THE EXPECTATIONS PRINCIPLE AS A REGULATIVE IDEAL

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INTRODUCTION

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

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

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

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

I. THE LIMITED SCOPE OF THE EXPECTATIONS "DOCTRINE"

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

7. See Keeton & Widiss, supra note 1, § 6.10(a), at 734.
8. See Henderson, supra note 2, at 828.
9. See id. at 828-29.
Finally, the doctrine is even more rarely invoked in commercial coverage disputes than in consumer cases.

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

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

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

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

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

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

II. THE SIGNIFICANCE OF THE EXPECTATIONS “PRINCIPLE”

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

As a regulative ideal, the expectations principle reflects an elegantly simple notion, which is why the principle serves so powerful an ideal. This is the notion that people should be able to buy the insurance that they reasonably want. Accompanying this notion is a corollary: people should not be led to believe that they have the insurance they reasonably want, when in fact they do not have that insurance. Since both the principle and the corollary refer to reasonable expectations of coverage, these are for the most part statements about the expectations of the vast majority of policyholders, not of isolated individuals. An expectation of coverage is most likely to be reasonable, after all, if a large number of people hold it in common. Indeed, most expectations of coverage held by the vast majority
of policyholders are reasonable, and most expectations that are not held by the vast majority of policyholders are not reasonable.\textsuperscript{11} Thus, taken together, the expectations principle and its corollary constitute a normative statement about the proper relation between the supply side of the insurance market and the demand side of the market. As a normative statement about this relation, the expectations “principle” is a regulative ideal that influences legal and policy decisionmakers in a variety of ways far more important than does the expectations “doctrine” proper. Re-addressing what I described earlier as four of the major developments in insurance law in the last two decades reveals how influential the expectations “principle” actually is.

\textbf{A. The Rise of Managed Health Care}

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

\textbf{B. The Explosion of CGL Coverage Litigation}

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

\textsuperscript{11} The exceptions to this generalization can be found in the occasional cases in which the expectations doctrine is employed because particular insurance company behavior created an individual policyholder’s expectation. See \textit{Kenneth S. Abraham, Distributing Risk: Insurance, Legal Theory, and Public Policy} 104–09 (1986).

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

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

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

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

15. ROBERT E. KEETON, INSURANCE LAW § 6.3(a), at 352 (1971).
reasonably have expected coverage of liability for damage caused by a gradually-occurring discharge of pollutants.16 One finds this same theme running through any number of decisions rejecting interpretations proposed by policyholders.

C. Large Verdicts for Insurer Bad Faith

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

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

D. Auto Insurance Rate Controversies

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


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

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

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

\textbf{CONCLUSION}

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

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\textsuperscript{18} See, \textit{e.g.}, Calf\textsuperscript{a}m Ins. Co. v. Deukmejian, 771 P.2d 1247 (Cal. 1989) (ruling on the constitutionality of Proposition 103).
\end{flushleft}
that leads to necessary *limitations* on the form and amount of insurance
that is sold is counterintuitive. Although this insight is not unique to
insurance,\(^{21}\) insurance is certainly the field in which this phenomenon is
most salient.

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

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