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Leveraging the Doctrine of Reasonable Expectations, Contra Proferentem, Unconscionability and Other Rules for Construing Policy Language

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The Reasonable Expectations Doctrine: Why Policyholders May Be Better Off Without It

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INTRODUCTION

Since Professor (later Judge) Robert Keeton first put a name to the reasonable expectations doctrine in 1970, it has generally been regarded as strongly pro-policyholder—a counterbalance to the adhesive nature of insurance contracts and the negotiating advantage insurers typically have over insureds. While forms of the doctrine widely persist, Keeton's formulation, under which an insured's reasonable expectations of coverage may trump unambiguous policy language negating coverage, has little continued support. What remains is often little more than a convenient justification for whatever result a court is inclined to favor. Moreover, contrary to the doctrine's underlying rationale, courts have increasingly invoked the doctrine in favor of insurers, in some instances negating coverage even where strict adherence to the policy language, or at least straightforward application of the rule of *contra-proferentem*, would have compelled the opposite result. Thus, as the examples explored below indicate, the reasonable expectations doctrine as it currently exists can do policyholders more harm than good.

THE REASONABLE EXPECTATIONS DOCTRINE'S DEVELOPMENT AND RATIONALE

Although Keeton denied that the phenomenon he dubbed "reasonable expectations" was necessarily pro-policyholder, in light of his formulation of the doctrine, and its underlying rationale, it is hardly surprising that the reasonable expectations doctrine is widely recognized as such, and that it has, as a result, met with stiff resistance and criticism from insurers. Under Keeton's formulation:

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

Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (Part I) (1970).[1] So stated, it is clear that Keeton's version of the doctrine is no mere adjunct to ambiguity analysis: even *unambiguous* coverage limitations may be ineffective if contrary to the insured's objectively reasonable expectation of coverage. In other words, Keeton's reasonable expectations doctrine operates to create contractual rights not reflected in, *or even contrary to*, express contract language.

Although the principle that a policyholder's expectations can trump unambiguous policy language may seem extreme at first glance, the reasonable expectations doctrine has been justified as an appropriate safeguard in light of the realities of insurance sales, where one party (the insurer) ordinarily has near control of the transaction. Policy language (typically offered on a take it or leave it basis) is so complicated as to be beyond comprehension for most insureds. Moreover, because policyholders typically receive their insurance contracts only *after* completion of the insurance transaction, policyholders' reasonable expectations of the coverage to be provided often form the entire basis for their insurance purchasing decisions.[2]

Arguably, these justifications apply with more force for individual consumers and small businesses than for large commercial insureds. As a consequence, large commercial concerns have seldom enjoyed the reasonable expectations doctrine's benefits, with some notable exceptions. *See, e.g.*, *Keene Corp. v. Ins. Co. of N. Am.*, 667 F.2d 1034 (D.C. Cir. 1981). Although such organizations have benefited least from the reasonable expectations doctrine's coverage-enhancing effects, to the extent Keene's doctrine has mutated into a tool for insurers to defeat coverage (as later discussed), these organizations are the doctrine's most frequent target.

Even with respect to non-commercial insureds, the doctrine of reasonable expectations has been considerably watered down despite its underlying justifications. Although most jurisdictions have recognized the reasonable expectations doctrine in one form or another, or at least use "reasonable expectations" terminology, ever fewer follow Keeton's formulation. Most jurisdictions look to the insureds' reasonable expectations only where there has been an initial finding of ambiguity or to counterbalance hidden policy provisions. *See, e.g.*, *Bd. of Regents of the Univ. of Minn. v. Royal Ins. Co.*, 517 N.W.2d 888 (Minn. 1994). Parting still further from the doctrine's underpinnings, other jurisdictions seek to enforce the reasonable expectations of *insurers*, not just their insureds. *See, e.g.*, *State Farm Auto. Ins. Co. v. Roberts*, 697 A.2d 667, 672 (Vt. 1997) (looking to the "reasonable expectations of the *parties*" to "avoid binding insurers to coverage that the parties did not reasonably contemplate") (emphasis added).

Whatever form the reasonable expectations doctrine takes, in typical practice, the doctrine has come to provide a justification for results-oriented decisions that reflect courts' own perception of fairness. As one commentator notes:

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[1] Section 211 of the Restatement (Second) of Contracts similarly provides that if a party to a standardized contract has cause to believe that the other would not agree to be bound to a particular contract provision, that provision is without effect. As Comment (f) to that section states, "Although customers typically adhere to standardized agreements and are bound by them without appearing to know the standard terms in detail, they are not bound to unknown terms which are beyond the range of reasonable expectation."

[2] See JEFFREY W. STEMPEL, STEMPEL ON INSURANCE CONTRACTS, § 4.09[C] (3d Ed. 2007 Supp.) for further discussion of the rationales underlying the doctrine of reasonable expectations.

> *There are in fact no expectations, and no real policyholders whose expectations are plumbed by the legal equivalent of a 'Vulcan mind-meld,' except in the mind of those who resolve the dispute, which will be judges since the matter involves construction of a contract . . .. A public policy base for altering and modifying contract obligations is simply a more honest and accurate statement of what [the doctrine of reasonable expectations] does. Public policy creates coverage when a court believes it is fair, just, and reasonable to do so, notwithstanding the contrary position of the contract terms. A policyholder's expectations have nothing to do with the result, unless they happen to coincide with those of the court.*

James M. Fischer, *The Doctrine of Reasonable Expectations is Indispensable, If We Only Knew What For?*, 5 CONN. INS. L. J. 151, 164 (1998). Indeed, the reasonable expectations of policyholders (or insurers for that matter) are typically deemed not to involve questions of fact, but are determined by courts as a matter of law. *See id.* Inasmuch as the reasonable expectations doctrine operates as a doctrinal hook on which to hang results perceived to be fair, perhaps inevitably, it has come to provide the basis for pro-*insurer* decisions, notwithstanding its pro-policyholder origins and underpinnings.

COVERAGE-DEFEATING "EXPECTATIONS"

Reasonable expectations as a means to construe ambiguity *against* insureds

Whereas Keeton's formulation of the reasonable expectations doctrine provides that a policyholder's expectations of coverage can prevail even over *unambiguous* policy language the majority of jurisdictions that continue to recognize some form of the doctrine employ it only as a means to resolve disputes over *ambiguous* provisions. It may appear that in such jurisdictions the reasonable expectations doctrine is "virtually indistinguishable from" the doctrine of *contra proferentem* because the outcome will often be the same under either doctrine.[3] On closer analysis, however, the ambiguity-based reasonable expectations approach is far less favorable to policyholders than the venerable rule that ambiguities are to be construed in favor of coverage. California's approach to resolving ambiguous policy language clearly illustrates how reasonable expectations may actually negate coverage.[4]

Until the 1990s, California, like most jurisdictions, adhered to the rule that any doubt as to the meaning of policy provisions should be resolved against insurers, and that policy language should be construed in favor of coverage if "semantically permissible." *See, e.g.*, *Cont'l Cas. Co. v. Phoenix Constr. Co.*, 296 P.2d 801 (Cal. 1956). But in 1990, California's approach to resolving ambiguities underwent a significant change. In *AIU Insurance Co. v. Superior Court*, 799 P.2d 1253 (Cal. 1990), the California Supreme Court supplanted the "semantically permissible" approach, and instead analyzed whether resolving the ambiguity in favor of coverage would be consistent with the

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[3] *See, e.g.*, Susan M. Popic & Carol D. Quackenbos, *Reasonable Expectations after Thirty Years: A Failed Doctrine*, 5 CONN. INS. L. J. 425, 429 (1998).

[4] *See generally*, H. Walter Croskey, *The Doctrine of Reasonable Expectations in California: A Judge's View*, 5 CONN. INS. L. J. 451 (1998).

policyholder's objectively reasonable expectations of coverage. *Id.* at 1268-69. Because the court ultimately ruled in favor of coverage, the potentially coverage-defeating nature of California's new approach to resolving ambiguities was not immediately appreciated. *See* Croskey, *supra* n. 4, 5 CONN. INS. L. J. at 462-63. The court's subsequent decision in *Bank of the West v. Superior Court*, 833 P.2d 545 (Cal. 1992) made the implications of the new *AIU* rule abundantly clear, however.

In *Bank of the West*, the policyholder sought coverage for a settlement paid to resolve a consumer class action suit alleging violations of the California Unfair Business Practices Act. *Id.* at 547-48. Although the policy at issue provided coverage for "'damages' the insured must pay for injuries arising out of 'unfair competition' occurring in the course of the insured's 'advertising activities,'" the insurer declined coverage, filed a declaratory judgment action, and prevailed on summary judgment before the trial court. *Id.* at 549. The Court of Appeal reversed, holding the policy term 'unfair competition' to be ambiguous inasmuch as it could refer either to the common law tort of unfair competition, or to the statutory violation alleged. *Id*. The Court of Appeal then simply construed the ambiguity against the insurer, and ruled in favor of coverage. *Id.*

Although the California Supreme Court acknowledged that "[i]t is obviously possible to argue that the term 'unfair competition' in the abstract, might refer to statutory claims," and that "definitions of 'unfair competition' in standard dictionaries generally include acts that harm the public as well as acts that harm competitors only," the court nevertheless rejected the approach taken by the Court of Appeal. *Id.* at 551. In place of that test, the Supreme Court set forth the following approach to resolving ambiguities:

> *If the contractual language is clear and explicit, it governs. On the other hand, "[i]f the terms of a promise are in any respect ambiguous or uncertain, it must be interpreted in the sense in which the promisor believed, at the time of making it, that the promisee understood it." This rule, as applied to a promise of coverage in an insurance policy, protects not the subjective beliefs of the insurer but, rather, "the objectively reasonable expectations of the insured." Only if this rule does not resolve the ambiguity do we then resolve it against the insurer.*

Id. at 552 (quoting *AIU*, 799 P.2d at 1264). If the implications of *AIU* had gone unnoticed, *Bank of the West* made absolutely clear that an insured's favored interpretation must now not only be "semantically permissible," but must also be consistent with the court's view of the insured's reasonable expectations of coverage. *See id.* Concluding—on the basis of a lengthy analysis of public policy concerns underlying the Unfair Business Practices Act—that the insured could not reasonably have expected coverage for statutory unfair competition claims, the Court denied coverage. *Id.* at 557. In other words, the *Bank of the West* court found an ambiguity, and then construed it *against the policyholder*, using one supposedly pro-policyholder doctrine (reasonable expectations) to undermine another (*contra proferentem*).

Reasonable expectations as a means to avoid finding ambiguity

Although California's use of the reasonable expectations doctrine as a means to resolve ambiguous policy language has produced pro-insurer results, courts in other jurisdictions have accomplished essentially the same thing by deploying reasonable expectations to avoid finding ambiguity—and application of *contra proferentem*—in the first place. One area where this approach has been particularly apparent involves the scope of coverage under the "personal injury" coverage part of commercial general liability policies.

An example of this phenomenon can be found in *Great American Insurance Co. v. Riso, Inc.*, 2006 WL 4158730 (D. Mass. 2006), *aff'd*, 479 F.3d 158 (1st Cir. 2007).[5] In *Riso*, Riso, Inc., a manufacturer of duplicating machines and supplies, was sued in two actions alleging that Riso's business practices had injured competitors and consumers. The first action involved a claim by one of Riso's competitors alleging that Riso had engaged in anti-competitive practices. The second action was a putative class action brought by consumers of Riso products, which alleged that the same anti-competitive practices alleged by Riso's competitor—including disparagement of generic alternatives to Riso supplies—had injured the consumers by causing them to pay inflated prices for Riso supplies and to forego cheaper alternatives. Riso's insurer defended the competitor's action, but refused to defend the consumer suit.

The policies at issue covered "personal injury . . . arising out of . . . [o]ral or written publication of material that . . . disparages a person's or organization's goods, products, or services." *Id.* at *3. By their plain terms, therefore, the policies provided coverage for suits alleging: (1) that the insured "publish[ed] material that . . . disparaged a[n] organization's goods [or] products"; and (2) resulting injury. *See id.* Although the consumer suit satisfied both prongs—alleging injury as a result of Riso's disparagement of competitors' products—the insurer refused to defend on the basis that the consumers' allegations failed to satisfy the "of and concerning" element of the tort of product disparagement, because the injuries alleged did not arise from disparagement of the consumers' own products.

Even if the insurer's position that the policy was intended to refer only to the tort of product disparagement was plausible, Riso's proffered interpretation seems at least equally so, thus at a minimum giving rise to an ambiguity to be construed in Riso's favor. Even more significantly, the insurers' interpretation appeared to be foreclosed under applicable Massachusetts law, because the Massachusetts Supreme Judicial Court had previously rejected an insurer's attempt to define "publication . . . of . . . disparaging material" as synonymous with the tort of product disparagement. *See Boston Symphony Orchestra v. Commercial Union Ins. Co.*, 545 N.E.2d 1156, 1159 (Mass. 1989). Nevertheless, both the U.S. District Court for the District of Massachusetts, and the United States Court of Appeals for the First Circuit held that Riso's personal injury coverage did not apply.

Although the district court cited various alternative grounds, its decision was, at root, based on its conclusion that "an objectively reasonable insured would understand the personal injury offense of 'disparage[ment of] a person's or organization's goods, products, or services,' when used in a commercial liability insurance policy, to cover [only the tort of disparagement], however specifically defined under state law in the forum of the underlying action." 2006 WL 4158730, at *4.

The First Circuit affirmed on similar grounds, denying the existence of any ambiguity on the basis of the court's gestalt conclusion that "the relevant core coverage in Riso policies is for defamation and

[5] The authors represented the insured, Riso, Inc.

commercial disparagement, and we think it unlikely in the extreme that the policy drafter or purchaser intended coverage for the antitrust offense framed in the complaint." 479 F.3d at 163. Although the First Circuit acknowledged the rule that ambiguities in policy language are to be construed against the insurer, the court found no ambiguity, reaching a result it found most fair based on its own notions of the parties' reasonable expectations of coverage under the policies. *See id.*; *see also Global NAPs, Inc. v. Fed. Ins. Co.*, 336 F.3d 59, 63 (1st Cir. 2003) (no reasonable expectation that coverage for "malicious prosecution" could apply to prosecution of meritless claims absent the elements of the tort of the same name); *Open Software Found., Inc. v. U.S. Fid. & Guar. Co.*, 2001 U.S. Dist LEXIS 12019, at *19 (D. Mass. 2001), *aff'd*, 307 F.3d 11 (1st Cir. 2002) (no reasonable expectation that "unfair competition" refers to conduct failing to satisfy the elements of the common law tort because "[i]t is hardly unreasonable for a drafter of an insurance policy, or any other instrument, to expect that a legal term used in the policy will be accorded the meaning that the courts have given it"). Of course, whether a court invokes reasonable expectations to avoid finding ambiguity (as in *Riso*), or to construe ambiguities against policyholders (as in *Bank of the West*), the end result is the same. Under either approach, reasonable expectations may operate to defeat coverage.

Reasonable expectations as a means to trump policy language favoring coverage

Whether explicit or implicit, courts' evaluation of reasonable expectations play a role in virtually any coverage dispute resolved by appeal to public policy, simple justice, or fairness, rather than through careful analysis of policy language. Here again, where courts attempt to derive "general principles" of insurance law, the results are often unfavorable to policyholders. Particularly striking are cases where courts consciously ignore policy language to avoid conflict with prior fairness-based, coverage-limiting decisions. These cases essentially turn the reasonable expectations doctrine on its head.

An example may be found in cases involving coverage for injuries spanning both insured and uninsured periods. Although the policy language at issue in such cases does not require it, a number courts allocate such losses across all implicated time periods, holding that a portion of the resulting loss must, in fairness, be allocated to the policyholder for any uninsured period. These decisions inevitably involve the court's perception that it would be unreasonable for the policyholder to expect full coverage for an injury taking place, in part, during periods when the policyholder chose to "go bare." As Judge Wald reasoned in her oft-cited concurrence in *Keene Corporation v. Insurance Company of North America*:

> *I just do not understand why an asbestos manufacturer, which has consciously decided not to insure itself during particular years of the exposure-manifestation period, should have a reasonable expectation that it would be exempt from any liability for injuries that were occurring during the uninsured period. It seems to me logical and fair . . . to distribute the ultimate financial liability on a pro rata basis among the various insurance companies on the line during the risk period, and to include [the insured] as a self-insurer for the years when it failed to take out any insurance.*

667 F.2d at 1058. Because Wald acknowledged that she "c[ould] find no first premises in the terms of the policies and canons of interpreting insurance policies" on which to base a result, it could have been appropriate simply to construe the policies against the insurer instead of allocating responsibility

to the insured. Instead, grounding her conclusions in "[her] own . . . notions of fairness," she turned her perception of the insured's reasonable expectations against the insured. *Id.* at n. 7. Although Wald's opinion on the matter did not carry the day in *Keene*, it has provided support for a number of subsequent decisions that have adopted her approach.

Thus, for example, in *Owens-Illinois, Inc. v. United Ins. Co.*, 650 A.2d 974 (N.J. 1994), the New Jersey Supreme Court adopted a pro-rata allocation approach, allocating a portion of long-tail losses to the insured for uninsured periods. Looking to "principles of simple justice," the court concluded that it would be unfair if "a manufacturer which had insurance coverage for only one year out of 20 would be entitled to . . . the same [benefit] as a manufacturer which had coverage for 20 years out of 20," and reasoned that such a result would be a "disincentive" to purchasing insurance. *Id.* at 992-93. This result was not compelled by policy language; the court itself noted that, "The language of the policies does not itself yield [the] result." *Id.* at 992. Indeed, reflecting on its decision years later, the Court stated that "*Owens-Illinois* eliminated reliance on particular contract language (other than limits and exclusions) and on traditional rules of interpretation, and set forth a uniform standard for resolving allocation issues in long-tail environmental exposure cases." *Spaulding Composites Co., Inc. v. Aetna Cas. & Sur. Co.*, 819 A.2d 410, 420 (N.J. 2003).

Remarkably, when later faced with a policy containing a provision inconsistent with the pro-insurer allocation methodology established in *Owens-Illinois*, the New Jersey Supreme Court simply refused to enforce the provision. *See id.* at 421-422. Like *Owens-Illinois*, *Spaulding* involved coverage for injuries spanning multiple policy periods. Unlike the policies at issue in *Owens-Illinois*, however, those in *Spaulding* contained "non-cumulation" clauses, which expressly addressed issues of allocation among multiple triggered policies issued by the same insurer. *Id.* at 412. Seeking to minimize coverage, the insurer in *Spaulding* urged application of both of its non-cumulation clause and the *Owens-Illinois* pro-rata allocation scheme.

Had the court turned to the policy language for guidance rather than to its own notions of "fairness and simple justice," it might have recognized analytical flaws in its *Owens-Illinois* decision. *See Chicago Bridge & Iron Co. v. Certain Underwriters at Lloyd's, London*, 797 N.E.2d 434, 440 (Mass. App. Ct. 2003) (recognizing that a non-cumulation clause "would be superfluous had the drafter intended that damages would be allocated among insurers based on their respective time on the risk" and rejecting time-on-the-risk pro ration on that basis). Instead, the court allowed its assessment of reasonable expectations to trump express policy language that supported an allocation approach often more favorable to policyholders.

CONCLUSION

As the doctrine of reasonable expectations moves further from its origins and underpinnings, policyholders, once the doctrine's intended beneficiaries, have more than occasionally become its victims. Perhaps this development simply highlights the mischief that inevitably results when contracts are interpreted by reference to generalized notions of fairness rather than analysis of contract terms. Though the doctrine may continue to aid policyholders in some situations, on balance, they may be better off without it.

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