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PENALTY DEFAULT RULES IN INSURANCE LAW

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ABSTRACT

A default rule tells a court how to fill a gap in a contract. A penalty default rule tells a court to fill the gap in a way that is undesirable to at least one of the parties. The threat of a penalty default rule is meant to induce parties to reveal information, to each other or the courts, by contracting around the penalty. Since the concept was first introduced by Ian Ayres & Robert Gertner in Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1990), major scholars have argued over which rules, if any, might qualify.*

A prime candidate has been nominated but never elected. Contra proferentem, the doctrine that ambiguities in a contract should be construed against the drafter, is repeatedly mentioned as a likely penalty default, including in the original Ayres & Gertner article and in a major critique by Eric Posner in 2006. Surprisingly, despite the shared intuition that contra proferentem is a penalty default rule, this Article is the first to seriously take it on.

Insurance contra proferentem provides an unusual test case because it is actively conceived of by many courts as punitive, aimed at producing more information in the form of a redrafted contract clause. If contra proferentem is not a penalty default, prospects look dim for the rule's existence. The doctrine is predominately applied in the insurance context, and I am the first insurance scholar to fully take the field.

By scrutinizing the candidate, this Article makes two contributions. To the study of contractual gaps, it proves there is at least one penalty default rule in the world, but one that does not operate in either of the two ways the existing literature envisions. This new category sharpens our understanding of the remaining defaults. To the interpretation of consumer contracts, and insurance contracts in particular, this Article sounds a warning about the dangers of penalty default rules. Contra proferentem operates as a regrettable penalty default and for reasons that hold for consumer contracts more broadly. In short, the rule does not consistently force the sophisticated party to better inform the consumer, but it does exact consumer cost. In a non-trivial subset of cases, the rule widens the misunderstanding between contract drafter and consumer.

There is a fundamental difficulty with information-forcing rules in insurance, at least to the extent the information is meant to be revealed to the policyholder and not the courts: the less informed party is tough to inform. In addition, the incentive to inform—the incentive to escape the penalty—is anemic when applied unilaterally to a class of drafters who can be indifferent to a penalty as long as (1) it applies to its competitors equally and (2) the costs of the penalty are ultimately paid by the buyer.

In short, the nature of insurance interpretation makes contra proferentem an excellent candidate for a penalty default rule descriptively and a poor candidate for the rule normatively. Parallel problems can be expected if a penalty default is applied to boilerplate consumer contracts.

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I. INTRODUCTION

The exploration of penalty default rules in contract law began twenty years ago.[1] It became a debate in 2006 when Eric Posner declared that the prior twenty or so articles had been discussing a null set.[2] A default rule tells a court how to fill a gap in a contract. A penalty default tells a court to fill the gap in a way that is undesirable to at least one of the parties, in the hopes of getting the parties to contract around the penalty. Much of the best thought has been focused on whether *Hadley v. Baxendale*,[3] the seminal example of a penalty default rule, does indeed contain a penalty default.[4] That is not the question asked here.

There is a more promising candidate for a penalty default in the real world: the contra proferentem doctrine that ambiguities in a con-

1. For starting the whole affair, one can thank Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1990). One precursor to their work was LON L. FULLER & ROBERT BRAUCHER, BASIC CONTRACT LAW 557-58 (Erwin N. Griswold ed., 1964).

2. *See* Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563 (2006). Posner called the penalty default rule "a theoretical curiosity that has no existence in contract doctrine." *Id.* at 563. Well more than twenty articles mentioned the concept of penalty defaults by 2006, but the author's WestLaw search revealed that approximately twenty took the subject as a central topic.

3. (1854) 156 Eng. Rep. 145 (Exch. Div.).

4. *See, e.g.*, Barry E. Adler, *The Questionable Ascent of* Hadley v. Baxendale, 51 STAN. L. REV. 1547 (1999); Ayres & Gertner, *supra* note 1; Lucian Ayre Bebchuk & Steven Shavell, *Information and the Scope of Liability for Breach of Contract: The Rule of* Hadley v. Baxendale, 7 J.L. ECON. & ORG. 284 (1991); Melvin Aron Eisenberg, *The Principle of* Hadley v. Baxendale, 80 CALIF. L. REV. 563 (1992); George S. Geis, *Empirically Assessing* Hadley v. Baxendale, 32 FLA. ST. U. L. REV. 897 (2005); Yair Listokin, *Learning Through Policy Variation*, 118 YALE L.J. 480 (2008).

tract should be construed against the drafter. By scrutinizing the candidate, this Article makes two contributions. To the study of contractual gaps, it proves there is at least one penalty default rule in the world, but one that does not operate in either of the two ways the existing literature envisions. This new category sharpens our understanding of the remaining defaults.

To the interpretation of consumer contracts, and insurance contracts in particular, this Article sounds a warning about the dangers of penalty default rules. Contra proferentem is "[t]he most frequently employed principle of interpretation" in insurance cases.[5] It operates as a regrettable penalty default and for reasons that hold for consumer contracts more broadly. In short, the rule does not consistently force the sophisticated party to better inform the consumer, but it does exact costs on consumers. In a non-trivial subset of cases, the rule widens the misunderstanding between contract drafter and consumer.

The taxonomy of penalty default rules is organized around two dichotomies: (1) default rules versus mandatory or immutable rules, and (2) majoritarian rules versus penalty default rules.[6] An immutable rule is simply a rule the parties cannot contract around.[7] A default rule is a background rule that fills a gap in a contract; it is a rule the parties can contract around by filling the gap with their own term.[8] Courts may set a default rule by attempting to determine what the parties would have agreed to *ex ante*, had they come to agreement.[9] This is the so-called majoritarian default rule.[10] Price is an example under the Uniform Commercial Code (U.C.C.): if the parties fail to set one, the price is the "reasonable price at the time for delivery."[11]

Ian Ayres and Robert Gertner, in their seminal work, proposed a contrary category in which the default is set counter to what the parties would have agreed.[12] The threat of these penalty default rules is meant to induce parties to reveal information, to each other or the courts, by contracting around the penalty.[13] Thus, these rules are also

5. KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 37 (5th ed. 2010).

6. The other counterpart to majoritarian rules is minoritarian rules. *See* Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1591 (1999).

7. Ayres & Gertner, *supra* note 1, at 87.

8. *Id.*

9. Frank Easterbrook and Daniel Fischel wrote the original work advocating corporate law default rules. "The gap-filling rule will call on courts to duplicate the terms the parties would have selected, in their joint interest, if they had contracted explicitly." Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1433 (1989).

10. *See* Ayres & Gertner, *supra* note 1, at 93.

11. U.C.C. § 2-305(1) (2012).

12. *See* Ayres & Gertner, *supra* note 1, at 91.

13. *Id.*

called information-forcing defaults.[14] (Less relevant here, a rule can be minoritarian without a punitive motivation.)[15]

Is contra proferentem a penalty default or information-forcing rule? If so, then penalty default rules exist. More important than having a dog in that fight, the analytical framework set up by the theory provides a new way to evaluate the efficiency of penalty defaults rules in consumer contracts. The primary candidate—contra proferentem—has been nominated but never elected. Freed from the insurance context, it is mentioned as a possible penalty default in a footnote in the original Ayres and Gertner article.[16] It is assumed to be a penalty default rule example in a few other pieces.[17] Both Posner and Ayres, in later pieces, momentarily consider whether insurance contra proferentem is a penalty default rule.[18] Surprisingly, despite the shared intuition that contra proferentem is a penalty default rule, this Article is the first to fully take it on.[19]

For those interested in the penalty dog fight, insurance contra proferentem provides an unusual test case because it is actively conceived of by many courts as punitive, aimed at producing more information in the form of a redrafted contract clause. One may differ as to whether a true penalty default rule needs to be recognized as such by the courts applying it. But if contra proferentem is *not* a penalty default, prospects look dim for the rule's existence. It is not surprising that of the nine or so court cases to directly cite to the Ayres and Gertner gap-filling concept, one-third are insurance cases.[20]

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14. *See* Ayres & Gertner, *supra* note 6, at 1593.

15. *See id.* at 1593.

16. Ayres & Gertner, *supra* note 1, at 105 n.80 ("[T]he common-law doctrine of construing ambiguities in contracts against the drafter can be viewed as a penalty default. The doctrine is not based on the judgment that the parties would have wanted the anti-drafter provision, but that such a penalty encourages drafters to draft more precise contracts." (citation omitted)).

17. *See* Omri Ben-Shahar, *"Agreeing to Disagree": Filling Gaps in Deliberately Incomplete Contracts*, 2004 WIS. L. REV. 389, 391 [hereinafter Ben-Shahar, *Agreeing to Disagree*]; William W. Bratton, Pari Passu *and a Distressed Sovereign's Rational Choices*, 53 EMORY L.J. 823, 863 (2004); Omri Ben-Shahar, *Contracts Without Consent: Exploring a New Basis for Contractual Liability*, 152 U. PA. L. REV. 1829, 1840-41 (2004) [hereinafter Ben-Shahar, *Contracts Without Consent*].

18. *See* Posner, *supra* note 2, at 578-80, 582-85, 587; Ian Ayres, *Ya-Huh: There Are and Should Be Penalty Defaults*, 33 FLA. ST. U. L. REV. 589, 596-99 (2006).

19. The best treatments to date have been fairly brief and not the central thesis of the work. In addition to Eric Posner's excellent critique concluding that contra proferentem is not a penalty default, *supra* note 2, at 578-80, see Kenneth S. Abraham, *Peril and Fortuity in Property and Liability Insurance*, 36 TORT TRIAL & INS. PRAC. L.J. 777, 779-80 (2001), accepting contra proferentem as a rule of interpretation that serves as a penalty default. *Id.* at 779-80. His contribution to default rules in insurance is in his analysis of the efficient lack of cost-reducing defaults in insurance. *See id.*

20. *See infra* Part I.B. Insurance cases: *See* City of Burlington v. Indem. Ins. Co. of N. Am., 332 F.3d 38, 49, 49 n.10 (2d Cir. 2003) (insurance case considering both fortuity and contra proferentem as possible penalty defaults); Am. Nat'l Fire Ins. Co. v. Kenealy, 72 F.3d 264, 269 n.1 (2d Cir. 1995); Harnischfeger Corp. v. Harbor Ins. Co., 927 F.2d 974, 976

For those interested in the insurance fight, the patchy and unpredictable application of contra proferentem stems in part from uncertainty over how the rule should operate. Contra proferentem in insurance is an inscrutable but ubiquitous doctrine.[21] This is an unfortunate combination. Understanding whether the rule is a penalty default, and whether it should be, would resolve many disputes. This Article also aims to clear up some confusion caused by the fact that one interpretive rule, going under one name, may be applied at different times as a penalty default, majoritarian, or mandatory rule.

Part I first sets out the gaps to be filled in insurance contracts and then proves that contra proferentem is a penalty default rule, despite some oddities. Part II asks whether contra proferentem *should* be a penalty default. In Part II.A, I establish that contra proferentem fails to have the desired effect on either insurers or consumers; it is ineffective. In Part II.B, I make the case that any benefits of contra proferentem are overwhelmed by its costs; it is inefficient. Finally, Part III envisions alternative forms of contra proferentem that fare better—a non-penalty majoritarian version and a penalty version aimed at courts, not consumers.

There is a fundamental difficulty with information-forcing rules in insurance, at least to the extent the information is meant to be revealed to the policyholder and not the courts: the less informed party is tough to inform.[22] In addition, the incentive to inform—the incentive to escape the penalty—is anemic when applied unilaterally to a class of drafters who can be indifferent to a penalty as long as (1) it applies to its competitors equally and (2) the costs of the penalty are ultimately paid by the buyer.

In short, the nature of insurance interpretation makes contra proferentem and related doctrines excellent candidates for a penalty default rule descriptively and poor candidates for the rules normatively. Parallel problems can be expected if a penalty default is applied to boilerplate consumer contracts.

(7th Cir. 1991). Non-insurance cases: *See* Am. Airlines, Inc. v. Wolens, 513 U.S. 219, 248-49 (1995) (contract class action case); Moreau v. Harris Cnty., 158 F.3d 241, 247 (5th Cir. 1998) (class action case under Fair Labor Standards Act); United States v. Westlands Water Dist., 134 F. Supp. 2d 1111, 1137 (E.D. Cal. 2001) (water reclamation fee case); Coronet Ins. Co. v. GACC Holding Co., No. 90 C 07189, 1991 WL 172182, at *4 (N.D. Ill. Aug. 30, 1991) (unreported breach of financial instrument case); *In re* Premier Entm't Biloxi LLC, 445 B.R. 582, 627 (Bankr. S.D. Miss. 2010) (bankruptcy case); Concord Real Estate CDO 2006-1, Ltd. v. Bank of Am. N.A., 996 A.2d 324, 332 n.4 (Del. Ch. 2010) (debt case).

21. *See* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 1.03[b], at 14-19 (10th ed. 1998).

22. *See* Michelle Boardman, *Insuring Understanding: The Tested Language Defense*, 95 IOWA L. REV. 1075 (2010).

II. IS CONTRA PROFERENTEM A PENALTY DEFAULT RULE?

A. The "Gaps" in Insurance: The Holes to Be Filled

Central to the question of penalty default rules is the meaning of "gap." Because insurance gaps tend to differ from a simple missing term, we must first investigate the hole to be filled. Default terms are meant to fill gaps, not substitute for present terms. If a contract is silent where a term could or should speak, there is a gap to be filled. Insurance contracts rarely have such stark gaps, at least on the much-litigated terms of coverage. This is because the *structure* of the contracts provides an inherent default answer to coverage questions.

An insurance contract contains an initial grant of coverage followed by multiple exclusions carving out risks that are returned to the policyholder.[23] (Smaller pockets of risk are then volleyed back to the insurer by exceptions to the exclusions.) Given this structure, there tends to be a term addressing whether a particular loss is covered. If it is not in the initial grant of coverage, it is explicitly not covered. If it is in the grant of coverage, it is covered unless there is an exclusion on point.[24]

The policies are often so comprehensive that even when a new risk arises in the world there is language in the policy that seems on point, suggesting coverage or exclusion.[25] For example, when policyholders first brought claims for the destruction of valuable *electronic* data, courts struggled with whether electronically stored data is "tangible property" and whether the loss of data is "property damage."[26] Note that while some courts labeled the data "tangible property" and some declined, none were flummoxed by the lack of an "electronic data clause"; instead, courts assumed that there were instructions to be followed in the existing policy language. [27] The contract remained

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23. These are generalizations about a mythical abstract insurance contract, but defensible generalizations. An unusually clear treatment of the organization of insurance policies can be found at EMERIC FISCHER, PETER NASH SWISHER & JEFFREY W. STEMPEL, PRINCIPLES OF INSURANCE LAW § 2.11 (Rev. 3d ed. 2006).

24. Insurance policies contain terms that are not coverage terms, of course. Notice requirements, amounts of coverage, and the right and duty to defend, for example, are also likely to cover the relevant ground without leaving gaps.

25. "Insurance law has had little need to generate cost-reducing default rules, because the insurance industry has already done so through the development of standard-form policy provisions." Abraham, *supra* note 19, at 779.

26. For a thorough analysis of the options under different policies and clauses, see Robert H. Jerry, II & Michele L. Mekel, *Cybercoverage for Cyber-Risks: An Overview of Insurers' Responses to the Perils of E-Commerce*, 8 CONN. L.J. 7 (2001). For two of the best opinions on each side, compare *America Online, Inc. v. St. Paul Mercury Insurance Co.*, 347 F.3d 89 (4th Cir. 2003) (holding under Virginia law, computer data not covered because not tangible property), with *Centennial Insurance Co. v. Applied Health Care Systems, Inc.*, 710 F.2d 1288 (7th Cir. 1983) (holding under California law, insurer had a duty to defend a computer hardware and software policyholder for loss of computer data).

27. *See, e.g.*, *Am. Online, Inc.*, 347 F.3d at 99; *Centennial Ins. Co.*, 710 F.2d at 1290-91.

incomplete in the sense that the parties had no intent on the new issue, but the contract could be construed without intent as opposed to the court throwing up its hands and refusing to issue a ruling.

Thus, the insurance contract is rarely "incomplete" and hence not an initial target of Ayres and Gertner's original work.[28] But a gap can also be a gap in application caused by an underspecified term.[29] While insurance contracts might not have blanks where a term should be, they can have gibberish where a term should be. Or they might have two equally plausible but mutually exclusive terms where one term should be. This gibberish or Cerberus creates a cavity in the contract where a term should be. This is the gap courts seek to fill.[30]

Courts may be engaged in more than gap filling, of course. Insurers often do not admit to a gap, naturally, and instead describe the court as having chosen not a default but a substitute. In some circumstances the substitute appears to be mandatory.[31] Or a gap filler may be on the borderline between default and mandatory; the rule is held out as a default, but contracting around it is extremely difficult or, at times, impossible.[32] This Article aims to clear up some confusion caused by the fact that one interpretive rule, going under one

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28. Ayres and Gertner are open to penalty defaults where a contract is indefinite rather than having a gap caused by an absent term. They conceive of the common law rule against enforcing contracts that are too indefinite as a penalty default, for example. *See* Ayres & Gertner, *supra* note 1, at 97 (using as an example "the common law's broader rule that 'for a contract to be binding the terms of the contract must be reasonably certain and definite' " (quoting Steinberg v. Chi. Med. Sch., 354 N.E.2d 586, 589 (Ill. App. Ct. 1976))); *id.* at 106 (discussing Lefkowitz v. Great Minneapolis Surplus Store, 86 N.W.2d 689 (Minn. 1957)).

29. Ayres and Gertner identify two types of "incompleteness." Ayres & Gertner, *supra* note 1, at 92. In the first type, the contract does not set the "duties for specific future contingencies," and in the second type the contract sets forth full duties but the duties do not vary with "relevant future contingencies." *See id.* at 92 n.29. Both of these failures could arise from a missing term or from an indefinite term.

30. While denying the existence of *penalty* default rules, Eric Posner agrees that some gaps are the result of ambiguity. *See* Posner, *supra* note 2, at 568-69.

31. A possible mandatory default in some jurisdictions is a certain amount of coverage for commercial pollution. After insurers redrafted older pollution exclusions to add that only "sudden and accidental" pollution would be covered, more than one court held that "sudden" does not include a temporal element. *See* Nancer Ballard & Peter M. Manus, *Clearing Muddy Waters: Anatomy of the Comprehensive General Liability Pollution Exclusion*, 75 CORNELL L. REV. 610, 618, 618 n.24 (1990). Given that "sudden" refers to time, if it refers to anything, these cases are best read as simply denying insurers the scope of exclusion they wanted. For the full history, see generally Ballard & Manus, *supra*, and Timothy M. Gebhart, *A "Timeless" Interpretation of the "Sudden and Accidental" Exception to the Pollution Exclusion?*, 41 S.D. L. REV. 314 (1996).

32. *See* Ayres & Gertner, *supra* note 1, at 123. In discussing the famous *Peevyhouse v. Garland Coal & Mining Co.* case, Ayres and Gertner state that "[e]ither the majority opinion is 1) disingenuously creating an immutable rule; or 2) creating a 'strong' default rule" that Peevyhouse did not overcome despite contract language to the contrary. *Id.* at 122 (discussing *Peevyhouse*'s use of diminution-in-value as the damages default for construction breach).

name, may be applied at different times as a penalty default, majoritarian, or mandatory rule.[33]

B. The Source of the Gap

The *source* of the gap can indicate how it should be addressed. Of the two often-named sources of incompleteness—the cost of contracting and strategic incompleteness[34]—neither is an obvious fit for insurance. While cost must constrain insurers at the margin, property/casualty insurers often draft policies through the industry-wide organization, the Insurance Services Office, spending large amounts of money and time.[35] The resulting policy language is then meant to be sold to hundreds of thousands, if not millions, of customers. The value of "getting it right" is so high to insurers that we might think it one of the least likely places to find a gap from failure of attention.

Courts do tend to assume insurers engage in strategic incompleteness or indifferent incompleteness, as opposed to being frequently hampered by the cost of contracting.[36] Strategy would explain intentionally drafting or retaining ambiguous or incomprehensible language to the insurer's benefit. Indifference might explain allowing poor language that harms the consumer but not the insurer. According to the District of Columbia Circuit, this "obscurantism which conveys one meaning of their contracts to lawyers and another meaning to laymen" requires a contra proferentem response from courts.[37] While I have argued elsewhere that it makes more sense to view insurers as conveying one meaning to judges and no particular meaning to laymen,[38] what matters here is the courts' view of what insurers are doing; in short, what evil are courts combating with contra proferentem?

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33. Kenneth Abraham has briefly suggested the possibility that courts can apply contra proferentem as a penalty default rule or as a majoritarian rule. *See* Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 544-50 (1996).

34. *See* Ayres & Gertner, *supra* note 1, at 92-94.

35. ISO formed in 1971 through the merger of similar entities for stock insurance companies (the National Bureau of Casualty Underwriters, later the Insurance Rating Bureau) and mutual insurance companies (the Mutual Insurance Rating Bureau), both of which had been drafting policy language for the entire industry since the early 1940s. *See* Douglas L. Talley, *Proving Standard Policy Language of Missing Insurance Policies*, IRMI.COM (June 2011), http://www.irmi.com/expert/articles/2011/talley06-risk-management-insurance-archeology.aspx. ISO bills itself as "the property/casualty insurance industry's leading supplier of statistical, actuarial, underwriting, and claims data." *How ISO Serves the Property/Casualty Insurance Industry*, ISO.COM, http://www.iso.com/About-ISO/Overview/ISO-Services-for-Property-Casualty-Insurance.html (last visited Feb. 18, 2013).

36. *See, e.g.*, City of Burlington v. Indem. Ins. Co. of N. Am., 332 F.3d 38, 49-50 (2d Cir. 2003); New Castle Cnty., Del. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa., 243 F.3d 744, 755-56 (3d Cir. 2001).

37. Buchanan v. Mass. Protective Ass'n, 223 F.2d 609, 612-13 (D.C. Cir. 1955) (finding ambiguity under accident insurance policy's provision of disability benefits).

38. *See* Michelle E. Boardman, Contra Proferentem: *The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105 (2006).

Courts may not know. The problem is that while courts can observe drafter action, or inaction, they cannot observe the cause. Consider a case where insurers knowingly retain language that has given rise to litigation with claims of ambiguity.[39] The strategic explanation is that the insurer gains from the ambiguity; the policy language somehow manages to preserve the veneer of coverage to the layman while inducing courts to exclude it. I have urged skepticism toward this as the *primary* explanation for ambiguity in insurance policies.[40] Without repeating that argument in full, consider here that, at a minimum, most clauses that raise ambiguity claims are verbose, legalistic, and appear to repeatedly deny coverage. No one would think these clauses are meant to *entice* potential buyers.[41] The clauses thus do not increase sales but do increase costly litigation.

No doubt ambiguous language can discourage a consumer from pursuing a claim or a suit, but so too would clear language excluding coverage. Add to this the fact that much policy language is shared across insurers, such that competitors use the same or similar language, and the case for rampant strategic ambiguity is difficult to press.[42] For the purposes at hand this need not be certain so much as plausible. If courts are ill suited to identify the cause of a gap, or if the cause varies, applying contra proferentem consistently as a default is a mistake.

Recall that the source of the gap dictates the choice of default. If, or when, courts are right that insurers are engaging in strategic in-

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39. In homeowners insurance, the anti-concurrent cause clause is a strong example. One version of this clause reads: "We will not pay for loss or damage caused directly or indirectly by any of the following. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss." INSURANCE SERVICES OFFICE, INC., CAUSES OF LOSS—SPECIAL FORM CP 10 30 04 02, *available at http://www.propertyinsurancecoveragelaw.com/uploads/file/CP%2010%2030%2004%2002.pdf*. In General Commercial Liability policies, the "sudden and accidental" pollution exclusion has caused courts great consternation. *See* Ballard & Manus, *supra* note 31. "In the context of pollution exclusions, insureds have argued quite vigorously that so-called 'historical intent' (much of which seems of questionable reliability) dictate how courts should narrowly construe those exclusions and indeed ignore the very words used in favor of some suggested original historical purpose." George B. Hall Jr., *An Historical Perspective on Attempted Recovery of Y2K Expenses Under Sue and Labor Clauses*, 14 MEALEY'S LITIG. REP.: INS., no. 4, 1999, at 12, 14, *available at* LEXIS 14-4 Mealey's Litig. Rep. Ins. 12; *see also* Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942 (1988).

40. *See* Boardman, *supra* note 38 (analyzing three ways in which courts counter-intuitively reinforce the retention of unclear language through the application of interpretative principles).

41. The anti-concurrent cause clause cited *supra* note 39 does not give a potential policyholder an impending sense of wide coverage, for example. Likewise, the "absolute" pollution exclusion defines "pollutant" broadly and excludes coverage "for loss or damage caused by or resulting from . . . discharge, . . . seepage, migration, release or escape of 'pollutants.' " INSURANCE SERVICES OFFICE, INC., *supra* note 39, at 2-4.

42. *But see*, Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389, 1405-06 (2007).

completeness, a penalty default is called for.[43] The penalty forces the insurer to partially internalize the cost that ambiguity imposes on consumers and courts. But if insurers are not acting strategically, a penalty default is the wrong solution. If insurers are bowing to the costs of contracting, then the Ayres and Gertner analysis would call for a majoritarian default.[44] It is costly for the parties to spell out every term, but the court can minimize their transaction costs by selecting the term the parties would have consented to in the absence of transaction costs.

On the other hand, given the repeat-player, mass-player nature of insurance, perhaps courts should use a penalty default to give insurers an incentive to state the majoritarian term *because* the court cannot identify that term and believes the insurer is in a better position to do so. This is in keeping with the idea that "[i]f it is costly for the courts to determine what the parties would have wanted, it may be efficient to choose a default rule that induces the parties to contract explicitly."[45] In cases where the larger repeat player does the drafting, "[t]he more informed party . . . may be able to amortize the cost of understanding and addressing the default rule over a number of transactions."[46] This possibility is examined in Part III.B.

A few examples of insurance gaps, and the use of contra proferentem to fill the gaps, are called for. This Part considers the two primary types of gaps—silent gaps and ambiguity gaps; there are others.[47] The point is not to be exhaustive but to give concrete contours to the discussion. To the extent these examples raise doubts about the appropriateness of contra proferentem as a penalty default rule, further doubting can be found in Part II.

1. The Silent Gap: "Water Below the Surface of the Ground"

A court excluded coverage for damage caused by "water below the surface of the ground."[48] In *Adrian Associates, General Contractors v. National Surety Corp.*, the Texas Court of Appeals found the phrase

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43. *See infra* Part III; *see also* Ayres & Gertner, *supra* note 1, at 94.

44. *See* Ayres & Gertner, *supra* note 6, at 1594-96.

45. Ayres & Gertner, *supra* note 1, at 93. "Courts, which are publicly subsidized, should give parties incentives to negotiate ex ante by penalizing them for inefficient gaps." *Id.*

46. Thomas J. Stipanowich, *Reconstructing Construction Law: Reality and Reform in a Transactional System*, 1998 WIS. L. REV. 463, 532.

47. Note that the rule of lenity is a form of contra proferentem, where the drafter is the legislature. In keeping with this, Einer Elhauge conceives of the rule of lenity as a "preference-eliciting default rule[]." Einer Elhauge, *Preference-Eliciting Statutory Default Rules*, 102 COLUM. L. REV. 2162, 2192-93 (2002). As a penalty default rule, lenity is meant to give legislatures an incentive to be as clear as possible in drafting criminal statutes. *See id.* at 2194; *see also* Jeffrey W. Stempel, *The Insurance Policy as Statute*, 41 MCGEORGE L. REV. 203, 256 (2010).

48. Adrian Assocs., Gen. Contractors v. Nat'l Sur. Corp., 638 S.W.2d 138, 141 (Tex. App. 1982).

ambiguous as to whether the water had to be from a natural source or any source.[49] The insurer argued that because the phrase was unqualified, it applied to water from any source; this reading would have denied coverage in the case because the offending water from an underground water main was below the surface of the ground.[50] The court found the clause ambiguous because it was (1) silent on the question and (2) preceded by two clauses, the first of which applied to water of natural origin and the second of which applied to water of artificial origin.[51] According to the court, if the insurer intended "water below the surface of the ground" to apply to "*all*" water below the surface of the ground, it "would have said so."[52]

To be clear, the two prior clauses applying first to natural source water and second to artificial source water did *not* draw the distinction explicitly but by clear implication. The first clause refers to "[f]lood, surface water, waves, tidal water" and the like, while the second refers to "water which backs up through sewers or basement drains."[53] One might think that a third clause referring to neither source would include both. The appellate court drew the opposite conclusion under contra proferentem.[54]

The *Adrian Associates* court adopted a particularly strict version of contra proferentem, stating that at least as to exclusionary clauses, the construction "urged by the insured must be adopted as long as" it is not "unreasonable and *even if* the construction urged by the insurer appears to be *more reasonable* or a *more accurate* reflection of the intent of the parties."[55] This case was later endorsed by the Texas Supreme Court, and "the position of the Texas Supreme Court is probably the majority rule" even though many jurisdictions might not adopt this extremely strict form of contra proferentem.[56]

Adrian Associates is an example of one type of gap to which contra proferentem can be applied as a default rule. The gap, as described by the court, is silence where additional words would have clarified the meaning.[57] In the language of default rules, the insurer has private information—the sub-surface water exclusion applies to all water—that it has failed to convey to the less informed party. More abstractly, the insurer has information about how it wants an exclusion

49. *Id.* at 140.
50. *See id.* at 138-39.
51. *Id.* at 140.
52. *Id.*
53. *Id.*
54. *See id.*
55. *Id.* (emphasis added).
56. Michael Sean Quinn & L. Kimberly Steele, *Insurance Coverage Opinions*, 36 S. TEX. L. REV. 479, 543 (1995). The court itself cites other jurisdictions in agreement. *See Adrian Assocs.*, 638 S.W.2d at 139.
57. *See Adrian Assocs.*, 638 S.W.2d at 140.

to apply, and it has only revealed some of that information to the policyholder. (This description may sound silly on these facts but an under-explained exclusion can indeed leave a contractual gap.)

This type of gap can be called the "silent gap." Courts identify gaps from silence by working backward from the judge's idea of a better, more specific clause. The clause could have read "water below the surface of the ground from whatever source." Instead, the argument goes, the insurer left out "from whatever source." The insurer was silent where it should have spoken. Contra proferentem could operate here to give the insurer an incentive to more fully share the nature of the exclusion with the policyholder.

The problem with the silent gap is that it may not be an empty hole waiting to be filled. Does the phrase "mental illness" include autism?[58] It would seem insulting to refer to an autistic person as mentally ill, but in the insurance context one can grant an ambiguity. The policyholder, arguing it does not include autism, probably has the sounder argument but, nonetheless, the insurer's view, that it does include autism, is plausible. Thus there is a gap from silence in a policy that does not further define mental illness.[59] This gap is robust because wherever one falls on the autism question, "mental illness" needs further description or else consumers and courts will also have to guess as to whether it includes alcoholism or ADHD, just to start.

But does "delivery on Tuesday" not exclude Wednesday because nothing is said of Wednesday? The clause could have read "delivery on Tuesday and not Wednesday," after all. (Under the U.C.C. we might have usage of trade showing that delivery on any day means within a week of that date, but this is an implied term, not the result of ambiguity.) This is the type of "silence" maintained in "water below the surface of the ground." "Water below the surface of the ground," would, without more, exclude "water below the surface of the ground from an artificial source." The clause does not specify the source of the water, but neither does it specify the temperature or color of the water. The natural reading is that it applies to all water, including hot, green, artificial source water.

What is the precise failure of contra proferentem as an information-forcing default for this type of silent gap? There is no gap to fill.

2. The Ambiguity Gap: "Civil Commotion" and Internal Conflict

A gap caused by ambiguity is more obvious and requires much less discussion than the silent gap. For example, was the 1970 hijacking of Pan American Flight 083 a form of "insurrection," "rebellion," or

58. *See* Kunin v. Benefit Trust Life Ins. Co., 910 F.2d 534, 535 (9th Cir. 1990).
59. *See id.* at 536.

"civil commotion," all of which were excluded under some of the relevant contracts?[60] Sound arguments are to be had in either direction. Some of these terms were themselves defined. The gap was not the result of silence but of an ill fit between the existing language and the facts of a politically motivated hijacking.[61]

Ambiguous contract language, as written or as applied, leaves a court without one set of instructions to follow. Two sets of instructions leave a hole in the contract as much as missing instructions do. Insurance policies in particular can be structurally ambiguous. It "result[s] from 'internal conflict' between policy provisions that renders uncertain the meaning of the policy as a whole."[62] A grant of coverage, followed pages later by a partial exclusion, which itself includes an exception to the exclusion granting back to the consumer a subset of coverage, is a common structure for homeowners policies in particular.[63] It may be possible to fit the pieces together in two plausible arrangements: one favoring the insurer and one the consumer. As with "mental illness," this type of ambiguity leaves the court without a clear command from the contract; there is a gap.

C. Filling Gaps by Penalty Default

1. The Initial Argument for Contra Proferentem as a Penalty Default

The argument for viewing contra proferentem as a penalty default rule is brief and straightforward. More interesting, and elaborate, is the succeeding analysis of reasons to think otherwise. Still, the case must first be made. As mentioned, it is common for scholars of penalty defaults to note, but not dwell on, contra proferentem as an example.[64] Several insightful judges have also remarked on the possibility.[65] But these treatments have been intentionally casual, a few lines here and there.

Contra proferentem is a *default* rule because it produces contract terms the parties can avoid by more explicit drafting. In insurance in particular, the default term it produces is "the policyholder receives coverage." This is obviously not a mandatory rule because insurers can, and do, cover parts of a property or risk—not the entire risk—from

60. *See* Pan Am. World Airways, Inc. v. Aetna Cas. & Sur. Co., 505 F.2d 989, 994 (2d Cir. 1974).

61. *See id.* at 1022.

62. Leonard v. Nationwide Mut. Ins. Co., 499 F.3d 419, 429 (5th Cir. 2007).

63. *See, e.g.*, INSURANCE SERVICES OFFICE, INC., HOMEOWNERS 3—SPECIAL FORM NO. HO 00 03 10 00 (1999), *available at* http://www.insuringflorida.org/assets/docs/pdf/HO3_sample.pdf.

64. *See, e.g.*, Ayres & Gertner, *supra* note 1, at 105 n.80; Ayres, *supra* note 18, at 596-98; Ben-Shahar, *Agreeing to Disagree*, *supra* note 17, at 391; Ben-Shahar, *Contracts Without Consent*, *supra* note 17, at 1840-41; Bratton, *supra* note 17, at 863; Posner, *supra* note 2, at 579-80.

65. *See infra* text accompanying notes 80-85 (discussing Judges Easterbrook and Calabresi).

harm caused by certain perils and not others. The contra proferentem doctrine does not turn insurance policies into automatic payment for all losses. As Judge Posner writes, " 'You wrote it, you lose' is not the insurance law" of contra proferentem.[66]

Contra proferentem is a *penalty and information-forcing* default rule because it seeks to fill a contractual gap with a term that one party does not want and has the power to avoid. The effect, and intent, of the undesired default is to get the drafter to convey more information to the consumer. While there is an urge toward consumer protection in many opinions, the doctrine does not identify a term by the policyholder's preference but by the insurer's aversion—contra proferentem rather than *pro lectore*.

Still, the "provide coverage" gap-filler is a little tricky to parse. The contra proferentem default takes the blunt position that the insurer would choose to deny coverage and the policyholder would choose to have coverage; this does *not* tell us where the two would have met had they hashed it out *ex ante*. It replicates only what the two parties are claiming in court *ex post*. From there, it takes the insurer/drafter's desire to deny coverage and plugs in the contrary term.

Note that this is not anti-majoritarian so much as non-majoritarian. A penalty default is not the mirror opposite of a majoritarian default, which would "call on courts to duplicate the terms the parties would have selected, in their *joint* interest, if they had contracted explicitly."[67] The majoritarian default thus focuses on *both* parties; a non-majoritarian penalty can focus on *one* party—here the drafter. Because a policyholder in court is asking for coverage, contra proferentem does give the policyholder what she wants at that moment (even if she would not have wanted to pay a premium for the coverage when signing the contract). But by denying the drafter its preferred term, the rule is information-forcing. The target is the insurer, and the arrow is a term the target wishes to avoid.

Put another way, contra proferentem does not seek to mimic the bargain the parties would have reached together. It would often be impossible to apply if it did. For any given risk it is difficult to know what goes in the majoritarian box; policyholders do not want to pay for total coverage from all losses, and insurers want to sell only coverage on which they can make a profit or meet market demand. Fortunately, it should be easier for courts to identify what one party does not want than to identify the agreement they would have reached.

Later Parts explore the neglected question of whether contra proferentem truly does provide a penalty or whether insurers are

66. Stone Container Corp. v. Hartford Steam Boiler Inspection & Ins. Co., 165 F.3d 1157, 1160 (7th Cir. 1999) (discussing contra proferentem in Illinois specifically).

67. Easterbrook & Fischel, *supra* note 9, at 1433 (emphasis added).

sometimes or often willing to accept the default "provide coverage."[68] For purposes of categorizing contra proferentem, however, it is enough to understand that (1) courts view the doctrine as one that dishes out an unpalatable term to insurers, the party with asymmetric information and drafting control, and (2) courts apply the doctrine with penalty or motivational intent.

2. Reasons to Doubt Contra Proferentem as a Penalty Default

In this Part, I consider three reasons why contra proferentem might not be a penalty default rule. Consider the reasons contra proferentem could be a (1) mandatory, (2) majoritarian, (3) interpretive rule.

(a) Mandatory or Default?

Is contra proferentem a mandatory rule? The doctrine itself is inescapable; a clause directing a court to avoid its use or to interpret ambiguities *pro proferentem* would have no legal effect.[69] But the terms that are inserted into insurance policies under the doctrine are "gap" fillers that can be averted by a more artfully worded contract. They are variations on the default rule "provide coverage."

Confusion has persisted on this point because of the looseness of the word "rule." At times, "default rule" is used to refer to a specific *default term*. At other times, "default rule" is used to refer to a *mechanism* by which the content of a gap-filling term is selected. Many cases can be described either way. The relevant question is whether the rule creates a mechanism by which courts fill gaps *ex post*—it does—and whether the parties can take action to avoid application of the mechanism—they can.

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68. In this, as in other ways, contra proferentem closely resembles the *Hadley* rule, which Ayres later acknowledged "is not the cleanest example of a penalty default" because it may be that the majority of contractors do not avoid the term—they have average expected costs from delayed shipment and need no additional damages. *See* Ayres, *supra* note 18, at 613.

69. On this view, Michael Rappaport concludes that contra proferentem "is not a default rule that the parties can contract around, but is a mandatory part of all insurance contracts to which it applies." Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171, 186 n.35 (1995). Rappaport made this observation in passing and it is not central to his thesis. *Id.* Some courts refrain from applying contra proferentem to contracts between two sophisticated parties, especially where it is inaccurate to refer to one side or the other as "the drafter." *See id.* at 256 n.244. These courts *might* allow such a clause to stand, but in consumer contracts the rule is immutable. Outside of insurance, Omri Ben-Shahar has identified and explored a category of "pro-defendant" gap fillers to be applied when the parties deliberately leave a gap. *See* Ben-Shahar, *Agreeing to Disagree*, *supra* note 17, at 390. Under this rule "a party who seeks enforcement of a deliberately incomplete agreement would be granted an option to enforce the transaction under the agreed-upon terms supplemented with terms that are the *most favorable* (within reason) to the defendant." *Id.*

The variations of "provide coverage" that contra proferentem creates are genuine defaults because they can be contracted around or avoided by giving information to the consumer. An insurer can redraft the ambiguous or unreadable clause and coverage can be denied. Or an insurer can draw the consumer's attention to policy limits during purchase; in many jurisdictions extrinsic evidence of this will be permitted to avoid a finding of ambiguity, and thus avoid the application of contra proferentem.[70]

In this way, contra proferentem is similar to the *Hadley* rule. The "rule" in *Hadley v. Baxendale* is that only foreseeable (or foretold) consequential damages will be awarded.[71] We can say that this term is inserted into every contract that does not explicitly state otherwise. But note that the many who have discussed *Hadley* do not envision the "opting out" of the rule to consist of an explicit contract term—"no consequential damages shall be awarded."[72] The benefit of the rule comes when a party with unusually high potential damages shares that fact, opening the door to a mutually agreed-upon distribution of the risk.

The analogy is not precise, but contra proferentem is similar. It is not a simple default *term* like so many that can be found in the U.C.C. "Unless otherwise agreed . . . the place of delivery of goods is the seller's place of business or if none, the seller's residence," for example.[73] It is a rule that gives the parties two broad choices: either say nothing and accept the pro-policyholder class of default terms *or* say something and craft your own term. Under *Hadley*, the choice is either say nothing and accept that consequential damages will be limited *or* reveal an unusual risk and explicitly assign it to one party. Under contra proferentem, the choice is either say nothing (by saying something ambiguous) and accept coverage *or* say something unambiguous and explicitly assign the risk to one party.

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70. Some jurisdictions apply contra proferentem if the text is unclear without first considering extrinsic evidence of intent or meaning. *See* Eli Lilly & Co. v. Home Ins. Co., 482 N.E.2d 467, 470 (Ind. 1985).

71. *See* Hadley v. Baxendale, (1854) 156 Eng. Rep. 145 (Exch. Div.) 151. Recall that *Hadley* involved a miller with a broken crankshaft and no back-up shaft. *Id.* at 145. His mill remained idle until the shipper, his contracting partner, could send the broken form and return a replacement. *Id.* The shipper assumed, apparently based on standard practice, that the miller had another crankshaft and was not shut down while he awaited shipment. *Id.* at 151. The miller had unusually high consequential damages from delay because his mill was stopped while he awaited a new shaft. *Id.* at 146. Ayres & Gertner saw the consequential damages rule as a penalty default because it incents the unusual miller to convey his high need to the shipper, prompting the shipper to take more care. *See* Ayres & Gertner, *supra* note 1, at 104.

72. *See, e.g.*, Ayres & Gertner, *supra* note 1, at 103-04.

73. U.C.C. § 2-308 (2012). It is an interesting question whether the many "unless otherwise agreed" default terms in the U.C.C. could be contracted around in one fell swoop: "No non-mandatory U.C.C. default terms shall apply to this contract." If the contract did not specify a substitute method for filling gaps, this clause might fail.

The background rule of *Hadley* is thus not meant to be *avoided*, but rather it is meant to be *fulfilled*.[74] The goal, as Ayres and others see it, is to cause the party with the risk of unusual consequential damages to reveal that risk during contracting, causing the other party to take extra precautions.[75] Likewise, the purpose of contra proferentem is not to induce the drafter to explicitly avoid the rule by inserting a *pro proferentem* clause. The goal is to induce the drafter to avoid the default *term*. The goal is to cause the party with private knowledge to share it.

In short, contra proferentem is best thought of as a *mandatory doctrine* that creates a subclass of *default* substantive *rules*.[76]

(b) Majoritarian Default or Penalty Default?

Accepting that contra proferentem is a default rule, perhaps it is not a penalty default but a majoritarian default. (Whether the ideal form of the rule *would* operate as a majoritarian default is addressed in Part III.B below.) This could be true in two ways, one superficial and one serious. First, the existence of the contra proferentem doctrine itself might be something the majority of parties want. Second, the gap-filling terms the rule produces may be those the parties would have hypothetically consented to in the absence of transaction costs.

The first option is superficial because a rule can be popular with a majority of parties while still filling gaps with non-majoritarian terms. *Hadley* is likely such a rule "in the sense that a majority of contracting parties would prefer the rule that deters the strategic withholding of information by an unrepresentative minority."[77] The

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74. The implied covenant of good faith and fair dealing is an example of a majoritarian immutable rule. The rule is immutable in the sense that courts would not likely enforce this clause: "The covenant of good faith and fair dealing shall not apply to this contract." The contours of the rule can be changed, however, in that if an act or option is explicitly anticipated or permitted in a contract, there can be no objection. "The general rule [regarding the covenant of good faith] is plainly subject to the exception that the parties may, by express provisions of the contract, grant the right to engage in the very acts and conduct which would otherwise have been forbidden by an implied covenant . . . ." Carma Developers (Cal.), Inc. v. Marathon Dev. Cal., Inc., 826 P.2d 710, 728 (Cal. 1992) (en banc) (quoting VTR, Inc. v. Goodyear Tire & Rubber Co., 303 F. Supp. 773, 777-78 (S.D.N.Y. 1969)).

75. *See* Ayres & Gertner, *supra* note 1, at 101-02. In the alternative, the newly informed party can clarify that it refuses to take on the risk, leaving the first party to arrange for his own insurance against the possible loss.

76. Drafter confusion, and thus inefficiency, comes when the same mandatory procedural rule contains both immutable and default substantive rules, as reasonable expectations does in many cases. The reasonable expectations principle may operate as a base immutable rule underneath a penalty default rule. Attempts to contract around the immutable rule incur a court's wrath; for the sin of going too far, and misleading policyholders who do not know about the immutable rule, the term is reset to the policyholder's best hopes, not his reasonable expectations. Ayres and Gertner call this type of rule "penalty reconstruction." *See* Ayres & Gertner, *supra* note 1, at 121-23.

77. Ayres, *supra* note 18, at 612. Ayres acknowledges the truth behind Robert Scott's point that *Hadley* is majoritarian in this sense. *Id.* (referring to Robert E. Scott, *Rethinking*

deterrence has *majority* support, but it is done by filling gaps with *non*-majority terms. With contra proferentem, the simplest reason it may be a majoritarian doctrine is that consumers demand a thumb on their scale in the face of difficult contract language they cannot change and that insurers bow to this market demand. Recall, of course, that to be majoritarian a rule does not have to fulfill both sides' fantasy of the perfect contract; rather it is the rule they would have agreed to together had they agreed on a rule.[78]

The second, more serious question then is whether the case-specific default rules contra proferentem creates mimic those the parties would have hypothetically chosen together. The short answer to this is that we should be agnostic on what the parties would have chosen. The slightly longer answer is that in some cases the "provide coverage" default will be what the parties would have agreed upon and in other cases it will not be. What is clear is that in applying contra proferentem, the court is not attempting to determine what the parties would have jointly chosen.

Contra proferentem does not ask what was in the drafter's *ex ante* interest when the contract was written. That interest might include a term that is beneficial to the non-drafter—a pro-buyer term the drafter includes to make the product desirable. Contra proferentem instead takes a snapshot of the drafter's interest *ex post*, at the moment of dispute; premiums have been paid, a loss has occurred, and the blunt assumption is that it is in the insurer-drafter's interest to exclude coverage. Therefore, courts reason, construing a term to *provide* coverage is an incentive to the insurer to change the term, returning it to its "desired" position of no coverage.

Courts have good reason to think this, given that the insurer is in court objecting to the interpretation that provides coverage. The insurer has basically stated that it does not want the written terms to provide coverage. But on this question, where are the many skeptics who assume insurers sell big and deliver little? If insurers are indeed trying to hoodwink consumers into buying attractive policies while simultaneously trying to avoid paying up after a loss, the insurers' favored position would be to (1) keep the deceptively attractive term but (2) have that term interpreted to preclude coverage. It is true that contra proferentem can foil that plan by taking away (2), but given that the insurer still has (1), it is not obvious that redrafting is in the insurers' interest. Moreover, the insurer only loses (2) for those policyholders who sue. Contra proferentem barely puts a chink in the

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the Default Rule Project, 6 VA. J. 84, 85-86 (2003)). Ayres points out, however: "If we go far enough back behind the veil of ignorance, all information-forcing rules are majoritarian. From this perspective, the dichotomy between majoritarian and penalty defaults is false." *Id.*

78. For arguments supporting this position, see *infra* Part III.B (imagining contra proferentem as majoritarian default).

evil insurer's armor, if it exists. Either way, the rule is not operating as either a de jure or de facto majoritarian rule.

Should it matter if the lawmaker understands a particular rule to operate as a penalty default or information-forcing rule? Ayres does not think so.[79] If the goal is to assess whether a rule effectively and efficiently produces information, which is one goal of this Article, then the intent of a legislature or original lawmaker in *making* a rule does not seem to matter. Whatever the lawmakers' intent, the rule may indeed force one or both parties to reveal information by presenting a default option they wish to avoid.

A few courts have considered the possibility that contra proferentem operates as a penalty. The Seventh Circuit Court of Appeals, in an opinion written by Judge Frank H. Easterbrook, has referred to the possible role of contra proferentem as a penalty default.[80] Citing Ayres and Gertner, Judge Easterbrook writes that "[p]erhaps the interpretive principle [of contra proferentem] could be recast as one requiring the insurer to come forth with information in its possession but unknown to the insured."[81] But Judge Easterbrook does not find that the state at hand (Wisconsin) "has . . . suggested this understanding of its approach, perhaps because it doubts judicial ability to determine how much information is optimal."[82]

The Second Circuit has also considered the possibility of penalty defaults in insurance interpretation.[83] If risk-expanding interpretative approaches are penalty defaults, "expanded coverage to the detriment of insurers in all-risk policies is justified since such expansions give insurers, who presumably have better knowledge of insurance laws than do insureds, a powerful incentive to insert explicit language into policies, thereby informing the insureds as to the precise scope of coverage."[84] On this reading, the penalty is aimed at getting more information to consumers, not courts. "The same argument," the court continued "can be used in support of the rule of interpreting ambiguities in insurance contracts against the insurer."[85]

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79. Ayres, *supra* note 18, at 592-93. "A broad definition of defaults lets lawmakers and analysts assess whether the choice of a given displaceable rule is best defended on the grounds of its informational impact." *Id.* at 592.

80. *See* Harnishfeger Corp. v. Harbor Ins. Co., 927 F.2d 974, 976 (7th Cir. 1991).

81. *Id.*

82. *Id*. He goes on to say, with information "there is always 'more,' and the evolution of 'warning' (i.e., disclosure) claims in the law of products liability provides ground to doubt that the principle could be confined." *Id.*

83. *See* City of Burlington v. Indem. Ins. Co. of N. Am., 332 F.3d 38, 49, 49 n.10 (2d Cir. 2003); Am. Nat. Fire Ins. Co. v. Kenealy, 72 F.3d 264, 268-69 (2d Cir. 1995). Both opinions were authored by Judge Guido Calabresi, who is also a colleague of Ian Ayres at Yale Law School.

84. *City of Burlington*, 332 F.3d at 49 (discussing Ayres & Gertner, *supra* note 1).

85. *Id.* at 49 n.10. In an earlier insurance case, Judge Calabresi noted that a penalty default might be appropriate if insurers were strategically withholding information, alt-

Of course, those who argue that the lawmakers' intent is necessary to the identification of a penalty default rule do not take the position that the lawmaker must use a phrase like "penalty default" or "information-forcing rule." Indeed, contra proferentem may be the only default that can pass the intent test by merely stating the rule. The rule *operates* by applying a meaning that one party does not want, explicitly looking for the option that is counter to the drafter's hypothetical consent. It also explicitly *anticipates* that the drafter will improve in the future by providing better information.

Thus far, then, the rule can be seen as a mandatory doctrine creating a sub-class of default terms that insurers are meant to opt out of by conveying more information to policyholders. But, lastly, perhaps contra proferentem is *only an "interpretative presumption"* and not a default rule at all.[86]

(c) Interpretative Rule or Penalty Default?

Whether contra proferentem is an interpretive rule is not a new question. While it is commonly and casually referred to as one, Arthur Corbin thought otherwise:

> The rule is not actually one of interpretation, because its application does not assist in determining the meaning that the two parties gave to the words, or even the meaning that a reasonable person would have assigned to the language used. It is chiefly *a rule of policy, generally favoring the underdog*. It directs the court to choose between two or more possible reasonable meanings on the basis of their legal operation, i.e., whether they favor the drafter or the other party.[87]

This reasoning explains why contra proferentem is often thought of as a rule of last resort, only to be used if other means of interpretation, including examining extrinsic evidence, fail.[88] On this view, the rule is not one of interpretation because it is applied only after the court has concluded it cannot interpret the language directly or make sense of the parties' joint intent.

The Restatement (Second) of Contracts takes a mixed view: contra proferentem "is in strictness *a rule of legal effect*, sometimes called construction, *as well as interpretation*: its operation depends on the

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hough not in the specific context of contra proferentem. *See Am. Nat. Fire Ins. Co.*, 72 F.3d at 268-69, 269 n.1.

86. Posner, *supra* note 2, at 578-80.

87. 5 CORBIN ON CONTRACTS § 24.27, at 306 (Joseph M. Perillo ed., rev. ed. 1998) (emphasis added). This paragraph was cited approvingly by the Michigan Supreme Court in an insurance case. *See* Klapp v. United Ins. Grp. Agency, Inc., 663 N.W.2d 447, 456 (Mich. 2003).

88. Not everyone believes the rule should be limited to last place. Some judges argue that when applying contra proferentem to a contract "drafted entirely by one party, without any bilateral negotiations," it should not be used as a last resort but as a "primary rule of construction." *Klapp*, 663 N.W.2d at 460 (Weaver, J., concurring).

positions of the parties as they appear in litigation, and sometimes the result is hard to distinguish from a denial of effect to an unconscionable clause."[89] In the insurance context specifically, the Michigan Supreme Court has rejected this equating of rules of legal effect with rules of construction:

> In our judgment, the rule of contra proferentem is not a rule of construction, rather . . . it is a rule of legal effect. While rules of construction are designed to help determine the parties' intent, the rule of contra proferentem is designed to resolve a dispute where the parties' intent cannot be determined.[90]

If the goal of modern interpretation is to determine the meaning the parties attached to the words at the time of contracting, counting the words themselves as primary but not exclusive evidence, contra proferentem is *not* a rule of interpretation. At least in the consumer insurance context, the rule may endorse a position that the consumer had *ex ante*, but this is not required. It is, as Corbin writes, a rule "favoring the underdog."[91] The enforced meaning is a matter of consumer protection and insurer penalty, not *ex ante* consumer intent.

This question matters because, as Eric Posner argues, if it operates at the interpretive stage and not the gap-filling stage, contra proferentem is probably *not* a default rule.[92] In his framework, a court must complete five stages in order to award damages.[93] In stage three a court "determine[s] what the contract says" (interpretation), and in stage four the court applies a default rule if there is a gap.[94] He does not hang his hat on where the gap must be found, but he seems to place the task of identifying a gap at stage three.[95]

Posner is not committed to rejecting all interpretive presumptions as outside of the set of default rules because "[a]rguably" they are "analytically the same as default rules."[96] To the extent he explores the separation, however, he is off about contra proferentem because he conflates the question of ambiguity with the application of contra proferentem. At stage three, a court considering contra proferentem must decide if a term is ambiguous (or unfathomable). If it is, the

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89. RESTATEMENT (SECOND) OF CONTRACTS.2D § 206, cmt. a (emphasis added). Section 206 is entitled "Interpretation Against the Draftsman" and reads: "In choosing among the reasonable meanings of a promise or agreement or a term thereof, that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds." *Id.*

90. *Klapp*, 663 N.W.2d at 457 (citation omitted).

91. 5 CORBIN, *supra* note 87, § 24.27, at 306.

92. *See* Posner, *supra* note 2, at 578-80.

93. *See id.* at 565 (explaining that stage one is following contract formation formalities, stage two is confirming real consent, and stage five is awarding a remedy if a term has been violated).

94. *Id.*

95. *See id.* at 579.

96. *Id.* at 566.

court declares a gap; where there should be a term there is a blank, gibberish, or two terms. The court then moves on to stage four, inserting the default. Posner's latent premise must be that because contra proferentem also tells the court how to determine what the default *is*, it is interpretive and therefore still operating at stage three.

This is fair enough. With many other rules there is no stage at which the content of the default rule is determined; the rule simply provides the content. If there is no term disclaiming warranties in writing, the U.C.C. fills in the warranties of merchantability and fitness for purpose.[97] But upon reflection it is not so uncommon to have a default rule that requires more work than confirming a missing term.[98] Under U.C.C. section 2-305, "Open Price Term," if a contract does not give a price, the court must determine the reasonable market price.[99] The default price is not five or five hundred dollars; it is an instruction that requires fact gathering.

With contra proferentem, at stage three the court determines if the term is ambiguous (if yes, then there is a gap) and at stage four it applies the default, following the instruction on how to fill the gap. In insurance, this instruction amounts to "the policyholder's loss is covered."[100] Identifying the precise term requires an extra step; it is not "cover loss to the unattached fence" for all contracts any more than the section 2-305 default is "$1,000" for all contracts.

There are several points to note here. First, as will be explored later, this may reveal one way in which insurance contra proferentem is a default rule while non-insurance contra proferentem is a rule of interpretation only. The insurer's permanent status as drafter, combined with the assumption that "against" the drafter means "provide coverage," allows for a far more specific default rule in insurance. "Where [an] act of interpretation is carried out according to a *predictable* rule, parties will contract around it just as they would a pure statutory default."[101]

Second, I do not mean to say there is nothing interpretive about the contra proferentem instruction. Although some courts seem unclear on the concept, contra proferentem is meant to be a rule of last

97. *See* U.C.C. §§ 2-314, 2-315 (2012).

98. Even under the *Hadley* rule, if the contract says nothing about consequential damages, the court must take the step of determining if the damages were foreseeable or foretold, and only then apply the default rule. *See* Eisenberg, *supra* note 4, at 565-67. The default rule is still one rule (no consequential damages), but it requires a step that does not fit neatly into either stage three or four. It is not interpretation, finding the gap, or inserting the default. *See generally* Hadley v. Baxendale, (1854) 156 Eng. Rep. 145 (Exch. Div.) 151.

99. U.C.C. § 2-305 (2012). Posner agrees that section 2-305 is a default rule, just not a penalty one. *See* Posner, *supra* note 2, at 576.

100. It is, or can be, more nuanced than this, of course.

101. Ayres, *supra* note 18, at 596 (emphasis added).

resort, a rule of construction.[102] Only after all other interpretive methods have been exhausted—and the court is still left with language that either has no clear meaning or two plausible meanings—is contra proferentem to apply. Then, perhaps at stage three and one-half, contra proferentem provides the substance of the default rule. In theory, this default is based on one possible reading or interpretation of the language. On the other hand, there are times when it cannot be said that the term the court adopts using contra proferentem is an interpretation of the written term. The written term is jettisoned, and the default term is "coverage" of whatever loss the discarded term was meant to address.

Implicitly, part of Posner's point about interpretation rules seems to be that they cannot be contracted around.[103] This is true of some interpretative rules but not others. Within bounds, the parol evidence rule can be altered by merger clauses. Parties can specify that terms are to be read in a technical light. Parties can state that a contract or a clause is not to be interpreted in light of trade usage. The individual substantiations of contra proferentem can be avoided by clear drafting, at least the theory goes.

At last, we do not need to use the interpretation stage question as an intermediary; we can ask directly whether contra proferentem is a mandatory rule. In the end, then, this question comes back to my description of contra proferentem as an immutable procedural rule that governs a class of substantive default rules.

III. SHOULD CONTRA PROFERENTEM BE A PENALTY DEFAULT RULE?

However one comes down on whether contra proferentem is a penalty default rule, its application has potential information-forcing

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102. To understand the extent to which modern *contra proferentem* has reshaped the way courts resolve policy disputes, it is useful to trace its evolution from (a) a rule of last resort allowing courts to construe ambiguities against drafters in those relatively rare instances where the meaning of the disputed terms could not be discerned through examining extrinsic evidence of the parties' intent, dealings and trade usage, to (b) a pro-insured rule in which any ambiguity in the relevant policy language is automatically construed in favor of coverage, without any need to evaluate extrinsic evidence concerning the parties' intent.

1 DAVID L. LEITNER ET AL., 1 LAW AND PRACTICE OF INSURANCE COVERAGE LITIGATION. § 1:11 (updated 2012). *See also, e.g.,* Klapp v. United Ins. Grp. Agency, Inc., 663 N.W.2d 447, 460 (Mich. 2003) (Weaver, J., concurring) (agreeing that the general rule is to apply contra proferentem as "last resort," but arguing that when "a contract is drafted entirely by one party, without any bilateral negotiations, [contra proferentem] should be applied as the primary rule of construction").

103. Posner does not state this explicitly in his discussion of contra proferentem but takes this position elsewhere and it seems to motivate the stage three/stage four analysis. *See* Posner, *supra* note 2, at 566.

effects.[104] Indeed, the analysis that the penalty default concept opens up is uniquely applicable to contra proferentem because contra proferentem has as its *justification* (1) applying an undesirable (i.e., non-majoritarian) term that (2) forces clearer information from the drafter. Information-forcing is, at a minimum, half the purpose of the rule, with immediate consumer protection being the second purpose. The long-term goal of encouraging clear drafting is both preventative and prospective. Courts can add to this goal the immediate benefit, or so it seems, of protecting the individual consumer in court.

This second Part of the Article therefore uses the penalty default model to examine whether contra proferentem achieves its aim, and if it does, whether the price is too high. It is one thing to identify the category of penalty default rules or to confirm the identity of a particular default rule. It is another thing altogether to conclude that a rule should operate as a penalty. Naturally, Ayres and Gertner have concerns, and others, including Posner, have strong doubts, about whether lawmakers will be able to select an optimal penalty default.[105] But Ayres argues that the most plausible penalty defaults can be crafted when the more knowledgeable party is a repeat player and the "asymmetric information [is] about the content of the law itself" and "the precise terms of the contract."[106] Insurers—and insurance contracts—fit this bill or no one does.

Contra proferentem in particular follows the instruction: "In the face of asymmetric legal information, a straightforward solution is to set the default against the more knowledgeable party."[107] This has abstract appeal and may work in another setting Ayres proposes—retail business—but insurance throws up roadblocks worth considering.[108] The next two Parts ask:

(1) Assuming contra proferentem effectively incents cleaner language (in initial drafting and redrafting), does more information reach consumers?
(2) When contra proferentem does not result in redrafted language, does the rule harm consumers on net?

To ask these questions is to also ask, in the language of penalty defaults:

(1) Does the penalty operate as a penalty, at least a decent percentage of the time?
(2) Is the asymmetry of information equalized or improved?

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104. This is also true of majoritarian default rules, it is readily recognized, because those with unusual preferences reveal them in response to the default. *See id.* at 580.

105. *See* Ayres & Gertner, *supra* note 6, at 1609; Posner, *supra* note 2, at 570.

106. Ayres, *supra* note 18, at 597.

107. *Id.*

108. *Id.* ("The repeat player—think retail business or insurance company—is more likely to learn the content of the legal rule than the one-off consumer.").

(3) Do the costs of the rule overwhelm the benefits? Would a majoritarian rule fare better?

Part II.A addresses effectiveness: whether contra proferentem is effective in getting more information out of insurers and in getting more information to consumers. Part II.B assumes that contra proferentem does get more information to consumers and addresses efficiency: whether this is worth the cost the rule imposes.

A. Is it Effective?

1. How Consumers Respond to the Rule

The function of a penalty is to give one or both parties an incentive to contract around the default, thus revealing information to the other party or to a third-party, usually the courts. Contra proferentem is meant to operate as the former, "giving a more informed contracting party incentives to reveal information to a less informed party."[109] In order for this type of information-forcing default to make sense, it has to be *possible* for the party with the private or hidden information to convey more information. If that party is speaking to consumers, the consumers must not be deaf to it.

In order for an information-forcing default to make sense in insurance, then, it has to be possible for the insurer to convey more information to policyholders. Presumably, this information will be conveyed in the text of the insurance policy.[110] Additional explanations and more clearly written terms would convey additional information to courts and to sophisticated policyholders. But if the information target is a consumer, what result?

The extent to which consumers read or understand their consumer contracts is a fight this Article will not seek to resolve. Instead, we

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109. Ayres & Gertner, *supra* note 1, at 97.

110. Very limited additional information could be conveyed in person or otherwise at the time of contracting. Some information can be conveyed outside of the policy text, of course. This is the primary vision of *Hadley,* that the rare shipper with a stopped mill will share his extraordinary costs of delay with the shipper, in person, at the time of contracting. *See* Hadley v. Baxendale, (1854) 156 Eng. Rep. 145 (Exch. Div.) 151; *see also* Ayres & Gertner, *supra* note 1, at 104. This works when the information asymmetry is limited to one piece of information. The asymmetry in insurance, and consumer contracts generally, is systematic. What few pieces of information should homeowners' insurers or their agents add to the sale or delivery discussion? In many locations a clear discussion of flood exclusions is called for, and had. Perhaps the anti-concurrent cause clause should be discussed. (If a covered cause of loss and a non-covered cause contribute to a single loss, the loss may not be covered). Or the agent should explain the exception to the general mold exclusion providing coverage for mold if it results from certain other covered losses. Even if insurers performed an analysis to identify and rectify the top three areas of possible concern, many areas would remain unexplained. In the end, consumers get the bulk of their perceptions of insurance policies from two sources: (1) their pre-conceptions based on experience and the purpose of the policy and (2) whatever policy language they happen to read. *See generally* Boardman, *supra* note 22.

can consider what would follow from applying an information-forcing rule to consumer contracts under several visions of consumer engagement. The three options considered are imprecise; option one—consumers do not read; option two—some read some text, but we do not know how much; option three—some consumers read *ex post*. Assuming for the moment a penalty default rule that aims to get information to *consumers* and *not courts*, here is what follows from the various levels of engagement:

> Option 1: Consumers do not read their contracts and will not. Improving a clause here and there changes nothing.

If this is correct, information-forcing rules aimed at consumers are inappropriate; they raise the costs for the drafter without providing any benefit to the consumer. The rule prompts the delivery of information, but it does not ensure the receipt of it. You can improve the horse's water, but you can't make it drink.

There is another subclass of inappropriate application that does not turn on whether consumers read but on whether they can understand. If no amount of rewriting or explanation can make a complex concept accessible to the average buyer, "forcing" the sophisticated party to reveal more information has no effect. Kenneth Abraham describes two versions of contra proferentem, for example, one of which is a rule of strict liability.[111] "If a policy provision is 'ambiguous'—reasonably susceptible to more than one interpretation by the ordinary reader of the policy—then the provision is interpreted against the drafter and the interpretation more favorable to the insured governs, *even if the provision could not reasonably be made less ambiguous*."[112]

The resurrection of contra proferentem as a rule that clarifies language *to courts* rather than consumers is discussed below. If courts can expend less time and effort to understand contractual language and get more accurate results, clearer language has a clear benefit. The problem is that the rule is not set to be triggered by judge-read ambiguity or to be satisfied by redrafting such that a judge understands. The rule requires the judge to base the ambiguity finding on the likelihood that a consumer would find the language ambiguous or confusing.

There is good reason to be skeptical of Option 1 in the insurance context. Policyholders have an extra chance to read their contracts, after a loss has occurred, even if they do not read at purchase.[113] Nonetheless, the more reality resembles zero consumer engagement, the less sensible is a penalty default aimed at producing information

111. *See* Abraham, *supra* note 33, at 537-50.
112. *Id.* at 537 (emphasis added).
113. *See* Boardman, *supra* note 22, at 1080-81.

to unengaged consumers. This brings us to the balancing of the next two options.

> Option 2: We are unsure how much consumers read or understand their contracts, but we know that some consumers read some parts some of the time.

If this is correct, and the intended result of an information-forcing rule is the production of the information, not its sure receipt, then penalty default rules may succeed in that goal. We may not be sure how much information consumers take in, but we can still hold the drafter responsible for the drafting. Of course, the lower one's expectations of its eventual receipt, the lower the expected value of forcing the drafter's hand in the first place. (If the rule is *also* meant to convey information to courts, the expected value goes up.)

Moreover, the value of an information-forcing default rule must be judged in the aggregate. With the right rule, some information will get through to some consumers. Perhaps more accessible information over time will increase consumer engagement or slowly seep into the general public understanding. Others may be able to accurately calculate how much information is accurately conveyed by operation of the rule; I cannot. The point here will play out in the next Part when the costs of the rule are weighed against its probable value. For now, Option 2 suggests that *some* value could be had from a penalty default aimed at resolving consumer ignorance.

> Option 3: Consumers, and their lawyers, do read their contracts *after* a problem arises.

If this view of consumer engagement is correct, information-forcing defaults may partially succeed and contribute more value than can be expected under the other scenarios. We may be skeptical that consumers read much during the purchase of a product or service. But after the product has failed or, in insurance, a loss has occurred, consumers get a second chance.[114] You may have skipped the warranty when purchasing your computer but if it breaks two weeks later, you will either read it before calling to request repair or read it after you have been told you are out of luck. Similarly, you may have skimmed the front page of your homeowners policy, but after extensive water damage from a broken pipe, the policy will tell you how to make a claim, whom to call, how long you have to call, how to gather evidence before cleaning up, if you need to use an approved vendor to clean up, or whether you are covered at all. Of course, some policyholders will call the insurer to get this information; those who are disappointed with what they hear then have an incentive to see if the policy promises more.

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114. *See id.* "On the back end, after a loss, is precisely when a policyholder experiences the true operation of the product he has purchased." *Id.* at 1085.

Giving consumers an accurate sense of their rights *after* failure or loss may thus be the more likely consumer use of a contract than reading before purchase. It may also be the more valuable use—more valuable than a consumer reading the clause before or during purchase. In most cases, the *ex ante* read does not give the consumer the power to change a clause.[115] The most likely, but still unlikely, *ex ante* response would require a consumer to dislike the clause more than he likes the product. Then he will switch products, *if* he can get a substitute product without the objectionable clause. The *ex post* read, on the other hand, opens more opportunities; it can tell the consumers whether to avoid the seller in the future for failing to meet its promises, whether and how hard to pursue a claim, and whether to praise or bash the product to others.[116]

There is reason to expect this "second read" opportunity to be more common with insurance contracts than with other consumer contracts, if for no other reason than many other forms of consumer contract are long gone by the time a good fails. The back of a shopping receipt may tell you how many days you have to return a television or dress, if you still have the receipt. The warranty provisions that accompany your television may be available online, if you bother to look for it. On the other hand, it may take a minute to find, but a copy of your automobile insurance and homeowners insurance policies are probably in a desk drawer.

This is not to make a stark empirical claim about the level of consumer engagement in either insurance or other areas. While there is reason for optimism that that penalty defaults aimed at informing consumers might be *more* effective in insurance than other areas, "more" may mean the consumer engagement number moves from ten percent to twenty. The point here is to raise skepticism about the appropriateness of penalty defaults when the rule is meant to divulge information to consumers in a consumer contract. "It is socially desirable for there to be communication . . . *if and only if* the social value of information exceeds the minimized cost of communication."[117] The effectiveness of the default must be discounted by the chance that the contract will be read. I do not purport to quantify that

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115. *See id.* at 1081-82.

116. With cleaner insurance contract language,

> policyholders will: (1) more accurately judge whether an insurer has breached; (2) share that judgment with other consumers; (3) share that judgment with the state insurance commissioner; (4) decide to switch insurers; (5) decide to purchase different coverage from the same insurer; (6) decide to act because a risk (flood) or an object (boat) is not covered; or (7) decide to sue.

Id. at 1081. One through four and seven are all relevant *after* a loss, usually long after the contract has been made.

117. Bebchuk & Shavell, *supra* note 4, at 289 (emphasis added) ("communication costs" are a subset of transaction costs).

chance, but I do feel comfortable omitting a possible "Option 4: Many consumers read much of their contract language."

2. How Insurers Respond to the Rule

In asking how consumers would respond to the rule, the proceeding Part assumed that insurers would respond to contra proferentem as the rule envisions—by redrafting and clarifying language the courts found ambiguous. This is only one possible response to the rule, however. Call it the redraft response. Another option is to redraft the policy language to *include* the coverage the courts extended through contra proferentem. Call it the acceptance response. The third option is to leave the language as it is, knowing there will be future litigation and that some, perhaps most, courts will hold that the language extends coverage. Call it a non-response, or call it crazy.[118] There has not been empirical work on the percentage of responses that fall into each category. That there are substantial numbers in each category is clear.

The choice behind the redraft response is obvious. A court has found a clause—usually an exclusion of coverage—ambiguous and granted coverage to the policyholder under contra proferentem. The insurer wanted to deny coverage for a certain risk before the case went to litigation, and it continues to want to deny coverage for that risk. In order to do so, it must restate the exclusion, or courts in that jurisdiction, and perhaps elsewhere, will continue to extend coverage.[119] In short, the redraft response is the natural envisioned response to contra proferentem. The perceived problem is a gap from poor drafting, and the solution is to fill the gap with clear drafting.

What then could motivate the acceptance response? The insurer *had* wanted to exclude coverage of a particular risk prior to litigation but is now willing to redraft the contract to extend coverage. The most positive explanation is that the insurer has learned from policyholder response, including multiple suits in multiple jurisdictions, that the public wants this aspect of coverage. The market demands it. If the insurer does not deem the risk uninsurable (broad terrorism

118. While the Third Circuit did not outright use the word "crazy," it did rail against the fact that insurers retained certain language despite the fact that it was "widely used in insurance policies and has been the subject of heated litigation throughout the entire country *over the past thirty years*." New Castle Cnty. Del. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa., 243 F.3d 744, 747 (3d Cir. 2001) (emphasis added).

119. A few courts will take a dispute among jurisdictions as proof of ambiguous language. "The mere fact that several . . . courts have ruled in favor of a construction denying coverage, and several others have reached directly contrary conclusions, viewing almost identical policy provisions, itself creates the *inescapable* conclusion that the provision in issue is susceptible to more than one interpretation," and is therefore ambiguous. Little v. MGIC Indem. Corp., 836 F.2d 789, 796 (3d Cir. 1987) (emphasis added) (quoting Cohen v. Erie Indem. Co., 432 A.2d 596, 599 (Pa. Super. Ct. 1981)).

coverage) or undesirable (life insurance for suicides within the first year after sale), it goes into the contract and the risk is folded into the price.

Another possibility is that the insurer still prefers not to provide coverage but is skeptical that courts will ever accept the exclusion, however drafted. If the coverage seems "mandatory," for public policy reasons or because courts find it is within the "reasonable expectations" of policyholders, it may be wiser to accept the inevitable and avoid further litigation.[120] Moreover, for insurers involved in collective drafting through the Insurance Services Office, the competitive effect of accepting coverage will be limited.[121] The new form of coverage will be extended by each insurer, and each will accept the cost of the new risk.

Perhaps the most puzzling response is the non-response. That this response happens not infrequently should be enough to give pause about the effective operation of contra proferentem.[122] With non-response, the insurer has decided to accept coverage for those cases that go to litigation but to keep the contract language as is.[123] This provides multiple benefits. First, the insurer can now consider the clause defined based on the court's interpretation. In many cases the insurer may care more for a *settled* meaning than a *particular* meaning; if the cost of the new interpretation can be passed onto consumers, the predictable interpretation has great value to the insurer.[124]

As I have discussed in an earlier piece, "[i]f instead the insurer redrafts the clause . . . the insurer rolls the dice . . . . Perhaps the court will . . . find the redraft ambiguous. Or perhaps it will become clear that the court has no intention of accepting the clause in any

120. The reasonable expectations doctrine holds: "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations." Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970). The doctrine is recent; in the early 1960s courts began to "clearly and explicitly employ[] the doctrine of honoring reasonable expectations." ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW § 6.3(a)(3), at 632 (Practitioner ed. 1988). David Horton contends that the rise of the reasonable expectations doctrine led to the "fall of the strict against-the-drafter doctrine." David Horton, *Flipping the Script:* Contra Proferentem *and Standard Form Contracts*, 80 U. COLO. L. REV. 431, 451 (2009).

121. *See supra* note 35 and accompanying text.

122. For examples of the non-response, including the continued use of "property damage" despite its ambiguity as to "electronic data," see Boardman, *supra* note 38, at 1115-16.

123. *See, e.g.*, *New Castle Cnty.*, 243 F.3d at 755 ("[I]n spite of this extensive history of litigation, and obvious disagreement amongst courts and parties alike, insurance companies . . . continue to use the phrase without any language defining its scope."); W. Cas. & Sur. Co. v. D & J Enters., Inc., 720 S.W.2d 944, 946 (Mo. 1986) (Blackmar, J., dissenting) ("This insurance company has perpetuated the language, without substantial change. It took no steps to clear up the confusion which numerous other courts have perceived.").

124. Policyholders are worse off because unclear language has become directly misleading language.

form," as described above.[125] "Insurers are risk-averse and this game is not worth the candle. Unless the insurer cannot live with the coverage the court has found in its ambiguous clause, insurers find it better to provide the coverage and raise the premium."[126]

In other words, "[b]etter to keep the language clear *to the court*, even if it means retaining language the court has ruled ambiguous, since at least this language [now] has a settled judicial meaning."[127] The non-responsive insurer thus "accept[s] an adverse interpretation, changing *premiums* in lieu of changing [*the contract*]."[128] This differs from the acceptance response in that the insurer can anticipate ongoing litigation on the language from confused consumers. On the other hand, since the language continues to purport to deny coverage, the insurer should be able to avoid actually providing coverage for the dominant percentage of consumers who do not sue.

From the standpoint of a penalty default rule, the non-response is an instance of the rule failing to operate. The rule imposes a cost for the purpose of incenting the disclosure of additional information, but no new information is forthcoming. In fact, the information asymmetry between insurer and consumer is markedly *increased* because the insurer now knows that language purporting to deny coverage will in fact be read by courts to provide coverage; the consumer continues to either be confused or to mistakenly believe a court would not grant coverage.

But what of the acceptance response? It does lead to the revelation of more information, but it simultaneously changes the content of that information. If policyholders in the aggregate do not want to *pay* for a particular form of coverage (let us assume everyone likes free coverage), will they be better off with an ambiguous denial of coverage, and no fee, than with a clearer statement of coverage for a fee?

The tentative conclusion of this section is that as an information-forcing rule contra proferentem is spotty at best. When insurers fail to respond to the penalty, consumers are left with less information, not more. When insurers change the relevant language, consumers may become aware of the change in only a few circumstances. Time then to consider the efficiency of contra proferentem.

B. Is it Efficient?

Asking if contra proferentem is effective is to ask what the benefits of the rule are. This Part now turns to the potential costs of the rule and attempts to weigh the two. Contra proferentem could be

125. Boardman, *supra* note 22, at 1080.
126. *Id.*
127. *Id.* (emphasis added).
128. Boardman, *supra* note 38, at 1118 (emphasis added).

inefficient because the costs outweigh the benefits, or it could be suboptimal in that it produces a net positive but less benefit than an alternative rule. This Part will thus also consider two alternative versions of the rule, one as a penalty default aimed at better informing courts, not consumers, and the second as a majoritarian rule.

1. The Cost of the Rule to Consumers

(a) When Insurers Redraft

Does contra proferentem operate efficiently under the redraft response? The primary cost of redrafting is borne initially by the drafter—the insurer, multiple insurers, or the industry if collectively drafting. To the extent the threat of the rule leads to cleaner first drafts, there may be an added initial expense at first drafting, but it could be slight. A secondary cost falls on state insurance commissioners and their offices; states vary by the extent to which new language must be approved before use.[129] There may be additional trickle-down costs. Brokers who sell insurance, for example, will have to learn about and understand the operation of new language, and a few who fail may mislead consumers about potential coverage.

On the other side of the scale, the benefits of redrafting could be dramatic. First, we can assume the experience of redrafting will cause insurers to take more care in their initial drafting. Assume for the moment, although it is doubtful, that this increase in care is warranted and not wasteful. Second, *if* the targeted language were truly ambiguous, *and if* the redraft is clear, it will improve consumer use, cabin opportunistic denials of coverage by insurers, decrease overall litigation, and decrease the courts' costs in reaching accurate holdings. Some of these benefits stem from the positive externality of improving a court's understanding. If language is improved to the point that a court is willing to find it unambiguous to consumers, it will automatically be unambiguous to the court. Note the reverse is not true. As discussed below, a court may find language to be confusing to laypeople even though the court has a good idea what it means.

For now, let us accept that for this subset of contra proferentem responses, the rule could very well be efficient. It is useful to start with this assumption because the costs of the next two responses are high enough to credibly overwhelm the benefits of the redraft response. Thus, not much turns on whether this subset is efficient, and its efficiency is plausible enough to warrant respect. To be clear,

129. One of the best pieces detailing state insurance regulation was written in 1999, but the structure for most states does not seem to have changed dramatically. *See* Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625 (1999).

however, the value of the benefits from redrafting do hinge on (1) the rule being applied to real gaps, not manufactured ambiguity, and (2) the redrafted language being unambiguous. In the end, whether contra proferentem is efficient overall hinges on whether the value of the beneficial subset of cases outweighs the costs of the detrimental subset of cases.

(b) When Insurers Do Nothing

Does contra proferentem operate efficiently when it elicits no response? Where the clause is not redrafted, the judicially enforced clause is at odds with one plausible reading of the contract text.[130] Policyholders who read a written exclusion as the insurer intended will conclude they have no coverage, unaware that courts have read the clause in policyholders' favor.[131] Or they will see gibberish in lieu of the court's "provide coverage" substitute term.[132] Contra proferentem, in these cases, *increases* the information asymmetry the doctrine is meant to combat.

Insurers can be blamed for this mess, one could say. If only they would respond properly to the incentive to avoid the penalty default by clarifying the contract language, the incentive would work as intended. But this amounts to saying the penalty would work if only it would work. To determine if contra proferentem is efficient we must take the incentives it produces as they come and not as we wish them to be.

There is enough blame to go around. Contra proferentem would be more efficient if *courts'* instructions to insurers were concrete. The default rule is "provide coverage," and the way around future application of the rule is "redraft." If it "would have been easy" for the insurer to have drafted a clause to avoid its default-coverage fate, as many courts state,[133] then it should be easy for the court to recommend language it would find clear and enforceable.[134] Thus, one inefficiency of contra proferentem is that it sends the signal to contract around the default without being clear about how to do so. This weakens the incentive to attempt to contract around the default when doing so is costly but success is uncertain. Repeated failures, or

130. *See* Boardman, *supra* note 38, at 1123-24.

131. *See id.* at 1115.

132. *See id.* at 1117.

133. *See, e.g.*, Smith v. Am. States Ins. Co., 586 N.W.2d 784, 787 (Minn. Ct. App. 1998) ("American States easily could have drafted its policy to preclude Smith's recovery in this case."); Neal-Pettit v. Lahman, 8th Dist. No. CV-545838, 2008-Ohio-6653, at ¶ 4 ("Had Allstate intended otherwise, the policy language could easily have been drafted to reflect that intention."); State Farm Mut. Auto. Ins. Co. v. Langridge, 683 N.W.2d 75, 90 (Wis. 2004) (Bradley, J., dissenting) ("While State Farm could have very easily drafted its policy language differently so as to preclude [the plaintiff's] claim . . . it chose not to do so.").

134. For a similar "safeharbor[]" suggestion, see Ayres & Gertner, *supra* note 1, at 123.

the failure of other insurers to succeed in redrafting, also fuel the view that perhaps the sub-rule for particular clauses is actually a mandatory substantive rule.[135] The costs and benefits of the non-response are not quite the mirror opposite of the redraft response. There are still costs on the insurer. Retaining language that some courts will construe in favor of coverage may require the insurer to take the cost of that coverage into premium calculation. If the insurer plans to continue denying coverage, and litigating larger claims, the cost of that increased litigation also gets folded in. Judicial costs will also increase; the promise of a positive outcome under contra proferentem will lure more policyholders to sue for coverage, if they have lawyers to tell them of the promise.

This raises the one benefit under the non-response subset: the lone policyholder or the few who sue and take the case to court judgment are awarded coverage. This is a certain benefit to that litigant. It carries with it the cost of failed contra proferentem to all other consumers—the gap between the written contract and the enforced contract plus an increase in premium. Even assuming the benefit to the few in court is much greater to them than the cost to out-of-court consumers, the sheer numbers of the latter make it difficult to defend this subset as providing a net benefit.

(c) When Insurers Accept the Default Rule

Does contra proferentem operate efficiently under the acceptance response? The cost to insurers and state insurance commissioners should be similar to those under the redraft response. In both cases, the insurers redraft and the regulatory officials review the new clause. The burden could easily be lower under the acceptance response, however, because it may be the simple removal of an exclusion and not an elaborate group endeavor to re-write a clause.

Note that the benefit to the litigating consumer who wins coverage through contra proferentem is the same across all three responses. That is because this benefit does not depend in any way on the insurer's *ex post* response. The benefit is a direct outcome of the court's actions and it accrues immediately. Unfortunately, the number of consumers to whom this benefit accrues is tiny. Most policyholders do not sue, and most who do sue settle out of court.[136]

The outcome for the bulk of consumers from the acceptance response is markedly different from the two other possible responses. If the newly expanded coverage is what consumers have wanted all along, the courts have successfully pushed insurers to sell more of their product; everyone wins. But if the newly expanded coverage is

135. *See* Stempel, *supra* note 47, at 206.
136. *See* Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113 (1990).

not what most consumers want, it becomes an inescapable burden of boilerplate. Which is it?

We might think that because a policyholder in court is seeking coverage, this represents the desires of his fellows. But contra proferentem fills the gap with what *this* policyholder prefers at *this* moment, not with what this policyholder would have wanted *ex ante* or with what other policyholders want *ex post*. A policyholder after a loss may pursue his individual compensation over a healthy, efficient insurance market. Insurers can represent the interest of the many policyholders against the few (or the future policyholders against the demands of the present).[137] If insurers are wrong about what consumers want, the expanded coverage expands social gain.

The compelling penalty default story for contra proferentem in insurance thus requires a *systemic market failure* in consumer insurance. The acceptance response is beneficial *only if* most consumers wanted the new coverage, and were willing to pay for it, *but* insurers had foolishly refused to sell it. This must happen at times: either market demand changes over time or insurers realize they missed a market opportunity. But a key question is whether the court's application of contra proferentem to ambiguous language would just happen to coincide with this market failure.

To see why a market failure is required, consider the alternatives. If insurers are not selling a form of coverage *because* most consumers do not want it, then the contra proferentem-triggered expansion of coverage harms consumers. The rule forces consumers to buy something they do not want. The acceptance response is only useful to consumers if the default is majoritarian as to policyholders, which is to say that most want to buy the coverage. But if most want to buy the coverage, we would ordinarily expect insurers to already be selling it. The contra proferentem plus acceptance response only adds value if most consumers want the coverage but it somehow is not being sold.

Market failures happen; they must happen in the consumer insurance market on occasion.[138] The question is whether courts are in a good position to identify a failure, especially if (1) they are constrained to remedy only those market failures that are accompanied by ambiguous policy language; and (2) identifying and correcting a

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137. First, insurance looks at groups, at the socialization of risk through standard standard contracts sold to large numbers of similarly situated persons who face an uncertain risk. What is good for the group, as a whole, in face of uncertainty, may not be what is good for any individual when sued.

Kent D. Syverud, *What Professional Responsibility Scholars Should Know About Insurance*, 4 CONN. INS. L.J. 17, 19 (1997).

138. For an excellent critique of the potential for market failure in insurance, see Rappaport, *supra* note 69, at 237-49.

market failure is not the task at hand. If we wish to empower courts to correct this type of market failure, we should adopt a rule granting courts the power to do so and to gather the necessary evidence. Contra proferentem does not make this attempt.

As it stands, courts do not seem troubled by questions of insurance market failure. Courts generally theorize that insurers value exclusions and policyholders do not. Policyholders prefer to be paid for losses, dislike exclusions, and would rather have more coverage than less, the assumption goes. This is true for one class of exclusions—those exclusions for which policyholders are willing to pay. If coverage were free, all policyholders would dislike all exclusions. Until that day, all policyholders value some exclusions. Courts seem to assume the contrary at times.

The acceptance response subset thus takes what is meant to be a temporary judgment about ambiguity and turns it into a long-lived "judgment" about the market desirability of a contract term. Where the application happens to coincide with a market failure, the rule may be momentarily efficient. In all other cases, it fails to produce information to the consumer while forcing the consumer to pay for more coverage than he wants.

Finally, is contra proferentem efficient over all, taking the two responses and one non-response into account? A definitive answer requires empirical proof about the percentage and value of the cases that fall within each subset response. Scholars and litigators may differ on this, but my own take is that the value of the expected redraft response may be overwhelmed by the non-response and the acceptance response. For purposes of calculating social benefit, the non-response category includes the years, sometimes decades, during which a clause is not redrafted, even if it is eventually changed, then falling into either redraft or acceptance.

The contribution of this analysis is not to definitively conclude that insurance contra proferentem is empirically inefficient. What the analysis does show is that contra proferentem produces many costs, including substantial unexpected costs such as pockets of increased asymmetry between consumers and insurers. Efficiency of the penalty default will turn in part on whether the aggregate asymmetry is increased or decreased.[139] That contra proferentem turns on itself is a point I have made elsewhere, but the penalty default rule framework provides a fresh way to weigh the costs.[140] With the pitfalls revealed, let the debate begin.

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139. It turns on other factors too, such as the cost to insurers of redrafting, sometimes without any effect on judicial outcomes.

140. *See* Boardman, *supra* note 38, at 1117-20.

2. Are Penalty Defaults More Desirable in Non-Insurance Consumer Contracts?

A relevant measure of whether a default rule is efficient is if it produces "whatever term . . . would have maximized the *ex ante* value of the contract to the two parties, *independent of any effect on third parties*."[141] One flaw of insurance contra proferentem in particular is that it has substantial third-party effects. Where the penalty is applied repeatedly but ineffectively, policyholders end up buying more than the market dictates. Contra proferentem says "coverage," and so coverage is extended and paid for. Admittedly, this is another way of objecting to a penalty default that penalizes but fails to force information—a rule that does not give the parties what they would have contracted for in pursuit of a lost cause. But because identical insurance clauses apply to so many parties simultaneously, the harm of an anti-majoritarian rule is widespread.

How much better does non-insurance contra proferentem fare? In the consumer context, the results are mixed. The primary difference for a large portion of non-financial consumer contracts is that the contract is less central to the product being sold and purchased.[142] The contract is largely the product in insurance, not so for many consumer purchases or services.[143] Changing the contract through the acceptance response should have a smaller change, in the aggregate, on the product consumers want to buy. Of course, key terms may already be limited by consumer protection laws, the U.C.C., and mandatory default rules.

On the other hand, one may be similarly skeptical about whether the rule has any effect on the contract reading habits of unengaged consumers. This skepticism should apply to any penalty default rule, contra proferentem or not, aimed at encouraging a commercial party to convey more information to consumers. The threat of negative externalities can also still arise; consumer boilerplate terms apply to a multitude of consumers simultaneously, as in insurance, if the drafter is a major seller or service provider. Even so, the effect of the rule is likely to be smaller outside of insurance because it is applied infrequently in the non-insurance context.

IV. IMAGINING ANOTHER FORM OF CONTRA PROFERENTEM

Gaps in insurance contracts cannot be avoided. Short of courts returning to an era of contract non-enforcement as a penalty, courts must have default terms at the ready. It would be hard to stomach non-enforcement of the insurance contract, which would leave the

141. *See* Posner, *supra* note 2, at 569 n.9 (emphasis added).
142. *See* Boardman, *supra* note 22, at 1081.
143. *See id.*

policyholder permanently uncompensated for his loss.[144] This leaves the choice between majoritarian and non-majoritarian defaults—either minoritarian or penalty defaults. The choice can turn on the cause of the contract gap.[145] Ayres and Gertner name two sources of incompleteness: the cost of contracting and strategic incompleteness.[146]

If the gap is due to the contracting cost of filling in the term, courts may want to hand parties the term they would have chosen had the costs been lower—a majoritarian default.[147] If the gap is due to a strategic choice by one of the parties, courts may adopt an information-forcing default—a penalty default.[148]

Although not asking explicitly whether the default should be a penalty, courts often attempt to determine the cause of the gap. Perhaps this causes some of the inconsistencies and inefficiencies in insurance default rules; courts are unsure or disagree about why the gaps—the ambiguities—exist. Are insurers acting strategically by writing intentionally obtuse language? Are they simply being sloppy? Did they try to draft well but then fail to see an emerging risk that it was their role to identify and handle?[149]

A. As a Penalty Default Aimed at Informing Courts

Some version of a penalty default rule might make sense if insurers are strategically withholding information to increase their gains from the contract. They have some incentive to do so in the consumer context. The insurer knows it excludes a particular loss, say from flood or mold. It also knows that a prospective buyer would dislike

144. *See* TOM BAKER, INSURANCE LAW AND POLICY 89-97 (2003) (discussing disproportionate forfeiture).

145. Ayres & Gertner, *supra* note 1, at 127. The choice between types of defaults also turns on the costs of contracting around the default, the costs of failing to contract around the default, and if the rule is to be majoritarian, whether the majority or minority will more likely contract around the default. *See id.* at 127-28; Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 735-36 (1992) (noting penalty default "serves as counterexample to those who would argue that default rules should simply replicate the contracts that a majority of parties would make in the absence of transaction costs").

146. *See* Ayres & Gertner, *supra* note 1, at 92-94.

147. *Id.* at 93.

148. *Id.* at 94 ("One party might strategically withhold information that would increase the total gains from contracting (the 'size of the pie') in order to increase her private share of the gains from contracting (her 'share of the pie')."). Ayres and Gertner argue that where the point is to provide information to courts, the efficient default is likely non-enforcement, which they argue gives both parties an incentive to inform. *See id.* at 97. Where the point is to force the more informed party to inform the lesser, the likely default is a one-sided default that harms the information holder. *See id.* At least in theory, contra proferentem fits this second model.

149. *See generally* Hall, *supra* note 39 (discussing the potential for coverage of Y2K claims, specifically under "sue and labor" and similar policy provisions); *supra* note 26 and accompanying text (discussing damage to tangible property and computer data); *supra* note 31 and accompanying text (discussing the "sudden and accidental" addition to pollution exclusions).

the exclusion if she were aware of it. The insurer further knows, however, that other insurers exclude these same losses such that, like it or not, the buyer will end up with a policy that does not cover the loss.

What does the insurer gain from bringing the exclusion to the attention of the buyer? Nothing is gained if the additional coverage is not offered for an additional price. The sale may be lost, however, if the buyer goes elsewhere in response. Even if the next insurer reveals its identical exclusion, many buyers may just complete the second purchase, having learned they cannot escape the exclusion, rather than return to the first insurer.

Nonetheless, a default rule providing coverage *unless* the insurer brings the exclusion to the buyer's attention is unworkable. Policies contain dozens, if not hundreds, of exclusions. A cover document that attempted to list, in bold and large font, all of these exclusions would overload the buyer's senses and remain unread, like the contract itself.[150]

Even in the face of known strategic behavior, contra proferentem fails in its current form because insurers focus on courts. (Courts focus in turn on consumers, creating an unrequited love triangle.) "No other enterprise, to the extent of the insurance industry, collects judicial data (court decisions) and uses them to draft standardized language for industry contracts."[151] The court is the insurers' drafting audience, however unwilling it may be.

Two of the reasons to doubt the value of contra proferentem as an information-forcing default stem from its focus on *consumers* as the receivers of the information. First, there is reason to doubt that incenting clearer language, in insurance contracts in particular, will necessarily lead to consumers reading more contract language. Second, one reason insurers take the inefficient acceptance response or non-response is that they doubt the courts will accept their attempts to clarify an exclusion.

Both of these problems would be solved by changing the rule's focus to courts. If language is redrafted in response to the operation of contra proferentem, and litigation continues, there is no question that judges will read the redrafted clause. And if the aim of the rule is to make the language accessible to courts, that can readily be accomplished by the court recommending improved language.

> The court-focused penalty default rule would command: If the *judge* finds the contract ambiguous, the gap should be filled contra

150. Perhaps this is where the reasonable expectations principle comes in. Only those exclusions that violate the buyer's reasonable pre-purchase assumptions need be highlighted. *See supra* note 120 and accompanying text.

151. James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. ST. L.J. 995, 995-96 (1992).

> proferentem to the advantage of the consumer. The command to the insurer is then to redraft language *the court* can understand. To avoid application of the rule in the first place, the insurer is to draft with the court in mind.

This is a radical proposal. It fits partially into the existing categories of default rules because Ayres and Gertner envisioned the option of an information-forcing rule aimed at giving courts more information.[152] This option, however, assumes two knowing contracting parties revealing more information to the courts. It does not include keeping one party relatively ill-informed.[153]

The Ayres and Gertner model for a default aimed at providing information to the courts operated by the default of non-enforcement of the contract. In the original model, non-enforcement as a penalty default is meant to give both parties an incentive to provide information to the courts.[154] The zero-quantity default under the U.C.C. is a prime example.[155] If the parties bother to go through the act of contracting, both believe the contract to be in their interest. Therefore, if they understand that a blank quantity term will render the contract unenforceable, they will come to a written agreement about quantity, saving the court the hassle. The common law rule against enforcing contracts that are too indefinite is another example.[156]

These two examples reveal the usual court-focused structure: both parties are aware that failing to choose a quantity or give much detail to a contract might keep it from being a contract at all, and both parties are encouraged by the threat of the penalty default to provide more detail to the court. The proposal here—call it contra proferentem *ad judex*—continues to be a unilateral default as opposed to incenting both parties. The wisdom of this proposal will require its own piece. For now, imagining the benefits of a clear language command that can truly be fulfilled by both the sender and the receiver of information provides a stark contrast to contra proferentem's anemic effort.

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152. *See* Ayres & Gertner, *supra* note 1, at 97.

153. *See id.* at 98.

154. *See id.* at 97-98.

155. The zero-quantity default under the U.C.C states that courts will not determine a "reasonable quantity" of a good sold if the contract does not specify, although the Code will fill a price gap with a court's determination of a "reasonable price." *See* U.C.C. §§ 2-201(1), 2-305(1) (2012). Ayres and Gertner argue that the quantity default makes sense as a penalty because it will cost more for courts to determine a reasonable quantity *ex post* than for parties to determine one *ex ante*. *See* Ayres & Gertner, *supra* note 1, at 96. We might wonder if the same is true with a price term, but it is certainly cheaper for the court to determine a "reasonable," i.e. market, price than a reasonable quantity. *See id.*

156. *See* Ayres & Gertner, *supra* note 1, at 97 (using as an example "the common law's broader rule that 'for a contract to be binding the terms of the contract must be reasonably certain and definite' " (quoting Steinberg v. Chi. Med. Sch., 354 N.E.2d 586, 589 (Ill. App. Ct. 1976))); *id.* at 106 (discussing Lefkowitz v. Great Minneapolis Surplus Store, 86 N.W.2d 689 (Minn. 1957)).

B. As a Majoritarian Default

Can the cost of accurately and unambiguously conveying coverage information to consumers ever be worth incurring?[157] If those costs are too steep, a majoritarian default makes more sense. Even if we do not have high hopes that it will ever be rational for consumers to read their insurance policies well, and we do not think the average consumer well-informed enough about risks to make minute decisions about the value of coverage for costly but improbable events, we prefer courts to grant consumers the product they demand. The current operation of contra proferentem is overly generous in coverage, but in the end, that generosity is paid for with the consumers' own money.

In an article focusing on the consent implications of default rules, Randy Barnett argues that where "only one party can be counted on to know the law, the law should adopt a conventionalist default rule reflecting the commonsense understanding of the community to which the rationally ignorant party belongs."[158] A "conventionalist default" is one that reflects the conventional understanding of the relevant community.[159] Here, the knowledgeable party is the insurer (or seller), and the rationally ignorant party is the consumer. If the informed party dislikes the consumer's "commonsense understanding," it will "explicitly contract around the default rule, and . . . call the new rule to the attention of the rationally ignorant party."[160]

This provides for a vision of a new form of contra proferentem; although it is perhaps a new rule altogether—*pro lectore*—in favor of the reader. The collective readers, consumers, have in some instances a conventional understanding about coverage. The insurer remains free to break with that understanding as this remains a default, not a mandatory rule. But if the language on point is ambiguous, the default reverts to the conventional understanding.

Pro lectore would have a more limited application than contra proferentem. For example, there has been a fight over whether the innocent spouse of an arsonist should be compensated for his or her home loss through their joint homeowners insurance, even though the loss was intentionally caused by one holder of the insurance policy.[161] There probably is a conventional understanding in the relevant

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157. *See* Boardman, *supra* note 22.

158. Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 895 (1992).

159. *Id.* at 829.

160. *Id.* at 895.

161. *See* Ronald S. Ribaudo, *Burning Down the House: Does Limiting the Innocent Spouse's Right to Recover Make Sense?*, 67 MO. L. REV. 77 (2002). Ribaudo argues that a pro-coverage default in the innocent spouse context leads to (1) clearer policy language and (2) more cooperation from the innocent spouse on the source of the arson. *See id.* at 94-96. *See also* Rachel R. Watkins Schoenig, *Property Insurance and the Innocent Co-Insured: Was*

community (homeowners) about whether the spouse should take; if my insurance students are representative, the conventional default would be that the innocent spouse *is* compensated. But *pro lectore* is limited because there are many instances where the community might have no conventional understanding. Contra proferentem always has an answer, which is part of the problem. *Pro lectore* would not always have an answer, creating a different problem.

Note that this doctrine is a little more complex than the conventional understanding of "majoritarian." Easterbrook and Fischel choose "the term that the parties would have selected *with full information* and costless contracting."[162] (What terms would a policyholder select with full information, including information about the cost of the term and the likelihood of loss?) This seems to lean toward a Socratic ideal form of term selection compared to an earlier description by Easterbrook and Fischel in which "[t]he gap-filling rule will call on courts to duplicate the terms the parties would have selected, in their joint interest, if they had contracted explicitly."[163] Similarly, Richard Posner advocates "supplying standard contract terms that the parties would otherwise have to adopt by *express* agreement."[164]

Pro lectore is not about express agreement. By design it follows the Barnettian conventionalist default.[165] The rule remains majoritarian because it assumes that insurers *accept* the conventional consumer understanding unless they, the insurer, explicitly reject it. This places a burden on the insurer of allowing the consumer to be the "first mover," but this burden is a natural one with or without the rule.

This returns us to the very beginning by raising the possibility that contra proferentem is already a majoritarian rule. Perhaps the default in insurance is coverage because shifting risk from the policyholder to the insurer is the *function* of the contract. As the Supreme Court of Indiana writes, "An ambiguous insurance policy should be construed to further the policy's basic purpose of indemnity."[166] As Judge Richard Posner has mused, the "precept [of construing ambiguities against the drafter] seems *related* to the fact that the purpose of an insurance contract is to shift risk from the insured to the insurer."[167]

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it All Pay and No Gain for the Innocent Co-Insured?, 43 DRAKE L. REV. 893, 899-02 (1995) (citing cases).

162. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 22 (1991) (emphasis added).

163. Easterbrook & Fischel, *supra* note 9, at 1433.

164. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 413 (6th ed. 2003) (emphasis added).

165. *See* Barnett, *supra* note 158, at 874-97.

166. Eli Lilly & Co. v. Home Ins. Co., 482 N.E.2d 467, 470 (Ind. 1985).

167. Smith v. N. Am. Co. for Life & Health Ins., 775 F.2d 777, 780 (7th Cir. 1985) (emphasis added).

Thus, the nature of the contract and the buyer's purpose for buying the contract suggest that rules like contra proferentem operate as *majoritarian* defaults. While insurers may dislike individual outcomes under contra proferentem when the insurer disagrees with the court that a clause is ambiguous as applied, the general application of the doctrine is a majoritarian *insurer* preference because (1) the insurer accepts its role as default risk bearer, and (2) the industry needs to convince wary consumers to purchase a policy they do not understand. "A natural solution to this problem is to agree that ambiguities will be construed against the drafter."[168]

But if the contra proferentem treatment of ambiguity is an insurer preference, it could easily be put into insurance contracts itself; why should it be a default? Judges might laugh at a *pro proferentem* clause and object to being told how to perform their duties, but a contra proferentem clause would be readily enforced. The absence of a contra proferentem clause cannot be blamed on contracting costs or unexpected circumstances. The "missing" contra proferentem clause is not in the class of inevitable gaps that all types of contracts will have, including those caused by unforeseen ambiguity.

The extreme care and precision, some say extreme precision,[169] with which insurance contracts are drafted obviates the need for sweeping or general majoritarian defaults in insurance.[170] Courts could apply the default rule of *pro lectore* in a majoritarian manner, but either *pro lectore* or contra proferentem will have to be imposed on insurers. In short, as with contra proferentem, the *pro lectore* doctrine would be mandatory, but the substantive rule reached in individual cases would be a default the insurer could avoid by drafting.

V. CONCLUSION

The doctrine of contra proferentem is a penalty default rule. Thus, at least one penalty default rule exists. As it operates in insurance, the rule creates a default mechanism for filling contractual gaps with a context-specific form of "provide coverage." Unfortunately, there is reason to doubt that the rule is effective at forcing insurers to convey, or policyholders to accept, additional information. Policyholders are partially ignorant of the details of their insurance contracts; rational

168. Posner, *supra* note 2, at 580; *see also* Omri Ben-Shahar, *A Bargaining Power Theory of Default Rules*, 109 COLUM. L. REV. 396, 419 (2009) ("It may be argued that despite the fact that the insureds have no bargaining power to change the policy terms, they do have the power to walk away from policies that provide insufficient coverage, or that cost more than they are worth. Through these interpretive practices, courts merely give insureds the coverage they originally sought (and paid for): the terms without which they would not have signed onto the contract. It is this *ex ante* power to say no to the policy that is effectively mimicked.").

169. *See* Rappaport, *supra* note 69, at 215-24.

170. *See id.*

ignorance or no, this limits the benefit of improving contract language. More importantly, when insurers do not redraft in response to the penalty, the two alternative responses can make consumers worse off.

When insurers retain ambiguous language in the face of court application of contra proferentem, the gap between the consumers' understanding of the language and its "legal" meaning, as applied by courts, widens. Ambiguous language is not improved, but consumers are worse off. When insurers "accept" an application of contra proferentem by adding coverage to the insurance policy, consumers are only better off if both the ambiguous language and the court application of contra proferentem happen to coincide with a market failure in the supply of insurance. That is, only where insurers' failure to provide coverage, despite consumer desire and willingness to pay for it, coincides with a court finding language ambiguous to consumers does consumer welfare increase. If these two circumstances do not align, the insurers' "accept" response causes policyholders to pay for undesired coverage.

This Article cannot conclude definitively that contra proferentem is inefficient. It is not likely, however, that the value to consumers of improved language in those cases where insurers do redraft outweighs the cost to consumers from the cases where insurers do nothing or add coverage. Thus, while contra proferentem is a penalty default, there is cause to think it should not be.