REASONABLE EXPECTATIONS REVISITED

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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.

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).

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.

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).

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.

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.

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).

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

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).

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.

"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.*

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.*

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

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.

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.

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).

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

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).

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.

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).

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.")

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).

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.

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.

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).

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").

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.

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*

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.

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

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.

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).

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.

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.

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).

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).

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).

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).

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).

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 ____.

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 ___.

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 ___.

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).

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).