).

70. *Id.* at 1056.

71. *See ACL Technologies, Inc.*, 22 Cal. Rptr. 2d at 213; Shell Oil Co. v. Winterthur Swiss Ins. Co., 15 Cal. Rptr. 2d 815 (Cal. Ct. App. 1993).

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context in which it appeared. Thus, its meaning could not reasonably be applied to conduct not related to libel, slander or invasion of privacy.[72]

An insured who had a general liability policy covering claims "arising out of premises or operations" and a separate product liability policy covering claims arising from the manufacture and sale of defective products could not reasonably expect the term "operations" to be construed so as to provide coverage for defective products under the general policy. In the context of the circumstances, the term "operations" was meant to cover risks different from those protected by the product liability policy.[73]

Where an attorney hired by a contractor to collect $420,000 owing on a particular project (1) failed to serve a stop notice on the project's construction lenders and (2) failed to file a timely complaint to foreclose on the client's mechanic's lien, the client was unable to collect the debt and sued the attorney for malpractice. The attorney's malpractice coverage was limited to $250,000 *per claim* and his policy provided that two or more claims arising out of a single act or a series of *related* acts were to be treated as a single claim. While the undefined word "related" was arguably ambiguous in the abstract (i.e., it could refer to either a broad *logical* relationship or a narrow *causal* relationship), it could not be deemed ambiguous when read in the *context* of the circumstances of this particular case. The two "separate" errors of the attorney were already related in that they arose out of the same transaction involving the same client, were committed by the same attorney and resulted in the same injury: the loss of the debt. No insured, under these circumstances, could have had an objectively reasonable expectation that he or she would have been entitled to receive separate policy limits coverage under the policy for these two separate but "related" acts of malpractice.[74]

When a dispute arose about whether a policy covered entities acquired by the corporate insured after the end of the policy period, the court relied upon other provisions in the policy, including those relating to retroactive premiums for subsequently acquired entities, to conclude that the original

72. *See* American Motorists Ins. Co. v. Allied-Sysco Food Services, Inc., 24 Cal. Rptr. 2d 106, 111 (Cal. Ct. App. 1993).

73. *See* Fibreboard Corp. v. Hartford Acc. & Indem. Co., 20 Cal. Rptr. 2d 376, 387 (Cal. Ct. App. 1993).

74. *See* Bay Cities Paving & Grading, Inc. v. Lawyers' Mut. Ins. Co., 855 P.2d 1263, 1271-72 (Cal. 1993).

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named insured could not have had an objectively reasonable expectation of coverage for an entity acquired *after* the end of the policy period.[75]

The circumstances of the claim for which coverage is sought are part of the "context" in which policy language must be examined.[76] An "employment-related practices" exclusion which expressly applied to termination of employment did not exclude coverage where the employer's defamatory statement about a former employee was related to that employee's post-termination unfair competitive acts in the marketplace and had nothing to do with the circumstances surrounding the employee's prior termination. Thus, read in the context of the entire case, the "employment related acts" exclusion could not be read, by the objectively reasonable layperson insured, to apply so as to preclude coverage.[77]

Where a limousine driver, driving his employer's vehicle, was involved in an accident after dropping off a passenger, a question arose as to whether his personal automobile liability policy provided coverage. That policy contained an exclusion which precluded coverage for "[b]odily injury or property damage arising out of the ownership, maintenance or *use* of a vehicle while used to carry persons or property for a charge."[78] Since the business of carrying passengers for hire *necessarily* includes a return trip to the place of business or further dispatching to pickup other customers, the court held that the phrase "use of a vehicle while used to carry persons" was not ambiguous and no layperson would otherwise conclude. Therefore, there could be no coverage. However, the court went on to hold that even if a layperson would find such language ambiguous, the insured driver could have had no objectively reasonable expectation of coverage for this accident.[79] Relying upon the principle articulated in *AIU* and *Bank of the West* that the court must interpret policy language in the context of the entire policy and the intended function of the disputed language in that policy, the court concluded, "[r]ead in its entirety the policy in question appears to be typical of personal automobile insurance policies issued to protect members of the general public when operating automobiles under normal circumstances. It does not appear to be the type of policy intended to provide coverage for insureds while they are engaged

75. *See* Cooper Companies v. Transcontinental Ins. Co., 37 Cal. Rptr. 2d 508, 515 (Cal. Ct. App. 1995).

76. *See Bay Cities Paving*, 855 P.2d at 1271-72.

77. *See* HS Services, Inc. v. Nationwide Mut. Ins. Co., 109 F.3d 642, 646-47 (9th Cir. 1997) (applying California law).

78. Farmers Ins. Exch. v. Knopp, 58 Cal. Rptr. 2d 331, 333 (Cal. Ct. App. 1996).

79. *See id.* at 335.

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in the *profession* of driving passengers for hire in passenger car type motor vehicles, such as taxicabs or limousines."[80]

A final example is presented by the homeowner's policy of a Malibu resident which contained an exclusion for loss occasioned by a "brush fire." This was an ubiquitous exclusion commonly included in fire policies covering homes in Malibu, California where devastating "brush fires" frequently occur. In rejecting the policyholder's argument that the exclusion should not apply to a fire started by an arsonist seven miles away, which had spread across the intervening mountains and valleys to consume his home, and which had become infamous as the "Old Topanga Canyon fire," the court read the exclusion in the *context* of then current underwriting practices of insurers to include the exclusion in policies issued in "high risk" areas.

> This practice reflects the intention of the insurer to exclude the risk, a risk well known to residents in the area of Malibu. A reasonable person in the position of the [insured] would have understood the terms as used to exclude coverage for all damage resulting from a brush fire such as the Old Topanga Canyon fire.[81]

CONCLUSION

While California decisions prior to 1990 did make reference to the need to recognize and accommodate the "reasonable expectations" of the insured, the result in many of those cases where any ambiguity existed was to find coverage irrespective of such expectations. If an ambiguity existed, that was sufficient. It was simply construed against the insurer. The result was justified by the stated need to meet the "reasonable expectations" of the insured, but without any analysis of what the expectations of the insured were other than to receive the benefit of *any* perceived ambiguity. In other words, the need to meet an insured's "reasonable expectations" was a rationale for a broad, pro-insured rule of construction which *required* ambiguities to be resolved in the insured's favor whether or not

80. *Id.* at 336.

81. Pieper v. Commercial Underwriters Ins. Co., 69 Cal. Rptr. 2d 551, 555 (Cal. Ct. App. 1997).

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the result reached by the court was *actually* within the insured's reasonable expectations.[82]

The change imposed by *AIU* and *Bank of the West* was to shift the emphasis with respect to the insured's reasonable expectations and to require that they be *objectively* reasonable. The long term effect of this change in emphasis will be to reduce the number of cases involving contested policy language where coverage will be found. Reliance on any pre-*AIU* decision relating to this issue is clearly problematic.[83]

In California, policy ambiguities can no longer be resolved in the insured's favor unless, in the context of the circumstances, coverage is consistent with the insured's *objectively* reasonable expectations in light of (1) the language of the entire policy, (2) the total circumstances of the particular case and (3) common sense. This is a much tougher standard and provides the courts with a powerful tool to broadly examine and evaluate those expectations.[84] Indeed, it can fairly be said that in

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82. As previously discussed, the only effective limitation on the utilization of this process and its standard of "semantic permissibility" was the requirement that for there to be ambiguity in the first place the disputed language had to be capable of two or more constructions, both of which were reasonable. *See* Producers Dairy Delivery Co. v. Sentry Ins. Co., 718 P.2d 920, 924-25 (Cal. 1986). In addition, a finding of ambiguity in policy language could not be based upon an unreasonable apprehension on the part of the insured of either the policy language or the circumstances in which it was being applied. *Id.* at 925.

83. *See also* note 53.

84. The emphasis placed by *AIU* and *Bank of the West* on the "plain meaning" rule in step one of the three-step analysis has called into question the applicability, in insurance policy interpretation cases, of California's parol evidence rule which allows resort to evidence extraneous to the contract in order to demonstrate an ambiguity in contract language. *See supra* note 33 and accompanying text. A recent appellate decision held that the rule announced in Pacific Gas & E. Co. v. G.W. Thomas Drayage etc. Co., 442 P.2d 641, 644 (Cal. 1968), did apply in the context of insurance policy interpretation. Quoting from the *Pacific Gas* decision, the court said: "The test of admissibility of extrinsic evidence to explain the meaning of a written instrument is not whether it appears to the court to be plain and unambiguous on its face, but whether the offered evidence is relevant to prove a meaning to which the language of the instrument is reasonably susceptible." Pfizer, Inc. v. Superior Court, 69 Cal. Rptr. 2d 345, 348 (Cal. Ct. App. 1997). The court in *Pfizer* simply assumed, without any analysis, that no conflict had been created with the parol evidence rule articulated in *Pacific Gas* by the decisions in *AIU* and *Bank of the West* and their emphasis on the apparent primacy of the "plain meaning" rule. On January 21, 1998, however, the California Supreme Court ordered this case to be "depublished." Thus, this issue clearly remains an open one, although the California Supreme Court has recently recognized that in some circumstances extraneous evidence in the form of drafting history would be relevant in "evaluating" the insurer's argument, in a major environmental pollution coverage case, that a particular trigger of coverage was "never anticipated" by the insurance industry. *See* Montrose Chem. Corp. v. Admiral Ins. Co., 913 P.2d 878, 891 (Cal. 1995) ("[W]e find the drafting history relevant in evaluating Admiral's argument that, from

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California the doctrine of reasonable expectations has moved from a rationale justifying a broad, pro-insured rule of construction to an analytical tool which will be utilized in many cases to deny coverage where it previously would have been recognized.

This new approach by California's Supreme Court represents the adoption of something very close to what Professor Swisher calls the "middle ground interpretive approach to insurance contract disputes."[85] The insurance contract will be interpreted according to general principles

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a public policy standpoint, the insurance industry will be harmed by the adoption of a continuous injury trigger that the industry assertedly never anticipated would be applied to [the subject] policies."). The *Montrose* court noted, but did not critically comment on, an existing dispute in the lower courts as to whether such extraneous evidence is relevant to help determine the meaning of policy language. *Compare* Maryland Cas. Co. v. Reeder, 270 Cal. Rptr. 719, 722-23 (Cal. Ct. App. 1990) *and* Fireman's Fund Ins. Co. v. Aetna Cas. & Surety Co., 273 Cal. Rptr. 431, 435 (Cal. Ct. App. 1990) *with* ACL Technologies, Inc. v. Northbrook Prop. & Cas. Ins. Co., 22 Cal. Rptr. 2d 206, 218-19 (Cal. Ct. App. 1993) *and* American Star Ins. Co. v. Ins. Co. of the West, 284 Cal. Rptr. 2d 45, 51 nn. 8-9 (Cal. Ct. App. 1991).

85. Peter Nash Swisher, *Judicial Interpretations of Contract Disputes: Toward a Realistic Middle Ground Approach*, 59 OHIO ST. L.J. 543, 634 (1996). Professor Swisher summarizes his description of the so-called "middle ground" by noting that it:

> continues to recognize the traditional insurance law doctrine holding that, in general, insurance contracts should be construed according to general principles of contract law, unless modified or regulated by state statute, or unless contrary to state public policy .... A middle ground interpretive approach to insurance contract disputes therefore recognizes the 'text' of an insurance contract, while at the same time it also recognizes the 'context' of honoring the reasonable expectations of the insured to coverage—but without the necessity of adopting Professor Keeton's noncontractual doctrine of reasonable expectations at variance with the language in the insurance policy.

See supra note 35 and accompanying text.

> A middle ground interpretive approach to insurance contract disputes therefore adopts the principle—if not the doctrine—of an insured's reasonable expectation to coverage, while at the same time remaining relatively true to, and consistent with, its underlying contractual roots, rationales, and defenses. It is a middle ground interpretive approach that successfully reconciles the competing doctrines of Legal Formalism and Legal Functionalism in an insurance law context.

Id. at 635-36.

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of contract construction and clear and plain meaning will be enforced according to the ordinary and popular usage of the words utilized; but if ambiguity still remains it will be resolved by looking to the insured's *objectively* reasonable expectations and then *only* if a construction in favor of coverage is consistent with those expectations will the disputed policy language be construed against the insurer.

At least from this judge's perspective, this was a sea change of considerable significance.

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FROM THE JOURNALS: INSURANCE LAW ABSTRACTS

*Edited by Jeffrey E. Thomas**

INSURANCE – GENERAL

William D. Anthony, Comment, *Vicarious Liability Concerns for Insurers Using In-house Insurance Defense Counsel*, 27 SW. U.L. REV. 125 (1997).

Insurers who retain control of insurance defense cases risk potential vicarious liability for the actions of their in-house counsel. Although no case has yet found such liability, Anthony argues that the trend in recent caselaw indicates a propensity toward finding such liability based on the doctrine of respondeat superior. The author also suggests that insurers who wish to reap the economic benefit associated with retaining control of defense investigation and coverage decisions should rightfully be liable in law and equity for torts of their in-house counsel.

Anthony argues that a convergence of several factors suggests a trend toward employing the doctrine of respondeat superior in order to assign vicarious liability to insurers for the torts of in-house counsel. First, in several recent cases the court found vicarious liability on the part of the insurer for the malpractice of outside counsel, based on agency principles. The finding was based on the principal insurer's right to control the counsel agent's actions—despite the fact that traditionally outside counsel has been considered an independent contractor.

According to Anthony, the right to control is even clearer for in-house counsel, who are considered employees by virtue of the employer insurer's control of factors such as personnel policies, salary, benefits and budgeting. In addition, in-house counsel typically represents the employer-insurer, unlike outside counsel who represents the insured. Both these factors argue for master-servant vicarious liability, despite the independent judgment exercised by in-house counsel. In fact, notes Anthony, in-house corporate counsel have been recognized as employees in the context of wrongful discharge and collective bargaining agreements. Finally, Anthony points to several analogous cases involving medical malpractice, where the medical

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corporation was held vicariously liable for the torts of physicians-employees, in spite of their exercise of considerable independent judgment.

William T. Barker, *Lobbying and the American Law Institute: The Example of Insurance Defense*, 26 HOFSTRA L. REV. 573 (1998).

In this case study of the process of drafting and approving Restatements of the Law, Barker details his experience as a (then) outsider attempting to lobby the American Law Institute (ALI) membership for changes to the ALI proposed draft on the subject of insurance defense. The topic was part of ALI's revision and updating of the Restatement of the Law Governing Lawyers dealing with ethical issues. According to Barker, the ALI's preliminary proposal on the topic in 1991 suggested that a liability insurer is not a client of the defense counsel which it appoints to defend its insured, meaning that the insurer may not have the traditional right to control the defense. Because of his work as a practicing attorney representing insurers in complex litigation, Barker was concerned with the practical implications of this viewpoint.

Barker discusses in detail the structure and operation of the ALI, as well as his lobbying efforts with both the Reporters (typically law professors) and the general ALI membership, composed of academics, judges and eminent practitioners. Barker's initial strategy was to persuade the Reporters charged with drafting the proposal that the insurer was a least a co-client of the counsel it had hired to defend its insured. When the Reporters continued to express support for restraints on control by third party payors even if the insurer were a co-client, Barker adopted a more tactical approach addressing practical, rather than theoretical concerns. He also expanded his lobbying efforts to include the general membership. The concrete product of his efforts was a final draft which incorporated much, though not all, of Barker's practical suggestions. But the experience also led Barker to several conclusions concerning the process. Now an insider as a new member of the ALI, Barker defends his efforts to persuade ALI members of the merits of his position. He proposes encouraging internal communications concerning the Restatement drafting and approval process. He also suggests that minority views receive more attention, and argues that the ALI should facilitate debate on its highly regarded and influential work of restating the law.

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R.D. Blanchard, *An Insurance Agent's Legal Duties to Customers*, 21 HAMLINE L. REV. 9 (1997).

This Article examines insurance agent liability for failing to advise customers to buy additional liability insurance coverage. Based on an examination of relevant case law, Blanchard proposes that liability arises when a legal duty to advise exists between the insurance-selling agent and the customer is breached. The author specifies that for such a duty to exist, there must be a special relationship between the insurance-selling agent and the customer, which is established by the agent's voluntary assumption of the duty by performance or advising the customer as an insurance specialist, or by express or implied contract between the agent and customer.

While emphasizing that the relevant standard of care for such matters is dependent on the circumstances, Blanchard identifies the evaluative factors used by courts in determining liability, and describes the elements of a cause of action, and the burden of proof, for agent negligence in failing to properly advise customers.

Keith A. Brown, Comment, *Conflicts of Interest Between Insurer and Insured: When Is Independent Counsel Necessary?*, 22 J. LEGAL PROF. 211 (1997-98).

Brown's Comment examines various situations with the potential for conflicts of interest in the tripartite relationship among insurer, insured and defense counsel. In general, conflicts arise during the course of joint representation when the attorney's representation of one client is rendered less effective by virtue of the representation of the other. Although such situations always create a potential for conflict, Brown concludes that, based on current case law, not every potential conflict requires the insurer to provide separate counsel for its insured.

Brown's discussion of specific situations which create the potential for conflicts of interest begins with the insurer's provision of defense for the insured under a Reservation of Rights. Based on a selective survey of court decisions on the issue of whether an insurer has a conflict when providing the defense of its insured under a Reservation of Rights, Brown concludes that there is no consensus on the issue. Even in post-*Cumis* California, courts are reluctant to require the insurer to pay for separate counsel for the insured if the Reservation of Rights has to do with a coverage issue which is not being litigated. According to Brown, under such circumstances,

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courts have found only the appearance of a conflict, which does not necessarily require separate counsel.

Another possible area for conflicts of interest is punitive damages. In jurisdictions where punitive damages are statutorily proscribed, or where the policy does not cover punitive damages, there exists a potential for conflict between the interests of the insurer and the insured if there can be no coverage for such damages. Nevertheless, Brown indicates that courts considering these circumstances are reluctant to decide, as a matter of law, that such a potential for conflict constitutes an actual conflict requiring separate counsel. Courts have applied similar reasoning to other areas of potential conflict, including multiple allegations by the plaintiff, some of which would be covered, while others may fall under a policy exclusion; settlement negotiations where the insured may wish to settle within policy limits, while the insurer prefers to roll the dice and proceed to trial; the situation of multiple defendants, where there are cross-claims and issues of comparative fault; and confidentiality of information, where defense counsel may have information from one client which could operate to the detriment of the other.

Brown concludes that potential conflicts of interest are inherent in all legal representation, and the conflicts of the tripartite relationship in insurance defense are simply a particularly clear illustration of the problem. Because courts tend to take a case-by-case approach toward assessing conflicts of interest, Brown says there is no bright-line test for attorneys to evaluate the potential for conflicts of interest; but a realistic goal is to be constantly on guard against such potential problems, and to mitigate any adverse effects as they arise. His best advice for attorneys practicing in the area is to err on the side of caution.

Colleen B. Hand, Casenote. *Limitations on an Insurer's Duty Toward Third-Party Claimants* (Theriot v. Midland Risk Ins. Co., 694 So. 2d 184 (La. 1997)), 43 LOY. L. REV. 489 (1997).

In 1990, the Louisiana legislature created a statutory duty on the part of insurers "to make reasonable efforts to settle claims with the insured or the claimant, or both." La. Rev. Stat. Ann. 22:1220(a) (West 1990). Section 1220(b) of the statute enumerated five acts which, if committed knowingly, would constitute a breach of the insurer's duty. The statute also provided for penalties for breaching insurers of double the assessed damages, or $5,000, whichever was greater.

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Subsequently, a split developed among the Louisiana appellate circuits regarding: 1) whether the duty created by Section (a) was intended to include third party claimants; and 2) whether the enumeration in Section (b) was intended to be exclusive, or merely illustrative. In *Theriot v. Midland Risk Ins. Co.*, the Louisiana Supreme Court decided both issues, holding that the statute was intended to create a duty by insurers toward third party claimants, as any intent to exclude such claimants must be express. The *Theriot* court also held that acts enumerated in Section 1220(b) were intended by the Louisiana legislature to be exclusive, not illustrative. The court reasoned that under principles of statutory construction, an enumeration of acts is necessarily exclusive if those acts must be knowingly committed in order to constitute a breach.

Mattias K. Polborn, et al., *Mandatory Insurance and the Judgment-Proof Problem*, 18 INT'L REV. L. & ECON. 141 (1998).

Using a mathematically-based economic analysis, the authors examine possible policy approaches to the problem of judgment-proof firms. The study builds on a 1986 analysis of mandatory insurance for risky projects, which postulated that if the level of care is observable, a firm will adopt an efficient level of care and will undertake a risky project only if it is socially beneficial. S. Shavell, *The Judgment-Proof Problem*, 6 INT'L REV. L. & ECON. 45 (1986). If the level of care is not observable, however, the authors suggest that Shavell's study does not determine whether mandatory insurance increases or decreases welfare. Based on their analysis, the authors conclude that 1) "it is never possible to increase welfare by prohibiting the voluntary purchase of insurance"; and 2) "a modified insurance requirement can achieve a second-best allocation if care is not observable."

Alan B. Shafer, Comment, *Allocating RI/FS Expenses Between Defense and Indemnity Provisions of Old Insurance Policies*, 1997 U. CHI. LEGAL F. 551.

Shafer's Comment proposes a reasonable expectations test for courts struggling to allocate costs of CERCLA-mandated environmental Remedial Investigation/Feasibility Studies (RI/FS) between capped indemnity limits and uncapped defense costs under old CGL policies. Under CERCLA

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(Comprehensive Environmental Response Compensation and Liability Act), "potentially responsible parties" (PRPs) may opt to undertake RI/FS costs themselves, in an effort to have some control over the conduct and outcome of the studies. Litigation has focused on whether the costs of the studies are more reasonably assigned to damages, which would be capped under policy limits (as insurers argue); or to defense costs, which were not capped under early CGL policies (the position supported by policyholders). After surveying tests used by courts to allocate these costs (Shafer identifies the Michigan, New Jersey and New York tests), Shafer proposes a test which takes into consideration both the reasonable expectations of the parties and the nature of the costs involved.

Shafer notes that standard CGL policies no longer cover environmental costs; and that separate, specialized environmental coverage is offered instead, with defense costs either assigned to policy limits, separately capped, or covered by higher premiums. Shafer's test would require courts to consider the reasonable expectations of both parties - as indicated by the trend toward separate coverage - that defense costs are subject to policy limits, unless additional coverage is purchased. In addition, using the New York test as a guideline, Shafer suggests that courts consider the remedial costs of the studies as defense costs, which would not be capped. The feasibility costs, however, should be treated as damages, subject to policy limits. Any additional costs could be equitably assigned by courts, while specifically considering the policy limits in their determination, as required by the New Jersey test.

Shafer concludes that "[c]ombining the New York test and the policy limit factor of the New Jersey test is a better solution for allocating RI/FS expenses between indemnity and defense," because it is fairer, simpler and more predictable. "By allowing more certainty in the outcome, the combination test also leads to more settlements and less strain on the already overburdened courts. Finally, it reduces the amount of money spent on the allocation fight, possibly freeing up resources for greater environmental cleanup."

Frank A. Sloan, et al., *The Road from Medical Injury to Claims Resolution: How No-Fault and Tort Differ*, 60 LAW & CONTEMP. PROBS. 35 (1997).

To analyze the effectiveness of tort versus no-fault medical compensation systems, the authors compare the experiences of no-fault and

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tort claimants under Florida and Virginia's no-fault compensation systems for neurological obstetrical injuries.

Florida's no-fault system provides compensation to victims of neurological obstetrical injury caused by oxygen deprivation or mechanical birth or postpartum injury. Congenital or genetic defects are excluded from coverage. Upon proof of permanent and substantial mental and physical impairment, compensation is provided for the cost of necessary medical and custodial care, less any collateral source payments. Payment for pain and suffering is capped at $100,000. The program is funded through contributions from participating obstetricians, non-public hospitals, and by a $40 million one-time payment from the state. Absent malicious or purposeful negligence, the system is intended as an exclusive remedy for claimants; but in practice, claimants may file a tort claim if they allege that they were not informed before the injury that their physician was a participant in the program. Virginia's system is substantially similar, except there is a higher standard of proof, requiring that the victim be permanently in need of assistance in all phases of daily living. In addition, the Virginia plan does not allow for compensation for pain and suffering. The program is funded by flat fees from hospitals and participating physicians, and if necessary, from taxes on all insurance companies doing business in the state, whether or not they sell medical coverage. Like the system in Florida, Virginia's no-fault scheme is intended to be the exclusive remedy for complainants, unless they allege gross or willful negligence. Unlike Florida, however, knowledge of physician participation does not allow the claimant to recover in tort.

Based on a statistical and medical analysis of claims brought under the tort and no-fault systems in the two states, the authors conclude that the existence of the no-fault option reduced the number of tort claims filed in both states (though the difference was less in Florida, where complainants had a greater recourse to tort claims). The study also suggested qualitative differences in the experiences of tort and no-fault claimants. Tort claimants were more likely to be seeking retribution and information through their claims, while no-fault claimants were typically more interested in compensation. In general, no-fault claimants also suffered higher economic losses than tort claimants, and were more likely to report higher quality of care than tort claimants. Interestingly, both groups were highly likely to retain legal counsel to pursue their claims; all tort claimant had legal representation, and 93% of no-fault claimants retained counsel. Claimant satisfaction was a function of compensation, particularly for no-fault complainants.

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David M. Studdert, et al., *Can the United States Afford a "No-Fault" System of Compensation for Medical Injury?*, 60 LAW & CONTEMP. PROBS. 1 (Spring 1997).

The authors present a study estimating the cost of a no-fault system similar to one in Sweden as applied to the U.S. healthcare system. The Swedish model provides compensation for medical injuries (Swedish Compensable Events or "SCEs,") which are determined to have been avoidable. The criterion for compensation is thus midway between a fault-based negligence model and a pure no-fault system which compensates for all iatrogenic injuries; but the model may be used either in conjunction with a fault-based system, or as one of several no-fault systems, each with different compensation criteria.

After discussing the origin, operation and claims experience of the Swedish model, the authors compare cost control efforts in medical injury compensation in Sweden, New Zealand and the United States. For the latter, some approaches include shortened statutes of limitations; statutory caps on attorney fees and damages; application of collateral source rules; mandatory pre-litigation screening panels; and judicial modification of the medical malpractice doctrine. The authors note that the success of these measures in reducing the claims rate per 100 physicians from 17 in 1987 to 11 in 1991 has triggered concerns about the adequacy of compensation. Based on a desire to steer between "the Scylla of undue access constraint and the Charybdis of system expense," the authors propose an avoidable occurrence model for estimating the costs of a medical injury compensation system not based on individualized determinations of fault, which may be used to assess the economic feasibility of a no-fault alternative. They then apply their proposed model to the tort systems in Colorado and Utah, where tort alternatives are currently being considered by a groups composed of physicians, hospital administrators, insurers, and attorneys.

Applying avoidable occurrence criteria to the tort claims in Utah and Colorado in 1992, the authors conclude that the direct costs of compensation under such a system are higher than comparable costs of a fault-based tort system. The number of victims compensated under this system, however, is substantially higher than under a negligence standard. Compensating victims in Colorado and Utah based on Swedish avoidable occurrence criteria would have cost $219.78 million for claims paid in 1992, while the comparable cost of the tort system that year was $141.24 million, according to the authors. Applying the Swedish criteria to these 1992 claims, however, would have resulted in compensating twice the number of victims. The authors note that the cost of the avoidable

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occurrence model could be controlled by instituting various cost saving measures, such as disability thresholds, deductible periods, limiting or omitting recovery for household production losses and/or pain and suffering, and caps on non-economic damages. In addition, administrative costs should be reduced by these cost-control measures. (The authors estimate these administrative costs at 30% of each claims dollar, as compared to approximately 55% for the tort system.) As a result of the cost of the avoidable occurrence model, however, the authors conclude that in order for the system to be economically viable, it would be necessary for it to be the exclusive remedy within fixed parameters based on geographic, provider or injury criteria.

AUTOMOBILE INSURANCE

Sal M. Anderton, Note, *Putting a Premium on Premiums: The High Cost of Auto Insurance and the 1997 Gubernatorial Campaign*, 22 SETON HALL LEGIS. J. 211 (1997).

This Note evaluates New Jersey auto insurance reform efforts during the 1997 gubernatorial campaign of Governor Whitman, the State Legislature, and gubernatorial candidate James McGreevey. The author describes New Jersey's automobile insurance law, and how mandatory coverage requirements have resulted in New Jersey's automobile insurance rates being the highest in the nation. Discussing the constitutionality of mandatory rate reductions, and evaluating the efficacy of prior and proposed legislative action, Anderton details how automobile insurance reform efforts in New Jersey have stalled or been considerably watered down on the road between campaign proposal and legislative action.

Deeming substantial reform unlikely, Anderton recommends that Governor Whitman's newly-formed bi-partisan legislative commission on auto insurance reform create further resources for investigating, prosecuting and punishing fraud, and establish a more open and fair rate-making process in order to lower insurance costs.

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Jeffrey O'Connell and Christopher J. Robinette, *"Choice Auto Insurance:" Do Theories of Justice Require Linkage Between Injurers and the Injured?*, 1997 U. ILL. L. REV. 1109 (1997).

This Article examines different theories of corrective justice and discusses the tortfeasor-victim relationship in the context of social justice. The Article centers around a comparison of the two major schools of thought concerning tort theory and corrective justice (the way to restore parties experiencing wrongful gain or loss to their original condition) as espoused by the legal philosophers Jules Coleman and Stephen Perry.

After describing Coleman's annulment theory–which emphasizes the difference between liability and recovery and proposes that the annulment of wrongful gains and losses results in social justice, O'Connell and Robinette contrast Coleman's theory with Perry's argument that there is a correlativity requirement to corrective justice: that because of their connection to a common tortious outcome, there must be a correlation between tort-feasor and victim in order for there to be social justice.

The authors maintain that the annulment theory can be disproved by the correlativity requirement, and illustrate this conclusion by comparing third-party tort liability for automobile accidents with Personal Injury Protection (PIP) "choice" automobile insurance plans. Because PIP plans allow motorists to choose insurance coverage payable either with or without fault, O'Connell and Robinette conclude that PIP plans fulfill the correlativity requirement by enabling the necessary self-evaluation essential to Perry's version of corrective justice, thereby providing a greater opportunity for social justice.

BAD FAITH

Lane Christine Boyarski, Casenote, The Best Place, Inc. v. Penn America Insurance Company*: Hawai'i Bad Faith Cause of Action for Insurer Misconduct*, 19 U. HAW. L. REV. 845 (1997).

Boyarski provides an overview of the range of standards used to demonstrate bad faith, the burden of proof, and analyzes the public policy concerns supporting adoption of the tort of bad faith claims against insureds.

After analyzing background statutory and case law, and the implication of the Hawai'i Supreme Court's decision in *Best Place v. Penn America*,

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the author concludes that the standard for bad faith tort cases against insurers adopted in *Best Place* will be limited in future cases, due to the fear of insurance costs rising due to increased litigation. The author recognizes this fear as unwarranted, but recommends the refinement of Hawai'i's bad faith law to clarify the relationship between insurer and insured.

LIABILITY INSURANCE

Richard L. Fruehauf, Note, *The Cost of Knowledge: Making Sense of "Nonfortuity" Defenses in Environmental Liability Insurance Coverage Disputes*, 84 VA. L. REV. 107 (1998).

Fruehauf's Note examines the non-fortuity doctrines of "known loss," "known risk," and "loss-in-progress" in the context of environmental liability insurance under CGL policies. These extra-contractual doctrines are derived from the underlying principle of insurance that all risks insured against must be fortuitous. Fruehauf argues that there is little need for these extra-contractual exclusions from coverage, given the "expected and intended" provision in standard CGL policies, as well as the insurer defenses of misrepresentation and concealment. Instead, Fruehauf advocates the use of these doctrines as part of a concealment defense, serving as a "shortcut" in the insurer's evidentiary burden to prove intent on the part of the insured.

Douglas R. Richmond, *The Business and Ethics of Liability Insurers' Efforts to Manage Legal Care*, 28 U. MEM. L. REV. 57 (1997).

Richmond examines the financial and ethical implications of insurers' efforts to manage the legal costs of liability defense counsel. The article explores the practical and ethical ramifications of billable hours, double billing, use of minimum billing increments, intra-office conferences, conversion of overhead expenses to revenues, and expense disbursements. Richmond's thesis is that insurers' attempts to make defense counsel accountable for controlling costs may have an adverse impact on attorneys' ethical obligations to client insureds under the Model Rules, specifically, Rules 1.1 (Competence); 1.2 (Scope of Representation); 1.3 (Diligence);

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1.4 (Communication); 1.6 (Confidentiality); 2.1 (Advisor); and 5.4 (Professional Independence).

Richmond discusses several cost-control measures in detail, including billable hours, double billing, and flat fees, as well as outside counsel guidelines (governing the form and timing of reports to the insurer, limits on discovery, caps on travel expenses, and restrictions as to the number of attorneys permitted to attend depositions, hearings and trials). He faults insurers for comparison shopping among law firms based on hourly rates, which he says encourages firms to offer unrealistically low rates and provides them with both an incentive and a need to pad their bills. Instead, insurers should negotiate more realistic hourly rates with defense counsel, to provide a disincentive for bill padding. In addition, Richmond argues that insurers (and their insureds) would be better served by staying with firms which have proved their efficiency, efficacy and loyalty, even if other firms offer lower hourly rates. He adds that insurers should avoid doing business with firms which impose unreasonably high billable hour requirements on their associates. Finally, Richmond suggests that flat fees be used with care, as they may discourage zealous advocacy on behalf of the insured, and may attract firms with less sophisticated, experienced or competent attorneys. In any case, says Richmond, flat fees should be used only with the advance consent of the insured.

LIFE INSURANCE

Alexander D. Eremia, Comment, *Viatical Settlement and Accelerated Death Benefit Law: Helping Terminally, but not Chronically Ill Patients*, 1 DEPAUL J. HEALTH CARE L. 773 (1997).

This student written comment summarizes and analyzes the tax and social implications of the Health Insurance Portability and Accountability Act of 1996 on viatical settlements (which involve an insured's sale of his or her interest in a life insurance policy to a third party) and accelerated death benefits (insurer-provided early access to life insurance proceeds by an insured). Examining the growing viatical settlement industry, Eremia also discusses the National Association of Insurance Commissioners' Model Regulations concerning viatical settlements.

Perceiving that those with indeterminate life expectancies offer viatical settlement providers and insurers limited gains, the author concludes that soon viatical settlements and accelerated death benefits will no longer be offered to AIDS patients and the chronically ill.

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Bernard A. Jacobs, *Viatical Settlements in Montana: New Legislation Serves the Terminally Ill*, 59 MONT. L. REV. 81 (1998).

This Article describes the regulatory issues surrounding the viatical settlement industry (the business which facilitates an insured's [or viator's] sale of his or her interest in a life insurance policy to a third party), and examines and evaluates the Montana Viatical Settlement Act in light of these issues.

After providing a history of the viatical settlement industry, the author examines the issues driving regulation of the industry. Jacobs focuses in particular on the ability of viatical settlement providers to control information concerning the solvency of the parties to the viatical settlement, the viator's medical records, and the financial implications of the viatical settlement. The author summarizes market- and property law-based arguments for and against regulation of the viatical settlement industry.

As the drafter of the Montana Viatical Settlement Act, Jacobs provides considerable insight into the Act's responsiveness to both sides of the regulatory debate. He concludes that the Act protects the interest of viators and the public, while minimally restricting the industry.

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RECENT CASE DEVELOPMENTS

*Jeffrey W. Stempel**

IN POLLUTION LIABILITY CASE, NEW JERSEY SUPREME COURT CLARIFIES ITS VIEWS ON ALLOCATION OF INSURER AND POLICYHOLDER RESPONSIBILITY FOR MULTIYEAR, MULTIPOLICY OCCURRENCES

Carter-Wallace, Inc. v. Admiral Insurance Company, 154 N.J. 312, 712 A.2d 1116 (1998).

In *Owens-Illinois, Inc. v. United Insurance Co.*,[1] the New Jersey Supreme Court adopted the so-called "continuous" trigger of coverage where a product or polluting activity causes injury over multiple policy periods. Under the continuous trigger approach as applied in the approximately 20 states that have utilized it for at least some types of liability insurance claims, the insurance policy on the risk at the time of initial injury due to an occurrence is triggered and so are all subsequent policies for the time period during which injurious activity continues, with the trigger terminating at the time the activity ceases, is discovered, becomes an expected or intended injury by the policyholder, or when some other fact or equitable consideration requires a secession of the continuous trigger.

In claims such as asbestos injury or groundwater pollution, the continuous trigger (or, for that matter, application of an exposure or actual

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1. 138 N.J. 437, 650 A.2d 974 (1994).

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injury trigger) frequently implicates many years and policies because of the long-term insidious development of the damage alleged. In *Owens-Illinois*, the New Jersey Supreme Court expressed a preference for precision and remanded the matter to the trial court with instructions that it appoint a master or use experts to attempt to develop direct evidence or a model of the quantum of injury taking place in different policy periods so that insurer responsibility could be apportioned according to the amount of damage and liability accruing in each policy period. The Court recognized that in many cases such attempted precision would prove impossible to achieve[2] and established a default method of allocating insurer responsibility across multiple policy periods—proration of insurer liability by the insurer's respective policy limits multiplied by the time on the risk.

Owens-Illinois also held that proration of responsibility included assigning a share of responsibility to the policyholder for time periods where the policyholder was uninsured or self-insured. But *Owens-Illinois* specifically did not address the question of apportionment of coverage responsibility to excess insurers. Also unclear was the manner in which the allocation formula would be applied in light of the "layering" of liability insurance coverage typically found in insurance programs of commercial policyholders, which usually includes primary insurance, a significant self-insured retention ("SIR") and several layers of excess liability insurance coverage, which may involve several insurers at each excess level.

In *Carter-Wallace, Inc. v. Admiral Insurance Company*, decided by the New Jersey Supreme Court on July 8, 1998, the New Jersey high court clarified these questions in applying the allocation methodology of *Owens-Illinois*, an asbestos case, to environmental pollution and site cleanup. Specifically, the Court held that the first step in allocating the responsibilities of successively triggered insurers for coverage of multiyear occurrences was to calculate the amount of coverage responsibility for each of the triggered years by determining that year's allocations by the ratio of the year to other triggered periods in terms of the total amount of coverage (both primary and all levels of excess insurance). For this first step in the calculation, each policy period was to be treated as one segment of insurance without regard to the designation of the insurers as "primary" or "excess". Rather, each year's

2. This was a point made by critics of the decision, who labeled the entire exercise one of futility, cost, and delay. At this writing, the *Owens-Illinois* coverage dispute continues at the trial level nearly four years after the Supreme Court decision remanding the case, a fact perhaps giving credence to the criticism.

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insurance is to be treated as a whole and entered into the "limits by time" proration policy.

For example, if there are 10 triggered years with $1 million of liability insurance in the first year and a $1 million increase in the policy limits each year,[3] this would result in ratios of allocation in which the insurer in Year 1 was responsible for 1/55th (slightly less than two percent) of the coverage if there were claims triggering all ten years of applicable liability insurance. The insurer in Year 10 would be responsible for 10/55ths (more than 20 percent of the coverage) even though both the Year 1 insurer and the Year 10 insurer were on the risk for an equivalent amount of time because of the higher policy limits of the Year 10 insurer. If Years 1 through 5 were all insured by the Acme Indemnity Company and Years 6 through 10 were all insured by the Becme Assurance Company, Acme would be responsible for 15/55ths (between a quarter and a third) of the coverage while Becme would be have 40/55ths (nearly three-fourths) of the coverage allocated to it.

Under the *Owens-Illinois/Carter-Wallace* approach and New Jersey law, if all ten years of policies are triggered but the amount of liability is less than $55 million dollars, each insurer's share of the coverage responsibility is determined by multiplying the fractions set forth above by the amount of total coverage responsibility for the triggered claims. Thus, if there were $30 million of coverage responsibility, the Year 1 insurer would be responsible for 1/55th of $30 million, the Year 2 insurer would be responsible for 2/55ths, and so on. In the two-insurer example above, Acme Indemnity would be responsible for 15/55ths of $30 million while Becme Assurance would have 40/55ths of the $30 million responsibility apportioned to it.

Under this approach, the respective policy limits of the insurers in question are most important although the time on the risk is also significant. Other courts favoring proration have restricted the allocation formula to time on the risk alone and have refused to consider respective policy limits.[4]

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3. Thus, there would be $1 million of liability insurance in Year 1, $2 million in Year 2, $3 million in Year 3, and so on until the policyholder has $10 million of coverage in Year 10, giving the policyholder $55 million in potentially applicable liability coverage over the 10-year period.

4. *See, e.g.*, Northern States Power Co. v. Fidelity & Casualty Co. of N.Y., 521 N.W.2d 28 (Minn. 1994)(adopting rule of allocation by time each insurer is on the risk and not attempting to have parties demonstrate quantum of damage taking place in different policy periods).

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Thus, in the examples above, each year's insurer would be responsible for one-tenth of the coverage responsibility.

From 1966 to 1979, pharmaceutical manufacturer Carter-Wallace through a licensed waste hauler disposed of waste byproduct from its Cranbury, New Jersey plant in the Lone Pine Landfill. Lone Pine was closed by the New Jersey Department of Environmental Protection in 1979. In 1982, the United States Environmental Protection Agency ("EPA") commenced an investigation and proceedings that ultimately resulted in a consent degree between Carter-Wallace and the EPA to clean up the Lone Pine facility, a cleanup that was apparently successfully accomplished. In 1989, Carter-Wallace filed suit against more than 20 of its insurers, attempting to obtain a court decree that the insurers were responsible for the cleanup costs at Lone Pine, which eventually exceeded $9 million. Carter-Wallace settled with all but one insurer, Commercial Union ("CU"), resulting in the coverage litigation culminating in the recent Supreme Court decision.

Commercial Union issued a second-layer excess insurance policy to Carter-Wallace for a policy period of April 30, 1969 to April 30, 1972. The CU policy contributed $1 million to a $10 million second level of excess/umbrella coverage that was in excess of a $5 million first level package of excess policies that was excess of a $100,000 level of primary coverage. In addition to arguing that Carter-Wallace had expected or intended the pollution damage (an argument rejected by the trial court),[5] CU argued that it's coverage responsibility did not attach until all primary and first level excess insurance for the years in question (1996 through 1979) had been exhausted.

The Court rejected the CU argument that "horizontal" exhaustion was required at each layer in each policy period triggered before a subsequent layer in a given year could be considered triggered for purposes of applying the "limits and time" allocation formula of *Owens-Illinois*. Instead, the Court declared that the *Owens-Illinois* methodology should be used to calculate the coverage responsibility to be allocated to each policy year. Once the dollar amount of coverage apportionment had been decided for

5. As a general matter, the Supreme Court in *Carter-Wallace* found that it is the insurer's burden to prove by a preponderance of evidence that the policyholder subjectively expected or intended the resulting injury if the insurer is to avoid coverage.

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each policy period, triggered policies for that year should be tapped in their respective orders of priority. For example:

> [a]ssume that primary coverage for one year was $100,000, first-level excess coverage was $450,000. If the loss allocated to that specific year was $325,000, the primary insurer would pay $100,000, the first-level excess policy would be responsible for $200,000, and the second-level excess policy would pay $25,000.

Carter-Wallace, 712 A.2d at 1124.

For example, in the 10-year/$55 million of coverage example used above, if the policyholder held $500,000 of primary insurance in each year, the excess layers in each policy period would be tapped in vertical order until the amount of coverage allocated to a given year was exhausted.

The Carter-Wallace Court approvingly cited the federal district court opinion in *Chemical Leaman Tank Lines, Inc. v. Aetna Casualty & Surety Co.*, 978 F. Supp. 589 (D.N.J. 1997) and expressly endorsed its interpretation and application of *Owens-Illinois* and New Jersey allocation law regarding the respective coverage responsibilities of successively triggered liability insurers.

The *Carter-Wallace* Court stated that it was adopting what might be termed its "vertical exhaustion within policy period share" method as the presumptive rule for allocating multiyear coverage responsibility unless exceptional circumstances dictate application of a different standard.

NEW JERSEY VOIDS SEXUAL HARASSMENT EXCLUSION IN EMPLOYER'S LIABILITY POLICY AS AGAINST PUBLIC POLICY

Schmidt v. Smith, 155 N.J. 44, 713 A.2d 1014 (1998).

Linda Schmidt filed a complaint against her employer Personalized Audio Visual, Inc. ("PAV") and its president, Dennis Smith, alleging hostile work environment sexual harassment as well as violation of the New Jersey Law Against Discrimination ("LAD"), assault, battery, invasion of privacy, and intentional infliction of emotional distress. In an amended complaint,

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she also alleged liability for negligent infliction of emotional distress against Smith and negligent failure to train supervisors against PAV as her employer.

PAV and Smith sought defense and indemnity coverage from United States Fidelity & Guaranty ("USF&G") under a comprehensive general liability (CGL) policy and also under an Employer's Liability ("EL") Policy. USF&G denied coverage under both policies. Trial of the discrimination action preceded trial of the coverage dispute; USF&G had the opportunity to participate in the defense but refused. At trial, Smith was found liable by the jury for hostile work environment sexual harassment, assault, assault and battery, and intentional infliction of emotional distress. PAV was found liable for only hostile work environment sexual harassment. The verdict form did not ask whether the employer's liability was direct or vicarious or whether the employer might be vicariously liable for the intentional torts found by the jury to have been committed by Smith.

After the jury verdict, the trial court found that USF&G was responsible for coverage. The intermediate appellate court (the "Appellate Division" in New Jersey) affirmed the trial court verdict and found that the EL policy provided coverage even though the CGL did not. The New Jersey Supreme Court affirmed this result in its June 15, 1998 decision.

The EL policy in question stated that it covered damages accruing to the employer for occurrences of "bodily injury by accident or bodily injury by disease" that arise "out of and in the course of the injured employee's employment" by the insured. The EL policy also contained an exclusion for damages

> arising out of coercion, demotion, evaluation, reassignment, discipline, defamation, harassment, humiliation, discrimination against or termination of any employee, or any personnel practices, policies, acts or omissions.

The Court found the broad language of this exclusion was textually applicable in the *Schmidt* claim because liability was premised on several legal theories but the different legal violations arose from sexual harassment behavior. However, the Court also found that the exclusion could not be enforced against the PAV or Smith because the exclusion was inconsistent with New Jersey law that requires employers to "make sufficient provision for the complete payment of any obligation [the employer] may incur to an injured employee."

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Specifically, the Court held that because the *Schmidt* claim in part was based on a finding of negligence by the employer and supervisor,[6] the *Schmidt* jury award was part of the type of bodily injury coverage for workplace mishaps that was mandated by state statute. Consequently, application of the harassment exclusion in the EL policy to injuries resulting from negligence violated New Jersey law and was unenforceable even if the negligent injury was related to or resulted in claims of harassment.

However, according to the Court, the harassment exclusion would be enforceable to bar coverage for claims not falling within the statutorily mandated coverage for accidental bodily injury. For example, state law does not require the employer to provide coverage for claims that do not result in "bodily injury". Thus, an insurer's use of the exclusion to bar coverage for the financial or reputational injury usually associated with "criticism, demotion, evaluation, and defamation", would normally be enforceable and a policyholder "would not expect to be covered" in such case, making the exclusion "valid as long as the liability arising from those discomforts is not related to bodily injury." *Schmidt*, 713 A.2d at 1018.

But in the *Schmidt* case, the employer's liability was "primarily related to the personal injuries [the employee plaintiff] suffered as a result of [the supervisor's] conduct." *Id.* New Jersey law regards emotional injury accompanied by physical manifestation as "bodily injury" under liability insurance policies. *See Voorhees v. Preferred Mut. Ins. Co.*, 607 A.2d 1255 (N.J. 1992).

The Supreme Court did not disturb the intermediate appellate holding that the employer's CGL, which included an employment-related injury exclusion, did not provide coverage. In a case decided the same day as *Schmidt*, the New Jersey Supreme Court also generally upheld the employee claims exclusion of the standard CGL as effectively excluding coverage for sexual harassment in the workplace claims. *See American Motorists Insurance Co. v. L-C-A Sales Co.*, 713 A.2d 1007 (N.J. 1998) (discussed below).

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6. Although the jury did not specifically make a finding of negligence or vicarious liability against the employer, neither did it foreclose negligence, which was pleaded by the plaintiff and on which evidence was presumably presented at trial. Although the Court does not elaborate on the point, it was implicitly concluding that the jury verdict must be viewed in the light most favorable to the employer policyholder, which argued that the verdict, although arguably ambiguous, was one based on negligence rather than intentional wrongdoing.

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NEW JERSEY JOINS JURISDICTIONS APPLYING EMPLOYMENT EXCLUSION IN CGL POLICY TO BAR CGL COVERAGE FOR DISCRIMINATION AND HARASSMENT CLAIMS

American Motorists Insurance Co. v. L-C-A Sales Co., 155 N.J. 29, 713 A.2d 1007 (1998).

The *American Motorists* decision makes clear that the *Schmidt* decision discussed above was based not on the language of the Employers Liability policy at issue in *Schmidt* but on state law and public policy mandating minimum insurance coverage for bodily injury to workers. In a case not presenting these statutory and public policy considerations, the New Jersey Supreme Court read the language of the employment exclusion contained in the standard commercial general liability policy ("CGL") to bar coverage for an age discrimination and harassment claim made by a former employee of the policyholder.

John Piccialo worked as a salesman for L-C-A Sales ("LCA") for more than thirty years until his termination in 1991 at age 67. He sued charging that he had been harassed because of his age into involuntary retirement. LCA sought coverage for the Piccialo suit under its CGL. The CGL contained the typical insuring agreement covering bodily injury claims against the policyholder and also contained the typical exclusionary language of the time that there would be no coverage for bodily injury to "[a]n employee of the insured arising out of and in the course of employment by the insured."

The court found this exclusion broad, clear, and enforceable despite the general rule that it is the insurer's burden to demonstrate the applicability of the exclusion. This burden was met according to the unanimous Court because the exclusion was "clear and unambiguous", particularly given its location in the policy adjacent to an exclusion for workers compensation claims. The plain language of the employment exclusion and its placement in the policy

> demonstrates that the objective of the CGL policy was to exclude from coverage all claims—whether falling within or beyond the workers' compensation systems—"arising out of an in the course of" Picciallo's employment. Were the

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> employee exclusion interpreted only to bar coverage for workers' compensation claims, the workers' compensation exclusion in LCA's CGL policy would be redundant."

American Motorists, 713 A.2d at 1012-13.

In addition, the Court applied an expansive meaning to the exclusion's words "arising out of" and equated the term with "originating from", "growing out of" or "having a `substantial nexus' with the activity for which coverage is provided." *Id.* at 1010. Consequently, Picciallo's claim that he was harassed by telephone calls at home, as well as by actions at work, did not bring the claim by this former employee within the CGL coverage.

CARBON MONOXIDE POISONING IN TRAILER ATTACHED TO CAR DOES NOT "ARISE" FROM USE OF MOTOR VEHICLE WITHIN THE MEANING OF STATE NO-FAULT AUTOMOBILE INSURANCE LAW AND POLICY

McKenzie v. Auto Club Insurance Association, 458 Mich. 214, 580 N.W.2d 424 (1998).

On a hunting trip, Francis and Hughie McKenzie slept in a camper/trailer attached to the back of Francis McKenzie's pickup truck. The truck was not in operation at the time. The camper/trailer's propane-powered forced-air heater malfunctioned, leaking carbon monoxide fumes into the camper. Fortunately, they were rescued and survived even though overcome by the fumes, injured, and hospitalized. As a result, Francis McKenzie sought coverage under this no-fault automobile policy for personal injury protection (PIP) benefits. The insurer resisted, arguing that the injury did not arise from the use of a motor vehicle within the meaning of the policy and state law. The trial court rejected the defense and found for the policyholder on the basis of past precedent and the intermediate appellate court affirmed. The Supreme Court reversed, finding no coverage.

The Court noted that under existing law, injury taking place in a parked or stationary vehicle is not necessarily excluded from coverage merely because the vehicle is not in motion at the moment damage takes place. However, the vehicle must be in use "as a motor vehicle" even if it is not in

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motion. In addition, there must be a causal relationship between the vehicle and the injury that "is more than incidental, fortuitous, or but for".[7]

Applying this standard, the Court found against coverage because the use of the trailer had insufficient linkage to the transportation function most commonly associated with automobile use. According to the Court:

> As a matter of English syntax, the phrase "use of a motor vehicle as a motor vehicle" would appear to invite contrasts with situations in which a motor vehicle is not used "as a motor vehicle." This is simply to say that the modifier "as a motor vehicle" assumes the existence of other possible uses and requires distinguishing use "as a motor vehicle" from any other uses. While it is easily understood from all our experiences that most often a vehicle is used "as a motor vehicle," i.e. to get from one place to another, it is also clear from the phrase used that the Legislature wanted to except those other occasions, rare as they may be, when a motor vehicle is used for other purposes, e.g., as a housing facility of sorts, as an advertising display (such as at a car dealership, as a foundation for construction equipment, as a mobile public library, or perhaps even when a car is on display in a museum). On those occasions, the use of the motor vehicle would not be "as a motor vehicle," but as a housing facility, advertising display, construction equipment base, public library, or museum display, as it were. It seems then that when we are applying the statute, the phrase "as a

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7. *See McKenzie*, 580 N.W.2d at 425 (quoting Putkamer v. Transamerica Ins. Corp. of America), 563 N.W.2d 683 (Mich. 1997). By "but for" causation, the Court means what is often referred to as "cause-in-fact". For example, it can be said that one cause of a plaintiff's injury in an auto accident was that she was driving to work at 8 a.m. Had the driver not been going to work at that time, she by definition could not have been in that particular accident. However, this mere cause-in-fact (which may be mere correlation rather than even irrelevant "cause") is normally insufficient to establish tort liability or similar legal responsibility. Rather, a cause-in-fact of an injury must also be a "proximate cause", one that is legally sufficient as well as factually contributory. For example, it would be a proximate and legally sufficient cause of the accident that the defendant ran a red light and smashed into the plaintiff on her way to work.

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> motor vehicle" invites us to determine if the vehicle is being used for transportational purposes.
>
> * * *
>
> Accordingly, we are convinced that the clear meaning of this part of the no-fault act is that the Legislature intended coverage of injuries resulting from the use of motor vehicles when closely related to their transportational function and only when engaged in that function.

American Motorists, 580 N.W.2d at 426 (footnotes omitted).

Three judges dissented, contending that the majority was not merely following precedent regarding the "use as a motor vehicle" requirement but was overruling it by taking a more narrow view of the term. The dissenters saw the camper/trailer as essentially a part of a motor vehicle at rest with a mechanical malfunction causing injury similar in type to that which can take place when the vehicle is actively in motion or engaged in transportation.

ERISA PRE-EMPTION DOES NOT APPLY TO BAR APPLICATION OF STATE COMMUNITY PROPERTY LAW TO FORCE REDISTRIBUTION OF LIFE INSURANCE PROCEEDS DESPITE BENEFICIARY DESIGNATION ON FACE OF POLICY

Emard v. Hughes Aircraft Company, 153 F.3d 949 (9th Cir. 1998) (applying California law and federal law of ERISA pre-emption).

Ginger Emard was an employee at Hughes Aircraft Company at the time of her death. When she began work at Hughes in 1981, she became eligible for the company's life insurance policy and designated her then-husband Alex Stencel as the beneficiary. She and Stencel divorced in 1985 and she remarried to Gary Emard in 1986 but did not change the beneficiary designation. In 1988, she purchased an optional term life insurance policy but failed to fill out a new designation of beneficiary form. Ms. Emard died intestate in 1995. The 1981 form designating Stencel as life insurance beneficiary remained the "only document directing the distribution of the insurance proceeds". Mr. Emard filed suit to obtain policy proceeds but lost in the trial court.

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Under California's community property law, a current spouse is entitled to a decedent spouse's life insurance benefits as a matter of law. But under the Employee Retirement Income Security Act ("ERISA"), the documentary designation of a beneficiary is controlling unless it can be set aside under the federal common law of contract applicable in ERISA disputes. On appeal, the United States Court of Appeals for the Ninth Circuit reversed the trial court and awarded the policy benefits to Mr. Emard as current husband.

The Ninth Circuit reasoned that ERISA was not controlling even though ERISA has a broad preemption clause that makes it applicable when in conflict with most state laws regulating benefits. However, in this case, the Court found no pre-emption because rigid application of the designation-of-beneficiary rule over important state policies that did not interfere with the federal statutory scheme was deemed by the Court to be too inequitable and insufficiently sensitive to the federal-state division of authority.

The Court utilized a two-step analysis drawn from Supreme Court precedent asking (1) whether California law conflicts with any specific provision of ERISA and (2) whether application of California law would frustrate Congress' purposes in enacting ERISA. If no conflict of this sort is found and there is no indication that Congress sought to occupy this field completely through federal law, preemption is not required.

State law traditionally has been the realm in which both the distribution of estates and the resolution of family law matters has taken place. According to the Court:

> ERISA is designed to ensure that benefits are paid out. It is silent as to the disposition of those funds after their receipt by the beneficiary. ERISA does not preempt California law permitting the imposition of a constructive trust on insurance proceeds after their distribution to the designated beneficiary.

Emard, 153 F.3d at 955. The Court further concluded:

> In enacting ERISA, Congress intended to safeguard the rights of plan participants and beneficiaries as against employers, insurers and administrators of employee benefit plans. *See* 29 U.S.C. § 1001 (setting forth Congress' findings and declaration of policy). ERISA therefore

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> preempts state law that concern those matters. But we see no indication that Congress intended to safeguard an individual beneficiary's rights to the proceeds of an ERISA insurance plan as against another person claiming superior rights, under state law, to those proceeds. Absent specific contrary provisions in ERISA, an action intended only to enforce such individual rights against a beneficiary does not fall within the scope of [the preemption provisions of the statute] and state laws on which such an action relies are not barred by ERISA preemption.

Id. at 958.

The Court felt sufficiently strongly about the strength of the state interest in equitable distribution of marital assets that it analogized the California community property interest to a state's interest in enforcing a "slayer statute", a frequently found law forbidding persons to receive insurance proceeds or distribution of an estate where that person has murdered the insured person or testator. If ERISA were as broadly preemptive as sought by Mr. Stencel, reasoned the Court, it would also require that ERISA insurance benefits go to even a murdering designated beneficiary, a result the Court suggested was absurd. This same rationale made it nearly as absurd to the Court to require that insurance money be paid to a former husband rather than the current husband simply because of a probable failure to update the designation of beneficiary.

Consequently, Mr. Emard would not be barred by ERISA from seeking a constructive trust upon Mr. Stencel's receipt of the Ginger Stencil insurance policy if Mr. Emard could persuade the trial court that under either California property law or equity he was entitled to the proceeds.

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STATE INSURANCE CODE DOES NOT DISPLACE APPLICATION OF UNFAIR COMPETITION LAW TO TITLE INSURERS; PLAINTIFF MAY SUE UNDER UNFAIR COMPETITION LAW FOR PURPORTED HARM FROM ALLEGED CONSPIRACY BY TITLE INSURERS

Quelimane Company, Inc. v. Stewart Title Guaranty Company, 19 Cal. 4th 26, 960 P.2d 513 (1998).

A group of plaintiffs purchasing real estate at tax sales sued title insurers for refusing to write title insurance on such property, alleging that this constituted an unfair business practice under the California Unfair Competition Law (Business and Professional Code §§ 17200-17209)("UCL"). The title insurers defended on the ground that since they were insurers, the state Insurance Code was the exclusive statute subjecting them to state regulation. The Court rejected the insurer's contention and permitted the suit to proceed.

Specifically, the Court concluded that the Insurance Code precluded application of the UCL only to the extent that the plaintiff's assertion of the UCL attacked title insurer activities regarding rate setting, a core aspect of state insurance regulation. The Supreme Court reasoned that the state's Insurance Code and insurance regulation should displace other generally applicable laws only to the extent that this is required because of an unavoidable clash between the laws. In the instant case, the Court found no such conflict because (except for the rate-setting issue), both the Insurance Code and the UCL could be applied to the title insurers without creating inconsistent demands or standards of conduct.

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FEDERAL COURT INTERPRETS WYOMING LAW AS NOT INCORPORATING LIFE INSURANCE SALES ILLUSTRATIONS INTO THE INSURANCE CONTRACT ITSELF; POLICY LANGUAGE CONTROLS OVER CONTRARY ILLUSTRATIONS AND INSURER NOT ESTOPPED FROM INVOKING POLICY LANGUAGE DESPITE POLICYHOLDER ASSERTION OF HAVING BEEN MISLED BY ILLUSTRATION

Brown v. Royal Maccabees Life Insurance Company, 137 F.3d 1236 (10th Cir. 1998) (applying Wyoming Law).

A group of plaintiffs sought to bring a class action complaint against the insurer for allegedly misrepresenting the terms of life insurance policies through illustrations of coverage, cash value, and operation that were unrealistic and misleading. Apparently, an error in the program did not take into a account surrender charges if the policy was terminated at any time during the first ten years. In particular, the illustrations were alleged to create the impression a policyholder could make one $8,000 premium payment on a $1 million face value policy, cease making premium payments, but continue to enjoy $50,000 of life insurance coverage and a $14,000 cash surrender value after 14 years. The policy language itself made no such guarantees and included disclosure of the prorated surrender charge for early cancellation of the policy.

The *Brown* plaintiffs wanted to receive the benefit of the policy illustration. Even if the policy language itself is to the contrary, plaintiffs argued that the illustration becomes part of the application process and the policy itself. They also argued that the insurer is estopped to give the class plaintiffs the benefit of the insurance as outlined in the illustrations even if the use of the illustrations does not formally become the contract between the parties.

The United States Court of Appeals for the Tenth Circuit, applying Wyoming law, rejected the *Brown* plaintiffs' theory of the case. Specifically, the Court held that insurance policy itself controls in any cases of conflict with an illustration of the operation of the policy. Also, the illustration is more in the nature of a brochure about the coverage and is not the equivalent of the policy itself or the application form, which is often specifically made a part of the policy by state law or provisions of the life insurance policy. Despite the appeal to equity and fairness advanced by the

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plaintiffs, the Court found no basis for estoppel against the insurer. Specifically, the Court assessed the matter as one of promissory estoppel and found insufficient evidence of a representation by the insurer and binding reliance by the policyholder. The Court did not expressly consider whether the insurer might be "equitably" estopped due to any possible unfairness from refusing to honor the insurance product outlined in the illustrations even if the program calculating the illustration was in error.

CONNECTICUT SUPREME COURT ENFORCES 1-YEAR LIMIT ON ACTION UNDER POLICY SET FORTH IN POLICY AND REJECTS ARGUMENT THAT GENERAL STATE STATUTE OF LIMITATIONS LAW COUNTERMANDS STATUTE

Bocchino v. Nationwide Mutual Fire Ins. Co., 246 Conn. 378, 716 A.2d 883 (1998).

The insurance policy in question provided a one-year time limit for commencing actions under the policy. A coverage suit was initially filed within this one-year period and then dismissed for lack of prosecution. The policyholder sought to reinstate the action under the state's general statutory provisions regarding the limitation of actions and revival of dismissed actions. The Supreme Court held that even if the plaintiff would be entitled to revive the action under the law if it were an ordinary tort claim or contract action on a contract that did not establish a time limit for actions on the contract, plaintiff was barred in the instant case. Where an insurance policy (and, presumably, any contract) establishes a reasonable time period for actions involving disputes under the instrument, these contractual agreements take precedence over general law and are controlling.

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