JUDGE-MADE LAW AND JUDGE-MADE INSURANCE: HONORING THE REASONABLE EXPECTATIONS OF THE INSURED*

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THE sharing and avoidance of risk through insurance is a phenomenon of incalculable importance. Insurance protects against financial misfortune caused by fire, liability, and other casualties, and it helps mitigate the adverse financial effects of ill health, disability, and death. The average citizen may be covered by social security, workers' compensation, life, health, accident, disability, homeowners', and automobile insurance. Insurance also figures prominently in the planning of business ventures from small to multinational. Yet, the intricacies of insurance mystify not only laypeople, but also most lawyers.

The obvious importance of insurance to our social and economic livelihoods, however, suggests that insurance law should be brought into the mainstream of our jurisprudence. This article attempts part of that task by exploring a widely recognized but dimly understood phenomenon in insurance law: courts consistently favor policyholders in disputes with insurers. The casual observer often can find little doctrinal support for such decisions other than the maxim that an instrument is to be construed against its drafter. Often courts even seem to search for an ambiguity to construe against the insurer. It is easy to conclude that this simply reflects an unprincipled preference for the policyholder at the expense of the deep-pocketed insurer, contrary policy provisions notwithstanding.

The courts, however, are beginning to articulate the reasons underlying their decisions in such cases. In many states, a principle authorizing the courts to honor the "reasonable expectations" of the insured is emerging.[1] This "expectations principle" is used to justify a wide range of decisions granting policyholders coverage in

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[1] *See* R. KEETON, BASIC TEXT ON INSURANCE LAW 350-57 (1971).

spite of policy language that seems to deny it.

In some ways, the expectations principle parallels certain contract law doctrines through which courts commonly alter otherwise legally enforceable relationships between contracting parties. But the expectations principle is more than a combination of such doctrines under another name. Many expectations decisions are unique because they turn on the nature of insurance marketing or the purposes particular kinds of insurance must serve. Still others may be explained primarily as judicial efforts to fill the vacuum created by weak administrative regulation of the insurance industry.[2]

The expectations principle is thus more than an unprincipled judicial preference for the insured; it is a discrete legal principle that can be analyzed, shaped to serve a variety of ends, and appropriately limited. This article attempts such an analysis. The first section examines the judicial development of the expectations principle by analyzing the major cases that have employed it. The second section explores several possible justifications for the principle. These can be broadly classified as promoting efficiency, equity, and risk distribution. Despite the legitimacy of such goals, the expectations principle has limitations. If these limitations are not properly recognized, improper use of the principle may lead to misapplication and to undesirable social and economic consequences. The third section tries to pinpoint these limitations and suggests guidelines for appropriate application of the expectations principle.

I. The Expectations Principle Proper

Although there were rumblings earlier, it was not until the 1960's that courts began to accept the argument that they should

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[2] With respect to these cases, Professor Keeton has identified a second principle, distinct from the expectations principle, which denies the insurer an unconscionable advantage. *See* Keeton, *Insurance Law Rights at Variance with Policy Provisions* (pt. 1), 83 Harv. L. Rev. 961, 963-64 (1970). He has defined that principle as follows:

> An insurer will not be permitted an unconscionable advantage in an insurance transaction even though the policyholder or other person whose interests are affected has manifested fully informed consent.

Id. at 963. This principle looks more to the substance of policy provisions than to the expectations of the insured. Courts, however, often fail to recognize this distinction. *See* text accompanying notes 11-13 & 45-58 *infra.*

honor the reasonable expectations of the insured, despite the presence of policy provisions negating coverage. The argument first succeeded in connection with accident,[3] life,[4] and liability[5] insurance, but was soon successfully invoked in other situations as well. By 1970, there were enough cases for Professor Robert E. Keeton to express the principle in formal terms:

> The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations.[6]

In the next decade, the principle was invoked frequently.[7] It is now clear that the expectations principle is being employed in varying situations and with varying justifications. The courts have employed the expectations principle in cases where the insured's expectation of coverage was probably real and reasonable.[8] They have also employed it where an expectation of coverage was less probable, but the policy's denial of coverage seemed unfair.[9] Finally, they have relied on the principle even where an expectation of coverage was improbable and the denial of coverage would not appear unfair.[10] In short, the judicial concept of an "expectation" of coverage is not a monolithic one.

The expectations principle is best understood by examining the opinions that have developed it. Several themes common to those opinions are worth noting in advance. First, although literal application of the principle seems to require that the insured in question actually expected coverage and that his expectation was reasonable, courts have generally focused instead on whether any reasonable insured might have expected coverage. Second, the courts often have not explained the source of the insured's "rea-

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[3] *See* Kievet v. Loyal Protective Life Ins. Co., 34 N.J. 475, 170 A.2d 22 (1961).

[4] *See* Ransom v. Penn Mut. Life Ins. Co., 43 Cal. 2d 420, 274 P.2d 633 (1954).

[5] *See* Gray v. Zurich Ins. Co., 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966).

[6] Keeton, *supra* note 2, at 967.

[7] The author's count yields opinions voicing the expectations principle in over 100 cases, decided both before and after Professor Keeton's article. *See, e.g.,* cases compiled in Note, *A Reasonable Approach to the Doctrine of Reasonable Expectations as Applied to Insurance Contracts,* 13 U. MICH. J.L. REF. 603 (1980).

[8] *See, e.g.,* Kievet v. Loyal Protective Life Ins. Co., 34 N.J. 475, 170 A.2d 22 (1961).

[9] *See, e.g.,* Smith v. Westland Life Ins. Co., 15 Cal. 3d 111, 539 P.2d 433, 123 Cal. Rptr. 649 (1975).

[10] *See, e.g.,* Gray v. Zurich Ins. Co., 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966).

sonable" expectation of coverage. Third, almost all the cases involve ordinary consumers without a sophisticated understanding of insurance. Finally, by sometimes finding ambiguities where none apparently existed, courts have avoided explaining why an insured's expectations, even though reasonable, should override the language of the policy. An effort to understand why courts have honored an insured's expectations, therefore, must focus not only on the language of the opinions, but also on the underlying facts of each case and on the patterns that emerge from application of the principle in a variety of disputes.

Several factors are consistently relevant to the application of the expectations principle. First, the likelihood that an insured actually expected coverage is relevant to, but not decisive of, the decision to honor any such expectation. Second, the insurer's responsibility for creating the insured's expectation or permitting the expectation to persist may be evidence of its reasonableness and may support the decision to honor it. Finally, other factors, such as the substantive unfairness of a policy provision, or the desirability of coverage, are often relevant to a court's decision. Sometimes these factors merely support the court's determination that the alleged expectation should be honored; in a few cases, they appear to be central to the decision.

Although classification risks oversimplifying the interplay of factors affecting each decision, identifying patterns both organizes and enhances the value of any analysis. In what follows, the decisions in which the insurer misleads the insured about the scope of coverage (misleading impression cases)[11] are therefore distinguished from those in which the insurer does not act misleadingly (mandated coverage cases).[12]

In the first group of cases, the insured, or a reasonable person in

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[11] In many cases, the courts have noted specifically the significance of the insurer's misleading conduct to the decision to honor the insured's expectations. *See, e.g.*, Smith v. Westland Life Ins. Co., 15 Cal. 3d 111, 122, 539 P.2d 433, 442, 123 Cal. Rptr. 649, 657 (1975); INA Life Ins. Co. v. Brundin, 533 P.2d 236, 242 (Alaska 1975); Prudential Ins. Co. v. Lamme, 83 Nev. 146, 149, 425 P.2d 346, 348 (1967). In other cases, the influence of that conduct on the court's decision is more speculative. *See, e.g.*, Thompson v. Occidental Life Ins. Co., 9 Cal. 3d 904, 513 P.2d 353, 109 Cal. Rptr. 473 (1973).

[12] The lahel is admittedly conclusory, but to the extent that there is little likelihood that the insured actually expected coverage or that the insurer in any sense misled him, it appears that the courts in these cases have simply mandated coverage where they have found it desirable.

his position, reasonably could have expected coverage. Significantly, in most of these cases it turns out that such an expectation is reasonable largely because the insurer's words, conduct, or a situation for which the insurer is responsible have created that expectation. In the second group of cases, although the courts speak of the insured's "reasonable expectations," it is much less likely that ordinary insureds would have expected coverage in the situations in question. In those cases, the courts have gone beyond honoring actual or reasonable expectations. They have relied on the expectations principle when in truth they are mandating coverage where it seems desirable. The courts have engaged most frequently in this kind of activity where the omitted coverage is otherwise unavailable from other sources. In cases where such coverage is available, the courts do not find a fictional expectation in order to create coverage where in fact it does not exist.[13]

A. *The Misleading Impression Theme*

1. *Automated Marketing*

The expectations principle has been invoked in two leading pairs of cases where coverage was sold impersonally. The first pair involved flight insurance sold through airport vending machines; the second involved accident insurance offered and sold through the mail. In all four cases, the principal concern was that the marketing context prevented the insured from determining whether the policy in question actually provided the expected coverage—a fact that underscored the insurers' responsibility for the mistaken expectations of coverage held by their insureds.

In *Lacks v. Fidelity & Casualty Co.*,[14] the insured died on a charter flight that the insurer claimed the policy excluded. The insurer, however, had placed its vending machine directly in front of the charter airline counter. Although the policy specifically excluded coverage on nonscheduled airlines, and a large sign near the charter airline counter listed it as nonscheduled,[15] the court found the policy ambiguous.[16] The court reasoned that the placement of

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[13] *See* note 59 *infra* and accompanying text.

[14] 306 N.Y. 357, 118 N.E.2d 555 (1954). For a recent case applying the *Lacks* rule, see Riordan v. Auto. Club, 422 N.Y.S.2d 811, 814 (1979).

[15] 306 N.Y. at 363, 118 N.E.2d at 558.

[16] *See id.* at 367, 118 N.E.2d at 560.

the machine could constitute an invitation to purchase insurance for flights on the nearby airline.[17] It also assumed that the decedent expected coverage and would not have purchased the insurance had she been informed that it would not cover her trip.[18]

In a subsequent case, *Steven v. Fidelity & Casualty Co.*,[19] a leg of the deceased's scheduled flight was cancelled because of poor weather conditions; he died on a substitute charter flight that the insurer argued was not covered by the policy. The court found for the decedent's estate, reasoning that because the purpose of "taking out the insurance was to obtain insurance protection for the trip," and because "his contract covered the *trip*," the insured would reasonably expect coverage for any reasonable substitute emergency transportation taken on that trip.[20]

In contrast to the situation in *Lacks*, there was no evidence in *Steven* that the insurer's marketing techniques actually created a misleading impression.[21] As the court noted, however, had the insured in fact mistakenly expected coverage, the marketing techniques of the insurer would have precluded the insured from correcting or clarifying those expectations before deciding to embark on the substitute flight. Because the policy was sold by a machine, there was no agent to warn him of the gap in coverage; the insured probably could not examine a specimen policy before deciding to purchase coverage; and he could not examine the relevant provision when the need to substitute flights arose because the machine had instructed him to mail the policy to his beneficiary before beginning his trip.[22] In addition to emphasizing the insurer's responsibility for the effects of its marketing technique, the court noted that the challenged provision "tended toward the harsh and

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[17] *Id.* at 365, 118 N.E.2d at 558-59. The question whether it did constitute such an invitation was left for the jury. *Id.*

[18] *Id.* at 366, 118 N.E.2d at 559.

[19] 58 Cal. 2d 862, 377 P.2d 284, 27 Cal. Rptr. 172 (1962).

[20] *Id.* at 869, 377 P.2d at 288, 27 Cal. Rptr. at 176 (emphasis in original).

[21] The insurer in *Steven* had not placed its vending machine in close proximity to counters of airlines not covered by the policy. The insured's misimpression arose from his failure to understand the fine print of the policy and the absence of an agent to correct any misunderstandings. Contrary to the court's finding, there was little evidence in *Steven* suggesting that a reasonable insured actually would have expected the disputed coverage; it is more likely that a reasonable insured would not have considered the possibility of a substitute flight, and thus would have had no preexisting expectation concerning the disputed coverage.

[22] 58 Cal. 2d at 877, 377 P.2d at 293-94, 27 Cal. Rptr. at 181-82.

unconscionable."[23]

The two leading solicitation-by-mail cases also reflect judicial concern that insurance marketing techniques inhibit clarification of coverage expectations. In *Klos v. Mobil Oil Co.*,[24] the insured received his policy, but died before its specified effective date. The court nevertheless held that there was coverage at the time of death. It found that the guaranteed acceptance of the insured's application, coupled with the language of the insurer's advertising brochure, would lead an average layman to expect coverage on receipt of his policy.[25]

In a similar case, *Fritz v. Old American Insurance Co.*,[26] the insured had signed an application stating "I understand that the policy becomes effective when issued,"[27] but died before his policy was issued. The court held that the insurer's use of the mails, the language of the solicitation, and the absence of an agent all encouraged the expectation that there was immediate coverage upon mailing the application.[28] As in the cases discussed above, the court emphasized that the insurer's choice of impersonal marketing conditions made it responsible for any reasonable but misguided expectations that persisted because of that choice.[29]

2. *Accident Insurance:*[30] *Coverage Bearing a Misleading Name*

Insurers have also created misleading impressions about cover-

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[23] *Id.* at 878, 377 P.2d at 294, 27 Cal. Rptr. at 182. For a discussion of other cases relying on both expectations and unconscionability, see text accompanying notes 39-45 *infra*. *Cf.* First Nat'l Bank v. Fidelity & Cas. Co., 428 F.2d 499, 501-02 (7th Cir. 1970) (rejecting expectations principle generally under Illinois law, but implying that an expectation of flight coverage was unreasonable because, in this case, change of itinerary was voluntary).

[24] 55 N.J. 117, 259 A.2d 889 (1969).

[25] *Id.* at 126, 259 A.2d at 894. *See also* Providential Life Ins. Co. v. Clem, 240 Ark. 922, 403 S.W.2d 68 (1966) (upholding insureds' right to rely on group accident insurance application and holding insureds were not bound by the terms of a policy they had no opportunity to read); Lawrence v. Providential Life Ins. Co., 238 Ark. 981, 385 S.W.2d 936 (1965) (same). *Cf.* INA Life Ins. Co. v. Brundin, 533 P.2d 236, 242 (Alaska 1975) (expectations of purchaser of accident coverage were influenced by advertising literature).

[26] 354 F. Supp. 514 (S.D. Tex. 1973).

[27] *Id.* at 516 (quoting the insurance application).

[28] *Id.* at 519.

[29] *See id.* at 518.

[30] Like life insurance, accident insurance provides coverage in the event of the insured's death. Often it also provides coverage if the insured suffers bodily injury. Unlike life insurance, however, accident insurance is limited to death and bodily injury caused by "accident," which is variously defined.

age by selling insurance bearing a commonly understood name—accident or disability—but providing coverage far narrower than the common name would lead the ordinary person to expect. In such cases, the issue is whether the court should enforce the transaction to comply with the insured's expectations, or whether it should read the terms of the policy literally and deny the expected coverage.

One of the earliest cases to employ the expectations principle involved accident insurance.[31] In *Kievet v. Loyal Protective Life Insurance Co.*,[32] the insured's policy covered certain specified injuries and " 'loss resulting directly and independently of all other causes from accidental bodily injuries.' "[33] On its next page, the policy excluded coverage of " 'disability or other loss resulting from or contributed to by any disease or ailment.' "[34] The insured received an accidental blow on the head that activated his preexisting but unknown Parkinson's disease.

Despite the policy limitations, the court found that Kievet was covered. It reasoned that an average member of the public would expect accident insurance to cover "accidental injury which results (in the commonly accepted sense) in his disability."[35] The court reasoned further that its construction was justified because if the policy were read literally, it would be of little value to the plaintiff.[36] The policy that Kievet purchased at age forty-eight was renewable to age sixty-five. By that time, "disability or death resulting from accidental injury would in all probability be in some sense contributed to by the infirmities of age."[37]

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[31] Earlier accident cases had also held for the insured, but without articulating a rationale resting on expectations. *See, e.g.*, Silverstein v. Metropolitan Life Ins. Co., 254 N.Y. 81, 85, 171 N.E. 914, 915 (1930) (holding that "thin skulled" plaintiffs can recover for accidents they suffer because "[a]ny different construction would reduce the policy and its coverage to contradiction and absurdity") (Cardozo, C.J.).

[32] 34 N.J. 475, 170 A.2d 22 (1961).

[33] *Id.* at 477, 170 A.2d at 24 (quoting insurance policy).

[34] *Id.*

[35] *Id.* at 489, 170 A.2d at 30.

[36] *Id.*

[37] *Id.* This theory of liability is similar to the English contract law doctrine of fundamental breach, under which provisions denying the buyer the essence of what he agreed to purchase are invalid. *See* Meyer, *Contracts of Adhesion and the Doctrine of Fundamental Breach*, 50 VA. L. REV. 1178, 1198 (1964). *Cf.* Llewellyn, Book Review, 52 HARV. L. REV. 700, 702-03 (1937) (discussing the need to mark out, for given transactions, the *"minimum decencies"* a court will insist upon) (emphasis in original).

The result in *Kievet* turned on both an objectively reasonable interpretation of the language of the policy and the fact that the insurer's interpretation would have emasculated coverage.[38] By implication, the insurer was held responsible for coverage because it did not dispel an expectation that was so common and so central to the value of the policy that it must have been aware of that expectation.

The accident insurance cases are similar in several respects to the automated marketing decisions. As in the latter, the insurer is responsible for creating a misleading impression that is independent of anything in the policy; in both, the insurer can escape liability by dispelling the insured's inaccurate expectation of coverage. This is unlikely to occur, however, because adequate disclaimers would interfere with effective marketing. Furthermore, the clear import of the accident insurance decisions is that the courts disapprove of provisions emasculating coverage and that they will scrutinize the substance of such provisions regardless of the insured's actual expectations. Yet, the courts' disapproval of restrictive coverage is not the sole nor necessarily even the major justification for their decisions. A substantive attack on a restrictive policy is triggered only after the insurer has created or encouraged a misleading impression about the scope of the policy.

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[38] Cases involving other kinds of insurance have adopted similar rationales. *See, e.g.,* C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169 (Iowa 1975) (burglary and robbery policy could not condition coverage on proof of visible marks of entry); Foremost Life Ins. Co. v. Water, 88 Mich. App. 599, 278 N.W.2d 688 (1979) (refusal to enforce a subrogation clause that would defeat the primary purpose of a disability policy); Lariviere v. New Hampshire Ins. Group, 120 N.H. 168, 413 A.2d 309 (1980) (liability policy covering insured's building and moving business could not exclude coverage for damage occurring during the movement of any building, because such exclusion would defeat the reasonable expectations of the insured). Most of the accident cases following *Kievet,* however, have relied only on the reasonableness of an assumption that "accident" coverage would include the injury at issue and not on whether literal application of the policy would emasculate coverage. *See, e.g.,* Corgatelli v. Globe Life & Accident Ins. Co., 96 Idaho 616, 533 P.2d 737 (1975); Perrine v. Prudential Ins. Co., 56 N.J. 120, 265 A.2d 521 (1970). The policy in *Kievet* extended coverage to all "accidental bodily injuries," but many policies, such as the one in *Perrine,* limit the right of recovery to injuries due to "accidental means." The distinction between accidental means and accidental results has sometimes affected reasoning and decision in accident insurance cases. *See, e.g.,* Landress v. Phoenix Mut. Ins. Co., 291 U.S. 491 (1934) (distinction drawn); Gottfried v. Prudential Ins. Co., 82 N.J. 478, 414 A.2d 544 (1980) (distinction drawn, but if policy insures against accidental bodily injury it is an accidental-result policy). *But see* Burr v. Commercial Travellers Mut. Accident Ass'n, 295 N.Y. 294, 67 N.E.2d 248 (1946) (distinction collapsed).

This mixture of substantive concerns with those based on the expectations of the insured becomes even more evident in the decisions analyzed below.

3. *Temporary Life Insurance*

Life insurance often is sold by agents who accept an application and first premium, and then forward them to the home office for processing and a decision whether to insure. Disputes arise when the prospective insured dies after submitting an application and first premium, but before the policy is issued. The insured's beneficiary then claims that although the application had not been accepted at the date of death, there was temporary coverage in effect at that time. In a sizeable body of cases, the courts have vindicated this claim.

In *Smith v. Westland Life Insurance Co.,*[39] the insured applied for life insurance, paid the first month's premium, and received a conditional receipt providing that: "[I]f the Company . . . after investigation shall be satisfied that on the date hereof . . . each person proposed for insurance was insurable and entitled under the Company's rules and standards to insurance . . . , the insurance protection applied for shall . . . take effect from the date hereof . . . ."[40] The insured was informed that he had not met the Company's conditions for insurability and that his premium would be refunded, but he died the next day.[41] Despite the language in the receipt, the court followed California's rule that temporary insurance coverage is effective upon payment of a first premium, subject to termination if the insured does not meet the insurer's conditions for permanent coverage. In applying this rule, the court reasoned that an insured could reasonably expect coverage after signing an application and paying a first premium.[42] The court also indicated

[39] 15 Cal. 3d 111, 539 P.2d 433, 123 Cal. Rptr. 649 (1975).

[40] *Id.* at 114 n.3, 539 P.2d at 435 n.3, 123 Cal. Rptr. at 651 n.3.

[41] *Id.* at 115, 539 P.2d at 436, 123 Cal. Rptr. at 652.

[42] *Id.* at 120, 539 P.2d at 442, 123 Cal. Rptr. at 655. The earlier cases adopting this rule had relied more directly on the ambiguity of the receipt than on the expectations of the insured. *See, e.g.*, Gaunt v. John Hancock Mut. Life Ins. Co., 160 F.2d 599, 601 (2d Cir.), *cert. denied*, 331 U.S. 849 (1947); Ransom v. Penn Mut. Life Ins. Co., 43 Cal. 2d 420, 425, 274 P.2d 633, 636 (1954). In those cases, although probably not technically ambiguous, the receipts were complex and convoluted. In *Smith*, the language of the receipt was much less convoluted, and the court put less stress on ambiguity than on the expectation created by

that "it is unconscionable for an insurance company to hold premiums without providing coverage."[43] The importance of the latter justification is underscored by the court's holding that the temporary coverage created by accepting a first premium with the application could not be terminated merely by providing clear notice of rejection, but only by returning the first premium as well.[44]

Smith and similar cases illustrate the variety of factors courts consider relevant in applying the expectations principle. The ambiguity of the receipt and payment of a first premium create an expectation of coverage, but the decisions generally have not rested on expectations alone; the unfairness of the insurer's conduct has also been an important factor in establishing the insurer's liability. In cases like *Smith*, for example, although the binding receipts purport to provide retroactive coverage if the application is accepted, such "retroactive" coverage is likely to be illusory.

Suppose the application contains a provision like the following:

> If the first premium is paid with this application, and if the applicant is insurable on the date of issue for the type and amount of coverage applied for at the rate applied for, then coverage shall be

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payment of a first premium. For another case relying on the insured's acceptance of a premium as the source of the insured's expectation of coverage, see Prudential Ins. Co. v. Lamme, 83 Nev. 146, 149, 425 P.2d 346, 347-48 (1967). The decisions generally do not indicate that, in the absence of ambiguity or other misleading facters, payment alone would create expectations of immediate coverage; for many applicants, the requirement of a returnable deposit may have become so commonplace that payment alone would encourage no expectations at all. *But see* Allen v. Metropolitan Life Ins. Co., 44 N.J. 294, 306, 208 A.2d 638, 645 (1965), where the court suggested that immediate coverage would be expected because obtaining immediate coverage is the insured's main purpose in submitting a first premium with the application. In any event, it is fairly clear that in the absence of a first payment with the application, an expectation of immediate coverage is not reasonable. *See* Megee v. United States Fidelity & Guar. Co., 391 A.2d 189 (Del. 1978).

[43] 15 Cal. 3d at 126, 539 P.2d at 443, 123 Cal. Rptr. at 659.

[44] The court insisted that return of the premium was required because otherwise the applicant could reasonably expect that he was still covered, despite notice of rejection. *Id.* at 126, 539 P.2d at 443-44, 123 Cal. Rptr. at 659-60. This rationale is implausible and suggests that the court was more concerned with the unfairness of accepting a premium without providing coverage than with the insured's actual expectations. The courts may also be concerned with the difficulty of proving expectations, although they generally do not specify this concern: the applicant is deceased, and normally the only testimony about what he expected comes from the insurer's soliciting agent. Courts may therefore place the burden of proving the absence of an expectation of coverage on the insurer. *See* Collister v. Nationwide Life Ins. Co., 479 Pa. 579, 595, 388 A.2d 1346, 1354 (1978) (insurer failed to establish by clear and convincing evidence that deceased could not have entertained reasonable expectations of coverage).

effective from the date of application.

Call the date of application Date 1 and the date of issue Date 2. If the terms of the application are binding, then no applicant will ever benefit from the retroactive coverage: any applicant who dies before Date 2 will be uninsured, because he will not have been insurable on Date 2; any applicant who survives until Date 2, and thereby becomes insured retroactive to Date 1, will have had no need for that coverage, because he will still be alive. The class of persons who will die between Date 1 and Date 2 and be covered is nonexistent. Thus, the promise to provide retroactive coverage is almost meaningless.[45]

Such "unfairness" as this arises from the substance of the agreement itself. It exists independently of and is distinct from the unfairness that arises from frustrating expectations. In the following cases, the substance of the coverage provided, rather than the insured's expectations, becomes even more important. Nevertheless, the courts continue to rely on the expectations principle as a ground of decision.

B. *The Mandated Coverage Theme*

In the misleading impression cases, policy language, the potential expectations of a reasonable insured, and the substantive unfairness of restrictions on coverage all play a role. These elements vary from case to case, and the strength of one may compensate for the weakness of another in explaining the decision. In the mandated coverage cases, however, each of those elements is weak or nonexistent. The policy language denying coverage is relatively clear; it is unrealistic to suppose that the insured would actually or reasonably expect the coverage in question; and the policy's denial of coverage does not appear unfair. The courts nevertheless pay lip service to the idea that the insured's reasonable expectations jus-

[45] Date 2 varies from receipt to receipt, but the principle is the same: no one has coverage for the period between application (Date 1) and satisfaction of whatever condition precedent is imposed (Date 2). This argument admittedly is a bit exaggerated. In fact, there are some advantages that will accrue to an insured who lives past Date 2 and is therefore covered "from the date of application." For example, the policy may be incontestable sooner, and there may be accelerated cash surrender value. *See* Gaunt v. John Hancock Mut. Life Ins. Co., 160 F.2d 599, 601 (2d Cir.), *cert. denied,* 331 U.S. 849 (1947). But these benefits are slim in comparison to the main advantage of having life insurance and the applicant's main purpose in purchasing it—insurance in the event of death.

tify their decisions in his favor. The opinions speak of expectations without satisfactorily pointing to their source.

A better explanation of the mandated coverage cases, however, concerns the desirability of providing coverage that is currently unavailable. Reference in the opinions to the insured's expectations or to the unfairness of denying the insured coverage makes much more sense if it is viewed as criticism of the insurance market as a whole. The mandated coverage decisions involve forms of coverage that simply are not marketed. The courts make such coverage available by tacking it onto conventional liability policies. In doing so, they step into a vacuum that neither the market nor administrative regulation has filled. But by mandating coverage only where it is otherwise unavailable, even this activist approach observes an implicit limit.

1. *The Duty to Defend*

Liability insurance policies typically impose two major duties on the insurer: (1) the duty to indemnify—to pay damages for which the insured is legally liable, and (2) the duty to defend—to provide or pay for the insured's defense against suits alleging liability for damages that are payable under the policy, regardless of whether the insured ultimately is found liable. The duty to defend normally extends even to a claim that is "groundless, false or fraudulent," so long as damages would be payable under the policy if the claim were successful; but it generally excludes coverage for intentionally inflicted injuries.[46] Disputes over the insurer's duty to defend arise when it is unclear whether the damages claimed would be payable under the policy if the suit against the insured were successful. Courts traditionally have resolved such disputes by examining the complaint to determine whether it pleaded a liability for which the insurer would be bound to indemnify the insured.[47]

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[46] *See* R. KEETON, *supra* note 1, at 286. The exclusionary provision usually is worded in one of two ways: (1) "This policy does not apply to bodily injury or property damage which is either expected or intended from the standpoint of the insured," or (2) "This policy does not apply: . . . to bodily injury . . . caused intentioually hy or at the direction of the insured." State Farm Fire & Cas. Co. v. Muth, 190 Neb. 248, 249, 252, 207 N.W.2d 364, 365, 366 (1973) (providing examples of policies employing both provisions).

[47] *See, e.g.*, Lamb v. Belt Cas. Co., 3 Cal. App. 2d 624, 630, 40 P.2d 311, 314 (1935). Other courts have recognized that the pleadings may not be an accurate indication of the merits of the case. They have looked beyond the pleadings, and have required a defense if the suit

In one leading case on the subject, *Gray v. Zurich Insurance Co.*,[48] the California Supreme Court rejected this pleadings test and instead rested its decision on the reasonable expectations of the insured.[49] Gray was insured by the defendant under a "Comprehensive Personal Liability Endorsement" covering him against liability for bodily injury and property damage. There was a standard insuring clause[50] and a separate clause excluding coverage of "bodily injury or property damage caused intentionally by or at the direction of the insured."[51] Gray was sued for "wilfully, maliciously, brutally and intentionally" assaulting the plaintiff.[52] Gray's insurer argued that because the suit was not one seeking damages payable under the liability endorsement, it had no duty to defend.

The court disagreed for several reasons. It found that the insured's interpretation that the policy required a defense was reasonable, because the policy contained a broad and apparently unqualified duty to defend. The scope of that duty and its relationship to the separate exclusionary clause were unclear in the policy itself.[53] The insured therefore could reasonably expect a de-

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potentially seeks damages covered by the policy. *See, e.g.*, Columbia S. Chem. Corp. v. Manufacturers & Wholesalers Indem. Exch., 190 Cal. App. 2d 194, 200, 11 Cal. Rptr. 762, 766 (1961); Ritchie v. Anchor Cas. Co., 135 Cal. App. 2d 245, 251, 286 P.2d 1000, 1004 (1955).

[48] 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966). *See also* National Indem. Co. v. Flesher, 469 P.2d 360 (Alaska 1970); Hogan v. Midland Nat'l Ins. Co., 3 Cal. 3d 553, 476 P.2d 825, 91 Cal. Rptr. 153 (1970); Lowell v. Maryland Cas. Co., 65 Cal. 2d 298, 419 P.2d 180, 54 Cal. Rptr. 116 (1966); Zurich Ins. Co. v. Rombough, 384 Mich. 228, 180 N.W.2d 775 (1970).

[49] The court found that the insurer had an obligation to defend because the policy led the insured reasonably to expect such coverage. 65 Cal. 2d at 275, 419 P.2d at 176, 54 Cal. Rptr. at 112. As an alternative ground of liability, it found that the complaint presented the possibility that the damages sought would be covered by the policy. *Id.* at 276, 419 P.2d at 177, 54 Cal. Rptr. at 113.

[50] Under the clause, the insurer agreed

> [t]o pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage, and the company shall defend any suit against the insured alleging such bodily injury or property damage and seeking damages which are payable under the terms of this endorsement, even if any of the allegations are groundless, false or fraudulent.

Id. at 267, 419 P.2d at 170, 54 Cal. Rptr. at 106 (quoting the insurance policy).

[51] *Id.*

[52] *Id.*

[53] *Id.* at 268, 273, 419 P.2d at 171, 174, 54 Cal. Rptr. at 107, 110.

fense in this situation.[54] The opinion reached beyond concern with the policy's language, however, and addressed the substantive fairness of the policy itself. The court noted that the limitations imposed by the company would "defeat the basic reason for the purchase of the insurance."[55] Consequently, it indicated that it would mandate a defense under the circumstances in *Gray*, apparently independent of any expectations the policy language might create.[56]

There are several flaws in the court's reasoning. First, the court's ambiguity rationale is implausible. Most insureds would not derive expectations from the policy language because they would never read it. If they did, few would understand the paragraph embodying the duty of defense well enough to be misled by it. Those who did read the provision carefully enough to understand it would probably also understand the exclusionary clause.

Second, there is little reason to believe that the insured would develop expectations of coverage independently of the policy language. A reasonable insured will not commonly expect defense coverage to include defense against claims of assault and battery.[57] Moreover, in contrast to cases where an exclusionary clause would have emasculated coverage,[58] the exclusionary clause in *Gray* did

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[54] *Id.* at 268, 419 P.2d at 171, 54 Cal. Rptr. at 107.

[55] *Id.* at 278, 419 P.2d at 178, 54 Cal. Rptr. at 114. The court's suggestion that the exclusion of coverage would defeat the basic reason for the purchase of the insurance and its instruction that such an exclusion must be "conspicuous, plain and clear," are not entirely compatible. It may be that the court would find the exclusion acceptable if the insured were not surprised by it. On the other hand, the court may also have recognized that if the clause in the present policy were only valid after disclosure, an insurer would have difficulty meeting the "conspicuous, plain and clear" requirement because of the complexity of the problem the clause deals with. Moreover, even if it did disclose, the insurer might have a duty to defend under the alternative "potential of liability" test. *See* Note, *The Insurer's Duty to Defend Made Absolute:* Gray v. Zurich, 14 U.C.L.A. L. REV. 1328, 1336-37 (1967). *See also* note 47 *supra.*

[56] The court stated: "The basic promise [the insuring clause] would *support* the insured's reasonable expectation that he had bought the rendition of legal services to defend agaiust a suit for bodily injury which alleged he had caused it, negligently, nonintentionally, intentionally or in any other manner." 65 Cal. 2d at 273, 419 P.2d at 174, 54 Cal. Rptr. at 110 (emphasis added). The court's use of the word "support" certainly implies that it believed the insured's expectation would exist independently of his reading of the policy; otherwise the basic promise could hardly be said to "support" that expectation.

[57] *See* Keeton, *supra* note 6, at 970 n.15.

[58] *See, e.g.,* Kievet v. Loyal Protective Life Ins. Co., 34 N.J. 475, 170 A.2d 22 (1961) (discussed in notes 32-38 *supra* and accompanying text).

not strike at the basic coverage purchased; it limited that coverage only tangentially. Finally, in contrast to the misleading impression cases, there is little evidence in cases such as *Gray* to support the court's assertion that the insured would not have purchased the policy had he properly understood the scope of the defense coverage. Consequently, it is difficult to conclude that the exclusion of defense of allegedly intentional tort claims is unconscionable.

This analysis suggests that in the duty-to-defend cases, the courts are concerned much more with the substance of coverage than with the expectations of the insured. Where they find excluded coverage desirable, they may mandate such coverage, regardless of the insured's reasonable expectations. Indeed, the coverage mandated in *Gray* might well be thought desirable. The cost of defending totally groundless claims of intentional tort could be so significant that in spite of victory in the underlying lawsuit, the insured will have suffered a catastrophic loss. Yet, insurance against these costs is not independently available.[59] *Gray* and the cases that follow it remedy that situation by tacking such coverage onto the duty of defense contained in the typical liability policy.[60] The rationale for such judicial action seems to be that regardless of whether anyone actually expects such coverage, people have a "right to expect" it from some source, and that it is most appropriately provided by primary liability insurers.[61]

2. *Extending the Duration of Coverage*

The final setting in which the expectations principle will be ana-

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[59] *Cf.* Herzog v. National Am. Ins. Co., 2 Cal. 3d 192, 197, 465 P.2d 841, 843, 84 Cal. Rptr. 705, 707 (1970) (expectation of automobile liability coverage under homeowner's policy unreasonable because liability coverage was otherwise available).

[60] *See, e.g.*, cases cited note 48 *supra*. *See also* St. Paul Fire & Marine Ins. Co. v. Weiner, 606 F.2d 864 (9th Cir. 1979); United States v. United States Fidelity & Guar. Co., 601 F.2d 1136 (10th Cir. 1979); Gowing v. Great Plains Mut. Ins. Co., 207 Kan. 78, 483 P.2d 1072 (1971). *Contra*, Chipokas v. Travelers Indem. Co., 267 N.W.2d 393 (Iowa 1978); Hins v. Heer, 259 N.W.2d 38, 40 (N.D. 1977).

[61] There are potential conflict-of-interest problems in requiring an insurer to defend an insured for an injury which, as in *Gray*, may or may not be covered by his policy. The insurer has an incentive to demonstrate that if the insured is liable, he is liable for an intentional rather than an accidental tort. An alternative solution is for the insured to provide his own defense and seek reimbursement from the insurance company. *See* Burd v. Sussex Mut. Ins. Co., 56 N.J. 383, 267 A.2d 7 (1970). The *Gray* court rejected this approach as denying the insured the benefit of the protection he had bargained for. *See* 65 Cal. 2d at 278, 419 P.2d at 178, 54 Cal. Rptr. at 114.

lyzed concerns the duration of coverage. In the simplest of situations, the effect of the "policy period" on coverage is clear. The policy provides coverage for the period between Time 1 and Time 2. If a covered loss occurs during that period, there is coverage; if the loss occurs before Time 1 or after Time 2, there is no coverage. Obviously, disputes do not arise when events and policy provisions are this simple; unfortunately, events and policy provisions often are not so simple.

The plaintiffs in *Gyler v. Mission Insurance Co.*[62] were attorneys covered by a malpractice policy issued by the defendant for the period 1964 to 1967.[63] A suit by a former client was filed against them in 1969, alleging malpractice in 1966. The policy insured " 'against any *claim or claims* for breach of professional duty as Lawyers *which may be made against them* during the period set forth in the Certificate . . . .' "[64] Mission denied coverage, arguing that the provision covered only those claims actually made during the policy period. Plaintiffs argued that there was coverage of any claim that "may" have been made during the policy period, whether or not the claim actually was made during the period. The court concluded that the phrase "may be made" was ambiguous in this respect and should be interpreted against the insurer.[65]

The court's conclusion that the word "may" was ambiguous is questionable. The court understood the word "may," in the phrase "any claims . . . which may be made against them during the period," to mean "could." Another provision in the policy, however, extended coverage to occurrences "which may subsequently give rise to a claim" if the insured gave written notice to the company of such a potentiality during the policy period.[66] The court understood this phrase to apply only to negligent acts that occurred during the policy period but that did not cause injury until after the period. Such claims would not fall within the first coverage provision (in which "may" means "could") because they *could not* be made until after the period.[67]

A reasonable insured, especially an attorney, could be expected

[62] 10 Cal. 3d 216, 514 P.2d 1219, 110 Cal. Rptr. 139 (1973).
[63] *Id.* at 218, 514 P.2d at 1220, 110 Cal. Rptr. at 140.
[64] *Id.* (quoting insurance policy) (emphasis by the court).
[65] *Id.* at 219, 514 P.2d at 1221, 110 Cal. Rptr. at 141.
[66] *Id.* at 218, 514 P.2d at 1220, 110 Cal. Rptr. at 140.
[67] *Id.* at 220, 514 P.2d at 1221, 110 Cal. Rptr. at 141.

to adopt a much simpler and more plausible interpretation of the policy. The first coverage provision—claims "which may be made against them during the policy period"—seems to cover claims actually made during the period; the second—occurrences "which may subsequently give rise to a claim"—seems to extend coverage to errors the insured thinks he may have made, but which have not yet been reduced to claims.

In imposing liability on the insurer, however, the court did not rely only on its strained interpretation of the policy language; it also insisted that the insured could reasonably expect coverage for the claim in question because without it, attorneys would have no coverage for claims brought against them *after* retirement.[68] In light of the seemingly straightforward language of the policy, however, it appears that the court found coverage after retirement to be desirable rather than actually expected.[69]

II. Why Honor an Insured's Expectations?

Several themes recurred throughout the preceding survey. First, the insurer can generally avoid liability by clearly informing the insured that the expected coverage is not included in the policy being purchased.[70] Second, in the vast majority of cases, the insurer's misleading conduct significantly influences both the finding that the insured's expectation of coverage is reasonable and the decision to honor it.[71] Finally, where the two preceding considerations wane in importance, the courts' preference for desirable but currently unavailable coverage plays an increasingly important

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[68] *Id.* "An attorney ordinarily buys malpractice insurance only during the time he is in practice. But because his liability for malpractice insurance may continue long after his negligent act and injury . . . he would . . . reasonably expect coverage against liability for negligent acts occurring during the policy period so as to be protected against claims asserted during retirement." *Id.* The court gave no indication why attorneys who had not yet retired would also expect such coverage, or even why they would need it.

[69] Thus, the court again seemed to be relying on the expectations principle to effect substantive changes in the policy. Though separate coverage for the "long tail" of claims after retirement is now readily available, there was probably little such coverage available at the time the policy in *Gyler* was issued. For a discussion of this kind of "claims-made" liability insurance for the medical profession, see Abraham, *Medical Malpractice Reform: A Preliminary Analysis,* 36 Md. L. Rev. 489, 492-94 (1977).

[70] *See* notes 21-38 *supra* and accompanying text.

[71] *See* notes 14-24 *supra* and accompanying text.

role.[72]

These three recurring themes correspond to three possible justifications for honoring the reasonable expectations of the insured. First, proper use of the expectations principle may promote a more fully informed choice by the prospective insured about the kind of coverage he desires. Second, the expectations principle may serve "equitable" interests by permitting the courts to look beyond the formal transaction between the parties and to hold the insurer responsible for any expectations concerning coverage that it may have created. Finally, the principle may serve a variety of risk-distributive concerns by spreading the cost of otherwise uninsured losses and by encouraging a diversity of coverage options that will help promote risk spreading. Of course, to say that the expectations principle may serve these interests is not to say that it will always serve them well or consistently. The purpose of this section is to explore the manner in which the expectations principle may serve such interests and to begin to assess its limitations in doing so.[73]

A. *Informational Goals: Economic Efficiency and Informed Assent*

Information about coverage is a central concern of the expectations principle. The insurer is held liable primarily because it is, in some way, responsible for the inaccurate information the insured possessed concerning coverage. The principle thus is very much concerned with the production of accurate information. The benefits of more accurate information about coverage may be twofold. First, relatively complete information about market choices may help promote economic efficiency. Without such information, it will be difficult for consumers to make decisions that effectively serve their interests. As a result, resources will be allocated inefficiently. Second, promoting informed decisionmaking is a means

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[72] *See* notes 45-69 *supra* and accompanying text.

[73] One preliminary note on terminology is necessary: because the cases use the term "expectations" to refer to various states of mind—actual or presumed—at various stages in the relationship between the insurer and insured, it will be helpful to define the term more precisely. In the following sections, the term "expectations" refers to the rights an insured believes he has against the insurer at the time the agreement is made. Where further qualifications are warranted—when the belief exists only after loss, or where the belief is presumed rather than actual, for example—they will be specifically noted.

of supporting and furthering individual autonomy and freedom of contract. Both of these interests and their relation to the expectations principle are discussed below.

1. *Economic Efficiency*

Modern economic theory postulates that because people know best what is good for them, they will allocate resources to their most efficient uses by pursuing their self interests.[74] If people do not have adequate information about available goods and services, however, they will not be able to make the choices that are best for them.[75]

By imposing liability on the insurer where the insured possesses inaccurate coverage information,[76] the expectations principle theoretically should encourage the production of more accurate information and thus create a more efficient market.[77] With such information, the insured may better assess the value of coverage offered

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[74] *See* R. Posner, Economic Analysis of Law 11 (2d. ed. 1977).

[75] Obstacles other than lack of information may also impede the movement of resources to their most efficient uses: the existence of public goods and monopolies are the most frequently cited examples.

[76] Although avoiding liability by a clear disclaimer of coverage is always theoretically possible in expectations cases, in several of the decisions discussed earlier the court appeared more concerned that the disputed coverage be provided than that the insured know of its absence. *See, e.g.*, Gyler v. Mission Ins. Co., 10 Cal. 3d 216, 514 P.2d 1219, 110 Cal. Rptr. 139 (1973); Gray v. Zurich Ins. Co., 65 Cal. 2d 253, 419 P.2d 168, 54 Cal. Rptr. 104 (1966). In those cases, justification of the principle based on the value of the increased information it could produce mistakes the courts' underlying purpose in employing the principle.

[77] Other judicial remedies rely on similar efficiency justifications. Dean Prosser has argued that the doctrine of strict liability in tort is predicated in part on the consumer's ability to appreciate and thus to avoid the risks of purchasing certain consumer goods. *See* W. Prosser, Handbook on The Law of Torts 655-56 (4th ed. 1971).

Strict liability theory offers some support for the expectations principle, but the difficulty of defining the concept of a "defective" product would only be magnified in the insurance context. Furthermore, increased information about a gap in coverage will promote efficiency only if the insured is in a position to evaluate the risks about which he receives the information and to pursue alternative courses of action. *See* Calabresi & Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 Yale L.J. 1055, 1062 (1972); note 78 *infra*.

In addition to strict liability, courts have used the doctrine of nonsubstantive unconscionability to deal with information gaps where the consumer lacks the information necessary to make utility-maximizing choices. *See* Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. Pa. L. Rev. 630, 678 n.104 (1979). For a criticism of the use of nonsubstantive unconscionability to remedy "imperfect" markets, see Schwartz & Wilde, *supra*, at 678-79; Schwartz, *Reexamination of Nonsubstantive Unconscionability*, 63 Va. L. Rev. 1053, 1058-59 (1977). Similar criticism may be made of the use of the expectations principle to promote economic efficiency.

him and may shop for coverage more completely meeting his expectations. If a particular form of coverage is unavailable but desired, promoting disclosure of its absence from standard coverage may encourage insurers to offer it.

Although the generation of increased market information is a valid goal, there may be limits on the extent to which increased information will promote efficiency, and there are certainly limits on the extent to which the expectations principle will promote increased information. First, it is unclear whether requiring the generation of increased information will, in fact, promote efficiency. The expectations decisions are efficient only if their economic benefits outweigh the costs they impose.[78] The difficulty of evaluating

[78] In technical terms, information should be produced as long as the marginal social benefit it yields exceeds the marginal cost of producing the additional unit of information. The limitation of the expectations principle to "reasonable" expectations may be seen as an implicit recognition of this efficiency calculus. For instance, the insured's expectations might be considered reasonable if the cost to the insurer (and thus to other insureds) of dispelling the expectations is outweighed by the benefits of mandating information production rather than leaving individuals to their own information acquisition costs. *See* Schwartz & Wilde, *supra* note 77, at 635-36. The efficiency effects of expectations decisions, however, cannot be assessed by examining the reasonableness of individual expectations alone. The expectations decisions entail additional costs, such as the cost of liability when the insurer does not dispel expectations, the cost of legal proceedings necessary to resolve disputes, and the potential chilling effect that insurers' uncertainty about the rights and responsibilities involved may have on the coverage they offer. *See id.* at 678-79 (arguing that administrative agencies are better suited than courts to intervene on the basis of imperfect market information, because courts are limited to resolving individual cases and cannot make the necessary analysis of overall market competitiveness).

An additional complication in assessing the efficiency effect of the expectations principle is the difficulty of determining how it will affect the occurrence of the injuries for which it provides coverage. Most of the losses with which the expectations principle deals will occur regardless of the principle and the liability it imposes. On the other hand, a sense that whatever the loss, its risk will be spread, may discourage some loss prevention efforts by insureds. There are, however, some situations in which the principle may help prevent injuries. Clear disclaimers of coverage for certain risky activities, such as hehnetless motorcycle riding or charter airline flying, may discourage insureds from engaging in these activities. Furthermore, if expectations decisions ultimately result in separate, additional coverage for such activities, insurance premiums will probably vary to reflect the higher risks they entail.

Professors Calabresi and Hirschoff have suggested, in a somewhat analogous context, that the law respond to its own ignorance in such cases by imposing liability on the party in the best position to detennine the more efficient course of action. *See* Calabresi & Hirschoff, *supra* note 77, at 1060. Assuming that an unexpected gap in coverage constitutes an injury to the insured, the insurer will most often be in the best position to weigh the costs and benefits of avoiding the injury. It will certaiuly be best able to determine the cost of dispelling false expectations. Although no party or institution will be very well placed to estimate these costs and benefits has resulted in sharp disagreement among economists over which approach is actually more efficient—government intervention or a "hands-off" attitude toward an imperfect market.[79]

Second, even if requiring increased information were guaranteed to promote efficiency, it is questionable whether reliance on the expectations principle would produce a great deal more coverage information. The principle does not mandate disclosure; it merely imposes liability for failure to comply with judicial guidelines. Thus, insurers will disseminate additional information only when the risk of increased liability outweighs the costs of doing so. In deciding whether to provide additional information, an insurer will consider both the cost of anticipating the insured's expectation of coverage and the cost of dispelling it. It is important to recognize these cost restraints in analyzing the probable effectiveness of the expectations principle in generating increased information.

Finally, because estimates of these costs are likely to be very imprecise, the expectations principle may encourage the production of information generally, but it cannot dictate whether the production of that information will be efficient in a particular case. In theory, a competitive market should produce optimal amounts of information and a desirable variety of coverage alternatives, without legal intervention. If for various reasons, however, the insurance market is not fully competitive—because of a history of price regulation or the high capital requirements for entry, for example—encouraging the production of more information through an expectations principle may help make the market more competitive.

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the marginal social benefit of producing such additional information, the insurer will at least be able to estimate the strength of one potential proxy for social benefit—the change in the demand for coverage that will result from disclosing the additional information.

Under this theory, the insurer's liability should end at the point at which the insured has more information than the insurer with which to assess the relative costs and benefits of a course of action and to alter it accordingly. *Id.* at 1064. It is at least clear that the insurer cannot be the appropriate focus of liability if it has no way of anticipating the insured's expectations. This would be true in the case of an entirely "unreasonable" expectation. To the extent that the expectations decisions impose liability on an insurer in such cases, they find no support in this theory of strict liability.

[79] *Compare* Goldberg, *Institutional Change and the Quasi-Invisible Hand,* 17 J.L. & ECON. 461 (1974) (suggesting that intervention to effect allocation of resources can be effective) *with* Coase, *The Choice of the Institutional Framework: A Comment,* 17 J.L. & ECON. 493 (1974) (arguing that regulation is likely to be anti-competitive).

In light of these limits, several generalizations can be made about use of the expectations principle to promote the disclosure of coverage information. First, there is an important connection between the insurer's responsibility for the insured's expectations and the feasibility of dispelling inaccurate expectations. The greater the insurer's responsibility for creating the insured's expectations, the better will be its position to anticipate them. Even if the insurer is not directly responsible for the expectations, they may be so common that an insurer could easily anticipate them. The accident and life insurance cases are good illustrations of this point. In the duty-to-defend cases, on the other hand, not only did the insurer do nothing to create a misleading impression, but the disputed coverage was probably not commonly expected. The expectations principle is less likely to produce increased information under the latter circumstances.

Second, the fact that the insurer is responsible for the insured's expectation provides strong evidence that the conduct creating the expectation is within the insurer's control and that it has the capacity to dispel it. This does not mean, however, that such conduct can be altered inexpensively, or that accurate information can be distributed inexpensively. It may be relatively easy to change the location of a vending machine or the wording of a printed solicitation, but if the expectations are created or furthered by the entire marketing situation, the insurer may be able to dispel them only at the cost of a complete revision of its marketing practices. Even if the coverage is sold through an agent, disclaimers may be only partially effective in dispelling false expectations. In the life insurance cases, for example, payment of a first premium was largely responsible for the expectation of immediate coverage. To dispel those expectations effectively would require that the insurer dispense with the requirement that an insured submit a first premium with the application[80] and possibly also that it assume the additional costs of issuing oral and written disclaimers.[81] Insurers would

[80] Payment of a first premium is thought to reduce the likelihood that the insured will withdraw from the transaction. *See* Prudential Ins. Co. v. Lamme, 83 Nev. 146, 149, 425 P.2d 346, 347 (1967).

[81] In addition, because in such cases it will be difficult to prove that an individual's expectations were actually dispelled, insurers may not find it worthwhile to try to do so. One can picture the precautions that might have to be taken in order to make such proof possible: it might be necessary, for example, to preserve an agent's notes in much the same way that a

weigh these costs carefully before assuming them simply to avoid liability at the hand of the expectations principle. Third, expectations may be difficult and costly to dispel when they involve minor or highly technical components of coverage.[82] Finally, the difficulties of a case-by-case application may render the expectations principle less effective in practice than in theory.[83]

In sum, the expectations decisions promise only limited success in promoting the dissemination of coverage information. Although the principle may encourage alterations in insurer conduct that can be achieved easily and inexpensively, it is unlikely to effect more fundamental features of insurer behavior where such changes would be contrary to the economic interests of insurers.

2. *Informed Assent*

The additional disclosure of coverage information that the expectations principle encourages may promote informed assent as well as economic efficiency. Encouraging fully informed choice is not only a means to an economic end; it is in a sense an end in itself. Choices made in comparative ignorance are more like guesses than choices. The production of information facilitates genuine choice and thereby serves the interests of autonomy and freedom of contract, as well as economic efficiency. Legal doctrines

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physician's notes concerning a patient's informed consent to treatment are now recorded on the patient's hospital chart.

[82] For example, in the accident insurance cases, the absence of a major component of coverage is of considerable significance and can probably be explained in a nontechnical fashion. In the duty-to-defend cases, however, because the gap in coverage is likely to be obscure, explanation might be difficult. Moreover, there are limits on the amount of information that can be disclosed effectively. One or two important features of coverage (or lack of it) can be explained easily, but the more that is disclosed, the less conspicuous the disclosures will be, unless substantial time is taken in explanation. The difference between the misleading expectations and mandatory coverage cases is important in this respect. Coverage may be desirable in many instances, but it would be impossible to disclaim coverage of all matters for which coverage might be desirable. Disclaiming only those that the insured expects because of an impression he has received from the insurer will be far less expensive.

[83] *See* Schwartz & Wilde, *supra* note 77, at 678-79. Not all those who reasonably expect coverage will bring suit, and not all meritorious claims will succeed. In addition, the courts are limited by the remedy they can impose. For arguments that remedies in some insurance cases should include additional damages in order to assure compliance with liability rules, see Holmes, *Is There Life After Gilmore's Death of Contract?—Inductions from a Study of Commercial Good Faith in First-Party Insurance Contracts*, 65 CORNELL L. REV. 330, 353-88 (1980); Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. CAL. L. REV. 1, 26-28 (1975).

such as informed consent[84] and the duty to warn about the dangers of unsafe products[85] encourage the dissemination of information to protect those interests. The expectations principle is analogous to these doctrines and serves similar interests.

As noted earlier, the effectiveness of the expectations principle in promoting disclosure is likely to be limited. The sole justification for the principle, however, does not lie in its success in promoting disclosure of additional information. Regardless of whether a decision to honor the insured's reasonable expectations affects the insurer's future behavior, such a decision acknowledges the value of informed assent by treating its absence as a circumstance of special legal concern. The decision to honor an insured's expectations thus recognizes an ideal. Despite this principled justification, however, and because the effectiveness of the expectations principle in promoting the disclosure of additional information is questionable, the principle must find justification in considerations that reach beyond economic efficiency and informed assent.

B. *Equitable Goals*

Equity provides a second justification for honoring the reasonable expectations of the insured. Many courts have pointed to the insurer's role in creating or failing to dispel expectations as a justification for imposing liability.[86] In such cases, the courts have relied implicitly on equitable principles of fairness to override even clear policy provisions. In many ways, the equitable reasons for honoring an insured's expectations are the most important at this stage in the development of the expectations principle. As in many other fields of law, efficiency and risk-distribution goals often must operate within the space left open by equity, or "corrective" justice. There are occasions when equity requires an inefficient allocation of resources, and situations in which achieving fairness be-

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[84] *See* Waltz & Scheuneman, *Informed Consent To Therapy*, 64 Nw. U.L. Rev. 628, 629 (1970) ("Consent, to be effective, must stem from an understanding decision based on adequate information about the therapy, the available alternatives and the collateral risks.").

[85] *See* 1 L. Frumer & M. Friedman, Products Liability § 8 (1980).

[86] *See, e.g.*, Smith v. Westland Life Ins. Co., 15 Cal. 3d 111, 539 P.2d 433, 123 Cal. Rptr. 649 (1975); Lacks v. Fidelity & Cas. Co., 306 N.Y. 357, 118 N.E.2d 355 (1954). In other cases, it appears that the insurer's role, although not mentioned specifically, was an implicit factor in the court's determination. *See, e.g.*, Kievet v. Loyal Protective Life Ins. Co., 34 N.J. 475, 170 A.2d 22 (1961).

tween the parties must run the risk of causing market adjustments inconsistent with the ideals of distributive justice. In this field, as in others, the law must serve competing interests. Because the tension among these three principles cannot always be reconciled completely, sometimes the best that the law can do to achieve consistency is to recognize the points at which one interest becomes more important than another.

Equity has developed a number of doctrines regulating the rights of parties who suffer losses due to misinformation. Remedies at law for such losses traditionally have been limited. The courts are hesitant to impose liability for losses caused by misinformation in the absence of fraud[87] or proof that there was a special relationship between the parties that would oblige the defendant to exercise reasonable care in transmitting the information in question.[88]

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[87] *See* Hill, *Damages for Innocent Misrepresentation,* 73 COLUM. L. REV. 679, 686-88 (1973).

[88] Only where the plaintiff and defendant have a relationship of trust and confidence, or where the defendant is an expert whose product is information, is such a recovery permitted. *See* W. PROSSER, *supra* note 77. *See also* James & Gray, *Misrepresentation* (pt. 1), 37 MD. L. REV. 286, 308 (1977).

An exception to the rule that fraud or negligence is required, and one that provides some analogical support to the expectations decisions, is found in the law of warranty. Warranty law holds a seller responsible for his express and implied representations concerning the quality of his product, regardless of his blameworthiness or his intent to deceive. Warranty law, however, has been confined mainly to specific commercial relations. A seller of goods may be held responsible for the expectations of a buyer if he had reason to know that the buyer was relying on his skill or judgment to fulfill those expectations. *See* U.C.C. § 2-315.

This liability would arise only if the buyer's needs were unusual and were peculiarly related to his trade or business. *Id.* at Comment 2. Where the buyer's needs are more common, as is usually the case when a buyer purchases insurance, warranty theory generally would not hold the seller responsible for meeting the buyer's expectations. If a gap in coverage were glaringly inadequate, however, an insurer might by analogy be said to have violated an implied warranty of merchantability. *See* U.C.C. § 2-314(2)(c); Leatherberry, *Remedies for the Buyer or Beneficiary of an Unsuitable Life Insurance Plan,* 32 RUTGERS L. REV. 431, 440-67 (1979) ("suitability" standard proposed).

Finally, commercial-law rules referring to express warranties provide that sellers may be liable for certain promises or affirmations of fact concerning goods sold, even if those affirmations have not been reduced to contract terms. *See* U.C.C. § 2-313. There are enough significant differences between express warranties and the expectations principle, however, to render the analogy weak. First, express warranties are normally just that: expressed. They need not be expressed as warranties, but it is doubtful whether conduct alone can constitute an "implied in fact" express warranty. Second, the seller's affirmation or promise must be made part of the "basis of the bargain." U.C.C. § 2-313(1). This has been interpreted as relaxing the pre-Code requirement of the buyer's reliance on the seller's warranty in purchasing the product warranted. But the Code merely relaxes the reliance requirement; it does not abolish it. At least some form of reliance probably must still exist. The affirma-

In most of the expectations cases—even those involving misleading impressions—the insurer's conduct generally would not meet the legal requirements of either fraud or negligent misrepresentation. Equity, however, often grants relief based on the relative blameworthiness of the party from whom the misinformation flows.[89] To this end, contract reformation has long been available in a variety of contexts, and the courts often have invoked the doctrine of equitable estoppel to prevent one party from benefiting from the mistaken impression it has conveyed to another. Both reformation and equitable estoppel operate in a fashion that is analogous to the expectations principle.

1. *Reformation*

Courts may invoke the equitable remedy of reformation when, due to the mistake of one or both parties, a written instrument fails to express the real agreement of the parties.[90] This remedy has its origin in a body of contract law that holds that the parties must come to a meeting of the minds before a contract is formed.[91] Thus, reformation was first invoked when the mistake in the instrument was mutual and the court's only task was to "reform" the written instrument to conform to the actual agreement of the parties. As the remedy developed, it was extended to include relief where only one party was mistaken about the content of the contract, but the other party was aware of that mistake.[92] Though by

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tion, for example, may have to provide assurances of quality that would have a substantial effect on the buyer's decision to purchase. Applying even this relaxed requirement to tbe expectations cases, would raise questions concerning the insureds' rights to recover in many of them.

[89] This article recognizes that no single principle, legal or equitable, can explain adequately all the expectations decisions. *See* R. KEETON, *supra* note 1, at 351. Nevertheless, the analysis suggests that there is only limited support for these decisions in justifications divorced from their equitable roots. Criteria for applying the principle therefore should draw heavily on its underlying equitable basis, even if the rules of equity cannot fully explain the expectations principle's operation.

[90] 3 J. POMEROY, EQUITY JURISPRUDENCE § 870 (2d ed. 1892).

[91] *Id. See also* RESTATEMENT (SECOND) OF CONTRACTS § 21A(1) (Tent. Draft Nos. 1-7, 1973).

[92] "Knowledge by one party of the other's mistake regarding the expression of the contract is equivalent to mutual mistake." S. WILLISTON, CONTRACTS §1548, at 125 (3d ed. 1970).

The Restatement adopts a similar rule: where one party knows or has reason to know the meaning the second party attaches to the contract, then the contract has that meaning, its terms this extension still turns on the parties' contractual intent, where the mistake is not wholly mutual, reformation also involves balancing the relative faults of the parties. As commentators have noted, reformation is available not only where one party knew of the other's mistake, but also where one was mistaken because of the other's fraudulent or inequitable misrepresentation.[93] In either case, whether one party actually induced the other's interpretation or only knew of it, he is the more blameworthy for having allowed the other party to labor under delusions about the contract's contents. Of course, where actual inducement is not involved, it may be difficult to show that the first party knew of the other's mistake. Thus, the more likely it is that the first party caused[94] the misinterpretation, the stronger the inference that he knew or should have known of it.

2. *Equitable Estoppel*

The doctrine of equitable estoppel may also provide some insight into the equitable foundations of holding the insurer responsible for the insured's expectations. Rather than examining the injured party's interpretation of an agreement, estoppel focuses directly on the injuring party's conduct. A person may be estopped from asserting as a defense the truth of a matter that he has misrepresented to another if the latter has relied on the misrepresentation.[95] Estoppel does not require an intent to deceive. If the mis-

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unless the second party also knows or has reason to know the meaning attributed to it by the first party. RESTATEMENT (SECOND) OF CONTRACTS § 21A (Tent. Draft Nos. 1-3, 1964). *See also* 3 A. CORBIN, CONTRACTS §357 (rev. ed. 1960).

[93] *See, e.g.,* D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES §§ 9.5, 11.6 n.20 (1973). *But see* G. PALMER, MISTAKE AND UNJUST ENRICHMENT 75 (1962) (inequitable conduct usually involves knowledge of the other person's mistake).

[94] The term "causal responsibility," as used here, includes situations where the insurer is not only a "but for" cause or a "cause in fact," but also, in common parlance, *the cause* of the misinterpretation. Where the concern is equity between the parties, this definition, rather than one concerned with cost avoidance (an efficiency concern) or cost spreading (a distributive concern), is the more appropriate. *Cf.* Calabresi, *Concerning Cause and the Law of Torts: An Essay for Henry Kalven, Jr.,* 43 U. CHI. L. REV. 69 (1976) (discussing causal responsibility from an economic perspective).

[95] W. PROSSER, *supra* note 77, § 105. One obvious difference between estoppel and the expectations principle is that the former requires detrimental reliance. For a discussion of the justifications for dispensing with a reliance requirement in expectations cases, see Keeton, *supra* note 6, at 977-79.

The expectations cases rarely refer explicitly to any reliance requirement. *But see* Harr v.

representation is active—involving words or conduct made with reason to believe another would rely—then the misrepresentation alone may be sufficiently blameworthy for estoppel to hold the other responsible.[96] If the misrepresentation is passive—failure to disabuse another of his misconceptions—estoppel requires that his silence at least be negligent.[97] In the latter case, estoppel would require that the offending party have some reason to know of the other party's misconceptions and of his intention to act on them.

3. *The Expectations Principle as a Doctrine of Equity*

An analysis of the expectations cases as an equitable balancing of relative faults requires consideration of three interrelated factors, derived in part from the principles underlying reformation and estoppel. First, if the insurer knew or should have known[98] of the insured's expectations, then the equities would weigh heavily in favor of holding it responsible for fulfilling them.[99] Second, if

Allstate Ins. Co., 54 N.J. 287, 255 A.2d 208 (1969) (proof of reliance required). Nevertheless, in many of the cases, the expectation is likely to have influenced the decision to purchase coverage; in a few of the misleading impression cases, the insured's expectation was probably very influential. In these cases, it may not be stretching things too far to presume reliance. In the mandatory coverage cases, however, reliance is unlikely.

Even apart from these considerations, it may be sensible to dispense with proof of specific reliance and causation in order to protect the more general reliance encouraged by insurance coverage. The belief that one has insurance protection against losses arising out of a particular kind of activity encourages broad, diffuse, and pervasive reliance. First, it encourages the insured activity. Second, by sheltering a portion of the insured's assets from casualty, or by providing future financial security, insurance encourages venturesome uses of capital that would otherwise be used more cautiously. This is exactly the kind of reliance that awards of expectation damages in commercial transactions cases encourage—everyday conduct so built into our system that there is no way to measure its cost, or to prove to what extent it has been caused by one of the many devices society uses to encourage it. In this sense, there has been reliance by the insured in any expectations case, but that reliance is too general to be proved. To encourage that reliance, the law may have to dispense with its proof. *See* Fuller & Perdue, *The Reliance Interest In Contract Damages* (pt. 1), 46 YALE L.J. 52, 62 (1936).

[96] *See* Williston, *Liability for Honest Misrepresentation*, 24 HARV. L. REV. 415, 424 (1911).

[97] *See* W. PROSSER, *supra* note 77, § 105.

[98] Although it is sensible to speak of the causal responsibility of a corporate entity for an individual's expectations, the assumption that a corporate body has knowledge of those expectations is a less comfortable one. Drawing an inference of "knowledge" from the fact of causal responsibility requires that the insurer be personified in perhaps unrealistic fashion. Nevertheless, because our concern here is not with the actual knowledge of any particular individual, but with what the insurer, as seller of coverage, has within its power to know, the personification seems appropriate.

[99] *See* note 92 *supra*.

the insurer also created or helped create those expectations, equity would suggest even more strongly that those expectations be fulfilled.[100] Finally, the insured's expectations must be reasonable before equity will demand that they be fulfilled. In most cases, this criterion will be met if one of the other two is: the insurer normally should not be presumed to know of an unreasonable expectation. Conversely, if the insurer created an expectation, it is probably reasonable for the insured to hold it.[101]

The extent to which the expectations decisions may be explained as involving a balancing of equities of this sort is best revealed by examining the insurer's role in creating the insured's expectations. As reformation doctrine indicates, equity might hold the insurer responsible simply for knowing of but not dispelling the insured's false expectations. In most situations, however, knowledge, if it existed without more, would be difficult to demonstrate. If the insurer created the expectations, it is arguably not only more blameworthy[102] than it would be had it merely failed to dispel them, but it is also more likely to have known of the expectations which it created. On the other hand, the less direct the link between the insurer's words or conduct and the insured's expectations, the less justifiable the inference of knowledge from causal responsibility. It is not surprising, then, that in the expectations cases where causal responsibility is less direct, the courts have reached for collateral support to justify honoring the insured's expectations. These cases are less easy to explain by reference to traditional equitable principles, but they find justification in considerations of substantive fairness. The following examples illustrate how the equitable component of the expectations principle varies with the directness of the insurer's responsibility for the insured's expectations.

[100] *See* notes 95-97 *supra* and accompanying text.

[101] Similarly, estoppel would limit recovery to cases where there is reasonable reliance. Reasonableness in the insurance context is probably different from reasonableness in other contract situations. In most cases, it would be unreasonable for one party to derive any expectations directly contradicted by the language of a contract he has entered. As has been frequently noted, however, in the insurance context the insured's contract is one over which he did not bargain and the terms of which he may not understand. It may therefore be reasonable for him to hold expectations contradicted by the policy language and for the insurer to be held responsible for them.

[102] For an effort to translate this notion of causal responsibility into rules of tort liability, see Epstein, *A Theory of Strict Liability*, 2 J. Legal Stud. 151 (1973).

a. Where the Policy Itself Creates the Expectation

The maxim that ambiguities in an instrument should be construed against the drafter itself emphasizes the element of comparative responsibility. Because the drafter could have avoided the ambiguous language, it is fair that, of the two parties, the drafter should be the one whose expectations are disappointed.[103] This balancing of equities is also manifested by the courts' tendency to limit the construction of ambiguities to meanings that could reasonably have been expected by the non-drafting party.[104]

The fairness of construing ambiguities against the drafter is made apparent in the insurance context by several factors. First, insurance policies are difficult to understand.[105] Second, policies are often not issued and made available to the insured until after their sale.[106] Finally, the typical personal insurance consumer has little opportunity to bargain with an insurance company over the terms of a policy.[107] These factors also support the extension of the

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[103] *See* 1 G. COUCH, CYCLOPEDIA OF INSURANCE LAW §15.73 (2d ed. R. Anderson 1959). Absent ambiguity, the logic of freedom of contract supports a presumption that the parties actually assented to the written agreement, and only a strong showing that one of the elements necessary to contract formation is missing will invalidate that agreement. *See* Murray, *Unconscionability: Unconscionability,* 31 U. PITT. L. REV. 1, 20-21 (1969); Slawson, *Standard Term Contracts and Democratic Control of Lawmaking Power,* 84 HARV. L. REV. 529, 539-47 (1971). It is therefore not surprising that in almost all of the expectations cases, the courts attempt to ground their decisions at least in part on the ambiguity of policy language.

[104] For examples of this principle applied in the insurance context, see Herzog v. National Am. Ins. Co., 2 Cal. 3d 192, 198-99, 465 P.2d 841, 844, 84 Cal. Rptr. 705, 709 (1970); Sorensen v. Farmers Ins. Exch., 56 Cal. App. 3d. 328, 128 Cal. Rptr. 400 (1976); Commercial Union Assurance v. Gollan, 118 N.H. 744, 394 A.2d 839 (1978). *But see* Note, *supra* note 7, at 418 n.69.

[105] The problem may be addressed by requiring that policies be drafted in plain language. But even this remedy is likely to render incomplete the expression of both parties' rigbts under the contract: the full meaning of the language may then only be determined on a case-by-case basis. *See* Young, *Insurance,* 26 SYRACUSE L. REV. 275, 280 (1975).

A related problem is that insurance contracts usually are not read. *See* W. YOUNG, CASES AND MATERIALS ON THE LAW OF INSURANCE 78-80 (1971). This phenomenon argues against searching scrutiny of ambiguities in the policy in order to justify invocation of the expectations priuciple. It has also been forcefully argued that an insured should not be awarded coverage simply because he did not read his policy. *See* Rodman v. State Farm Mut. Auto. Ins. Co., 208 N.W.2d 903, 906-07 (Iowa 1973). *See generally* MacCauley, *Private Litigation and the Duty To Read—Business Run by IBM Machine, The Law of Contracts and Credit Cards,* 19 VAND. L. REV. 1051, 1054 (1966).

[106] Package policies of homeowners' and automobile insurance, for example, are often ordered by telephone. *See* R. KEETON, *supra* note 1, at 352.

[107] Insurance policies are standard forms and are not altered for individual purchasers.

expectations principle beyond the construction of ambiguities to situations where the insurer has caused an expectation of coverage despite clear and contrary policy language.

b. Where the Insurer is Directly Responsible for the Insured's Expectations

Although many expectations cases are based in part on the ambiguity of policy language, the expectations in these cases are in fact often derived independently of the contract. In such cases, the equities clearly weigh in the insured's favor if the insurer is directly responsible for the insured's expectations. Thus, in the solicitation-by-mail cases,[108] the court held the insurer responsible because language in its solicitation had a tone of urgency sufficient to create the expectation of immediate coverage. In *Klos v. Mobil Oil Co.*,[109] these expectations were confirmed by delivery of the policy. In the temporary life insurance cases,[110] insurers created the expectation of immediate coverage by accepting a first premium. In both sets of cases, the inference that the insurer was aware of the expectations it had created seems legitimate. This combination of causal responsibility and presumptive knowledge of the insured's expectations certainly justifies a balancing of the equities in the insured's favor.

c. Where the Insurer is Only Indirectly Responsible for the Insured's Expectations

Where the insurer is only indirectly responsible for the insured's expectations, the relative responsibilities of the parties is more difficult to assess. In those cases, courts have tended to reach beyond expectations and the equities related to them to justify finding for

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Although the insured may have a choice concerning amounts and categories of coverage, each is offered on a take-it-or-leave-it basis. In addition, because the terms offered tend to be nearly identical for certain kinds of insurance, there is little incentive to compare the provisions offered by several insurers. This market advantage provides insurers with greater opportunity to include policy provisions that contradict the expectations of prospective insureds than would otherwise be available. Furthermore, because the attempt to negotiate for terms more consonant with his expectations usually would be futile, the insured has little reason to examine policy terms to determine whether they meet his expectations.

[108] *See* text at notes 24-29 *supra*.

[109] 55 N.J. 117, 259 A.2d 889 (1969).

[110] *See* text at notes 39-45 *supra*.

the insured. In each of the flight insurance cases,[111] for example, the insurer was indirectly responsible for the insured's expectations in that it chose an automated marketing technique. In *Lacks*, the insurer went further and created an expectation of coverage more directly by placing the vending machine in front of the charter counter.[112] The insurer in *Steven*, however, did nothing directly to create an expectation of coverage.[113] The court therefore supported its decision to hold the insurer in the latter case responsible by finding that the exclusion of coverage was not only unexpected, but tended toward the harsh and unconscionable.[114] Similarly, in

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[111] *See* text at notes 14-23 *supra.*

[112] *See* text at notes 14-15 *supra.*

[113] *See* text at note 21 *supra.*

[114] *See* text at note 23 *supra.* The relationship between the expectations principle and the doctrine of unconscionability has never been entirely clear. Professor Keeton described it as follows:

> [R]ights at variance [with policy provisions] that would otherwise be recognized under the expectations principle [are not] defeated by a policy holder's specific knowledge of the policy provisions that limit protection in a surprising way . . . [if] such a knowledgeable policyholder would receive coverage disproportionately small in comparison with its premiums.

Keeton, *supra* note 6, at 974-75. Keeton's theory is supported by the cases that apply the principle, despite the absence of evidence of the insured's actual expectation, for reasons of substantive unconscionability. Often it is not clear, however, whether the courts in these cases have held such provisions unconscionable hecause most people would be surprised by them or because (regardless of surprise) the provisions were unduly harsh or one-sided. In theory, the expectations principle should apply only in the former cases. To the extent that the cases impose liability on the latter ground, they find support not in the considerations underlying the expectations principle, but in the doctrine of commercial unconscionability. *See* U.C.C. § 2-302.

The remedy granted in the expectations cases, however, goes beyond that normally available for unconscionability. U.C.C. § 2-302 provides that upon finding a contract or provision unconscionable, the court may refuse to enforce the contract, enforce the contract without the unconscionable clause, or so limit the unconscionable clause as to avoid an unconscionable result. *See* U.C.C. § 2-302. The expectations principle, by contrast, does not limit itself to declaring exclusions from coverage invalid; it also broadens unexpectedly narrow insuring clauses. For example, consider a policy insuring against all injuries "caused solely and exclusively by external, violent, and accidental means." *See* Burr v. Commercial Travellers Mut. Accident Assoc., 295 N.Y. 294, 67 N.E. 2d 248 (1946). A court finding the clause unconscionable could rescind the contract and return the insured's premium. The court would also have authority under U.C.C. §2-302 to limit application of the clause. But there is no way to "limit" the clause so as to expand coverage. The expectations principle, on the other hand, would not merely invalidate the clause; it would reform it to supply the expected coverage. In sum, to the extent that courts find provisions in insurance policies unconscionable because the coverage they offer is unexpectedly and misleadingly small, their rationale would appear consistent with the expectations principle. On the other hand, to the extent that the basis of these decisions is the inherent harshness of the provisions in question, regardless of the accident insurance cases, there was no evidence that the insurer actively encouraged the insured's expectations. The insurer could be charged with knowledge of the insured's expectations only because of the common understanding of the word "accident" in the title of the policy. As in the other indirect responsibility cases, however, the court reinforced its decision by finding that the coverage that the insurer offered was not only unexpected, but was disproportionately narrow considering the substantial premium the insured paid.[115]

d. Where Expectations are Created by Forces for Which the Insurer is not Responsible

In most cases, the less responsibility the insurer has for the insured's expectations, the less notice it will have of the probable existence of those expectations. If there is neither causal responsibility nor presumptive knowledge on the part of the insurer, the balance of equities between insurer and insured is nearly equal. A scattering of cases refusing to invoke the expectations principle may be explained on this basis.[116]

The analysis in Section One suggests that in the mandated coverage decisions, not only were both causal responsibility and presumptive knowledge missing, but it was unrealistic to suggest that the average insured would possess any expectations, independent or otherwise, concerning the coverage questions those cases raised. Even if insureds occasionally do possess such expectations, however, the equitable analysis would still be applicable. In such a case, the insured would simply have a reasonable expectation that happened to conflict with the reasonable expectation of the in-

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whether they were expected, the decisions appear to have used the expectations principle as a mask for otherwise unprecedented expansion of the remedies available under the doctrine of unconscionability.

[115] *Kievet* provides an example of a provision that the court apparently found both substantively unconscionable and misleadingly harsh. *See* note 114 *supra*. Probably the substantive unfairness of the provision made it more likely that the insurer knew that the insured would expect more for his premium than the policy provided. *See also* the discussion in Smith v. Westland Life Ins. Co., 15 Cal. 3d 111, 539 P.2d 433, 123 Cal. Rptr. 649 (1975), discussed at notes 42-44 *supra*.

[116] *See, e.g.*, First Nat'l Bank v. Fidelity & Cas. Co., 428 F.2d 499 (7th Cir. 1970), *cert. denied*, 401 U.S. 912 (1971); Herzog v. National Am. Ins. Co., 2 Cal. 3d 192, 465 P.2d 841, 84 Cal. Rptr. 705 (1970); Rodman v. State Farm Mut. Auto. Ins. Co., 208 N.W.2d 903 (Iowa 1973).

surer. Because the equities would be balanced, from an equitable standpoint the contract terms should prevail. If such a conflict were to be resolved in the insured's favor, therefore, it would have to be for reasons that transcend equity. As we saw above,[117] although it might be conducive to economic efficiency and informed assent if the insureds in such cases were informed of various omitted coverages, it is unlikely that the expectations principle would often have this effect. Only distributive justifications therefore seem available to support the mandated coverage decisions. The distributive implications of both sets of cases are examined below.

C. *Risk Distribution*[118]

Insurance is a tool for distributing the risk and the cost of various kinds of losses among groups of risk bearers. A court's decision to honor the expectations of an insured may thus be justified as furthering this cost-spreading feature of insurance.[119] The ultimate effect of any particular decision or decisions will depend on the kind of expectations being honored and the kind of coverage involved. The results of the cases may therefore be evaluated by tracing these distributive effects and by assessing the costs and benefits of the increased risk sharing achieved by the expectations principle in particular situations.

In this regard, there is little basis for drawing an initial distinction between the misleading impression and the mandated coverage cases. Whether the absence of coverage is unexpected, both unexpected and unfair, or merely undesirable has little relevance to the desirability of mitigating the effects of an otherwise uninsured loss. But the expectations decisions may have beneficial effects in addition to the immediate cost spreading that results from invok-

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[117] *See* notes 74-84 *supra* and accompanying text.

[118] The term "risk distribution" is often used to refer to a number of separate concepts. *See* Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts,* 70 YALE L.J. 499 (1961). It is used here to refer to risk spreading, which is one of many of the possible goals of distributive justice.

[119] Though the effect of any individual decision is the redistribution of wealth between the insurer and the insured, there is little question that ultimately the insurer will spread at least part of its increased cost to its other policyholders. Preventing the second redistribution would require airtight regulation of prices and policy terms, a task to which the courts are not equal. *See* Schwartz, *Seller Unequal Bargaining Power and the Judicial Process,* 49 IND. L.J. 367, 374 (1974).

ing the expectations principle. An increase in the flow of information and, consequently, in market efficiency may result in a greater variety of coverage options or in coverage for previously uninsured activities.[120]

On the other hand, the expectations decisions may have other, perhaps undesirable, distributive effects. By upsetting private risk-distribution decisions, the expectations principle may reallocate wealth. Because purchasers of insurance have entered a risk-sharing arrangement voluntarily, it is perhaps more legitimate to ask that they share additional risks than almost any other contracting parties. Even given this tacit consent to a limited amount of wealth redistribution, however, questions remain whether the final distribution is equitable and whether courts are well suited to fashion it.[121]

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[120] *See* notes 76-77 *supra* and accompanying text. For the most part, however, this probably has not been the major distributive effect of the expectations principle. For whatever reason, insurers have not generally considered it worthwhile to differentiate their coverage offerings very much further. This suggests that the skepticism expressed above about the efficiency-inducing effects of the principle is in fact warranted. *See* notes 78-82 *supra* and accompanying text.

[121] Distributive justice has been broadly defined as a fair division of wealth among members of society. *See* Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472, 472 (1980). The validity of distributive justice as a social goal is a much debated issue. *Compare* F. HAYEK, THE CONSTITUTION OF LIBERTY 93-102, 133-61 (1960) *and* R. NOZICK, ANARCHY, STATE AND UTOPIA 149-53, 167-74 (1974) *with* Kronman, *supra*, *and* J. RAWLS, A THEORY OF JUSTICE (1971). Controversy stems both from the difficulty of defining the concept of a "fair division of wealth," *see* Kronman, *supra*, at 498, and of agreeing on the merits of the approaches to be used to achieve that goal. *Compare* J. RAWLS, *supra*, at 87-88, 274-79 *with* Kronman, *supra*, at 498-511 *and* R. DWORKIN, LIBERALISM IN PUBLIC AND PRIVATE MORALITY 133 (S. Hampshire ed. 1978). In particular, commentators have argued that using judicial wealth distribution as a means of increasing economic efficiency may be inconsistent with democratic values. *See* R. DWORKIN, TAKING RIGHTS SERIOUSLY 84-86 (1977); Schwartz, *Products Liability and Judicial Wealth Redistribution*, 51 IND. L.J. 558 (1976); Wellington, *Common Law Rules and Constitutional Double Standards: Some Notes on Adjudication*, 83 YALE L.J. 221, 243-54 (1973). *See also* Kimball & Pfennigstorf, *Legislative and Judicial Control of the Terms of Insurance Contracts: A Comparative Study of American and European Practice*, 39 IND. L.J. 674, 729 (1964) (judges should assume less dogmatically that they know what minimum decencies require).

Risk spreading, on the other hand, though it is one form of wealth redistribution, often is applauded. *See* G. CALABRESI, THE COSTS OF ACCIDENTS 55-58 (1970). For example, it has been argued forcefully that risk spreading considerations play a major role in such doctrines as "respondeat superior" in torts and "impossibility of performance" in contract. *See* Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961); Posner & Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 89-92 (1977). The question remains, however, whether the courts are the proper branch of government through which to effect such a distribution of

The increased possibility of adverse selection is the first long-term distributive effect of the expectations principle that should be noted.[122] For example, the flight insurance cases may increase the number of charter fliers who purchase coverage, the temporary life insurance cases may increase the number of applicants for insurance who have a better-than-average chance of dying during the application period, and so forth. If this pressures insurers to raise premiums, then other insureds will have to pay higher premiums than their own loss potential would otherwise require. Whether this is appropriate depends on many factors, including the nature of the characteristic that distinguishes the two groups.

Other things being equal, it would seem fairer to pool risks where insureds have no control over risk-increasing characteristics than where they do.[123] For example, some people prefer not to fly on unscheduled or charter airlines because of their safety records; others willingly take the increased risk of flying on such carriers. Decisions like *Lacks* and *Steven* tend to force these two groups, perhaps unfairly, to share the risk of mishaps on such flights. Similarly, the duty-to-defend cases pool two distinct groups: those who are sued for committing intentional torts and those who are not. To the extent that the former group has some control over the activities that give rise to this litigation, it might well be thought unfair to ask the latter group to help "subsidize" these activities.

In contrast, many of the decisions could have distributive effects that seem intuitively acceptable. In the accident insurance cases, the extension of coverage to all losses generally understood as accidental spreads the risk of having a natural handicap or physical infirmity to all those in the insurance pool. This appears to be fair, because the odds are good that everyone has infirmities that could combine with external forces to cause "accidental" injury.[124] Even

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risks.

[122] Adverse selection occurs when a group of potential insureds are treated alike, regardless of characteristics that distinguish their loss potential. A disproportionately high percentage of "adverse" risks may then apply for coverage because they will get a better bargain than the low-risk applicants. *See* R. KEETON, *supra* note 1, at 8.

[123] Others may legitimately disagree with the arguments concerning risk-distributive justice asserted here. Part of the point of this analysis, however, is to demonstrate that because there will be distributive consequences about which people will feel differently, the courts probably should not invoke the expectations principle for reasons of distributive justice alone.

[124] Similarly, as a result of the solicitation by mail and temporary life insurance cases, all

in connection with these cases, however, questions may be raised about the distributive effects of honoring expectations of coverage. These questions stem not from the fact that these effects are necessarily inequitable, but from the improbability of achieving a consensus as to exactly what constitutes risk-sharing fairness in a given situation.[125] When this is so, the most that can be said for the rearrangement achieved by judicial intervention is that it is "not inequitable." In such cases, a satisfactory justification for the judicial use of the expectations principle to promote risk spreading alone does not seem available.

Moreover, a second possible byproduct of the risk spreading entailed in the expectations decisions is that they will limit the insured's freedom of choice by involuntarily increasing the scope of the coverage he purchases. Any increase in a policy's package of insurance protection will often increase its price. Those who would prefer the narrower but cheaper coverage will then be forced to accept more insurance than they want in order to obtain the coverage they need.[126] Where having insurance coverage is optional, some people will choose not to buy it at all—the increase in cost caused by the expectations principle will have priced them out of the market. Where the coverage is effectively mandatory—automobile liability or fire insurance on mortgaged real estate—insureds will have to give up other noninsurance goods in order to buy the mandated but overly broad coverage.

This analysis demonstrates the importance of tracing the distributive effects of the expectations decisions where distributive concerns are a significant factor in the decision. It is deceptively easy to find an insured's expectations "reasonable" and require that they be honored in order to mitigate the consequences of the insured's unfortunate loss. It is more difficult, but very important, to realize that the award of compensation in such cases may have

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insureds bear the risk of death during the application period. In the duration of coverage cases, however, the difference between ventures insured might in some cases be significant. For example, compare the length of the "tail" of potential malpractice claims against a collection lawyer with that of the title searcher. Most of the former's claims would be resolved shortly after the error giving rise to them. The latter's claims might not manifest themselves for many years.

[125] *See* note 121 *supra* and accompanying text.

[126] For a criticism of the *Gray* opinion, based in part on its potential effect on insureds' freedom of choice, see Note, *supra* note 55, at 1338.

more profound effects than a simple reduction of the insurer's surplus. Saving one insured from catastrophe may not simply spread a neutral risk to all insureds; it may spread it in ways that a court sensitive to the consequences of its actions would find disturbing. Because of the potential wealth redistribution effects of the expectations principle, the degree of fault in an insurer's behavior may be a much more reliable ground for application of the principle than the desire to achieve an appropriate distribution of risks.

III. Guidelines for Adjudication

The expectations principle may be used to pursue a number of goals in a variety of insurance settings. As the preceding survey and analysis demonstrate, however, the principle's capacity to achieve these goals is not unlimited. In an effort to formulate guidelines for use of the principle, this section examines three kinds of limitations: (1) the institutional constraints that courts should observe in regulating insurance coverage in light of the concurrent authority of other governmental agencies; (2) the legitimacy of the courts' use of the principle to pursue economic, equitable, and distributive goals, considering their complexity and interdependence; and (3) the limits on the probable effectiveness of judicial regulation in view of the formal characteristics of adjudication and of the principle itself. These limits may be characterized as institutional, substantive, and formal.

A. *Institutional Constraints*

Legislation in every state has established an administrative agency—usually a state insurance commission or commissioner and his staff—with authority to regulate the prices and terms of insurance coverage.[127] The scope of that agency's authority and the means that may be used to exercise it vary, but in every state the agency has the authority to affect, directly or indirectly, the terms of most policies of personal insurance.[128] The question therefore is

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[127] *See* R. Keeton, *supra* note 1, at 68-73, 554-57; Kimball & Pfennigstorf, *Administrative Control of the Terms of Insurance Contracts: A Comparative Study*, 40 Ind. L.J. 143 (1965); Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 Minn. L. Rev. 471 (1961).

[128] Most of the legislation was enacted after the McCarran-Ferguson Act, 15 U.S.C. §1011 (1976), overruled United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944),

whether, in light of this administrative authority, the courts have a legitimate role to play in this field.

Several arguments may be made in support of the role the courts have played in creating the expectations principle. First, the enactment of regulatory legislation indicates that the industry's activities sufficiently affect the public interest to justify legal control over those activities. Although the exercise of this regulatory authority may on occasion preempt judicial involvement in this field, not all regulation should be viewed as preemptive. General administrative approval of premium levels and policy terms should not foreclose inquiry into their acceptability in exceptional cases. Moreover, approval of the substance of policy terms does not necessarily indicate approval of the procedures used to market the policies containing them. In both respects, the tradition of judicial intervention to guard against the more egregious examples of insurer misconduct is strong enough to counter any inference that a judicial role has been foreclosed, except where that intention is expressed specifically.

Second, regulation often has been unsystematic and ineffective.[129] In many states, the flexibility necessary for effective regulation has not been available, resources provided regulatory agencies have been insufficient, and the industry has tended to dominate the regulators.[130] These deficiencies tend to justify judicial intervention.[131] Finally, judicial intervention is subject to an administrative check against radical judicial innovation: although judicial decisions are final, the rules they establish are not. Just as the

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by rendering the insurance industry immune from federal antitrust law in states that enacted insurance regulatory legislation by 1948.

[129] *See* Kimball & Pfennigstorf, *supra* note 121, at 698. The inconsistency has been furthered by a general lack of systematic theory in regulation. *See* S. KIMBALL & H. DENENBERG, INSURANCE, GOVERNMENT AND SOCIAL POLICY 4 (1969).

[130] For a catalog of complaints, see N.Y. INSURANCE DEPARTMENT, THE PUBLIC INTEREST NOW IN PROPERTY AND LIABILITY INSURANCE REGULATION (1969), *cited in* R. KEETON, BASIC INSURANCE LAW: CASES AND MATERIALS ON BASIC INSURANCE LAW 983-98 (1977).

[131] Had agencies made the deliberate decision to refrain from detailed regulation, the argument against judicial involvement would be stronger. *See* Morris, *Waiver and Estoppel In Insurance Policy Litigation*, 105 U. PA. L. REV. 925, 951-52 (1957). Consider also one court's assessment of the issue: "In Idaho, as in most states, the consuming public and the public interest is to be guarded by a state insurance commissioner. The policy in question herein is an example that the efforts of the state authority have at times fallen short of adequately discharging that responsibility." Corgatelli v. Globe Life & Accident Ins. Co., 96 Idaho 616, 619, 533 P.2d 737, 740 (1975).

courts and legislatures sometimes engage in a colloquy over the meaning and validity of legislation, so regulatory action subsequent to a judicial decision may send a message to the courts that such intervention contravenes considered regulatory policy. In such instances, the courts generally should refrain from further intervention.

In sum, the courts should be reluctant to act where regulation has already addressed the specific question at hand, but the mere existence of paramount regulatory authority does not preclude judicial action in the field. That judicial action may be legitimate, however, does not necessarily mean that it will be effective in pursuing its goals. The limits on judicial effectiveness are both substantive and formal.

B. Substantive Limits

The efficiency, equitable, and distributive justifications considered in Section Two[132] each offers support for judicial use of the expectations principle. Each also suggests clear limits on the extent to which courts can and should pursue those goals.

1. Efficiency

Promoting efficiency through the expectations principle may be an elusive judicial goal. Determining optimal amounts of coverage information inevitably will be an uncertain process; encouraging the production of that information may be little more than an exercise in exhortation. In contrast to legislated disclosure requirements, the expectations principle is likely to be effective only where the cost to the insurer of anticipating and dispelling inaccurate expectations is not high. Thus, although not a perfect test, the more likely it is that the insurer actually created the insured's expectations, the more likely that the benefits of anticipating and dispelling those expectations will outweigh the costs of doing so. The vagueness of this test and the difficulty of implementing it with confidence suggest that efficiency and its complement, informed assent, should be viewed as subsidiary goals. The potential for achieving them may add support to decisions made for other reasons, but they normally will not suffice as independent justifica-

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[132] *See* notes 70-72 *supra* and accompanying text.

tions for judicial action.

2. *Equity*

Balancing tbe equities between parties to an insurance contract is an acceptable judicial function. That function, however, cannot be pursued liberally without sacrificing the certainty and predictability afforded by written policies of insurance. Therefore, the courts should restrain their equitable supervision of insurance transactions. Limiting the application of the expectations principle to cases where the insured's expectations of coverage are "reasonable" is one way to reconcile the need for equitable flexibility with the particular demand of the insurance industry that its obligations be predictable. But the reasonableness test will not effectively regulate the application of the principle until the courts clarify its content. Otherwise, insurance companies may be subject to endless claims of coverage at variance with policy provisions.

The likelihood that the insurer actually created a misleading impression about coverage provides a reliable index of the equities in most of the insurance disputes analyzed here.[133] The misleading

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[133] There are, of course, exceptions to the accuracy of the misleading impression test. There may be cases in which the insurer appears to have created a misleading impression, but the insured in fact was not misled. This possibility again raises the question whether the insured should have to demonstrate that, absent the misleading impression, he would have purchased other coverage or avoided the risky behavior causing his loss. Analogous doctrines based in tort, such as estoppel, fraud, and negligent misrepresentation, usually require such a showing of reliance. *See* W. PROSSER, *supra* note 77. It can be argued that this is also true in unconscionability analysis, where the presumption often seems to be that the oppressive term would not have been agreed to had it been pointed out. Similarly, part of the rationale for liability for failure to bargain in good faith has been that the oppressed party would have refrained from entering the contract if he had been aware of all the objectionable provisions. Even upon a finding of failure to bargain in good faith, however, remedies are limited to reliance and restitution, rather than expectation damages. *See* Kessler & Fine, Culpa In Contrahendo, *Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 HARV. L. REV. 401, 402 (1964).

There are several arguments against a reliance requirement. First, reliance may be difficult to prove in the absence of a range of coverage alternatives from which the insured may choose. Second, a loss of an expected bargain is a loss, regardless of whether the party injured detrimentally relied on tbe promise of the bargain. The law allows recovery for such lost contract expectations, in large part to promote general reliance on business agreements. *See, e.g.*, Hadley v. Baxendale, 9 Ex. 341, 156 Eng. Rep. 145 (1854); Fuller & Perdue, *The Reliance Interest In Contract Damages* (pt. 2), 46 YALE L.J. 373, 375-76 (1936). That factor is particularly siguificant in insurance contracting. Reliance on insurance promotes a sense of financial security that is crucial to the health of the economy. Thus, in many cases in which the insurer appears to have created a misleading impression, reliance by the insured impression standard not only serves as a test for blameworthy conduct by insurers; it also grounds the expectations principle in fundamental principles of contract law by establishing the relevance of the insurer's knowledge of the insured's interpretation of the contract.[134] As a result, the situations in which the principle may be invoked will become more predictable and the competing concerns of equity and certainty may be reconciled.

3. *Risk Distribution*

Courts are understandably uncomfortable with legal doctrines designed to redistribute wealth. Doctrines that promote risk spreading in general, however, may be somewhat less controversial, because society increasingly favors the spreading of the risks against which personal insurance typically protects. Nevertheless, redistributing wealth through mandatory risk spreading is a controversial judicial aim, even in the insurance context. Decisions promoting wealth redistribution often appear inconsistent with democratic values,[135] and the courts seem institutionally ill-suited to make decisions, such as these, that require weighing a series of incommensurable factors.[136] Further, in the insurance context, decisions made for distributive reasons alone threaten the statistical basis of the insurer's decisionmaking. They may therefore render some forms of coverage actuarially unsound or unmarketable. Perhaps this explains the courts' tendency in the mandated coverage cases to base their decisions on fictional expectations instead of revealing more forthrightly the latent distributive reasons for their actions.

Although the courts are probably not the proper branch through

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properly may be presumed; requiring proof of specific reliance might deny recovery in cases where there has been real injury.

[134] *See* text accompanying notes 91-94 *supra*.

[135] *See* R. Dworkin, Taking Rights Seriously 84-86 (1977).

[136] The seminal article on this problem referred to such issues as "polycentric." The article was in circulation for many years before it was published. *See* Fuller, *The Forms and Limits of Adjudication*, 92 Harv. L. Rev. 353 (1978). For applications of Fuller's notions, see Henderson, *Judicial Review of Manufacturers' Conscious Design Choices: The Limits of Adjudication*, 73 Colum. L. Rev. 1531 (1973); Henderson, *Expanding the Negligence Concept: Retreat From The Rule of Law*, 51 Ind. L.J. 467 (1976). This point of view has also been disputed. *See, e.g.*, Chayes, *The Role of the Judge in Public Law Litigation*, 89 Harv. L. Rev. 1281 (1976); Fiss, *Foreword: The Supreme Court, 1978 Term—The Forms of Justice*, 93 Harv. L. Rev. 1 (1979).

which to achieve significant wealth redistribution, there are justifications for taking distributive consequences into account in resolving insurance disputes. First, common-law courts historically have considered distributive effects relevant to their decisions,[137] and the practice has gained some legitimacy simply through precedent. Second, the courts have long been thought capable of determining what kind of conduct falls below minimum standards of justice, even though they may not be as capable of structuring optimally just arrangements in the first instance.[138]

Thus, although the expectations principle should not be invoked for distributive reasons alone, distributive factors are relevant, because the decisions will have distributive consequences.[139] First, awareness of those consequences may assist decisionmaking in cases where other considerations are closely balanced.[140] For example, the flight insurance decisions may appear suspect because they disregard the differences between the risks chosen by passengers of charter and regularly scheduled flights. Second, the apparently undesirable, short-run distributive consequences of such decisions might be acceptable if they encourage a variety of coverage options in the long run. For example, the threat of liability for the deaths of an entire charter party might eventually encourage insurers to

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[137] *See* Calabresi, *supra* note 121; Posner & Rosenfield, *supra* note 121.

[138] *See, e.g.*, E. KAHN, THE SENSE OF INJUSTICE 13-27 (1949). For an argument that judge-made contract law justifiably may be concerned with achieving distributive justice, see Kronman, *supra* note 121. The argument in that article depends on a version of Rawls's difference principle, which is itself controversial. *See* J. RAWLS, *supra* note 121, at 60-75 (1971).

[139] For other points of view about the proper relation of risk spreading and other distributive concerns to nondistributive goals, see Calabresi & Hirschoff, *supra* note 77, at 1091-93 (distributive concerns should rarely be automatically excluded from consideration); Fletcher, *Fairness and Utility in Tort Theory,* 85 HARV. L. REV. 537, 547 n. 40 (1972) (just deserts are the only proper distributive consideration in allocating tort liability); Schwartz, *Products Liability and Judicial Wealth Redistributions,* 51 IND. L.J. 558 (1976) (action for distributive reasons alone is justified if there is popular agreement that it is proper and application of the rules resulting can be predictable and certain).

[140] In situations where informational or equitable concerns are balanced or are not implicated, however, insurers' reasons for restrictions on the scope of coverage may have considerable influence. To give a few examples, expanded defense insurance may encourage commission of intentional torts or create defense conflicts of interests. Post-retirement malpractice coverage may be difficult to price. Narrow accident insurance coverage may eliminate the need for physical examinations to qualify applicants for policies. If risk distribution is the only consideration involved in determining whether such explanations are satisfactory, it is difficult to know how to assess these administrative needs. The law normally allows market forces to provide answers to issues like these.

offer charter coverage at an appropriately higher premium. Finally, proper analysis of the expectations decisions requires a clear understanding of the relationship between risk distribution and substantive unfairness. In the insurance context, a decision that a particular policy provision or gap in coverage is substantively unfair has special significance: it represents a judicial determination that the risk that the policy fails to cover is one that insureds as a group should share, even if this means increased premiums in the future or curtailment of coverage in other ways.

All the consequences of the decision to mandate coverage under such circumstances should, of course, be considered before the decision is made. But the decision need not constitute a finding that the coverage it mandates is the fairest or best that could be fashioned. The decision is not a dictation by the court of its own coverage preferences, but merely a judicial determination that whatever the acceptable possibilities, the one embodied in the policy does not meet minimum standards of fairness in risk sharing. Such minimum standards of risk-sharing fairness must be articulated if judicial determinations are to be made properly and have the proper effect. Courts relying even partly on substantive dissatisfaction with particular coverage provisions should explain the basis of their dissatisfaction so that insurers can determine with some measure of predictability whether their policies meet judicial standards.

C. *Formal Considerations*

The effectiveness of judicial involvement in regulating insurance contracts depends not only on the goals it pursues, but also on the form and procedure under which it pursues them. The first formal consideration concerns the comparative strengths of administrative and judicial rulemaking;[141] the second concerns the advantages and disadvantages of general standards, as opposed to discrete sets of rules, as methods of judicial regulation.

1. *Administrative or Judicial Rulemaking*

The major advantage of adjudication is its flexibility. Courts have a special ability to accommodate and respond to individual

[141] *See generally* Kimball, *supra* note 127.

claims and needs as they arise in particular fact situations. For example, administrative regulation could require that insurers provide temporary life insurance unless they disclaim coverage in a designated color and size of type. Judicial rules need not be so rigid; they can allow inquiry into the effectiveness of the disclaimer rather than its form alone.[142]

Adjudication also allows the insurer to choose between compliance and the threat of liability. This element of choice is also the expectations principle's greatest limitation: the principle's capacity to alter standard practices is limited by the strength of the economic incentives it can create. Thus, the principle is likely to be more effective as a remedial measure in cases where there have been losses sufficiently severe to justify a lawsuit, rather than as a force for industry-wide reform.[143] Administrative regulation could circumvent this limitation by requiring insurers to provide generally expected coverage or by prescribing disclosure procedures.[144]

Despite its limitations, the expectations principle may mesh with administrative regulation in a valuable way. By making the courts available to resolve individual coverage disputes, the principle may help regulators with limited resources determine which problems are sufficiently widespread and severe to justify regulatory intervention. The issues that are most commonly litigated are probably those most in need of the attention of a regulatory agency equipped to resolve them through its rulemaking authority.

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[142] Nor need courts decide all at once the full scope of prohibited and permitted conduct. The expectations principle has enabled the slow elaboration of the situations in which misleading insurer conduct results in liability. Adjudication of this sort puts insurers on notice that they should examine their practices, but without mandating specific changes.

[143] *See* notes 80-83 *supra* and accompanying text.

[144] A state insurance commissioner desiring to address the problems highlighted by the temporary life insurance cases, for example, could do so with relative dispatch. He would not have to wait for the parties to a dispute to present it to him; his factfinding authority and capacity would almost certainly be greater than that of the courts; and he could take broader and more systematic remedial action than the courts. Consider also an administrative directive that liability policies contain the duty to defend mandated in *Gray*, for example, or a refusal to approve a proposed premium increase until such coverage is offered. Each and every policy issued thereafter would be affected by such action. Decisions like *Gray* cannot hope to have such a systematic effect.

It should be noted, of course, that mandatory disclosure runs the risk of becoming a mere formality, as experience with truth-in-lending has proven. *See* Whitford, *The Functions of Disclosure Regulation In Consumer Transactions*, 1973 Wis. L. Rev. 400, 442.

2. General Standards or Specific Rules

The expectations principle still functions more like a general standard than as a discrete set of rules. The courts have not arrived at a systematic understanding of the purposes the principle should serve, and there is no common standard against which to measure the reasonableness of an expectation. This is not unusual early in the development of a legal principle. Discrete purposes are not determined at once because adjudication occurs in piecemeal fashion. A broadly formulated standard prevents premature specification. Nevertheless, powerful reasons suggest that it is time for the expectations principle to mature into a body of doctrine composed of a discrete set of rules.[145]

First, the move from general toward specific explanations of the principle may focus judicial inquiry on exactly what makes an expectation reasonable and why such an expectation should be honored.[146] This article has suggested three interests served by the expectations principle—informational, equitable, and distributive—and two considerations—the insurer's causal responsibility for and knowledge of the expectation—that appear to be decisive. Others may emerge, but in each case, courts should make an effort to explain their decisions in a way that will establish some uniformity in this field.

Second, more particularized rules will provide better guidance for the parties whose conduct the principle governs. If insurers can determine from established rules what conduct renders the expectations of an insured reasonable, they can alter that conduct and correct false expectations more easily. Without the predictability provided by rules, insurers can only guess at the kind of conduct

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[145] There are, of course, advantages to retaining more general standards. General standards using indeterminate language leave the courts with considerably more flexibility than more precise rules, which are triggered by specific fact situations. *See* R. Dworkin, Taking Rights Seriously 22-28 (1977); H. Hart & A. Sacks, The Legal Process: Basic Problems in the Making and Application of Law 155-58 (Tent. ed. 1958); Kennedy, *Legal Formality*, 2 J. Legal Stud. 351 (1973). The more precise the rule, the less room tbat is left for achieving the purposes underlying the rule, unless its purpose is to provide a clear cut solution, regardless of the rule's substance. *See generally* Kennedy, *Form And Substance In Private Law Adjudication,* 89 Harv. L. Rev. 1685, 1689-90 (1976).

[146] In Professor Dawson's words, this focus would restructure the principle into "distinct subordinate norms that become intelligible and manageable through tbeir narrowed scope and function." Dawson, *Unconscionable Coercion: The German Version,* 89 Harv. L. Rev. 1041, 1044 (1976).

governed by the expectations principle. Where uncertainty exists, the principle may be disregarded, especially if the consequences of altering behavior in all the situations conceivably regulated by the principle would be too costly.[147]

Third, casting the principle into a set of more specific rules will tend to legitimize it. Broad standards are intrinsically and deliberately vague; they suggest a desire to avoid explanation of the specific grounds for decision. Such standards allow judicial retreat or inconsistency without acknowledgement. Judicial wavering of this sort appears to have occurred in the mandated coverage cases.[148] Rules, on the other hand, call much more clearly for close factual analysis, explicit recognition of similar cases, and reconciliation with traditional legal doctrine. Shaping the expectations principle into a set of rules will compel this focused inquiry. This article has suggested several ways of formulating rules to govern the articulation and application of the principle. Much more work remains to be done.

Finally, the expectations principle will operate much more effectively if it is applied pursuant to a discrete set of rules. Appellate courts sometimes make law, but they cannot always enforce it. Specific rules will provide lower courts with the guidance necessary for them to apply accurately and effectively the law determined by the courts above. Moreover, in reality, appellate courts must justify their decisions to the lower courts before the appellate courts can expect those decisions to be enforced with complete fidelity and enthusiasm. The formulation and explanation of rules helps to provide the justification necessary to gain this support from the lower courts.

IV. Conclusion

The expectations principle addresses a variety of important and difficult legal problems—freedom of contract between individuals and financially powerful institutions, judicial intervention into complicated economic transactions, articulation of legal doctrines that properly reconcile individual needs with the demands of legal generality, and the allocation of authority between different legal

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[147] *See* text accompanying notes 78-82 *supra*.

[148] *See* text accompanying notes 46-69 *supra*.

and administrative institutions. The principle serves a variety of objectives, some of which are not entirely consistent. The principle must therefore be assessed holistically, keeping in mind the purposes it serves. Although the courts have generally applied the principle correctly, the strong temptation to use the principle to achieve risk-spreading purposes alone has not always been resisted. This should come as no surprise, for insurance disputes are a stage on which private parties and institutions trace responsibility for their respective misfortunes. That this responsibility is not shouldered by government, but is nevertheless supervised and adjusted by it, is perhaps the most telling reflection of how mixed our goals and our legal system really are.