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This Essay has two goals: one descriptive and one normative. Descriptively, it explicates the connection between interpretation of insurance contracts and the Insurer's disclosure duty. Disclosure duties and interpretation rules constitute a two way street. The interpretation of insurance contracts by courts, ex post, influences the incentives of insurance companies to disclose information to consumers, ex ante. Correspondingly, the scope of ex ante disclosure by insurance companies impacts the willingness of courts to overwrite insurance contracts by broadly interpreting provisions to increase the liability of insurance companies. To illustrate this claim, the Essay discusses the two principal interpretive tools used by the courts to expand the liability of insurance companies: the "Interpretation against the Drafter" rule and "The Reasonable Expectations" test.

Normatively, the Essay proposes a new interpretative model for interpreting insurance contracts. The model establishes a three step approach to interpretation. First, courts ought to discern the "subjective purpose" of the insurance contract, namely, the joint subjective intent of the parties. Second, in those cases where subjective intent cannot be inferred by the court, it should resort to the objective purpose of the contract by employing the reasonable expectations test. Third, and finally, when courts cannot identify the objective purpose of the contract, they ought to use the interpretation against the drafter rule.

This Essay seeks to elucidate and explore the important connection between the interpretation of insurance contracts and the Insurer's disclosure duty—a connection that has been widely overlooked in the extant literature. At first glance, this ambition may seem puzzling. After all, the insurer's duty to disclose is important ex ante, before the insurance contract is consummated, whereas interpretation rules come into play ex

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post, after a dispute arises between the parties. Upon further reflection, however, it becomes apparent that the insurer's disclosure duty and interpretive rules are inextricably related. The way courts interpret insurance contracts ex post shapes the incentives of the insurer to disclose information to potential consumers ex ante. And vice versa, the scope and extent of the initial disclosure invariably affect the interpretation of insurance contracts ex post. Hence, the unique interpretation rules of insurance law should be understood against the background of the insurer's duty to disclose.

En route to establishing the connection between interpretation and disclosure in insurance law, the Essay will discuss the two principal interpretation tools used by the courts: the "Interpretation against the Drafter" rule and "The Reasonable Expectations" test. It will examine the evolution of these doctrines, the policy rationales behind them and their application by the courts. Special attention will be devoted to the internal hierarchy between the two doctrines. The Essay then builds on this discussion to propose two new models of interpretation that are specifically designed to take account of the effect of the insurer's disclosure on interpretation doctrines. Moreover, the Essay demonstrates that the proposed models are superior to the existing interpretive rule.

To get a handle on the importance of interpretive rules in the insurance context, one must first understand the unique nature of insurance contracts. Although insurance contracts share certain characteristics with contracts that regulate other consumer transactions,[1] these common characteristics bear a *different weight* when they appear in insurance transactions. More importantly, the insurance contract has some characteristics *that do not exist* in other contractual transactions, not even consumer transactions. These latter, unique characteristics have caused insurance contracts to develop into a separate field of law, which, although affected by the perceptions underlying contract laws in general and consumer laws in particular, nonetheless developed as an independent branch of law with a theoretical environment and legal regime all its own.

The special characteristics of insurance contracts may be summarized in a nutshell: first, the subject matter of insurance

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[1] For example, 90% of all consumer contracts are standard contracts and entail professional or economic gaps between the parties. *See* W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 529 (1971).

contracts is an abstract and intangible one, the nature of which insured consumers find difficult to understand due to various informational and economic disadvantages. Second, the manner of entering into an insurance contract differs from that of other contracts. Third, the insurance contract itself is usually a standard, or adhesion, contract and therefore the Insured's freedom to negotiate and ability to influence its terms are limited. Fourth, the contents of insurance contracts are lengthy and strewn with concepts that are difficult for a non-professional to understand. Finally, the transaction itself, which is often perceived to be a transactional contract, is in fact a relational contract.

These unique characteristics of insurance contracts have had a direct influence on the formulation of the duties of disclosure and rules of interpretation applicable in this field, as well as on the symbiotic relationship that exists between the disclosure and interpretation doctrines. The rules of interpretation, just like duties of disclosure, function differently in insurance contracts than in other contracts because they are modified to respond to the complexities that characterize insurance contracts.[2] Insurance policies not only qualify as contracts of adhesion, in the sense that the weaker party to the transaction has no real ability to negotiate and is made subject to terms dictated by the Insurer,[3] but are also difficult to understand

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[2] *See* ROBERT H. JERRY, UNDERSTANDING INSURANCE LAW 129 (2d. ed. 1996); JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS 311 (1994); KENNETH H. YORK AND JOHN W. WHELAN, INSURANCE LAW, MATERIALS AND PROBLEMS XV (1982); ROBERT E. KEETON AND ALAN I. WIDISS, INSURANCE LAW 614 (1988); Jay M. Feinman, *The Jurisprudence of Classification*, 41 STAN. L. REV. 661, 680-681 (1989); James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. ST. L.J. 995 (1992); Dudi Schwartz, *Insurance Laws – Processes and Trends*, THE ISRAELI LAW YEARBOOK – 1997, 31, 60-71.

[3] On insurance contracts as typically satisfying the definition of a standard contract, see EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION 45-48 (1997); JERRY, *supra* note 2, at 139; KEETON AND WIDISS, *supra* note 2, at 119-120; STEMPEL, *supra* note 2, at 87; SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACT 19-20 (4th ed. 1990); Eugene R. Anderson and James J. Fournier, *Why Courts Enforce Insurance Policyholders' Objectively Reasonable Expectations of Insurance Coverage*, 5 CONN. INS. L. J. 335, 359 (1998); Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 240-245 (1995); Victor P. Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 J. L. & ECON 461, 486 (1974); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1177 (1983); W. David Slawson,

due to the specialized, professional argot and arcane wordings that appear in those same terms, so that even when laypeople do read them, they do not fully understand them.[4] Unlike other consumer goods, whose purchasers can examine what they are buying at the time of purchase, insurance goods are intangible and too abstract for the insured consumer to understand fully the nature of the sale.[5]

The New Meaning of Contract: The Transformation of Contracts Law by Standard Forms, 46 U. PITT. L. REV. 21, 26 (1984).

[4] On the difficulties of reading and understanding an insurance policy, see JERRY, *supra* note 2, at 139; STEMPEL, *supra* note 2, at 319; KEETON AND WIDISS, *supra* note 2, at 127; Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1, 11 (1993); Jeffrey Davis, *Protecting Consumers from Overdisclosure and Gobbledygook: An Empirical Look at the Simplification of Consumer-Credit Contracts*, 63 VA. L. REV. 841, 850-856 (1977); Eisenberg, *supra* note 3, at 240-244; Melvin Aron Eisenberg, *Text Anxiety*, 59 S. CAL. L. REV. 305, 309 (1986); Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 968 (1970); Uriel Procaccia, *Readable Insurance Policies: Judicial Regulation and Interpretation*, 14 ISR. L. REV. 74 (1979).

[5] *See* Kenneth S. Abraham, *The Expectations Principle as a Regulative Ideal*, 5 CONN. INS. L.J. 59, 63 (1998); Fischer, *supra* note 2, at 1047; Mark C. Rahdert, *Reasonable Expectations Revisited*, 5 CONN. INS. L.J. 107, 125 (1998) [hereinafter Rahdert, *R.E. Revisited*]; Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 326 (1986) [hereinafter Rahdert, *R.E. Reconsidered*]; Schwartz, *supra* note 2, at 60-71. The intangibility of insurance as a consumer good results from the fact that it is a sale of risk. This widespread term, "intangibility," requires clarification. On the basic cognitive level of a reasonable person who purchases insurance, the risks that he perceives, and against which he purchases insurance, are the risks that he can describe. In the simple sense of the word "tangible," they are very tangible. Thus, for example, when a person purchases life insurance, he foresees the event of his death, and when a person purchases property insurance, he foresees the risk of property loss, and so forth. What can perhaps be considered to be intangible in an insurance transaction is the time of the occurrence of the insurance event and the manner in which it occurs. An additional intangible matter (except in life insurance) is the level of certainty that the event will occur. Obviously, the parts considered to be intangible, in the simple sense of the word, in the eyes of the reasonable Insured are the various exclusions to his insurance coverage. When the insurance event occurs and the Insurer is finally required to pay the insurance benefits is when the reasonable Insured first deals with those same matters of which he had not been conscious before. This is, in fact, the first time the reasonable Insured understands what the good that he purchased is and into exactly what transaction he has entered. As such, insurance resembles a suit ordered from a seamstress according to a general description of the client's desires and measurements but which, until the client tries it on, is not necessarily understood to be clothing that may or may not look like the client's

Compounding the abstractness of insurance goods is the procedure by which they are sold. This procedure creates an inevitable discrepancy between the insurance good as it is perceived by the insured consumers at the time they enter into the contract, and the good as it is delineated thereafter in the detailed terms of the contract, or insurance policy.[6] This discrepancy also develops because, at the time that they enter into insurance contracts, the Insureds do not have the detailed terms of the policies at their disposal, and even if they did, it is very doubtful that they could fully appreciate the terms because of their professional and cognitive limitations. These same limitations are therefore likely to create an additional market failure because the consumers' inability to process and assimilate this information deters them from demanding it from their Insurers.[7]

Furthermore, insurance contracts look like transaction contracts, although they are in fact relational contracts. The Insurers provide the insurance products at the time the insured consumers sign the contract. When the Insured pay the premiums, they are considered to have purchased the insurance coverage. In contrast to regular consumer transactions, however, the relationship between the parties does not end the minute that they sign the policy. Rather, the insurance contract binds the parties to perform specified acts and to cooperate long after they enter into the contract and even after the occurrence of the insured-against event, a situation more characteristic of a relational contract.[8]

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assumptions about it.

[6] On the procedures used when Insured consumers sign insurance contracts and on the problems involved therein, *see generally* JERRY, *supra* note 2, at 200; KEETON AND WIDISS, *supra* note 2, at 39; STEMPEL, *supra* note 2, at 319-20; William A. Mayhew, *Reasonable Expectations: Seeking A Principled Application*, 13 PEPP. L. REV. 267, 270-71 (1986); Rahdert, *R. E. Reconsidered*, *supra* note 5, at 329; Schwartz, *supra* note 2, at 40; Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1463 (1989).

[7] For descriptions of other market failures, such as those that relate to the health insurance industry, see Abraham, *supra* note 5. On cognitive restrictions and their effect on the insurance consumer, see the discussion on the Insurer's duty of disclosure and its theoretical basis, *see* Abraham, *supra* note 5, at Ch.1 notes 135-260 and accompanying text.

[8] *See* Ian R. MacNeil, *The Many Futures of Contracts*, 47 S. CAL. L. REV 691 (1974); *see also* Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697, 709-12 (1990); D. Campbell, *Reflexivity and Welfarism in the Modern Law of Contract*, 20 OXFORD J.L. STUD. 477 (2000); Charles J. Goetz and Robert E. Scott,

These traits of insurance contracts have led to the development of unique interpretive doctrines. In contract law, courts generally resolve disputes by examining the parties' *mutual intent*.[9] By contrast, in disputes involving insurance contracts, courts ignore the actual intent of the parties, and resolve disputes through *interpretation* of the contracts. This approach rests on the notion that invalidating an insurance contract for lack of mutual intent will likely lead to repudiation of the insurance coverage itself, whereas treating the case as one of contract interpretation will allow courts to preserve the insured consumer's insurance coverage. We can therefore view the insurance contract rules of interpretation that the courts have formulated as a means to recast abstract insurance goods into a form more closely resembling those of more concrete consumer goods. This approach bridges the inherent information gaps between the Insurer and the Insured, not in advance when the contract is entered into, but at least in retrospect, when the dispute is decided. As I will show, the courts' use of interpretive rules is thus not intended to resolve what are typically classified as problems of interpretation, as is customary in commercial or consumer contracts.[10] Rather, because of the special public

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Principles of Relational Contracts, 67 VA. L. REV. 1089 (1981); Ian R. MacNeil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483, 483 (1985); Steven R. Salbu, *The Decline of Contract as a Relationship Management Form*, 47 RUTGERS L. REV. 1271 (1995); Schwartz, *supra* note 2, at 42.

[9] Fischer, *supra* note 2, at 997; Rahdert, *R. E. Reconsidered*, *supra* note 5, at 337; Ware, *supra* note 6, at 1467.

[10] The problem of insurance contract interpretation arises when the language of the contract is vague, the contract's structure is defective, or the contract contains non-contractual information that is otherwise incompatible with its contents, such as references to various publications. There are various sources for these interpretation problems including those of which the Insurer is aware but does nothing to address, as well as those of which the Insurer is completely unaware. For example, Insurers may draft contracts without considering future developments not within the cognizance of either party at the time. Nonetheless, Insurers may also choose to use vague wording because they want to avoid deterring potential Insureds from agreeing to the policy or because some situations are difficult to predict and anticipate. Sometimes the Insurer simply chooses to leave the wording as is because the costs of changing it would probably exceed the total potential damages from any resulting claims. *See* E. ALLAN FARNSWORTH, CONTRACTS 427-28 (3d ed. 1999); JERRY, *supra* note 2, at 126-128; Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 590 (1982).

interest in preserving insurance coverage, these rules have often served to implement broader public policy considerations.[11]

After explaining the goal and operation of the interpretation against the drafter rule and the reasonable expectations test, I examine the relationship between these interpretive tools and the Insurer's duty to disclose. I show that while courts do consider the scope and level of information disclosure by Insurers in interpreting insurance contracts, they do not give this factor sufficient weight. Hence, I conclude with a normative proposal of how better to incorporate disclosure considerations into the two leading interpretive approaches to insurance contracts.

The remainder of the Essay unfolds in three parts. In Part I, I present and discuss the two main interpretive approaches to insurance contracts—the "Interpretation Against the Drafter" rule and the "Reasonable Expectations" test. I discuss the evolution of each doctrine and how courts apply them in practice. In Part II, I explore the symbiotic relationship between interpretation rules and disclosure duties in insurance law. Finally, in Part III, I propose a new approach to interpretation of insurance contracts that takes into account the scope and extent of insurance companies' disclosure duties. A short conclusion ensues.

I. RULES OF INTERPRETATION FOR INSURANCE CONTRACTS

A. An Overview

The two central rules of interpretation that have evolved with regard to insurance contracts are the rule of *Interpretation against the Drafter*[12] (usually the Insurer) and the *Reasonable*

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[11] It was in this context that the Reasonable Expectations of the Insured doctrine was specially developed. *See* discussion, *supra* notes 45-97, and accompanying text.

[12] For a description of how this rule relates to insurance contracts in England, see JOHN BIRDS, MODERN INSURANCE LAW 234 (4th ed. 1997); MALCOLM A. CLARKE, THE LAW OF INSURANCE CONTRACTS 352-57 (1994); ARTHUR L. CORBIN, ON CONTRACTS, Vol. 3, 262 (1960); E.R.HARDY IVAMY, GENERAL PRINCIPLES OF INSURANCE LAW 388-94 (6th ed. 1993); in the United States, see FARNSWORTH, *supra* note 10, at 471; JERRY, *supra* note 2, at 144; KEETON AND WIDISS, *supra* note 2, at 628; STEMPEL, *supra* note 2, at 173; Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531 (1996); Rahdert, *R. E. Reconsidered*, *supra* note 5, at 328; see also RESTATEMENT (2D) OF CONTRACTS § 206 (1981) ("In choosing among the

Expectations of the Insured test.[13] Customarily, principles of interpretation that apply to contract law generally are said to apply to insurance law as well,[14] and indeed, the above two interpretation doctrines can be viewed as lying at the heart of the well-known dispute between the two schools of thought on general contract interpretation. The first school is identified with Samuel Williston[15] and preaches reliance on the *language* within the four corners of the contract. This school thus relies on assigning responsibility to the drafter in event of any textual ambiguity under the rule of Interpretation against the Drafter. The other school is associated with Arthur Corbin[16] and preaches

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reasonable meanings of a promise or agreement or a term thereof, that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds.").

[13] ANDERSON, *supra* note 3, at 66-76; JERRY, *supra* note 2, at 141; KEETON AND WIDISS, *supra* note 2, at 627; BARRY R. OSTRAGER AND THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES 17-38 (9th ed. 1998); STEMPEL, *supra* note 2, at 311; Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151 (1981); Abraham, *supra* note 12; Laurie Kindel Fett, *The Reasonable Expectations Doctrine: An Alternative to Bending and Stretching Traditional Tools of Contract Interpretation*, 18 WM. MITCHELL L. REV. 1113 (1992); Fischer, *supra* note 2, at 1002; Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823 (1990); Robert E. Keeton, *Reasonable Expectations in the Second Decade*, 12 FORUM 275 (1976); Robert H. Jerry, *Insurance, Contract and the Doctrine of Reasonable Expectations*, 5 CONN. INS. L.J. 21 (1998); Schwartz, *supra* note 2, at 70. On the distinction between a principle and a doctrine in the context of the Reasonable Expectations of the Insured test, see Abraham, *supra* note 5, at 59, 61; Robert E. Keeton, *supra* note 13, at 275, 276-77.

[14] JERRY, *supra* note 2, at 129; KEETON AND WIDISS, *supra* note 2, at 627; STEMPEL, *supra* note 2, at 311; Fischer, *supra* note 4, at 1001; Jerry, *supra* note 13, at 21; David S. Miller, *Insurance as Contract: The Argument for Abandoning the Ambiguity Doctrine*, 88 COLUM. L. REV. 1849 (1988); Peter Nash Swisher, *Judicial Rationales in Insurance Law: Dusting Off the Formal for the Function*, 52 OHIO ST. L.J. 1037, 1038 (1991).

[15] *See* WILLISTON, *supra* note 3. This is the "Four Corners" approach.

[16] ARTHUR L. CORBIN, ON CONTRACTS, Vol. 3, 262 (1960); *see also* FARNSWORTH, *supra* note 10, at 417. For a description of the dispute between Williston and Corbin's approaches and its developments over the years in the United States, see Jean Braucher, *The Afterlife of Contract*, 90 NW. U.L. REV. 49 (1995); for a history of American interpretation of legal text, see GUIDO CALABRESI, A COMMON LAW IN THE AGE OF STATUTES (1982); William S. Blatt, *The History of Statutory Interpretation: A Study in Form and Substance*, 6 CARDOZO L. REV. 799 (1982); Robert Weisberg, *The Calabresian Judicial Artist: Statutes and New Legal Process*, 35 STAN. L. REV. 213 (1983).

interpretation informed, from the outset of the interpretive process, by the *external circumstances and evidence* surrounding the agreement. Because the Insured's reasonable expectations are perceived to be a part of these external circumstances, they have the power to prevail over the express text of the agreement.[17] Despite this and the fact that rules on insurance contract interpretation can be seen as a part of contract law more generally, we shall nonetheless see that insurance law's rules, including interpretive rules, were designed to distinguish the insurance industry from other fields of contract law.[18]

The one common denominator of insurance law interpretation rules is that they are all designed to accord protection to the Insured's interests. For example, the rule of "Interpretation against the Drafter" was once and still remains the most popular rule of interpretation for insurance contracts. According to this rule, the scales always tip in favor of the Insured, and against the Insurer who drafted the contract, whenever the disputed contract text is receptive to two or more reasonable interpretations.[19] To this rule the courts have also added local rules of interpretation, which share this common goal of protecting the interests of the Insured. These local rules include those requiring, insofar as possible, insurance contract

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[17] RESTATEMENT (2D) OF CONTRACTS § 211 (1981) follows the Corbin school of interpretation. This section allows the attribution of greater weight to the circumstances leading to contract formation and the abandonment of textual interpretation framework. The section states that each detail in a contract that one of the parties has reason to believe is a detail customarily found in that kind of contract, must be honored unless that same party has reason to believe that the other party would have refrained from signing the agreement had it known the detail's inclusion therein. Comment f to this section states that, although signatories to standard contracts are, for the most part, bound to all the details in the contract, including those that they either did not read or understand, they are not bound to details that both are unread and deviate from their reasonable expectations. The tension between the two schools of interpretation is also reflected in the debate between Justice Scalia, who favors textual interpretation of statutes, and Justice Stevens, who prefers interpretation of statutes based on their legislative intent. *See, e.g.*, AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366 (1999); Landgraf v. USI Film Prods., 511 U.S. 244 (1994); Morales v. Trans World Airlines, Inc., 504 U.S. 374 (1992); Am. Nat'l Red Cross v. S.G., 505 U.S. 247 (1992); *see also* the debate between Judges Easterbrook and Posner, United States v. Marshall, 908 F.2d 1312 (1990).

[18] *See* sources cited *supra* note 4.

[19] *See* sources cited *supra* note 12; *see also* Fischer, *supra* note 2, at 996, 1005-07.

interpretations that maintain the Insured's coverage; that comport with the understanding of a *reasonable Insured party*, not a reasonable Insurer; and that give broad construction to terms and conditions that expand coverage but narrow construction to those that restrict it.[20]

These rules of interpretation are therefore anchored either directly or indirectly in the actual text of the insurance contract itself, as are other doctrines used in contract interpretation. Among this latter group, the doctrines of estoppel, forbearance, and unconscionability figure prominently.[21] Just as the Interpretation Against the Drafter rule effectively gives courts the discretion to find ambiguity in a policy, even where none can truly be said to exist, so as to the employ the rule for the benefit of the Insured,[22] so, too, do courts use the unconscionability doctrine to grant themselves the relative power to intervene in the contractual text.[23] As already stated, however, these doctrines depend on the text of the insurance contract and on the conduct of the parties to it. The courts are therefore limited in their ability to use these rules beyond what is required by the particular issues at hand in any given dispute.

Against this background of limited applicability of interpretation doctrines, and the artificial ways in which courts often must use them to protect the interests of the Insured even

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[20] *See* cases cited *infra passim*; JERRY, *supra* note 2, at 136; Fischer, *supra* note 2, at 1004-05.

[21] It is doubtful whether estoppel and forbearance can be viewed as rules of interpretation, but they can be classified as complementary doctrines, which come after interpretation of the contract has been complete. JERRY, *supra* note 2, at 149-50; KEETON AND WIDISS, *supra* note 2, at 614-17; STEMPEL, *supra* note 2, at 155, 209-24; Abraham, *supra* note 12, at 514; Abraham, *supra* note 5, at 61; Mayhew, *supra* note 6, at 267, 268; Ware, *supra* note 6, at 1465.

[22] BENJAMIN M. ANDERSON, ON LIFE INSURANCE 182-183 (1991) (calling this ambiguity "Constructive Ambiguity"); Fischer, *supra* note 2, at 1000; Rahdert, *R. E. Reconsidered*, *supra* note 5, at 328; Rahdert, *R. E. Revisited*, *supra* note 5, at 118; Schwartz, *supra* note 2, at 66; Ware, *supra* note 6, at 1465.

[23] On the unconscionability doctrine in general contract law and its application in insurance contracts, see SINAI DEUTSCH, UNFAIR CONTRACTS: THE DOCTRINE OF UNCONSCIONABILITY (1977); ROBERT COOTER AND THOMAS ULEN, LAW AND ECONOMICS 280 (3d ed. 2000); FARNSWORTH, *supra* note 10, at 495; KEETON AND WIDISS, *supra* note 2, at 623; STEMPEL, *supra* note 2, at 242; M.P. Ellinghaus, *In Defense of Unconscionability*, 78 YALE L.J. 757 (1969); Jerry, *supra* note 14, at 36; Arthur A. Leff, *Unconscionability and the Code – The Emperor's New Clause*, 115 U. PA. L. REV. 485 (1967); Rahdert, *R. E. Revisited*, *supra* note 5, at 126; *see also* RESTATEMENT (2D) OF CONTRACTS §§ 208, 211 (1981).

absent any sound textual or contextual foundation,[24] the principle of the "Reasonable Expectations of the Insured" evolved.[25] Its main innovation lies in its ability to overcome the explicit terms of the insurance agreement in those cases in which the terms are inconsistent with the Insured's reasonable expectations.[26] As distinguished from the more textually bound interpretive rules described above, the Reasonable Expectations principle has the potential to affect judicial policies independently of the text of the contract and the conduct of the parties. These judicial policies can thereby extend beyond determination of the immediate dispute and toward a more general consideration of the Insured public's interests and, in exceptional cases, of the insurance market as a whole.[27] Accordingly, in this Part, I will show that any discussion of the parties' duties of disclosure, especially the Insurer's duty to disclose, cannot be complete without examining the symbiotic relationship that exists between the duties of disclosure and the rules of interpretation. The course of the following discussion will therefore turn first to the rule of "Interpretation against the Drafter" and second to the principle of "Reasonable Expectations." The discussion will then describe in further detail the symbiotic relationship existing between the rules of disclosure and the rules of interpretation and develop an outline for an applied model of insurance contract interpretation.

B. Interpretation against the Drafter

In the proceeding subsections, I discuss the moral, economic and distributional rationales behind the interpretation against the drafter rule. My goal in this discussion is to show how

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[24] *See* sources cited *supra* note 22.

[25] On the argument that the interpretation doctrines were insufficient in order to resolve disputes in the insurance field, see KEETON AND WIDISS, *supra* note 2, at 628; STEMPEL, *supra* note 2, at 320; Abraham, *supra* note 13, at 1174-82; Fischer, *supra* note 2, at 1002; Rahdert, *R. E. Reconsidered*, *supra* note 5, at 336-345; Ware, *supra* note 6, at 1465.

[26] Keeton, *supra* note 4. The classic version of the Reasonable Expectations test was formulated in this article and is called the "whole transaction" version. Keeton explains, "[t]he objective and intended expectations of the beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations." *Id.*; *see also* KEETON AND WIDISS, *supra* note 2, at 613-652.

[27] *See* JERRY, *supra* note 2, at 143; KEETON AND WIDISS, *supra* note 2, at 646; STEMPEL, *supra* note 2, at 321; Abraham, *supra* note 5, at 60; Fischer, *supra* note 2, at 1004.

the rule is tailored to the unique characteristics of insurance transactions. I then examine how the rule has been applied in practice by the courts.

1. The Rationales For Applying The Rule

Much ink has been spilled over the rule of Interpretation against the Drafter.[28] The significance of the rule, in essence, is that when more than one reasonable interpretation of a contract term exists, the court will adopt the interpretation disfavoring the party who drafted the term. The rationale behind the rule incorporates the concept of fault, as well as other economic, distributional and consumer protection considerations.[29] The primary application of the rule is in the insurance field, stemming from the fact that the Insurer drafts the contract and therefore, as the party at fault, appropriately bears the responsibility for any vague language.[30] However, economic, distributional and consumer considerations that are unique to the insurance field also play a role. From an economic efficiency perspective, an agreement would be efficient only when its terms are clear and unambiguous because only unambiguous terms can lead to realization of the agreement without imposing undue costs on the parties or wasting judicial time in interpreting the contract. Under this view, the courts should confine themselves to resolving these ambiguities and thereby preserving the economic efficiency of the underlying contract.[31]

The party best able to minimize textual ambiguity is the party that controls the language of the agreement, and thus, it is this party that should be held liable for failure to do so. Also, from a professional and economic standpoint, the Insurer should bear the liability as the generally more powerful party, and therefore more capable of influencing the ambiguity of a contract's terms. The justification for interpreting vague terms against Insurers also relies on insurance's putative function as an important means for dissipating the cost of harm. In fact, the entire purpose of insurance is to dissipate costs by shifting risk

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[28] *See* sources cited *supra* note 12.

[29] *See id.* For criticism, see Miller, *supra* note 14, at 1849; 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).

[30] *See* sources cited *supra* note 12.

[31] Fischer, *supra* note 2, at 1004, 1060; Rahdert, *R. E. Revisited*, *supra* note 5, at 117; Ware, *supra* note 6, at 1465.

onto a larger group of Insured parties (the insurance pool). An interpretive rule that favors the Insured and treats the Insurer as the "deep pocket" is therefore justified because it shifts liability onto Insurers and thereby achieves insurance's purpose of dissipating cost.[32] Thus, under this approach contract ambiguity is considered to be a transaction cost the Insurer assumes and then redistributes through premiums onto the Insured public as a whole so as not to burden the wallet of a single Insured consumer.

Furthermore, as already stated, insurance is not a market good but rather is an abstract and intangible product embodied in an insurance agreement.[33] Vague language is therefore likely to be perceived as a defect in the product for which the Insurer must be held accountable, just as other manufacturers are held accountable for their products.[34] In other words, the Interpretation Against the Drafter rule rests on rationales that apply to all agreements unilaterally drafted by a single party, but in the insurance industry these same rationales apply with even greater force, further adding to the unique nature of insurance contracts.

2. Application Of The Rule

A perusal of how courts use the Interpretation against the Drafter rule reveals that they deal with it in a rather simplistic manner. No attempt has been made to establish a complex model for applying the rule, beyond the maxim that the rule shall be applied wherever ambiguities appear in an insurance agreement. It is also difficult to infer from the case law any meaningful guidelines for determining when insurance language is vague and the rule therefore applicable.[35] As I will show in this Part, courts in practice apply the rule not only in those cases where the text is indeed open to several reasonable interpretations, but also in cases where the most reasonable interpretation favors the Insurer. In fact, courts also apply it in even more extreme cases where the text is actually clear but the court simply conjures "ambiguity out of thin air" in order to employ the rule. By using it in this manner, the courts have in fact turned the rule of Interpretation Against the Drafter into one that broadens judicial policy, albeit in the

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[32] STEMPEL, *supra* note 2, at 321; Abraham, *supra* note 13, at 1185-87; Abraham, *supra* note 12, at 534, 538-39; Fischer, *supra* note 2, at 1004, 1060.

[33] *See* sources cited *supra* note 5.

[34] Rahdert, *R. E. Revisited*, *supra* note 5, at 123.

[35] *See* sources cited *supra* note 22.

guise of a textual interpretation rule.[36] I will therefore examine various possible standards for applying the rule and then analyze the ways in which the courts have applied the rule under those same standards.

The first step in applying the rule is to find that the text of an insurance policy is vague. When courts decide that text is vague, however, and therefore assign responsibility to the Insurer, they do not consider whether the Insurer could possibly have drafted the text in a clearer manner and eliminated the ambiguity.[37] Although it can be argued that whereas an Insurer who negligently drafts vague policy terms should bear the resulting costs, an Insurer who takes due care in drafting terms that are in fact impossible to phrase in a less ambiguous manner should not be subject to the rule.

The next question that then arises is whether the ambiguity of text should be determined from the perspective of what the Insurer knew and understood *at the time it drafted the contract*, or from the perspective of what the Insurer knew and understood only *after the insured-against event occurs*, that is, in hindsight.[38] The courts do not address these distinctions, however, and instead seem not to take into account at all either the drafter's level of care or its ability to improve on the clarity of its contracts. Thus, in those cases where ambiguous contract terms are susceptible to several possible interpretations, the courts effectively impose absolute liability on the Insurer. In this way the courts further deemphasize the textual dimension of the contract: among the various rationales that courts could use to justify applying the Interpretation Against the Drafter rule, the rationales to which they actually resort do not depend on the Insurer's level of care in drafting of the contract terms, but are instead rationales based essentially on judicial policies such as distributive justice and consumer protection. From an economic perspective, this approach imposes fewer administrative costs

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[36] Schwartz, *supra* note 2, at 69; *see also* sources cited *supra* note 22.

[37] Had the court examined it, it would have been appropriate to decide at what point in time the ambiguity should have been examined. Examination at the stage of contract formation is usually to the benefit of the Insurer because only the information known at that time would be relevant, not information learned in retrospect. In this sense, the time of contract formation is the same pivotal point to which the contract law reverts to analyze other contractual issues such as the scope of the injured party's just compensation.

[38] On the cognitive bias in the matter of hindsight wisdom – "The Hindsight Bias," – see the discussion on the Insurer's duties of disclosure, *supra* Ch. 1 notes 188-91 and accompanying text.

than one that examines whether the drafter could have improved the clarity of the contract's text. This strict liability approach thus absolves the courts from deciding the issue of Insurer fault, a process that involves looking at what alternative wordings would have been possible at the time the parties entered into the contract and what the nature of the market was at that time.[39]

Because they dogmatically impose absolute liability on Insurers, courts also do not examine whether the Insured consumers were indeed interested, at the time of contract formation, in receiving the level and type of coverage that the courts ultimately award them. Nor do they examine whether the Insured consumers were indeed willing to pay for this coverage. Were courts to take these latter issues into consideration, they would presumably apply the Interpretation Against the Drafter rule only in those cases in which the Insured consumers would have been willing ex ante, at the time that they bought the insurance, to pay for the level of coverage that they ultimately receive under this rule. In all other cases, the Insurer should be exempt from liability for the additional coverage. According to this test, in other words, not every ambiguity in the text of an insurance contract should lead to interpretation in favor of the Insured.[40] If, in applying the Interpretation Against the Drafter rule, the courts would take into consideration the ability of the Insurer to improve the clarity of the text, on the one hand, and the willingness of the Insured to pay for broader insurance

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[39] Abraham, *supra* note 12, at 546. The test of whether the text is vague is ostensibly based on the logic of the "reasonable reader," but it is clear that this test relies heavily on judicial intuition and therefore is likely to lead the courts to accept and examine circumstantial evidence, an examination which in itself is problematic when the contract is a standard contract.

[40] Kenneth S. Abraham suggests this method of interpretation in his article. Abraham, *supra* note 12. A similar method of analysis is also used when deciding whether to compensate a party breach of contract with injuries that are not financial. Here, too, if the injured party is asked after the contract is breached whether he would be willing to receive compensation for mental damages due to the breach, he would certainly answer in the affirmative. If, however, the injured party *ex ante*, at the time that the contract was entered into, would be willing to pay a higher price for the contract so that the other party can insure himself against the risk of having to pay the first party for mental damage, he would obviously answer in the negative. This shows that contracting parties are usually more interested in compensation for their financial damages from the breach of contract, and they are not necessarily interested in a more expensive transaction simply for the chance to obtain damages unrelated to profits. *See* Samuel A. Rea, *Nonpecuniary Loss and Breach of Contract*, 11 J. LEGAL STUD. 35 (1982).

coverage on the other hand, then it could be said that the Interpretation Against the Drafter rule indeed functions in the contractual domain and takes into account the apparent intent of the parties to the contract.

The scope of the courts' discretion could also be expanded, however, into a more complex and less one-dimensional approach that would fluctuate between a moderate defense of the Insured with real consideration of the Insurer's interests and the traditional consumer model, which takes into account only the Insured's interests. By taking into account the Insurer's level of care in drafting the policy and Insured's willingness to pay for the insurance coverage ultimately provided, the courts can protect the Insured's interests and, of course, benefit the Insurer. An approach that would place even more weight on the interests of the Insured, however, could be created by imposing liability on the Insurer whenever ambiguity exists, regardless of the Insurer's level of care, but subject to the willingness of the Insured to pay for the additional insurance coverage. Under such an approach, the Insurer's liability is not absolute but is nonetheless rather strict. The standard that places the most weight on the interests of the Insured is one that imposes absolute strict liability on the Insurer, regardless not only of the Insurer's level of care in drafting the contract but also of the Insured's willingness to pay for the additional coverage.[41]

As already stated, the courts in actual practice do not in fact look at either of these considerations. Instead, they act under the guise of contract law in order to dictate judicial policy of a non-contractual, public nature. Contract-related concerns, such as the Insurer's fault and the Insured's intent, are discarded at the courts' discretion in applying the "Interpretation against the Drafter" rule.[42] It should be noted, though, that courts could

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[41] Abraham, *supra* note 12.

[42] The Interpretation against the Drafter rule is sometimes presented as a rule of last resort in interpretation and as coming into effect only after the other interpretation methods have been exhausted. Thus, only after judges have exhausted methods for trying to determine the subjective and objective purposes of the parties and have arrived at a number of interpretations of possible objective purposes that are reasonable to the same degree, will they turn to the Interpretation Against the Drafter rule. This rule is perceived to be a secondary rule that exempts judges from limits on their discretion. An analysis of the case law indicates that in practice, the courts apply the Interpretation Against the Drafter rule much more powerfully than the case law rhetoric would suggest. In fact, the rule is predictably applied in favor of the Insured, in that courts already assume from the start that the subjective

easily modify this rule to take account of the Insurer's level of care and the Insured's ex ante willingness to purchase additional coverage.

C. The Reasonable Expectations of the Insured

In the following subsections, I examine how the "the Reasonable Expectation test" has emerged alongside the Interpretation Against the Drafter rule. I pay particular heed to the similarities and differences between the two rules. I then discuss how the reasonable expectation test evolved over time in the courts' decisions.

1. Historical Background

Along with the "Interpretation Against the Drafter" rule, a second interpretive standard was developed to resolve insurance disputes: the Reasonable Expectations of the Insured test.[43] Robert Keeton introduced the test in an article published in 1970.[44] In this article Keeton analyzed the case law on insurance disputes and showed that in practice, courts resolve insurance disputes through interpretive means and in doing so, assign decisive weight to the Insured's reasonable expectations. He further noted that under this doctrine, courts favor the Insured even when the language of the policy explicitly indicates otherwise, adhering instead to the Insured's reasonable expectations.[45] According to Keeton's article, the novelty of this

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purpose of an insurance contract will be difficult to determine and that the objective purpose of the contract will not be mutual, and therefore the rule that supposedly is one of last resort in fact becomes a rule of first resort. Perusal of all case law indicates that those courts that apply the rule do so in a simplistically decisive manner, without employing a more complex application model that would take into account the weave of considerations detailed above. Thus, it becomes apparent that in practice, the Interpretation Against the Drafter rule becomes a vehicle for judicial policy that merely acts under the guise of a contract interpretation rule to seem less invasive than its true practical application. As was discussed above, the application of the rule in fact takes into consideration only the Insured consumer's interests and distributive public interests, without taking into account other considerations such as the Insurer's blamelessness in drafting the wording and the Insured's willingness to pay in advance for the doubtful insurance coverage.

[43] *See* sources cited *supra* note 13.

[44] *Id.*

[45] *See* sources cited *supra* note 26.

doctrine is that, where application of the "Interpretation Against the Drafter" rule requires an element of textual ambiguity, the Reasonable Expectations of the Insured test can be applied even when the wording of the text is unequivocally clear.[46]

This article later proved to be very influential in the way courts and scholars resolved insurance disputes: although the courts were already taking the Insured's reasonable expectations into consideration even before Keeton's article appeared,[47] Keeton positively identified the phenomenon and formulated it into an express test. Indeed, ever since he coined the phrase "reasonable expectations" test, the reasonable expectations of the Insured have become a point of reference for both those who support and oppose their use.[48] A review of the case law and of scholarly articles suggests that no other doctrine has led to such an ambivalent reaction in the insurance field as has the Reasonable Expectations test.[49]

The power of the test lies in the fact that courts now have an unconventional tool that, in contrast to the "Interpretation Against the Drafter" rule, enables them to disregard the text of an insurance agreement and instead reach a decision according to judicial policies that they themselves design and dictate. Whereas the Interpretation Against the Drafter rule, even in its broadest construction, such as when various interpretations of the text are

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[46] *Id.*

[47] On the Insured's reasonable expectations as an important element in contract disputes long before the publication of Keeton's article, see SPENCER L. KIMBALL, INSURANCE AND PUBLIC POLICY: A STUDY IN THE LEGAL IMPLEMENTATION OF SOCIAL AND ECONOMIC PUBLIC POLICY, BASED ON WISCONSIN RECORDS, 1835-1959, 210 (1960); Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 633-36 (1943); Karl N. Llewellyn, *The Effect of Legal Institutions upon Economics*, 15 AM. ECON. REV. 665 (1925); Karl N. Llewellyn, *Book Reviews*, 52 HARV. L. REV. 700, 704 (1939).

[48] KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY AND PUBLIC POLICY 103 (1986); STEMPEL, *supra* note 2, at 311; Keeton, *supra* note 13, at 275; Mayhew, *supra* note 6, at 267-77; Rahdert, *R. E. Reconsidered*, *supra* note 5, at 323-25; Jeffrey W. Stempel, *Unmet Expectations: Undue Restriction of the Reasonable Expectations Approach and the Misleading Mythology of Judicial Role*, 5 CONN. INS. L.J. 181, 188 (1998); Ware, *supra* note 6, at 1466.

[49] *See, e.g.*, JERRY, *supra* note 2, at 141; STEMPEL, *supra* note 2, at 313; Abraham, *supra* note 13, at 1153; Abraham, *supra* note 5, at 60-63; James M. Fischer, *The Doctrine of Reasonable Expectations Is Indispensable, If We Only Knew What For?*, 5 CONN. INS. L.J. 151, 160-61 (1998); Henderson, *supra* note 13, at 823.

possible but not necessarily equally reasonable, ultimately depends on the text of an insurance policy, the Reasonable Expectations test relegates that same text to merely *one* of the factors that warrant consideration, *not* the decisive factor. In fact, in certain cases the courts might even ignored the text.[50] Even under the strong form of the Interpretation Against the Drafter rule, where the courts focus on the text to find ambiguities that a lay reader would be hard-pressed to detect, the Insurer can at least cope with the rule by improving the language of the insurance agreement and replacing the (often dubious) ambiguity with accurate and unequivocal wording. The Reasonable Expectations test, on the other hand, releases the courts from these obvious manipulations of the text, which sometimes traverse the borders of reasonableness. The test thus enables the courts to rule in contradiction to the text and in agreement with whatever policy considerations they deem appropriate for the case at hand.

Indeed, it is easy to understand why the debate that arose around the Reasonable Expectations test probed the very roots of contract law and rekindled the dispute between the Williston and Corbin schools of thought.[51] The test reflects the tension between the one approach, which views contract text as the main and sometimes exclusive indicator of the parties' intent, and the other more expansive approach, which treats a contract's text as only

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[50] Kievit v. Loyal Protective Life Ins. Co., 170 A.2d 22 (N.J. 1961) well exemplifies the aforesaid and is perceived to be one of the first judgments in which use was made of the Reasonable Expectations test. In this case, the court determined that the Insured was entitled to coverage due to a disability from Parkinson's disease. The policy contained an explicit exclusion according to which the Insured was not entitled to coverage in the event of disability as a result of a disease. The court determined that: "When members of the public purchase policies of Insurance they are entitled to the broad measure of protection necessary to fulfill their reasonable expectations." *Id.* at 24. Another earlier case which is seen as the birth of the Reasonable Expectations test is Gaunt v. John Hancock Mut. Life Ins. Co., 160 F.2d 599 (2d. Cir. 1947). In this case, the policy explicitly prescribed that insurance would not come into force until the Insurer had explicitly accepted the Insured's application. The applicant completed the application but died in the interim period, and the court determined that the insurance would cover the event, despite the explicit language, because any other result would be incompatible with the reasonable expectations of the Insured applicant. After these cases, many courts began to apply the Reasonable Expectations of the Insured test to command insurance coverage even when contrary to the clear and explicit language of the insurance contract.

[51] *See supra* notes 15, 16 and accompanying text.

one part of a much larger picture that includes other parameters such as surrounding circumstances, policy considerations, and function. Insofar as they relate to the Reasonable Expectations test, these debates provoke discussions in much wider circles as well, sometimes to the point of positing a connection between the development of this test and the political and cultural dimensions of the United States as a nation.[52]

The actual development of the Reasonable Expectations of the Insured test in the United States occurred over a span of four decades. In the 1960s up to the publication of Keeton's article in 1970, before the test was given an explicit name, it was applied by way of a rather broad legal principle, namely, a recurring and often unconscious tendency to view the Insured's reasonable expectations[53] as relevant in an insurance dispute. As Keeton argued, the only way to understand the underlying logic of decisions rendered during the 1960s is to view the courts as tending to honor the Insured's reasonable expectations.[54] After Keeton published his article in 1970, however, a significant number of states expressly adopted the test, and it evolved from the general and abstract principle used in the 1960s to a specific and concrete doctrine and judicial tool in resolving insurance disputes.[55] Acceptance of the doctrine in various states sometimes may have resulted from the relatively bad reputation of Insurers.

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[52] STEMPEL, *supra* note 2, at 267; *see also* BOB WOODWARD AND SCOTT ARMSTRONG, THE BRETHREN: INSIDE THE SUPREME COURT INTRODUCTION (1979).

[53] Abraham, *supra* note 5, at 60; Keeton, *supra* note 13, at 276-77; Stempel, *supra* note 48, at 184-86.

[54] Keeton, *supra* note 4, at 967.

[55] *See* sources cited *supra* note 53; on the use of the doctrine as a tool to resolve disputes in the 1970's, see C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169 (Iowa 1975). In this case, the Insured obtained insurance coverage despite the policy's explicit statement that signs of a burglary were necessary in order to receive insurance coverage. The court held that it was the reasonable expectation of the Insured to receive coverage in the event of a burglary, even in the absence of signs of force. In Corgatelli v. Globe Life & Accident Ins. Co., 533 P.2d 737 (Idaho 1975), a rodeo rider broke part of his collarbone while riding. Under his personal injury insurance policy, insurance coverage would be granted only in case of a complete fracture. The court used the doctrine in granting coverage contrary to the language of the policy. In Collister v. Nationwide Life Ins. *Co.*, 388 A.2d 1346 (1978), the court used the doctrine to find that the Plaintiff was entitled to insurance coverage, even though the insurance contract explicitly determined that the Plaintiff was not entitled to insurance coverage until the express confirmation by the Insurer of the acceptance of its application.

It was this ill-repute that had led the courts to create judicial policies favoring the Insured consumers in the first place, as an act pursuant to a national interest in protecting the interests of the Insured and even in indirectly encouraging faith in the insurance system as a whole.[56] The early adoption of the broad principle and its later transformation into a specific doctrine also released the courts from whatever philosophical distress they must have experienced in trying to decide in favor of the Insured where the text of an insurance policy unequivocally favored the Insurer.[57] In this way the Reasonable Expectations test freed the courts from unreasonably stretching the boundaries of the "Interpretation Against the Drafter" rule beyond the actual text. Keeton's article had landed on fertile soil, and the enthusiastic adoption of the doctrine and its application marked the 1970s.[58]

However, enthusiasm for the Reasonable Expectations test waned somewhat after the 1970s. A certain regression can be detected in the doctrine's use in the United States during the 1980s,[59] due to fear that massive overuse could potentially undermine the stability and certainty of contractual relations between Insurers and Insureds.[60] In the last decade various states

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[56] *See* discussion on comparative research of mutual disclosure in an insurance transaction, *supra* Ch. 2 notes 10-12 and accompanying text; *see also* Reuben Hasson, *The Special Nature of the Insurance Contract: A Comparison of the American and English Law of Insurance*, 47 MOD. L. REV. 505, 521-522 (1984). On concerns about increasing the faith of the public in the insurance system, see, e.g., Anderson and Fournier, *supra* note 3, at 385; Fischer, *supra* note 2, at 1025; Fischer, *supra* note 49, at 170; Schwartz, *supra* note 2, at 39.

[57] For a review of the doctrine in the various states in the United States, since Keeton's article and throughout the years, see OSTRAGER AND NEWMAN, *supra* note 13, at 22; STEMPEL, *supra* note 2, at 342; YORK AND WHELAN, *supra* note 2, at 54-63; Henderson, *supra* note 13; Rahdert, *R. E. Reconsidered*, *supra* note 5, at 324; Susan M. Popik and Carol D. Quackenbos, *Reasonable Expectations After Thirty Years: A Failed Doctrine*, 5 CONN. INS. L.J. 425 (1998).

[58] *Id*; *see also* Abraham, *supra* note 13; Arnold P. Anderson, *Life Insurance Conditional Receipts and Judicial Intervention*, 63 MARQ. L. REV. 593 (1980); Sheldon T. Fleck, *Reasonable Expectations: The Insurer's Dilemma*, 24 DRAKE L. REV. 853 (1975); Frank E. Gardner, *Reasonable Expectations: Evolution Completed or Revolution Begun?* 69 INS. L.J. 573 (1978).

[59] *See* sources cited *supra* note 56. For an example of the retreat of the doctrine as it is reflected in the case law, *see also* STEMPEL, *supra* note 2, at 342; William Mark Lashner, *A Common Law Alternative to the Doctrine of Reasonable Expectations in the Construction of Insurance Contracts*, 57 N.Y.U. L. REV. 1175 (1982); Rahdert, *R. E. Reconsidered*, *supra* note 5; Stempel, *supra* note 48, at 196, 265.

[60] For a discussion of positions both supporting and qualifying the

have remained aware of the Reasonable Expectations test, but only some of them actually use it,[61] and even those states that do use the test, do so cautiously and only after they have exhausted less controversial legal tools such as the Interpretation Against the Drafter rule and supplementary doctrines such as estoppel and forbearance.[62] To a great extent, the Reasonable Expectations test of the past decade has again become a general tendency or abstract legal principle that courts merely take into account, rather than a defined doctrine for daily use.[63] In this way, the evolution of the test can be seen as the closing of a circle. From its inception in the 1960s, it was often an unrecognized but active consideration just beneath the surface; in the 1970s the abstract principle became a specific doctrine used on a relatively massive scale; and in the 1980s a sobering up occurred, leading to repression of the doctrine for fear that extensive application would subvert the fundamental allocation of risks between Insurers and Insureds, cause Insurers to increase premiums, and even in certain cases, to hurt or cripple Insurers' financial stability.[64] Finally, the 1990s combined the 1970s' thesis of

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Reasonable Expectations test, see infra notes 77-97 and accompanying text.

[61] ANDERSON, *supra* note 3, at 66-76; JERRY, *supra* note 2, at 141-47; OSTRAGER AND NEWMAN, *supra* note 13, at 17-38; STEMPEL, *supra* note 2, at 311-358; Henderson, *supra* note 13, at 823; Jerry, *supra* note 13, at 22-23; Popik and Quackenbos, *supra* note 57; Stempel, *supra* note 48, at 210.

[62] *Id.*

[63] Abraham, *supra* note 5, at 60; Abraham, *supra* note 12, at 541; Stempel, *supra* note 48, at 184.

[64] For a discussion on the various criticisms of the Reasonable Expectations of the Insured test, see *infra* notes 77-97 and accompanying text. For a review of the regression in the use of the doctrine, see sources cited *supra* note 55, some of which, for example, review the use of the Reasonable Expectations test in Iowa. In 1975, the courts began to use the test massively in *C & J Fertilizer, Inc.*, 227 N.W.2d at 169. For several years, it appeared as though the Iowa courts were consistently using the test. *See, e.g.*, Edwards v. State Farm Mut. Auto Ins. Co., 296 N.W.2d 804 (Iowa 1980); Johnson v. Fireman's Fund Ins. Co., 272 N.W.2d 870 (Iowa 1978); Gibson v. Milwaukee Mut. Ins. Co., 265 N.W.2d 742 (Iowa 1978). In time, this trend began to change, however, and in several later cases, the courts ruled it impossible to ground a reasonable expectations analysis in either the wording of the contract or in the actions of the Insurer. The courts also held that the test could not be used so long as there was reasonable language in the insurance contract, and in fact, they refused to apply it unless they found a textual ambiguity or term or condition that contradicted the intentions of the parties. *See, e.g.*, Chipokas v. Travelers Indem. Co., 267 N.W.2d 393 (Iowa 1978); Farm Bureau Mut. Ins. Co. v. Sandbulte, 302 N.W.2d 104 (Iowa 1981); M-Z Enterprises v. Hawkeye-Sec. Ins. Co., 318 N.W.2d 408 (Iowa 1982); Bankers Life Co. v. Aetna Cas. &

emphasis on reasonable expectations with the 1980s' antithesis into a synthesis converting the Reasonable Expectations test from a specific and express doctrine back into a more abstract super-principle that serves to affect judicial policy and guide the conduct of Insurers and their Insureds.[65]

2. Application Of The Test

A perusal of various United States court rulings reveals that courts employ the Reasonable Expectations test on a wide scale. Use of the test ranges from no use at all in certain states to use in its classic sense as Keeton defined it: namely, honoring the Insured's reasonable expectations even when it contradicts the explicit language of the insurance policy. Most states apply the test in variations between these two extremes, with the only common denominator being the use of the phrase "Reasonable Expectations of the Insured." In other words, states refer to the test by the same name, even though their particular version differs from both Keeton's original conception and versions used in other states.[66]

Sur. Co., 366 N.W.2d 166 (Iowa 1985). A similar process occurred in New Jersey. *Kievit*, 170 A.2d at 22 marked the beginning of the Reasonable Expectations test in New Jersey and even served as one of the sources for Keeton's article. During the 1960s and 1970s, the use of the test was well-established in the State. *See* Rahdert, *R. E. Reconsidered*, *supra* note 5, at 362. At the end of the 1970s, the status of the test was undermined, and it was held that the test would be used only when the insurance contract conditions were vague. In contrast, when the language of the contract was clear, no use could be made of the test. *See* Diorio v. New Jersey Mfrs. Ins. Co., 398 A.2d 1274 (N.J. 1979); Weedo v. Stone - E - Brick, Inc., 405 A.2d 788 (N.J. 1979). From the 1980s onwards, this trend of narrowly defining the boundaries of the test continued. *See* Scarfi v. Aetna Cas. & Sur. Co., 559 A.2d 459 (N.J. Super. Ct. App. Div. 1989).

[65] On the concepts of thesis, antithesis and synthesis, see the discussion of Hegelian perceptions in PETER SINGER, *Hegel*, in THE ENCYCLOPEDIA OF PHILOSOPHY 339 (Paul Edwards ed. 1967) (summarizing Hegel's life, philosophy, and impact). For more extensive treatment in PETER SINGER, HEGEL (1983); ROBERT SOLOMON, IN THE SPIRIT OF HEGEL (1983); CHARLES TAYLOR, HEGEL (1979); MICHAEL INWOOD, A HEGEL DICTIONARY (1992), all of which are cited in Stempel, *supra* note 48.

[66] JERRY, *supra* note 2, at 141; KEETON AND WIDISS, *supra* note 2, at 633; STEMPEL, *supra* note 2, at 313; Abraham, *supra* note 13, at 1153; Fischer, *supra* note 49, at 161; Roger C. Henderson, *The Formulation of the Doctrine of Reasonable Expectations and the Influence of Forces Outside Insurance Law*, 5 CONN. INS. L.J. 69(1998); Henderson, *supra* note 13, at 838; Stempel, *supra* note 48, at 189; Jeffrey E. Thomas, *An Interdisciplinary Critique of the*

It is nevertheless possible to identify a few general ways in which states apply the test. The Reasonable Expectations test in its "strong" form—as captured by Keeton's classic formulation—privileges the Insured's reasonable expectations above the explicit language of the contract.[67] The test in its "weak" form[68] limits itself to those cases in which the contract's text contains some ambiguity. The Reasonable Expectations test in its weak sense is not intended for use in the same manner as the Interpretation Against the Drafter rule, however. Whereas the Interpretation Against the Drafter rule is applied only when the text raises more than one *reasonable* interpretation and directs courts to choose the one disfavoring the drafter, the "weak" version of the Reasonable Expectations test is applied whenever the text is vague, regardless of whether or not more than one reasonable interpretation exists. A third, intermediate version of the Reasonable Expectations test is applied when the contract's

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Reasonable Expectations Doctrine, 5 CONN. INS. L.J. 295, 296 (1998).

[67] This is the classic version of the Reasonable Expectations test, also known as "the Whole Transaction Version." *See* KEETON AND WIDISS, *supra* note 2, at 613-652; Keeton, *supra* note 4. For the list of states in the United States that have adopted this classic version of the test, a "rights at Variance" version of it, see Rahdert, *R. E. Reconsidered*, *supra* note 5. The following judgments are widely cited as adopting this version: *C & J. Fertilizer Inc.*, 227 N.W.2d at 169; *Kievet*, 170 A.2d at 22; Atwater Creamery Co. v. Western National Mutual Insurance Co., 366 N.W.2d. 271 (Minn. 1985); Parker v. Unum Life Insurance Co., 930 F. Supp. 1343, 1346 (D. Ariz. 1996) ("[I]n limited situations, however, even an unambiguous term in standardized insurance contacts will not be enforced where the insured did not reasonably expect it."); Grinnell Mutual Reinsurance Co. v. Voeltz, 431 N.W.2d 783 (Iowa 1988). Of course, the use of this strong version of the test could lead to a ruling that the Insured's expectations were unreasonable and therefore yield a result contrary to the Insured's interests.

[68] The weak version is called "the Ambiguity Version." For a list of states in the United States that have adopted the test in its weak version, see Rahdert, *R. E. Reconsidered*, *supra* note 5, at 353-67; Ware, *supra* note 6, at 1467. This version of the test is in fact the most cautious use made of the test. *See* Abraham, *supra* note 13, at 1181. The following cases are widely cited as adopting this version: Dickins v. Stiles, 916 P.2d 435, 439 (Wash. Ct. App. 1996) ("[T]here must be either an ambiguity or inconsistency between policy provisions. When this occurs, the provisions are to be interpreted in accordance with the reasonable expectations of the insured."); Silk v. Flat Top Construction, Inc., 453 S.E.2d 356 (W. Va. 1994); Wellcome v. Home Insurance Co., 849 P.2d 190 (Mont. 1993); Farmers Insurance Exchange v. Young, 832 P.2d 376 (Nev. 1992); Tonkovic v. State Farm Mutual Auto Insurance Co., 521 A.2d 920 (Pa. 1987); National Union Fire Insurance Co., v. Reno's Executive Air Inc., 682 P.2d 1380 (Nev. 1984).

language is indeed clear but the disputed terms are nonetheless insufficiently prominent and buried in the text, are surprising, or are contradictory to the purpose for which the insurance agreement was original drawn.[69]

The difference between the Reasonable Expectations test in its "strong" and "weak" versions is that only the "strong" version acts completely independent of the contract text and can therefore help implement far-reaching judicial policies that significantly deviate from the text. Thus, the strong version of the test is not really a test in the interpretive sense at all. By contrast, the test in its "weak" version depends on the text and as such constitutes a true interpretive test similar to the Interpretation Against the Drafter rule, albeit with more intrusive potential. In fact, the weak version of the Reasonable Expectations test can to a large extent be seen to lie within the boundaries of the Interpretation Against the Drafter rule's more expansive versions, some of which Kenneth Abraham originated,[70] and thus, can be seen as merely a variant on the "Interpretation Against the Drafter" rule. Finally, like the weak version, the intermediate variation of the "Reasonable Expectations" test depends on the actual text of the contract but in a looser sense as it requires merely obscure or surprising wording rather than ambiguous language.

3. A Critical Discussion

Surprisingly, despite frequent application of the Reasonable Expectations of the Insured test over the last four decades, one can detect no rigorous attempt to construct a complex application model for it. The many references to the test, whether in the case law or in scholarly articles, basically concentrate on the same simplistic discussions of its pros and cons. They fail to delve into the details and boundaries of the test or its relationship with the duties of disclosure that govern insurance transactions. As will be presented in further detail below, this relationship has exerted a decisive influence on the formulation of the Reasonable Expectations test, on the one hand,

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[69] Stempel, *supra* note 48, at 192; Fischer, *supra* note 49, at 155; *see also*, *e.g.*, Ross v. City of Minneapolis, 408 N.W.2d 910 (Minn. Ct. App. 1987). For other, less common variations of the Reasonable Expectations of the Insured test, see Stempel, *supra* note 48, at 192.

[70] Abraham, *supra* note 12; *see also supra* notes 28-43 and accompanying text.

and on the formulation of the duties of disclosure, on the other hand, even though no recognized standard for applying the test existed.

The discussion above described the possible justifications for the Reasonable Expectations test, as well as those special characteristics of the insurance industry that led to the development of the test and to the development of other industry-specific principles and doctrines.[71] Nonetheless, formulating a proper standard for applying the Reasonable Expectations test and analysis analyzing the symbiosis that exists between it and the duties of disclosure require an examination of the possible criticisms of the test. The proceeding discussion will therefore present some of these criticisms.

It is possible to present these criticisms from three main viewpoints: a comparison with the principles of contract law; economic analysis of the law; and psychological analysis of the law. I will discuss them in turn.

Contract Theory

The main criticism from the contract law viewpoint asserts that widespread use of the Reasonable Expectations test impinges on freedom of contract because it allows courts to draft new contracts for the Insurer and the Insured, regardless of what they had originally agreed.[72] As such, the test undermines certainty and reliance on the express wording of the contract and thus interferes with the Insurer's ability to price insurance risk. In the long-term, the test could therefore lead to increased premiums and burdens on the pockets of the Insured themselves.[73] This criticism of the Reasonable Expectations of the

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[71] *See supra* notes 1-12 and accompanying text; *see also* KEETON AND WIDISS, *supra* note 2, at 634.

[72] JERRY, *supra* note 2, at 144; STEMPEL, *supra* note 2, at 319, 335; Fischer, *supra* note 49, at 171; Gardner, *supra* note 58, at 578; Lashner, *supra* note 59, at 1175; Mayhew, *supra* note 6, at 267; Harry F. Perlet, *The Insurance Contract and the Doctrine of Reasonable Expectation*, 6 FORUM 116 (1971); Conrad L. Squires, *A Skeptical Look at the Doctrine of Reasonable Expectation*, 6 FORUM 252 (1971); Rahdert, *R. E. Reconsidered*, *supra* note 5, at 368; Rahdert, *R. E. Revisited*, *supra* note 5, at 115; Stempel, *supra* note 48, at 206; Ware, *supra* note 6, at 1476, 1487.

[73] *Id.*; *see also* Michael E. Bragg, *Concurrent Causation and the Art of Policy Drafting: New Perils for Property Insurers*, 20 FORUM 385 (1985); Fischer, *supra* note 2, at 1052; Popik and Quackenbos, *supra* note 57, at 431-32; George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96

Insured test is put forth by those who caution against liberal judicial intervention in other types of contracts as well. Nonetheless, this criticism has even greater cogency in relation to insurance agreements because the insurance industry relies very heavily on its ability to appraise and price risk[74] and uses this information in writing policy terms and exclusions. When the Reasonable Expectations test runs contrary to the terms of the insurance agreement, and especially when it runs contrary to the agreed-on level of underlying insurance coverage, it might undermine the Insurer's pricing of the transaction.[75] Along with this criticism based on contract law, some also criticize the judicial activism embodied in the use of the Reasonable Expectations test for encroaching not only on legislative authority but also on the supervisory authority of those that specifically regulate the insurance industry and sometimes draft mandatory insurance policy terms themselves.[76]

Economic Analysis of Law

Criticism of the Reasonable Expectations test also comes from an economic analysis of the law. As a rule, the economic approach encourages free-market activity, as expressed in the principle of freedom of contract and its emphasis on party choice and intent. Because parties' choices are perceived as joint maximization of their respective interests, the Reasonable

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YALE L.J. 1521, 1524 (1987).

[74] ABRAHAM, *supra* note 48, at 11; COOTER AND ULEN, *supra* note 23, at 45-55; Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87-89 (1989); Bragg, *supra* note 73; Fischer, *supra* note 2, at 1059-64.

[75] It might possibly be argued that even the use of the Reasonable Expectations test is a kind of pricing that the Insurer could engage in before entering into the contract, and therefore, the disruption of the pricing of the risks due to the Reasonable Expectations test is lessened.

[76] *See generally* J.H. BAKER, FROM SANCTITY OF CONTRACT TO REASONABLE EXPECTATION IN CURRENT LEGAL PROBLEMS 71 (1979); Mayhew, *supra* note 6; Perlet, *supra* note 72; Rahdert, *R. E. Revisited*, *supra* note 5, at 136; Squires, *supra* note 72; Stempel, *supra* note 48, at 266; Ware, *supra* note 6, at 1483; E. Neil Young, John R. Lewis, and J. Finley Lee, *Insurance Contract Interpretation: Issues and Trends*, 625 INS. L.J. 71, 73, 78-81 (1975). It must be noted that judicial intervention through the Reasonable Expectations test differs from potential legislative intervention in the insurance field, in that legislative intervention is usually applied prospectively, whereas judicial intervention is of a retroactive nature and hence tends to undermine the foundations of the transaction's pricing.

Expectations test may very well subvert the certainty, reliance, and planning that the contract embodies, thus lowering the efficiency of the free market. In addition to this more general criticism, economic analysts also challenge the various justifications for the Reasonable Expectations test, listed above, in an attempt to refute them one by one.[77] For example, economists question the idea that the Reasonable Expectations test bridges over the disparity between the relative negotiating abilities of the Insurer and the Insured, even absent bargaining power disparities, and argue that unfair wealth distributions should be resolved in more efficient ways such as taxation, not contract law.[78] Thus, the Reasonable Expectations test leads to an increase in premiums and a perversion of insurance into a luxury only the wealthy can afford.[79] In other words, instead of redistributing wealth and bridging the gap between the Insurer and the Insured, the Reasonable Expectations test creates disincentives for people to purchase insurance and lowers efficiency. The test therefore redirects the Insured's resources from efficient investment in both insurance and business development to over-investment in self-defense measures, or, even worse, to no investment in insurance at all, not even self-insurance.[80]

Another popular justification for the Reasonable Expectations test argues that insurance agreements are for the most part standardized contracts dictated by the Insurer. The Insurer can therefore assert its preferences ahead of the Insured's. The Reasonable Expectations test presumably protects the Insured from the Insurer's power and from the unfavorable terms that the Insurer drafts as a result.[81] In the opinion of the economists, however, the use of standardized contracts does not necessarily constitute evidence that a strong Insurer has taken advantage of an Insured consumer; rather, standardized contracts result from a desire to mitigate transaction costs.[82] As Michael

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[77] *See, e.g.*, STEMPEL, *supra* note 2, at 321; Stempel, *supra* note 48, at 273; Ware, *supra* note 6, at 1461.

[78] Ware, *supra* note 6, at 1476.

[79] *See* sources cited *supra* note 73.

[80] Schwartz, *supra* note 2, at 39-40, and sources cited therein.

[81] *See supra* note 3 and accompanying text.

[82] *See, e.g.*, FARNSWORTH, *supra* note 10, at 295-303; JERRY, *supra* note 2, at 139; KEETON AND WIDISS, *supra* note 2, at 118; Anderson and Fournier, *supra* note 3, at 365; R. H. Coase, *The Choice of the Institutional Framework: A Comment*, 17 J.L. & ECON. 493, 494 (1974); Fischer, *supra* note 2, at 1012;

Trebilcock has shown, an Insurer who is forced to sell its product through personal negotiations with each and every Insured will incur large costs in investigating the profitability of each sale and in drafting each policy, costs that would ultimately burden both parties and damage the insured consumers' ability to purchase affordable insurance.[83]

The main criticism of economic analysis, however, focuses on the rationale that the "Reasonable Expectations" test helps counter-balance the Insurer's advantage in comprehending the verbose and complex language used in insurance policies, filled with professional terms beyond the comprehension of most laypeople.[84] For example, policies often greatly limit insurance coverage by using exclusions of which the Insured is not aware. The Reasonable Expectations test ostensibly was especially designed to overcome this problem, but from an economic analysis perspective, is not the most desirable way to solve it. Law and economics scholars instead suggest that the Insured will eventually be able to weed out those terms and conditions that they find unattractive because competition in the free market will force profit-maximizing Insurers to offer policies with more favorable and attractive terms. This process supposedly will continue until Insurers finally devise a policy with the optimal terms and prices.[85] Thus, any intervention through use of the Reasonable Expectations test will only hinder this process and interfere in those policies that have already achieved optimality consequent to free-market competition.[86]

A more moderate position would qualify this criticism by acknowledging that Insured consumers have incomplete information regarding policy conditions and terms and that the cost of obtaining this information frustrates their attempts to shop for optimal policy terms. Insured consumers are not able to discern which policies have attractive and unattractive terms

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Eric M. Holmes, *Is There Life After Gilmore's Death of Contract? – Inductions from a Study of Commercial Good Faith in First-Party Insurance Contracts*, 65 CORNELL L. REV. 330, 345(1979); Kessler, *supra* note 47, at 631-32; Mayhew, *supra* note 6, at 270; Rakoff, *supra* note 3, at 1220-25; Squires, *supra* note 72, at 253; Ware, *supra* note 6, at 1477.

[83] M. J. Trebilcock, *The Doctrine of Inequality of Bargaining Power: Post-Benthamite Economics in the House of Lords*, 26 U. TORONTO L.J. 359, 364 (1976); *see also* sources cited *supra* note 82.

[84] *See supra* note 4 and accompanying text.

[85] Coase, *supra* note 82, at 494; Richard A. Posner, *Strict Liability: A Comment*, 2 J. LEGAL STUD. 205, 211(1973).

[86] For elaboration on this issue, see Ware, *supra* note 6, at 1478.

anyway. Therefore, the optimal standardized contract will never evolve, even in the presence of free-market competition.[87] Such competition will affect only relative *price*, a parameter that consumers can identify and compare, but the lowest competitive price will probably involve a reduction in insurance coverage as well, a parameter that competition cannot affect because information about it is inaccessible.[88] In response, some have argued that Insurers will voluntarily provide insured consumers with information about any unfavorable terms in their competitors' insurance products, and thus, the Insured's cost of obtaining information will remain low.[89] Moreover, risk-averse consumers will be willing, during times of high uncertainty, to pay more for uncomplicated policies and thus counteract Insurers' incentives to create complex policies.[90] Essentially, economic analysts claim that there is no room for the Reasonable Expectations test, not even to cope with the complexities and inter-party disparities of policy design, because free-market competition and reputation effects will resolve these problems more efficiently.

Psychological Analysis of the Law

Psychological analysis of law also concludes that no real weight should be given to the Reasonable Expectations test but for reasons different from those given by economists. Instead, psychological analysis suggests that an inherent conceptual inability prevents consumers in general, and insured consumers in particular, from having any "reasonable expectations" at all. In other words, insured consumers' limited knowledge and cognitive biases preclude them from making educated decisions about insurance purchases, even when they are provided with complete information.[91] Hence, the search for the reasonable expectations of the insured is invariably futile. All judges can do, therefore, is

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[87] Goldberg, *supra* note 3, at 461, 485; Alan Schwartz and Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 638 (1979).

[88] Trebilcock, *supra* note 83, at 364-65.

[89] *See* sources cited *supra* note 85.

[90] Ware, *supra* note 6, at 1480.

[91] Thomas, *supra* note 66. On cognitive biases and their influence on the design of legal tests, see the discussion on the theoretical basis of the Insurer's duty of disclosure, Thomas, *supra* note 66, Ch.1 notes 135-260 and accompanying text.

rely on their own reasonable expectations.

II. THE SYMBIOTIC RELATIONSHIP BETWEEN INTERPRETATION RULES AND THE INSURER'S DUTY OF DISCLOSURE IN INSURANCE SETTINGS

After having extensively discussed both the duties of disclosure and the rules of interpretation that apply to insurance contracts, in this Part, I discuss the symbiotic relationship between the disclosure doctrine and the interpretation doctrine. In general, both the duties of disclosure and the rules of interpretation applicable in the insurance industry were formulated to respond to the complexities inherent in insurance transactions, the common denominator among which is the fact that insurance products are abstract and intangible. The Insured first sees the insurance contract only after entering into it, so the contract includes terms that the Insurer, as the more powerful party, dictates. The insured consumer, in turn, usually has no choice but to accept these dictated terms. As a consequence, insured consumers are often unaware of all of the terms and conditions of the transaction, particularly those worded in an obscure way and riddled with professional argot.[92] Both the disclosure doctrine and the rules of interpretation can be seen as tools courts can employ to cope with these immanent complexities and to commute insurance transactions, whether in advance or in retrospect, into transactions that emulate as much as possible sales of products that consumers understand. In other words, rules on disclosure and contract interpretation help turn the rather abstract and abstruse insurance product into a more concrete and straightforward product that reflects the apparent intent of the parties.[93]

The most obvious connection between the doctrines of disclosure and interpretation is that the Interpretation Against the Drafter and Reasonable Expectations of the Insured doctrines give Insurers an incentive to provide their Insureds with more detailed and more accurate information. Insurers can thereby transmute the Insureds' *reasonable* but as yet unascertained expectations into their *actual* expectations, so that, consequent to the Insurer's compliance with its duties of disclosure and verification, the Insured now have an actual awareness of the

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[92] *See supra* notes 1-12 and accompanying text.

[93] *Id.*

terms and conditions of their insurance policies.[94] Thus, the Reasonable Expectations test and the Interpretation Against the Drafter rule presumably lead to greater transfers of information such that the expectations of the Insured match the expectations of the Insurer. Moreover, the more information the insured consumers have, the more intelligent consumers they become, which ultimately increases the level of competition within the insurance industry itself. This, in turn, leads to the eventual adoption of optimally efficient insurance policies that confer maximal benefits on both parties to the transaction.[95]

Moreover, the duties of disclosure and the rules of interpretation complement one another, in that they foster certainty at both ends of the insurance transaction. While certainty in advance of an insurance sale is fostered by the duties of disclosure, certainty in retrospect is fostered by the interpretive rules, particularly the Reasonable Expectations test, which bridges the gap between what the Insured expected to receive and what the Insurer actually sold him.[96] Both the duties of disclosure and the rules of interpretation help the Insurer redistribute the cost of liability in a more efficient manner because insured consumers receive, either in advance via their own informed choices or in retrospect via the court's intercession, insurance packages that better fit their needs. Thus, risk will be more accurately redistributed over the entire community of insured consumers, and insurance policies arising from inefficient insurance transactions will be weeded out of the market.[97] These

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[94] CLARKE, *supra* note 12, at 349; JERRY, *supra* note 2, at 146; KEETON AND WIDISS, *supra* note 2, at 642; STEMPEL, *supra* note 2, at 321; Abraham, *supra* note 13, at 1169-74.

[95] As described, the advantage for the Insured is the generally increased consumer awareness of the nature of the transaction into which they are entering, which in turn leads to the development of a competitive market. As a result, Insurers will develop improved policies to meet the needs of such a competitive market because the Insured consumers now deal with a more tangible, comprehensible good that they can examine and which they will want to obtain for minimal cost. The advantage to the Insurer in imposing the duty of disclosure in this context is that he will be able to price his risks in a way that reflects the insurance good that he actually sells, without being exposed to the disruption of this pricing by external intervention by the courts, who would be unable to resort to the Reasonable Expectations of the Insured test as a result of the Insurer's disclosures.

[96] *See* sources cited *supra* note 94; *see also* Fischer, *supra* note 2, at 997.

[97] STEMPEL, *supra* note 2, at 321; Abraham, *supra* note 13, at 1185; Ware, *supra* note 6, at 1476.

two points suggest that the duties of disclosure and the rules of interpretation are compatible and complement one another. Both serve to reshape insurance into a less abstract and more comprehensible product and to foster certainty and efficient distribution of liability costs among the entire community of insured consumers.

Nonetheless, another side to the coin exists. The rules of interpretation, and the Reasonable Expectations test in particular, encourage Insurers to provide the Insureds with information and thus obviate recourse to the Reasonable Expectations test. Indeed, inasmuch as they receive more information, the expectations of insured consumers do become more realistic and concrete. In certain cases, then, Insurers can curtail the courts' ability to intervene, and as a result, insured consumers will not be able to obtain the full protection of the courts' interpretive rules. Because they enter into insurance transactions supposedly enabled to make educated choices, insured consumers cannot plead ignorance of the terms of their insurance policies.[98] In this situation, the courts will still be asked to protect the realistic expectations of the Insured and will have to use more intrusive and less "analytical" doctrines to intervene in the contract, such as public welfare and the disparate bargaining positions inherent in standardized contracts.[99] Furthermore, the cognitive failures from which Insured consumers suffer will likely prevent them from fully internalizing, processing, and rationally using information even when they do receive it. This in turn will likely cause market failures and a

[98] It seems that Insured consumers can be assumed to have actual, fully internalized expectations only as to that portion of the insurance policy dealing with the amount of their premiums and maybe even their insurance ceiling and deductible, at most. As for all other details of the insurance policy, Insured consumers are assumed to have no actual expectations, even after the Insured satisfies its duty of disclosure, because of the cognitive restrictions discussed above. Thus, the Reasonable Expectations test is designed to cover this portion of the insurance policy not internalized into the awareness of the Insured, even if the Insurer has a duty to disclose it. This latter portion includes definitions of the insured against events and any exclusions to insurance coverage.

[99] Nevertheless, and as stated above, it is possible that market powers will act such that the Insured consumer, now a very well-informed consumer after the Insurers fulfill their rather exacting duties of disclosure, will wield the power to choose between various competitive alternatives based on the information the Insurers provide. As a result of this heightened market competition, Insurers will then focus on offering better insurance policy packages with more favorable terms and more extensive coverage with fewer exclusions.

deficiency of proper insurance coverage in certain sectors.[100] Thus, in certain cases the relationship between the duties of disclosure and the rules of interpretation will be such that one makes the other unnecessary: the Insurer who satisfies its duty of disclosure thereby limits the protection the Insured can seek under the rules of interpretation.

In endeavoring to construct a model of the doctrines of disclosure and interpretation, however, we can also gain some inspiration from examining these doctrines from the perspective of contract and tort law. The mutual duties of disclosure imposed on both parties to an insurance contract assume that both are capable of exchanging information. This assumption of mutual exchange is an integral part of "contractual" thinking, according to which parties can allocate and price risks based on the information they both possess at the time of contract formation. In this way, however, the interpretation doctrines more closely reflect a tort law thought process. This "tort law" thinking recognizes the fact that in most insurance transactions, the negotiations between the parties as to details of coverage and its exclusions almost do not exist; instead, the Insurer simply dictates the policy to the Insured.[101] Thus, negotiations cannot aid in the evaluation of risk and the determination of coverage in each and every case. To this the Insured's cognitive limitations also add further difficulties.[102]

All of this leads to the conclusion that insurance transactions reflect more than just any contract negotiations that might, or might not, have taken place when the Insured first purchased the insurance coverage. Rather, the transaction extends over the entire period of time for which the Insured bought coverage, recalling the fact that insurance contracts are relational, not transactional, contracts. Indeed, the first substantive opportunity for the parties to meet and actually exchange information, at least from the insured consumer's point of view, most often does not come until the insured-against event finally occurs. That is to say, when a liability-causing event occurs and the parties meet in their first substantive encounter, the insured consumer often expects to be covered for the *full extent* of the damage, based on the information that the insured

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[100] On cognitive biases, see *supra* note 91.

[101] On the influence of insurance contract characteristics, including the Insured's inability to negotiate with the Insurer, and the formulation of rules of interpretation and discovery, see *supra* notes 1-12 and accompanying text.

[102] On cognitive biases, see *supra* note 91.

consumer possesses up to that point. The insured consumer buys insurance coverage for a particular *kind of liability*, and therefore in the framework of her expectations, she believes that she has coverage for the full extent of that liability and does not take any exclusions into account.[103] In fact, this "tort like" situation underlies the creation of the Reasonable Expectations of the Insured test because it allows courts to control insurance coverage retroactively when the parties never truly negotiated over the scope of the coverage prospectively. As compared to contract law, in which parties themselves often are found later to re-evaluate and re-price risk, this type of retroactive judicial intervention typifies tort law. Courts can resolve cases according to their own *judicial policies*, whereas exclusive reliance on the duties of disclosure would lead courts to resolve disputes on a purely factual basis.[104]

What, then, should the standard for applying the rules of interpretation in insurance transactions be? And how will their symbiotic relationship with the Insurer's duty to disclose influence the formulation of the interpretation model? Now, after the relevant aspects of the duties of disclosure and the rules of interpretation have been discussed, it is possible to try and establish such a model. Within the framework of an interpretive model, reference can be made both to the "Interpretation Against the Drafter" rule and the "Reasonable Expectations" test, as well as to additional interpretive rules. The scope of application of all these rules can also be examined, along with the normative hierarchy among them, within the larger framework of a more general contractual interpretation macro-model.

III. TOWARD A NEW INTERPRETIVE APPROACH

A. The Insurance Contract Interpretation Hierarchy

The interpretation hierarchy of insurance contracts is usually structured in the following manner:

The insurance contract shall be interpreted according to

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[103] *Id.*

[104] The external intervention and dictation of policy through the use of the Reasonable Expectations test is also similar to tort law because tort law embodies a protection of public interests as perceived by the legislature and the court, whereas contract law reflects the interests and values of the parties as perceived by the parties themselves. *See generally* GRANT GILMORE, THE DEATH OF CONTRACT (1974).

its purpose, that is, according to the intent of the parties. "Purpose" is a term with two meanings, subjective purpose and objective purpose. The contract shall be interpreted first and foremost according to its subjective purpose, namely, according to the *joint* subjective intent of the parties and what those specific parties actually meant.[105] The subjective purpose of the insurance contract is inferred from its language or from the surrounding circumstances.[106]

If, however, the joint subjective intent of the parties to the contract cannot be inferred, the interpretation shall proceed to the next stage and examine the joint *objective* purpose of the parties. "Objective" purpose refers to the purpose that is typically thought to take into account those interests acceptable to decent or reasonable parties, as distinguished from the parties to the specific insurance contract in question. Customarily, the subjective purpose of an insurance contract is considered difficult to determine because insurance contracts usually follow the format of standard insurance policies and are not personally negotiated and therefore not "tailored" to the specific interests of the Insured. For the most part, insurance contracts will therefore be interpreted according to the mutual *objective* intent of the parties.

When no mutual objective purpose can be identified, the court shall resolve the dispute according to the "*Interpretation against the Drafter*" rule; that is, the dispute shall, for the most part, be resolved against the Insurer and in favor of the Insured.

The "Interpretation Against the Drafter" rule can be

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[105] That is to say, the joint subjective intent depends on what the specific parties at hand intended, as distinguished from what reasonable parties in the same situation would have done.

[106] There are those who believe that the relationship between the language of the contract and the circumstances surrounding the contract parallels the relationship between the two stages of contract interpretation, such that the language of the contract is decisive in the first stage when its wording is clear and does not ostensibly lead to an absurd result. When, and only when, the contract wording is not so clear, however, will reference be made to the circumstances surrounding the contract. By contrast, there are those who view both the language of the contract and the circumstances surrounding it as a single normative hierarchy, according to which both the circumstances and the language of the contract are examined as a single interpretive bloc. Should the language and circumstances of the contract contradict one another, the circumstances will prevail as the more accurate indication of the parties' state of mind. For a more on the different relevant schools of thought on contract interpretation in the United States, see *supra* notes 14-17 and accompanying text.

conceived of as a "last resort" rule of interpretation; one that is employed only after the other interpretational rules listed above have been exhausted. In addition, other rules of interpretation have been formulated, which some insurance scholars refer to as independent rules. Under these rules any coverage exclusions that appear in an insurance policy shall be *narrowly* construed, while grants of coverage shall be *broadly* construed.[107] These rules can therefore be seen as *industry-specific derivations* of the "Interpretation Against the Drafter" rule and should not necessarily be viewed as independent. Note also that the hierarchy above does not include the Reasonable Expectations of the Insured test that often favors the Insured despite the explicit language of its insurance policy. Moreover, the hierarchy is schematic and does not exhaust the mutual interaction of the various principles, doctrines, and rules that affect the interpretation of the insurance contract. The hierarchy also does not illustrate the reciprocal relationship between these principles and doctrines and the normative hierarchy into which they fall, nor does the hierarchy take into account the effect it might have on the Insurer's duty of disclosure. The discussion will therefore concentrate on those cases that implicate both the "Interpretation Against the Drafter" and the "Reasonable Expectations" doctrines in order to determine how to apply them, both alone and in conjunction with the Insurer's duty of disclosure. The discussion will first address the application of the "Interpretation Against the Drafter" rule and then the "Reasonable Expectations" test. Then, it will focus on the strategic positions of both within the contract interpretation scheme.

B. The Interpretation Against the Drafter Rule – An Applied Model

A condition precedent for applying the "Interpretation Against the Drafter" rule is *textual ambiguity*, as seen from the perspective of the *reasonable reader* and not the Insurer. This ambiguity is likely to appear in the terms or the internal structure of the agreement. Classic application of the rule should be obtained only in those cases in which the insurance text raises several possible interpretations *of equal reasonableness*. In these cases, as a matter of *fairness*, the Insurer logically should bear the liability as the party at fault for, and as the least-cost avoider of,

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[107] *See supra* notes 19-20 and accompanying text.

the ambiguity; as the party with the deeper pocket and the most efficient means for redistributing the cost; and lastly, as the stronger party to the negotiation and the party that drafted the standardized contract.[108] Moreover, the *procedural* advantage of the rule in these cases is that it usually does not involve *factual* clarification. The inherent disadvantage of this rule, however, is that it presumably distances the court's decision from the *intent of the parties* and leaves a certain sense of arbitrariness in its application. The cases typically applying the "Interpretation Against the Drafter" rule are those that follow this classic example, that is, those in which the text is receptive to multiple interpretations of equal reasonableness.[109] Nonetheless, one of the challenges that courts avoid confronting is the set of cases in which alternative interpretations are *not equally reasonable*. This set of cases includes those in which the interpretation that tends to favor the Insurer is also the most reasonable interpretation, as well as those in which the text does not seem vague at all. Even in these cases, courts will tend to interpret the insurance contract in favor of the Insured. The courts do so either because they believe that all ambiguities, even those that tend to favor the Insurer, should be interpreted to the detriment of the Insurer, or because courts create ambiguity out of thin air, where it does not necessarily exist, in order to find in favor of the Insured.[110]

In a *proper* model of the Interpretation Against the Drafter rule, a more expansive use of it is possible, but only when taking into consideration the following: As a rule, it is indeed appropriate to apply the Interpretation Against the Drafter rule in cases of textual ambiguity, especially where the text admits of a number of equally reasonable interpretations. The basic rationales that underlie the rule easily justify such an application, both separately and together, and the liability to be imposed on the Insurer in such cases is in fact *absolute liability*. By contrast, when insurance policies contain terms that are indeed vague but whose more reasonable interpretations favor the Insurer, courts should also determine the Insurer's *level of fault* in drafting the text, particularly as to whether *the Insurer could have drafted the text in a less vague manner*. The standard by which to measure the ambiguity of the policy's text and the Insurer's ability to draft

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[108] On the justifications for applying the Interpretation Against the Drafter rule, see *supra* notes 1-11, 28-33 and accompanying text.

[109] *See* sources cited *supra* note 107.

[110] *See* sources cited *supra* note 22.

clearer alternatives must take into account the information the Insurer had at the time it drafted the policy or at the time the insured-against event occurred.[111] If the Insurer could have drafted the policy in less ambiguous terms based on the information it had at either point in time, the "Interpretation Against the Drafter" rule should apply. If, however, the text could not have been worded in a less ambiguous manner, the courts could conceivably carve out an exemption for the Insurer because it was not at fault.

Nonetheless, the other rationales underlying the "Interpretation Against the Drafter" rule will still warrant consideration of *additional* factors before the courts can exempt the Insurer from liability. One such consideration looks at whether *most* insured consumers would have agreed ex ante to higher insurance premiums in exchange for the disputed insurance coverage the ambiguous text addresses.[112] If the answer to this question is in the affirmative and most insured consumers would willingly have paid higher premiums in order to remove doubts as to the covered risk, then the Insurer should bear the liability. Conversely, if most Insured consumers would not have paid the extra premium, the scales tip in favor of the Insurer and he should be exempted from liability for the textual ambiguity. The advantages of this more complex model are that it is less arbitrary and reflects to a greater extent the *intent* of the parties. In other words, a model of the "Interpretation Against the Drafter" rule that considers both the Insurer's level of fault and the Insured's willingness to pay for extended coverage returns to contract-law analysis in that it takes into account the joint objective purpose of the parties. Such a model thus employs the "Interpretation Against the Drafter" rule as a rule of *discretion* and not as a last resort rule of *decision* placed at the bottom of the interpretation hierarchy to absolve the courts from resolving insurance disputes discretionarily.[113] The disadvantage of such a complex model, however, lies in the procedural difficulties of determining both the Insurer's level of fault in drafting ambiguous policy terms and the reasonable insured consumer's willingness to pay higher premiums. The absolute-liability version of the "Interpretation Against the Drafter" rule, by

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[111] *See supra* notes 37-38 and accompanying text.

[112] *See supra* notes 38-40 and accompanying text.

[113] This description of the rule does not consider the cognitive biases mentioned in note 91 *supra*.

contrast, makes the costs of such determinations unnecessary.

Notably, certain kinds of textual ambiguity can be weeded out in the preliminary stages, before resorting to the "Interpretation Against the Drafter" rule. Whenever textual ambiguity arises, courts could examine the *rationales* that underlie and possibly explain the disputed textual ambiguity and could thereby eliminate the need to apply the rule. Relevant considerations in ascertaining theses rationales include: what led the Insurer to draft the term or condition in dispute; whether the term or condition derived from the Insurer's evaluation and pricing of risk; and whether the circumstances under which the insured-against event actually occurred comport with or confound those envisioned by the Insurer at the time it priced the risk and drafted the policy. Thus, if the actual circumstances under which the insurance event occurred do not contradict or negate the Insurer's considerations when originally pricing the risk of the event, the court should interpret the text to the detriment of the Insurer.

For example, imagine an insurance policy against burglary that covers only burglaries *accompanied by force*, but the parties disagree on whether the insurance coverage includes burglaries not accompanied by force.[114] First, the court should identify what motivated the Insurer to offer coverage only for those burglaries accompanied by force. Possible rationales might include the Insurer's wish to eliminate incentives for the Insured to *stage* her own burglaries, by conditioning coverage upon signs of force. The Insurer might also have wished to encourage the Insured to take more precautions. For example, if the Insured is aware that only burglaries by force are covered, she will be certain not to handle the keys to her premises in an unsupervised manner because illegal entry with a key would not qualify as "accompanied by force." The Insured might also take more care to close and secure all windows and doors and might even install additional security measures. In other words, the Insurer priced the risks with these rationales in mind and therefore drafted the text to reflect the fact that it would cover only those burglaries accompanied by force. If it becomes apparent, however, that the Insured did not in fact stage the burglary, and that the burglars instead broke into the business by circumventing the security devices and leaving no signs of force, the Insurer should not be able to hide behind the

[114] These were the facts in the case of *Atwater Creamery Co.*, 366 N.W. at 271.

contract's text to avoid covering the burglary. Because the Insured took proper security measures and because no staged burglary occurred, the Insurer achieved the purpose of its "accompanied by force" limitation. When the insured-against event materializes, the Insurer's rationale in drafting the ambiguous text at issue still remains, and the factors on which the Insurer relied in pricing the risk are left intact and uncontradicted, the Insurer has no grounds on which to ask for exemption from paying the appropriate insurance benefits, even though the text itself might indicate otherwise. Holding the text dispositive in such cases yields a random and arbitrary result, not a result consistent with the underlying risks.[115] Thus, a *preliminary* determination of the fundamental rationales for the text at issue will likely eliminate the need to discuss its ambiguity or to use the "Interpretation Against the Drafter" rule. The advantage of such a determination, particularly when the rationales are immediately clear, is that the resulting decision is less arbitrary and more closely matches the joint *objective* purpose of the parties, without recourse to rules of last resort such as "Interpretation Against the Drafter."

C. Interpretation Against the Drafter in Conjunction with the Duty of Disclosure

In formulating an appropriate model for the "Interpretation Against the Drafter" rule, the extent to which the Insurer complies with its duty of disclosure can be taken into account. An inverse correlation can be created between the two, so that the greater the Insurer's compliance with its duty of disclosure, the *less* courts need resort to the Interpretation Against the Drafter rule, and vice versa. An Insurer who complies with its duty of disclosure, with respect to the insurance contract, effectively changes the Insured's resulting knowledge into the external *circumstances* surrounding the insurance contract. This places their dispute at the top of the interpretation scheme, where the joint subjective purpose of the parties is dispositive. In other words, by complying with its duty of disclosure, the Insurer clarifies its understanding of what the

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[115] On the public status of an Insurer and the unseemliness of appearing to be arbitrary, see Fischer, *supra* note 2, at 1044-1046, and the references cited therein.

insurance policy means,[116] so that both the Insurer and the Insured now have the same subjective (actual) understanding of it. The information that the Insurer imparts to the Insured pursuant to the Insurer's duty of disclosure thus becomes part of the external circumstances surrounding the formation of the contract.We can see that the Interpretation Against the Drafter rule creates potential incentives for the Insurer to comply with its duty of disclosure in order to avoid being subject to a contract interpretation contrary to its interests.

D. The Reasonable Expectations Test – An Applied Model

As discussed above, the Reasonable Expectations test can take one of three main forms: weak, intermediate, or strong.[117] In its weak version the test resembles the Interpretation Against the Drafter rule, namely, by requiring textual ambiguity as a condition precedent to its application, but is also distinguishable from Interpretation Against the Drafter in that it applies to text of any degree of vagueness and to interpretations of any degree of reasonability. Stretching the borders of Interpretation Against the Drafter would lead to a similar result, however, so the weak version of the Reasonable Expectations test appears to offer no unique advantages. This Part will therefore show that the weak version does not embody the purposes for which the Reasonable Expectations test was developed. The *intermediate* and *strong* versions of the Reasonable Expectations test, however, apply even in contradiction to explicit text, although the point of departure for the intermediate version is hidden or surprising contract terms that run contrary to the basic purpose of the insurance policy. The strong version, on the other hand, applies regardless of whether the text is either explicit or sufficiently prominent.[118] Nonetheless, even the weak form of the Reasonable

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[116] *See* sources cited *supra* note 107.

[117] *See supra* notes 68-78 and accompanying text.

[118] There are those who say that the Reasonable Expectations test in its intermediate and strong versions does not act as a test of interpretation, but rather as a principle that comes into play only after the interpretation rules have been exhausted. *See* Abraham, *supra* note 5, at 60. The Reasonable Expectations test in its strong version differs from the unconscionability principle in that the unconscionability principle is more limited than the Reasonable Expectations test. Unconscionablility requires a factual determination that the Insurer knew that the Insured would have rejected the insurance policy had it been aware of its restrictive terms, whereas the Reasonable Expectations test is not conditioned upon the knowledge of the

Expectations test may still be preferable to its "Interpretation Against the Drafter" alternative because it is more closely cabined and restricted to the *objective expectations* of at least of one of the parties to the contract. As such, the Reasonable Expectations test may be less arbitrary than the "last resort" Interpretation Against the Drafter rule.

The various applications of the versions described above nevertheless do not clarify why the test pertains only to the *Insured's* reasonable expectations and what the role the *Insurer's* reasonable expectations might have. It is also unclear where the Reasonable Expectations test should be placed within the interpretation hierarchy presented above, as well as what reciprocal relationships it might have with the Insurer's duty of disclosure. This Part will therefore show that the following hierarchy of considerations should be taken into account when using the Reasonable Expectations of the Insured test:

To what extent does the Insured have actual, concrete expectations? Usually, the *actual* expectations of the specific Insured in question will make irrelevant the *reasonable* expectations that a hypothetical Insured in the same situation would have had; that is to say, the Insured's actual "subjective" expectations will override his putative "objective" expectations, such that an Insured who actually *knows* that he does not in fact have a particular kind of insurance coverage cannot claim entitlement to that coverage just because a reasonable, but

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Insurer. In other words, the Insurer's compliance with its duties of disclosure and verification make it impossible for the Insured to rely on the unconscionability principle and thereby escape the literal terms of the insurance policy. Assuming that the unconscionability principle is subject to good faith, another difference between the Reasonable Expectations and unconscionability principles is that unconscionability can be affected by the cognitive capacities of the parties in order to decide whether the parties acted in good faith, whereas the Reasonable Expectations test is not subject to considerations of good faith but only to those of public interest: insofar as the State has an interest in insurance goods as a staple commodity, it will make judicial use of the Reasonable Expectations principle. Another way of looking at the difference between the Reasonable Expectations and unconscionability principles is to note that when the courts look at the Insured's reasonable expectations in cases of market failure, they does not look at the specific parties to the dispute but rather at the entire universe of Insurers and Insureds. The unconscionability principle, by contrast, focuses only on the individual parties before the court and on their specific cognitive capacities and factual understandings. A final way of comparing the two doctrines is to view the unconscionability principle as a test remaining within the confines of contract law, while the Reasonable Expectations test is mostly non-contractual.

presumably uninformed, Insured in the same situation would have *expected* that kind of coverage. Here, too, a relationship exists between the Reasonable Expectations test and the Insurer's duty of disclosure because the test will likely give an Insurer incentives to fully disclose all information to the Insured: an Insured consumer whom the Insurer has fully informed has only actual, subjective expectations and therefore cannot invoke the Reasonable Expectations test. As will be discussed below, however, courts may nevertheless overlook an Insurer's efforts to avoid the Reasonable Expectations test, despite the fact that the Insured actually knows the extent of his insurance coverage, when a dispute nevertheless arises because of a market failure or otherwise would lead to a market failure if resolved without recourse to the Reasonable Expectations test. In other words, even when the Insured consumer should have had concrete expectations compatible with those of his Insurer and with the text of his insurance contract, he may still be awarded the insurance coverage he seeks because of overriding judicial policies.[119]

The Reasonable Expectations test will likely apply, *even when an insurance policy is otherwise explicit and unambiguous*, whenever the Insured is not aware that the text includes terms and conditions that are surprising, that frustrate the basic purpose of the insurance policy, or that lead to an absurd result and give the Insurer an unfair advantage.

One can also formulate auxiliary tests that would allow courts to apply the Reasonable Expectations test, despite the limitations listed above. Such auxiliary rules would take into consideration issues such as the following:

To what extent did the Insurer reasonably assume that the Insured would not have entered into the insurance contract had the Insured known about the problematic terms and conditions originally incorporated into the contract? In this case, the court should look not just at the reasonable expectations of the Insured but also at the reasonableness of the *Insurer's conduct and expectations*.

The Insurer's reasonable expectations can also be influenced by the nature of the Insured's reasonable expectations. For instance, what an Insurer can reasonably expect from an insured business customer is different from what it can

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[119] For an example of cases in which there are market failures that the Reasonable Expectations test can address, see Abraham, *supra* note 5.

reasonably expect from an insured consumer.[120] When dealing with an insured consumer, the Insurer should attribute to the Insured a broader reasonable expectation of insurance coverage, but an insured business customer's reasonable expectations are likely to be different.[121]

Furthermore, courts should view a contract's terms and conditions in light of the underlying rationales, just as they might do under the Interpretation Against the Drafter rule.[122] In other words, courts should give no force to terms and conditions that provide Insurers with an inappropriate advantage in those cases where the insured-against event occurs under circumstances that do not derogate from the Insurer's reasonable expectations at the time of drafting the contract. If the Insurer's original pricing of risk still applies, despite the circumstances that actually materialized, then the Insurer should not be able to rely on a literal reading of the contract's terms and conditions to escape liability. Not only do these terms and conditions not comply with the reasonable expectations of the Insured, they also do not comply, on the merits, with the reasonable expectations of the Insurer at the time it drafted them.

In this context the Reasonable Expectations test

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[120] On the distinction between the consumer Insured and the business Insured in terms of applying the various interpretation tests, see, e.g., ABRAHAM, *supra* note 48, at 103; JERRY, *supra* note 2, at 145; OSTRAGER AND NEWMAN, *supra* note 13, at 26; STEMPEL, *supra* note 2, at 325; Fischer, *supra* note 2, at 1034; David B. Goodwin, *Disputing Insurance Coverage Disputes*, 43 STAN. L. REV. 779, 796 (1991); Barry R. Ostrager and David W. Ichel, *Should the Business Insurance Policy be Construed Against the Insurer? Another Look at the Reasonable Expectations Doctrine*, 33 FED'N INS. COUNS. Q. 273 (1983); Jeffrey W. Stempel, *Reassessing the 'Sophisticated' Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807 (1993); Ware, *supra* note 6, at 1466.

[121] For example, a volunteer association insured against burglary will enjoy a reasonable expectation of broader insurance coverage, which in turn leads interpretation of the "penetration by way of force" requirement to require only minimal force to satisfy it. The Insurer of a business Insured, on the other hand, is entitled to expect that it will take the proper security measures against penetration, so that the risk that Insurer takes upon himself is limited to penetration by way of actual force. It is important to emphasize, however, that the distinction between the consumer Insured and the business Insured is not drawn on the basis of their respective professional skills in understanding their insurance policies or their respective economic negotiation strengths, although some scholars suggest that these distinctions should serve as a basis for differing duties of disclosure and rules of interpretation consumer and business insurance policies.

[122] *See supra* notes 37-42, 116-25 and accompanying text.

effectively functions in the zone between a specific and focused doctrine and the kind of abstract super-principle that courts can use to dictate judicial policy. Where the text is unambiguous, the Reasonable Expectations test operates at a level above the "Interpretation Against the Drafter" rule[123] because the "Reasonable Expectations" test becomes, to a great extent, more of a non-interpretation principle employed only after the local insurance contract interpretation rules have been exhausted. Nonetheless, a relatively *temperate* use of the Reasonable Expectations Test, especially one that focuses not only on the reasonable expectations of the Insured but also on the viewpoint of the Insurer, may still be placed within the hierarchical interpretation scheme. This fact serves as a point of departure for the following discussion because the temperate version of the Reasonable Expectations test takes into account, albeit indirectly, the apparent intent of the parties. As such, the Reasonable Expectations test can be located in the interpretational hierarchy at the level where the mutual objective purpose of the Insured and Insurer is ascertained.

E. The Reasonable Expectations Test in Conjunction with the Duty of Disclosure

The question of exactly what relationship exists between the Reasonable Expectations of the Insured test and the Insurer's duties of disclosure and verification still remains open. This question arises even more sharply because of the frequent mix in insurance caselaw between court decisions that are based on the disclosure doctrine and decisions that are based on interpretative doctrines. The appropriate relationship between these two doctrines that serve to expand the Insurer's liability conforms to a dual-stage model. In the first stage, the court determines whether the Insurer satisfied its duties of disclosure and verification. Generally, if the Insurer has indeed satisfied its disclosure duties, the court will disregard the reasonable expectations otherwise attributable to the Insured and look only at his concrete expectations. Yet, as a practical matter, the Insurer's compliance with its duties of disclosure and verification is often difficult to determine.

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[123] Anderson and Fournier, *supra* note 3, at 342; Henderson, *supra* note 66, at 72; Jerry, *supra* note 13, at 37; Rahdert, *R. E. Reconsidered*, *supra* note 5, at 327; Ware, *supra* note 6, at 1465.

Nonetheless, from both a substantive and a procedural perspective, the Insurer's compliance with its duties of disclosure is clearly germane to resolution of insurance disputes over the policy text. Because of the inherent difficulties of ascertaining compliance, however, courts in practice often examine first what they should more appropriately save for the *second stage*; that is, courts move on to the interpretive doctrines, including the Reasonable Expectations test, rather than the disclosure doctrines. It is much more appealing to resolve disputes by skipping ahead to the second stage, even though adequate first stage analysis would often make such analyses superfluous. Decisions made on interpretive bases enable courts to avoid lengthy and costly factual determinations, and, more importantly, rules of interpretation, particularly the Reasonable Expectations test, allow courts significant leeway to invoke whatever judicial policies they deem appropriate.

Only in rare cases, therefore, will the Insurer be able to prove that the Insured's concrete expectations should take precedence over whatever reasonable expectations would otherwise be attributed to the Insured, that is, the expectations of a reasonable but not necessarily fully informed Insured. Courts instead tend to turn immediately to the rules of interpretation without first determining the Insurer's level of compliance with its duties. This being the case, the Reasonable Expectations test will likely continue to hold its strategic position in the interpretation hierarchy. Nevertheless, the Reasonable Expectations test will also likely continue to function as a broad and non-interpretive super-principle, particularly when used to overcome market failures. Market failures in this context refer to those situations in which, without judicial intervention through application of the Reasonable Expectations principle, either insured consumers would systematically lack appropriate insurance coverage or Insurers would systematically have to provide the disputed level of insurance coverage, no matter what the underlying facts were.[124] Regardless of what the insurance

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[125] An example of market failures are those countries in which there is no meaningful health insurance. In these countries, the natural gap between the Insurer and the Insured leads to the downfall of the insurance market. The Insured prefers to have as much health insurance coverage as possible, but the Insurer prefers to spend as little as possible paying for Insured's health care. As a result, the Insured is willing to offer only coverage for only the least expensive medical care, which also tends to be the most inferior care, so the Insured will more likely than not find it not worth her while to buy health

contract actually stipulates in such cases, the Reasonable Expectations principle functions as a mechanism through which the courts correct market failures by judicially awarding or denying insurance coverage. In such cases courts will not even look at the issues of disclosure, verification, or the actual expectations of either the Insured or Insurer, but instead will use the Reasonable Expectations test as a super-principle to affect nationwide policies and regulate relationships between Insureds and Insurers in the private market.[125]

Ostensibly, the Reasonable Expectations principle in the context of market failures does not function within the hierarchy of contract interpretation rules but rather, lies outside of it. From a more abstract point of view, however, we can still place the Reasonable Expectations test as applied to market failures within a framework based on the collective expectations of reasonable Insureds and Insurers nationwide. In the long run, this broader viewpoint inures to the benefit of both communities, the community of insured consumers and the community of insurers as businesses, because it protects and regulates the interests and expectations of both communities. On the one hand, courts can protect the legitimate interests of the Insured who buy insurance coverage and thereby serve the interests of the Insured community more generally by reinforcing their trust in insurance as a concept. On the other hand, courts can also protect the interests and expectations of Insurers as a business community by awarding insurance coverage only within the borders of what Insurers can pay for and yet remain financially viable.[126] The overall result is that the reasonable expectations of both the

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insurance. This obviously runs contrary to the national interest and thus constitutes an outright market failure, which, without the intervention of the State either through legislation or judicial decree, cannot be remedied.

The same is true but in the opposite direction in the field of tort insurance for environmental damage. Here, market failure is likely to lead to the collapse of Insurers because the Insured's expectations will often far surpass the Insurer's financial ability to meet those expectations. Therefore, courts will tend to lower the standard of the Insured's reasonable expectations. For example, Insureds cannot reasonably expect coverage for daily air pollution because it would exhaust the financial resources of the Insurers, whereas coverage for accidental air pollution would be much more feasible. Any other approach to such a market failure might cause the environmental insurance industry to collapse. *See* Abraham, *supra* note 5.

[126] Obviously, market failures are more likely to be resolved not through the courts but through government regulations, according to appropriate policies including minimal conditions of a cognitive nature.

[127] *See supra* note 125 for relevant examples.

Insureds and the Insurers converge on a status quo.[127]

F. Summary

In summary, we can describe the hierarchy of rules for insurance contract interpretation in the following manner:

The *Interpretation against the Drafter* rule indeed constitutes a last-resort rule of interpretation but nonetheless is the primary rule applicable whenever the text of an insurance policy is ambiguous. Its application can involve a number of complexities, subject to conditions such as those described above. In any event, the rule will always entail a certain very intricate degree of judicial discretion and therefore certainly cannot be considered a rule that eliminates or restricts discretion.[128]

The *Reasonable Expectations of the Insured* test, on the other hand, applies mainly when the text is clear and unambiguous, although it might also act as a complement to the Interpretation Against the Drafter rule where the text is ambiguous. Moreover, the test takes into account other considerations besides merely the insured consumers' reasonable expectations, such as the reasonable expectations the *Insurers* themselves, and therefore can more accurately be called simply the *Reasonable Expectations* test, without limiting the relevant reasonable expectations to only those of the insured consumer. As discussed above, the strategic location of this test within the hierarchical interpretation model, whether in its role as a specific doctrine or as a more abstract super-principle, can be seen as lying at the level where courts examine the *joint objective purpose* of the parties.

Thus, both substantively and procedurally, application of the insurance contract interpretation model as a whole depends on the Insurer's level of compliance with its duties of disclosure and verification. As discussed above, compliance with these duties of disclosure and verification may even make the rules of interpretation superfluous because compliance with disclosure focuses the court's attention on *circumstances external to the text* and therefore bearing on both parties' *subjective* intent. As also discussed above, however, the courts' limited ability to determine the Insurer's actual level of compliance with its duties of

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[128] On the confidence of the public in Insurers, see sources cite *supra* note 56.

[129] Schwartz, *supra* note 2, at 62.

disclosure ultimately leads the courts to resort to the rules of interpretation after all in resolving disputes over insurance contracts.

CONCLUSION

In this Essay, I presented and discussed the unique interpretive doctrines that courts developed in the context of insurance law. An important goal of mine was to highlight the relationship between the insurer's duty of disclosure and the interpretive approach of the courts. The interpretation of insurance contracts is an intricate task that requires courts to consider multiple factors. Chief among those, I have argued, is the Insurer's level of compliance with its duty to disclose. I demonstrated that although courts take into account the extent of the Insurer's disclosure in resolving insurance disputes, they do not give sufficient weight to this factor. Therefore, I proposed modifications to the existing interpretive approach that would make it more sensitive to this consideration. My proposed modifications carry a promise for a more efficient and fairer resolution of insurance conflicts and will therefore benefit both the insurance industry and the Insureds as a group.