Note

REASONABLE EXPECTATIONS: THE INSURER'S DILEMMA

In *C & J Fertilizer, Inc. v. Allied Mutual Insurance Co.*[1] the Supreme Court of Iowa applied the doctrine of reasonable expectations, reversing a district court decision, which had held that an insurance policy under dispute was unambiguous. This recent application of the reasonable expectations doctrine will be analyzed in light of both its history and effect.

The judicial process has created a dilemma for insurers with the adoption of the doctrine of reasonable expectations in the interpretation of insurance contracts. The result is that the insurer can no longer rely on the sanctity of his written insurance agreement. Courts have found the reasonable expectations of insureds violated where a policy has contained: an ambiguity (evident or strained),[2] a provision confusing to the average layman,[3] a broad provision followed by restrictive definitions,[4] or even a clear provision which has some "unconscionable effect."[5]

Traditional contract law has, in the past, been applied to the interpretation of insurance contracts. It was considered the duty of courts to enforce and carry out contracts which parties had made without imputing meanings contrary to the express terms or to make better or different contracts.[6] It had been accepted that courts could not change terms by judicial construction provided they were free from ambiguity and uncertainty as to meaning.[7]

In addition to these ordinary contract rules one author has found other doctrines recently applied to insurance contracts. These are the doctrines of *contra proferentem*, adhesion, reasonable expectation and the "wayfaring fool."[8]

Contemporary insurance contracts have become difficult to understand due to their complex wording and burdensome language. This has been the result of necessary harmonization of "technical, economic and legal requirements of insurance companies, regulators and the courts."[9] The result has been a continuing legal conflict between insurance companies and policyholders. To

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1. 227 N.W.2d 169 (Iowa 1975).
2. *See* note 15 *infra* and accompanying text.
3. *See* Gerhardt v. Continental Ins. Co., 48 N.J. 291, 225 A.2d 328 (1966).
4. *See* C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169 (Iowa 1975).
5. *Id.*
6. 1 COUCH ON INSURANCE 2d, § 15:37 (1959).
7. *Id.*
8. For a good explanation of the various doctrines used in the interpretation of insurance contracts see Young, *Insurance Contract Interpretation: Issues and Trends*, 625 INS. L.J. 71 (1975) [hereinafter cited as Young].
9. *Id.* at 72.

protect the weaker party (the policyholder) ordinary rules of contract construction have been giving way to new formulations or doctrines solely applied to insurance contracts.[10]

Of those previously mentioned, the doctrine of reasonable expectations could be described as creating a body of insurance contract law *sui generis*. This doctrine, which is seldom applied without mentioning the adhesion concept,[11] has been viewed by some courts as an aid in interpreting insurance contracts where the language has been deemed ambiguous and by others as a "concept in its broader meaning as an independent and fundamental approach to insurance policy interpretation."[12]

The doctrine of reasonable expectations can be classified as having application in three situations. One expression of the doctrine is "that insurance contracts should provide that coverage which one would reasonably expect upon a reading of the policy."[13] This view which is basically the established rule of construing ambiguous phrases against their maker has no application where an ambiguity is absent.[14] Courts, however, have not let this requirement deter them and have reached the point of inventing ambiguities.[15]

A second view is "that the insured is entitled to all the coverage he may reasonably expect to be provided under the policy and that only an unequivocally conspicuous, plain and clear manifestation of the company's intent to exclude coverage will defeat that expectation."[16] Following this approach one could recover where an actual ambiguity did not exist. For instance, this view can be applied when a policy has stated a broad form of coverage and subsequently detracted from it by use of restrictive definitions which could not reasonably be expected.

This last approach has seldom been applied where there has not been some confusing or unclear provision which could be termed as tantamount to an ambiguity. In fact it has been suggested that the "formal definition" of ambiguity should be enlarged to match the phrase "plain, clear and conspicuous."[17]

A third approach, which has recently been espoused by Professor Robert Keeton would dispense with the need to seek out any ambiguity or equivalent imperfection. The general principle Keeton has formulated is as follows:

> The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be hon-

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10. *Id.*
11. *E.g.*, Gray v. Zurich Ins. Co., 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1968).
12. Rodman v. State Farm Mut. Auto. Ins. Co., 208 N.W.2d 903, 906 (Iowa 1973).
13. *See* Young, *supra* note 8, at 78.
14. *Id.*
15. Keeton, *Insurance Law Rights at Variance With Policy Provisions*, 83 HARV. L. REV. 961, 972 (1970) [hereinafter cited as Keeton].
16. Young, *supra* note 8, at 78.
17. Squires, *A Skeptical Look at the Doctrine of Reasonable Expectation*, 6 FORUM 252, 254 (1971) [hereinafter cited as Squires].

ored even though painstaking study of the policy provisions would have negated those expectations.[18]

This view is described by Keeton as merely a direction in which the insurance law appears to be moving.[19] He further states that the question of whether the policyholder has sufficiently examined the policy is only one part of the overall calculation of the objective reasonableness of his expectations.[20] One need not find any ambiguity or need he even read a policy to come under this extension of the doctrine. The limitlessness of Keeton's approach is evidenced by his statement that the insured's reasonable expectations should not be violated "even though the insurer's form is very explicit and unambiguous, because insurers know that ordinary policyholders will not in fact read their policies."[21]

The policy reasons supporting Keeton's view are not without merit. He asserts that the reasonable expectations of a policyholder, having an ordinary degree of familiarity with the type of coverage, should be upheld since: (1) policy forms are long and complicated and cannot be fully understood without detailed study; (2) few policyholders ever read their policies as would be required for a moderately detailed understanding; and (3) most kinds of insurance do not ordinarily place the detailed policy terms in the hands of the policyholder until the contract has already been made.[22]

An analysis of these approaches should not be made without first being exposed to the discussion courts have given to the "adhesion" doctrine in insurance contract interpretation. While insurance policies are recognized as being contractual in nature they are often referred to as not being ordinary contracts but contracts of adhesion between parties not equally situated.[23] The Iowa supreme court has adopted the adhesion doctrine as a backdrop against which the doctrine of reasonable expectations can be viewed when interpreting an insurance contract.[24]

In *C & J Fertilizer* the Iowa court stressed the oppressive nature of standardized contracts used in the insurance industry. Citing from the *Restatement of Contracts*,[25] the court emphasized that a party who adheres to another's standard terms does not assent to such terms if the other party has

18. Keeton, *supra* note 15, at 967.
19. *Id.*
20. *Id.*
21. *Id.* at 968.
22. *Id.*
23. Gerhardt v. Continental Ins. Cos., 48 N.J. 291, 297, 225 A.2d 328, 332 (1966); Allen v. Metropolitan Life Ins. Co., 44 N.J. 294, 305, 208 A.2d 638, 644 (1965). In *Allen* the court expressed its concern over the insured's weakened position by saying: "The company is expert in its field and its varied and complex instruments are prepared by it unilaterally whereas the assured or prospective assured is a layman unversed in insurance provisions and practices. He justifiably places heavy reliance on the knowledge and good faith of the company and its representatives and they, in turn, are under correspondingly heavy responsibility to him." Allen v. Metropolitan Life Ins. Co., 44 N.J. 294, 305, 208 A.2d 638, 644 (1965).
24. C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 277 N.W.2d 169, 176 (Iowa 1975).
25. RESTATEMENT (SECOND) OF CONTRACTS § 237 (1973).

reason to believe that the adhering party would not have accepted the agreement if he had known of the particular term.[26] The strength of this view is emphasized due to the position there taken that the "[r]eason to believe may be inferred from the fact that the term is bizarre or oppressive, from the fact that it eviscerates the non-standard terms explicity [sic] agreed to, or from the fact that it eliminates the dominant purpose of the transaction."[27]

In *C & J Fertilizer* the Iowa court, in discussing the adhesion concept, also alluded to the facts that: (1) the insured has no ability to dicker for the coverage or provisions that he wants; (2) the policies are, through this private lawmaking process, causing the insured to succumb to privately made laws without allowing him any judicial review; and (3) further, as noted before, since the insured has no opportunity to dicker over the provisions of the policy he should not be constrained by those he would not reasonably expect that his policy of insurance would contain.[28]

It has been suggested that the foregoing analysis is an improper utilization of the adhesion doctrine.[29] One author has stated:

> It is not an absence of an opportunity to dicker, but a narrowing of choice which coerces, and a sufficient range of choice to make a contract nonadhesive is present if an individual has the ability to choose among a variety of materially different standard forms, although he may be powerless to change any of them by "dickering."[30]

The arguments supporting the adhesion doctrine upon first glance may appear as a justifying force behind the fall of ordinary contract construction rules in the area of insurance. These arguments should, however, be viewed along with certain considerations which are so often disregarded in the reasonable expectation cases. It must be realized that insurers no longer insure on an individual contract basis. "A contract ceases to be a wager and becomes insurance when it is one of many identical contracts which have been entered into with many different policyholders."[31] Insurance involves both risk-shifting and risk-distributing.[32] "A contract may be a risk-shifting device, but to be a contract of insurance, which is a risk-distributing device, it must possess both features, and unless it does it is not a contract of insurance whatever be its name or its form."[33] Insurance can be described as "a device which furnishes protection against a risk of loss by distributing the losses of the few among the many who are subject to the same risk . . . ."[34] To enable the insurer to conduct this risk-distributing business the use of standard forms has proved to

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26. C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 176 (Iowa 1975).
27. *Id.*
28. *Id.*
29. 47 TEMP. L.Q. 748, 754 (1974).
30. *Id. citing* Slawson, ***Standard Form Contracts and Democratic Control of Lawmaking Power***, 84 HARV. L. REV. 529, 553 (1971).
31. Squires, *supra* note 17, at 252.
32. *In re* Smiley's Estate, 216 P.2d 212, 214 (Wash. 1950).
33. *Id.*
34. *In re* Barr's Estate, 104 Cal. App. 2d 506, 508, 231 P.2d 876, 878 (Dist. Ct. App. 1951).

be a necessity. The harsh treatment of insurers due to their use of these standard forms has been attacked by one author:

> No one has suggested a better way. If the insurance industry is to be castigated for the use of "adhesion contracts," it is ironic that it could not cease to use standard forms without at the same time ceasing to conduct an insurance business.[35]

There is also the problem of giving every policyholder the same coverage for his premium dollar. The argument is logical that knowledge of a limiting provision should defeat any claim based on the doctrine of honoring one's reasonable expectations, "since such knowledge negates the surprise that would be the basis for departing from ordinary contract principles."[36] Such an approach would allow one to get more for his premium dollar by being more careless in his insurance purchase. The question must be posed as to whether the reasonable expectations doctrine can justifiably allow different kinds of protection for different insureds under identical policies depending upon the degree of diligence used by the insured in the reading of his policy. Many times a policy may be of a general nature excluding certain areas of coverage which can be purchased under separate contracts of insurance.[37] Allowing coverage based on what is expected rather than what is had would defeat the purpose of tailoring policies so insureds need only pay for coverages they desire. This follows from the fact that insurers will have to begin providing more coverage on their existing policies to take care of those whose reasonable expectations have been offended. This would especially be true if a jurisdiction should happen to adopt the reasonable expectations approach which would allow recovery without regard to whether the person knew of the liability-avoiding term or provision.[38]

If the doctrine of reasonable expectations is to prevail based on what an insured would gain from the cover page of a policy, from a cursory reading, or merely from what he was expecting based on the general type of policy as evidenced by its title, then an unfortunate result must surely follow. Many potential insureds will end up being forced to purchase coverages which they do not want or need.

The foregoing division of this Note provides the backdrop which is necessary for an understanding of where a jurisdiction has ventured in the area

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35. Squires, *supra* note 17, at 252-53.
36. Keeton, *supra* note 15, at 974.
37. *Cf.* Gerhardt v. Continental Ins. Cos., 48 N.J. 291, 225 A.2d 328 (1966). In *Gerhardt* the policy under dispute had a provision which excluded coverage where the insured had another policy giving a particular coverage or if that coverage was by law to be provided under a separate type of insurance. The separate type of insurance applicable in *Gerhardt* was that required to be provided under the workmen's compensation or occupational disease law.
38. Keeton, *supra* note 15, at 974. Professor Keeton discusses an approach which combines the reasonable expectation doctrine with the principle of disallowing unconscionable advantage. He has stated a general proposition which is as follows: "If the enforcement of a policy provision would defeat the reasonable expectations of the great majority of policyholders to whose claims it is relevant, it will not be enforced even against those who know of its restrictive terms." *Id.*

of reasonable expectations. In recent years the Iowa supreme court has been mentioning the reasonable expectations doctrine in its decisions. With the case of *C & J Fertilizer, Inc. v. Allied Mutual Insurance Co.*,[39] the court appeared to move as far as any jurisdiction has in following the trends which Professor Keeton has espoused. *C & J* will be viewed in light of how other jurisdictions have approached the doctrine.

In *C & J* the plaintiff was insured under policies issued by defendant and titled "Broad Form Storekeepers Policy" and "Mercantile Burglary and Robbery Policy." Each policy defined "burglary" as requiring visible marks of force and violence to the exterior of the premises at the place of entry. A theft occurred in which only an interior door of the building was damaged, the exterior of the building showing no visible marks as required by the policy. The trial court found the provision to be unambiguous and since nothing in the record showed that a "burglary" as defined had occurred, held in favor of the insurer. On appeal, the Iowa supreme court found that where there was shown hard evidence of a third-party burglary (burglary in the legal sense)[40] the insured could recover under the doctrine of reasonable expectations. The court further held that the liability-avoiding provision under the circumstances was unconscionable. Four of the court's nine justices dissented.[41]

The Iowa court did not make it easy to determine which of the aforementioned approaches it followed. The court appeared to stress that the insured was unaware of the definitional provision. Reference was made to the fact that the policy was delivered subsequent to the transaction in which it was purchased. The court also found the definition to be of a fine print nature. The real trouble the court seemed to be having was that the policy definition of "burglary" did not conform to the layman's concept of that term. The court appeared to be saying that where one buys a policy which purports to cover "burglary" then the layman's concept of that coverage must be met.

One could argue that the Iowa court was in fact expressing the second approach discussed in this Note which honored an insured's reasonable expectations where a provision was not clear, conspicuous and unambiguous. The trial court found that the definition was unambiguous. The supreme court's holding in light of this trial court finding left many unanswered questions for insurers. If a provision is not clear and conspicuous, then what does meet those tests? The court's emphasis of the provision being in fine print did not impress the dissenting justices who responded by saying:

> Except for larger type on the face sheet and black (but not larger) print to designate divisions and sub-headings, the entire policies are

39. 227 N.W.2d 169 (Iowa 1975).

40. Here the court was referring to "burglary" as it is legally defined rather than as it was defined in the policy.

41. Three of the court's nine justices concurred that the plaintiff should recover based on the doctrine of reasonable expectations, on the theory of implied warranty, and because the definitional provision was unconscionable. Two justices concurred in result but did not concur with the majority opinion as far as it related to the theory of implied warranty. The remaining four justices dissented, disagreeing with all three theories asserted by the others.

> of one size and style of print. To compare the *face* sheet with the body of the policy is like comparing a book's jacket cover with the narrative content; and use of black type or other means of emphasis to separate one part of an instrument from another is an approved editorial expedient which serves to *assist*, not *hinder*, readability.[42]

The tone of the majority opinion appears to read more like Keeton's view which was discussed here as the third approach. The court emphasized that insureds do not read their policies and that the majority rule is insureds are not bound to know the contents of their policy.[43] This can lead one to believe that the insured's expectations from his concept of the type of coverage he thinks he is purchasing will prevail. This is supported later where the court cited authority for the proposition that the insured, when he assents to a contract of insurance, is not assenting to any unreasonable terms the seller may have on his form, which may alter or eviscerate the reasonable meaning of the dickered terms.[44] In fact the willingness of the Iowa court to strike down the policy provision due to its unconscionable nature appears to step beyond even Keeton's approach which is at least limited to where the policy provisions would defeat the reasonable expectations of the great majority of policyholders.[45] This conclusion is supported where the court puts reliance on Corbin's view of the unconscionability doctrine which emphasizes the harshness of contracts drafted by powerful commercial units and put before the public on an "accept this or get nothing" basis.[46]

The adoption of a view which implies that laymen are relieved of any responsibility to read their contracts is dangerous precedent. This does not, however, appear to be the view of most courts. A brief analysis of some major decisions in the reasonable expectation area shows a willingness of the courts to press for a test based on ambiguity.

One case often cited by those discussing the reasonable expectations doctrine is *Gerhardt v. Continental Insurance Cos.*[47] In *Gerhardt,* plaintiff purchased a homeowner's policy which was issued to her in comprehensive form. A domestic employee of the insured was injured at the insured's home. When her insurer was notified of the incident it declined to defend and indemnify her contending that workmen's compensation claims were excluded from the policy coverage. In the trial court and on appeal to the intermediate court of appeals, the defendant-insurer had a favorable decision based on the exclusion in the policy. The New Jersey supreme court reversed these rulings basing its finding on the doctrine of reasonable expectations. The court began its opinion with a discussion of a previous case in which the court had stated "that fairness to the ordinary layman who is the average insured dictates that

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42. C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 182-83 (Iowa 1975) (dissenting opinion).
43. C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 174 (Iowa 1975).
44. *Id.* at 175.
45. *See* note 38 *supra.*
46. C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 180 (Iowa 1975).
47. 48 N.J. 291, 225 A.2d 328 (1966).

exclusions be 'so prominently placed and so clearly phrased that he who runs can read.' "[48] The court proceeded to discuss how the exclusionary clause in the policy "was neither conspicuous nor plain and clear."[49] Then it was emphasized that "[t]he policy form was prepared unilaterally by the company and was sold on a mass basis as affording broad coverage to homeowners."[50] The court said that it seemed unlikely that the ordinary insured would have understood the provision on his or her own reading.

Because of the prominence afforded the *Gerhardt* decision with respect to its analysis of the reasonable expectations doctrine it would prove beneficial to determine which of the aforementioned approaches the New Jersey court was actually expressing. It appears that the court did not find an ambiguity from a conflict in coverage terms. It seems rather that the court was applying an approach similar to that discussed here which stated that the insured is entitled to all the coverage he may reasonably expect to be provided under the policy and that only an unequivocally conspicuous, plain and clear manifestation of the company's intent to exclude coverage would defeat that expectation. Though no ambiguity is usually mentioned by the courts when following this approach, it appears that what the court was actually saying was that since the exclusion was not clear and conspicuous the policy was in effect ambiguous.

In the case of *Cox v. Santoro*,[51] a law division court construed *Gerhardt* when it stated:

> This court takes *Gerhardt* to mean simply that an insurance carrier must be clear in its expression of coverage and must not mislead by implying coverage and then later in another part of the policy exclude it with obscure and vague language.[52]

From these cases the courts have shown that some distinct requirement of ambiguity, either actual or from lack of clarity and conspicuousness, existed. They stop short, however, of the tests adopted by Keeton who asserts that the language need not itself be confusing, in fact allowing the reasonable expectations doctrine to apply even where the policies are clear and unambiguous.[53]

The approach of the California courts has been close with that of New Jersey. In *Gray v. Zurich Insurance Co.*,[54] which was cited by the New Jersey supreme court in *Gerhardt*, the California supreme court stated:

> Since the policy sets forth the duty to defend as a primary one and since the insurer attempts to avoid it only by an unclear exclusionary clause, the insured would reasonably expect, and is legally entitled to, such protection.[55]

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48. *Id.* at 296, 225 A.2d at 331.
49. *Id.* at 298, 225 A.2d at 332.
50. *Id.*
51. 94 N.J. Super. 319, 228 A.2d 101 (1967).
52. *Id.* at 323, 228 A.2d at 104.
53. Keeton, *supra* note 15, at 968.
54. 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966).
55. *Id.* at 268, 419 P.2d at 171, 54 Cal. Rptr. at 107.

The *Gray* decision on more than one occasion refers to ambiguity in the disputed insurance policy. In discussing uncertainties in the wording of the policy's exclusionary clause, the court referred to a "built-in ambiguity" which it termed as being not " 'plain and clear' to the layman."[56] The court stated that since it "must resolve uncertainties in favor of the insured and interpret the policy provisions according to the layman's reasonable expectations, and since the effect of the exclusionary clause . . . [was] neither conspicuous, plain nor clear . . . "[57] it must hold in favor of the insured. From the court's opinion it is quite evident that had the exclusion been found to be clear, conspicuous and unambiguous, the court would have found for the insurer. The approach in *Gray* appears to be the same utilized by the Iowa supreme court when it decided the case of *Rodman v. State Farm Mutual Insurance Co.*[58] In *Rodman*, when the Iowa court was asked to apply the doctrine of reasonable expectations, it said:

> The real question here is whether the principle of reasonable expectations should be extended to cases where an ordinary layman would not misunderstand his coverage from a reading of the policy and where there are no circumstances attributable to the insurer which foster coverage expectations.[59]

The Iowa court appeared to express the position that where a policy is clear and unambiguous to a layman who would read it then the court is powerless to grant relief since it cannot rewrite the policy. The dissent in *C & J* was in accord with this interpretation of the *Rodman* decision.[60]

The Iowa supreme court in *Rodman* employed the concept of reasonable expectations in its broader meaning as an independent and fundamental approach to insurance policy interpretation rather than as most courts apply it as an interpretive tool where the language of a policy is deemed ambiguous. This was made evident by the *Rodman* court when it stated: "It is clear the principle of reasonable expectations undergirds the congeries of rules applicable to construction of insurance contracts in Iowa."[61]

In *Rodman*, the Iowa court based its decision on what it believed an ordinary insured would reasonably believe after reading the policy exclusion.[62] The court appeared to find what "an ordinary insured would reasonably believe" from his reading by looking to how such policies containing the exclusion had been uniformly enforced.

This apparent evidentiary use of other court constructions may suggest a different result in *C & J*. It appears that the courts have uniformly construed provisions which require that there be physical signs of force and violence to

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56. *Id.* at 273, 419 P.2d at 174, 54 Cal. Rptr. at 110.
57. *Id.* at 274, 419 P.2d at 174-75, 54 Cal. Rptr. at 110-11.
58. 208 N.W.2d 903 (Iowa 1973).
59. *Id.* at 906.
60. C & J Fertilizer v. Allied Mut. Ins. Co., 227 N.W.2d 169, 183 (Iowa 1975) (dissenting opinion).
61. Rodman v. State Farm Mut. Ins. Co., 208 N.W.2d 903, 906 (Iowa 1973).
62. *Id.* at 907.

expected to read their contracts will not prove fortunate for the future of insurance law. The presence of such a holding will only encourage lack of attentiveness in the layman's insurance negotiating.

Even though a holding such as *C & J* may be supported by the current trend of contract law where standardized documents are considered contracts of adhesion, this approach may not be applicable to insurance because of its basic risk-distributing nature. Also it is arguable that the adhesion analysis should not be applied where there has been no evidence presented to show lack of ability on the part of the individual to choose among materially different standard forms.[79]

In *C & J*, the Iowa supreme court may actually have been expressing its own view that certain forms of coverage are not sufficiently extensive. Such a holding would appear to infringe on the lawmaking function of the legislature. One could also respond that a private enterprise should be left to sell those things which it may deem are economically feasible to sell.

Courts holding that unambiguous contracts may defeat insureds' reasonable expectations may be moving in an unfortunate direction. One author appropriately noted his feelings in this matter when he stated:

> If a reasonable expectation is that impression formed upon a cursory and hurried reading of the policy, then the courts have much work cut out for them. Perhaps some will long for the day when the English language was treated with respect, even in insurance policies.[80]

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79. *See* note 30 *supra* and accompanying text.
80. Squires, *supra* note 17, at 255.