INTERPRETING THE RULES OF INSURANCE CONTRACT INTERPRETATION

*Mark A. Geistfeld**

INTRODUCTION

The rules that courts apply to interpret insurance policies are surprisingly difficult to define. "The first principle of insurance law is captured by the maxim *contra proferentem*, which directs that ambiguities in a contract be interpreted 'against the drafter,' who is almost always the insurer."[1] To apply contra proferentem, a court must first conclude that the policy language is ambiguous before deciding whether the policyholder's proposed interpretation is reasonable. As Kenneth Abraham has shown, these two dimensions of the inquiry can yield at least four different permutations of contra proferentem, each of which has been applied by courts that are all purportedly applying the same black-letter rule.[2] A related rule of insurance contract interpretation—the doctrine of reasonable expectations—is also ambiguous in application. The doctrine can be a component of contra proferentem, entitling an insured to the coverage that she would reasonably expect when confronted by an ambiguous policy term, or the doctrine can function independently of contra proferentem by providing coverage in the face of unambiguous policy language to the contrary.[3] According to Jeffrey Stempel, "[d]etermining the exact status of the reasonable expectations school is difficult" because courts have not

* Sheila Lubetsky Birnbaum Professor of Civil Litigation, New York University School of Law.

1. Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 531 (1996) (footnote omitted).

2. *Id.* at 537–57.

3. *See generally* Mark C. Rahdert, *Reasonable Expectations Revisited*, 5 CONN. INS. L.J. 107 (1998) (describing different forms of the expectations doctrine).

clearly specified how they employ the doctrine.[4] Like contra proferentem, the doctrine of reasonable expectations can be interpreted in different ways, and yet courts have not been sufficiently clear about which form of the doctrine they have adopted or otherwise apply in a particular case.

A restatement of this case law holds both considerable promise and peril. A restatement can structure the analysis in a manner that has been immanent in the case law but not adequately recognized by courts, creating the potential for improving these rules by clarifying the issues at stake. But an accurate restatement of this case law will also have to recognize that courts do not necessarily have a shared understanding of the problem, explaining why different courts can apply the same black-letter rule in different ways. Without widespread agreement about the appropriate method for interpreting insurance policies, how can the case law be restated in a coherent manner?

Consider in this regard the "[o]bjectives of liability insurance policy interpretation" that are set forth in the most recent draft of the Restatement of the Law of Liability Insurance ("Restatement"):

> These objectives include: effecting the dominant protective purpose of insurance; facilitating the resolution of insurance-coverage disputes and the payment of covered claims; encouraging the accurate description of insurance policies by insurers and their agents; and providing clear guidance on the meaning of insurance policy terms in order to promote, among other benefits, fair and efficient insurance pricing, underwriting, and claims management.[5]

After listing these varied objectives, the Restatement gives no guidance on how they ought to be pursued. Are the rationales unified in any way? If not, then what determines whether one will prevail over another in a particular case? For example, the objective of "effecting the dominant protective purpose of insurance" supports interpretive rules that favor accurate findings of coverage, regardless of their complexity, whereas the objective of "facilitating the resolution of insurance-coverage disputes" supports interpretive rules that are simple to apply, regardless of their consequences for coverage. These two objectives are not inherently unified, leading to the question of how courts should evaluate any tradeoffs between them. Disagreement about these matters can

4. JEFFREY W. STEMPEL, STEMPEL ON INSURANCE CONTRACTS § 4.09[A], at 4-105 (3d ed. 2006 & Supp. 2015).

5. RESTATEMENT OF THE LAW OF LIAB. INS. § 2 cmt. c (AM. LAW INST., Discussion Draft 2015).

explain why courts apply the same black-letter interpretive rules in substantively different ways.

Thus, to fully specify the rules of insurance contract interpretation, one must identify the underlying substantive rationale for the rules in question. What, exactly, are the rules supposed to accomplish?

The most plausible rationale is supplied by the principle that insurance policies ought to be interpreted to protect the policyholder's reasonable expectations of coverage, which Abraham has called "a regulative ideal: the expression of a value that should help to shape the development of insurance law."[6] But of the varied "[o]bjectives of liability insurance policy interpretation" that are invoked by the Restatement, none expressly reference the expectations principle. The Restatement instead states that its rules of interpretation are "broadly consistent with the principle that insurance policy terms are to be interpreted according to the reasonable expectations of the insured."[7]

As I will argue, courts should interpret standard-form insurance policies to protect the ordinary policyholder's reasonable expectations of coverage, and there are ample reasons for concluding that the Restatement honors this principle. The difficulty stems from ambiguities involving both policyholder expectations and the Restatement's interpretive rules. By relying on a rigorous specification of the ordinary policyholder's reasonable expectations of coverage, courts can resolve the ambiguities in the Restatement's rules, yielding an appealing method for interpreting insurance contracts.

The argument proceeds in three parts. Part I describes the Restatement's interpretive rules and shows that they depend on two forms of policyholder expectations—*actual expectations* based on the ordinary policyholder's understanding of the policy language (its plain meaning), and *reasonable expectations* based on a hypothetical, well-informed policyholder's understanding of the policy term (its plain meaning supplemented with extrinsic evidence about purpose and the like). Based on sufficiently compelling proof of extrinsic evidence, the Restatement permits courts to depart from actual expectations (the plain meaning) to reach coverage interpretations that protect the reasonable expectations of policyholders in all cases, with one notable exception. If the plain meaning of the policy term is not "reasonably susceptible" to the alternative interpretation based on extrinsic evidence, then the

6. Kenneth S. Abraham, *The Expectations Principle as a Regulative Ideal*, 5 CONN. INS. L.J. 59, 63 (1998).

7. RESTATEMENT OF THE LAW OF LIAB. INS. § 4 cmt. b (AM. LAW INST., Discussion Draft 2015).

Restatement requires courts to adopt the plain meaning.[8] Such an interpretation could be contrary to the ordinary policyholder's reasonable expectations of coverage, depending on how courts interpret the "reasonably susceptible" requirement.

To analyze more rigorously the relation between an interpretation based on plain meaning (or actual expectations) and one based on extrinsic evidence (of reasonable expectations), Part II develops the expectations principle. The ordinary policyholder's actual expectation of coverage is usually misinformed, creating the potential for policyholders to be exploited by insurers, regardless of the clarity of the policy language. To remedy the informational problems that undermine policyholder coverage decisions, courts should interpret standard-form insurance contracts to provide the amount of coverage that would be chosen by the ordinary policyholder who is well informed about the relevant issues. This formulation of the expectations principle is not merely a regulative ideal. The ordinary policyholder has reasonable expectations of coverage for an identifiable set of reasons that are sufficient to structure the interpretive inquiry, enabling courts to evaluate the reasonableness of a proposed interpretation of the policy language in the manner required by the Restatement's interpretive rules.

Part III illustrates the issues by applying the Restatement's interpretive rules to three different cases in which the plain meaning of a policy term arguably conflicts with the underlying purpose of the provision. The Restatement permits courts to override plain meaning with extrinsic evidence of reasonable expectations, as long as the plain meaning is "reasonably susceptible" to such an alternative interpretation. The meaning of this requirement can be derived from the expectations principle, which shows why the proper interpretation of these policy provisions depends on an empirical question of whether a departure from the plain meaning poses a risk of legal error that can significantly disrupt the insurer's actuarial calculations and work to the net detriment of policyholders. As illustrated by the three case studies, this inquiry is easy in some cases and complex in others for reasons that map into a structured inquiry for determining whether the plain meaning of a policy term is "reasonably susceptible" to an alternative interpretation based on extrinsic evidence. The same set of considerations would also enable courts to determine what types of extrinsic evidence are admissible for interpreting a policy term that does not have a plain meaning and is ambiguous. When applied in this manner, the Restatement's interpretive rules have the potential for implementing the expectations principle in a

8. *Id.* § 3(2).

manner that requires courts to clearly specify the substantive reasons for their decisions of how to interpret insurance contracts.

I. THE RESTATEMENT RULES OF INSURANCE CONTRACT INTERPRETATION

Although the Restatement is limited to liability insurance, its rules of insurance contract interpretation are valid for the other common forms of insurance. When applying the rules for interpreting insurance policies—that is, the doctrines of contra proferentem and reasonable expectations—courts do not distinguish among the different types of insurance.[9] The type of insurance can obviously affect the particular interpretation of a policy term, but the method for interpreting any term is invariant to the form of insurance. Hence, the Restatement rules of interpretation are not limited to liability insurance.

The Restatement's interpretive rules are deceptively simple. A policy term has a "plain meaning" if that is the "single meaning . . . to which the language of the term is reasonably susceptible when applied to the claim at issue, in the context of the insurance policy as a whole, without reference to extrinsic evidence regarding the meaning of the term."[10] A policy term must be

> interpreted according to its plain meaning, if any, unless the court determines that a reasonable person would clearly give the term a different meaning in light of extrinsic evidence. That different meaning must be one to which the language of the term is reasonably susceptible after consideration of the extrinsic evidence.[11]

If the term does not have a single plain meaning and is ambiguous, then "the term is interpreted in favor of the party that did not supply the term, unless the other party persuades the court that this interpretation is unreasonable in light of extrinsic evidence."[12]

These rules are supposed to strike a balance between the "two opposing approaches to the interpretation of insurance policy

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9. Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 346 (1986) ("The courts have not confined the reasonable expectations doctrine to any particular type of insurance transaction. Like the ambiguity principle before it, reasonable expectations cuts across the field of insurance and applies to most insurance arrangements.").

10. RESTATEMENT OF THE LAW OF LIAB. INS. § 3(1) (AM. LAW INST., Discussion Draft 2015).

11. *Id.* § 3(2).

12. *Id.* § 4(2).

language."[13] "Under the 'plain-meaning rule,' . . . a term [that] is unambiguous 'on its face'" will be enforced without resort to any extrinsic evidence, whereas "the 'contextual approach' [permits] any kind of extrinsic evidence . . . to show that a term is ambiguous."[14] By adopting a "presumption in favor of plain meaning," the Restatement "rejects the plain-meaning rule's absolute preclusion of extrinsic evidence regarding the meaning of policy terms . . . but accords the language of those terms a significance that the contextual approach may deny them."[15]

The Restatement understandably adopts a position that is intermediate between two opposing approaches, each of which has substantial support in the case law. The question, however, is whether such an intermediate approach is defensible. Can it be justified by the objectives that courts should pursue when interpreting insurance policies?

Consider in this regard the objectives of insurance contract interpretation that are recognized by the Restatement. The objective of "effecting the dominant protective purpose of insurance"[16] supports interpretive rules that favor accurate findings of coverage, regardless of their complexity. This objective accordingly justifies the contextualist approach to interpretation, which rejects the simplicity of the plain-meaning rule in an effort to interpret policy terms in light of their underlying purpose. In contrast, the objective of "facilitating the resolution of insurance-coverage disputes"[17] supports interpretive rules that are simple to apply, regardless of their consequences for coverage. This objective accordingly justifies the plain-meaning rule. By adopting a presumption in favor of plain meaning, the Restatement in effect is striking a balance between these two potentially conflicting objectives.

When understood in these terms, the Restatement's interpretive rules take on new meaning. Should the goal of "effecting the dominant protective purpose of insurance" be compromised by the objective of "facilitating the resolution of insurance-coverage disputes?" If so, what is the proper form of that tradeoff? These questions are directly implicated by the presumption in favor of plain meaning, and yet the resultant policy decision is never expressly addressed by the Restatement.

The underlying policy issues are complex for reasons that become clear once we consider more closely the "reasonable policyholder" that defines the interpretive inquiry required by the Restatement:

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13. *Id.* § 3 cmt. a.
14. *Id.*
15. *Id.*
16. *Id.* § 2 cmt. c.
17. *Id.*

> The plain meaning of an insurance policy term is the understanding of the term that an ordinary, reasonable person would have, if that person took the time to read all of the relevant parts of the policy in the context of the claim at issue, without taking any other circumstances into account. . . . The plain meaning of any insurance policy term is determined from the perspective of the same reasonable person, an imaginary being that is properly understood as a legal construct.[18]

A reasonable policyholder whose understanding is limited to the policy language can ascribe meaning to a term that differs from the interpretation she would adopt if fully informed about the relevant issues. According to the Restatement, "[i]t is not assumed or expected that consumers ordinarily read their insurance policies, nor that legal rules can do very much to change consumer behavior in that regard."[19] The Restatement's definition of plain meaning, therefore, imputes knowledge of the policy language to the reasonable policyholder that is not held by the ordinary policyholder who is unlikely to have read the policy. This imputation of knowledge about the policy language, however, does not necessarily enable the reasonable policyholder to make informed decisions. The ability to make informed coverage decisions is not limited to the contract language itself, but instead depends on whether the policyholder has the requisite information about all factors relevant to the coverage question.[20] Frequently, the average policyholder is not well informed of the relevant issues, leading her to ascribe plain meaning to a policy term that differs from the interpretation she would adopt if well informed about the matter. Under the plain-meaning rule, the reasonable policyholder only has an actual expectation of coverage that can differ from the reasonable expectation based on a fully informed decision about the coverage question.

Because the ordinary policyholder's actual expectations about plain meaning can diverge from her well-informed or reasonable expectations of coverage, a role is created for extrinsic evidence. According to the Restatement, the plain meaning of a term can be displaced by a different meaning "that a reasonable person would clearly give the term . . . in light of extrinsic evidence," provided that the alternative meaning is "one to which the language of the term is reasonably susceptible after

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18. *Id.* § 3 cmt. e.
19. *Id.* § 2 cmt. d.
20. *See infra* Section II.A (defining the various properties of insurance coverage that are relevant to informed decisionmaking by the ordinary policyholder).

consideration of the extrinsic evidence."[21] Once able to draw upon the various sources of extrinsic evidence, a reasonable policyholder would gain the knowledge required for informed coverage decisions. Extrinsic evidence enables the ordinary or reasonable policyholder to formulate well-informed or reasonable expectations of coverage.

Relevant forms of extrinsic evidence include "expert testimony regarding topics such as the custom and practice in the insurance industry and the history, purpose, and function of policy terms and forms of insurance coverage."[22] The purpose of the clause is particularly important because

> [a] policy term that might otherwise be subject to a wide range of meanings can sometimes be given greater precision by reference to the purpose of the term. For standard-form terms, the purpose inquiry is entirely objective. The objective purpose of a standard-form term can be determined from sources such as learned treatises, insurance industry trade literature, the drafting history of the policy, prior court decisions, statements made to regulatory agencies during the policy approval process, expert testimony, and comparison with other insurance policy forms available on the market.[23]

Extrinsic evidence of this type would enable the ordinary policyholder to make informed coverage decisions, potentially leading her to interpret a particular policy term in a manner different from its plain meaning. Thus, by relying on extrinsic evidence to interpret insurance terms, courts can require insurers to provide the coverage that would be expected by policyholders if they had the time and sufficient knowledge for making informed coverage decisions. This interpretive approach won't induce actual policyholders to read the contract, but it nevertheless corrects their erroneous coverage decisions based, at best, on the policy's plain meaning.

The Restatement, though, has an additional requirement that could block outcomes required by the ordinary policyholder's reasonable or well-informed expectations of coverage. Regardless of the interpretation that would be obtained under conditions of full information (through resort to extrinsic evidence), the plain meaning of a term cannot be given a "different meaning . . . to which the language of the term is [not]

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21. RESTATEMENT OF THE LAW OF LIAB. INS. § 3(2) (AM. LAW INST., Discussion Draft 2015).
22. *Id.* § 3 cmt. f.
23. *Id.* § 4 cmt. m.

reasonably susceptible after consideration of the extrinsic evidence."[24] In these cases, the policy language creates actual expectations—a plain meaning—that could override reasonable expectations based on extrinsic evidence about the purpose of the term and related matters.[25]

Whether the Restatement mandates such an outcome, however, depends on how one interprets the "reasonably susceptible" requirement. Despite the central importance of this requirement, it is neither defined by the Restatement nor otherwise self-defining. The Restatement instead explains how this requirement should affect the interpretive inquiry:

> The plain meaning prevails unless the court concludes, after considering extrinsic evidence in favor of another meaning, that a reasonable person in the policyholder's position would clearly give the term this other meaning, and the language of the term is reasonably susceptible to this other meaning under the circumstances. In other words, for the plain meaning to be displaced, the court must conclude that the plain meaning is a less reasonable meaning.[26]

Whether the plain meaning of a policy term is "reasonably susceptible" to an alternative interpretation based on extrinsic evidence, therefore, depends on how the reasonable policyholder would evaluate the two interpretations. By relying on the extrinsic evidence, the reasonable policyholder could make a well-informed judgment about the matter. Hence the ordinary policyholder's well-informed or reasonable expectations determine whether the plain meaning of a policy term is "reasonably susceptible" to an alternative interpretation.

To see why, consider the overall interpretive approach adopted by the Restatement. If the plain meaning of the policy language supplied the sole basis for determining whether the term is "reasonably susceptible" to an alternative interpretation, then unambiguous policy language could never be overridden by extrinsic evidence of purpose. As a linguistic matter, unambiguous policy language cannot be "reasonably susceptible" to an alternative interpretation; if it were, the language would be ambiguous. And if unambiguous policy language were never "reasonably susceptible" to an alternative interpretation, then the plain-meaning rule would always prevail over the contextual approach, an outcome contrary to the Restatement's objective of striking a balance between these two

24. *Id.* § 3(2).

25. *Cf. id.* § 3(1) (stating that the plain meaning of a term is determined "without reference to extrinsic evidence regarding the meaning of the term").

26. *Id.* § 3 cmt. c.

interpretive methods.[27] To value both the plain-meaning rule and the contextual approach, the "reasonably susceptible" requirement must be interpreted in substantive terms that do not depend solely on the linguistic properties of the policy language.

When the "reasonably susceptible" requirement is defined in such a substantive manner, it prevents courts from adopting the plain meaning of a policy term unless it is substantively reasonable as compared to the alternative interpretation based on extrinsic evidence. Given the assumption that policyholders do not ordinarily read the insurance contract,[28] plain meaning cannot be substantively reasonable on the ground that the parties mutually agreed to the term. The relevant conception must instead involve the meaning that would be mutually acceptable if the ordinary policyholder had actually read and fully understood the policy language. Whether the plain meaning of the policy language is "reasonably susceptible" to an alternative interpretation accordingly depends on the ordinary policyholder's well-informed or reasonable expectations of coverage.

The plain meaning, though unambiguous, could be "reasonably susceptible" to an alternative interpretation based on extrinsic evidence simply because that is how the reasonable policyholder would understand the language if she were well informed of the relevant issues. This formulation of the expectations doctrine, however, would always favor extrinsic evidence of purpose over unambiguous policy language, contrary to the Restatement's objective of striking a balance between the plain-meaning rule and the contextual approach.

This problem explains why the Restatement limits the expectations doctrine with the "reasonably susceptible" requirement:

> By requiring that the meaning be one to which the words are reasonably susceptible, [the] Restatement rejects the strongest formulation of the reasonable expectations doctrine, pursuant to which an insurance policy is to be interpreted according to the reasonable expectations of the insured even if the insurance policy language is to the contrary.[29]

Extrinsic evidence of purpose and the like cannot invariably trump the plain meaning of the policy language.

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27. *See id.* § 3 cmt. a; *see also supra* text accompanying notes 13–15.

28. RESTATEMENT OF THE LAW OF LIAB. INS. § 2 cmt. d (AM. LAW INST., Discussion Draft 2015).

29. *Id.* § 4 cmt. b.

In order to value both the plain-meaning rule and the contextual approach, the "reasonably susceptible" requirement must give appropriate weight to plain meaning while also allowing for alternative interpretations based on sufficiently persuasive extrinsic evidence of reasonable expectations. The weight given to plain meaning, however, must depend on some substantive reason that is not simply a matter of linguistic convention (for otherwise, plain meaning would always trump a purposive interpretation based on extrinsic evidence). The question, then, is whether there is some substantive principle that is capable of unifying these two interpretive approaches.

The most promising solution resides in the principle that courts should interpret insurance policies to protect the policyholder's reasonable expectations of coverage. Under the Restatement, the expectations doctrine cannot invariably override plain meaning, leading to the question of whether the underlying expectations principle can explain how courts should value the plain meaning of policy language in order to determine whether it is "reasonably susceptible" to an alternative interpretation based on extrinsic evidence. Having addressed this question, we will then be able to evaluate the Restatement's claim that its rules are "broadly consistent with the principle that insurance policy terms are to be interpreted according to the reasonable expectations of the insured."[30]

II. THE ORDINARY POLICYHOLDER'S REASONABLE EXPECTATIONS OF THE RULES OF INSURANCE CONTRACT INTERPRETATION

"Although courts in at least two-thirds of the states have endorsed a doctrine of reasonable expectations in one form or another, these endorsements do not have a uniform meaning."[31] One approach relies on reasonable expectations to interpret ambiguous policy language, whereas the other invokes those expectations to override unambiguous policy provisions.[32]

Despite disagreement about the appropriate form of the expectations doctrine, courts and commentators largely agree on the rationale for protecting the ordinary policyholder's reasonable expectations of coverage. As Robert Jerry and Douglas Richmond have observed,

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30. *Id.*

31. ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW § 25D[b] (5th ed. 2012).

32. Rahdert, *supra* note 3, at 112.

> If there is a unifying theme across all cases, it is probably a recurring circumstance that routinely appears: the insured is an ordinary, unsophisticated consumer, possessing an understanding of only the most rudimentary aspects of the coverage. In other words, the reasonable expectations doctrine is used by courts to protect consumers, not to adjust a commercial relationship between parties with roughly equal bargaining power. Beyond this simple observation, generalizations become more difficult.[33]

Regardless of how they have formulated the expectations doctrine, courts widely recognize that they should interpret insurance contracts in a manner that protects policyholders from a pervasive informational problem, one that has been well described by Mark Rahdert:

> As numerous commentators beginning with Patterson, Kessler and Llewellyn have noted, there is no mutual assent to most terms of an insurance policy. Policy language is standardized and mass produced. It, or language very similar to it, appears in nearly every policy of like kind offered by underwriters. The purchaser of the policy probably has no opportunity to read the policy language before purchase. And even when read, the import of much of the technical language used would, in most circumstances, escape notice. Beyond that, in the unlikely event that the potential insured could both read and understand the policy before purchase, he or she would be powerless to negotiate any change. In other words, in most cases the insurance policy is the classic example of the "adhesion" contract.[34]

Due to the inability of the ordinary policyholder to make informed coverage decisions, insurers can take advantage of policyholders by designing the policy to create misleading appearances of coverage. Under these conditions, as Daniel Schwarcz has rigorously shown, "insurance policies may indeed be exploitive in the absence of government intervention."[35] Courts intervene to protect policyholders from being

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33. JERRY & RICHMOND, *supra* note 31, § 25D[b].

34. Rahdert, *supra* note 9, at 329 (footnote omitted).

35. Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389, 1403 (2007). The rationale for judicial regulation is even stronger than Schwarcz has recognized. According to his analysis, even if the average policyholder is uninformed, insurers might nevertheless supply the amount of coverage that policyholders reasonably expect *if* a large enough proportion of policyholders

exploited in this manner by interpreting insurance contracts to protect the ordinary policyholder's reasonable expectations of coverage.

This definition of the regulatory problem has implications for the rules of insurance contract interpretation. A rule that is justified by the need to protect uninformed policyholders ought to provide the coverage that would be chosen by policyholders if they were well informed. The proper interpretation of the insurance contract, therefore, depends on the coverage decision that would be made by the ordinary policyholder if she were well informed of the relevant issues—the principle of reasonable expectations.

After defining the policyholder's coverage decision in this manner, we can then determine how courts should protect those reasonable expectations when interpreting policy language. How does the expectations principle translate into rules of interpretation—the expectations doctrine? This analysis shows that the expectations doctrine entails a structured legal inquiry that fully implements the expectations principle by enabling courts to override unambiguous policy language under certain conditions.

A. The Ordinary Policyholder's Reasonable Expectations of Coverage

To date, no one has rigorously specified the substantive content of the ordinary policyholder's reasonable expectations of coverage, explaining why the expectations doctrine "has failed to emerge as either a popular or an analytically sound basis for guiding the judicial regulation of

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are well informed and forego policies with exploitative terms. *Id.* at 1402–03, 1406. This dynamic, however, actually exacerbates the informational problem and substantially strengthens the case for regulation. If insurers respond to the demands of a sufficiently large subset of well-informed policyholders, then the conduct of well-informed policyholders creates an information externality that benefits uninformed policyholders. As I have discussed in a related context involving product safety,

> [t]his informational externality . . . reduces consumer incentives to acquire costly information in the first instance. When information is costly to acquire and process, any consumer may rationally decide to free ride on the informed choices of others, thereby saving the information costs. The consumer can get the benefits of information (safe products) without incurring the costs of acquiring and processing the information. Reasoning similarly, other consumers will make the same choice. The free-rider problem may result in no consumer incurring the costs necessary for making informed decisions about product safety.

Mark A. Geistfeld, *Products Liability*, *in* I ENCYCLOPEDIA OF LAW AND ECONOMICS § 11.6, at 295 (Michael Faure ed., 2d ed. 2009) (citation omitted). By this same reasoning, each individual policyholder can rationally decide not to become informed about coverage provisions, creating the informational problem that justifies judicial intervention.

insurance."[36] The ordinary policyholder, however, has reasonable expectations of coverage that can be defined by the insurance contract that she would agree to if sufficiently well informed about the relevant issues. The economic logic of such an insurance transaction is well understood,[37] yielding an analytically sound method for interpreting insurance contracts.

Risk-averse parties, whether individuals or corporations, benefit by transferring risk to an insurer that is able to pool a large number of similar, independent risks.[38] Due to the statistical law of large numbers, an insurer that covers such a pool of risks can be highly confident that the total loss within the pool approximates its expected value—the probability that covered losses will occur multiplied by the total amount of such losses. By paying a premium equal to the expected value of the loss, the policyholder incurs a small loss with certainty that is less costly for her than the alternative, an uncertain situation threatening the risk of substantial financial loss. This benefit or reduction of costs for the ordinary policyholder is often substantial enough to enable the insurer to charge a premium above the expected value of loss that makes the transaction profitable for the insurer. Both parties can accordingly benefit from insurance contracts that provide the maximal amount of coverage for risks having these characteristics.

Maximal coverage, however, can create costs that ultimately work to the net detriment of policyholders. A reduction in coverage decreases the value of the insurance for the policyholder but can still result in overall cost savings that inure to her net benefit. A reasonable policyholder who is well informed of the relevant issues would understand that insurance coverage must be limited for these reasons. Like coverage itself, certain limitations of coverage can be justified by the reasonable expectations of the ordinary policyholder.

1. Uninsurable risks. The economic logic of the insurance transaction relies on the statistical law of large numbers in order to make the transfer of risk mutually beneficial. In order to be insurable, a risk must have the properties required by the law of large numbers. These properties, as Michelle Boardman has fully explained, involve three attributes.[39]

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36. Schwarcz, *supra* note 35, at 1427.

37. For example, all of the concepts discussed in this Section are described by GEORGE E. REJDA, PRINCIPLES OF RISK MANAGEMENT AND INSURANCE 7–8, 21–35 (4th ed. 1992).

38. *See id.* at 22–23.

39. Michelle E. Boardman, *Known Unknowns: The Illusion of Terrorism Insurance*, 93 GEO. L.J. 783, 812–24 (2005).

First, the risk must be calculable, involving an adequate actuarial understanding of the probability of loss and its magnitude.[40] Without knowledge of risk, the insurer cannot reliably calculate the expected loss within the pool of covered risks. Without knowledge of the expected loss, the insurer cannot rely on the law of large numbers to calculate its expected costs of coverage.

In addition, insurers can pool risks in a manner that satisfies the law of large numbers only if the risk of loss faced by an individual policyholder is sufficiently independent of the risk of loss faced by other policyholders in the pool. Risks that are highly correlated across policyholders effectively create one large risk for statistical purposes, unlike independent risks that predictably balance out within a sufficiently large pool. "War is perhaps the ultimate correlated clash event. Over time, most policyholders in a warring region will suffer losses across most types of insurance. War is not insurable . . . ."[41]

Finally, even if the risk satisfies all of the foregoing properties, "it may be impossible to specify a rate for which there is sufficient demand and incoming revenue to cover the development, marketing, and claims cost of the insurance and still yield a net positive profit."[42] For example,

> there is no gain in paying another to bear the cost of a fully known event. A homeowner who knows his house will be consumed by fire tomorrow, and knows the full extent of the damage, could reveal these facts to his insurer (it would be fraud to not do so), but the price of the resulting coverage would be the amount of his loss (minus a deductible) plus administrative costs and profit. The homeowner gains nothing. In fact, he is worse off for purchasing insurance, having paid the insurer more than he gets in return.[43]

In order for coverage to be beneficial for both parties, the policyholder's cost of bearing a risk must exceed the costs that a profitable insurer would otherwise incur to pool the risk. This condition is not satisfied for low level losses or ones that otherwise occur with sufficient frequency, making these risks uninsurable in an economic sense. The well-informed policyholder would rather bear the cost of these risks than pay a more costly premium to transfer them to an insurer.

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40. *Id.* at 813.
41. *Id.* at 821 (footnotes omitted).
42. *Id.* at 814.
43. *Id.* at 810.

Numerous policy provisions limit coverage for risks that are uninsurable, involving correlated risks (like losses caused by war) or those for which coverage is not economical (like the ordinary "wear and tear" of property).[44] These limitations of coverage are reasonably expected by the ordinary policyholder, who understands why the economic logic of the insurance transaction makes it infeasible for the insurer to provide coverage for risks that do not have the right type of characteristics.

2. Moral hazard. When a loss is shifted from the insured to the insurer, the insured has reduced financial incentives for exercising costly precautions that would reduce the risk of the covered loss—the well-known problem of moral hazard.[45] Lacking sufficient "skin in the game," the insured is not sufficiently concerned about whether or not the insured-event occurs. Why spend $10 to reduce the risk of a covered loss, even if doing so would reduce the expected cost of the loss by $100 for the insurer?

The decision not to undertake such cost-effective safety measures is rational for each policyholder, but collectively these decisions harm all policyholders. The total cost of the risk faced by each policyholder includes the premium, her precautionary expenditures, and the expected cost of uninsured losses. When each policyholder decides to forego cost-effective precautionary expenditures, the incidence of loss within the pool of insured risks will increase across the board, thereby increasing premiums for all policyholders by a total amount that exceeds the savings the group attains by foregoing (cost-effective) precautionary expenditures. The ordinary policyholder, therefore, reasonably expects the insurer to adopt measures for controlling moral hazard that would reduce the policyholder's total cost for the risks in question.

To address the problem of moral hazard, "[i]nsurers employ a variety of different mechanisms" such as underwriting, experience-rating, coverage design, loss control, ex-post auditing, and external control measures.[46] Issues pertaining to coverage design are particularly relevant for interpreting the insurance contract.

Insurers structure the policy coverage to combat moral hazard in different ways, including policy provisions pertaining to deductibles, co-

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44. Because coverage for ordinary wear and tear of property is so clearly uneconomical, courts will even go so far as to deem these losses an "implied exception[] to coverage" because "insurers must be permitted to protect the actuarial integrity of their businesses even where the policy language is silent, vague, or even unfavorable concerning this point." STEMPEL, *supra* note 4, § 1.06[B][5], at 1-112 (sentence structure omitted).

45. *See* REJDA, *supra* note 37, at 7–8.

46. Tom Baker & Peter Siegelman, *The Law and Economics of Liability Insurance: A Theoretical and Empirical Review*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF TORTS 169, 179–81 (Jennifer Arlen ed., 2013).

payment provisions, and policy limits. By making the insured responsible for, say, the first $100 of loss, the deductible gives the insured a financial incentive for taking any precaution that would cost less than the associated reduction in the expected cost of the deductible. These measures do not fully solve the problem. The policyholder's incentives are still insufficient, because her safety decision is still driven by the desire to reduce only her uninsured losses (the deductible and so on) rather than the total expected loss covered by the policy. Increasing the total amount of uninsured loss (e.g., increasing the deductible) would increase the policyholder's incentive to take care, but comes at the cost of shifting the risk onto the policyholder, who loses the associated value of the insurance coverage. The optimal limitation—the amount that would be expected by a reasonable policyholder—reduces the amount of coverage only to the extent that the lost value of coverage for the ordinary policyholder is less than the cost-savings that she would experience through the reduction of moral hazard.

Any limitation of coverage has the potential for reducing moral hazard, but only certain types of policy limitations can be justified on this basis. The problem of moral hazard is generic and pervasive, requiring general policy provisions such as deductibles or co-payment provisions that limit coverage for all forms of insured-against loss. More targeted limitations of coverage, therefore, must be justified by particularly acute problems of moral hazard that are not adequately addressed by these general policy provisions.

A good example involves the obligations that the policy imposes on the insured following the occurrence of damage to covered property. Because the damage will often exceed the deductible, that policy provision is no longer capable of combating moral hazard. Property insurance policies accordingly require the insured to "[m]ake reasonable and necessary repairs to protect the property" from further damage.[47] An insured who fails to satisfy this requirement cannot reasonably expect coverage, as the ordinary policyholder who is well informed about the matter benefits from the provision and expects coverage to be limited in this manner.

3. Adverse selection. To the extent that individual policyholders have different risk characteristics, the expected value of covered losses will differ for each one. High-risk policyholders have a higher expected loss than low-risk policyholders. If each type of policyholder were charged the

47. *E.g.*, Insurance Services Office, Homeowners 3 Special Form HO 00 03 05 11, Section I-Conditions, C.4.a (2010), *reprinted in* KENNETH S. ABRAHAM & DANIEL SCHWARCZ, INSURANCE LAW AND REGULATION: CASES AND MATERIALS 186, 199 (6th ed. 2015).

same premium despite their different risk characteristics, then the pooled premium would cause the well-known problem of adverse selection. The pooled premium would be below cost for high-risk policyholders, increasing their demand for coverage, whereas the premium would be above cost for low-risk policyholders, reducing their demand for coverage. In the extreme, the low-risk policyholders would find coverage to be too expensive and leave the pool, resulting in coverage being purchased only by the high-risk policyholders.[48]

Ordinarily, low-risk policyholders reasonably expect the policy to be designed in a manner that deals with the problem of adverse selection, and high-risk policyholders cannot reasonably expect otherwise. A pooled premium forces low-risk policyholders to subsidize high-risk policyholders. Ordinarily, such a subsidy is unfair for low-risk policyholders, in which case the high-risk policyholders cannot reasonably expect to be subsidized in this manner.[49] By increasing the premium above the amount otherwise justified by the policyholder's individual risk—the actuarially fair premium—the pooled premium will also induce low-risk policyholders to reduce their purchase of coverage, further harming them. Absent any reasons of public policy to the contrary, the reasonable expectations of the ordinary policyholder typically justify policy provisions that combat adverse selection by enabling the insurer to charge actuarially fair premiums for individual policyholders.[50]

To ensure that each policyholder pays a premium adequately reflective of her underlying risk characteristics, insurers establish risk-classification schemes that attempt to place individual policyholders within their appropriate risk category, thereby enabling insurers to charge different premiums for the respective categories. This screening largely occurs during the application process and underwriting period. "Underwriting is the process of selecting among insurance applicants and

48. *See* REJDA, *supra* note 37, at 27.

49. Under certain conditions, the risk-classification scheme can actually harm low-risk policyholders. Instead of serving as a subsidy, the pooled premium can serve as a valuable form of insurance that protects individuals from exogenous shocks that change their status from low-risk to high-risk. Legal restrictions that prevent insurers from classifying risks on this basis can enhance the value of insurance for all policyholders.

50. Federal mandates concerning health insurance illustrate this type of public policy, as they reject "actuarial fairness" in favor of "health care solidarity" that embodies a "fair share" approach to health insurance. Tom Baker, *Health Insurance, Risk, and Responsibility After the Patient Protection and Affordable Care Act*, 159 U. PA. L. REV. 1577, 1577 (2011). For reasons discussed in the prior footnote, however, restrictions on "actuarial fairness" can also benefit all policyholders by providing coverage for financial risks of increased premiums threatened by exogenous changes in one's health status.

assigning them to risk categories according to, inter alia, their propensity to engage in loss-prevention behavior and honesty in relation to claims practices. Underwriting has the potential to reduce both *ex ante* and *ex post* moral hazard."[51] Risk-classification schemes can reduce moral hazard by giving policyholders a financial incentive to take risk-reducing actions that affect their actuarial status for underwriters.

For these reasons, the insurance policy can defensibly limit coverage in order to maintain the integrity of the risk-classification schemes upon which the actuarially fair premiums are set. A policy provision that voids coverage based on the policyholder's fraudulent misrepresentation of her risk characteristics provides a good example.

When properly designed, limitations within the insurance contract that combat adverse selection satisfy the reasonable expectations of the ordinary policyholder, further illustrating how the expectations principle makes it possible for courts to identify defensible limitations of coverage.

4. Segmentation of risk across policies. An important method of classifying policyholders in terms of their risk characteristics involves the segmentation of risk across the insurance market, producing different lines of insurance for different types of risk. An insurance contract limited to coverage for legal liabilities encompasses a risk category obviously different from the one covered by life insurance. By segmenting risks across different lines of insurance policies, insurers can more accurately establish premiums in an actuarially fair manner.

To maintain the integrity of these risk-classification schemes, insurance contracts limit coverage for a loss that is otherwise covered by a different line of insurance. For example, policies covering commercial general liability contain express limitations of coverage for workplace injuries and injuries arising out of the use of automobiles.[52] Each type of liability is covered by a different line of insurance—workers' compensation coverage and automobile insurance. By excluding these losses from the commercial general liability policy, these provisions segment risk in a manner that combats adverse selection, thereby increasing the total coverage available to policyholders across the insurance market as a whole. Consequently, a policyholder cannot reasonably expect a commercial general liability policy to cover workplace accidents, because such coverage would undermine the integrity of the

51. Baker & Siegelman, *supra* note 46, at 179.

52. *E.g.*, Insurance Services Office, Commercial General Liability Coverage Form CG 00 01 04 13, Section I-Coverages, 2.d, 2.g (2012), *reprinted in* ABRAHAM & SCHWARCZ, *supra* note 47, at 439–40, 442.

associated risk-classification schemes and ultimately harm policyholders across the full set of insurance markets.[53]

Insurers can also segment risk within a policy by offering endorsements. An endorsement provides coverage for those policyholders who sufficiently value that coverage while enabling the remaining policyholders to decline coverage because the premium is too high relative to their expected coverage benefit. Like the segmentation of risk created by the different lines of insurance policies, endorsements serve the purpose of risk classification and reduce the costs of adverse selection. The ordinary policyholder, therefore, does not reasonably expect coverage under the policy that she can otherwise obtain by purchasing an endorsement.[54]

5. Reduction of transaction costs. As is true of any contract, insurance policies must account for transaction costs. For example, transaction costs prevent insurers from creating risk-classification schemes that attain perfect actuarial fairness for each policyholder.[55] The cost of such refined schemes of risk classification (via the associated increase in premiums) would substantially exceed the benefits for the ordinary policyholder (via the more refined actuarially fair premium). Any limitation of coverage has the potential to reduce transaction costs. But like the concern for moral hazard, the concern for transaction costs justifies a particular exclusion only if the coverage would otherwise pose an acute problem. For example, the cost of investigating a particular type of loss can be substantial enough so that the ordinary policyholder would benefit from a provision excluding coverage for such losses. The ordinary policyholder, therefore, reasonably expects the policy to limit coverage anytime that the transaction costs of more expansive coverage—that is, the costs of creating and administering the coverage in question—exceed the value of such coverage.

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53. *Cf.* Allstate Ins. Co. v. Naai, 490 F. App'x 49, 51 (9th Cir. 2012) ("[Policyholder] offers no explanation of how his expectation of coverage [under a homeowner's policy for injuries caused by an automobile accident] could be deemed reasonable given that the policy unambiguously excludes coverage.").

54. *Cf.* Thoracic Cardiovascular Assocs. v. St. Paul Fire & Marine Ins. Co., 891 P.2d 916, 918–22 (Ariz. Ct. App. 1994) (holding that a claims made professional liability insurance policy unambiguously limited coverage to claims made within the policy period, despite the policyholder's practical inability to provide notice within this period, because such coverage would be an "unbargained-for expansion of coverage, *gratis*" as it could have been separately purchased under either an occurrence-based policy or as "an optional extension of coverage, referred to as a 'reporting endorsement,'" that would have allowed the policyholder to be covered for a claim reported "after the policy term and before the end of the term of the reporting endorsement").

55. *See, e.g.*, Baker, *supra* note 50, at 1598.

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All else being equal, the ordinary policyholder reasonably expects the insurance contract to provide the maximal amount of coverage. This expectation of coverage, however, is limited for identifiable reasons. Insurance coverage is not feasible for uninsurable risks. Even when a risk is insurable, coverage is not cost effective for the ordinary policyholder if it poses excessive problems of moral hazard or adverse selection. Risks that satisfy all of these requirements might still not be worth covering if doing so would create transaction costs that exceed the benefits of coverage. Recognizing as much, the ordinary policyholder who is well informed about these matters would reasonably expect the insurance contract to limit coverage for any of these reasons.

B. Reasonable Expectations and the Structure of the Judicial Interpretive Inquiry

When interpreting insurance contracts, courts confront a regulatory problem that is created by the poorly informed coverage decisions of policyholders. This problem is defensibly solved by judicial interpretations that strive to grant the amount of coverage that would be chosen by the ordinary policyholder if she were well informed of the relevant factors—the principle of reasonable expectations.

This interpretive approach is pro-policyholder for a defensible reason. In a well-functioning market, an insurer will provide the amount of coverage that is demanded by well-informed policyholders. The insurer will charge a premium that covers its costs and provides a margin for normal profit. Because the premium fully accounts for the insurer's interests, courts do not have to consider those interests when interpreting insurance policies. By paying the premium, policyholders both pay for the insurer's costs and derive a benefit from the coverage, and so their interests are the only ones that defensibly factor into the interpretive inquiry.[56]

An interpretive approach that only considers policyholder interests does not necessarily favor the plaintiff policyholder in each coverage dispute. The interpretation championed by an individual litigant is not necessarily identical to the one that is best for the ordinary policyholder.

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56. For the same reasons, tort rules governing the contractual relationship between product manufacturers and consumers exclude consideration of manufacturer interests. *See* RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 2 cmt. f (AM. LAW INST. 1998) ("[I]t is not a factor . . . that the imposition of liability would have a negative effect on corporate earnings or would reduce employment in a given industry.").

Insurance companies respond to aggregate consumer demand, and no individual policyholder can reasonably expect the insurer to tailor the policy language in a standard-form contract to satisfy her own particular needs.[57] As applied to interpretive questions, the individual policyholder does not reasonably expect courts to make coverage decisions that depart from the reasonable expectations of the ordinary policyholder.[58] The principle of reasonable expectations accordingly justifies the rule that the plaintiff policyholder in a particular case cannot interpret an ambiguous policy term in a manner that would be unreasonable or contrary to the interpretation of the ordinary policyholder.[59]

When considering the question of how a court should interpret policy terms that are not ambiguous, the ordinary policyholder who is well informed about the matter would want courts to depart from the plain meaning of the policy language under certain conditions. The plain meaning can be the result of uninformed coverage decisions. Recognizing as much, the reasonable policyholder would want courts to depart from the plain meaning of the policy language when doing so would provide the coverage reasonably expected by the ordinary policyholder. The principle of reasonable expectations straightforwardly justifies interpretive rules that permit departures from the plain meaning of the policy—the expectations doctrine.

In considering how courts should apply the expectations doctrine, the reasonable policyholder would sharply distinguish between two different forms of the doctrine. When defined by reference to the expectations principle, the "weak" form of the expectations doctrine applies to unambiguous policy terms that limit coverage for reasons that have

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57. For the same reasons, the tort rules of strict products liability are defined by reference to the ordinary consumer's reasonable expectations of product safety. *See* MARK A. GEISTFELD, PRINCIPLES OF PRODUCTS LIABILITY 41–42 (2d ed. 2011).

58. It is a separate question whether courts should grant coverage based on an individual policyholder's expectations derived from particular representations made by brokers or insurance agents, as coverage in these cases can be afforded under distinctive doctrines such as equitable estoppel. *See* Abraham, *supra* note 1, at 559 ("Traditionally this aim was achieved . . . through doctrines such as waiver and estoppel, which focus on specific factual interactions between particular policyholders and their insurers. The legal significance of these interactions is that they trump policy language, but typically only in the particular context in which the individual policyholder-plaintiff finds himself." (footnote omitted)).

59. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 4 cmt. e (AM. LAW INST., Discussion Draft 2015) ("In this case [of ambiguity], the question becomes whether the coverage-promoting interpretation is one that would be given to the term by a reasonable person in this policyholder's position.").

extremely weak, if any, support from the expectations principle.[60] The weak form of the doctrine also imposes relatively weak evidentiary demands on courts, in contrast to the "strong" form that involves more demanding or stronger evidentiary requirements because the unambiguous limitation of coverage finds stronger support in the expectations principle. Both forms of the expectations doctrine identify the conditions under which courts should override the plain meaning of a policy provision that limits coverage in order to protect the ordinary policyholder's reasonable expectations of coverage.

The weak form of the doctrine applies to unambiguous policy language that limits coverage for no plausible reason that can be supported by the ordinary policyholder's reasonable expectations of coverage; that is, the limitation does not plausibly pertain to the insurability of risk or the problems of moral hazard, adverse selection, market segmentation of risk, or reduction of transaction costs.[61] Absent such a reason for limiting coverage, the ordinary policyholder would reasonably expect the policy to cover the loss in question. Although unambiguous, such a limitation clearly violates the principle of reasonable expectations and is presumptively exploitative, justifying a judicial interpretation that grants coverage despite the plain meaning of the term.

This interpretation benefits policyholders by providing the amount of coverage that they would choose if well informed about the matter. The coverage is more expansive than that granted by the plain meaning of the term, but the insurer presumably did not set premiums on the reasonable expectation that coverage would be limited by the plain meaning. Sound actuarial practices would recognize that the limitation is indefensible or exploitative and unlikely to be enforceable. Rather than reducing premiums to reflect such a limitation of coverage, the insurer more likely based these premiums on the actuarially defensible assumption that coverage is available in these cases despite the unambiguous limitation of coverage. The failure of courts to grant such coverage would accordingly confer a windfall on the insurer for no defensible reason; the insurer would instead profit by exploiting the inability of the ordinary consumer to make a well-informed decision about the matter.

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60. As conventionally defined, the "weak" form of the doctrine cannot override unambiguous policy provisions, unlike the "strong" form. *See* Rahdert, *supra* note 9, at 367. The conventional definitions are not derived from the expectations principle but instead merely describe the manner in which courts expressly invoke the expectations doctrine when interpreting insurance contracts.

61. *See supra* Section II.A (identifying the types of coverage limitations that would be reasonably expected by the ordinary policyholder).

Because the weak form of the expectations doctrine is limited to policy provisions that cannot be plausibly justified by the expectations principle, courts can apply this doctrine without engaging in a complex evidentiary inquiry. A court must only determine that the unambiguous limitation of coverage has an extremely weak or nonexistent justification under the expectations principle, an analytic inquiry that does not depend on detailed information concerning the insurance market. Consequently, this application of the expectations doctrine is also "weak" in the sense that it does not depend on a demanding evidentiary inquiry.

Under the strong form of the expectations doctrine, the insurer can provide a plausible rationale for the limitation in question. The expectations principle provides stronger but not necessarily decisive support for enforcing the plain meaning of the policy language. The policy provision, for example, can limit coverage with an easily applied rule that reduces claims costs (and premiums) by an amount that plausibly exceeds the lost value of reduced coverage, in which case the provision can be justified by the expectations principle. Alternatively, the provision might unduly restrict coverage and ultimately increase total costs for the ordinary policyholder, thereby violating the expectations principle. In light of this possibility, the strong form of the doctrine would permit courts to determine whether the plain meaning of such a provision ought to be overridden by the policyholder's reasonable expectations of coverage, an inquiry that requires courts to have sufficient evidence about the associated costs and benefits of the provision. Such a full-blown cost-benefit analysis places more complex or stronger evidentiary demands on courts as compared to the weak form of the doctrine, which only requires courts to determine whether the limitation of coverage has *any* rationale that can be plausibly justified by the expectations principle.

Courts that apply the strong form of the expectations doctrine can significantly increase the legal uncertainty faced by insurers. The doctrine overrides unambiguous limitations of coverage that have a plausible rationale and can factor into the insurer's calculations of the actuarially fair premium. To the extent that the insurer is unsure about whether courts will enforce the plain meaning of such a policy provision, the resultant legal uncertainty increases the insurer's cost of capital, resulting in higher premiums.[62] Legal uncertainty also makes it more difficult for insurers to establish actuarially sound premiums, exacerbating a pricing problem that predictably causes insurance markets to cycle through "hard" and "soft" markets characterized by

62. *See* Mark A. Geistfeld, *Legal Ambiguity, Liability Insurance, and Tort Reform*, 60 DEPAUL L. REV. 539, 552–56 (2011).

substantial differences in the price and availability of insurance coverage.[63] Legal error and the associated uncertainty impose costs on the ordinary policyholder that factor into her assessment of the expectations doctrine.

A well-informed policyholder would recognize that the strong form of the expectations doctrine involves costs that could more than offset the benefits of expanding coverage by overriding unambiguous policy language. The issue depends on the strength of the evidence before the court and the associated likelihood of legal error. Unless the evidence is sufficiently strong, the resultant risk of an erroneous interpretation would lead the ordinary policyholder to reasonably expect that courts will enforce the plain meaning of unambiguous policy language.

Consequently, the ordinary policyholder who is well informed about these matters would recognize the substantive value of the plain-meaning rule. Departures from unambiguous policy language can benefit policyholders in some cases but run the risk that courts will adopt an erroneous interpretation that ultimately works to the net detriment of policyholders by increasing costs and disrupting the supply of insurance. The benefits and costs of judicial interpretation factor into the reasonable expectations of the ordinary policyholder, which is why the appropriate rules for interpreting insurance contracts can be derived from the expectations principle.

III. REASONABLE EXPECTATIONS AND THE INTERPRETIVE RULES IN THE RESTATEMENT

Having defined the ordinary policyholder's reasonable or well-informed expectations of insurance coverage, we are now in a position to more fully evaluate whether the expectations principle can justify the Restatement rules of insurance contract interpretation. The threshold question is whether the Restatement specifies objectives for the judicial interpretation of insurance policies that can be squared with the expectations principle.

> These objectives include: [1] effecting the dominant protective purpose of insurance; [2] facilitating the resolution of insurance-coverage disputes and the payment of covered claims; [3] encouraging the accurate description of insurance policies by insurers and their agents; and [4] providing clear guidance on the meaning of insurance policy terms in order to promote, among

63. *Id.* at 556–64.

> other benefits, [5] fair and efficient insurance pricing, underwriting, and claims management.[64]

The first objective of "effecting the dominant protective purpose of insurance" recognizes the value of coverage. Policyholders always value insurance; the only question for them is whether the coverage is worth the cost.[65] Consistent with this expectation, the Restatement objectives 2–4 relate to the reduction of costs that would ultimately promote objective 5 by enabling insurers to engage in "fair and efficient insurance pricing, underwriting, and claims management." These objectives conform to the ordinary policyholder's reasonable expectation that coverage, though otherwise valuable, must be limited under certain conditions in order to reduce overall costs.

The Restatement, therefore, identifies objectives for the judicial interpretation of insurance contracts that are all rendered coherent by the expectations principle. Such a unifying principle enables courts to resolve conflicts among these objectives. For example, the "dominant protective purpose of insurance" always favors coverage, whereas the cost-reducing objectives can favor limitations of coverage. To determine how these potentially conflicting objectives ought to be applied in any given case, courts can rely on the expectations principle, which is capable of specifying how all of these matters relate to the ordinary policyholder's reasonable expectations of coverage.

Consistent with this reasoning, the expectations principle also provides guidance on how courts should apply the Restatement's interpretive rules. According to these rules, courts can override the plain meaning of a term only if "a reasonable person would clearly give the term a different meaning in light of extrinsic evidence," provided that the plain meaning is "reasonably susceptible" to this alternative interpretation.[66] These questions can all be resolved by the expectations principle:

- In some cases, the plain meaning limits coverage for no plausible reason that can be supported by the reasonable policyholder's well-informed expectations of coverage (based on extrinsic evidence), and so the reasonable policyholder would "clearly" give the term a different meaning that grants

64. RESTATEMENT OF THE LAW OF LIAB. INS. § 2 cmt. c (AM. LAW INST., Discussion Draft 2015).

65. *See supra* Section II.A.

66. RESTATEMENT OF THE LAW OF LIAB. INS. § 3(2) (AM. LAW INST., Discussion Draft 2015).

coverage. The plain meaning is presumptively exploitative and unlikely to factor into the insurer's calculation of the actuarially fair premium, rendering the plain meaning "reasonably susceptible" to this different interpretation. When applied in this manner, the Restatement rules permit courts to apply the weak form of the expectations doctrine in the appropriate cases.[67]

- In the remaining cases, the plain meaning limits coverage in a manner that can be plausibly supported by the reasonable policyholder's well-informed expectations of coverage (based on extrinsic evidence). Whether the plain meaning satisfies the expectations principle, however, depends on a full cost-benefit analysis of the limitation. Unless such extrinsic evidence clearly shows that the plain meaning is unduly restrictive, then the reasonable policyholder would not "clearly" give the term a different meaning, nor would the plain meaning be "reasonably susceptible" to such an interpretation. When applied in this manner, the Restatement rules limit the strong form of the expectations doctrine to the appropriate cases.[68]

Under this approach, courts will strike an appropriate balance between the plain-meaning rule and the contextual approach for interpreting insurance contracts. As the Restatement recognizes, the rules of insurance contract interpretation should promote "fair and efficient insurance pricing, underwriting, and claims management."[69] The substantive value of the plain-meaning rule accordingly stems from the manner in which it can facilitate the actuarial and underwriting processes of establishing premiums. In contrast to a contextual or purposive interpretive approach, the plain-meaning rule is more certain in application. By reducing legal uncertainty, the plain-meaning rule supports a more stable actuarial environment, thereby facilitating the smooth operation of the insurance market. When the plain-meaning rule is interpreted in this substantive manner, exceptions to the rule can be defensibly implemented. If courts can depart from the plain meaning of a

67. *See supra* notes 60–62 and accompanying text (defining the weak form of the expectations doctrine).

68. *See supra* notes 61–64 and accompanying text (defining the strong form of the expectations doctrine).

69. RESTATEMENT OF THE LAW OF LIAB. INS. § 2 cmt. c (AM. LAW INST., Discussion Draft 2015).

policy term in a manner that is unlikely to disrupt the actuarial and underwriting processes, then the rationale for adhering to plain meaning no longer applies. All of these substantive concerns are addressed by the expectations doctrine in both its weak and strong form.

This approach is illustrated by three different unambiguous policy provisions that have been interpreted by courts. The implications of this interpretive approach are then further illustrated by an analysis that extends the expectations principle to cases involving ambiguous policy language. As the discussion shows, the Restatement has formulated the rules of interpretation in a manner that would enable courts to adequately protect the reasonable expectations of the ordinary policyholder across the full set of cases.

A. The "Weak Form" of the Expectations Doctrine as Illustrated by the Absolute Pollution Exclusion Clause

The weak form of the expectations doctrine would seem to be uncontroversial, at least in principle. If the plain meaning of a policy term unambiguously limits coverage for no reason that can be plausibly justified by the ordinary policyholder's reasonable expectations of coverage, then the provision is presumptively exploitative and not incorporated into the actuarially fair premium established by the insurer. Under these conditions, enforcing the plain meaning of the term by denying coverage is substantively problematic, and yet many courts have done so in cases involving the so-called absolute pollution exclusion in commercial general liability (CGL) policies.

> Responding to the flurry of environmental coverage litigation over the application of the 1970 "sudden and accidental" pollution exclusion, the insurance industry during the mid-1980s largely adopted new standard pollution exclusion language for CGL policies. . . . The standard form ISO CGL absolute pollution exclusion provides that the insurance does not apply to bodily injury or property damage "arising out of the actual, alleged or threatened discharge, dispersal, seepage, migration, release or escape of pollutants." A "pollutant" is defined as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste. Waste includes materials to be recycled, reconditioned, or reclaimed."
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> . . . .

> The language of the absolute pollution exclusion is obviously broad and has the potential, if read literally, to bar coverage for any bodily injury claim that involves chemicals or other irritants. Although there is no evidence that the insurance industry . . . intended this result (at least not *ex ante*), insurers have occasionally sought hyperliteral readings of the exclusion to avoid coverage. These efforts have met with mixed success. Courts are divided on the issue, with perhaps a slim majority of courts resisting . . . the hyperliteralism of some insurers. These courts have eschewed literalism and construed the absolute pollution exclusion in what might be termed a functional or instrumental manner designed to effectuate the purpose of the insurance policy and the agreement of the parties.[70]

A tally of this case law by one court in 2009 listed "representative decision[s]" from courts in seventeen different jurisdictions that applied "the exclusion literally because they find the terms to be clear and unambiguous," whereas courts in eighteen other jurisdictions "have limited the exclusion to situations involving traditional environmental pollution, either because they find the terms of the exclusion to be ambiguous or because they find that the exclusion contradicts policyholders' reasonable expectations."[71]

Courts that grant coverage for liabilities stemming from nontraditional pollution, such as the escape of carbon monoxide from a negligently maintained furnace in an apartment building,[72] are applying the weak form of the expectations doctrine. "The broad language of the exclusion cannot be read literally without eliminating coverage for many claims that fit snugly within the traditional notion of liability insurance coverage."[73] The elimination of coverage for traditional tort claims and the like, however, does not plausibly further the interests of policyholders, who lose the value of coverage without sufficient offsetting benefits. Unlike the liability risks pertaining to traditional environmental pollution, the risk that one will incur tort liability for a negligently maintained furnace is not segmented under other policies,[74]

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70. STEMPEL, *supra* note 4, § 14.11[C], at 14-165 to -167 (footnotes omitted).

71. Apana v. TIG Ins. Co., 574 F.3d 679, 682–83 & n.3 (9th Cir. 2009).

72. *Cf.* Stoney Run Co. v. Prudential-LMI Commercial Ins. Co., 47 F.3d 34, 38 (2d Cir. 1995) (applying New York law) (granting coverage under a CGL policy in such a case because "the release of carbon monoxide into an apartment is not the type of environmental pollution contemplated by the pollution exclusion clause").

73. STEMPEL, *supra* note 4, § 14.11[C], at 14-171.

74. Traditional forms of environmental liability, which all agree are governed by the absolute pollution exclusion clause, are now covered by separate forms of insurance such as

nor is such a risk excluded from coverage under the CGL policy for any other reason that can be plausibly justified by the expectations principle. As compared to other forms of traditional tort liability, the escape of carbon monoxide from a negligently maintained furnace does not pose particularly acute problems of moral hazard that would justify a special limitation of coverage, nor does the coverage involve transaction costs any different from those posed by most other forms of tort liability. By defining pollution to encompass nontraditional sources such as the escape of carbon monoxide from a negligently maintained furnace, the absolute pollution exclusion is presumptively the product of overbroad drafting, limiting a basic form of coverage in a way that is not plausibly justified by the expectations principle. Consequently, courts that override the plain meaning of the exclusion to grant coverage for liabilities stemming from nontraditional pollution are applying the weak form of the expectations doctrine.

Under the weak form of the expectations doctrine, courts override a term with a plain meaning that is presumptively exploitative and not plausibly factored into the insurer's calculation of the actuarially fair premium. The absolute pollution exclusion satisfies these conditions for reasons identified by Jeffrey Stempel's historical analysis of this clause:

> [A] decade after the implementation of the exclusion, one continues to see no powerful insurer evidence supporting the current breadth claimed for the exclusion. But if the exclusion was truly designed to radically change the CGL and remove toxic torts and similar incidents from coverage, one would have expected a great deal of direct evidence to this effect.[75]

Put somewhat differently, if insurers had set premiums on the assumption that the absolute pollution exclusion would substantially limit coverage for nontraditional forms of pollution, one would expect to find some direct evidence to that effect.

> Conversely, policyholder counsel have presented a good deal of evidence suggesting that insurers, policyholders, risk managers,

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the Environmental Impairment Liability policy. *See id.* § 22.09, at 22-48 (discussing these policies). These policies narrowly define the scope of coverage to "environmental damage," *id.* § 22.09, at 22-50, and would not cover tort liabilities such as bodily injury caused by the escape of carbon monoxide from a negligently maintained furnace.

75. Jeffrey W. Stempel, *Reason and Pollution: Correctly Construing the "Absolute" Exclusion in Context and in Accord with Its Purpose and Party Expectations*, 34 TORT & INS. L.J. 1, 36 (1998).

> brokers, and regulators expected the exclusion to only preclude coverage for the sort of gradual pollution claims that were slipping by the qualified "sudden and accidental" exclusion and to save insurers from the feared avalanche of Superfund-type [environmental] claims.[76]

The drafting history shows that insurers intended to bar coverage for traditional environmental pollution subject to "Superfund-type" legal liability, no matter how the pollution occurred. Having set premiums with respect to environmental liabilities only on the basis of this limitation, insurers would gain a windfall at the expense of policyholders through legal interpretations that extend the exclusion to nontraditional forms of pollution subject only to tort liability and the like. The rationale for the weak form of the expectations doctrine is fully illustrated by the absolute pollution exclusion clause.

The evidence regarding the drafting history of the absolute pollution exclusion, though instructive, is not required in order for a court to apply the weak form of the expectations doctrine. The doctrine applies for analytic reasons pertaining to the economic logic of the insurance transaction and does not otherwise require evidence concerning the insurance market.[77] Without any plausible rationale for the limitation of coverage as applied to nontraditional forms of pollution, the plain meaning of the exclusion is presumptively exploitative. If a court were to give the term an alternative meaning based on extrinsic evidence of its undisputed purpose, the departure from plain meaning would not likely upset the insurer's premium calculations. Consequently, the court can interpret the clause solely on the basis of the extrinsic evidence described earlier showing that the unambiguous policy language limits coverage for no reason that plausibly works to the net benefit of the ordinary policyholder.

The absolute pollution exclusion accordingly provides a good test for the interpretive rules in the Restatement. By relying on the Restatement, could judges adopt the interpretation justified by the weak form of the expectations doctrine?

Consider again a case in which the policyholder landlord incurs tort liability to a tenant for bodily injury caused by a negligently maintained furnace in the building that emitted carbon monoxide into the tenant's apartment. The injury was caused by a chemical and is expressly

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76. *Id.* at 27.
77. *See supra* Section II.B.

excluded from coverage,[78] giving it a "plain meaning" as defined by the Restatement:

> The plain meaning of an insurance policy term is the single meaning, if any, to which the language of the term is reasonably susceptible when applied to the claim at issue, in the context of the insurance policy as a whole, without reference to extrinsic evidence regarding the meaning of the term.[79]

The Restatement permits courts to depart from the plain meaning of the exclusion if "a reasonable person would clearly give the term a different meaning in light of extrinsic evidence."[80] Such an interpretation "can be determined from sources such as learned treatises, insurance industry trade literature, the drafting history of the policy, prior court decisions, statements made to regulatory agencies during the policy approval process, expert testimony, and comparison with other insurance policy forms available on the market."[81] Based on this type of extrinsic evidence about the purpose of the absolute pollution exclusion, a reasonable policyholder evaluating the negligence claim against the landlord would "clearly" give the absolute pollution exclusion clause a meaning different from its plain meaning as required by the Restatement. A court, however, must then conclude that this "different meaning [is] one to which the language of the term is reasonably susceptible after consideration of the extrinsic evidence."[82]

Because the meaning of "reasonably susceptible" is not defined by the Restatement or otherwise self-defining, disagreement about the matter could yield a split in the case law like the one that now exists. Courts that have exclusively relied on the absolute pollution exclusion's plain meaning could conclude that this language is not "reasonably susceptible" to the different interpretation that grants coverage for nontraditional forms of pollution, whereas courts that have granted coverage in these cases could conclude that the plain meaning of the exclusion is "reasonably susceptible" to such an interpretation. If courts were to split over the meaning of the "reasonably susceptible"

78. *See* STEMPEL, *supra* note 4, § 14.11[C], at 14-166 ("A 'pollutant' is defined [for purposes of the absolute pollution exclusion clause] as 'any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste.'" (footnote omitted)).

79. RESTATEMENT OF THE LAW OF LIAB. INS. § 3(1) (AM. LAW INST., Discussion Draft 2015).

80. *Id.* § 3(2).

81. *Id.* § 4 cmt. m.

82. *Id.* § 3(2).

requirement, then this interpretive approach would accurately restate the existing law.

Interpreting the Restatement rules so that they recreate splits in the case law, however, cannot be squared with the underlying objectives of these rules, particularly the concern for consistency.

> Insurance policies generally are standard-form contracts sold on a mass-market basis. . . . Adjudication of the meaning of a standard-form term in one case has consequences for the scope of the risks insured under all similar policies. Interpretive rules that give the same meaning to an insurance policy term in all contexts facilitate the orderly operation of the insurance market and, accordingly, are preferred.[83]

The Restatement's interpretive rules will not attain consistent results if courts do not strike the right balance between the plain-meaning rule and the contextual approach based on extrinsic evidence. To do so, courts must recognize that enforcing the plain meaning of a policy term has substantive value only insofar as the plain meaning factors into the insurer's calculation of the actuarially fair premium.[84] That requirement is not satisfied in the case of a landlord policyholder subject to traditional tort liability for carbon monoxide poisoning caused by a negligently maintained furnace. Highly persuasive evidence shows that the purpose of the absolute pollution exclusion is to limit coverage only for traditional forms of environmental liability, a rationale that is clearly inapplicable to the case at hand. Consequently, the plain meaning of the exclusion is "reasonably susceptible" to an interpretation that grants coverage to the landlord policyholder in our example. When applied in this manner, the interpretive rules in the Restatement permit judicial interpretations that satisfy the weak form of the expectations doctrine in the appropriate cases.

B. The "Strong Form" of the Expectations Doctrine as Illustrated by the "Forcible Entry" Requirement in Property Insurance

Unlike the weak form of the expectations doctrine, the strong form does not invariably justify an interpretation that overrides the plain meaning of the policy language. The strong form of the doctrine applies to a policy term that unambiguously limits coverage for one or more reasons

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83. *Id.* § 2 cmt. d.
84. *See supra* Section II.B.

that can be plausibly justified by the ordinary policyholder's reasonable expectations of coverage. To decide whether the plain meaning should be overridden by an alternative interpretation based on extrinsic evidence of purpose and the like, the court must evaluate the strength of the evidence in favor of the alternative interpretation. If the evidence is not sufficiently persuasive, the alternative interpretation runs too great a risk of being erroneous, justifying an interpretation based on the plain meaning of the policy language.

To see why, consider the interpretive problem regarding unambiguous policy provisions pertaining to the definition of a "burglary" covered by property insurance:

> One example of a burglary definition in a businessowner's policy covers loss by burglary defined as "the taking of property from inside the described premises by a person unlawfully entering or leaving the premises as evidenced by marks of forcible entry or exit." The purpose of such a clause is to limit coverage to the forcible taking of property by "outsiders," meaning persons other than the insured or those who work for the insured. It is the insured's responsibility to take reasonable steps to secure the insured's own property; the insurer does not want to be liable if the insured fails to take such steps, such as locking a door. Moreover, the insurer does not intend to provide coverage for "inside jobs"—thefts by the insured or the insured's employees. It is the insured's responsibility to safeguard [including the purchase of separate coverage] against theft by persons with regular access to areas where property is stored. In the absence of visible marks of forcible entry, it is more likely that property has simply been mislaid or that the insured or an employee appropriated the property.[85]

The potential problem with such a clause, as Robert Jerry and Douglas Richmond have observed, is that although it is "drafted with good intentions, sometimes an insured will be burglarized and the burglar will leave no visible marks."[86] In cases of this type, "courts have sometimes interpreted the visible marks condition as an evidentiary requirement not determinative of coverage. Other courts have enforced the conditions according to their literal terms."[87] But the problem, as at

85. JERRY & RICHMOND, *supra* note 31, § 62B[b], at 402–03 (paragraph structure and footnotes omitted).

86. *Id.* at 403.

87. *Id.* (footnotes omitted).

least one court has recognized, implicates the doctrine of reasonable expectations, requiring a determination of whether the plain meaning of the clause frustrates the policyholder's reasonable expectations of coverage.[88]

To override the unambiguous policy language requiring evidence of forcible entry, courts cannot apply the weak form of the expectations doctrine. The policy provision was plausibly drafted with the good intentions of (1) combating moral hazard and fraudulent claims, (2) reducing the insurer's costs of investigation, and (3) maintaining the integrity of risk segmentation attained by two different lines of policies—one covering only burglaries, and the other (a fidelity bond) covering only thefts by employees. The policy provision accordingly reduces costs for policyholders in a manner that plausibly exceeds the lost value of coverage for burglaries that leave no evidence of forcible entry. The limitation, however, could instead be exploitative by limiting coverage in an overbroad manner—the reduction of costs for policyholders might not exceed the lost value of coverage for burglaries of this type. To determine whether the plain meaning of this provision should be overridden by an alternative interpretation based on extrinsic evidence of purpose, courts must evaluate the total costs and benefits of the provision requiring evidence of forcible entry. The interpretive inquiry required by this particular policy provision is substantially more demanding than the one required by the weak form of the doctrine, which only asks whether there is any reason why the provision could be plausibly justified by the expectations principle.

Unless the evidentiary record is sufficiently complete and accurate, courts can reach erroneous conclusions about the costs and benefits of the provision as drafted. A court that relies on the expectations doctrine to override the plain meaning of the "forcible entry" requirement has effectively eliminated that requirement from the policy. In future cases, any policyholder who has suffered a loss of property without evidence of forcible entry would be able to invoke the expectations doctrine to justify coverage. The evidentiary requirement no longer reduces costs and lowers premiums; it instead is replaced by an expansion of coverage that benefits policyholders in burglary cases lacking evidence of forcible entry. Unless the court reaches a correct conclusion about the relative magnitude of these costs and benefits, policyholders as a class will be harmed by the mistaken interpretation that grants coverage despite the unambiguous policy language requiring evidence of forcible entry.

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88. Atwater Creamery Co. v. W. Nat'l Mut. Ins. Co., 366 N.W.2d 271, 275 (Minn. 1985) (en banc).

For these reasons, the ordinary policyholder is concerned about the risk of an erroneous interpretation that overrides unambiguous policy language. The magnitude of that risk depends on the complexity of the coverage question and the strength of the evidence. If a court decides that the risk of an erroneous interpretation is too high, then it can conclude that the plain meaning of the policy language is not "reasonably susceptible" to the alternative interpretation as required by the Restatement.[89] Departing from the plain meaning is not reasonable in these cases because the ordinary policyholder who is well informed about these matters would expect courts to enforce the plain meaning of the provision due to the unduly high risk that the alternative interpretation is erroneous.

C. The "Strong Form" of the Expectations Doctrine as Illustrated by Late Notice Provisions

Although the strong form of the expectations doctrine would seem to be more controversial than the weak form, the issue ultimately depends on the complexity of the coverage question and the strength of the evidence before the court. In some cases, the strong form of the doctrine is not a controversial method for overriding the plain meaning of a policy term. A good example is provided by policy provisions requiring the insured to notify the insurer of a claim under the policy.

"Most policies purport to require the insured to give the notice 'immediately,' 'as soon as practicable,' or 'as soon as possible,' but courts have interpreted this language as requiring notice to be given within a reasonable time in light of all the circumstances."[90] Most courts have further departed from the plain meaning of the policy language by adopting the additional requirement that "late notice does not discharge the insurer's duties unless the insurer is prejudiced as a result of the late notice."[91]

Courts in these cases depart from the plain meaning of the policy language by applying the strong form of the expectations doctrine. "The

89. RESTATEMENT OF THE LAW OF LIAB. INS. § 3(2) (AM. LAW INST., Discussion Draft 2015).

90. JERRY & RICHMOND, *supra* note 31, § 81[c], at 575; *see also* STEMPEL, *supra* note 4, § 9.01[A], at 9-6 ("A typical notice provision in a CGL policy provides that in the event of 'occurrence, claim or suit' the policyholder must notify the insurer as soon as 'practicable' . . . . Some liability policies require 'immediate' notice, although these tend to be read by courts as if they required only 'reasonably prompt' notice.").

91. JERRY & RICHMOND, *supra* note 31, § 81[e], at 580; *see also* Prince George's Cty. v. Local Gov't Ins. Tr., 879 A.2d 81, 93–94, 94 n.9 (Md. 2005) (finding that thirty-eight states have clearly adopted the rule requiring prejudice in order to bar coverage for late notice).

primary purpose of the notice of loss provision is to enable the insurer to investigate the circumstances of the loss or claim before information becomes stale or disappears . . . ."[92] This purpose is obviously furthered by the plain meaning of immediate or prompt notice. By not requiring any additional proof of prejudice, the plain meaning of the policy language further reduces the costs of processing claims and can benefit policyholders in this respect as well. The plain meaning of the policy language, therefore, plausibly works to the net benefit of policyholders. Only the strong form of the expectations doctrine can justify the majority rule that overrides the unambiguous policy language by instead requiring policyholders to give reasonably prompt notice or otherwise not prejudice the insurer in the event of late notice.

In applying the majority rule, courts are applying the strong form of the expectations doctrine, but doing so is not controversial. Courts have extensive experience with the types of issues implicated by the notice provision. The provision serves purposes fundamentally similar to those furthered by other legal rules in other contexts, most notably statutes of limitations.[93] The judicial familiarity with the costs and benefits of notice explains why courts are so confident about their interpretation of notice provisions in insurance policies. The risk of erroneously interpreting the notice provision to require "reasonably" prompt notice and prejudice in the event of late notice—that is, the risk of unduly increased transaction costs—most likely is outweighed by the benefits of extending coverage to cases in which the notice was not immediate and the insurer was not otherwise prejudiced. Such an interpretation would be reasonably expected by the ordinary policyholder, and so the unambiguous policy language requiring "prompt" notice is "reasonably susceptible" to the interpretation requiring "reasonably prompt" notice or a showing that the insurer has otherwise been prejudiced in the event of late notice, thereby satisfying the Restatement's interpretive rules.

The Restatement, therefore, does not foreclose courts from applying the strong form of the expectations doctrine to override an unambiguous limitation of coverage. To do so, however, courts must evaluate the underlying substantive issues in light of the available evidence. The interpretive inquiry in these cases requires courts to evaluate the costs and benefits of departing from the plain meaning of the policy language. Unless courts are sufficiently confident about their conclusion, the risk of

92. JERRY & RICHMOND, *supra* note 31, § 81[a], at 572–73.

93. *Cf.* DAN B. DOBBS, THE LAW OF TORTS § 216, at 551–52 (2000) (listing the various "justice and process concerns" that courts have invoked to justify statutes of limitations, including that "[e]vidence will deteriorate as memories fade" and that "insurers find it costly to insure against a defendant's liability for an indefinite time into the future").

an erroneous interpretation outweighs the benefit of expanding coverage by departing from the unambiguous policy language. The costs and benefits of judicial interpretation factor into the ordinary policyholder's reasonable expectations of coverage, providing a substantive basis for determining whether unambiguous policy language is nevertheless "reasonably susceptible" to an alternative interpretation as required by the Restatement.

D. Reasonable Expectations and the Interpretation of Ambiguous Policy Language

In addition to providing a method for interpreting policy terms with an unambiguous or plain meaning that limits coverage in a questionable manner, the expectations principle also provides a method for interpreting ambiguous terms without a plain meaning. Under the Restatement, an unambiguous policy provision can be overridden by extrinsic evidence showing that the plain meaning is "reasonably susceptible" to an alternative interpretation, whereas an ambiguous policy provision must be interpreted in a reasonable manner.[94] For each type of case, courts can evaluate the reasonableness of a proposed interpretation by relying on the expectations principle.

Most obviously, an interpretation is unreasonable if it cannot be plausibly supported by the ordinary policyholder's reasonable expectations of coverage. The plaintiff policyholder must offer an interpretation of the ambiguous language that permits the policy provision to limit coverage for reasons that plausibly pertain to the insurability of risk or the problems of moral hazard, adverse selection, market segmentation of risk, or reduction of transaction costs.[95] Any other interpretation of the ambiguous language would be unreasonable for the same reasons that the plain meaning of such a policy term is rendered unreasonable under the weak form of the expectations doctrine.[96]

The remaining cases of ambiguity involve two competing interpretations that are each plausibly justified by the expectations principle, making the policy language "reasonably susceptible" to either

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94. *Compare* RESTATEMENT OF THE LAW OF LIAB. INS. § 3(2) (AM. LAW INST., Discussion Draft 2015) (defining rule for overriding the plain meaning of a policy term), *with id.* § 4(2) (defining rule for interpreting ambiguous policy terms).

95. *See supra* Section II.A (identifying the types of coverage limitations that would be reasonably expected by the ordinary policyholder).

96. *See supra* Section II.B.

interpretation.[97] In these cases, the Restatement adopts the interpretive rule of contra proferentem: "When an insurance policy term is ambiguous, the term is interpreted in favor of the party that did not supply the term, unless the other party persuades the court that this interpretation is unreasonable in light of extrinsic evidence."[98]

The Restatement's formulation of contra proferentem differs from the "mechanical version of the . . . rule, in which the drafter always loses whenever a term is found to be facially ambiguous when applied to the claim in question, without any reference to extrinsic evidence to ascertain whether the coverage promoting interpretation is unreasonable in context."[99] The Restatement rejects the "mechanical version" of contra proferentem on the ground that it "sometimes produces outcomes that are not consistent with the reasonable expectations of the policyholder."[100] To address this problem, the Restatement permits the insurer to rely on extrinsic evidence proving that the policyholder's proposed interpretation is unreasonable, as doing so is "more likely to result in outcomes that are consistent with the reasonable expectations of the policyholder."[101]

Unless properly applied, the Restatement's formulation of contra proferentem could frustrate the reasonable expectations of the ordinary policyholder. To show that a plaintiff policyholder's interpretation in favor of coverage is unreasonable, the defendant insurer could introduce extrinsic evidence concerning the costs and benefits of coverage. Although the policyholder's interpretation is plausibly justified by the expectations principle, further inquiry into the costs and benefits of such coverage could prove otherwise, in which case the policyholder's proposed interpretation would be unreasonable. But hotly contested disputes involving a full-blown cost-benefit analysis of coverage will ordinarily be quite costly and prolonged, leading to the question of whether the ordinary policyholder would reasonably expect courts to consider extrinsic evidence of this type when interpreting ambiguous policy language.

Resolution of this question implicates the same concerns addressed by the strong form of the expectations doctrine. When evaluating an interpretive rule, the ordinary policyholder will consider litigation costs and the risk of legal error. For these reasons, the strong form of the

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97. RESTATEMENT OF THE LAW OF LIAB. INS. § 4(1) (AM. LAW INST., Discussion Draft 2015) (adopting this definition for an ambiguous policy term).

98. *Id.* § 4(2).

99. *Id.* § 4 cmt. j.

100. *Id.*

101. *Id.*

expectations doctrine provides a basis for courts to evaluate two competing interpretations of policy language that can each be plausibly justified by the expectations principle.[102] So, too, the ordinary policyholder who is well informed about these matters would consider how litigation costs and the risk of legal error should factor into the rule of contra proferentem as applied to two competing interpretations of ambiguous policy language, each of which can be plausibly justified by the expectations principle.

As compared to interpretations that override the plain meaning of policy language, the interpretation of ambiguous policy language ordinarily involves a lower risk of legal error that can disrupt the pricing and supply of insurance. When a particular limitation of coverage factors into the insurer's calculation of its expected indemnity costs, the insurer is more likely to ensure that the provision is not ambiguous in the first instance. Ambiguous limitations of coverage, therefore, will ordinarily play a less decisive role in the pricing and supply of insurance as compared to the unambiguous limitations of coverage governed by the strong form of the expectations doctrine. Moreover, if the court were to grant coverage in the case at hand when a limitation of coverage would, in fact, be better for policyholders across all cases, then the insurer could rectify matters by redrafting to eliminate the ambiguity. The insurer does not have that option with respect to policy language that was not ambiguous in the first instance, which is another reason why the risk of legal error is a dominant concern for the expectations doctrine.[103] In contrast to the expectations doctrine, the risk of legal error is typically much less of a concern for the ambiguity doctrine of contra proferentem.

Under limited conditions, however, the risk of legal error is a prominent concern. The ambiguous language may govern a large number of high-stake cases for which redrafting is not an option, as with decades-old CGL policies that cover current liabilities for traditional forms of pollution, subject to the "sudden and accidental" exclusion.[104] When the costs of an erroneous interpretation are substantial, the ordinary policyholder would reasonably expect courts to engage in a costly inquiry for determining whether an individual plaintiff's interpretation is reasonable.

But in other cases of ambiguity, the primary concern for the ordinary policyholder involves the reduction of litigation costs. Rather than trying to "perfect" the policy language through a costly inquiry into the single

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102. *See supra* Section II.B.

103. *See supra* text accompanying notes 88–89.

104. *Cf. supra* text accompanying note 70 (discussing the "flurry of environmental coverage litigation" over this clause and its subsequent revision).

best interpretation of the ambiguity, the ordinary policyholder could reasonably expect courts to avoid these costs by deeming any interpretation of ambiguous policy language "reasonable" if it can be plausibly justified by the expectations principle. A particular plaintiff's interpretation of the ambiguous policy language might be erroneous when evaluated by reference to a complete evidentiary record, but the risk of legal error is not a significant concern in these cases, unlike the reduction of litigation costs. Consequently, if the extrinsic evidence shows that the plaintiff policyholder's interpretation can be plausibly justified by the expectations principle, then a concern for cost would enable a court to foreclose the defendant insurer from introducing any other extrinsic evidence. The plaintiff's interpretation would prevail.

So, too, for cases in which the extrinsic evidence entails a relatively simple inquiry into the reasonableness of the plaintiff's proposed interpretation, the court could permit the insurer to introduce extrinsic evidence of this type. The reasons for doing so are no different from those that enable a court to apply the strong form of the expectations doctrine to override an unambiguous limitation of coverage.[105] In each type of case, the extrinsic evidence does not require the court to engage in an overly complicated and costly inquiry posing a significant risk of legal error. Under these conditions, the ordinary policyholder would reasonably expect the court to consider such evidence when interpreting the policy. Reliance on such evidence, therefore, would further the Restatement's objective of applying contra proferentem to achieve "outcomes that are consistent with the reasonable expectations of the policyholder."[106] Like other interpretive questions, courts can resolve issues pertaining to contra proferentem by relying on the expectations principle.

CONCLUSION

The interpretation of any written document, whether an insurance policy or the U.S. Constitution, obviously depends on its plain meaning—what the drafter presumably intended by the chosen language—and yet a purely textual interpretation is problematic for reasons discussed by Stanley Fish in his review of a book on constitutional interpretation:

105. *See supra* Section III.C (illustrating this approach with policy provisions requiring prompt notice).

106. RESTATEMENT OF THE LAW OF LIAB. INS. § 4 cmt. j (AM. LAW INST., Discussion Draft 2015).

> Not going outside the text leaves the text [of] a document profoundly unresponsive to our goals and aspirations because our goals and aspirations—the huge number of unwritten ones—have been edited out. . . . [W]e have unwritten constitutions in every area of our discursive life. Whether it is the law, or higher education, or politics, or shop talk, or domestic interactions, utterances and writings are meaningful only against the background of a set of assumptions they do not contain. Textualism is not only a nonstarter in constitutional interpretation; it is a nonstarter everywhere.
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> When your spouse or partner says, "We don't go out anymore," what does he or she mean? Well, it depends on within which unwritten constitution—which understanding of the protocols and hazards of the domestic project—you are hearing the words. Parsing them lexically and grammatically isn't going to help you. What might help—or at least put you in the ballpark—is a sensitivity to everything that has happened in the course of a continuing relationship. The last thing you want to do in a situation like this is be a clause-bound literalist and start researching the number of days the two of you have gone out. That's not what is at stake and you will have a chance of knowing what is at stake only if, as you listen to the words, you are hearkening to the unwritten constitution of your life together.[107]

Recognizing that textualism is also a nonstarter for interpreting insurance contracts, the Restatement embraces the contextual or purposive approach while also trying to retain the value of the written text, resulting in a set of rules that strive to balance these two interpretive methods. Throughout the Restatement, the balance depends on whether the plain meaning of the text is "reasonably susceptible" to an alternative interpretation based on extrinsic evidence of purpose and the like.

To apply the Restatement's interpretive rules, courts will have to interpret the meaning of the "reasonably susceptible" requirement. It cannot be solely a matter of the linguistic properties of the textual language, for otherwise the interpretive exercise would devolve into a cumbersome form of textualism. Some substantive principle—the

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107. Stanley Fish, Opinion, *Is There a Constitution in This Text?*, N.Y. TIMES (Oct. 8, 2012, 9:00 PM) (reviewing AKHIL REED AMAR, AMERICA'S UNWRITTEN CONSTITUTION (2012)), http://opinionator.blogs.nytimes.com/2012/10/08/is-there-a-constitution-in-this-text/?_r=0.

animating ideal of insurance law's "unwritten constitution"—must guide the interpretive exercise in a manner that gives value to the plain meaning of the policy language.

The most promising approach resides in the expectations principle. Courts widely recognize that they should interpret insurance policies in order to protect the ordinary policyholder's reasonable expectations of coverage, but they have not formulated the expectations doctrine in a sufficiently clear or reliable manner. "According to a number of insurance law scholars, this variability in the case law is emblematic of the reasonable expectations doctrine's inherent vagueness and lack of predictability."[108] The solution lies in a more rigorous specification of the ordinary policyholder's reasonable expectations of coverage, one that can be fully incorporated into the interpretive approach adopted by the Restatement.

When interpreted in this manner, the Restatement permits courts to override the plain meaning of a policy term under a limited set of conditions. The plain meaning of a policy term can be the product of insurer practices that exploit policyholders who do not read or otherwise adequately understand the contract. By departing from the plain meaning of a term, courts can interpret the policy to provide the amount of coverage that would be expected by policyholders if they were well informed. Interpretations that depart from the policy language, however, run the risk of being erroneous, yielding coverage decisions that ultimately harm the ordinary policyholder. For this reason, the reasonable policyholder values the plain meaning of the policy language insofar as it reduces the risk of legal error and the associated costs of uncertainty that insurers impound into the premium that they charge for the policy. Once the value of plain meaning has been incorporated into the ordinary policyholder's reasonable expectations of coverage, the expectations principle can be translated into a set of interpretive rules that correspond to those adopted by the Restatement, making it possible for courts to determine whether the plain meaning of the policy language is "reasonably susceptible" to an alternative interpretation based on extrinsic evidence of purpose and the like. So interpreted, the Restatement strikes a defensible balance between the plain-meaning rule and the contextual or purposive approach to the judicial interpretation of insurance policies.

The logic of this interpretive approach also applies to ambiguous policy provisions without a plain meaning, as the underlying issues pertaining to cost provide a basis for courts to determine what types of

108. Schwarcz, *supra* note 35, at 1429.

extrinsic evidence should be admissible for evaluating the reasonableness of the policyholder's proposed interpretation. Once again, the Restatement's interpretive rules for these cases contain important ambiguities, but as in the other types of cases, these ambiguities can all be resolved by the principle that courts should interpret insurance policies in the manner reasonably expected by the ordinary policyholder—the regulative ideal of insurance law.[109]

109. *Cf.* Abraham, *supra* note 6, at 59 (characterizing the "expectations principle as a regulative ideal").