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EXPECTATIONS LOST: *BANK OF THE WEST V. SUPERIOR COURT*¹ PLACES THE FOX IN CHARGE OF THE HENHOUSE

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*That portion of the field of law that is classified and described as the law of contracts attempts the realization of reasonable expectations that have been induced by the making of a promise. Doubtless, this is not the only purpose by which men have been motivated in creating the law of contracts; but it is believed to be the main underlying purpose, and it is believed that an understanding of many of the existing rules and a determination of their effectiveness require a lively consciousness of this underlying purpose.*²

INTRODUCTION

The California Supreme Court established a benchmark for measuring insurance coverage when it decided *Gray v. Zurich Insurance Co.*³ For twenty-five years, the *Gray* decision controlled insurance coverage disputes. *Gray* achieved landmark status by (1) setting the standard for an insurer's duty to defend⁴ and (2) defining the California law for construing insurance contracts.⁵ The Traynor Court⁶ determined insurance contracts to be adhesion contracts.⁷ Therefore, the Court mandated a special set of rules

1. 833 P.2d 545 (Cal. 1992).

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2. 1 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 1, at 2 (1963).

3. 419 P.2d 168 (Cal. 1966).

4. See generally Daniel A. Miller, Note, *The Insurer's Duty to Defend Made Absolute: Gray v. Zurich*, 14 UCLA L. REV. 1328 (1967) [hereinafter *Duty to Defend Made Absolute*] (suggesting that the *Gray* decision's effect on insurance practice in California would be an absolute duty to defend imposed upon insurers).

5. Building upon the foundation laid by *Steven v. Fidelity & Casualty Co. of N.Y.*, 377 P.2d 284 (Cal. 1962), the *Gray* decision legitimized the reasonable expectations doctrine in California by providing the rules under which the doctrine would operate.

6. Chief Justice Roger Traynor served the California Supreme Court in the capacity of Associate Justice from 1940-1964 and as Chief Justice from 1964-1970.

7. *Gray*, 419 P.2d at 171. "The term [adhesion contract] signifies a standardized contract, which, imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it." *Neal v. State Farm Ins. Cos.*, 10 Cal. Rptr. 781, 784 (Cal. Ct. App. 1 Dist. 1961).

under which insurance policy coverage disputes would be analyzed. Using the adhesion contract theory, a substantial number of cases molded,⁸ modified,⁹ and subsequently entrenched¹⁰ the reasonable expectations doctrine¹¹ in California jurisprudence. Although the *Gray* decision drew intense criticism,¹² it influenced insurance law throughout the country.¹³

Bank of the West v. Superior Court essentially overturned *Gray v. Zurich sub silentio*. Although the Lucas Court recognized that insurance contracts are "special,"¹⁴ it decided to treat insurance contracts just like any other contract.¹⁵ The Court followed in the footsteps of the Iowa and Arizona

8. See *Neal*, 10 Cal. Rptr. 781 (Cal. Ct. App. 1 Dist. 1961); *Steven*, 377 P.2d 284 (Cal. 1962); *Gray*, 419 P.2d 168 (Cal. 1966); *Barrera v. State Farm Mut. Auto Ins. Co.*, 456 P.2d 674 (Cal. 1969).

9. See *Herzog v. Nat'l Am. Ins. Co.*, 465 P.2d 841 (Cal. 1970) (requirement of ambiguity); *Garcia v. Truck Ins. Exch.*, 682 P.2d 1100 (Cal. 1984) (exception for "sophisticated insured" or contracts actually negotiated upon between both parties to an adhesion contract).

10. See *Century Bank v. St. Paul Fire & Marine Ins. Co.*, 482 P.2d 193 (Cal. 1971); *State Farm Mut. Auto. Ins. Co. v. Jacober*, 514 P.2d 953 (Cal. 1973); *Holz Rubber Co. v. American Star Ins. Co.*, 533 P.2d 1055 (Cal. 1975); *Ins. Co. of N. Am. v. Sam Harris Constr. Co., Inc.*, 583 P.2d 1335 (Cal. 1978); *Reserve Ins. Co. v. Pisciotto*, 640 P.2d 764 (Cal. 1982); *Producers Dairy Delivery Co., Inc. v. Sentry Ins. Co.*, 718 P.2d 920 (Cal. 1986).

11. The reasonable expectations doctrine is discussed in detail *infra* at parts I.C. and II.

12. See David S. Miller, Comment, *Insurance as Contract: The Argument for Abandoning the Ambiguity Doctrine*, 88 COLUM. L. REV. 1849 (1988); William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267 (1986); *Duty to Defend Made Absolute*, *supra* note 4.

13. *Jarvis v. Aetna Casalty & Sur. Co.*, 633 P.2d 1359, 1363 (Alaska 1981) (adhesion contract theory and reasonable expectations doctrine); *Transamerica Ins. Group v. Meere*, 694 P.2d 181, 187 (Ariz. 1984) (intentional acts exclusion); *Hartford Ins. Group v. District Court for Fourth Judicial Dist.*, 625 P.2d 1013, 1017 (Colo. 1981) (duty to defend); *Missionaries of Co. of Mary, Inc. v. Aetna Casalty & Sur. Co.*, 230 A.2d 21, 26 (Conn. 1967) (duty to defend); *Standard Oil Co. of Cal. v. Hawaiian Ins. & Guar. Co., Ltd.*, 654 P.2d 1345, 1349 (Haw. 1982) (duty to defend); *Corgatelli v. Global Life & Accident Ins. Co.*, 533 P.2d 737 (Idaho 1975) (reasonable expectations doctrine); *Rodman v. State Farm Mut. Auto. Ins. Co.*, 208 N.W.2d 903, 905-06 (Iowa 1973) (adhesion contract and reasonable expectations doctrine); *Gowing v. Great Plains Mut. Ins. Co.*, 483 P.2d 1072, 1074-75 (Kan. 1971) (adhesion contract and reasonable expectations doctrine); *Travelers Indem. Co. v. Dingwell*, 414 A.2d 220, 227 (Me. 1980) (duty to defend); *Markline Co. v. Travelers Ins. Co.*, 424 N.E.2d 464, 468 (Mass. 1981) (adhesion contract and reasonable expectations doctrine); *Zurich Ins. Co. v. Rombough*, 180 N.W.2d 775, 777, 778 (Mich. 1970) (duty to defend, adhesion contract and reasonable expectations doctrine); *Atwater Creamery Co. v. W. Nat'l Mut. Ins. Co.*, 366 N.W.2d 271, 277 (reasonable expectations doctrine); *McAlear v. St. Paul Ins. Cos.*, 493 P.2d 331, 335 (Mont. 1972) (duty to defend, adhesion contract and reasonable expectations doctrine); *Allstate Ins. Co. v. Novak*, 313 N.W.2d 636, 640, 641 (Neb. 1981) (intentional acts exclusion and duty to defend); *Gerhardt v. Continental Ins. Cos.*, 225 A.2d 328, 332 (N.J. 1966) (reasonable expectations doctrine); *Mills v. Agrichemical Aviation, Inc.*, 250 N.W.2d 663, 671-72 (N.D. 1977) (adhesion contract and reasonable expectations doctrine); *Preferred Mut. Ins. Co. v. Thompson*, 491 N.E.2d 688, 691 (Ohio 1986) (intentional acts exclusion); *Conner v. Transamerica Ins. Co.*, 496 P.2d 770, 773, 774 (Okla. 1972) (duty to defend); *State Farm Mut. Auto. Ins. Co. v. Mastbaum*, 748 P.2d 1042, 1047 (Utah 1987) (reasonable expectations doctrine); *Boston Ins. Co. v. Maddux Well Serv.*, 459 P.2d 777, 779-80 (Wyo. 1967) (duty to defend).

14. *Bank of the West v. Superior Court*, 833 P.2d at 551.

15. *Id.* at 551-52 ("[I]nsurance contracts . . . are still contracts to which the ordinary rules of contractual interpretation apply.").

Supreme Courts¹⁶ in forsaking the reasonable expectations doctrine¹⁷ by following a canon of contract construction similar to the rule embodied in the Restatement (Second) of Contracts section 211.¹⁸ The words “adhesion contract” were notably absent¹⁹ from the opinion, and in a sweep of judicial legerdemain, a quarter century of *Gray* and its progeny apparently vanished to be replaced by the vagaries of California Civil Code section 1649²⁰ as the law that governs construction of insurance policies in coverage disputes. The insurance industry had won a decisive victory—the reasonable expectations doctrine is effectively dead.²¹ Because the *Bank of the West* decision strays

16. *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, 682 P.2d 388 (Ariz. 1984); *State Farm Mutual Ins. Co. v. Sandbulte*, 302 N.W. 2d 104, 112 (Iowa 1981), *later proceeding*, 343 N.W.2d 457 (Iowa 1984). See Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 843-46 (1990).

17. In *Gray*, the California Supreme Court held that in the event of uncertainty or ambiguity in insurance contract language, the contract will be construed against the insurer in accordance with the reasonable expectations of the insured. 419 P.2d at 172. The doctrine will be discussed in more detail *infra* at parts I.C. and II.

18. Restatement (Second) § 211 relates to “Standardized Agreements” the text of which reads as follows:

- (1) Except as stated in Subsection (3), where a party to an agreement signs or otherwise manifests assent to a writing and has reason to believe that like writings are regularly used to embody terms and agreements of the same type, he adopts the writing as an integrated agreement with respect to the terms included in the writing.
- (2) Such a writing is interpreted wherever reasonable as treating alike those similarly situated, without regard to their knowledge or understanding of the standard terms of the writing.
- (3) Where the other party has reason to believe that the other party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement.

RESTATEMENT (SECOND) of Contracts § 211 (1979). Both canons heed traditional contract interpretation precepts.

19. The absence of the term is noteworthy because the adhesion doctrine has been the basis for the special rules that governed insurance contract interpretation for twenty five years. See parts I.C. & II *infra*.

20. The Code Section is entitled “Ambiguity or uncertainty; promise” and provides in pertinent part:

- If the terms of a promise are in any respect ambiguous or uncertain, it must be interpreted in the sense in which the promisor believed, at the time of making it, that the promisee understood it.

CAL. CIV. CODE § 1649 (West 1985).

21. The reasonable expectations doctrine developed as a judicial reaction to the real threat of overreaching and unconscionable advantage which insurance companies and other large businesses enjoyed as drafters of standardized contracts which governed the actions of the contracting parties. See generally Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961 (1970). The doctrine of reasonable expectations, like the law of implied warranties, is a consumer protection principle which sheltered the individual bargainer’s legitimate expectations by taking account of those expectations when construing the usual garbled language of the insurance contract. By placing the weight of the contractual analysis upon the insurer’s perceptions at the time of contracting, the California Supreme Court has dangerously tipped the balance in favor of the insurance industry. See *infra* part III.

far from rules which governed for a quarter of a century, it is important to trace the history of insurance contract interpretation through the years.

Part I of this article outlines the history of contract interpretation in the insurance context. It traces the development of case law pertaining to the allied principles of *contra proferentem* and reasonable expectations up to the resultant California doctrine established by *Gray* and its progeny. Part II discusses *Gray* as the basis for subsequent California case law pertaining to insurance coverage disputes. Part III recounts California Civil Code section 1649 and its traditional applications prior to the implementation of *Gray*, its rudimentary incursions into the domain of insurance contracts, and its subsequent emergence as California's dominant doctrine. Part III also contrasts the *Gray* approach with the section 1649 analysis in *Bank of the West*. Section 1649's probable effects on California insurance law will also be discussed. This article concludes that *Gray*'s reasonable expectations approach should have been retained.

The logical starting point for this inquiry begins with the traditional contract interpretation rules which were supplanted by *Gray* and the reasonable expectations doctrine.

I. HISTORY

The history of insurance contract interpretation, at least until *Gray v. Zurich* and its progeny, mirrored the prevailing socio-economic conditions and philosophical theories which affected legal doctrine through the years.²² Modern insurance contract interpretation theory is derived from traditional contract law.

A. The Treatment of Insurance Policies as "Ordinary" Contracts

Originally, the courts treated insurance policies like all other contracts. Historically, the primary purpose behind judicial contract construction was ascertaining the intent of the parties when they entered into the agreement.²³ The language in the contract was viewed as the "Rossetta Stone" through which the objective manifestation of intent²⁴ could be discerned.²⁵ Because

22. The discussion *infra* at parts I.A., I.B., and I.C. will establish that a link between "freedom of contract" notions and traditional contract interpretation principles exists while status-based contract construction is allied with the reasonable expectations doctrine.

23. CAL. CIV. CODE § 1636 (West 1985); 3 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 538, at 55 (1960).

24. Judge Learned Hand once said that in the law of contracts, the intent of the parties is established by writings (acts) of the parties which "ordinarily" signify intent. *Hotchkiss v. National City Bank of New York*, 200 F.287, 293 (D.C.N.Y. 1911), *aff'd*, 201 F. 664 (2nd Cir. N.Y. 1912), *aff'd*, 231 U.S. 50 (1913). Thus, "the meaning of the words or other conduct of a party may not necessarily be the meaning he expects or understands." RESTATEMENT (SECOND) of Contracts § 200 cmt. b (1979).

of the grave importance²⁶ placed upon the “language and terms” embodied in the contract, drafting of clear contract language was a crucial endeavor.²⁷ In short, insurance policy construction in the early years hardly ever strayed far from the four corners of the contract document.²⁸

In 1910, the California Supreme Court in *Pacific Heating and Ventilating Co. v. Williamsburgh City Fire Insurance Co. of Brooklyn*²⁹ had this to say about the status of insurance policies in the overall contracts scheme:

A policy of insurance is but a contract, and like all other contracts it must be construed according to the language and terms used therein in order to arrive at its true sense and meaning. Courts will not undertake to relieve

25. The process of construing terms in the contract is an activity which seeks to derive the “plain meaning” of the words and symbols used. Edwin W. Patterson, *The Interpretation and Construction of Contracts*, 64 COLUM. L. REV. 833, 838 (1964). Whenever plain meaning is derived from the contract language, the court will not look elsewhere. *Id.* The “plain meaning” rule may be subject to certain pitfalls, namely: (1) It does not apply to ambiguous provisions (the court will have to evaluate extrinsic evidence on such occasions), (2) It only applies if the meaning derived is not unconscionable (unconscionability voids the contract), (3) There may be different versions of this one “plain meaning” in vernacular use or in the “universal dictionary” (in situations like this, the court must ascertain the one “appropriate” meaning), (4) Customary, local, or trade usages may vary from the derived “plain meaning” (wherein the court must determine whether proof of such specialized usage exists). *Id.* at 839.

26. “[The] traditional doctrine gave great deference to the drafter’s terms.” Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1174, 1183-84 (1983).

27. “The ideal result that legal draftsmen seek to attain and that judicial interpreters commonly seek to find in a written contract is that a judge should be able, by reading the contract without lifting his eyes from the page, to determine its one and only “true” meaning in relation to the issues being litigated.” Patterson, *supra* note 25, at 838. But “a clear and definite mind is a rarity; an artist in the use of words is as great a rarity.” 3 CORBIN, *supra* note 23, § 534.

28. Professor Rakoff enumerated four propositions which represented the traditional construction approach:

- 1) The party who has an opportunity to read the document and signs it is taken to have assented to it and is thereby bound.
- 2) There is no legal relevance as to whether a party has subjectively read, understood, or assented to the contract terms.
- 3) The assent of the party covers the entire document; this includes terms that may or may not have been dickered over.
- 4) There are very narrow exceptions to the traditional rules. Failure of the drafting party to explain form terms is not an exception. The only acceptable exception involves intentional creation of a misunderstanding by the drafting party.

Rakoff, *supra* note 26, at 1185.

29. 111 P. 4 (Cal. 1910). *Pacific Heating* involved scrutiny of a fire insurance policy which expressly disclaimed the insurer’s liability for “loss caused directly or indirectly by invasion, insurrection, riot, civil war or commotion, or military or usurped power, or by order of any civil authority; or for loss or damage occasioned by or through any volcano, earthquake. . . .” *Id.* at 4. The court held that the semi-colon separating the “war” clause from the natural disaster clauses effectively removed damage occasioned by earthquakes from the limiting provision: “caused directly or indirectly.” *Id.* at 5. The insured, whose property was destroyed by a fire which started in another building following an earthquake, was covered by the policy. *Id.* This was because after the earthquake, the insured building was undamaged and it was the subsequent fire, for which the policyholder plainly had coverage, which effectively caused the damage. *Id.*

parties from the express and plain stipulations into which they have entered.³⁰

This sentiment was echoed in *Kautz v. Zurich General Accident and Liability Insurance Co., Ltd.*³¹ where the insurer sought to escape liability by contending that: (1) the auto insurance policy expressly excluded coverage for injuries occasioned by persons “not legally operating” the auto (the driver, who had permission from the owner to operate the vehicle, was intoxicated), and (2) the policyholder did not adhere to an express condition that the car be used, garaged, and maintained in a specified city.³² In finding for the insured, the court noted that the policy was silent regarding the duty of the insured to inform the insurer about changes of address and location of principal usage, maintenance and operation of the vehicle; nor were there express limitations imposed for such a move.³³ Moreover, the term “legally operating” was ambiguous³⁴ and the interpretation given by the insured was more in line with the intentions of the parties when entering into the agreement.³⁵

Similarly, when the court determined the insurer’s duty to defend a policyholder in a third party negligence action in *Lamb v. Belt Casualty Co.*,³⁶ the court disregarded extrinsic evidence pertaining to the insurer’s preliminary investigation of the lawsuit.³⁷ The court declared that the fundamental analysis should involve the contract language itself, and it was there that specific terms binding the insurer were found.³⁸

The prevailing notion that the insurance policy was first and foremost a contract was subject to a caveat which could operate in favor of the policyholder when the insurance contract contained ambiguous terms. In *Pacific Heating*, the court noted that:

It is . . . a fundamental rule that the insurer is in duty bound to use such language as to make the conditions, exceptions and provisions of the policy clear to the ordinary mind, and in case it fails to do so, any ambiguity or

30. *Id.* at 5.

31. 300 P. 34 (Cal. 1931).

32. *Id.* at 36.

33. *Id.* at 37-38. It was also noted by the court that the area where the car was being operated, maintained and garaged was contiguous with the city of San Francisco which was the venue of coverage specified in the contract endorsement. *Id.* at 37.

34. *Id.* at 37. This gave rise to the interpretation rule of *contra proferentem* wherein ambiguous contract language mandates construction against the drafter of the contract. *Id.* at 36-37. *Contra proferentem* is discussed more fully *infra* part I.B.

35. The insured contended that the policy only excluded coverage in situations when the car was being driven illegally—that is without the permission of the insured. *Id.* at 37. The court agreed that the express provision was not so broad as to exclude coverage for driving while in violation of any law. *Id.*

36. 40 P.2d 311 (Cal. Ct. App. 1 Dist. 1935).

37. *Id.* at 314.

38. *Id.*

reasonable doubt must be resolved in favor of the insured and against the insurer.³⁹

This was the traditional contract construction rule of *contra proferentem*.⁴⁰

B. *Contra Proferentem*⁴¹

The doctrinal foundation for the modern reasonable expectations principle in insurance law is found in the venerable rule of *contra proferentem*.⁴² Under this rule, uncertain or ambiguous contract language is construed against the party who drafted the terms or selected the wording of the contract.⁴³ Faced with ascertaining the meaning of uncertain or ambiguous contract terms, courts initially analyze "all existing usages, general, local, technical, trade, and the custom and agreement of the two parties with each other"⁴⁴ including the relevant circumstances and communications surrounding the agreement.⁴⁵ If the initial analysis does not remove the uncertainty or ambiguity,⁴⁶ *contra proferentem* is traditionally used as a judicial tool of last resort⁴⁷ and the ambiguity is construed strictly against the drafting party.⁴⁸

39. *Pacific Heating*, 111 P. at 5. The court made a similar observation in *Kautz*. See *supra* note 34 and accompanying text.

40. See *supra* note 34. *Contra proferentem* was applied to all contracts containing ambiguous language but was "more rigorously applied in insurance than in other contracts, in recognition of the difference between the parties in their acquaintance with the subject matter." *Gaunt v. John Hancock Mut. Life Ins. Co.*, 160 F.2d 599, 602 (2d Cir. Conn. 1947), *cert. denied*, 331 U.S. 849 (1947) (footnote omitted).

41. The term *contra proferentem* is a short form of the latin phrase: "*Omnia praesumuntur contra proferentem*." Edwin W. Patterson, *supra* note 25, at 854. The term literally means: All things are presumed "against the party who proffers or puts forward a thing." BLACK'S LAW DICTIONARY 327 (6th ed. 1990).

42. Professor Williston included *contra proferentem* in his treatise among "secondary rules." 3 SAMUEL WILLISTON & GEORGE J. THOMPSON, WILLISTON ON CONTRACTS § 621, at 1788 (1936). Professor Patterson regards the doctrine as a "secondary maxim" of contract interpretation. Patterson, *supra* note 25, at 852, 854.

43. 3 WILLISTON & THOMPSON, *supra* note 42. See also RESTATEMENT (SECOND) OF CONTRACTS § 206 (1979); 3 CORBIN, *supra* note 23, § 559 at 262.

44. 3 CORBIN, *supra* note 23, § 559. See also RESTATEMENT (SECOND) of Contracts § 212 cmt. b (1979).

45. *Id.* See generally Patterson, *supra* note 25, at 838-55 (providing a clear and concise explanation of traditional contract construction rules).

46. If the court deems the ambiguity too great, the inquiry may end here with a determination of non-existence of contract. But if the court recognizes that the parties indeed attempted to make a binding agreement, and the only doubt remaining concerns two feasible and rational interpretations, then *contra proferentem* will apply. 3 CORBIN, *supra* note 23, § 559.

47. Miller, *supra* note 12 at 1851. See 3 CORBIN, *supra* note 23, § 559; see also *supra* note 42.

48. Professor Williston pronounced an alternate version of the rule: "[T]he contract, if ambiguous, will be interpreted in favor of the promisee." 3 WILLISTON & THOMPSON, *supra* note 42, at 1789. Williston recognized that most of the time, the promisor drafts the contracts in these types of cases. *Id.* at 1788-89. Application of *contra proferentem* arose out of the realization that the party who chooses the contract language: (1) will naturally safeguard her own

Contra Proferentem was easily incorporated into the field of insurance. California courts consistently held that as a matter of black letter law, ambiguous⁴⁹ policy provisions were to be construed against the insurer (who drafts the policy and controls its language) and in favor of the insured.⁵⁰

For example, in *Continental Casualty Co. v. Phoenix Construction Co.*,⁵¹ the California Supreme Court acknowledged the rule that ambiguous provisions are construed against the insurer.⁵² The court held that insurance contract terms must be interpreted in the most inclusive sense for the benefit of the insured.⁵³ Accordingly, the court read a provision limiting coverage to certain officials including "managing employees" to cover a regular employee/driver who was "in control of" and therefore "managing" the vehicle at the time of the accident.⁵⁴

In time, use of *contra proferentem* was strained beyond its traditional doctrinal underpinnings which led to awkward applications of the rule.⁵⁵ It was under these conditions that courts, struggling to apply their equitable powers under color of an unmalleable doctrine,⁵⁶ turned to the concept of

interests more carefully than that of the other party, and (2) will probably be more aware of any dubious meanings inherent in the chosen language. RESTATEMENT (SECOND) OF CONTRACTS § 206 cmt. a (1979); Cf. 3 CORBIN, *supra* note 23, § 559 at 270 (noting that *contra proferentem* is "chiefly a rule of public policy . . . favoring the underdog").

49. "Ambiguity arises when policy language may reasonably be interpreted in two or more ways." *Aim Insurance Co. v. Culcasi*, 280 Cal. Rptr. 766, 771 (Cal. Ct. App. 6 Dist. 1991), *review denied*, 1991 Cal. LEXIS 2891 (Cal. 1991).

50. *See e.g.*, *Arenson v. Nat'l Auto. & Casalty Ins. Co.*, 286 P.2d 816, 818 (Cal. 1955); *Coit v. Jefferson Standard Life Ins. Co.*, 168 P.2d 163, 165 (Cal. 1946). *See also* 39 Cal. Jur.3d *Insurance Contracts* § 42 (1977) ("Since an insurance policy is drawn by the insurer, and since the insurer is bound to use such language as to make the provisions of the contract clear to the ordinary mind, any ambiguity . . . is to be resolved against the insurer.") (footnotes omitted).

51. 296 P.2d 801 (Cal. 1956).

52. *Id.* at 805, 809.

53. *Id.* at 810.

54. The court defined "manage" in accordance with Webster's Dictionary and derived a somewhat forced and awkward reading of the term "managing employee." *Id.*

55. ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES* § 6.2, at 628-30 (Student ed. 1988). Judge Keeton cited *Lachs v. Fidelity & Casalty Co. of N.Y.*, 118 N.E.2d 555 (N.Y. 1954), *reh'g denied*, 120 N.E.2d 216 (N.Y. 1954) & *Steven v. Fidelity & Casalty Co.*, 377 P.2d at 868. Both cases involved the purchase of airline trip insurance. *Steven* will be discussed in more detail *infra* part I.C. *See supra* note 54 and accompanying text.

56. Mechanical use of construing ambiguities against insurers invites inconsistency and confused results. Martin Kamarck, *Opening the Gate: The Steven Case and the Doctrine of Reasonable Expectations*, 29 HASTINGS L.J. 153, 159 (1978). Two drawbacks can be ascertained from strict compliance with the doctrine of construing ambiguities against the insurer: (1) At times, courts are unable to stretch the doctrine so far as to encompass undoubtedly nebulous contract terms, *id.* (citing *Interinsurance Exch. of Auto. Club of S. Cal. v. Velji*, 118 Cal. Rptr. 596, 599 (Cal. Ct. App. 2 Dist. 1975)) and (2) courts will eventually concoct ambiguities and interpret the contract in direct contravention of its expressed terms. *Id.* "Hence, the court which adheres mechanically to the rule of construing ambiguity against the draftsman . . . either . . . allow[s] perceived "wrongs" to go unremedied or . . . creat[es] "remedies" based on strained factual interpretation." *Id.*

“honoring reasonable expectations.”⁵⁷ The doctrine of reasonable expectations appeared to: (1) provide much needed legitimacy to decisions holding contrary to traditional contract construction rules, and (2) serve the judicial need to exercise equity where it was needed.

C. Adhesion Contracts and the Reasonable Expectations Doctrine⁵⁸

1. The Adhesion Doctrine Develops as a Reaction to Form Contracts, Standardized Language and “Freedom of Contract”⁵⁹

Because of perceived shortcomings inherent in the traditional interpretation rule of *contra proferentem*,⁶⁰ reform-minded courts developed the adhesion contract theory⁶¹ as: (1) a means of achieving the flexibility absent in *contra proferentem* and (2) a legitimizing force in light of insurance law decisions holding contrary to established contract construction norms. Notions of *laissez faire*⁶² and “freedom of contract”⁶³ provided the rationale for remaining faithful to traditional contract interpretation rules.⁶⁴ The

57. See KEETON & WIDISS, *supra* note 55, at 628-32.

58. Because the adhesion theory applies to all other contracts as well as insurance contracts, the discussion below is not reserved exclusively for insurance contract cases.

59. “Freedom of contract” is a principle which assumes that individuals are free to “shop around” and choose whom to enter contracts with and thus escape any oppressive agreements. Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 630 (1943). As the discussion *infra* in the present section will show, the insurance contract obviates any individualized bargaining or exercise of choices on the insured’s part, thus the rationale of “freedom of contract” is problematic when used in the insurance contract domain.

60. Kessler points out that allowing for this type of recovery via the “back door” leads to inconsistency and places unfair pressure on the stability of the insurance industry which relies on precise calculation of risks in order to flourish. *See id.* at 635.

61. The concept of the adhesion contract was first introduced to American legal theory by Professor Patterson in 1919. *See* Edwin W. Patterson, *The Delivery of a Life Insurance Policy*, 33 HARV. L. REV. 198 (1919). Professor Patterson specifically categorized the life insurance policy as a classic adhesion contract in view of the fact that the insurer drafts the contract while the insured “merely ‘adheres’” to the contract with “little choice as to its terms.” *Id.* at 222. The doctrine of adhesion contracts originated in Continental Europe from the studies of the German Civil Code conducted by the French jurist, Raymond Saleilles. Patterson, *supra* note 25, at 856-57. The concept was further expanded by the French Professor Demogue in 1910. *Id.* The theory grew out of the initial reluctance of courts to admit extrinsic evidence under traditional contract doctrine to the gradual acceptance of such evidence in order to show which side drafted the agreement. *Id.* In addition, if the drafting party was in a stronger bargaining position, prevailing twentieth century concepts of justice favored the weaker party, and as such, formed the basis of modern adhesion contract doctrine. *Id.*

62. “Expresses a political-economic philosophy of the government allowing the marketplace to operate relatively free of restrictions and intervention.” BLACK’S LAW DICTIONARY 876 (6th ed. 1990).

63. *See supra* note 59.

64. Professor Kessler quoted Sir G. Jessel’s oft-cited passage to exhibit the almost religious reverence paid to traditional contract construction rules under freedom of contract: “[M]en of full age and competent understanding shall have the utmost liberty of contracting, and . . . their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice.” Kessler, *supra* note 59, at 631 (quoting Sir G. Jessel in, *Printing and*

traditional freedom of contract theory recognized that parties were free to choose whom to enter an agreement with and thus escape the consequences of an "oppressive" bargain.⁶⁵ At the same time, contracting parties were deemed capable of protecting their own interests.⁶⁶ The freedom of contract theory, therefore, justified identical judicial treatment of all contracts. However, the theory seemed to lose validity as the use of form contracts containing standardized language⁶⁷ offered to the consumer in a "take-it-or-leave-it" manner⁶⁸ increasingly formed the basis of frequent contract disputes.⁶⁹

Equality in bargaining power is no longer the norm in today's world of monolithic business entities and impersonal business transactions.⁷⁰ The language of the present economic and social agreement is the language of the standardized form contract. The overpowering utility of the form contract to present day enterprise is its ability to identify, standardize, and limit risks.⁷¹ Nowhere has the desire to quantify, limit, and manage risk been

Numerical Registering Co. v. Sampson, L.R. 19 Eq. 462, 465 (1875)).

65. *Id.* at 630.

66. *Id.* Furthermore, Freedom of Contract assumes that (1) contracts are private matters—not social institutions and thus, courts may only *interpret* the agreements and *not create* contracts for the parties and (2) a party is presumed to know about a contract she entered into. *Id.*

67. "Standardized agreements are commonly prepared by one party. The customer assents to a few terms, typically inserted in blanks on the printed form, and gives blanket assent to the type of transaction embodied in the standard form." RESTATEMENT (SECOND) OF CONTRACTS, § 211 cmt. c (1979). The evolution of the freely bargained contract to the standard form contract demonstrated the economic progression towards mass production. Kessler, *supra* note 59, at 631. Insurance contracts originated from individual agreements at Lloyd's Coffeehouse in London entered into by parties of roughly equal bargaining power. Keeton, *supra* note 21 at 966. For a general overview of the birth of the insurance contract at Lloyd's, see William R. Vance, *The History of the Development of the Warranty in Insurance Law*, 20 YALE L.J. 523 (1911).

68. Kessler, *supra* note 59, at 632 ("[S]tandardized contracts are frequently contracts of adhesion; they are a *prendre ou a laisser*.")

69. "Today freedom of contract does not commend itself to us as a social ideal in quite the same way. In the more complicated social conditions of our industrialized society it wins approval only to the extent that there is reasonable equality of bargaining power between the parties and no injury is done to the economic community at large. The moral principle that persons should abide by their agreements is today met by the equally cogent principle that one should not take advantage of an unfair contract which one has persuaded another to enter into under economic or social pressure. . . ." Akin v. Business Title Corp., 70 Cal. Rptr. 287, 291 (Cal. Ct. App. 2 Dist. 1968) (quoting from C.H. Bright, *Controls of Adhesion and Exemption Clauses*, 41 Austl. L.J. 261, 266 (1967) (excerpted from statement by Phillip Jeffrey)).

70. Kessler, *supra* note 59, at 631.

71. Kamarck, *supra* note 56, at 157. See RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. a (1979) (detailing the usefulness of the standard contract in streamlining internal business operations as well as minimizing cost by treating certain transactions as a class instead of individually). See also Keeton, *supra* note 21, at 966 (explaining that interests in simplification, clarity, and precision gave rise to the increased use of the form contract). The form contract is evidence of what has been called the rise of "neo-formalism" in contracts law. *Id.* Formalism denotes a "strict . . . attention to . . . outward forms." WEBSTER'S NEW WORLD DICTIONARY 530 (3d College ed. 1991). There is a parallel judicial rationale called Legal Formalism which is "the traditional view that correct legal decisions are determined by pre-existing legal precedent, and the courts must reach their decisions solely based upon logical deduction, applying the facts of a particular case to a set of pre-existing rules." Peter Nash

more apparent than in the insurance industry.⁷² The industry's pioneering efforts at conquering risk through the form contract paved the way for other businesses to use similar methods.⁷³

Six features of the standardized insurance contract disturbed the courts. These features are: (1) Unequal bargaining power,⁷⁴ (2) the inability of the consumer to control any of the contract terms,⁷⁵ (3) the tendency of such contracts to be offered on a take-it-or-leave-it basis,⁷⁶ (4) the quasi-public nature of⁷⁷ or universal need for the product or service offered,⁷⁸ (5) the fact that the consumer rarely, if ever, reads the contract,⁷⁹ or (6) even if the consumer does read the contract, they may not understand it.⁸⁰ These concerns resulted in different treatment for insurance contracts and other adhesion contracts.⁸¹ Thus, in determining the enforceability of certain terms in a contract exhibiting the suspect characteristics outlined above, courts began to look outside of the contract itself. The status⁸² of the

Swisher, *Judicial Rationales in Insurance Law: Dusting Off the Formal for the Function*, 52 OHIO ST. L.J. 1037, 1040 (1991).

72. "The standard clauses in insurance policies are the most striking illustrations of successful attempts . . . to select and control risks assumed under a contract. The insurance business . . . first realized the full importance of . . . 'judicial risk', the danger that a court or jury may be swayed by 'irrational factors' to decide against a powerful defendant." Kessler, *supra* note 59, at 631.

73. *Id.*

74. See *Madden v. Kaiser Foundation Hospitals*, 552 P.2d at 1185.

75. See *Garcia v. Truck Ins. Exch.*, 682 P.2d at 1105-06.

76. Kessler, *supra* note 59, at 632.

77. See *e.g.*, *Barrera v. State Farm Mut. Auto Ins. Co.*, 456 P.2d at 680 n.5; *Gray*, 419 P.2d at 179. See generally Matthew O. Tobriner & Joseph R. Grodin, *The Individual and the Public Service Enterprise in the New Industrialized State*, 55 CALIF. L. REV. 1247 (1967) (discussing the new judicially mandated protection of economically weaker entities from powerful private entities performing quasi-public obligations).

78. See *Henningsen v. Bloomfield Motors, Inc.*, 161 A.2d 69, 84, 92 (N.J. 1960).

79. Rakoff, *supra* note 26, at 1179 n.21 and accompanying text. See Eugene Wollan & Jeffrey S. Weinstein, *Great (or Reasonable) Expectations*, BEST'S REVIEW—PROPERTY-CASUALTY INSURANCE EDITION, May, 1990, at 84 ("In the real world, most individual insureds do not read their policies. They check to make sure their names are spelled correctly, and then they file the policy away without a second thought until a loss occurs. This inevitably leads to a situation where the policy does not provide coverage for a loss for which the insured assumed he had coverage.").

80. "[Standardized language limiting insurance coverage], prepared by lawyers, defended by lawyers and authoritatively interpreted by lawyers, are probably not appreciated by the lay insured." *Gray*, 419 P.2d at 175 n.14 (quoting from Comment, *The Insurer's Duty to Defend Under a Liability Insurance Policy*, 114 U. PA. L. REV. 734, 748 (1966)).

81. This basic realization was echoed time and again in California Supreme Court treatment of insurance contracts. See, *e.g.*, *AIU Ins. Co. v. Superior Court (FMC Corp.)*, 799 P.2d 1253, 1265 (Cal. 1990) ("These rules stem from the fact that the insurer typically drafts policy language, leaving the insured little or no opportunity to bargain for modifications."); *Garcia*, 682 P.2d at 1105-06 (drafting policy language, unequal bargaining power); *Barrera*, 456 P.2d at 680 n.5 (quasi-public nature of insurance business).

82. The shift from form to status as the controlling factor in interpretation of adhesion contracts marks a dramatic deviation from notions of freedom of contract. See Kessler, *supra* note 59, at 640 (arguing that freedom of contract does not guarantee equal freedom for all parties and may become a "one-sided privilege" in favor of the stronger parties). Freedom of

parties as well as the relevant circumstances surrounding the agreement gained importance.⁸³

2. *Henningsen v. Bloomfield Motors* Sets the Stage for General Acceptance of the Adhesion Contract Doctrine

The landmark decision in *Henningsen v. Bloomfield Motors*⁸⁴ set the tone for future adjudication of standardized form contract disputes. Justice Francis, writing for the New Jersey Supreme Court conceded that freedom of contract which mandates strict adherence to the contract language is "an important factor."⁸⁵ However, under the same breath, the court recognized the inability of traditional contract doctrine to surmount the novel problems raised by the adhesion contract.⁸⁶ The court made a radical departure from traditional rules of contract construction.⁸⁷ This decision, the precursor of modern consumer protection cases proclaimed that contracts of adhesion (or standardized form contracts) must be read in light of their realistic and pragmatic effects.⁸⁸ The court construed the contract by appraising the social policy implications arising from the bargaining position of the consumer "in today's economy."⁸⁹ The court essentially rewarded the reasonable expectations of the consumer by voiding the contract's limiting provisions as unconscionable⁹⁰ and creating the concept of implied warranties.⁹¹ The assault on traditional notions of contract interpretation governing

contract surmounted the status based classifications of the feudal system, but the reality of today's business practices requires a return to status-based distinctions derived from natural law in contracting. *Id.* at 641-42. The law, Kessler contends, should be malleable enough to fit the ever-changing needs of society. *Id.*

83. *See Gray*, 419 P.2d at 171-72 (establishing in California that the "relationship" of the parties must also be analyzed in construing adhesion contract terms). Several articles discuss the importance of the new status-based distinction. *See e.g.*, Tobriner & Grodin, *supra* note 77; Barbara B. Rintala, Foreword: "Status" Concepts in the Law of Torts, 58 CALIF. L. REV. 80 (1970).

84. 161 A.2d 69 (N.J. 1960). In *Henningsen*, the plaintiff brought suit against a car dealer for the sale of a defective automobile. *Id.* at 73. The dealership utilized a form contract containing difficult to read and hard to find terms absolving the dealership from liability. *Id.* at 74-75. The New Jersey Supreme Court delivered progressive holdings for the two issues confronting the bench: issues of implied warranty of merchantability and exclusionary language expressed in boilerplate contract documents.

85. *Id.* at 84.

86. *Id.*

87. *Id.* The court quoted approvingly from the Kessler article cited in the present work (*supra* note 59) to justify the unconventional treatment of the contract at issue. *Id.* at 86.

88. *Id.* at 84.

89. *Id.*

90. The location of and manner in which the disclaimers appeared in the contract document also affected the outcome of the litigation. *Id.* at 89-92. An argument that the rules invoked by the court here was limited to industries assuming a quasi-public nature was repudiated by the court which likened the automobile industry to common carriers because of the widespread societal reliance on the automotive industry to fulfill the basic need for transportation. *Id.* at 92.

91. *Id.* at 84.

adhesion contracts had begun. The inescapable conclusion to be derived from the adhesion theory was simply this: *Contracts of adhesion are special and must be treated differently from other contracts.*

3. California Adopts the Adhesion Contract Theory Under The Guidance of Justice Tobriner

The California Supreme Court defined an adhesion contract as: “[A] standardized contract . . . imposed and drafted by the party of superior bargaining strength [which] relegates to the subscribing party only the opportunity to adhere to the contract or reject it.”⁹² Justice Matthew Tobriner may be called the architect of the adhesion contract doctrine in California.⁹³

In a 1972 essay,⁹⁴ Tobriner likened the development of the insurance-contract-as-adhesion-contract-doctrine with that of the then burgeoning law of products liability.⁹⁵ He proposed that the laws of products liability and insurance contract interpretation merit special rules (what he termed a “status” approach) because of the unique roles and social functions played by both insurance carriers and mass producers.⁹⁶ In the field of insurance law, this meant a departure from traditional contract interpretation dogma to the construction rules of the adhesion contract in adjudicating policy disputes.

The “Tobriner trilogy,” *Neal v. State Farm Insurance Companies*,⁹⁷ *Steven v. Fidelity & Casualty Insurance Co. of New York*,⁹⁸ and *Gray v.*

92. *Graham v. Scissor-Tail, Inc.*, 623 P.2d 165, 171 (Cal. 1981). The Supreme Court utilized the definition forwarded by then Judge Tobriner in *Neal v. State Farm Ins. Co.*, 10 Cal. Rptr. at 784. In *Graham*, the California Supreme Court held that a standard musicians’ union form contract between a musical promoter and a musical group was an adhesion contract. 623 P.2d at 171.

93. Charles L. Hurd & Philip L. Bush, *Unconscionability: A Matter of Conscience for California Consumers*, 25 HASTINGS L.J. 1, 33 n.185 (1973). Justice Tobriner evinced a penetrating interest in the socio-economic considerations facing the consumer in an era of mass production and powerful conglomerates which typified a concern for the ability of the law to conform to current situational realities. See Tobriner & Grodin, *supra* note 77. For an eye-opening view of the use and abuse of the standard form contract by California businesses and the inefficient legal response thereof, see W. David Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. CAL. L. REV. 1 (1974).

94. Matthew O. Tobriner, *Retrospect: Ten Years on the California Supreme Court*, 20 UCLA L. REV. 5 (1972).

95. *Id.* at 8-11. The ambiguous insurance contract is analogous to a defective product. Both do not provide the consumer with the safety and security expected after purchasing the product or service; the consumer usually cannot recognize the defect in the product or coverage until harm occurs while the producer (drafter) is in a much better position to prevent the problem from arising to begin with.

96. *Id.* at 8 (“I suspect that the mass producer and mass carrier, in common, evidence a liability based not on privity, or willed contract, but on the role they play in society—on the societal functions they assume.”).

97. 10 Cal. Rptr. 781 (Cal. Ct. App. 1 Dist. 1961).

98. 377 P.2d 284 (Cal. 1962).

Zurich Insurance Co.,⁹⁹ comprised a progressive set of cases through which Justice Tobriner translated his concerns for equity into a doctrine covering adhesion contract interpretation.¹⁰⁰ The resulting doctrine which reached its zenith in *Gray* governed California's law pertaining to insurance contract construction for almost three decades.

In *Neal*, Tobriner, then a judge of the First District Court of Appeals, opined that the standard form contract provided by an employer insurance company for use in its hiring of employee-agents was an adhesion contract.¹⁰¹ It was important to the court that the contract was drafted by the party of greater bargaining strength, while the weaker party or "adherent" had no option but to either take the contract as it was or leave it.¹⁰² The opinion declared that the contract in question "[did] not issue from that freedom in bargaining and equality in bargaining which are the theoretical parents of the American law of contracts."¹⁰³

After discussing the wide-reaching effect of standardized contracts in daily life, the court held that the canon of resolving ambiguities against the drafter "applies with peculiar force in the case of the contract of adhesion."¹⁰⁴ The court's rationale relied heavily upon the work of Professor Kessler.¹⁰⁵

The controlling principle exemplified by *Gray v. Zurich* built upon the foundation laid by *Steven v. Fidelity & Casualty Co.*¹⁰⁶ In *Steven*, the decedent purchased and sent away for flight insurance from a vending machine located by the ticket desk of a commercial airliner prior to his departure.¹⁰⁷ One of Steven's scheduled flights was canceled.¹⁰⁸ Mr. Steven, aided by an agent of the canceling airline, located and chartered a plane from a small airline outfit.¹⁰⁹ The plane crashed—killing Steven.¹¹⁰ The insurer refused to pay out the claim based upon exclusionary language

99. 419 P.2d 168 (Cal. 1966).

100. See Kamarck, *supra* note 56, at 164 ("Justice Tobriner has been deeply concerned with the responsibility of the law to protect the individual from the abuses of concentrated economic power, and his opinions in *Steven* and *Gray* are informed with an understanding that the adhesion contract is but a manifestation of this larger problem." (footnote omitted)).

101. *Neal*, 10 Cal. Rptr. at 784.

102. *Id.*

103. *Id.*

104. *Id.*

105. Kessler, *supra* note 59.

106. For an enlightening discourse on the *Steven* case and its role in the development of the reasonable expectations doctrine in California, see Kamarck, *supra* note 56.

107. *Steven*, 377 P.2d at 286.

108. *Id.* at 286-87.

109. *Id.* at 287.

110. *Id.*

in both the insuring clause¹¹¹ and definitions section of the insurance contract.¹¹² The *Steven* court pronounced two rationales for finding coverage in this instance: (1) construing ambiguities against the insurer as drafter of the contract¹¹³ and (2) the necessity of bringing exclusionary language to the attention of the insured.¹¹⁴ This latter concern was a response to two additional concerns: (a) unfair surprise and (b) defeating the reasonable expectations of the promisee; both of which would make enforcement of the terms unconscionable.¹¹⁵ The doctrine of reasonable expectations, like the

111. "Provision in insurance policy or bond which recites the agreement of the insurer to protect the insured against some form of loss or damage." BLACK'S LAW DICTIONARY 808 (6th ed. 1990).

112. Under the insuring clause, the insurer agreed to pay for losses caused by accidental bodily injury incurred during the first one-way trip or during the return trip provided that a round trip ticket was procured prior to the purchase of the insurance policy. *Steven*, 377 P.2d at 288. The clause further provided that the policy only covered travel using "a transportation ticket . . . covering the whole of said airline trip, issued . . . for transportation on an aircraft operated by a scheduled airline carrier." *Id.* The policy then defined "scheduled airline carrier" as either: (1) a U.S. carrier possessing a Certificate of Public Convenience issued by the Civil Aeronautics Board which publishes rates and schedules for passenger service between specified cities at regular scheduled times, (2) foreign registered aircraft, and (3) U.S. registered airlines which could fly legally within the boundaries of a specified state during published and regular time intervals. *Id.* Excluded from the definition set up above were military flights and flights on aircraft considered by civil aviation authorities to be either irregular or unscheduled air carriers. *Id.* The Court found it important that the risk incurred by the insurer is substantially unchanged in a substituted conveyance. *Id.* at 289.

113. The Court based its holding upon two ambiguities found in the insurance contract. (1) The first ambiguity concerned the availability of coverage for substituted land transportation expressed in the contract. Justice Tobriner reasoned that Mr. Steven, or the reasonable person in his shoes, would have expected coverage for a substituted flight in the exigency of an emergency. *Id.* at 288-289. Even if the policy expressly provided for coverage on land transportation in such situations, it was not sufficiently clear that the coverage was for alternate land transportation exclusively. *Id.* at 289. The maxim *expressio unius est exclusio alterius* ("mention of one matter excludes all others") did not apply because "the maxim . . . is . . . a legalistic concept [which] hardly enters into the thinking of the reasonable layman. As we have stated, we interpret an insurance contract in the light of that understanding." *Id.* at 290. (2) The definition of "Scheduled Air Carrier" was ambiguous because the ill-fated flight taken by Steven comprised a third category of air carrier not specifically defined or excluded in the policy and as such, did not apprise Mr. Steven about non-coverage. *Id.* at 290-92.

114. *Id.* at 290.

115. "[T]he potential for unconscionable insurance policy provisions provides [the reasonable expectations doctrine's] . . . chief motivating force." Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 338. Professor Rahdert points out that insurance companies are in a unique position to be able to insert various definitions, exclusions, exceptions, and conditions which shift risks to the consumer into the policy without arousing any suspicions on the part of the policyholder. *Id.* at 341. The potential for such activity is related to the "lopsidedness" inherent in the typical adhesion bargain. *Id.* at 339. *Accord* Logan v. John Hancock Mut. Life Ins. Co., 116 Cal. Rptr. 528, 530-31 (Cal. Ct. App. 1 Dist. 1974) (explaining that courts do not effectuate clauses which are unclear, unexpected, inconspicuous, or unconscionable). *See* Graham v. Scissor Tail, 623 P.2d 165, 172-73 (Cal. 1989) (listing two limitations imposed upon the enforcement of a contract of adhesion, one of which was the equitable principle denying enforcement of unduly "oppressive" or unconscionable provisions attributed by the California Supreme Court to *Steven*).

equitable principle of mistake¹¹⁶ and unconscionability¹¹⁷ may be invoked by the courts to invalidate a contract or certain portions thereof.

Steven modified *contra proferentem* by elevating it from a "tie-breaker" rule into a legitimate primary interpretation theorem justified by public policy.¹¹⁸ In addition, construction of the ambiguity against the insurer was tied by the court to considerations revolving around the reasonable expectations of coverage derived from the agreement by the policyholder.¹¹⁹

Because *Steven* had reasonable expectations of coverage in the instant case, it was incumbent upon the insurer to make the exclusions from the expected coverage as clear as possible.¹²⁰ Since the insurer failed to bring the exclusions to the attention of the policyholder,¹²¹ the policy provisions

116. Under the mistake doctrine, reformation of the contract may be had when there is an erroneous belief regarding some fact material to the agreed exchange of performances. RESTATEMENT (SECOND) OF CONTRACTS § 151 cmt. a (1979). When there is only one mistaken party, the contract is voidable (1) if that party does not bear the risk of the mistake, (2) enforcement of the contract in light of the situation would be unconscionable, or (3) the other party knew or should have known about the mistaken belief. *Id.* § 153.

117. A court may refuse to enforce certain terms in a contract if doing so would lead to an unconscionable result. *Id.* § 208. Like the adhesion theory, which provides the rationale for the doctrine of reasonable expectations, in determining whether a contract term is unconscionable, one relevant factor that may be considered is the disparity in the bargaining process. *Id.* § 208 cmt. a & cmt. d.

118. "The rule of resolving ambiguities against the insurer does not serve as a mere tie breaker; it rests upon fundamental considerations of public policy." *Steven*, 377 P.2d at 290. The decision stressed the fact that, in light of the circumstances surrounding the purchase of the insurance, *Steven* did not get a chance to read the contract terms. *Id.* at 294. The policies supporting the holding of this case were derived from the adhesion theory discussed *supra* in this work. See Kamarek, *supra* note 56, at 159-61. Professor Kamarek discussed the *Steven* court's rejection of a "mechanistic analysis" in construing ambiguities against the drafter for one within which "a larger principle was at work." At the "heart" of the *Steven* analysis, Kamarek opined, were "fundamental considerations of policy" buttressed by the doctrine of adhesion contracts and the necessity of making exclusionary language sufficiently clear to an adhering party who has reasonable expectations of coverage. *Id.* See Miller, *supra* note 12, at 1852 (noting change from presumption of unfair language to *per se* contra-insurer application of *contra proferentem*).

119. *Steven*, 377 P.2d at 288-89. Compare *Gaunt v. John Hancock Mut. Life Ins. Co.*, 160 F.2d 599, 601-02 (2d Cir. 1947), *cert. denied*, 331 U.S. 841 (1947). Finding coverage for the insured in *Gaunt*, Judge Learned Hand articulated his view that in the sphere of life insurance, the policyholder develops expectations of coverage as soon as the insurance application form is completed and payment is tendered; not upon "acceptance" of the application by the insurance company. *Id.* As in *Stevens*, the *Gaunt* decision utilized the doctrine of *contra proferentem* but similarly analyzed the expectations derived by the policyholder in the transaction as a factor.

120. *Steven*, 377 P.2d at 288-90. The risk undertaken by the insurer would not have been magnified by coverage on unscheduled airliners and coverage for substituted transportation "fell within the obligation undertaken by the insured," thus the need for making such exclusion clear to the insured. *Id.* at 290.

121. The Court reached this conclusion based upon the circumstances surrounding the purchase of the insurance policy. Although the policy contained a heading in bold print which read in part: "NOR FOR TRAVEL ON OTHER THAN SCHEDULED AIR CARRIERS," it was not clear whether the physical position of the document inside the vending machine obstructed said heading from *Steven's* view. *Id.* at 286. Justice Tobriner theorized that even if *Steven* had read the bold print exclusion, he probably did not have the opportunity to read the definitions of "Scheduled Air Carrier." *Id.* at 293-94. Moreover, the Court held that "the manner of sale negated any possibility of such notice." *Id.*

were construed against the insurer. Based upon the frequency with which the opinion mentioned Steven's reasonable expectations, it would seem that reasonable expectations, rather than the ambiguity itself, was the primary trigger for construing ambiguities against the insurer.¹²² It was up to *Gray*¹²³ to sever the reasonable expectations doctrine from *Steven*'s hybrid form of construing ambiguities against the insurer and refine it into the final form of the reasonable expectations doctrine in California.

In 1966, *Gray v. Zurich* established the reasonable expectations doctrine. Zurich Insurance Company was sued for its failure to defend one of its policyholders in a third-party suit alleging intentional assault.¹²⁴ The relevant issue facing the court involved the insurer's duty to defend its policyholder from such a suit.¹²⁵ In addressing the scope of the insurer's duty, the California Supreme Court adopted the reasonable expectations doctrine. The court effectively removed adhesion contracts from the sphere of traditional contract interpretation by these words:

[A] contract entered into between two parties of unequal bargaining strength, expressed in the language of a standardized contract, written by the more powerful bargainer to meet its own needs, and offered to the weaker party on a "take it or leave it basis" carries some consequences that extend beyond orthodox implications. Obligations arising from such a contract inure not alone from the consensual transaction but from the relationship of the parties.¹²⁶

Through Justice Tobriner, the *Gray* Court further opined that the adhesion doctrine applied to insurance contracts and as such mandated a retreat from the practice of "look[ing] to the words of [the] contract to find the meaning which the parties expected from them."¹²⁷ Thus, the court held that the insurance policy, which is a contract of adhesion would be construed in light of the insured's reasonable expectations of coverage.¹²⁸ The *Gray* reasonable expectations doctrine drew scrutiny, but inspired many scholars, most notably Judge Keeton.

122. It would appear that the California Supreme Court was leaning towards the establishment of a doctrine which honored reasonable expectations even in the absence of an ambiguity in the contract. California later adopted a version of the reasonable expectations doctrine which is conditioned upon a finding of ambiguity in the contract. See discussion *infra* part II.B.1.

123. *Gray* is discussed in detail *infra* in Part II.

124. *Gray v. Zurich Ins. Co.*, 419 P.2d 168, 169 (Cal. 1966).

125. *Id.*

126. *Id.* at 171.

127. *Id.*

128. *Id.* at 171-72. *Gray* and the reasonable expectations doctrine will be treated more fully *infra* Part II.

4. The Keeton Theorem

By 1970, courts in various jurisdictions recognized a need to treat adhesion contracts differently. Confusion developed as judges struggled with diverse rationales¹²⁹ in hopes of doing as little damage to traditional contract principles while zealously implementing some equitable relief for weaker parties in insurance coverage disputes.¹³⁰ Professor (now Judge) Keeton's article, *Insurance Rights at Variance with Policy Provisions*,¹³¹ granted a scholastic imprimatur upon the confusing array of court created rationales by uniting them under a common rubric.¹³² Judge Keeton observed that the many doctrines used by the courts to provide benefits which were apparently beyond those technically provided for by the policy were governed by a common principle.¹³³ This broad principle, already being applied *de facto* by the courts, was the doctrine of honoring reasonable expectations. Keeton translated the new doctrine as follows: "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."¹³⁴

Ironically, Keeton's enunciation of the rule is open to two possible interpretations.¹³⁵ Professor Rahdert recognized these two distinct interpretations as either the "strong form"¹³⁶ or the "weak form."¹³⁷

Using the strong form reading, the courts are to read the policy as a whole, and simply determine whether a reasonable consumer would expect coverage under the facts of the case. If the court determines that such an expectation was reasonable, then coverage is provided. This would be true

129. Keeton named (1) strained forms of *contra proferentem*, (2) implicit references to reasonable expectations under the general rubric of construing ambiguities against the drafter (citing *Steven* discussed *supra*), (3) delivery of markedly different coverage from that applied for, and (4) renewals granting lesser scope of coverage as the most popular rationales proposed by the courts. Keeton, *supra* note 21, at 969-73.

130. Which led Professor Keeton to observe: "[T]he favorite generalization advanced by outside observers to explain a judgement against an insurance company at variance with policy provisions is the ambivalent, suggestive, and wholly unsatisfactory aphorism: 'It's an insurance case.'" *Id.* at 961.

131. Keeton, *supra* note 21.

132. See Mayhew, *supra* note 12, at 276-77; Rahdert, *supra* note 115, at 333-34; Karen K. Shinevar, Comment, *A Reasonable Approach to the Doctrine of Reasonable Expectations as Applied to Insurance Contracts*, 13 MICH. J.L. REF. 603, 611-12 (1980).

133. Keeton, *supra* note 21, at 967.

134. *Id.*

135. Rahdert, *supra* note 115, at 335.

136. *Id.* Under the strong form, the entire contract is analyzed and if it is sufficient under the circumstances to give rise to reasonable expectations of coverage, the insured will prevail on the coverage dispute.

137. *Id.* at 335-36. Professor Rahdert indicates that this reading is a variant of *contra proferentem* differing only in the weak formulation's allowance for the "insured's circumstances and lack of sophistication to be taken into account." *Id.* at 336.

even if a technical reading of the policy would negate coverage. Consequently, an insured could be covered even if he admitted he had never read the policy¹³⁸ provided that extrinsic sources¹³⁹ created expectations of coverage which a person in the insured's position would expect under like circumstances.¹⁴⁰

Six basic application principles derive from the strong Keeton formula: (1) Courts may determine the existence of reasonable expectations through extrinsic circumstances¹⁴¹ or through the contract language. (2) The court will interpret the insurance contract language from a reasonable layperson's point of view; not through the understanding of a "sophisticated underwriter."¹⁴² (3) Since under the "strong form" there is no mandatory requirement that the insured actually read the policy,¹⁴³ *the doctrine will apply even in the absence of any ambiguity in the contract language.*¹⁴⁴ (4) The insurer escapes liability if: (a) the insurer shows an unreasonable failure on the policyholder's part to read the unusual but clearly worded contract terms or (b) the insurer can prove that it called the insured's attention to the express qualification when the agreement was entered into.¹⁴⁵ (5) Even when express but ambiguous policy provisions are brought to the insured's attention, such provisions will not be enforced if they are

138. "[W]hether the policyholder sufficiently examined the policy is only one part of the overall calculation of the objective reasonableness of his expectations." Keeton, *supra* note 21, at 967.

139. Keeton did not address what extrinsic circumstances give rise to reasonable expectations. Rahdert, *supra* note 115, at 335. Professor Rahdert alludes to what he calls the "good hands" phenomenon arising out of present day insurers' advertising activities. *Id.* at 343. These advertisements foster certain expectations in policyholders that they would be covered for almost any contingency and under the circumstances, Rahdert posits, the expectations are reasonable. *Id.* The California Supreme Court, however, noted that extrinsic evidence required to prove the intent of the parties should include testimony regarding the "circumstances surrounding the agreement," such as the object for and content of the writing pertinent to enabling the court to analyze the exact situation when the agreement was reached. *Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 645 (Cal. 1968).

140. For cases involving court-mandated insurance coverage even when express limiting provisions arguable excluded the type of injury suffered by the plaintiff, see generally *Kievit v. Loyal Protective Life Ins. Co.*, 170 A.2d 22, 30 (N.J. 1961); *Corgatelli v. Global Life & Accident Ins. Co.*, 533 P.2d 737 (Idaho 1975). Note the dissent of Justice Donaldson in *Corgatelli* where he criticizes adoption of the reasonable expectations doctrine *sans*-ambiguity. *Corgatelli*, 533 P.2d at 742-43.

141. See *supra* note 139 and accompanying text.

142. Keeton, *supra* note 21, at 967.

143. See *supra* note 138 and accompanying text.

144. "[N]ot only should a policyholder's reasonable expectations be honored in the face of difficult and technical language, but those expectations should prevail as well when the language of an unusual provision is clearly understandable. . ." Keeton, *supra* note 21, at 968. The rationale provided by Keeton for abandoning the requirement of ambiguity involved a disapproving view of insurance marketing techniques and the use of convoluted policy language which virtually negated any possibility that the insured would carefully read the policy (if he even reads it at all). *Id.* By logical inference, the clarity or ambiguity of the language is irrelevant since the language will most likely not be read.

145. *Id.*

unconscionable ("mislead the great majority of policyholders").¹⁴⁶ (6) A particular policyholder's knowledge about limiting provisions which are not generally known by a majority of policyholders does not negate coverage under the doctrine.¹⁴⁷ The strong Keeton formula was predated and established in California law by the principal holding of *Gray v. Zurich*.¹⁴⁸

The "weak form" of the Keeton formula was the version adopted by most of the jurisdictions applying the doctrine of reasonable expectations. The weak form reasonable expectations rule obtains from a looser reading of the term "painstaking analysis" in Keeton's pronouncement of the rule.¹⁴⁹ Professor Rahdert proposed this translation of the weak form of the reasonable expectations principle:

[E]xpectation[s] formed from a cursory reading of the policy, though technically wrong, may yet be reasonable, and if so should be honored; but . . . expectations derived from sources other than at least a cursory review of the policy language are not reasonable, and should not be honored in the face of unambiguous contrary policy language.¹⁵⁰

The weak form is, in effect, a variant of *contra proferentem* but requires construction against the insurer only when the language of the contract is sufficiently ambiguous so as to create a reasonable expectation of coverage.¹⁵¹ In the absence of any ambiguity, the terms of the insurance policy will be interpreted according to their plain meaning.¹⁵²

Keeton advanced several rationales for the dramatic departure from established contracts dogma in the insurance field. A survey of the justifications include: (1) Countering the threat of overreaching by insurance companies correlative to the unequal bargaining positions of the parties,¹⁵³

146. *Id.* at 968-69.

147. "If the enforcement of a policy provision would defeat the reasonable expectations of the great majority of policyholders to whose claims it is relevant, it will not be enforced even against those who know of its restrictive terms." *Id.* at 974. Although the element of unfair surprise is negated, the reasonable expectations doctrine is a corollary of the principle disallowing unconscionable advantage. *Id.* Prohibition of unconscionable advantage requires uniformity of application in the treatment of the ills brought about by the mass contract. *Id.* Keeton reasoned that disallowing coverage in such an instance would, in effect, provide greater protection to the ignorant policyholders for the same amount of money. *Id.*

148. *See infra* part II.A.2.

149. Rahdert, *supra* note 115, at 335.

150. *Id.*

151. *Id.* at 336. This reading can be easily reconciled with the rule proposed in *Steven* discussed *supra*. Tobriner's opinion in *Steven* implied a yet undefined role for reasonableness but predicated its holding on an impure form of *contra proferentem*.

152. *See Fritz v. Metropolitan Life Ins. Co.*, 123 P.2d 622, 626 (Cal. Ct. App. 2 Dist. 1942).

153. Keeton, *supra* note 21, at 964. Because the insurer controls the contract language, terms unfavorable to the weaker party can easily be incorporated into the agreement by the insurer. This is exacerbated by the fact that the insured party is faced with the classic adhesion dilemma—he can take the terms as drafted or leave it. Although Judge Keeton used this rationale to explain the doctrine of disallowing unconscionable advantage, he later asserts that the principle of honoring reasonable expectations is closely related to disallowing unconsciona-

(2) the utility and pervasiveness of judge-made regulatory measures governing adhesion contracts;¹⁵⁴ (3) providing incentives for insurers to clarify language and bring limiting provisions to the attention of insureds;¹⁵⁵ (4) the superiority of the reasonable expectations doctrine as opposed to straining *contra proferentem* in the manner then being applied by the courts;¹⁵⁶ (5) filling in the gaps unprotected by the traditional mistake doctrines of estoppel and unconscionability.¹⁵⁷

5. Inter-Jurisdictional Acceptance of the Reasonable Expectations Doctrine

The concept of honoring reasonable expectations spread to jurisdictions which had not already applied the principle in one form or another. A thorough 1990 study by Professor Roger Henderson¹⁵⁸ catalogued sixteen states applying the concept in different forms, ten of which hinted possibly at adopting the "strong" Keeton formulation.¹⁵⁹ The remaining six states appeared to embrace the theory although there were indications that their laws were still in flux.¹⁶⁰ Nine states expressly¹⁶¹ declined to apply the doctrine, out of which one state expressed definite non-compliance,¹⁶² and

ble advantages. *Id.* at 974. See Rahdert, *supra* note 115, at 338-42 (explaining the unconscionability rationale). Rahdert observes three basic justifications for setting insurance contracts apart from "ordinary" contracts: (1) adhesion, (2) unconscionability, and (3) estoppel. *Id.* at 336-45.

154. State regulation of the insurance industry is relatively weak, and even when regulation of contract language exists, insurers can merely accept or reject the same words proposed by the insurer verbatim or with moderate alterations. Keeton, *supra* note 21, at 967. "The history of insurance cases . . . is . . . replete with instances of judicially created regulatory doctrines. Court-made doctrines are particularly pervasive in the area of rights at variance." *Id.* at 964 n.4. Professor Rahdert similarly noted the ineffectiveness of administrative regulatory entities and legislatures to control abuse of insurance contract fine print. Rahdert, *supra* note 115, at 341-42.

155. Keeton is careful to explain that his proposed doctrine affords the insurer an opportunity to bring explicit and unambiguous contract limitations to the attention of the insured and negate surprise. Keeton, *supra* note 21 at 968.

156. The earlier use of *contra proferentem* exhibited a tendency of going beyond the mandates of the venerable doctrine resulting in its perversion through fusion with otherwise distinct principles like unconscionability (basis for decision in *Henningsen* treated *supra* part I.C.2.) and detrimental reliance. See *Tomerlin v. Canadian Indem. Co.*, 394 P.2d 571, 576-78 (Cal. 1964). Not only are the interests of doctrinal purity offended, but such applications result in confusion as well as notions of uncontrolled judicial activism undermining the credibility of the courts. Keeton also noticed a disturbing tendency of the courts to create ambiguities where none existed in order to implement equity and imbue the result contradictory to traditional precepts with quasi-legitimacy. Keeton, *supra* note 21, at 972.

157. Keeton, *supra* note 21, at 973-77.

158. Henderson, *supra* note 16.

159. These were: Alabama, Alaska, Arizona, California, Iowa, Montana, Nebraska, Nevada, New Hampshire, and New Jersey. *Id.* at 828.

160. Pennsylvania, Hawaii, North Carolina, Rhode Island, Delaware, and Colorado. *Id.* at 829-34.

161. Idaho, Illinois, Massachusetts, North Dakota, Ohio, Oklahoma, South Carolina, Washington, and Wyoming. *Id.* at 834-35 n.68.

162. Idaho. *Id.* at 834.

one state expressed interest.¹⁶³ Henderson concluded that the concept of honoring reasonable expectations was no longer an “emerging doctrine” anymore, but had come to its own as a full-fledged and flourishing doctrine¹⁶⁴ with a substantial probability of expanding its jurisdictional reach further.¹⁶⁵ Henderson, who identified California as a “strong” Keeton state was right.¹⁶⁶ However, the California rule which predated the Keeton article also embraced the “weak” Keeton formula. This was established in California law by the alternative holding in *Gray v. Zurich*.¹⁶⁷

II. APPLICATION OF THE REASONABLE EXPECTATIONS DOCTRINE: *GRAY V. ZURICH*, ITS PROGENY, AND THE TRIUMPH OF SUBSTANCE OVER FORM

A. *The Gray Court Establishes the Primacy of the Reasonable Expectations Doctrine in California*

Although courts have long followed the basic precept that they would look to the words of the contract to find the meaning which the parties expected from them, they have also applied the doctrine of the adhesion contract to insurance policies, holding that in view of the disparate bargaining status of the parties we must ascertain the meaning of the contract which the insured would reasonably expect.¹⁶⁸

With these words, *Gray v. Zurich* established the primacy of the reasonable expectations doctrine in California’s law governing the interpretation of insurance contracts during the last two decades.¹⁶⁹ The basic principle espoused by *Gray* continued the *Steven* court’s efforts at distancing insurance contract interpretation rules from orthodox contract law precepts, and effectively severed insurance policies from traditional contract construction concepts.

163. Massachusetts. *Id.* at 835.

164. *Id.* at 834. Henderson differentiated the “strong” and “weak” forms of Keeton’s reasonable expectations doctrine in this manner: the weak form, requiring an ambiguity for application is an extension of *contra proferentem* and is thus a *mere rule* of contract construction; the strong emanation of the Keeton formula represents a distinct and legitimate *doctrine*. *Id.* at 827.

165. *Id.* at 834. *Contra* Rahdert, *supra* note 115, at 324. A mere six years earlier, Professor Rahdert observed that the initial appeal of the doctrine was beginning to fade.

166. *See supra* text accompanying note 148.

167. The *Gray* opinion initially analyzed the location and obtuseness of the limiting provision in the insurance policy and held that such gave rise to reasonable expectations of coverage. In the alternative, the court held that the language of the limiting provision was itself ambiguous and as such should be construed against the insurer in light of the reasonable expectations of the insured. The latter holding was adopted subsequently by the California Supreme Court. *See infra* part II.B.1.

168. *Gray*, 419 P.2d at 171-72 (citations omitted).

169. This language (reflecting a “strong” Keeton formulation) was later discredited by the California Supreme Court in *Herzog v. National Am. Ins. Co.*, 465 P.2d 841 (Cal. 1970). *Herzog* is treated briefly *infra* parts II.B.1. & II.B.3.

Although the decision was not universally lauded,¹⁷⁰ *Gray's* reasonable expectations doctrine brought order to insurance contract interpretation in California¹⁷¹ by proposing a single dominant principle as opposed to the wide array of axioms previously used by the courts.¹⁷² *Gray* was seen as a landmark case for two reasons: (1) it set a new standard for insurance contract interpretation, and (2) it delineated the scope of an insurer's duty to defend.¹⁷³ The influence of *Gray* was extended beyond application to insurance policy coverage disputes in California¹⁷⁴ and has been cited extensively in other jurisdictions.¹⁷⁵

1. The Facts Facing the *Gray* Court

The dispute in *Gray* arose out of a fist fight between Dr. Vernon Gray and one John R. Jones which resulted from a near collision of their two vehicles.¹⁷⁶ Jones sued for assault while Gray maintained he acted in self-defense.¹⁷⁷ Gray was insured by the Zurich Insurance Company which under a "Comprehensive Personal Liability Endorsement" promised coverage for sums which Gray would become legally obligated to pay as damages resulting from bodily injury or property damages and provided for a legal

170. See e.g., Mayhew, *supra* note 12, at 276, 281 (describing *Gray* holding as "illogical" and based upon "faulty reasoning").

171. Many critics observe certain applications of the reasonable expectations doctrine as resulting in unpredictability and confusion. See *id.* at 269, 270; Rahdert, *supra* note 115, at 329, 371.

172. *Gray* was decided four years before Keeton's seminal article (discussed *supra* in part I.C.4.) proposed to lend legitimacy to disparate court rationales.

173. Cf. *Duty to Defend Made Absolute*, *supra* note 4, at 1335 (noting that the scope of the duty to defend was "not clearly articulated"). The present work does not treat the duty to defend issue in great detail but addresses the issue only collaterally to the reasonable expectations doctrine. For detailed analyses on *Gray's* influence and the duty to defend issue, see Sampson A. Brown & John L. Romaker, Cumis, *Conflicts and the Civil Code: Section 2860 Changes Little*, 25 CAL. W. L. REV. 45 (1988); Donald F. Farbstein & Francis J. Stillman, *Insurance for the Commission of Intentional Torts*, 20 HASTINGS L.J. 1219 (1969). See generally *Duty to Defend Made Absolute*, *supra* note 4.

174. See e.g., Richard C. Maxwell, *The Due-on-Sale Clause: Restraints on Alienation and Adhesion Theory in California* 28 UCLA L. REV. 197 (1980) (acceleration of secured loans upon sale of real property serving as security); James R. McCall, *Due Process and Consumer Protection: Concepts and Realities in Procedure and Substance—Repossession and Adhesion Contract Issues*, 26 HASTINGS L. J. 383 (1974) (oppressive repossession clauses); Barbara B. Rintala, *California's Anti-Deficiency Legislation and Suretyship Law: The Transversion of Protective Statutory Schemes*, 17 UCLA L. REV. 245 (1969) (anti-deficiency and suretyship law); Edward L. Rubin, *Toward a General Theory of Waiver*, 28 UCLA L. REV. 478 (1981) (waiver); Charles F. Wilkinson & John M. Volkman, *Judicial Review of Indian Treaty Abrogation: "As Long As Water Flows or Grass Grows Upon the Earth"—How Long A Time Is That?*, 63 CAL. L. REV. 601 (1975) (Native American treaty rights); Elizabeth P. Allor, Note, *Keating v. Superior Court: Oppressive [sic] Arbitration Clauses in Adhesion Contracts*, 71 CAL. L. REV. 1239 (1983) (application to arbitration clauses in relation to class actions).

175. See e.g., *supra* note 13.

176. *Gray*, 419 P.2d at 170 n.1.

177. *Id.* Apparently, after the near mishap Jones approached Gray's automobile and opened its door; Gray then got up and struck Jones. *Id.*

defense upon such allegations against Gray even if such charges were "groundless, false, or fraudulent."¹⁷⁸ Under exclusion "c" of the policy, Zurich excepted coverage for "bodily injury or property damages caused intentionally by . . . the insured."¹⁷⁹

Gray requested Zurich to defend him and Zurich refused to do so on the basis of exclusion "c."¹⁸⁰ Gray paid for his own defense and lost the case.¹⁸¹ However, the jury did not award punitive damages to Jones.¹⁸² Gray sued Zurich for breach of its contractual duty to defend him.¹⁸³ Zurich responded by disclaiming liability on three grounds: (1) On its face, the Jones complaint did not allege any basis for which Zurich provided coverage since the policy specifically excluded bodily injuries caused by the insured's intentional acts, (2) providing coverage would violate public policy, and (3) if Zurich defended, it would be embroiled in a conflict of interest.¹⁸⁴

2. The Two Alternate Theories for Recovery Proposed by the *Gray* Court

The *Gray* Court found coverage under two alternative analyses. The first inquiry relied upon location and conspicuousness of the limiting provisions as the crucial points of analysis. The second test stressed ambiguity.

Initially, the opinion did not seem to place primary significance on ambiguity, merely noting that the intentional acts exclusion was not "conspicuous, plain, and clear";¹⁸⁵ the exclusion occupied an inconspicuous location in the policy; contained obscure language and was scored in fine print and it followed language purporting to provide broad protection, which

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

182. *Id.* This fact is noteworthy since the complaint against Gray alleged intentional conduct and only compensatory damages were awarded by the jury. As discussed *infra*, this tends to bolster the court's observation that the reasonable layperson equates "intentional" conduct with acts having an element of ill will.

183. *Id.*

184. *Id.* at 170-71. The discussion in this study relates to the first contention only. The public policy and conflict of interest arguments are best left to other works. See Brown & Romaker, *supra* note 173 (discussing public policy and conflict of interest issues surrounding the insurer's duty to defend in California).

185. *Id.* at 174 (citing *Steven*).

gave rise to a reasonable expectation of coverage.¹⁸⁶ Since the insured had a reasonable expectation of coverage, his expectation was to be honored.¹⁸⁷

In the alternative,¹⁸⁸ the text's emphasis then shifted to highlight an observation that the language of the exclusionary clause itself was ambiguous since the layman could reasonably interpret the term "intentional" to mean "planned" or "wilful" rather than the tort notion of intent.¹⁸⁹ As a result, the court noted that:

The insured is unhappily surrounded by concentric circles of uncertainty: the first, the unascertainable nature of the insurer's duty to defend; the second, the unknown effect of the provision that the insurer must defend even a groundless, false, or fraudulent claim; the third, the uncertain extent of the indemnification coverage.¹⁹⁰

The court then opined that such uncertainties must be resolved in favor of the insured and the language interpreted "according to the layman's reasonable expectations."¹⁹¹ This alternate analysis emphasized the consumer's reasonable expectations based upon the existence of an ambiguity in the insurance contract. Resolving uncertainties to protect the consumer's reasonable expectations became the cornerstone of California insurance law.

3. The Factors Affecting Expectations

The broad coverage clauses relating to the insurer's promise to defend and indemnify the insured were held out in an endorsement purporting to be a "*Comprehensive Personal Liability Policy*" and expressly provided for the contingency of false, groundless, or fraudulent suits.¹⁹² This created a

186. *Id.* at 173-74. This rationale would lead one to conclude that an ambiguity is not really necessary for the doctrine of reasonable expectations to kick in. Both *Steven* and *Gray* flirted with this rationale, but as the subsequent case law will reveal *infra*, the California Supreme Court would later adopt the second rationale herein which would require an ambiguity to exist before honoring the insured's reasonable expectations.

187. *Id.* at 171 ("Since the policy sets forth the duty to defend . . . and since the insurer attempts to avoid it only by an unclear exclusionary clause, the insured would reasonably expect, and is legally entitled to, such protection.").

188. It is important to note that the *Gray* court made its primary holding based solely upon the reasonable expectations of the insured. *Id.* at 171-72. However, the *Gray* court itself emphasized the secondary importance of the remainder of the opinion as "an alternative but secondary ground for our ruling." *Id.* at 171.

189. *Id.* at 174.

190. *Id.*

191. *Id.* at 174-75. On this note, Justice Tobriner defined the role of reasonable expectations which he left unspecified in *Steven*. Although similar to traditional *contra proferentem* because of the notion of construing ambiguities against the insurer, the rule here specified by the court is remarkably different for injecting the requirement that the contract terms be read in accordance with reasonable expectations. Previous to *Steven* and *Gray*, construing ambiguities against the insurer meant a *per se* determination against the insurer regardless of reasonable expectations. See *Gaunt*, 160 F.2d at 601 (holding that ambiguities be interpreted colloquially in the manner of the person unacquainted with the "niceties" of insurance).

192. *Gray*, 419 P.2d at 173.

reasonable expectation in *Gray* (or any layman for that matter) that the insurer would defend any suit whether resulting from intentional, negligent, or non-intentional conduct.¹⁹³ Furthermore, the obligation to defend was found to be ambiguous since the condition giving rise to such a duty (determination of non-intentional conduct) could only be resolved at the end of the lawsuit in which the insurer would have had to defend the insured.¹⁹⁴ Because such expectations would have reasonably developed under the circumstances, and the scope of the duty was ill-defined, it was incumbent upon Zurich to make any limitations affecting those expectations, as well as the scope of the duty clear and conspicuous, or risk an interpretation in conformance with the insured's reasonable expectations.¹⁹⁵

The court carefully declared that only expectations which are reasonable are to be rewarded.¹⁹⁶ Furthermore, the opinion clearly limited the insured's reasonable expectations to those embracing the nature and kind of damage insured against.¹⁹⁷ Since then, Courts have found many insured's expectations to be unreasonable.¹⁹⁸ For example: A homeowner's policy which includes coverage of auto-related accidents which occur on ways adjoining the insured's property cannot propagate a reasonable expectation of coverage for an automobile accident occurring away from the premises in the same manner that an automobile insurance policy would.¹⁹⁹

Through *Gray*, the California Supreme Court manifested Justice Tobriner's sensitivity to the plight of the consumer who increasingly entered into standardized agreements with more economically powerful entities.²⁰⁰

193. *Id.* at 174.

194. *Id.* at 173. "[T]he insured would reasonably expect a defense by the insurer in all personal injury actions against him. If he is required to finance his own defense and then, only if successful, hold the insurer to its promise by means of a second suit for reimbursement, we defeat the basic reason for the purchase of insurance." *Id.* at 178.

195. *Id.* at 174 (citing *Steven*).

196. *Id.* at 175.

197. *Id.*

198. The "nature" limitation applies to the type of damage insured against. For example, where a policy promises protection for bodily injury, property damage, and personal injury, lawsuits seeking these types of damages are presumptively covered. The "kind" limitation applies to the type of insurance provided, i.e., Business Insurance, Homeowners Insurance, Auto Insurance, Errors and Omissions Insurance. See discussion of *Herzog v. Nat'l. Am. Ins. Co.* *infra* at Part II.B.3.

199. These were the facts controlling the decision in *Herzog*, 465 P.2d 841 (Cal. 1970).

200. *Gray*, 419 P.2d at 171-72. As Justice Tobriner later explained in his *Retrospect* essay, the law had to make allowances for the demise of freely bargained contracts brought on by the mass standardized contract in today's "standardized society." Tobriner, *supra* note 94, at 7. The more powerful party, who is more able to take the loss, controls the language of the policy thus relegating the consumer to a position of complete dependency. *Id.* Tobriner compared the doctrine in *Gray* with the law governing products liability and submitted that just as the reasonable expectations of the buyer for the safety of the product are honored, so too should the reasonable expectations of the policyholder about coverage under the policy be respected. *Id.* Kessler noted the importance of standard contracts to business enterprises as: (1) a method of controlling the effects of the "irrational factor" in litigation and (2) controlling and regulating the flow of goods from manufacturer, to distributor, all the way to the consumer. Kessler, *supra* note 59, at 632. Standardized contracts reflect society's need for predictability in the judicial

Gray's quotations from Isaacs, and Pound²⁰¹ revealed the tendency of standardized contracts to create status (not contractual) relationships directly opposing freedom of contract, thus justifying removal of such adhesive agreements from traditional contracts law.²⁰² The end result was a status-based approach to determine the responsibilities of the insurance company.²⁰³ If the status relationship is found to be adhesive, the contract is interpreted based upon what the weaker party reasonably expects "according to the enterpriser's 'calling.'"²⁰⁴

The *Gray* Court made it clear that insurance contracts were contracts of adhesion which were to be *construed differently from other contracts in California*. The opinion was a signal to California judges that they were to protect the reasonable expectations of the insurance consumer.

The California Supreme Court developed two ways for the courts below to protect the expectations of the insurance policyholder. One embodied a strong formulation of the reasonable expectations doctrine, providing that if the reasonable consumer would expect coverage—he got it. The other was a weaker version of the reasonable expectations doctrine which protected the consumer's reasonable expectations anytime the policy proved ambiguous. The latter tool became the dominant law of California.²⁰⁵

B. Post-Gray Application of the Reasonable Expectations Doctrine

The reasonable expectations doctrine first pronounced by *Gray v. Zurich* evolved over subsequent years into a primary interpretive doctrine governing judicial construction of all insurance policies. The doctrine's scope was refined through subsequent court decisions. Such refinement gave rise to the following operative requirements: (1) The contract language must give rise to an ambiguity before the doctrine can be invoked, (2) the expectations derived from such ambiguities must be reasonable, and (3) the doctrine does not apply in cases involving "sophisticated insureds" who bargain for particularized contract terms.

process. *Id.* See Keeton, *supra* note 21, at 963 (recognizing the danger of lopsided agreements resulting in unconscionable overreaching by the stronger bargaining party).

201. *Gray*, 419 P.2d at 171 n.6.

202. The principle of freedom of contract was instrumental in tearing down the old feudal order governed by status relationships. Kessler, *supra* note 59, at 641. Because the propensity of free-rein capitalism has been towards the formation of monopolies, the playing field had to be leveled, so to speak, in order to protect consumers from the oppression of the business establishment wielding powers even more awesome than the old feudal lords. *Id.* at 640-41. Because of his status, the consumer in a society dominated by big business, does not have the power to negotiate or bargain with the larger entity whose chief weapon is the standardized contract. The courts returned to status-based classifications precisely to protect the consumer's freedom of contract. *Id.* at 640.

203. *Id.* at 641. See Tobriner, *supra* note 94, at 8.

204. *Gray*, 419 P.2d at 172 (quoting Kessler, *supra* note 59, at 637).

205. Implied by the holding in *Herzog*, 465 P.2d at 844.

1. There Must Be An Ambiguity Before the Contra-Insurer Rules Apply

The purpose of judicial construction of contract terms is to ascertain the mutual expectation of the parties.²⁰⁶ In the construction of insurance policies, the crucial analysis involves determining ambiguity in the contract.²⁰⁷ An insurance contract provision is ambiguous if it is capable of two or more reasonable interpretations.²⁰⁸ But if there is no ambiguity in the contract provisions, the contract terms will be enforced exactly as expressed.²⁰⁹ Absent extrinsic evidence, interpretation of contract terms is a question of law.²¹⁰

The interpretation rules which require construction against the insurer do not apply in the absence of ambiguity. The First District Court of Appeals stated thus:

[The] rule requiring all uncertainties, ambiguities, inconsistencies and doubtful provisions to be resolved against the insurer and in favor of the insured is subject to the important limitation . . . that it is applicable only when the policy actually presents such uncertainty, ambiguity, inconsistency or doubt. In the absence thereof, the courts . . . give effect to the contract of insurance as executed by the parties.²¹¹

In *Herzog v. National American Insurance Company*, the California Supreme Court implicitly adopted the alternative holding of *Gray* which required the presence of an ambiguity in the contract provisions before the court resorts to an interpretation which takes account of the reasonable expectations of the insured.²¹² The homeowner's insurance policy provision in *Herzog* expressly excluded coverage for auto accidents occurring "away from the [policyholder's] premises or the ways immediately adjoining."²¹³

206. See RESTATEMENT (SECOND) OF CONTRACTS § 201 cmt. c (1979).

207. *Producers Dairy Delivery Co. v. Sentry Ins. Co.*, 718 P.2d at 924-25. Ascertainment of the ambiguity entails an analysis of extrinsic evidence pertaining to the mutual intent of the parties. BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES §101[b] (4th ed. 1991). See *Delta Dynamics, Inc. v. Arioto*, 446 P.2d 785, 786 (Cal. 1968) (stating that admissibility of extrinsic evidence is tested by its tendency to show a reasonable interpretation of the language in contention).

208. *Aim Insurance Co. v. Culcasi*, 280 Cal. Rptr. at 771.

209. 2 GEORGE J. COUCH, CYCLOPEDIA OF INSURANCE LAW § 15:10 (Ronald A. Anderson ed., Mark S. Rhodes rev. vol. 2d ed. 1984).

210. *Aerojet-General Corp. v. San Mateo County Superior Court (Cheshire & Cos.)*, 257 Cal. Rptr. 621, 625 (Cal. Ct. App. 1 Dist. 1989), *reh'g denied*, 258 Cal. Rptr. 684 (Cal. Ct. App. 1 Dist. 1989), *and review denied*, 1989 Cal. LEXIS 4071 (Cal. 1989). See RESTATEMENT (SECOND) OF CONTRACTS § 212(2) cmt. d (1979).

211. *Jarrett v. Allstate Ins. Co.*, 26 Cal. Rptr. 231, 234 (Cal. Ct. App. 1 Dist. 1962).

212. This formulation predated and accords with the "weak Keeton" reasonable expectations doctrine. See *supra* part I.C.4.

213. *Herzog*, 465 P.2d at 842.

The court held that although the policy language may have been “imprecise,” the intent to geographically limit coverage was clear enough to provide a rational definition under the circumstances.²¹⁴ Provisions found to be ambiguous under a certain set of facts may not be ambiguous in other situations.²¹⁵ As a result, the provision in question was not construed against the insurer.²¹⁶

2. Clearly Drafted Insurance Policy Language Obviates the Need for a Reasonable Expectations Analysis

The *Gray* rationale imposed a duty upon insurers to draft policy language with great clarity in order to escape the consequences of the reasonable expectations doctrine. For example, in *Insurance Company of North America v. Sam Harris Construction Company, Inc.*,²¹⁷ the insured possessed a liability and indemnity policy which purported to cover property damage and bodily injury arising out of maintenance of its aircraft.²¹⁸ Relevant “policy period” language indicated that the policy covered “accidents or occurrences” transpiring during the policy period listed as September 3, 1971 to July 1, 1972.²¹⁹ The insured sold the aircraft and canceled the policy, but was sued thereafter by the buyer for negligent maintenance of the aircraft when the plane crashed after the sale.²²⁰ The insured requested the insurer to defend against the claim.²²¹ The insurer sued the insured for declaratory relief to determine its rights and liabilities under the policy.²²²

The insurance company asserted non-coverage because the event causing the injury happened outside the covered policy period. The court construed the term “occurrences or accidents” to be ambiguous.²²³ Interpreting the terms in accordance with the insured’s reasonable expectations, the court determined that the provision “occurrences or accidents” signified a choice of alternatives as opposed to a synonymous relationship.²²⁴ The high court then contended that it was reasonable for the insured to assume that the

214. *Id.* at 844.

215. *Id.*

216. *Id.* at 843. See II.B.3 *infra*.

217. 583 P.2d 1335 (Cal. 1978).

218. *Id.* at 1336.

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.*

223. *Id.* at 1336-37.

224. *Id.* at 1336-37. Thus, the policy would cover either (1) accidents, as a separate category of events from occurrences, or (2) occurrences which entailed a whole different set of incidents. The court opposed the insurer’s construction equating “occurrences or accidents” to define a single event giving immediate rise to the injury for which the claim related. *Id.*

policy covered "occurrences"²²⁵ as well as "accidents" during the policy period.²²⁶ The negligent maintenance could reasonably be regarded as an "occurrence" under the policy terms and the negligent act occurred during the relevant period.²²⁷ To protect the consumer's reasonable expectations, the court held that the insurer was obligated to defend the suit.²²⁸

The opinion noted that the same terminology was held unambiguous in two previous cases.²²⁹ However, those cases were distinguished from the present case because the insurers in the earlier cases were careful to define "occurrence" as "an accident causing injury during the policy period."²³⁰ Encouraging clarity in insurance contract language remained one of the important policies supported by the reasonable expectations doctrine.²³¹

3. The Expectations Must Be Reasonable

California's hybrid formula retained the requirement that an ambiguity exist before the contra-insurer rule applies,²³² but the policy is then construed in light of the insured's reasonable expectations.²³³ The additional requirement that the policyholder have reasonable expectations that arise because of ambiguous terms, strikes a balance between traditional *contra proferentem*²³⁴ and the "strong" Keeton reasonable expectations doctrine.²³⁵ As Keeton noted:

[I]t might be objected that resolving ambiguities against the insurer would sometimes be more favorable to the insured than would honoring reasonable expectations. For example, even though the contractual language was ambiguous, there might have been no expectation at all, or the expectation

225. The court used the Webster's definition for "occurrence" as "the general word for anything that happens or takes place." *Id.* at 1337.

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*, at 1336. The cases were: *Remmer v. Glens Falls Indem. Co.*, 295 P.2d 19 (Cal. 1956) and *Tijsselling v. General Acc. & Life Assur. Corp.*, 127 Cal. Rptr. 681 (Cal. Ct. App. 1 Dist. 1976). *Sam Harris*, 583 P.2d at 1336.

230. *Sam Harris*, 583 P.2d at 1336.

231. Justice Tobriner so picturesquely stated as a prologue to his opinion in *Bareno v. Employers Life Insurance Co.* that: "On countless occasions we have inveighed against the careless draftsmanship of documents of insurance and have decried the evil social consequences that flow from lack of clarity. We have emphasized that the uncertain clause leaves in its murky wake not only the disillusioned insured and the protesting insurer but also the anguished court." 500 P.2d at 890 (citations omitted).

232. *Jarrett v. Allstate Ins. Co.*, 26 Cal. Rptr. at 234.

233. *Sam Harris*, 583 P.2d at 1336; 2 COUCH, *supra* note 209, § 15:16.

234. *Contra proferentem* had developed from a last resort interpretational device to a *per se* rule requiring construction against the insurer. Miller, *supra* note 12, at 1852.

235. No ambiguity is required under a strong Keeton analysis. See *supra* note 144 and accompanying text.

might be unreasonable, thus defeating a claimed expansion of coverage beyond the letter of the contract.²³⁶

Gray v. Zurich defined the limits of reasonable expectations to those that fell within the nature and kind of protection which the insurer held out to provide.²³⁷ *Herzog* again provides a classic example. There the insured asserted that the language of her homeowner's policy gave rise to reasonable expectation of coverage for an auto accident which occurred at a location away from the home.²³⁸ Nonetheless, the court found the insured's expectations unreasonable,²³⁹ because (1) the type of information sought in an application for homeowner's insurance is very different from that required in an automotive policy, (2) an insignificant premium was charged (which coincides with the lesser risk imposed upon the insurer in providing homeowner's coverage), and (3) there was separate availability of automobile insurance policies. Accordingly, no reasonable expectation could have arisen that the homeowner's policy in question covered automobile accidents away from the insured's premises.²⁴⁰ In accordance with *Gray*, coverage for automobile accidents away from the insured premises did not fall into the nature and kind of insurance proffered by the insurer.

4. The Reasonable Expectations Doctrine Does not Apply to Cases Involving "Sophisticated" Insureds or When There is Sufficient Bargaining Between the Parties Over Particularized Terms

It is also relevant for the court to analyze the relative bargaining strengths of the contracting parties.²⁴¹ Contract terms are presumed enforceable unless the contesting party can show that the agreement is an

236. Keeton, *supra* note 21, at 969.

237. 419 P.2d at 175.

238. The insured reasoned that coverage by the policy of automobile-related accidents on the premises or on "ways immediately adjoining" such converted the subject policy into a motor vehicle liability policy which is subject to all statutory law applicable to the motor vehicle liability insurance. *Herzog*, 465 P.2d at 842. One motor vehicle statute mandated that auto insurance cover the entire continental United States. *Id.* As a result, according to the insured, the geographic limitation imposed by the policy was void and therefore, the insurance policy should cover the accident which occurred away from and not within an area immediately adjoining the home. *Id.*

239. *Id.* at 843.

240. *Id.* See *Producers Dairy Delivery*, 718 P.2d at 925 ("[A] finding of ambiguity in policy language cannot be based on an unreasonable misunderstanding on the part of the insured."). The Fourth District Appeals Court similarly stressed that actionable expectations that arise from policy language must be reasonable. *Foremost Ins. Co. v. Eanes*, 184 Cal. Rptr. 635, 637 (Cal. Ct. App. 4 Dist. 1982) (commenting that the reasonable expectations doctrine is not an "authorization to ignore common sense." *Id.* See also *Safeco Title Ins. Co. v. Moskopoulos*, 172 Cal. Rptr. 248, 252 (Cal. Ct. App. 2 Dist. 1981); *Hover v. St. Paul Fire & Marine Ins. Co.*, 138 Cal. Rptr. 646, 649 (Cal. Ct. App. 1 Dist. 1977).

241. *Gray*, 419 P.2d at 171-72.

unenforceable adhesion contract.²⁴² If the contract is found to be an adhesion contract, its meaning is ascertained in light of the insured's reasonable expectations.²⁴³ The very foundation that the reasonable expectations doctrine builds upon is the adhesion contract theory which developed as a judicial reaction to agreements reached absent any significant bargaining between the stronger and weaker parties to the contract. Where there is sufficient negotiating between the parties to the contract, or both parties are equally powerful bargaining entities, the reasonable expectations doctrine does not apply.²⁴⁴

Thus, in *Madden v. Kaiser Foundation Hospitals*,²⁴⁵ the California Supreme Court refused to apply the reasonable expectations doctrine since the policy held by the insured was the product of bargaining between the powerful State Employees Retirement System's Board of Administration and the insurer.²⁴⁶ In explaining why the adhesion doctrine did not apply in this case, the court stated:

[The policy] represents the product of negotiation between two parties, Kaiser and the board, possessing parity of bargaining strength . . . [the board] exerted its bargaining strength to secure medical protection for employees on more favorable terms than any employee could individually obtain.²⁴⁷

This rule was reconfirmed eight years later in *Garcia v. Truck Insurance Exchange*²⁴⁸ when the court similarly declined to apply a reasonable expectations analysis of a hospital's malpractice insurance policy which was the product of joint drafting and individualized negotiations between the carrier and the influential California Hospitals Association.²⁴⁹ The same rationale

242. See *Graham v. Scissor-Tail, Inc.*, 623 P.2d at 172; 3 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 559H, at 367 (Supp. 1992). *Contra*, Rakoff, *supra* note 26 (arguing main thesis that adhesion contracts should be presumed invalid unless proven otherwise).

243. *Gray*, 419 P.2d at 171-72.

244. *AIU Ins. Co. v. Superior Court (FMC Corp.)*, 799 P.2d at 1265 ("[W]here the policyholder does not suffer from lack of . . . bargaining power, and where it is clear that an insurance policy was actually negotiated and jointly drafted, we need not go so far in protecting the insured from ambiguous or highly technical drafting"). *Contra* Curtis M. Caton, Wondie Russell, & Barry S. Levin, *The Rules of Insurance Policy Construction and the Myth of the "Sophisticated Insured,"* 385 PRACTICING L. INST./LITIG. 9 (1990).

245. 552 P.2d 1178 (Cal. 1976). *Madden* was another Tobriner opinion.

246. *Id.* at 1185.

247. *Id.*

248. 682 P.2d 1100 (Cal. 1984). The plaintiff in *Garcia* sought medical malpractice proceeds from a hospital's malpractice carrier based upon a stipulated judgement between herself and the defendant hospital staff surgeon in the underlying case. *Id.* at 1102. The carrier denied coverage based upon exclusionary language exempting coverage when the physician is privately employed by the injured party. *Id.* at 1103. The court found that the injury arose from such an occasion. *Id.*

249. *Id.*

was used by the court in holding that the reasonable expectations doctrine did not apply to reinsurance coverage disputes which involve two insurers.²⁵⁰

5. The *Gray* Doctrine's Scope of Application

Throughout the 1970s and 1980s, California courts remained bent on honoring the insurance consumer's reasonable expectations of coverage in policy disputes involving the various types of insurance available on the market. The reasonable expectations doctrine was applied to coverage disputes involving varied types of coverage: title insurance,²⁵¹ group life insurance²⁵² and disability policies,²⁵³ aircraft,²⁵⁴ watercraft,²⁵⁵ and automobile²⁵⁶ liability policies, professional liability policies,²⁵⁷ and construction insurance.²⁵⁸ Standardized exclusion provisions such as the products hazard exclusion,²⁵⁹ business pursuit exclusion,²⁶⁰ intoxication and felony exclusions in life insurance policies,²⁶¹ pilot or crew member exclusions in aircraft liability policies,²⁶² and family member exclusions in watercraft liability policies,²⁶³ as well as other limiting provisions,²⁶⁴ were all construed in light of the insured's reasonable expectations of coverage.²⁶⁵ Federal Courts in the Sixth,²⁶⁶ Ninth,²⁶⁷ and Tenth²⁶⁸ Circuits

250. See *Signal Cos. v. Harbor Ins. Co.*, 612 P.2d 889 (Cal. 1980).

251. *Paramount Properties Co. v. Transamerica Title Ins. Co.*, 463 P.2d 746 (Cal. 1970).

252. *Bareno v. Employers Life Ins. Co. of Wausau*, 500 P.2d 889 (Cal. 1972).

253. *Williams v. American Casulty Co. of Reading, Pa.*, 491 P.2d 398 (Cal. 1971).

254. *Nat'l Ins. Underwriters v. Carter*, 551 P.2d 362 (Cal. 1976).

255. *Harris v. Glens Falls Ins. Co.*, 493 P.2d 861 (Cal. 1972).

256. *Barrera v. State Farm Mut. Auto. Ins. Co.*, 456 P.2d 674 (Cal. 1969).

257. *Gyler v. Mission Ins. Co.*, 514 P.2d 1219 (Cal. 1973).

258. *Healy Tibbitts Constr. Co. v. Employers' Surplus Lines Ins. Co.*, 140 Cal. Rptr. 375 (Cal. Ct. App. 1 Dist. 1977).

259. *Hays v. Pac. Indem. Group*, 86 Cal. Rptr. 815 (Cal. Ct. App. 3 Dist. 1970).

260. *Wint v. Fidelity & Casulty Co. of N.Y.*, 507 P.2d 1383 (Cal. 1973).

261. *Logan v. John Hancock Mut. Life Ins. Co.*, 116 Cal. Rptr. 528 (Cal. Ct. App. 1 Dist. 1974).

262. *Castro v. Fireman's Fund Am. Life Ins. Co.*, 253 Cal. Rptr. 833 (Cal. Ct. App. 1 Dist. 1988), *review denied*, (Mar. 29, 1989).

263. *Reserve Ins. Co. v. Pisciotta*, 640 P.2d 764 (Cal. 1982).

264. *Jauregui v. Mid-Century Ins. Co.*, 3 Cal. Rptr.2d 21 (Cal. Ct. App. 3 Dist. 1991), *review denied*, 199 Cal. LEXIS 1632 (Cal. 1992) (limiting provision to insure liability only to extent required by Financial Responsibility law invalidated). Coverage provisions are also subject to the reasonable expectations doctrine. See *Century Bank v. St. Paul Fire & Marine Ins. Co.*, 482 P.2d 193 (Cal. 1971) (liberal construction of Banker's Blanket Bond which insures banks against losses from loans approved based upon documents later found to be counterfeit).

265. Far from being a *per se* contra-insurer rule, courts utilizing the reasonable expectations doctrine held true to limiting coverage only for those cases where the expectations are reasonable. See *Producers Dairy Delivery Co. v. Sentry Ins. Co.*, 718 P.2d 920, 925 (Cal. 1986) (holding that employer could not have reasonable expectation that its workmen's compensation insurance covered an injury to a non-employee).

have also used the reasonable expectations doctrine in insurance coverage disputes. For the meantime, there appeared to be no clear danger of eroding the reasonable expectations doctrine in California.

III. EXPECTATIONS LOST

Long before *Gray*, it was uncontested that insurance contracts were just contracts warranting no special contract construction rules.²⁶⁹ Subsequently, the courts manipulated *contra proferentem* and other contract interpretation doctrines to provide better protection for the insurance consumer.²⁷⁰ Then came *Gray v. Zurich*. As noted above, *Gray* established that insurance contracts are special contracts which require different interpretive rules from those applied to other contracts.²⁷¹ For twenty five years, the California Supreme Court analyzed insurance policies under the dictates of the special doctrine of reasonable expectations.²⁷² Insurance policies were authorita-

266. See *Lebow Associates, Inc. v. Avemco Ins. Co.*, 439 F.Supp. 1288 (E.D. Mich. 1977) (finding that insurer was obligated to defend underlying claim when limiting provision to exclude occurrences outside of employment was ambiguous and gave rise to reasonable expectations of coverage).

267. See *Aetna Casalty & Surety Co. v. Trans World Assur. Co.*, 745 F.Supp. 1524 (N.D. Cal. 1990) (Company charged with fraudulent tax practices sought indemnity and defense from insurer; the court did not apply broad statutory definition of "unfair competition" because the underlying claim did not allege statutory unfair competition under § 17200 of the Business and Professions Code; see also *infra* Part III.B. which details the *Bank of the West* decision relating to the same "unfair competition" provision); *Healy Tibbitts Const. Co. v. Foremost Ins. Co.*, 482 F.Supp. 830 (N.D. Cal. 1979) (holding there would have been a duty to defend in light of reasonable expectations had the language been less clear; but the policy provision at issue unambiguously provided for a *right* of the insured to take over the lawsuit, *not a duty* to defend such); *Price v. Zim Israel Navigation Co., Ltd.*, 616 F.2d 422 (9th Cir. Cal. 1980) (providing coverage under Comprehensive General Liability policy for suit filed by longshoremen against shipowner-insured); *St. Paul Fire & Marine Ins. Co. v. Weiner* 606 F.2d 864 (9th Cir. Cal. 1979) (finding that exclusion of claims involving criminal conviction was ambiguous and should be read in light of insured's reasonable expectations).

268. See *Evanston Ins. Co. v. International Mfg. Co.*, 641 F.Supp. 733 (D. Wyo. 1986) (providing coverage after the policy period elapsed when "occurrences" language in policy providing coverage for the manufacture of insured's product during the relevant policy period was ambiguous and could have given rise to reasonable expectations of coverage).

269. See *Yoch v. Home Mut. Ins. Co.* 44 P. 189, 189 (Cal. 1896); *Wells, Fargo & Co. v. Pac. Ins. Co.*, 44 Cal. 397, 406-07 (1872).

270. See *supra* Parts I.A. & I.B.

271. See *supra* text accompanying note 167.

272. See *AIU Ins. Co. v. Superior Court (FMC Corp.)*, 799 P.2d 1253 (Cal. 1990); *Producers Dairy Delivery Co. v. Sentry Ins. Co.*, 718 P.2d 920 (Cal. 1986); *White v. Western Title Ins. Co.*, 710 P.2d 309 (Cal. 1985), *reh'g denied*, (Feb. 14, 1986); *Searle v. Allstate Life Ins. Co.*, 696 P.2d 1308 (Cal. 1985); *Garcia v. Truck Ins. Exch.*, 682 P.2d 1100 (Cal. 1984); *Reserve Ins. Co. v. Pisciotta*, 640 P.2d 764 (Cal. 1982); *Samson v. Transamerica Ins. Co.*, 636 P.2d 32 (Cal. 1981); *Signal Cos. v. Harbor Ins. Co.*, 612 P.2d 889 (Cal. 1980); *Insurance Co. of N. Am. v. Sam Harris Constr. Co.*, 583 P.2d 1335 (Cal. 1978); *National Ins. Underwriters v. Carter*, 551 P.2d 362 (Cal. 1976); *Holz Rubber Co. v. American Star Ins. Co.*, 533 P.2d 1055 (Cal. 1975); *Gyler v. Mission Ins. Co.*, 514 P.2d 1219 (Cal. 1973); *State Farm Mut. Auto. Ins. Co. v. Jacober*, 514 P.2d 953 (Cal. 1973); *State Farm Mut. Auto. Ins. Co. v. Partridge*, 514 P.2d 123 (Cal. 1973); *Thompson v. Occidental Life Ins. Co. of Cal.*, 513 P.2d 353 (Cal. 1973); *Wint v. Fidelity & Casalty Co. of N.Y.*, 507 P.2d 1383 (Cal. 1973); *Bareno v. Employers Life*

tively interpreted under the protective eye of *Gray* and its progeny. The focus of the analysis turned upon the existence of ambiguities in the contract and the resolution of such to promote the reasonable expectations of the insurance consumer. Most importantly, insurance contracts were read through the eyes of the reasonable consumer as a layperson.²⁷³ The focus of the analysis was consistently based upon whether a reasonable consumer could read the policy in such a manner as to require coverage. If so, coverage was provided by the courts.

A. *The Move to Limit the Reach of Gray*

1. The Intrusion of the California Civil Code into the Interpretive Equation

With two opinions,²⁷⁴ the Lucas Court undid twenty-five years of law. Ignoring the principle which declared insurance contracts to be subject to different rules of construction,²⁷⁵ the court treated insurance policies as ordinary contracts by applying the general rules of contract interpretation²⁷⁶ found in the California Civil Code. The varied doctrines long used by the courts to protect reasonable consumer expectations were scrapped by simply adding an extra step to the insurance contract analysis. That step is embodied in the California Civil Code section 1649²⁷⁷ (hereinafter referred to as "section 1649"). This dramatic change stems from the California Supreme Court's adoption of traditional contract interpretation law in place of the special rules rationalized by the adhesion contract doctrine.

Ins. Co. of Wausau, 500 P.2d 889 (Cal. 1972); *Harris v. Glens Falls Ins. Co.*, 493 P.2d 861 (Cal. 1972); *Argonaut Ins. Co. v. Transport Indem. Co.*, 492 P.2d 673 (Cal. 1972); *Williams v. American Casulty Co. of Reading, Pa.*, 491 P.2d 398 (Cal. 1971); *Crane v. State Farm Fire & Casulty Co.*, 485 P.2d 1129 (Cal. 1971); *Century Bank v. St. Paul Fire & Marine Ins. Co.*, 482 P.2d 193 (Cal. 1971); *Hogan v. Midland Nat'l Ins. Co.*, 476 P.2d 825 (Cal. 1970); *Herzog v. Nat'l Am. Ins. Co.*, 465 P.2d 841 (Cal. 1970); *Paramount Properties Co. v. Transamerica Title Ins. Co.*, 463 P.2d 746 (Cal. 1970); *Barrera v. State Farm Mut. Auto. Ins. Co.*, 456 P.2d 674 (Cal. 1969).

273. *Pisciotta*, 640 P.2d at 767.

274. *Bank of the West v. Superior Court*, 833 P.2d 545 (Cal. 1992); *AIU Ins. Co. v. Superior Court (FMC Corp.)*, 799 P.2d 1253 (Cal. 1990).

275. *Gray*, 419 P.2d at 171-72, 172 n.6.

276. *Bank of the West*, 833 P.2d at 551-52 ("[I]nsurance contracts . . . are still contracts to which the ordinary rules of contractual interpretation apply.").

277. The Code section reads:

§ 1649. Ambiguity or uncertainty; promise

INTERPRETATION IN SENSE IN WHICH PROMISOR BELIEVED PROMISEE TO RELY. If the terms of a promise are in any respect ambiguous or uncertain, it must be interpreted in the sense in which the promisor believed, at the time of making it, that the promisee understood it.

CAL. CIV. CODE § 1649 (West 1985).

2. *AIU Insurance Co. v. Superior Court* Foreshadows the Doctrinal Transition

Application of the reasonable expectations doctrine was pervasive during the *Gray* Era.²⁷⁸ However, *AIU v. Superior Court* quietly ushered in a new era, one which protects the beliefs of the insurance companies rather than the expectations of insureds.²⁷⁹ There appeared to be no remarkable change in the law. Unheralded, and almost unnoticed,²⁸⁰ the Lucas Court subtly changed the equation governing insurance contract interpretation. This change was then emphasized, but not followed in the *Bank of the West* decision.

In *AIU*, the California Supreme Court was to decide the insurer's liability under a Comprehensive General Liability policy for response and cleanup costs incurred by the insured for violation of the Comprehensive Environmental Response Compensation and Liability Act²⁸¹ (hereinafter CERCLA).²⁸² FMC Corporation, the insured real party in interest, was

278. One aberrational Supreme Court decision went against the weight of *Gray*, however, *Gribaldo, Jacobs, Jones & Associates v. Agrippina Versicherungen A.G.*, 476 P.2d 406 (Cal. 1970). The court decided the professional liability policy issued to the plaintiff company by the defendant insurer contained no ambiguities and applied CAL. CIV. CODE § 2778 (which governs indemnity policies that show no "contrary intent"). *Id.* at 412-13. The court noted that the *Gray* rule must be applied in conjunction with standard practice contract construction. *Id.* at 410. The court distinguished *Gray*, however, by noting that *Gray* was decided without the aid of extrinsic evidence. *Id.* at 410 n.5. A strong dissent decried the use of § 2778 because the three dissenting justices found an ambiguity (*id.* at 419-20) in the insurance policy which mandated a reasonable expectations analysis. *Id.* at 421 ("My interpretation of the defense duties of Underwriters is indicated not only by the legal construction . . . but also by pragmatic aspects of the parties' relationship" (italics added)). The case had negligible effect on the strength of the *Gray* doctrine which was applied vigorously for two decades beyond the *Gribaldo* decision.

279. In *Bank of the West*, Justice Panelli opined that implementation of § 1649 protects the objectively reasonable expectations of the insured as opposed to the subjective beliefs of the insurer. 833 P.2d at 552. The discussion in part III.C.3. *infra* will illustrate that such an assumption is erroneous.

280. The Sixth District Appellate Court did notice the change. *See Aim Ins. Co. v. Culcasi*, 280 Cal. Rptr. 766 (Cal. Ct. App. 6 Dist. 1991), *review denied*, 1991 Cal. LEXIS 2891 (Cal. 1991). The New Jersey Supreme Court declined to follow the result obtained in *Culcasi supra*. *Voorhees v. Preferred Mut. Ins. Co.*, 607 A.2d 1255 (N.J. 1992). Contrary to the holding of the California 6th Appellate District, the New Jersey court held that the term "bodily injury" was ambiguous when related to physical symptoms accompanying emotional distress. *Id.* at 1261. The ambiguity in *Voorhees* was resolved in favor of the insured as it was in accordance with the latter's reasonable expectations of coverage. *Id.* It appears that the California and New Jersey courts, once the leading reformers in torts jurisprudence are headed in divergent directions. The rise of the reasonable expectations doctrine can be attributed to the radical steps taken by both courts during the early 1960's. New Jersey, as exemplified by the recent *Voorhees* case noted above, still adheres to the reasonable expectations doctrine while California now appears to embrace traditional contract interpretation norms, following the lead of Arizona and Iowa.

281. 42 U.S.C. §§ 9601-9675 (1988).

282. *AIU Ins. Co. v. Superior Court*, 799 P.2d at 1253, 1258 (Cal. 1990). For instructive reading on the varied judicial responses to CERCLA lawsuits, *see* Howell A. Burkhalter, Comment, *Liability for CERCLA Cleanup Costs—Are Insurers the Victims of Judicial Activism?*, 26 WAKE FOREST L. REV. 221 (1991); Laurence T. Vetter, Note, *Law, Equity and the*

sued by the United States and various administrative agencies for violation of CERCLA because of its alleged contamination of several hazardous waste sites, the groundwater underneath those sites, surrounding premises, and nearby surface waters.²⁸³

FMC was in possession of over sixty CGL policies issued by several insurers.²⁸⁴ The court's analysis proceeded upon the contention that three basic elements had to be fulfilled in order to merit insurance coverage²⁸⁵: (1) Complying with the cleanup orders constituted a "legal[] obligation" to pay, (2) such costs could be considered "damages" and (3) the costs were incurred because of property damage.²⁸⁶ In deciding upon the mode of interpretation to apply, the court tacitly accepted the fact that insurance policies are to be construed differently from other contracts.²⁸⁷

The court recognized the adhesive nature of insurance contracts as the rationale for treating insurance policies differently.²⁸⁸ Nonetheless, the Lucas Court inserted the canon of section 1649 as applicable to insurance contract interpretation.²⁸⁹ Absent the unwelcome intrusion (albeit unobtrusive in this case) of the California Civil Code, *AIU's* analysis appeared to be a strong reaffirmation of the reasonable expectations doctrine.²⁹⁰

Chief Justice Lucas' opinion seemed to continue the court's unwavering resolve to construe the insurance policy terms in the reasonable layman's point of view. The court agreed with the insurers that CERCLA lawsuits demanding response costs and injunctive relief are actions in equity.²⁹¹

Comprehensive General Liability Policy: The Scope of Coverage for CERCLA Cleanup Costs, 11 VA. ENVTL. L.J. 157 (1991); Debi L. Davis, Comment, *Insureds Versus Insurers: Litigating Comprehensive General Liability Policy Coverage in the CERCLA Arena—A Losing Battle for Both Sides*, 43 Sw. L.J. 969 (1990).

283. *AIU*, 799 P.2d at 1260.

284. *Id.* at 1259.

285. *Id.* at 1261.

286. These three factors were deemed necessary to a finding for coverage in light of the standard coverage provisions which provided protection for sums that the insured will become "legally obligated to pay" as a result of "property damages." *Id.* at 1259. Two of the sixty policies held by the insured purported to provide protection for sums paid as or for "damages." *Id.* All these terms were not defined in the policies. *Id.*

287. *Id.* at 1264-65. Although the court catalogued the statutory contract construction rules, they were referred to as rules of "contract" interpretation. *Id.* at 1264 (emphasis added). The court proceeded to enumerate the reasonable expectations rules expounded by *Gray* and its progeny as rules applied "[i]n the insurance context." *Id.* at 1264-65 (emphasis added).

288. The court acknowledged the lack of meaningful negotiations in the insurance contract formation process and the fact that the insurer, as drafter of the policy, bore the burden of clear expression of terms. *Id.* at 1265.

289. "If there is an ambiguity, however, it is resolved by interpreting the ambiguous provision in the sense the promisor (i.e., the insurer) believed the promisee understood them at the time of formation." *Id.* at 1264. It is puzzling why § 1649 was explained since it was not applied to affect the outcome of the case. Even though the court decided there was an ambiguity in the contract provisions, there was no § 1649 analysis. Instead, the court went on to decide the case using the familiar reasonable expectations doctrine.

290. "To the extent that policy language is ambiguous . . . our goal remains to protect the objectively reasonable expectations of the insured." *Id.* at 1269.

291. *Id.* at 1266.

However, the court did not agree that this fact prevented recovery under the contract even if the policy only covered "damages."²⁹² The opinion explained that the reasonable layperson would not be cognizant of the distinction between "legal" and "equitable" relief.²⁹³ In honoring the reasonable expectations of the policyholder, the plain meaning of the policy required CERCLA lawsuit costs be considered sums that an insured is "legally obligated to pay."²⁹⁴

Similarly, the court employed the dictionary definition of "damages" meaning any pecuniary compensation collected by a third party for an injury sustained upon him, as opposed to a technical reading of the term which again related to the distinction between relief provided by courts of law or equity.²⁹⁵ The court concluded that the CERCLA clean up costs²⁹⁶ and the costs incurred in compliance with injunctive orders,²⁹⁷ were "damages"

292. *Id.* at 1266-67.

293. *Id.* at 1266. Quoting from an earlier appellate court decision (*Aerjet-General Corp. v. San Mateo County Superior Court (Cheshire & Cos.)*, 257 Cal. Rptr. 621 (Cal. Ct. App. 1 Dist. 1989), *reh'g denied*, 258 Cal. Rptr. 684 (Cal. Ct. App. 1 Dist. 1989), and *review denied*, 4071 Cal. LEXIS (Cal. 1989)), the court commented that an insured would be surprised to discover that coverage would hinge upon arcane lawyerly distinctions between equitable and legal relief. *Id.*

294. *Id.* at 1267.

295. "Defining 'damages' as sums paid to third persons as a result of 'legal claims' would render the policy language . . . inconsistent with an ordinary interpretation of the word damages." *Id.* at 1268. Chief Justice Lucas evaluated both narrow definitions (sums paid upon a claim brought in an action at law) and over-broad applications of the term "damages" (*any sum paid out under law or equity for harm brought to another's person or property*) and hesitated to apply either in light of inherent interpretational flaws in both renditions. *Id.* at 1267-68. But since CERCLA remedies requiring injunctive relief and compensation for harm to third parties were used interchangeably, it was decided that application of such remedies created at least a latent ambiguity and called for the interpretation providing for coverage in favor of the insured. *Id.* at 1268-69.

296. Two elements of the plain meaning of "damages" had to be fulfilled: (1) monetary compensation to the third party as a result of (2) loss or detriment occasioned upon the third party. *Id.* at 1267. (1) Even if the United States had no interest in the contaminated property, it had to undertake cleanup operations which cost money and thus constituted a loss or detriment satisfying the first element. *Id.* at 1269. (2) The insured was required to compensate the United States for the latter's remedial clean up, investigation, and monitoring costs, fulfilling the second element of "damages." *Id.* at 1270. The court was not convinced by the insurer's arguments that CERCLA response are statutorily distinguishable from damages, the sums paid out by the insured were merely a "cost of doing business," and response costs are restitutionary in nature. *Id.* at 1269-75.

297. The court hesitated to equate injunctive relief with a broad definition of "damages" because compliance with an injunction would require the insured to pay sums to contractors and employees as opposed to the purported party injured by the insured's actions (the United States). *Id.* at 1276. Furthermore, judicial construction of "injunctions" as a sum for which the insured is legally obligated to pay as damages "because of property damage" is redundant and would violate the canon of construction requiring a reading of the contract to give effect to every part of the contract. *Id.* But again, the opinion emphasized the reasonable expectations of the insured by stating: "[I]t would exalt form over substance to interpret CGL policies to cover one remedy but not the other. Given the practical similarity of remedies available under the environmental statutes at issue here, we believe a reasonable insured would expect both remedies to fall within coverage as 'damages'." *Id.* at 1277.

for which the insured could reasonably have expected coverage under the policy.²⁹⁸

The court further held that CERCLA response costs and injunctive remedies imposed upon the insured are costs associated with “property damage.”²⁹⁹ The court discounted the argument that the party seeking recovery had to suffer some form of “harm to a proprietary interest.”³⁰⁰ It was enough for the court that “the event precipitating [the] legal action [was] contamination of property. The costs that result[ed] from such action [were] therefore incurred ‘because of’ property damage.”³⁰¹

AIU was a transitional case. It embodied the reasonable expectations doctrine of *Gray v. Zurich* but foreshadowed a doctrinal shift toward applying traditional contract interpretation rules to insurance contracts.

B. Bank of the West v. Superior Court: *Ordinary Rules of Contract Interpretation Regain Primacy in California Insurance Law*

1. The Facts Giving Rise to the Claim in *Bank of the West*

When Bank of the West decided to settle a lawsuit brought about by alleged unfair business practices,³⁰² it asserted that the claim which was in the process of settlement was covered by its CGL policy issued to it by Industrial Indemnity Co.³⁰³ The insurer filed for a declaratory judgement to ascertain the rights and liabilities of the parties under the insurance policy; to which the Bank cross-complained for alleged breach of the insurance contract.³⁰⁴ The issue was whether the claim in the underlying case was covered under the “advertising injury” provision of the insurance con-

298. *Id.* at 1278-79.

299. *Id.* at 1279.

300. *Id.*

301. *Id.* at 1280. Although the opinion does not express it as such, the foregoing analysis is essentially a “nature and kind” inquiry.

302. Bank of the West (then Central Bank) set up the Coast Program, a system by which consumers, applying through their own insurance agents, could finance their insurance premiums through the bank to be paid in monthly installments. Bank of the West v. Superior Court, 833 P.2d at 547-48. The consumers did not know that the applications they submitted to their insurance agents were forwarded to Bank of the West for loan approval. *Id.* at 548. Upon approval, the Bank then notified the consumers about their “new loan” which was allegedly subject to unconscionable terms. *Id.* The erstwhile “borrowers” filed suit under several consumer protection statutes, but when this case reached the California Supreme Court, the suits were incorporated under the Unfair Business Practices Act (§ 17200 et. seq.). *Id.*

303. The policy provided in pertinent part: “[To] pay on behalf of the insured . . . all sums which the insured shall become legally obligated to pay as *damages* because of . . . *advertising injury* to which this insurance applies . . . ‘Advertising injury’ means injury arising out of an offense committed during the policy period occurring in the course of the named insured’s advertising activities, if such injury arises out of libel, slander, defamation, violation of right of privacy, *unfair competition*, or infringement of copyright, title or slogan.” *Id.* at 550.

304. *Id.* at 549.

tract.³⁰⁵ In reaching its conclusion, the court had to construe two relevant policy terms: (1) “unfair competition,” and (2) “damages.”

2. The Court of Appeals Used the Reasonable Expectations Doctrine to Find Coverage for the Insured

The First District Court of Appeals³⁰⁶ found the term “unfair competition” ambiguous because “unfair competition” was not defined in the policy and was susceptible to two reasonable interpretations.³⁰⁷ The term could reasonably mean either (1) the common law tort of “passing off another’s goods as one’s own,” or (2) the broad notion of any “unlawful, unfair or deceptive act committed against both a business competitor or the public” as defined in the Business and Professions Code section 17203, *Webster’s Dictionary*, textbooks, and legal essays.³⁰⁸ In light of such an ambiguity in the coverage provision of the contract, the court applied the longstanding rule that doubts as to coverage will be construed against the drafter to protect the reasonable expectations of the insurance consumer.³⁰⁹ Therefore, the court used the broader definition of “unfair competition” which provided coverage for the insured.³¹⁰

Addressing the issue as to whether a statutory unfair competition claim sought “damages,” the appeals court noted that the reasonable insured would not be able to distinguish the difference between relief in equity (most remedies under the Unfair Business Act are equitable) and those derived from law in order to provide a broad interpretation of “damages” favoring

305. See *supra* note 303.

306. The treatment of *Bank of the West* in the appellate level will hereinafter be cited to as “*Bank of the West I.*”

307. *Bank of the West I*, 277 Cal. Rptr. 219, 224 (Cal. Ct. App. 1 Dist. 1991), review granted, 807 P.2d 1006 (Cal. 1991), superseded, 833 P.2d 545 (Cal. 1992). This reasoning is much in line with the interpretational rules set out by *Gray* and its progeny. See *Producers Dairy Delivery*, 718 P.2d at 924-25.

308. *Bank of the West I*, 277 Cal. Rptr. at 223 (“[U]nfair competition is a much broader notion which includes not only the common law, but the statutory and dictionary definitions of the tort as well.”). The court reasoned (and rightly so) that the statutory definition was relevant in ascertaining the reasonable expectations of the insured because it is a settled principle that “all law (including common and statutory) becomes a part of every contract by inference.” *Id.* at 224 (italics added). Similarly, it is reasonable for the insurer to believe that all the law of California is integrated into the contract. See *Pisciotta*, 640 P.2d at 770 (“Our function is not to select one definition . . . , but rather to imply from among the range of reasonable meanings the definition which most favors coverage for the insured”) (italics added). Moreover, dictionary definitions have always helped courts in determining reasonable interpretations and provided strong inferences as to how a reasonable person would interpret certain nebulous terms. See e.g., *AIU*, 799 P.2d at 1269; *Pisciotta*, 640 P.2d at 769-70.

309. *Insurance Co. of North Am. v. Sam Harris Constr. Co.*, 583 P.2d 1335, 1337 (Cal. 1978); *Holz Rubber*, 533 P.2d at 1063.

310. *Bank of the West I*, 277 Cal. Rptr. at 224.

coverage for the insured.³¹¹ The court also observed that sums paid out by the unjustly enriched insurance agents and brokers as a result of Bank of the West's Unfair Business Practices Act violation were "sums sought [to] constitute compensation for detriment caused by an unlawful act of another" in accordance with the statutory definition of "damages."³¹²

In so ruling, the appellate court applied the reasonable expectations doctrine as it had existed for over twenty years. First, the court reviewed the allegations in the underlying case. Next, it assessed the policy language contained in the CGL policy to determine whether patent or latent ambiguities³¹³ existed in the instrument. When the court determined that an ambiguity existed in the policy, it construed the ambiguous terms against the insurer in light of the insured's reasonable expectations.³¹⁴ To shed light upon what a reasonable insured would expect in coverage, the court looked to statutory and dictionary definitions of the questionable terms. The ambiguities were then construed in the broadest manner in favor of the insured.³¹⁵

3. The Supreme Court Reverses the Reasonable Expectations Doctrine Along With the Appellate Court Decision

Justice Panelli's opinion pointed out that the overwhelming weight of authority, contrary to the finding of the appeals court, construed "advertising injury" arising from "unfair competition" unambiguously to mean the common law tort, and excluded coverage for statutory claims of unfair competition.³¹⁶ The opinion continued by stating that the reasoning of the appeals court was correct "as a matter of abstract philology" but such an interpretation of "unfair competition" ignored the context of the policy which

311. *Id.* at 228. See *Pisciotta*, 640 P.2d at 768 ("[C]overage clauses are interpreted broadly so as to afford the greatest possible protection to the insured" (quoting from *State Farm Mut. Auto Ins. Co. v. Partridge*, 514 P.2d 123, 128 (Cal. 1973))).

312. *Bank of the West I*, 277 Cal. Rptr. at 228-29. "Damages" is defined in Cal. Civ. Code § 3281. *Id.* at 229.

313. Patent ambiguities are discernable on the face of the instrument, while latent ambiguities do not arise out of the language in the instrument itself but by some collateral matter not found in the document. *In re Black's Estate*, 27 Cal. Rptr. 418, 424 (Cal. Ct. App. 1 Dist. 1962). See *Executive Aviation, Inc. v. National Ins. Underwriters*, 94 Cal. Rptr. 347 (Cal. Ct. App. 1 Dist. 1971) (illustrating a latent ambiguity; policy terminology was not ambiguous but uncertainty arose from the extrinsic circumstances as to whether flight of insured airplane was conducted for sales purpose or air taxi purpose).

314. "It is a basic principle of insurance contract interpretation that . . . ambiguities arising out of the policy language ordinarily should be resolved in favor of the insured in order to protect his *reasonable* expectation of coverage." *Bank of the West I*, 277 Cal. Rptr. at 224 (quoting from *Producers Dairy Delivery*, 718 P.2d at 924).

315. It was a longstanding principle that doubts as to coverage were to be construed against the insurer and the language read broadly to provide coverage for the insured. *Pisciotta*, 640 P.2d at 768; *Sam Harris*, 583 P.2d at 1337; *Holz Rubber*, 533 P.2d at 1063.

316. *Bank of the West v. Superior Court*, 833 P.2d at 551. The California Supreme Court reasoned that administrative regulatory procedure mandated a distinction between statutory unfair business practice claims and claims pertaining to the common law tort. *Id.*

purported to cover a wrong for which damages may be collected.³¹⁷ Only the tort interpretation of unfair competition fit such a context since damages are not recoverable under statutory unfair competition claims.³¹⁸

Using public policy arguments, the court similarly noted that the term "damages" as it appeared on the policy was insupportable under the broad definition³¹⁹ forwarded by the Bank. The Unfair Business Practices Act, according to the court, only allows for one form of non-punitive monetary relief which is disgorgement³²⁰ of wrongfully obtained funds.³²¹ Following the interpretation proposed by the Bank would allow insured's who are in violation of the statute to keep their ill-gotten gains while shifting the loss to their insurers.³²² Because such an interpretation would run counter to

317. *Id.* at 552. The necessary contextual interpretation proposed by the California Supreme Court did not adequately address the argument that statutory and dictionary definitions are reliable indicators of what interpretations are reasonable under the circumstances. Interpreting the terms in a contextual manner runs counter to the settled principle that the words in an insurance contract are to be read "in their ordinary sense." *Producers Dairy Delivery*, 718 P.2d at 925. California courts realized long ago that such sophisticated interpretations are not within the purview of the ordinary layman. *See Steven*, 377 P.2d at 294 ("The average man is [not] expected to carry the Civil Aeronautics Act or the Code of Federal Regulations." (quoting from *Lachs v. Fidelity & Casalty Co.*, 118 N.E.2d at 558)). It is somewhat ironic that a cornerstone principle of insurance contract interpretation is that courts may not strain to find ambiguities in the insurance policy. *See Producers Dairy Delivery*, 718 P.2d at 925; *Burr v. Western States Life Ins. Co.*, 296 P. 273, 276 (Cal. 1931). The "abstract philology" rationale forwarded by the Lucas Court appears to be a strained attempt to avoid a finding of actual ambiguity in this case. The very act of straining to find a contextual reading of the policy shows that there was an ambiguity in the policy that should not have been sidestepped.

318. *Bank of the West*, 833 P.2d at 552-553.

319. The Bank contended that "damages" should be construed broadly to cover any form of monetary relief requested. *Id.* at 553.

320. "[R]estoring . . . money . . . which may have been acquired by means of . . . unfair competition." *Id.*

321. *Id.* at 552-53.

322. *Id.* at 553. The Bank had argued that the case before the bench was analogous to the situation in *AIU* wherein the California Supreme Court upheld insurance coverage, which in essence, allowed FMC, the real party in interest to insure its illegal contamination activities. The court explained the holding in *AIU* was narrowly tailored to fit the needs of that particular case because the cleanup costs to return the land to its original state, as required by CERCLA, are sufficiently analogous to damages occasioned by injury to property. *Id.* at 555-56. The authors have to wonder whether the court is making its decisions based upon its own result-oriented public policy agenda rather than legal analysis. In *AIU*, the court had to decide essentially whether insurers had to participate in indemnifying the state for clean up costs. *See* discussion of *AIU supra* in Part III.A.2. The court decided that the ordinary layman could not ascertain the difference between legal damages and equitable relief. However, in *Bank of the West*, the court rejected the same reasoning. Furthermore, the court impliedly held that an ordinary consumer could, by contextual analysis, determine the difference between common law unfair competition and statutory unfair competition. There are two distinguishing features between the cases: (1) In *AIU*, the money recovered would go to the State, or losses would be borne by the taxpayers who vote for judges, and; (2) *Bank of the West* involved only money, and conduct which would almost certainly cause losses. If the court had retained the reasonable expectations doctrine, a "nature and kind" analysis could have defeated the Bank's alleged expectation. *See supra* part II.A.3. & note 198. In *AIU*, the reasonable consumer would expect coverage for losses "because of property damage." Therefore, the losses certainly stemmed from the nature and kind of harm insured against, whereas in *Bank of the West*, a pure loss of money was not the nature and kind of harm that the policyholder was insured against.

the legislative intent of deterring unfair business practices, insurable damages do not include disgorgement relief available under the Unfair Business Practices Act.³²³ Consequently, the interpretation forwarded by the Bank could not conform with the reasonable expectations of the insured.³²⁴

The California Supreme Court declared that the Bank invoked the rule of construing ambiguities against the insurer “too early in the interpretive process.”³²⁵ The court, citing to *AIU supra* ruled that:

While insurance contracts have special features, they are still contracts to which the ordinary rules of contractual interpretation apply . . . “[i]f the terms of a promise are in any respect ambiguous or uncertain, it must be interpreted in the sense in which the promisor believed, at the time of making it, that the promisee understood it.” This rule, as applied to a promise of coverage in an insurance policy, protects not the subjective beliefs of the insurer but rather, the objectively reasonable expectations of the insured. Only if this rule does not resolve the ambiguity do we then resolve it against the insurer.³²⁶

Because the court found no ambiguity in the policy, there was no opportunity for the court to apply this line of reasoning.

From the analyses above, the steps taken by the Supreme Court in *Bank of the West* can be compared to the treatment of the same case by the appellate court which applied the reasonable expectations doctrine in its usual sense. After reviewing the allegations in the underlying case, the Supreme Court analyzed the policy language and strained to find clarity by contextual

323. *Id.* at 553. Here again, the court strained a rationale which would accommodate *Bank of the West* without overruling *AIU*. The public policy of deterring illegal conduct applies as much to would-be CERCLA violators as it does to prospective violators of the Unfair Business Practices Act. In *AIU*, the California Supreme Court upheld the definition of “damages” and the rationale (as far as it accords with the reasonable expectations of the insured) as such in the *Aerojet* opinion (*Aerojet* is mentioned briefly in the *AIU* section *supra* note 293 in part III.B.). *AIU*, 799 P.2d at 1272. A factor in the *Aerojet* analysis of the term “damages” (as far as the term conformed with legal/equitable relief) was that “it would come as an unexpected . . . shock to the insureds to discover that their insurance coverage was being denied because the plaintiff chose to frame his complaint in equity rather than in law.” *Aerojet-General Corp. v. Superior Court*, 257 Cal. Rptr. 621, 628 (1st Dist. 1989). The California high court agreed with this rationale in *AIU*. 799 P.2d at 1266. In *Bank of the West*, the insured would similarly be “surprised” to learn that the CGL policy did not cover the claims in the underlying case only because of the manner in which the complaint was framed.

324. *Bank of the West*, 833 P.2d at 557.

325. *Id.* at 551.

326. *Id.* at 551-52 (citations omitted). Within these lines lies the biggest danger posed by the *Bank of the West* decision to the insurance consumer. In phrasing the ruling this way, the court has subtly rejected the usual practice that an ambiguity *per se* gives rise to the *contra proferentem* aspect of the reasonable expectations doctrine. Adopting the California Civil Code procedure in deciding insurance coverage disputes negates the reasonable expectations doctrine and all the pro-consumer rationales that have supported the *Gray* rule for all these years. Furthermore, as we will see *infra*, adopting section 1649 as the determinative step in the ambiguity analysis is not only doctrinally and practically problematic but it also poses a grave risk of abuse by the insurer. The insertion of section 1649 in the interpretive equation is enigmatic because the court labored to find no ambiguity in the CGL and did not have an opportunity to apply the section 1649 analysis.

interpretation and analyses of extrinsic circumstances like public policy and judicial treatment of the same issue in other jurisdictions. The court then used the absence of an ambiguity to deny the insured from having had any reasonable expectations of coverage under the policy.

Although it was unused and unnecessary for the disposition of the matter at hand, the court laboriously inserted section 1649 into the analytical picture.³²⁷ Justice Panelli explained that “[t]his rule . . . protects not the subjective beliefs of the insurer, but rather, ‘the objectively reasonable expectations of the insured.’”³²⁸ If section 1649 did not clear up the uncertainty, according to the court, then the ambiguity must be construed against the insurer.³²⁹

The Court indirectly provided the framework for a new doctrine to govern insurance contract interpretation, but did not apply it to dispose of the present case. Such judicial action is an obvious invitation for the lower courts to experiment with the rule.

Had the California Supreme Court wished to revert back to traditional contract interpretation maxims (extant in the California Civil Code), there should have been no mention whatsoever of the insured’s reasonable expectations³³⁰ in the opinion. Oddly enough, Justice Panelli rationalized the result obtained therein by referring to the expectations of the insured.³³¹ *Bank of the West* instructs courts to apply section 1654’s directive of strict construction against the insurer only when reasonable expectations are derived by the insured from the contract language.³³² Under the traditional theory practiced by the California courts prior to *Gray*, ambiguous contract language was *strictly construed against the insurer regardless of any expectations derived by the insured*.³³³ Within the framework established by *Gray* and its progeny, judicial construction of the insurance policy against

327. The use of the Cal. Civil Code was legitimized by its appearance in the recent *AIU* decision (although it was not used to decide *AIU* either).

328. *Id.* at 552. It is puzzling why an objective analysis requires the perceptions of the opposing party to the contract to control the determination of reasonableness. Pragmatically, the result obtained therein is analogous to letting the fox guard the hen house. See *infra* Part III.C.3. for a more detailed analysis of this issue.

329. CAL. CIV. CODE § 1654 (West 1985).

330. Analysis of the insured’s reasonable expectations resulted from judge-made law (making its first California appearance in *Neal*) subsequent to the pronouncements of the California Civil Code enacted in 1872.

331. *Bank of the West*, 833 P.2d at 557.

332. *Id.* at 552 (“[A] court that is faced with an argument for coverage based on assertedly ambiguous policy language *must first attempt to determine whether coverage is consistent with the insured’s objectively reasonable expectations.*” (emphasis added)).

333. Traditional contract interpretation’s use of *contra proferentem* (embodied in § 1654) is distinct from its variant reasonable expectations formulation. Judge Keeton recognized the difference in application of the two theories when he extolled the virtues of the reasonable expectations formulation as often being more favorable to the insurer since construing contract language against the insurer under *contra proferentem* is not tempered by the requirement the insured develop reasonable expectations from the ambiguity which is inherent in the reasonable expectations doctrine. Keeton, *supra* note 21, at 969.

the insurer required that the insured had objectively reasonable expectations³³⁴ of coverage and steered clear of the section 1649 rule mandated by *Bank of the West*.

Justice Panelli's opinion bodes ill for the insurance consumer because aside from re-introducing section 1649 and the traditional analytical structure to the insurance sphere, the insured is made to jump an extra hoop by the court's version of section 1654. Unlike the statutory rule, the court now mandates strict construction against the insurer only when the insured derives reasonable expectations from the assertedly ambiguous language.³³⁵ Such an analysis neither remains true to the traditional contract construction theory of the California Civil Code nor to *Gray* and its progeny.

C. What Section 1649 Means to Future Insurance Coverage Disputes

It is not immediately certain what *Bank of the West* has left of the old law in its wake.³³⁶ The foregoing discussion, however, illustrates the immense doctrinal shift that *Bank of the West* embodies. This enormous shift stems from the California Supreme Court's apparent adoption of inapplicable traditional contract interpretation canons in complete disregard of the adhesion contract doctrine. There are doctrinal and practical problems associated with the entry of traditional contract interpretation rules into the insurance contract arena. This may have prompted the California Supreme Court not to apply the analysis mandated by section 1649 even in light of its introduction into the interpretive scheme.

1. The Canons of Construction Mandated By *Bank of the West* Reflect Traditional, But Inapplicable, Contract Law Assumptions

The California Civil Code's rules governing the construction of contracts reflects the traditional contract interpretation model. It states that the primary purpose for judicial construction of contracts is to ascertain the

334. "[T]here has always been an implicit understanding that ambiguities which in most cases might be resolved in more than just one or the other of two ways, would be resolved favorably to the insured's claim only if a reasonable person in his position would have expected coverage." *Id.* (citing *Steven v. Fidelity & Ca. Co.*, 374 P.2d 284, 288-89 (Cal. 1962)).

335. The court decided that statutory Unfair Competition does not contemplate an award of damages and a definition of "unfair competition" which envisions a damages award "cannot reflect the objectively reasonable expectations of the insured." *Id.* at 557. "Because the context elucidates the meaning [of 'unfair competition'] there is no need to resort to the rule that ambiguities are resolved against the insurer." *Id.*

336. Some see *Bank of the West* as a narrow decision confined to the "unfair competition" and "advertising injury" coverage clauses only. John E. Morris, *Insurers Relieved By High Court Coverage Ruling; Justices Give Narrow Reading of "Advertising Injury,"* THE RECORDER, July 31, 1992, at 1. "Some lawyers said the decision could signal a larger shift away from the traditional rule that any ambiguity in the policy is interpreted in favor of the insured." *Id.*

intent of the parties.³³⁷ This intent is to be derived from the language of the contract provided that the language is clear and unambiguous.³³⁸ When the language is reduced to writing, the intention of the parties should be ascertained from the written memorial alone if possible.³³⁹ But in the event of ambiguous language, extrinsic evidence which has a tendency to prove the parties' intentions will be allowed³⁴⁰ and the ambiguous terms will be construed in light of what the promisor believed, at the time of the agreement, that the promisee understood it to mean.³⁴¹ If that does not resolve the ambiguity, then the doctrine of *contra proferentem* may be used and the terms are to be construed against the drafter of the contract.³⁴² These canons of construction presuppose a bargained-for agreement resulting in a contract which was mutually assented to. Furthermore, the interpretive rules dictated by the California Civil Code were enacted in 1872 and did not foresee the widespread use of adhesion contracts, the disparate bargaining power between the parties, nor the lack of competition in a market best described as an oligopoly.

The *Gray* approach coincided with the Civil Code only up to the point of section 1649 where the two principles diverged. Reasonable expectations skipped the section 1649 analysis and went straight into section 1654's *contra proferentem* rule,³⁴³ differing only in that such construction against the drafter is limited by reasonable expectations of the consumer/promisee.³⁴⁴ The jump to *contra proferentem* was due to a judicial realization that the insurer/promisor, when contracting with insureds, was in a power position over the consumer as promisee.³⁴⁵

337. "A contract must be so interpreted as to give effect to the mutual intention of the parties as it existed at the time of contracting, so far as the same is ascertainable and lawful." CAL. CIV. CODE § 1636 (West 1985); *Bank of the West*, 833 P.2d at 552; *AIU*, 799 P.2d at 1264.

338. "The language of a contract is to govern its interpretation, if the language is clear and explicit, and does not involve an absurdity." CAL. CIV. CODE § 1638 (West 1985).

339. "When a contract is reduced to writing, the intention of the parties is to be ascertained from the writing alone, if possible; subject, however, to the other provisions of this Title." CAL. CIV. CODE § 1639 (West 1985).

340. See CAL. CIV. PROC. CODE § 1856 (West 1983). See also *Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641 (Cal. 1968).

341. CAL. CIV. CODE § 1649 (West 1985); See *supra* note 277 for the full text of § 1649. See also *Medical Operations Mgt., Inc. v. National Health Lab. Inc.*, 222 Cal. Rptr. 455, 459 (Cal. Ct. App. 4 Dist. 1986).

342. CAL. CIV. CODE § 1654 (West 1985); *Bank of the West*, 833 P.2d at 552; *Beaumont-Gribin-Von Dyl Management Co. v. Cal. Union Ins. Co.*, 134 Cal. Rptr. 25, 27 (Cal.App. 2 Dist. 1976). Construction against the drafter outside the domain of insurance is a secondary maxim of construction. See *supra* note 42. But it must be recalled that the reasonable expectations doctrine in California is a variant of *contra proferentem* which was elevated to a rightful primary doctrine on its own, supported by legitimate judicial policy. See *Steven*, 377 P.2d at 290.

343. "[I]n the law of insurance . . . the ambiguity principle is transformed from a last-resort interpretive 'tie-breaker' into a tool of substantive policy that is intended systematically to favor the weaker party in the transaction." *Rahdert*, *supra* note 115, at 328.

344. See *Producer's Dairy Delivery*, 718 P.2d at 924.

345. See *Garcia*, 682 P.2d at 1105-06.

2. Section 1649 Does Not Adequately Address the Absence of Mutual Assent in an Adhesion Contract

Section 1649 embodies a requirement that the courts resolve ambiguities in contracts to effect the intentions of the parties.³⁴⁶ This is done by construing the policy in the manner in which the promising party thought the other party understood.³⁴⁷ It is a way of trying to ascertain what it was that the parties agreed to.³⁴⁸ However, such a laborious effort is not applicable to insurance contracts. Insurance contracts are “special” precisely because there is no mutual assent to an adhesion contract.³⁴⁹ *Gray* and its progeny made it clear that distinct rules applied to adhesion/insurance contracts because insureds rarely read, much less understand, the promises in their insurance policies.³⁵⁰ In the absence of cognizance by the insured of the matters contained within the contract document, there can be no mutual assent.³⁵¹

Consequently, a judicial search for mutual assent is a legal impossibility. For this reason, all ambiguities were construed against the insurer to effectuate the reasonable expectations of the insurance consumer.³⁵²

346. See CAL. CIV. CODE § 1636 (West 1985). See also Patterson, *supra* note 25, at 854. Professor Patterson notes that looking for the mutual intent of the parties “must be used with caution” because often both parties are at cross purposes which if apparent, encourages courts to fill in the gaps by judicial ascertainment of a “common purpose.”

347. *Bank of the West*, 833 P.2d at 552.

348. “It is . . . a general rule that the intent and meaning of the parties is far more important than the strict literal sense of the words used in the contract.” *Dart Equipment Corp. v. Mack Trucks, Inc.*, 88 Cal. Rptr. 670, 676 (Cal. Ct. App. 2 Dist. 1970).

349. “[I]n the purely judicial development of our law we have taken the law of insurance practically out of the category of contract, and we have established that the duties of public service companies are not contractual . . . but are instead relational.” *Gray*, 419 P.2d at 171 n.6 (quoting POUND, *THE SPIRIT OF COMMON LAW* 47 (1921)) (italics added).

350. Professor Rakoff expresses this view about traditional contracts analysis being used to determine mutual intent in adhesion contracts: “[T]he traditional treatment requires that adherents to form contracts be treated as if they had read and understood the document presented to them, even if that conclusion is false and known by the other party to be so . . . [T]he adherent has a ‘duty to read’ the document before signing it.” Rakoff, *supra* note 26, at 1187. See also Keeton, *supra* note 21, at 968.

351. Rahdert, *supra* note 115, at 329. To further exacerbate the problem, “[t]he risk manager knows enough to read the policy and check for the basics of the coverage, but it is not the basic situations that give rise to coverage disputes and lawsuits. Instead, it is the extraordinary situation which was never contemplated by the parties and therefore could not possibly have been in the risk manager’s mind when he or she reviewed the coverage.” Wollan & Weinstein, *supra* note 79, at 84 (italics added). Thus, “in the absence of plain and unequivocal exceptions, [insurance contracts] are construed to intend that which the insured is likely to understand.” *Moore v. Fidelity & Casulty Ins. Co. of N.Y.*, 295 P.2d 154, 157 (Cal. App. Dept. Super. Ct. 1956).

352. Interpreting contracts involves analysis of intent and reasonable expectations of the parties upon entering into an agreement; thus, the court must study not only the contract form but also the policyholder’s knowledge and cognizance as a layperson and the “normal” expectations of coverage under the insurance policy. *Aas v. Avemco Ins. Co.* 127 Cal. Rptr. 192, 198 (Cal. Ct. App. 1 Dist. 1976).

The biggest apparent deviation from *Gray* involves the introduction of section 1649 to the insurance contract interpretation rules. Because it was introduced but not used by the court, section 1649 appeared to assume the role of gatekeeper, preventing the *contra proferentem* rule of section 1654 from coming to play too early in the interpretive process. What makes the *Bank of the West* decision ominous, is the relegation of *contra proferentem* back into a doctrine of last resort.³⁵³ The courts may now construct uncertain language against the insurer only upon exhaustion of all the other traditional contract construction rules.³⁵⁴ The previous rule that any reasonable doubt as to coverage will be construed strictly against the insurer, and the language will be understood in its most inclusive sense,³⁵⁵ seems to have no place under *Bank of the West*.

3. Section 1649 Invites a Subjective Interpretation to Govern the Construction of Insurance Contracts

When Professor Keeton introduced his reasonable expectations theorem, he exalted the fact that the standard used in honoring the insured's reasonable expectations was an objective one.³⁵⁶ Under the reasonable expectations doctrine, the fiction of mutual intent was resolved by honoring the expectations of the reasonable consumer. Therefore a judge would: (1) read the insurance policy, (2) compare it to the factual circumstances, and (3) determine objectively whether an ordinary consumer would, in light of the prevailing circumstances, reasonably expect coverage from the policy at hand. This model generally made a subjective inquiry unnecessary and irrelevant.³⁵⁷

As the court noted in *Reserve Insurance Co. v. Pisciotto*, "[w]hen confronted with standardized provisions in a form insurance contract, the

353. See *supra* note 342. *Beaumont-Gribin-Von Dyl* and *Bank of the West* explain that to resolve the ambiguity section 1654, which expressly conditions its use *after* section 1636 et seq., should only be used as a last resort rule. It appears from the early insurance cases (which are treated *infra* part III.C.4.), that the doctrine of *contra proferentem* was a per se rule when involving insurance companies. Non-insurance contracts cases use § 1654 as a tie-breaker rule only. See *Western Camps, Inc. v. Riverway Ranch Enter.*, 138 Cal. Rptr. 918, 924 (Cal. Ct. App. 2 Dist. 1977); *Felt v. L.B. Frederick Co.*, 206 P.2d 676, 678 (Cal. Ct. App. 2 Dist. 1949).

354. See *supra* text accompanying note 328.

355. *Holz Rubber*, 533 P.2d at 1063.

356. "An objective standard produces an essential degree of certainty and predictability about legal rights, as well as a method of achieving equity . . . between insurer and insured. . . ." Keeton, *supra* note 21, at 968.

357. See *Producers Dairy Delivery*, 718 P.2d at 925 ("[I]f the evidence offered would not persuade a reasonable man that the instrument meant anything other than the ordinary meaning of its words, it is useless." (quoting from *Blumenfeld v. R.H. Macy & Co.*, 154 Cal. Rptr. 652 (Cal. Ct. App. 1 Dist. 1979)); *City of Mill Valley v. Transamerica Ins. Co.*, 159 Cal. Rptr. 635, 638-39 (Cal. Ct. App. 1 Dist. 1980) (explaining that testimony of underwriter in as far as it purports to show intended coverage other than that defined on the face of the policy has no probative value).

primary focus of our inquiry is on the reasonable expectations of the insured at the time he purchased the coverage."³⁵⁸ The *Bank of the West* analysis maintains that "this rule [section 1649], as applied to a promise of coverage in an insurance policy, protects not the subjective beliefs of the insurer but rather, the 'objectively reasonable expectations of the insured.'"³⁵⁹ However, the rule, by its own terms, belies the foregoing statement. Section 1649 demands inquiry into what the insurer believed that the consumer understood—thus requiring scrutiny of *the parties themselves*. No analysis of the promisee's (insured's) reasonable expectations is required by the Code section. Rather, the sole inquiry pertains to what the promisor (insurer) *believed* the promisee understood. The test proposed by *Bank of the West* necessarily involves a test of *actual subjective understanding* involving no inquiry whatsoever into reasonableness. Ascertaining the belief of one particular party vis-a-vis the understanding of the other party cannot be disguised as an objective determination.

The Lucas Court's shifting of the focus of inquiry from the objectively reasonable expectations of the ordinary consumer to the subjective understanding of the insurance company blatantly ignores the fundamental adhesion theory of insurance contracts. This doctrine sought to protect the consumer from the inequity inherent in unequal bargains and the readily apparent danger of overreaching by insurers.³⁶⁰ As Professor Rahdert pointed out in 1986, "such a retreat [to traditional contract doctrine] displays an ostrich-like unwillingness to confront head on the realities of the adhesion insurance contract."³⁶¹ California's hybrid reasonable expectations doctrine supplied a means to check the power of the insurance industry in the contract equation, but at the same time prevented the misuse of the doctrine by the

358. 640 P.2d at 769. See *Gray*, 419 P.2d at 171-72.

359. *Bank of the West*, 833 P.2d at 552.

360. See also Keeton, *supra* note 21, at 963. Cf. 13 JOHN ALAN APPLEMAN & JEAN APPLEMAN, *INSURANCE LAW AND PRACTICE* § 7401 (rev. vol. 1976) ("And if, from the language employed in the policy, it is possible to adopt either of two reasonably consistent interpretations, that construction will be adopted which permits recovery, rather than the one which would deny coverage. This is true *even though the insurer may have contemplated a different construction*") (italics added).

361. Rahdert, *supra* note 115, at 373. This is an echo of Professor Kessler's belief that: "The task of adjusting in each individual case the common law of contracts to contracts of adhesion has to be faced squarely and not indirectly. . . . [C]ourts have an understandable tendency to avoid this issue by way of rationalizations. They prefer to convince themselves and the community that legal certainty and 'sound principles' of contract law should not be sacrificed to the dictates of justice or social desirability. Such discussions are hardly profitable." Kessler, *supra* note 59, at 637. Current non-insurance contracts cases mirror the pre-*Gray* insurance contract interpretation analyses. See e.g., *Medical Operations Mgt., Inc. v. Nat'l Health Lab., Inc.*, 222 Cal. Rptr. 455 (Cal. Ct. App. 4 Dist. 1986); *W. Camps, Inc. v. Riverway Ranch Enter.*, 138 Cal. Rptr. 918 (Cal. Ct. App. 2 Dist. 1977). The promisor, however, is not always the drafter in these cases. See *Western Camps*, 138 Cal. Rptr. at 924. The steps in the proof process, the type of evidence allowed, the rule governing ambiguities, *contra proferentem* as a secondary interpretation maxim are identical in all respects to the pre-*Gray* rules of insurance contract interpretation. In light of the *Bank of the West* decision, future insurance contract construction cases will probably resemble all other contract construction cases. Contrary to Justice Panelli's assertion, insurance contracts will not be so "special" after all.

insured through the requirement that the expectations derived by the insurer be objectively reasonable.³⁶²

Under the *Gray* formulation, analysis of reasonable expectations involved the judiciary as the outcome determinative party. The judge, as a neutral third party determined whether the expectations derived by the insured were reasonable under the circumstances.³⁶³ As Professor Henderson correctly points out, the insurer's reasonable belief will likely differ from that of the insured.³⁶⁴ By virtue of the insurer's greater experience and knowledge of the intricacies of insurance, his perception of what is objectively reasonable to expect under particular policy provisions will undoubtedly differ from that of the reasonable unversed insured.³⁶⁵ The insurer, with the plethora of knowledge he possesses, will not contemplate expectations which would have been reasonable in a layperson's point of view when drafting policy terms. A truly objective determination would weigh the particular insured's expectations with those reasonably derived by others with an equal lack of sophistication³⁶⁶ because only insurers and creative lawyers can derive any meaning from standard "insurese."³⁶⁷ The standard proposed by section

362. "[A] finding of ambiguity in policy language cannot be based on an unreasonable misunderstanding on the part of the insured." *Producers Dairy Delivery*, 718 P.2d at 925; See also Rahdert, *supra* note 115, at 370. Thus, the reasonable expectations doctrine was not merely a "sword" for the insured's benefit, but could also be used as a "shield" by the insurer in the appropriate case where expectations were unreasonable or not present. Wollan & Weinstein, *supra* note 79, at 84.

363. This has been a point of contention for those opposed to the reasonable expectations doctrine. See generally Mayhew, *supra* note 12 (reasonable expectations doctrine used as covert judicial tool). But as the court in *Henningsen* *supra* quoted from Corbin, judges are still "chancellors" who look to equity in situations where there is fundamental unfairness in the bargaining situation. *Henningsen*, 161 A.2d at 85-86 (quoting 1 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 128 (1950)). "The task of the judiciary is to administer the spirit as well as the letter of the law." *Steven*, 377 P.2d at 297 (quoting *Henningsen*, 161 A.2d at 94). One's view regarding this issue will be influenced greatly by one's predilection towards judicial activism or conservatism. For an illuminating study of this issue in the area of reasonable expectations, see generally Swisher, *supra* note 71.

364. Henderson, *supra* note 16, at 847. Professor Henderson was analyzing the objective "reasonableness" standard and the differences inherent between the Keeton-type reasonable expectations and that contained in the Restatement (Second) of Contracts § 211. The Restatement (Second) formulation is similar to that espoused by § 1649 because in both cases, the determination of objective reasonableness is predicated upon the insurer's perception of the insured's state of mind at the time of contracting. Under § 211 of the Restatement (Second), an adhesive standard form contract is presumed enforceable unless the insurer (promisor) had reason to believe that the insured (promisee) would not have assented to the contract had she known that certain terms existed in the contract. See *supra* note 18 for the full text of § 211.

365. *Id.* Leaving the market forces to shape what is reasonable under the circumstances is unacceptable because the businessman is out to protect his own interests and lacks the impartiality of the judge. Rakoff, *supra* note 26, at 1204.

366. "The thrust of the reasonable expectations doctrine is . . . more concerned with the impact of particular policy provisions in the run of cases. Accordingly, the expectations of the average insured, not the plight of the particular claimant should be the main inquiry." Rahdert, *supra* note 115, at 387.

367. As shown by the disparate treatment of *Bank of the West* by the First District appellate court and the California Supreme Court (detailed *supra*), even learned judges disagree over the meanings to be given to insurance language.

1649 is only quasi-objective. Shifting the focus of inquiry from the insured to the insurer "contains a . . . bias, that does not exist in the Keeton formulation."³⁶⁸

The reasonable expectations doctrine also imposed a clearer duty upon the insurer to draft clear and unambiguous policy language.³⁶⁹ The section 1649 analysis would permit an insurer to hide behind obfuscating language since his perceptions will control the outcome of the case. The problem concerning the adhesive nature of insurance contracts is still as real today as it was in 1966. Unfortunately, the post-*Bank of the West* state of the law may be attributed not to a change in the circumstances surrounding insurance contracts but merely to changes in the composition of the California Supreme Court in recent years.³⁷⁰

4. Addition of Section 1649 Imposes a Heavier Evidentiary Burden on the Insured

Under the *Bank of the West* analysis, the insured must prove that the insurer knew what the insured understood the contract to mean. In order for the insured to prove the insurer's knowledge of the insured's expectations, resort must be had to extrinsic evidence. The type of extrinsic evidence required by section 1649 is not readily available to the modern-day insured in light of prevailing business practices.

Pre-*Gray* insurance coverage cases using section 1649 exemplify the need for extrinsic evidence in order for the insured to satisfy his burden of proof. In *Norton v. Farmers Inter-Insurance Exchange*,³⁷¹ the dispute arose out of auto insurance contract language limiting the insurer's liability to occurrences giving rise to injuries when only the insured himself was operating the insured vehicle.³⁷² The plaintiff, who was the deceased insured's daughter-in-law, appealed from the trial court's refusal to allow extrinsic evidence.³⁷³ The proffered evidence consisted of testimony concerning the negotiations between the insured and the defendant company.³⁷⁴ The conversations tended to show that the deceased insured commu-

368. Henderson, *supra* note 16, at 848.

369. *Id.*

370. It is ironic to note that the increasing trend towards formalist courts in California would result in these courts pursuing the very same type of judicial activism that they railed against and eventually supplanted.

371. 105 P.2d 136 (Cal. Ct. App. 1 Dist. 1940).

372. The limiting provision, under the heading "Terms and Conditions Forming a Part of This Contract" and sub-heading, "Risks Not Assumed By This Exchange" stated in part: "The Exchange shall not be liable for loss or damage . . . (D) Caused while the said automobile is being driven or operated by any person other than the Insured or a member of his immediate family or his paid driver; unless said person, otherwise qualified hereunder, is temporarily operating said vehicle with the consent of the Insured except that the extension provided for in this condition shall not be available to: . . ." *Id.* at 137.

373. *Id.*

374. *Id.* at 138.

nicated his desire to have his daughter-in-law covered under the policy, to which the insurer's agent orally acquiesced.³⁷⁵

The California Supreme Court held that the language employed by the insurer was ambiguous.³⁷⁶ Therefore, extrinsic evidence³⁷⁷ relating to the situation surrounding the transaction was admissible.³⁷⁸ The court also noted that neither party had to show which of the interpretations was more logical, since under section 1649, the policy is construed in light of what the insurer believed, at the time, the insured understood the transaction to mean. The extrinsic evidence showed that the insurer knew about the insured's expectation of coverage.

The importance of extrinsic evidence to a section 1649 determination is obvious. The contract which contains language ambiguous enough to trigger the application of section 1649, cannot provide the court with the information it needs to establish the intent of the parties.³⁷⁹

The extrinsic evidence need not pertain exclusively to the time the agreement was reached.³⁸⁰ Thus, in *McPhail v. Pacific Indemnity Co.*,³⁸¹ the First District Appeals Court analyzed extrinsic evidence such as the conversations between the insurer's agent and the insured prior to the

375. *Id.* The extrinsic evidence stricken by the trial court consisted of testimony by two witnesses who said that they were present and overheard the conversations on several occasions between the insured and the insurance agent wherein the insured stated unequivocally that he wanted coverage under the policy for his daughter-in-law since he (the insured) was not driving anymore and she was doing most of the driving at the time. The agent replied that the request would be taken care of in the policy.

376. *Id.* at 139.

377. "[F]or the purpose of determining what the parties intended by the language used, it is competent to show not only the circumstances under which the contract was made, but also to prove that the parties intended and understood the language in the sense contended for; and for that purpose the conversations between and declarations of the parties during the negotiations at and before the time of execution of the contract may be shown." *Id.* at 140 (paraphrasing from *Balfour v. Fresno C. & I. Co.*, 41 P. 876, 877 (Cal. 1895)).

378. See CAL. CIV. CODE § 1647 (West 1985); RESTATEMENT (SECOND) OF CONTRACTS § 212 cmt. b (1979) (allowing for extrinsic evidence to ascertain the transaction in "length and breadth" but language still remains the most important evidence).

379. Extrinsic evidence is especially important considering that, contrary to the *Bank of the West* Court's claims, § 1649 seeks evidence of the insurer's subjective knowledge. See *supra* discussion of *Norton v. Farmers Inter-Ins. Exch.*

380. See *Pac. Gas & Elec.*, 442 P.2d at 645. ("[R]ational interpretation requires at least a preliminary consideration of *all* credible evidence offered to prove the intention of the parties") (italics added).

381. 180 P.2d 735 (Cal. Ct. App. 1 Dist. 1947). In this case, the plaintiff acquired a comprehensive liability policy from the defendant insurer which offered to cover all other risks not protected against by the plaintiff's present insurer who only covered the plaintiff's company-owned vehicles. *Id.* at 736. The insurer issued the policy with the following qualification: "[T]he insurance provided . . . shall not extend to cover any bodily injuries, . . . death or property damage arising out of the ownership, maintenance or use by the assured of automobiles, motor vehicles, trailers and/or non motor driven road making equipment *while being towed behind or carried upon motor driven equipment, including the loading and unloading thereof.*" *Id.* at 737. The appellate court agreed with the trial court and found that the policy covered all vehicles except when such were being carried or towed. *Id.* at 737-38. Thus, when the insured hired cement mixers, one of which injured a third party, the insurer was held responsible for defense of the suit and indemnity for the insured pursuant to the policy of insurance.

purchase of insurance and both the insurer's and the insured's actions subsequent to the issuance of the policy, to determine that the insurer was well aware of what the insured thought was covered under the contract.³⁸² Modern business practices are more impersonal than they were when the early cases discussed above were decided. Insurance policies are purchased over the telephone and through networks of independent insurance brokers. The insured has scant opportunity to derive any useable extrinsic evidence in the absence of face to face transactions.

Section 1649 requires an evidentiary showing by the insured that the insurer was aware of the insured's understanding of the policy coverage. It would seem a simple matter to impute any knowledge of the insurance sales agent to the insurer.³⁸³ Therefore, the insured, as in *Norton* and *McPhail*, could establish that she expressed her expectations of coverage to the agent. This would tend to demonstrate the insurer's knowledge of the insured's expectations which would result in a decision in favor of the insured. However, this analysis depends upon the law of agency.³⁸⁴ It assumes that the insurance salesman is the agent of the insurer. Such a situation is fast becoming a rarity in present day insurance business practice. Much of the insurance business is conducted through insurance brokers who are considered agents of the *insured*,³⁸⁵ therefore, the statements and knowledge of the broker are not binding upon the insurer.³⁸⁶

For greater market share, today's insurers drown the consumer with advertisements to get under the "Traveler's umbrella," that they "are in good hands with Allstate," or "like a good neighbor, State Farm is there." These blurbs are designed to elicit a feeling of trust and reliance by the insured upon the good faith of the insurer:

The policyholder's chronic tendency to rely on the insurer's determination as to what constitutes adequate protection is widespread and often reasonable under the circumstances. In part, it has been fostered by

382. *Id.* at 739. See RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (1979) ("Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement").

383. See *supra* discussions of *Norton* and *McPhail*.

384. Whether the insurance sales representative is a principal of the insurer or the insured is determined by the laws of agency. 39 CAL. JUR. 3D *Insurance Companies* § 146 (1977). See *Eddy v. Sharp*, 245 Cal. Rptr. 211 (Cal. Ct. App. 3 Dist. 1988) (holding that an insurance broker who selects one among a number of insurers to provide coverage for the insured at the insured's direction is an agent of the insured).

385. "[A]n insurance agent is one who is authorized by an insurer to transact insurance on its behalf, whereas a broker . . . transacts insurance on behalf of the insured." 39 CAL. JUR. 3D *Insurance Companies* § 145 at 142 (1977).

386. See CAL. EVID. CODE § 1222 (West 1966) (requiring party opponent admissions be made by authorized agent). One probable result of the difficult evidentiary burden imposed by the decision in *Bank of the West* would be a tremendous increase in lawsuits by consumers against insurance brokers for the insurance industry's failure to provide the coverage which the insured reasonably expected. This is because the insured will be better able to establish what she told the broker she wanted as opposed to what the insurer ultimately knew.

insurance marketing practices, ranging from the selling techniques of local agents to representations in national advertising—one might call it the “good hands” phenomenon. In part, it represents a sensible human response to the adhesive character of the transaction.³⁸⁷

Unfortunately, the insurance consumer cannot use these representations as extrinsic evidence to prove any knowledge of the insurer vis-a-vis the insured’s reasonable expectations of coverage precisely because the advertisements sell *security*³⁸⁸ and *service, not coverage*.

5. Section 1649 Gives Insurers an Unfair Advantage in the Proof Process

The change of focus to the perceptions of the insurer will cause any evidence proffered by the insured regarding the insurer’s knowledge to be refuted facily by the insurer. Ninety-five percent of all casualty policies are written by the Insurance Services Office³⁸⁹ (ISO). The ISO collects statistical data from which it calculates the risks pertaining to specific standard form language.³⁹⁰ Consequently, it is fair to assume that the language that appears on the consumer’s form contract is the “safest” possible terminology favoring the risk-averse insurer.³⁹¹ A reasonable insurer would not logically include terms in the standard policy which an insured would reasonably misconstrue—this is the *raison d’être* of the ISO.

Thus, when an insured claims expectations of coverage based upon an ambiguous policy provision, the insurer need only offer the ISO data pertaining to the provision in question to swiftly negate any perception on the insurer’s part regarding the contested language.³⁹² The ISO data is intrepidly guarded by insurers as a trade secret and many a lawsuit has been bogged down in pre-trial discovery due to the refusal of insurers to share this “trade” information with counsel for the insured.

387. Rahdert, *supra* note 115, at 343 (footnote omitted).

388. *See Crisci v. Security Ins. Co. of New Haven, Conn.*, 426 P.2d 173, 179 (Cal. 1967) (explaining that insurance company is in the business of selling peace of mind).

389. Henry J. Reske, *Was There a Liability Crisis?*, A.B.A. J., Jan. 1989, at 46 (the percentage figure above was alleged in an insurance industry lawsuit). The ISO creates the standard policy language used in insurance contracts; it is a trade pact which represents over a thousand insurance companies and is run on a non-profit basis. *Id.*

390. *Bank of the West*, 833 P.2d at 550.

391. Insurance companies require exact calculation of risks in order to thrive, and in the drive for increased profits, insurers are especially leery of what Professor Patterson describes as “judicial risk”—the risk that courts would find contrary to the insurer when the probabilities derived by the insurer in the calculation of risk, pertaining to specific provisions in the contract were determined to fall the other way. Risks that are difficult to calculate can be excluded altogether. *See Kessler, supra* note 59, at 631.

392. *See Maryland Casulty Co. v. Reeder*, 270 Cal. Rptr. 719 (Cal. Ct. App. 4 Dist. 1990), *review denied*, 1990 Cal. LEXIS 4366 (Cal. 1990). Finding coverage under the policy provisions, the court in *Reeder* used an ISO circular (published for use of insurer to explain “extent, purpose, and effect” of ISO-drafted standardized language) to show that the insured’s explanations were identical to the ISO interpretation. *Id.* at 725.

6. If Section 1649 is applied literally, insurance litigation will become more complicated and expensive

The reasonable expectations analysis was a streamlined process which involved the following steps: (1) review the policy, (2) analyze the underlying lawsuit, (3) ascertain ambiguity, (4) determine the reasonable expectations of an ordinary consumer, and (5) resolve the case. Under the interpretation rule of section 1649, the reviewing court would also employ the first three analytical steps in the reasonable expectations method but the similarity ends there.

After *Bank of the West*, courts would have to continue the analysis by subsequently: (1) determining the insured's beliefs, and (2) ascertaining whether the insurer was aware of the insured's beliefs (failure in this step ends the analysis). Furthermore, if the objectively reasonable expectations dicta in *Bank of the West* is applied, the analysis must continue with: (3) determining whether the insured's expectations are reasonable, (4) if they are reasonable, then the ambiguity is resolved against the insurer. Consequently, *Bank of the West* harms the insurance consumer in a number of ways: (1) It subrogates the insured's reasonable expectations to that of the insurer; (2) it revives traditional and technical canons of construction formerly deemed inapplicable to an insurance contract analysis; (3) It creates an impossible burden of proof considering the structure of the modern marketplace and the concentrated might of the ISO.

Additionally, if the "reasonable expectations" language contained in the *Bank of the West* opinion has any force, it acts to further limit the insured's ability to recover under the insurance policy. As noted previously, under a non-insurance contract analysis, once section 1649 fails to resolve an ambiguity, the court applies section 1654's *contra proferentem* as a *per se* rule regardless of any determination of reasonableness. *Bank of the West* added an extra analytical step into the interpretive equation by requiring that the expectations derived by the policyholder be reasonable before *contra proferentem* applies.

In order to satisfy his burden of proof³⁹³ using section 1649, an insurance litigant will require the services of expert industry witnesses such as underwriters and insurance agents³⁹⁴ to determine what an insurer would believe an insured expects by way of coverage under certain circumstances. Pre-trial discovery procedures will be magnified in complexity and expense

393. The insured has the burden of showing inclusion under the policy's coverage provisions while the insurer bears the burden of establishing non-coverage under the policy's exclusion language. See *City of Beverly Hills v. Chicago Ins. Co.*, 668 F.Supp. 1402, 1405-06 (C.D. Cal. 1987).

394. This assumes the plaintiff can convince them to testify against their employers. If the plaintiff decides to go by another route, he may procure the services of ex-industry workers which will also undoubtedly be expensive.

and unfortunately, it is the insurance consumer, less capable of shouldering the economic cost, who will undoubtedly suffer.

The practical effect of adding section 1649 is to deny consumers the ability to obtain that which they expected when they bought insurance. Only the very wealthy will now be able to afford a battle against the economic might of an insurer.

7. Even the Restatement (Second) of Contracts Section 211 Provides No Refuge

The Restatement (Second) of Contracts specifically provides for the form contract situation.³⁹⁵ The Restatement's application is flawed in the same manner as the California Civil Code's traditional contract interpretation canons because both approaches do not adequately provide for the realities of the modern marketplace.³⁹⁶ Furthermore, as the discussion below will illustrate, section 211 concerns itself more with conscionability rather than ambiguity.

Professor Henderson forecast in 1990, that the new trend in the law appears to be towards the adoption of Restatement (Second) section 211 (hereinafter section 211) to govern insurance contract disputes.³⁹⁷ He based his predictions upon recent decisions of the Iowa³⁹⁸ and Arizona³⁹⁹ Supreme Courts. Section 211 mandates that standardized contracts, whether read by the insured or not are presumptively enforceable.⁴⁰⁰ Subsection (3) of the rule contains this language: "Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that

395. The Restatement (Second) of Contract's § 211 is entitled "Standardized Agreements." See *supra* note 18 for the complete text of the relevant Restatement (Second) section.

396. See *supra* discussion in part III.C.4.

397. Henderson, *supra* note 16 at 846.

398. *Farm Bureau Mut. Ins. Co. v. Sandbulte*, 302 N.W.2d 104 (Iowa 1981), later *proceeding*, 343 N.W.2d 457 (Iowa 1984). In *Sandbulte*, the insured farmer held a general farm liability policy which contained a motor vehicle exclusion clause which provided no coverage for incidents arising out of the use of a motor vehicle outside of the insured's farm or the ways adjoining such. *Id.* at 106-07. Since the insured owned several separate parcels of land, he would travel between the parcels in the course of his farm work and it was while engaged in such an endeavor, that a collision occurred between the insured's truck and another vehicle. *Id.* at 107.

399. *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, 682 P.2d 388 (Ariz. 1984). In *Darner*, the insured motor vehicle sales and leasing company obtained a general business risk policy and separate insurance coverage for lessees of their vehicles from an agent of the insured. *Id.* at 390. There was some misunderstanding pertaining to the coverage amount of the lessee liability policy upon its renewal a year and a half later. *Id.* The insured believed that the coverage amount fell below the amount in the original policy and claimed to have phoned the agent to see the agent about it because the insured's rental agreements contained representations of the alleged higher coverage amount. *Id.* Before any action was taken by either side, a lessee was involved in an accident and sued the insured for coverage of the amount represented in the rental agreement. *Id.* at 391.

400. RESTATEMENT (SECOND) OF CONTRACTS § 211 (1), (2) (1979).

the writing contained a particular term, the term is not part of the agreement."⁴⁰¹

Under section 3, comment f, the A.L.I. authors proposed that "reason to believe" can be inferred by three factors: (1) the term is bizarre or oppressive, (2) eviscerates expressly agreed terms, or (3) eliminates the dominant purpose of the transaction.⁴⁰²

The shift of focus to the promisor/insurer here seems less formalistic than the section 1649 formulation because the third test pertaining to the "dominant purpose" sounds very much like the "nature and kind" formulation proposed by Justice Tobriner in *Gray v. Zurich*.⁴⁰³ However, the application of the doctrine by the Iowa Supreme Court in *Farm Bureau Mutual Insurance Company v. Sandbulte* was not very promising. The court took a very narrow view of the "dominant purpose test" by placing greater weight on the exclusionary language rather than the fact that the damages occurred within the scope of the farming business, which was arguably the dominant purpose for the procurement of the insurance.⁴⁰⁴ The problem with the "dominant purpose test" is that an insured's "dominant purpose" will always be the procurement of insurance protection⁴⁰⁵ and unless the policy provisions so grossly undercut all coverage expectations will any construction in favor of the insured occur. All three exceptions to the general rule of section 211 enforceability hinge upon extraordinary coverage-defeating provisions but not to the subtle methods by which insurers may manipulate language in order to gut most of the substance out of a coverage provision but still leave some of it intact for events most unlikely to happen—in semblance of protection still offered to the unwary insured.

The state of Arizona expressly rejected the reasonable expectations doctrine because it was felt that a rule must be applied which recognized more than just "fervent hope usually engendered by loss."⁴⁰⁶ The court made it very clear that it intended to uphold the supremacy of traditional contracts law in the construction of insurance policies.⁴⁰⁷

Yet in both states, the restriction that the insurer should have reason to believe the non-assent of the insured was not plainly addressed,⁴⁰⁸ and

401. *Id.* § 211(3).

402. See Rahdert, *supra* note 115, at 359-60 (explaining that the first two conditions most likely will never occur in the insurance context and only the third condition will probably supply the issue which the insured could litigate).

403. 419 P.2d at 175.

404. Rahdert, *supra* note 115, at 360.

405. *Barrera v. State Farm Mut. Auto. Ins. Co.*, 456 P.2d at 682 ("The reasonable expectation of both the public and the insured is that the insurer will duly perform its basic commitment: to provide insurance.").

406. *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, 682 P.2d at 388, 395 (Ariz. 1984).

407. "In our view, a better rationale is to be found by application of *established principles of contract law.*" *Id.* (emphasis added).

408. Henderson, *supra* note 16, at 848.

subsequent case law appears to be in flux.⁴⁰⁹ The three methods by which an insured is likely to infer some knowledge of non-assent upon the insurer under section 211 are extraordinary situations which are most unlikely to happen in light of the sophistication of the insurer in the manipulation of language. They are contingent upon a nebulous and yet untested requirement that the insurer have reason to believe that the insured would not have assented—which, if taken literally fails for all the same reasons indicated earlier that section 1649 fails in solving the adhesion problem both doctrinally and procedurally.⁴¹⁰

Both section 211 and the California Civil Code section 1649 are unrealistic in their failure to address the realities of the adhesive nature of insurance contracts. Both are founded upon and mandate a return to the traditional notions of contract construction for insurance policies. Had there been adequate protection for the expectations of the insured, the reasonable expectations doctrine would never have developed. The rise of the reasonable expectations doctrine was a revolt against the traditional contracts view which did not provide and to this day still does not provide an adequate deference to the realistic expectations that may arise out of a transaction between two vastly unequal parties.

CONCLUSION

The *Bank of the West* decision appears to signal a lamentable departure from the well-settled practice of protecting the insurance consumer's reasonable expectations. For twenty-five years the reasonable expectations doctrine provided a check on the unbridled power of the insurance industry. The insurance contract remains an adhesion contract. It forces the individual to accept "organizational hierarchies" rather than an agreed upon deal.⁴¹¹ In this scenario "bargaining ceases to be expected, or even appropriate, consumer behavior."⁴¹² Consequently, canons of construction designed to oracle the terms of mutual assent have no place in the insurance context and judicially created interpretive rules were specifically developed to close this doctrinal gap.

409. Professor Henderson sees some hybrid form of the reasonable expectations doctrine evolving in Arizona and Iowa. *Id.* at 852. In fact, both states appear to be moving away from strict Restatement (Second) § 211 applications. *Id.*

410. *See supra* Part III.C.1. Assume a consumer wishes to purchase a policy on the London Market at Lloyd's. He would contact an American broker who, in turn, would contact a London broker. The London broker would prepare a sheet specifying essential terms. The sheet would then be posted, allowing thousands of entities to bid for interests in the contract. Once it is completely underwritten, the London broker would send the policy, usually comprised of multiple risk ISO forms to the American broker. There is no point in the transaction where the promisor becomes aware that the insured would not assent to the contract due to any particular policy term. *See also* Keeton, *supra* note 21, at 968 (recognizing that the insured receives the policy (and has the opportunity to read it) after he is already bound by its terms).

411. Rakoff, *supra* note 26, at 1225.

412. *Id.*

Gray's reasonable expectations doctrine, which was designed for the adjudication of insurance contract disputes, recognized that the average consumer would not read his policy, nor understand it even if he had read it. Under *Gray*, mutual assent of the specific parties was replaced by the implied assent of the reasonable ordinary consumer. What the ordinary consumer would expect under like circumstances provided the template for what the courts would order by way of insurance coverage.

The reasonable expectations doctrine had many positive features. First, it acknowledged the practical problems involved in proving the subjective intent of the economically powerful insurance industry. Second, it provided a check upon the coercive economic power of the insurer by protecting the objectively reasonable expectations of the ordinary consumer, regardless of the outcome of a technical policy analysis. The *Gray* doctrine correspondingly protected the insurer's interests by conditioning application of the rule only to cases involving ambiguous contract language. Even then, coverage would be limited to that which the ordinary consumer would reasonably expect, regardless of the insured's actual subjective expectations.

Moreover, the reasonable expectations doctrine made coverage disputes relatively facile and inexpensive. Under *Gray*, most cases could be resolved by judicial review of the insurance policy and the underlying facts (usually as pleaded in the underlying complaint). Minimal extrinsic evidence of circumstances and negotiations was needed since the court was enforcing an objective test.

Through *Bank of the West*, the California Supreme Court provided the insurance industry with a valuable benefaction—protection of the insurance industry's expectations at the expense of the ordinary consumer. The judicial fiat of *Bank of the West* ignores the problem of the adhesion contract and the settled law specifically developed to address such. Applying the traditional canons of contract construction (embodied in the California Civil Code⁴¹³) to the insurance sphere will encourage insurers to use ambiguous language. This inference derives from the fact that under section 1649, the insurer's perception of the insured's understanding of the contract terms controls the outcome of the litigation. Consequently, the insured's purported beliefs will be incongruously derived from the ISO's position papers.

Bank of the West did not only relegate *contra proferentem* into a doctrine of last resort, but distorted it by discarding the notion of *per se* strict construction against the promisor for a weaker version conditioned upon objectively reasonable expectations on the insured's part. This reflects the court's adherence to a newly created rule which remains neither true to *Gray* and its progeny nor to traditional contract canons.⁴¹⁴ Under ordinary contract interpretation theory, *contra proferentem's* strict contra-insurer application was employed regardless of whether the non-drafting party had

413. CAL. CIV. CODE § 1635 et. seq (West 1985).

414. See discussion *supra* part III.B.3.

reasonable expectations of coverage. *Bank of the West* perverted the rule espoused by *Gray* and its progeny by adopting *Gray's* variation of *contra proferentem* conditioned upon reasonable expectations but adding the inapplicable section 1649 analytical step.

The insurance industry performs a quasi-political role in the manner in which it controls the conduct of the parties with which it contracts, yet state regulation of the industry is weak—a situation compounded by the presence of the monolithic insurance lobby which wields its power over legislatures throughout the nation. Because of all the advantages⁴¹⁵ afforded the insurance industry, courts used to employ their equitable powers through the reasonable expectations doctrine to correct the fundamentally unjust situation. Aristotle once wrote that equity applied,

[I]n a situation in which the law speaks universally, but if the case at issue happens to fall outside the universal formula, it is correct to rectify the shortcoming, in other words, the omission and mistake of the lawgiver due to the generality of his statement.⁴¹⁶

Indeed the universal contracts law failed to address the special situation inherent in the adhesion transaction and equity provided the answer. When courts lose sensitivity to circumstances beyond the physical form of the contract and refuse to honor the reasonable expectations induced by promises, it is as if we have made true what Professor Kessler intimated in 1956: “[R]easonable expectations created by promises [must] receive the protection of the law or else we will suffer the fate of Montesquieu’s Troglodytes, who perished because they did not fulfill their promises.”⁴¹⁷

415. “[Insurers] are . . . seen as bound by an implicit social contract to make their product available to those who need it. That and their sheer size are why insurers have long occupied a position in America somewhere between that of a public utility and that of the “private government . . . They are treated in law as even more special than banks . . .” *American Insurance: The Trick is to Stay Upright*, THE ECONOMIST, October 27, 1990 at 5. The industry is also exempt from federal antitrust laws under the McCarran-Ferguson Act and thus can escape the legal consequences of such “collusive practices” as collective rate making in exchange for good faith dealings and availability of the service to the public. *Id.*

416. ARISTOTLE, NICHOMACHEAN ETHICS 141-42 (Ostwald trans. 1962).

417. Kessler, *supra* note 59, at 629. The ancient Troglodytes (or “Troglodytes”) were a mythical “brutish” tribe who were fabled to inhabit a portion of Arabia. CHARLES LOUIS, BARON DE MONTESQUIEU, LETTRES PERSANES, IN PERSIAN AND CHINESE LETTERS: BEING THE LETTRES PERSANES BY CHARLES LOUIS, BARON DE MONTESQUIEU AND CITIZEN OF THE WORLD BY OLIVER GOLDSMITH 25, 45 (Oliver H.G. Leigh, ed., John Davidson, trans., 1901). These people “lacked all notions of justice and equity.” *Id.* Because they favored only their own selfish interests and abandoned the “general welfare,” *id.* at 46, they “perished in their sins.” *Id.* at 48. Of the entire tribe of ancient Troglodytes, only two righteous families survived. *Id.*