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## **The Insurance Policy as Thing**

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## THE INSURANCE POLICY AS THING

*Jeffrey W. Stempel*

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## I. INTRODUCTION

It is perhaps a truism to say that an insurance policy is a contract,<sup>1</sup> but a truism that glosses over many of the most problematic questions when adjudicating insurance coverage disputes. Within contract law itself, scholars

1. See, e.g., *United Servs. Auto Ass'n v. Riley*, 899 A.2d 819, 833 (Md. 2006) (insurance policies are "treated as any other contract."); *Vestin Mortg., Inc. v. First Am. Title Ins. Co.*, 139 P.3d 1055, 1057 (Utah 2006) (insurance policy is "merely a contract between the insured and the insurer" to be "construed pursuant to the same rules applied to ordinary contracts"); *Rory v. Continental Ins. Co.*, 703 N.W.2d 23, 27 (Mich. 2005) (insurance policies governed by rules governing all contracts). This view is also uniformly embraced in leading insurance and contract treatises and casebooks, including my own. See, e.g., BARRY R. OSTRAGER & THOMAS R. NEWMAN, *HANDBOOK ON INSURANCE COVERAGE DISPUTES* § 1.01 (14th ed. 2008) (treating insurance policies as contracts, emphasizing intent of contracting parties over text of policy but noting that courts typically treat policy language as best indicator of party intent); ROBERT H. JERRY II & DOUGLAS R. RICHMOND, *UNDERSTANDING INSURANCE LAW* § 25A (4th ed. 2007) (discussing insurance contract interpretation); LEO P. MARTINEZ & JOHN W. WHELAN, *CASES AND MATERIALS ON INSURANCE LAW* (5th ed. 2006) (Ch. 2: "Forming and Negotiating the Insurance Contract"; Ch. 3: "Interpretation of Insurance Contracts"); JEFFREY W. STEMPEL, *STEMPEL ON INSURANCE CONTRACTS* Chs. 3 passim (3d ed. 2006 & Supp. 2009) (treating insurance as matter of contract); KENNETH S. ABRAHAM, *INSURANCE LAW & REGULATION: CASES AND MATERIALS* Ch. 2 (4th ed. 2005) (treating insurance policies as contracts); EUGENE R. ANDERSON, JORDAN S. STANZLER & LORELIE S. MASTERS, *INSURANCE COVERAGE LITIGATION* Chs. 1 & 2 (2d ed. 2004) (same but noting Williston's observation that insurance policies have elements of chattel as well as contract); EMERIC FISCHER, PETER NASH SWISHER & JEFFREY W. STEMPEL, *PRINCIPLES OF INSURANCE LAW* Ch. 2 (3d ed. 2004 & Supp. 2006) (extensive discussion of contract interpretation groundrules and application to insurance); ROGER C. HENDERSON & ROBERT H. JERRY II, *INSURANCE LAW: CASES AND MATERIALS* § 1.03 (3d ed. 2001) (treating insurance as subspecies of contra in introductory chapter on the "nature of insurance arrangements"); PETER J. KALIS, THOMAS M. REITER & JAMES R. SEGERDAHL, *POLICYHOLDER'S GUIDE TO THE LAW OF INSURANCE COVERAGE* (1997 & Supp. 2004) (same). But see STEMPEL ON *INSURANCE CONTRACTS*, *supra*, § 3.01 at 3-5: ("For the most part, insurance contract law is 'real' or 'regular' contract law applied to situations involving insurance—situations that may to a greater degree than usual involve: standard form contracting, unequal bargaining power, non-negotiated terms, ambiguity, and recurring equitable considerations that tend to bring results less doctrinaire and consistent than those perhaps found in other areas of law. Frequently, courts or legislatures have attempted to organize or explain these results by enunciating contract axioms that purport to be peculiar to insurance disputes. . . . Those pronouncements and case outcomes, however, are not so different from what one would expect from 'ordinary' contract litigation.")

With the wisdom of hindsight, I now see this view, albeit one acknowledging the limits of a narrow contractual approach to insurance coverage disputes, as one that remains perhaps excessively moored to the traditional view of insurance policies as mere contracts and insufficiently appreciative of the manner in which insurance policies also resemble products or statutes, and are part of a social and economic fabric of effective risk management. Other observers were quicker to pick up on this facet of insurance. See, e.g., HENDERSON & JERRY, *supra*, at 18 (perhaps the most significant characteristic of insurance contracts that differentiates them from ordinary, negotiated commercial contracts is the increasing tendency of the public to look upon an insurance policy not as a personal contract between the insurer and insured but as a special form of chattel") (citing 7 SAMUEL WILLISTON, *A TREATISE ON THE LAW OF CONTRACTS* § 900 at 34 (3d ed. Jaeger 1963) ("The typical [insurance] applicant buys 'protection' as much as he buys groceries. . . . [F]or most purposes, insurance must still be considered a contract between insurer and insured, but it is a very special type of contract and one currently involved in a prolonged period of popular gestation form which it may

and courts differ over the respective primacy of text, party intent, contractual purpose, extrinsic evidence, and public policy in determining interpretative outcomes. Even where interpreters focus on a single dimension of the meaning of contract (e.g., the text of the contract documents), they often disagree as to the meaning of the text in question as well as over the general approach to construing text (e.g., broad vs. narrow, plain meaning vs. ordinary meaning, etc.).

In a world where most contracts are based on standardized forms, contracts have begun to look more like off-the-rack products or services rather than the individually negotiated deals that spawned the law of contract, a fact emphasized forty years ago by noted contracts scholars.<sup>2</sup> But despite the longstanding realization of the goods-like character of contracts in the academy, contract construction law has largely failed to make effective use of this observation to improve judicial resolution of disputes over contract meaning. This is especially true, and regrettable, regarding insurance policies, in which standardization is particularly dominant and where the transaction evinces a sale of a certain scope of risk shifting and distribution rather than entry into any particular or ongoing business relationship. Relentlessly, and often simplistically, courts continue to intone that they are merely reading insurance policies as written and contending that even highly problematic language is crystal clear<sup>3</sup> or that difficulty in translating

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well eventually emerge as a new and special form of chattel, or perhaps, quasi-chattel.”). Despite the truth and venerability of Williston’s observation, one scholar recently suggested that modern “[i]nsurance case law is increasingly marked by judicial reliance on the principle of freedom of contract.” See Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. INS. L.J. 107, 107 (2007).

2. See, e.g., W. David Slawson, *Standard Form Contracts and Democratic Control Over Law-making Power*, 84 HARV. L. REV. 529 (1971); Arthur A. Leff, *Contract as Thing*, 19 AM. U.L. REV. 131 (1970). See text and accompanying notes 15-24, *infra*, discussing implications of Slawson and Leff observations. See also note 1, *supra* (product-like characteristics of insurance policies noted by contracts scholar Samuel Williston).

3. See, e.g., *Nehra v. Provident Life & Accident Ins. Co.*, 559 N.W.2d 48 (Mich. 1997) (finding term “accident” to clearly preclude coverage for injury occurring over time); *E. Assoc. Coal Corp. v. Aetna Cas. & Sur. Co.*, 632 F.2d 1068, 1075 (3d Cir. 1980) (applying Pennsylvania law) (finding policy unambiguous, cautioning that courts should not “torture” policy language in effort to find ambiguity doctrine and invoke contra proferentem principle); *Deni Assoc. of Fla. v. State Farm Fire & Cas. Ins. Co.*, 711 So. 2d 1135 (Fla. 1998) (language of absolute pollution exclusion unambiguously clear as applied to claim stemming from broken blueprint machine leaking fumes forcing evacuation of office building); *E.C. Fogg v. Fla. Farm Bureau Mut. Ins. Co.*, 711 So. 2d 1135 (Fla. 1998) (same as applied to accidental spraying of field inspector by crop duster); *Sharon Steel Corp. v. Aetna Cas. & Sur. Co.*, 931 P.2d 127 (Utah 1997) (qualified pollution exclusion language unambiguous as applied to gradual pollution at manufacturing plant despite exception to exclusion for release that was “sudden and accidental”). See also KALIS, REITER & SEGERDAHL, *supra* note 1, § 10.04 at 10-3810.38.1 (chart notes near 50-50 split in states as to the meaning of language of qualified pollution exclusion contained in standard commercial general liability (CGL) policies, with courts applying exclusion concluding its language unambiguous despite disagreement of nearly half the states).

the words of a policy immediately triggers the ambiguity principle requiring resolution of controversies against the insurer.<sup>4</sup>

This article attempts to move toward sounder construction and application of insurance policies, with resulting improvements in the resolution and consistency of disputes over insurance coverage by expressly applying the notion that insurance policies are products or “things” purchased by policyholders in order to obtain particular benefits and sold by insurers as goods conveying particular value to the policyholder. Fully appreciating this trait of the insurance policy and the insurance relationship can assist courts in better determining the contours of coverage in all cases, particularly difficult cases, especially those in which the policy text at issue admits of multiple reasonable readings or appears to lead to a problematic result if read literally.

## II. PRODUCT-LIKE CHARACTERISTICS OF STANDARD CONTRACTS AND INSURANCE POLICIES

There are several mainstream perspectives regarding the “right” way of viewing contracts and discerning their meaning as applied to various disputes. Competing for primacy in construing contracts (and listed in rough presumptive order of hegemony) are the following. First is the text of the contract documents,<sup>5</sup> an indicator of contract meaning that is alternately

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4. See, e.g., *Eli Lilly & Co. v. Home Ins. Co.*, 794 F.2d 710, 716 (D.C. Cir. 1986) (applying Indiana law) (“the only factual predicate of the rule that insurance contracts should be construed against the insurer is the requirement that the contract be ambiguous.” *Contra proferentem* principle activated upon finding of facial ambiguity; no resort to other interpretative tools); *Bowler v. Fid. & Cas. Co.*, 250 A.2d 580 (N.J. 1969) (court makes decision based on ambiguity principle after finding text facially unclear; no resort to extrinsic evidence or assessment based on nontextual factors).

5. See E. ALLAN FARNSWORTH, *CONTRACTS* Ch. 7 (4th ed. 2004). Contract interpretation is considered a question of law rather than a question of fact, which, as a practical matter, means that courts decide the meaning of contracts and contract text, even if certain factual disputes bearing on contract meaning must be resolved by a jury. Further, a trial court’s construction of a contract and assigned meaning, being a question of law, is reviewed *de novo* on appeal, with no deference to the trial court’s contract analysis (although as a practical matter, appellate courts will, of necessity, grant some weight to the trial judge’s close position for observation and will of course defer to fact findings bearing on the question of contract meaning).

In determining textual meaning, courts often use, sometimes implicitly, canons of construction or presumptions about language. For example, words are generally to be given their “ordinary” meaning rather than any specialized meaning, unless the facts and circumstances suggest that a specialized meaning was intended. See FISCHER, SWISHER & STEMPER, *supra* note 1, § 2.10. In addition, the entire policy or contract (and not only the term in dispute) is to be examined, with more weight accorded to customized language or endorsements than is accorded to the standard form boilerplate of the insurance policy. *Id.* The structure and organization of the policy may also have a bearing on the weight and interpretation accorded to policy text. *Id.* § 2.11.

enshrined in the “plain meaning” and “ordinary meaning” approaches<sup>6</sup> and indirectly regulated through the *contra proferentem* principle of construing unclear contract language against the drafter.<sup>7</sup> Application of ambiguity analysis to unclear text can vary accordingly among courts.<sup>8</sup> In addition, courts to varying degrees consider the intent of the contracting parties;<sup>9</sup> the purpose of the agreement;<sup>10</sup> the understanding and expectations of the

6. For purposes of this article, I use the term “plain meaning” to refer to judicial decisions that read the face of contract text literally without regard to the connotative value a term may have in a given context or with a particular audience. Courts typically use the term “ordinary meaning” as a synonym for plain meaning. See Alani Golanski, *Linguistics in Law*, 66 ALB. L. REV. 61, 63 (2002); Ellen Aprill, *The Law of the Word: Dictionary Shopping in the Supreme Court*, 30 ARIZ. ST. L.J. 275, 280 (1998). This article will follow the same convention. Accord, ANDERSON, STANZLER & MASTERS, *supra* note 1, § 2.01[A] at 2–9 (in construing insurance policies, “[t]he court will first attempt to construe an insurance policy term according to its *plain and ordinary meaning*. In the insurance context, the plain and ordinary meaning usually is that of the reasonable ordinary layperson.”) (italics in original). See also ANDERSON, STANZLER & MASTERS § 2.03 (suggesting that by “plain and ordinary meaning,” treatise authors have in mind what many term “ordinary meaning” as opposed to “plain” and literal dictionary definition of policy term) (also suggesting that older cases and treatises take a more objectively literalist view of text along lines of what is termed “plain” meaning in this article); FARNSWORTH, *supra* note 5, § 7.12 at 463 (discussing “plain meaning rule” that limits use of parol evidence if the language of the contract documents, “when taken in context, is so clear that evidence of prior negotiations cannot be used in its interpretation.”).

However, three linguistic experts have argued that the two terms differ in that properly understood, ordinary meaning suggests construing the a document’s meaning not solely from its text but also its context and with greater solicitude for the term’s understanding among laypersons as opposed to its technically correct or dictionary meaning. See, e.g., Lawrence M. Solan, *The New Textualists’ New Text*, 38 LOY. L.A.L. REV. 2027, 2038 (2005); Peter W. Schroth, *Law and Language*, 46 AM. J. COMP. LAW 17, 26 (1998); Eileen Scallen, *Classical Rhetoric, Practical Reason, and the Law of Evidence*, 44 AM. U.L. REV. 1717, 1745 (1995).

7. The *contra proferentem* principle (from Latin for “against the drafter”) posits that if contract language is ambiguous, the language shall be construed against the drafter of the instrument. See FARNSWORTH, *supra* note 5, § 7.8; STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 4.08; Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531 (1996) (finding ambiguity principle to be touchstone for insurance policy construction); E. Allan Farnsworth, “*Meaning*” in *the Law of Contracts*, 76 YALE L.J. 939 (1967) (addressing types and nature of contractual ambiguity and its consequences). As discussed in text and accompanying notes 74–78 below, the text in question, in both insurance and non-insurance contexts, is really part of a contract document memorializing the contract. The contract itself is the actual agreement between the parties. However, common usage routinely speaks of the language of a contract rather than the language of a contract document, a convenient but potentially misleading style of discourse that this article, like almost all others, will use for ease of reference.

8. See FISCHER, SWISHER & STEMPER, *supra* note 1, § 2.05 (noting variance of courts and commentators regarding proper role of ambiguity analysis, dividing jurisdictions roughly into strong ambiguity courts quick to invoke *contra proferentem*, weak ambiguity courts resistant to use of the doctrine, and moderate courts). Compare Abraham, *supra* note 7, with Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171 (1995); David S. Miller, Note, *Insurance as Contract: The Argument for Abandoning the Ambiguity Doctrine*, 88 COLUM. L. REV. 1849 (1988).

9. See FARNSWORTH, *supra* note 5, §§ 7.7; 7.10.

10. *Id.* §§ 7.10; 7.11.

parties (a factor most obviously enshrined in the reasonable expectations approach which, at least in moderate form, is a mainstream contract interpretation doctrine);<sup>11</sup> and social and judicial values that, on occasion, permit judicial policing of even unambiguous agreements in order to prevent contracts from becoming oppressive or otherwise undermining sociolegal norms. Use of unconscionability analysis is an example of this type of contract interpretation, as is the striking down or modifying of a contract on grounds of illegality or violation of public policy.<sup>12</sup>

In addition to these mainstream views of contract and insurance policy construction,<sup>13</sup> there has long been percolating, but not fully articulated, the notion that an insurance policy, despite being a contract, is also something other than a contract. Based on its history of industrywide formulation to meet a perceived market need, its standardization, and the manner in which it is marketed and sold, the insurance policy, in many ways, is more a product or good than it is a contract. Courts have occasionally hinted at this characterization of an insurance policy, most often when deciding cases on reasonable expectations or purpose grounds,<sup>14</sup> but have not fully developed the insurance-policy-as-product in sight into a full-fledged jurisprudential approach.<sup>15</sup> In the aftermath of Robert Keeton's reasonable

11. Judicial use of party intent, overall purpose of the contract, or party expectations will vary according to the courts' attitudes toward extrinsic evidence in relation to policy test. See FISCHER, SWISHER & STEMPEL, *supra* note 1, § 2.07. It appears, however, that most courts will consider contractual course of performance, the parties' course of dealing, and trade usage in construing insurance policy terms, even if the text of the policy standing alone is reasonably clear. See FISCHER, SWISHER & STEMPEL, *supra* note 1, at 109-10.

12. See STEMPEL ON INSURANCE CONTRACTS, *supra* note 1, § 4.10.

13. Regarding the hierarchy and coordination of these mainstream contract construction factors, see FISCHER, SWISHER & STEMPEL, *supra* note 1, § 2.06.

14. See, e.g., *C & J Fertilizer, Inc. v. Allied Mut. Ins. Co.*, 227 N.W.2d 169 (Iowa 1975). Prior to Keeton's article and scholarly recognition of the reasonable expectations doctrine, courts had on occasion found the product/warranty analogy helpful in resolving insurance disputes. See, e.g., *State Sec. Life Ins. Co. v. Kintner*, 185 N.E.2d 527, 531-33 (Ind. 1962) (Arterburn, C.J., concurring); *Glickman v. N.Y. Life Ins. Co.*, 107 P.2d 252 (Cal. 1940).

15. The prospect of *C & J Fertilizer* opening the door to sustained judicial examination of whether an insurance policy was fit for its intended purpose received a setback when the Iowa Supreme Court curtailed the use and breadth of the reasonable expectations approach to contract construction in *Farm Bureau Mutual Insurance Co. v. Sandbulte*, 302 N.W.2d 104 (Iowa 1981). This was part of the general "counter-revolution" of sorts against the Keetonian strong form of the reasonable expectations doctrine discussed in STEMPEL ON INSURANCE CONTRACTS, *supra* note 1, § 4.09[D][4]. See also Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323 (1986).

The tide against a strong form of the reasonable expectations doctrine, one that would even trump clear but problematic policy language, tended to also pull back the possible use of a breach-of-warranty or product-defect approach to construction. Nearly thirty-five years after it was rendered, *C & J Fertilizer* remains the insurance coverage case that most directly addresses the insurance policy as a product and the insurer's promise as akin to a manufacturer's warranty, although there have been cases alluding to this aspect of *C & J Fertilizer*. See, e.g., *Carper v. State Farm Mut. Ins. Co.*, 758 F.2d 337 (8th Cir. 1985); *Estrin Constr. Co., Inc. v. Aetna Cas. & Sur. Co.*, 612 S.W.2d 413 (Mo. Ct. App. 1981); *Batton v. Tenn. Farmers Mut. Ins. Co.*, 736 P.2d 2, 8 (Ariz. 1987).

expectations articles and cases adopting the doctrine,<sup>16</sup> insurance scholars noted the product-like aspects of insurance policies, but did not develop the concept of insurance policies as products at length.<sup>17</sup>

By contrast, non-insurance contract scholars in the late 20th Century have done quite a bit of writing about the degree to which modern, mass standardized contracting arguably creates “contract-products” and thus calls into question the efficacy of traditional, bargain-based theories of contract law in deciding cases. A well-known salvo in this scholarly discussion was Professor W. David Slawson’s article *Standard Form Contracts and Democratic Control of Lawmaking Power*,<sup>18</sup> which brought the issue to the fore in a way that the contract of adhesion articles of the 1940s had not. With the statement that “standard form contracts probably account for more than ninety-nine percent of all the contracts now made,”<sup>19</sup> Slawson caught the attention of the scholarly and judicial world, which thereafter paid increased attention to the impact of standardized contracts of adhesion.<sup>20</sup> At the same time, there appeared to be an upsurge in concern for

16. Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961 (1970); Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part II*, 83 HARV. L. REV. 1281 (1970). In the wake of Keeton’s seminal articles, much was written about the reasonable expectations approach to insurance policy construction. See, e.g., Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151 (1981); Symposium, *The Insurance Law Doctrine of Reasonable Expectations After Three Decades*, 5 CONN. INS. L.J. 1 (1998). See generally STEMPEL ON INSURANCE CONTRACTS, *supra* note 1, § 4.09.

17. See, e.g., WILLIAM F. YOUNG & ERIC M. HOLMES, CASES AND MATERIALS ON THE LAW OF INSURANCE 83–91 (2d ed. 1985) (discussing judicial construction and regulation of insurance policies with an “Implied Warranty of Fitness” approach, excerpting *C&J Fertilizer and Farm Bureau v. Sandbulte*, with only two pages of notes and commentary regarding the concept); Rahdert, *supra* note 15, at 710–25; John N. Ellison & Timothy P. Law, *Bad Faith and Punitive Damages the Policyholder’s Guide to Bad Faith Insurance Coverage Litigation—Understanding the Available Recovery Tools*, SK095 ALI-ABA 251 (2005); Eugene R. Anderson, Randy Paar & Sarah Hectman, *The Submission of a Claim Under Directors and Officers Liability Insurance Will Lead to an Adversarial Response by the Insurance Company, as Evidenced by Disputes over Allocation and Advancement*, 692 PLI/Comm 191 (1994); William Mark Lashner, *A Common Law Alternative to the Doctrine of Reasonable Expectations in the Construction of Insurance Contracts*, 57 N.Y.U.L. REV. 1175 (1982); Eric Mills Holmes & Dagmar Thurmman, *A New and Old Theory for Adjudicating Standardized Contracts*, 17 GA. J. INT’L & COMP. L. 323 (1987); Peter D. Rosenthal, *Have Bank Regulators Been Missing the Forest for the Public Policy Tree? The Case for Contract-Based Arguments in the Litigation of Regulatory Exclusions in Director and Officer Liability Policies*, 75 B.U.L. REV. 155 (1995); Peter Nash Swisher, *A Realistic Consensus Approach to the Insurance Law Doctrine of Reasonable Expectations*, 35 TORT & INS. L.J. 729 (2000); Joseph E. Minnock, Comment, *Protecting the Insured from an Adhesion Insurance Policy: The Doctrine of Reasonable Expectations in Utah*, 1991 UTAH L. REV. 837.

18. See Slawson, *supra* note 2, at 529.

19. See *id.* (emphasis removed).

20. See, e.g., Daniel D. Barnhizer, *Inequality of Bargaining Power*, 76 U. COLO. L. REV. 139 (2005); Larry Bates, *Administrative Regulation of Terms in Form Contracts: A Comparative Analysis of Consumer Protection*, 16 EMORY INT’L L. REV. 1 (2002); Carl B. Swanson, *Unconscionable Quandry: UCC Article 2 and the Unconscionability Doctrine*, 31 N.M.L. REV. 359 (2001); John Dwight Ingram, *The Insured’s Expectations Should be Honored Only If They Are Reasonable*,



contract fairness and judicial use of policing tools such as illegality, public policy, and the unconscionability doctrine.<sup>21</sup>

During this same period, Professor Arthur Leff, who had attacked the unconscionability concept as too much freewheeling judicial license to alter contract meaning,<sup>22</sup> extended the concept that standardization had

23 WM. MITCHELL L. REV. 813 (1997); Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. MIAMI L. REV. 1263 (1993); Holmes & Thurmann, *supra* note 17; John E. Murray, Jr., Symposium, *The Standardized Agreement Phenomenon in the Restatement (Second) of Contracts*, 67 CORNELL L. REV. 735 (1982); Edward A. Dauer, *Contracts of Adhesion in Light of the Bargain Hypothesis: An Introduction*, 5 AKRON L. REV. 1 (1972). Professor Slawson was also part of his own intellectual wake, continuing to write important articles on the topic. See W. David Slawson, *Contractual Discretionary Power: A Law to Prevent Deceptive Contracting by Standard Form*, 2006 MICH. ST. L. REV. 853 (2006); Slawson, *The New Meaning of Contract: The Transformation of Contracts by Law by Standard Forms*, 46 U. PITT. L. REV. 21 (1984); Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. CAL. L. REV. 1 (1974). See also SLAWSON, *BINDING PROMISES: THE LATE 20TH-CENTURY REFORMATION OF CONTRACT LAW* (1996).

21. See FARNSWORTH, *supra* note 5, §§ 4.28, 5.1 (citing several important cases applying these doctrines from 1955 to 1965. See, e.g., *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965); *Weaver v. Am. Oil Co.*, 276 N.E.2d 144 (Ind. 1971).

22. See Arthur Allen Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 487 (1967). Leff's critique of both the unconscionability section of the revised Uniform Commercial Code (§ 302) and unconscionability generally spurred a torrent of debate. Compare, M.P. Ellinghaus, *In Defense of Unconscionability*, 78 YALE L.J. 757 (1969) (vigorously defending unconscionability concept and attacking Leff's analysis); John E. Murray, Jr., *Unconscionability: Unconscionability*, 31 U. PITT. L. REV. 1 (1969) (same); Richard E. Speidel, *Unconscionability, Assent and Consumer Protection*, 31 U. PITT. L. REV. 359, 374-75 (1970) (supporting unconscionability); Robert Braucher, *The Unconscionable Contract or Term*, 31 U. PITT. L. REV. 33, 338 (1970) (modestly supporting unconscionability, but agreeing with much of Leff's critique); with Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 294-95 (1975) (criticizing unconscionability on ground it excessively undermines freedom of contract ideal); Victor P. Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 J.L. & ECON. 461, 485-90 (1974) (less critical of unconscionability, but finding such ad hoc judicial regulation misguided, advocating legislative or administrative solution for problem of unfair contract terms); Arthur Allen Leff, *Unconscionability and the Crowd—Consumers and the Common Law Tradition*, 31 U. PITT. L. REV. 349 (1970) (policing of contract terms, even if justified for consumers, should be done by elected branches, not courts).

Although one can debate whether defenders or opponents of unconscionability had better arguments, there is no doubt that Leff and those critical of unconscionability had more influence among courts and counsel, perhaps because its resistance to judicial regulation of contract terms struck a responsive court with businesses and courts seeking to set reasonable limits on the judicial role. See Jeffrey W. Stempel, *Arbitration, Unconscionability, and Equilibrium: The Return of Unconscionability Analysis as a Counterweight to Arbitration Formalism*, 19 OHIO ST. J. ON DISP. RESOL. 757, 814-21 (2004) (noting that Leff's article and its critique was cited much more frequently than articles responding to Leff or defending unconscionability analysis).

In addition, the rise of the Law and Economics scholarship, which took a similarly critical view of judicial policing of contract terms, added wind to Leff's sails. Stempel, *supra*, at 818-25. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (1973) (publication of leading treatise, now in its Sixth Edition, designed for general legal audience of students, practitioners and judges marks the "arrival" of law and economics as a mainstream form of self-conscious legal analysis); Epstein, *supra*; Goldberg, *supra*. Ironically, although Leff had

changed the nature of contract and labeled standardized contracts as “things” rather than traditional contracts.<sup>23</sup> Leff did not regard standardization as bad or view standardized terms as inherently oppressive. He did, however, see most modern contracts as mass produced items more than negotiated agreements. Consequently, he advocated treating the standardized agreement more like a product for purposes of government regulation, including judicial interpretation and policing of contract terms. However, he urged only limited government interference with standard form contract terms.<sup>24</sup>

Subsequent scholars developed the Slawson and Leff insights at greater length and applied them to specific types of contracts, in particular noting the analog of product liability law,<sup>25</sup> with insurance scholarship follow-

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reservations about judicial use of the unconscionability concept and was certainly not antagonistic toward economic analysis, neither was he a true disciple. See Arthur Allen Leff, *Economic Analysis of Law: Some Realism About Nominalism*, 60 VA. L. REV. 451 (1974) (reviewing Posner's *Economic Analysis of Law*).

But an intellectual trend seldom succeeds in accomplishing a paradigm shift in which the new way of thinking completely displaces the old, thereby forcing a revision of basic texts and teaching. See THOMAS KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTIONS* (2d ed. 1970) (describing characteristics of true paradigm shift in science) (as distinguished from the overuse of the word “paradigm” in modern political, legal, and social discourse). Unconscionability is still a significant part of contracts treatises and casebooks, is still taught in law school classes, and (most important perhaps) is still used with some frequency by the courts, albeit often in tandem with judicial invocation of public policy concerns, perhaps suggesting that unconscionability alone often lacks the requisite punch to defeat freedom of contract and plain textual meaning arguments. See, e.g., *Hanks v. Powder Ridge Rest. Corp.*, 885 A.2d 734 (Conn. 2005) (ski resort's broad waiver of liability clause unconscionable and against public policy); *Donovan v. RRL Corp.*, 27 P.3d 702 (Cal. 2001) (applying unconscionability analysis to save automobile dealer from financial consequences of misprint in advertisement stating low sale price for expensive vehicle); *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669 (Cal. 2000) (finding arbitration clause unconscionable); *Valley Med. Specialists v. Farber*, 982 P.2d 1277 (Ariz. 1999) (finding noncompetite clause in medical doctor's contract with professional corporation so broad as to be unconscionable and in violation of public policy).

23. Arthur Allen Leff, *Contract As Thing*, 19 AM. U.L. REV. 131 (1970).

24. *Id.* at 135–40. Leff's argument was that even standardized contract terms contained in contracts of adhesion were sufficiently subject to market forces that problematic terms would eventually be revised to become adequately fair and efficient. Subsequent law and economics scholarship has defended this view. See, e.g., Jason Scott Johnston, *The Return of Bargain: An Economic Theory of How Standard-form Contracts Enable Cooperative Negotiation Between Businesses and Consumers*, 104 MICH. L. REV. 857 (2006); Lucian A. Bebchuk & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 MICH. L. REV. 827 (2006); Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interest*, 69 VA. L. REV. 1387 (1983); George L. Priest, *A General Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297 (1981); Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981).

25. See, e.g., Richard Craswell, *Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere*, 92 VA. L. REV. 565, 624 (2006); Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-form Contracting in the Electronic Age*, 77 N.Y.U.L. REV. 429, 444 (2002); Richard Craswell, *Interpreting Deceptive Advertising*, 65 B.U.L. REV. 657, 681 (1985);

ing to some degree.<sup>26</sup> Ironically, insurance scholarship was once ahead of this metaphorical curve of contract analysis. Professor Edwin Patterson touched upon the issue in *Essentials of Insurance Law*<sup>27</sup> and in an article discussing the insurance policy as a contract of adhesion.<sup>28</sup> For the most part, however, modern insurance law scholarship has not focused at any length on the product-like qualities of insurance policies and the implications for insurance coverage disputes.

#### A. Professor Schwarcz's Product Liability Approach to Insurance Policies

In *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, Professor Daniel Schwarcz made a substantial contribution toward filling this void and a persuasive case for the view that it is instructive for courts to view insurance policies as products as well as contracts, and to apply defective product analysis to determine whether the court should mandate coverage even in the face of contrary policy language.<sup>29</sup> Schwarcz argues that courts should police ("regulate" in his terminology) insurance policy content, not by reference to the reasonable expectations of consumers, but according to a product-liability theory that considers whether an insurance policy is defectively designed and whether the insurer has failed to warn the policyholder of limitations on coverage.<sup>30</sup>

One could read Schwarcz's article as finding it permissible for courts to mandate coverage in cases where it can be said that the insurance policy in question is not adequate for the purpose for which it was sold, although

Ian R. Macneil, *Bureaucracy and Contracts of Adhesion*, 22 OSGOODE HALL L.J. 5, 18-19 (1984). See also Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173 (1983).

26. See, e.g., Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholders' Objectively Reasonable Expectations of Insurance Coverage*, 5 CONN. INS. L.J. 335, 422-23 (1998-99) (previously "insurance policies were treated as contracts. Today, more and more they are treated like products"); James M. Fischer, *The Doctrine of Reasonable Expectations Is Indispensable, if We Only Knew What for?*, 5 CONN. INS. L.J. 151, 158 (1998-99) (making analogy of insurance policies and consumer products).

27. See EDWIN PATTERSON, *ESSENTIALS OF INSURANCE LAW* (1955).

28. See, e.g., Edwin W. Patterson, *The Delivery of a Life-Insurance Policy*, 33 HARV. L. REV. 198 (1919). See also Comment, *The Application to Insurance Contracts of the Implied Warranty in Sales Law*, 35 YALE L.J. 203 (1925). Subsequently, non-insurance contracts scholarship came to focus on contracts of adhesion. See, e.g., Nathan Isaacs, *The Standardization of Contracts*, 27 YALE L.J. 34 (1917); Karl N. Llewellyn, *What Price Contract?—An Essay in Perspective*, 40 YALE L.J. 704 (1931); Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 628 (1943); Albert A. Ehrenzweig, *Adhesion Contracts in the Conflict of Laws*, 53 COLUM. L. REV. 1072 (1953); Edwin W. Patterson, *The Interpretation and Construction of Contracts*, 64 COLUM. L. REV. 833 (1964); Nicholas S. Wilson, *Freedom of Contract and Adhesion Contracts*, 14 INT'L & COMP. L.Q. 172 (1965).

29. See Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389 (2007).

30. *Id.* at 1395-1401, 1439-56.

this may be a stronger statement than the nuances of the article justify.<sup>31</sup> Professor Schwarcz suggests that cases of market failure and inefficient terms present the greatest case for judicial regulation, perhaps the only case justifying a departure from clear policy language. He suggests that courts take this more aggressive approach to insurance policy construction and mandate coverage primarily in cases where it can be said that the insurance policy is inefficient in design and where the insurer has insufficient market discipline to constrain self-serving or opportunistic behavior in the course of drafting, marketing, and issuing policies.<sup>32</sup>

Under this approach to insurance policy adjudication, the product liability approach to be applied is not the consumer expectations test that formerly enjoyed substantial support in tort law, but the modern risk-utility test.

Following products liability law, courts could improve the drafting incentives of insurers by imposing insurance coverage, despite clear policy language to the contrary, when the coverage dispute involves (a) a provision that is particularly likely to be the result of inefficient drafting by insurers due to market failure ("insurance harms"), and (b) policy language that fails a cost-benefit, reasonable-alternative-design test that assesses whether the insurer acted inefficiently in choosing to draft or adopt policy language ("insurance design defects"). When there is both an insurance harm and an insurance design defect, (c) insurers could be required to pay coverage that causes them to internalize the costs of their failure to act efficiently ("damages").<sup>33</sup>

...

[A]n "insurance harm" [is defined as] the denial of insurance coverage when any ambiguity exists, from an ex post perspective, about whether the underwriting purposes of the applicable policy exclusion warrant not covering the loss at issue. Under this test, a court would ask whether the insurer has any legitimate underwriting purpose for not insuring against the specific loss that befell the insured.<sup>34</sup>

....

31. *Id.* at 1397–1401, 1435–62.

32. *Id.* at 1397–1401, 1445–52.

33. *Id.* at 1445–46 (footnotes omitted).

34. *Id.* at 1447–48. Schwarcz notes basic underwriting purposes reflected in the insurance literature stating that a loss subject to sound underwriting must be "(1) measurable, (2) observable," (3) uncorrelated or only weakly correlated, with "(4) low risk of moral hazard," "(5) low risk of adverse selection," and (6) anticipated (although he finds this inapplicable in light of the ex post analysis he proposes). *Id.* at 1448 (footnotes omitted). In addition, he cites "juridical hazard" as an underwriting concern. Juridical hazard is the risk of incurring high, unpredictable, or unmanageable transaction costs in connection with a claim. It refers to "the transaction costs to insurers of deciding whether to pay a claim, which include the costs of fact gathering and legal fees." *Id.* This risk may prompt insurers to use bright-line terms in policies "that imperfectly facilitate legitimate underwriting purposes while minimizing juridical hazard, because they are easy to apply:" after a loss. *Id.*

Insurance law could follow products liability law and jettison its consumer expectations approach in favor of a defective design test that evaluates whether an insurance harm was the result of inefficient insurer behavior, by applying a marginal cost-benefit test premised on reasonable alternative designs. . . . [If] a plaintiff can show that (1) the insurance harm was foreseeable ex ante, and (2) could have been avoided by reasonable alternative language, the inefficiency of the insurer's drafting will be clear.<sup>35</sup>

....

Following the lead of products liability law, the two types of insurance claims described above should be mutually exclusive from one another, so that insureds can assert defective design claims against insurers regardless of the adequacy of the warnings that the insurer provides, and vice versa.<sup>36</sup>

Regarding failure to warn, Schwarcz proposes following, for insurance, a regime similar to that of tort law, in which

firms are strictly liable for providing an "inadequate" warning or instruction to consumers "when the foreseeable risks of harm posed by the product could

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As an example of a case presenting an insurance harm to a policyholder and justifying judicial regulation of the policy term, Schwarcz cites *Coblentz v. Oklahoma Farm Bureau Mutual Insurance Co.*, 915 P.2d 938, 939 (Okla. Civ. App. 1995), overruled by *Bratcher v. State Farm Fire & Casualty Co.*, 961 P.2d 828, 831 (Okla. 1998). Schwarz, *supra* note 29, at 1448-49, 1455. In *Coblentz*, the policyholder's home was destroyed. The insurer sought to apply the "holdback" provisions of the policy's replacement cost terms, which mandated that the policyholder actually rebuild a damaged home in order to enjoy full replacement cost benefits. The purpose of such a clause is to lower the risk that a policyholder may find it advantageous to arrange destruction of property in order to obtain insurance proceeds for a planned relocation. To get all the insurance money, the policyholder has to go through rebuilding. But policyholder Coblentz was caught in a Catch-22 situation in which he did not have enough savings to procure a contractor and he could not rebuild without first getting full payment from the insurer.

As Schwarcz observes, *Coblentz* presents a strong case for refusing to enforce the policy's holdback provision. "From an ex post perspective, it is relatively clear that the applicable clause's underwriting purpose did not apply: Coblentz's home was destroyed by a tornado, which is impossible to fake. . . . the very nature of Coblentz's loss made clear that the underwriting purpose did not apply. *Id.* at 1449 (footnotes omitted). In addition, "the overbreadth of the policy's replacement clause relative to its underwriting purpose was fairly obvious, and it could have been reasonably resolved ex ante through myriad drafting techniques" such as providing "that insurance money in excess of the market value of the home will be paid directly to contractors or builders who are replacing the home." *Id.* at 1455, n.287.

In addition, Schwarcz uses this as an example of the advantages a product liability model of insurance can have over a reasonable expectations model in that, under "the dominant interpretation of the reasonable expectations doctrine . . . an insurer [can] exclude coverage for any loss so long as the exclusion is adequately communicated to the insured." *Id.* at 1460.

35. See Schwarcz, *supra* note 29, at 1454-55 (footnotes omitted).

36. *Id.* at 1459 (noting that "Products liability adheres to this rule because of the inherent limitations of warnings [and that] a defectively designed product cannot be made safe with a good warning." (footnotes omitted)). The parallel to insurance is clear language in exclusions, endorsements, sales materials, or agent statements that may be ineffective for communicating the limitations of a policy to an applicant or policyholder about a defective policy design, structure, or wording. Relatedly, even a substantial warning may be insufficient to make enforceable a policy with severe limitations on coverage.

have been reduced or avoided by the provision of reasonable instructions or warnings.” [But because] [m]ultiple warnings tend to crowd one another out, leaving consumers with a diluted set of information that most will either ignore or fail to appreciate. . . .<sup>37</sup>

Insurance law could mimic products liability law and impose insurance coverage for risks that insurers do not “adequately disclose” to insureds. Either on the declarations page, or in another appropriately highlighted document, insurers could cheaply and effectively inform consumers about a limited number of coverage exclusions and their potential implications. If written in bold, large print, and place below a heading with large, capitalized letters reading, “WARNING,” many, if not most, consumers would read an appropriately limited disclosure.<sup>38</sup>

Although the details of a disclosure regime would need to be worked out over time, several basic suggestions can be made. First, insurers could be required to disclose the basic ways in which their policies substantially deviate from any existing industry norms. . . . Second, and more generally, insurance law could require a basic disclosure to consumers that they are less likely to receive coverage if they act in a manner that clearly and obviously increases their risk of loss.<sup>39</sup>

....

A third potential insurance warning might seek to mitigate consumers’ cognitive biases when it comes to assessing insurance policy coverage. Rather than assuming the persistence of consumers’ bounded ability to assess the limitations of insurance, this approach would attempt to help consumers overcome this limitation through the use of insurance warnings.<sup>40</sup>

[A] fourth warning strategy could inform consumers about specific limitations in their insurance coverage that could be addressed by purchasing state-underwritten supplemental coverage. . . . For instance, private insurance companies sell federally underwritten flood insurance. Similarly, the California Earthquake Authority relies on participating insurers to sell its policies. However, private insurers are likely to have inadequate incentives to market these policies to their customers: “[in spite of financial incentives currently in place because in such cases insurers] do not earn any investment income from insured’s premium dollars, a primary source of income for ordinary insurance policies.”<sup>41</sup>

As a prelude to his proposal of a product liability model for regulating insurance policies, Schwarcz makes a compelling case for viewing insur-

37. *Id.* at 1440 (footnotes omitted) (quoting *Restatement (Third) of Torts: Products Liability* § 2(c)).

38. *Id.* at 1441.

39. *Id.* at 1441–42 (footnotes omitted).

40. *Id.* at 1443 (footnote omitted).

41. *Id.* at 1444–45 (footnotes omitted) (quoting Daniel Schwarcz, *Keep On Giving to Katrina Relief*, DENVER POST, Sept. 17, 2005, at E-05). See also Adam F. Scales, *A Nation of Policyholders: Governmental and Market Failure in Flood Insurance*, 26 MISS. C.L. REV. 3 (2006–07) (proposing that, as a condition of licensing, homeowners’ insurers be required to include flood coverage in standard home insurance policies).

ance policies as products as well as contracts and also describes the manner in which traits of the insurance market may result in policy terms less favorable to consumers than those of other mass contracts.

For one, consumer policyholders appear systematically uninformed about standard policy terms, which presents insurers with an opportunity to exploit consumer ignorance for greater gain unless there is countervailing judicial regulation or some other type of government regulation.<sup>42</sup> Contributing to this is the massive use of standard forms for insurance, which "as a practical matter, must be used by all but the largest market participants."<sup>43</sup> The type of market competition that might otherwise produce efficient and fair terms even in mass standardized contracts is thus unlikely to occur.<sup>44</sup> Insurance policy drafting is largely a collective enterprise, particularly in the property and casualty markets in which standard forms authored by the Insurance Services Organization (ISO) dominate the market.<sup>45</sup>

[I]nformed and rational consumers faced with inefficient coverage provisions may not have the option of going to a competing insurer to find different and better coverage. . . . [T]he only way these consumers can "punish" insurers for using inefficient terms is to drop out of the market for insurance altogether. This result stands in stark contrast to a competitive drafting market. . . .<sup>46</sup>

"[The problem is particularly severe for consumers and small businesses, which,] unlike large corporations, . . . do not have the capacity to substitute from traditional insurance to alternative risk transfer devices, such as catastrophe bonds or self-insurance."<sup>47</sup> These broadly drafted policy forms are so open-ended as to invite difficulty in the future when events take place that were not specifically considered or discussed by the parties, but arguably fall within the scope of the broad policy form language.<sup>48</sup>

Because responsive consumers are by assumption knowledgeable about policy terms, they will choose endorsements that eliminate inefficiently one-sided exclusions. By offering exploitive coverage in the standard base policy, but then providing efficient coverage in alternative base policies or endorsements, insurers can conceivably discriminate between responsive and unresponsive consumers.<sup>49</sup>

42. See Schwarcz, *supra* note 29, at 1402-03, 1407-09.

43. *Id.* at 1404.

44. *Id.* at 1405-06.

45. *Id.*

46. *Id.* at 1406.

47. *Id.* at 1407.

48. *Id.* at 1404, 1410-12.

49. *Id.* at 1408. As an example, Schwarcz cites *Atwood v. Harford Accident & Indemnity Co.*, 365 A.2d 744 (N.H. 1976), in which a court refused to enforce against a self-employed

In addition, the costs to insurers of changing policy forms is substantial, a fact that prompts insurers to continue using forms they know are problematic<sup>50</sup> and perhaps even “perniciously” ambiguous.<sup>51</sup> In addition, the use of standard form endorsements as a means of varying insurance policy content, while perhaps adequate for providing some measure of bargaining choice to sophisticated policyholders, makes it more difficult for less informed consumers to resist being misled by standardization of a complex product that they do not understand.<sup>52</sup> Also, widespread price regulation likely prompts insurers to attempt to gain surplus through the use of unreasonably favorable policy terms rather than through price competition of the sort that would take place in a more typical market.<sup>53</sup>

Market discipline is unlikely to cure these problems, particularly for insurance sold to consumers and small or less sophisticated businesses because of the “bounded rationality” of the policyholders. A considerable body of theoretical and empirical work suggests that market participants, and consumers in particular, are not fully rational, but only boundedly rational, in that they are capable of correctly evaluating only a limited number of variables in assessing the value of a product or service.<sup>54</sup> This makes these policyholders poor de facto regulators of oppressive contract terms through market participation. For example, it appears that consumers place undue stock in insurer reputation created by advertising, while simultane-

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electrician policyholder the policy’s exclusion for completed operations liability in a case arising out of a child’s death from heat exposure due to faulty installation of a thermostat. An endorsement providing coverage for such completed operations was readily available at comparatively low cost for “knowledgeable consumers” and is purchased by “[m]any informed insureds.” *Id.* at 1408–09. For discussion of the distinctions between premises/operations liability and products/completed operations liability in the context of general liability insurance, see STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 14.07.

50. See Schwarcz, *supra* note 29, at 1404, 1412–13. *Accord*, Michelle E. Boardman, *Contra Proferentem: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105 (2006). See also Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 VA. L. REV. 713 (1997).

51. See Lawrence M. Solan, *Pernicious Ambiguity in Contracts and Statutes*, 79 CHI.-KENT. L. REV. 859 (2004).

52. See Schwarcz, *supra* note 29, at 1404, 1407–09.

53. *Id.* at 1404, 1409–10.

54. *Id.* at 1420–22. See, e.g., Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1217–18 (2003); Robert A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, 85 CORNELL L. REV. 717, 721 (2000); Russell Korobkin, *The Efficiency of Managed Care “Patient Protection” Laws: Incomplete Contracts, Bounded Rationality, and Market Failure*, 85 CORNELL L. REV. 1, 8–9 (1999); Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 240–44 (1995); David M. Grether et al., *The Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 S. CAL. L. REV. 277, 300 (1986) (psychological studies suggest that consumers normally cannot utilize more than five salient product features in evaluating product).



ously not investing significant resources in evaluating the design, language, and operation of an insurance policy.<sup>55</sup>

Among the problems created by the cognitive errors of policyholders is a tendency to ignore improbable risk and thus, not examine and consider policy terms related to such risks.<sup>56</sup> Conversely, policyholders may overvalue certain risks (and overpay for protection against such risks) because of a mistaken view that these risks are more likely than is actually the case. This type of “availability” heuristic error often occurs when a type of risk or loss received unusual media attention disproportionate to the actual danger it presents. For example, during Fall 2001, most people mistakenly thought that the risk of injury from terrorism (including anthrax poisoning, which was a momentary frenzy because of a few widely reported cases) was high, when it is in fact quite low relative to the danger presented by everyday activities, such as driving, going to a bar or restaurant, or mowing the lawn.

The Schwarcz thesis posits that oppressive or inefficient insurance policy terms exact significant social cost because policyholders are left with a significant loss for which they are unable to spread and manage risk after the loss has taken place. By contrast, judicial regulation of coverage in such cases “will typically be a small loss relative to the insurer’s net assets, [which means] the insurer is not particularly harmed by bearing that risk.”<sup>57</sup> State legislative or administrative regulation is unlikely to be optimally effective at stemming this social cost because of the political clout of insurers and the prospect of regulatory capture or inadequate resources regarding insurance commissioner offices.<sup>58</sup> Regarding judicial regulation, Schwarcz sees the reasonable expectations approach to policy construction as too flawed to correct the problem.<sup>59</sup>

### *B. Improving Upon the Product Liability Model*

Professor Schwarcz’s article is a major contribution to insurance law and insurance coverage theory. His defective product-market correction-avoid

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55. See Schwarcz, *supra* note 29, at 1412–15. In addition, the value of reputation evidence is often both overrated and comparatively low due to insurer marketing and an apparent strategy of treating policyholders well on small claims but being quite willing to deny or resist a large claim, which is the type of claim a consumer is less likely to experience and hence less likely to communicate to his or her social networks. *Id.* at 1414–15. Although insurance intermediaries can be helpful in enhancing consumer or small business policyholder understanding, this mode of information transmittal and market regulation is also problematic. *Id.* at 1415–19. Secondary literature, such as *Consumer Reports*, is also of reduced value for insurance, as compared to most consumer products. *Id.* at 1419.

56. *Id.* at 1420–21.

57. *Id.* at 1423.

58. *Id.* at 1424–25.

59. *Id.* at 1426–35.

opportunism approach to judicial policing of insurance policies is a major step forward in legal thinking about insurance and the policyholder-insurer relation, one that deserves to be widely read, considered, and, under appropriate circumstances, applied by the courts. Notwithstanding its impressiveness, its use of the concept of an insurance policy as a product is unduly limited. Rather than being utilized only as a means of justifying judicial regulation of insurance by imposing coverage in the face of seemingly contrary text, the insurance-as-product approach presents a valuable interpretative tool for insurance coverage disputes generally and determining the apt construction to be accorded to policy text, the meaning of which is often unclear, at least if the text is viewed in isolation.

Another arguably unnecessary limitation of the Schwarcz insurance-as-product approach is that it could be interpreted as applying only to consumer insurance products.<sup>60</sup> The rationale for this limitation appears to stem from product liability law imputing knowledge of product limitations and means of sue to experienced purchasers, as well as the widespread notion of insurance law that individuals may need greater judicial protection in coverage matters than do commercial entities. The so-called sophisticated policyholder defenses to coverage or bad faith claims incorporate much of this thinking. Under this view, often proffered by insurers wishing to avoid the imposition of either the reasonable expectations approach or the ambiguity doctrine when litigating coverage disputes with commercial policyholders, neither approach to contract construction would apply when the policyholder is a frequent purchaser of substantial insurance or has assistance from brokers or legal counsel.<sup>61</sup>

60. *Id.* at 1395–96.

61. See STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 4.11 (discussing insurance coverage and “sophisticated policyholder” arguments); OSTRAGER & NEWMAN, *supra* note 1, § 1.03[c] (suggesting that ambiguity principle should not be available to sophisticated commercial policyholders); Hazel Glenn Beh, *Reassessing the Sophisticated Insured Exception*, 39 TORT, TRIAL & INS. L.J. 85 (2003) (opposing different rules for sophisticated policyholders); Jeffrey W. Stempel, *Reassessing the “Sophisticated” Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807 (1993) (policyholder sophistication may properly be considered in determining intent, objective, expectations, and understanding but not to alter normal interpretative groundrules protecting policyholders). See, e.g., *Eagle Leasing Corp. v. Hartford Fire Ins. Co.*, 540 F.2d 1257, 1261 (5th Cir. 1976) (applying Missouri law) (“We do not feel compelled to apply, or indeed, justified in applying the general rule that an insurance policy is construed against the insurer in the commercial insurance field when the insured is not an innocent but a corporation of immense size, carrying insurance with annual premiums in six figures, managed by sophisticated business men, and represented by counsel at the same professional level as the counsel for insurers. In substance, the authorship of the policy is attributable to both parties alike”); *McNeilab, Inc. v. North River Ins. Co.*, 645 F. Supp. 525 (D.N.J. 1986) (noting that policyholder, a subsidiary of Johnson & Johnson, was large company with risk management department, broker, and counsel assistance; finding it implausible that McNeilab could interpret standard CGL policy to provide product recall coverage). *But*

However, it is overbroad and oversimplified to attempt to divide the world of policyholders into consumers and businesses (or even to divide it according to wealth or volume of insurance business). The acumen, resources, and sophistication of consumers can vary widely. Warren Buffett, Bill Gates, and Donald Trump all purchase insurance as consumers, but their context for these purchases is quite different than that of the average citizen. Similarly, there is a wide spectrum of experience, knowledge, resources, and sophistication regarding insurance among commercial policyholders. To continue the same analogy, the insurance-buying experience of General Electric, Ford, or Google is likely to be considerably different than that of a small shop owner, lawn service, plumber, or electrician.

Further, even large businesses differ considerably in their sophistication and capacity for evaluating insurance policies. Some companies, even relatively small ones, are assisted by their own risk managers, savvy brokers, and experienced coverage counsel. Some may even draft or co-draft policy language clarifying and memorializing their insuring agreements. Other companies, in spite of their comparative size and wealth, may have no in-house risk management or legal expertise, may employ only mediocre brokers or counsel, or may, in a hard market, have no realistic choice regarding policy forms offered for coverage. Here, size matters in the sense that a company must realistically be of a minimum size in order to self-insure or form its own captive insurer or must be part of an industry or trade group that, through collective action, can form a supportive captive insurer or risk retention group.

For these reasons, the sophistication of a type of policyholder cannot be assumed, but must be assessed on a case-specific basis. The degree of a policyholder's sophistication, once determined, may then have consequences regarding what understanding the policyholder had of a term or insuring arrangement and whether its expectations are objectively reasonable under the circumstances. Similarly, but with less dramatic variance, insurers may differ in these traits as well, which may have implications regarding a given insurer's intent, purpose, understanding, and expectations regarding an insurance policy.

A more limiting aspect of the Schwarcz insurance-as-product analysis is that it appears to operate from the presumption that most insurance policy text is in fact clear and that problems arise when a court is asked to apply

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*see* *Ogden Corp. v. Travelers Indem. Co.*, 681 F. Supp. 169 (S.D.N.Y. 1988) (rejecting argument that sophisticated policyholder may not benefit from contra proferentem principle); *Boeing Co. v. Aetna Cas. & Surety Co.*, 784 P.2d 507 (Wash. 1990) (same). *See also* *Madden v. Kaiser Found. Hosp.*, 552 P.2d 1178 (Cal. 1976) (ambiguity analysis inapt where contract was negotiated rather than standard form generated by one party).

clear text under circumstances where this seem unfair to the policyholder or at odds with the overall insuring arrangement. One can therefore take a limited view of the Schwarcz methodology as one to use in place not only of reasonable expectations analysis, but also in lieu of unconscionability or public policy policing of insurance policies. Limited to just this niche of insurance law, the Schwarcz suggestions are nonetheless valuable and may find warmer reception from courts (and perhaps even from insurers) than these other doctrines, which are often seen as too result-oriented, too unpredictable, too pro-policyholder, and insufficiently principled and consistent.

More promising still is a broader application of the insurance-policy-as-thing approach, one that is not restricted to consumer or individual policies and is not dependent on market failure or inefficiency alone in order to support policy construction that avoids textual literalism. The insurance-as-product approach should be used not only in cases where policy text is seen as clear, but arguably oppressive, but should also be applied as an aid to judicial analysis regarding the meaning of policy text itself. In this fashion, the insurance-as-thing construct helps to inform (or substitute for) not only unconscionability, public policy, and reasonable expectations analysis, but also inform textual interpretation and the discernment of party intent and purpose associated with the insurance at issue in a dispute.

Without a doubt, insurance policies have much in common with tangible goods and are not "pure" contracts like the type of party-crafted agreements that formed the basis of traditional and much modern contract law. In addition to the product-like features of insurance noted by Professor Schwarcz, overwhelming practical evidence supports the view that insurance policies are as much products as contracts. In the real world of insurance, brokers, carriers, and risk managers are perhaps the farthest along on this dimension. The insurance trade press (e.g., *Best's Review*, *National Underwriter*, *Business Insurance*, *Insurance Journal*) routinely speaks of insurance policies as "products" to be researched, designed, unveiled, marketed, and sold in the manner of manufactured goods.<sup>62</sup> Insurers are sometimes

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62. See, e.g., *Darwin Launches New Clinical Research Liability Product*, *Team*, *INS. J.*, Apr. 5, 2007, at <http://www.insurancejournal.com/news/national/2007/04/05/78495.htm>; *The Hartford Expands Professional Liability Product for Tech Firms*, *INS. J.*, July 17, 2006, at <http://www.insurancejournal.com/news/national/2006/07/17/70528.htm>; *ICAT, National Fire and Marine Launch New Catastrophe Product*, *INS. J.* (Mar. 16, 2006), at <http://www.insurancejournal.com/news/national/2006/03/16/66540.htm>; Robert Grubka, *What The New Annuity-LTC Combo Products Might Look Like*, *NAT'L UNDERWRITER*, Mar. 5, 2007, at [http://www.nationalunderwriter.com/LTC/articles/2007\\_4\\_feature.asp](http://www.nationalunderwriter.com/LTC/articles/2007_4_feature.asp). See also TOM BAKER, *INSURANCE LAW AND POLICY: CASES, MATERIALS, AND PROBLEMS* 46 (2003) (noting this customary jargon of insurance industry).

said to “unveil” a new policy form<sup>63</sup> in the manner of a new model year of automobiles or an electronic innovation, such as Apple’s iPhone (although it is probably safe to say that no one camped out overnight to be first in line for a new insurance policy). Insurance e-mail services regularly speak of products of “programs” to provide coverage and may talk of “customizing” the insurance purchased.<sup>64</sup> Although this type of portrayal is not inconsistent with insurance policies as contracts, it is clearly consistent with viewing the insurance policy as a product as well.

Not only do those in the insurance industry see policies as products, but apparently, so do consumers and marketing experts. According to a study released in 2007, baby boomer policyholders (those born between 1946 and 1964) regard insurance as a good of sorts, albeit one with a substantial service component. According to the survey, baby boomer consumers displayed higher “brand loyalty” toward insurance than to almost all other products, with more than two-thirds expressing high brand loyalty toward their insurers. This compared to brand loyalty of roughly 25 percent for televisions, computers, and clothing, with home appliances evincing only slightly greater loyalty.<sup>65</sup>

63. See *ACE Unveils “Spectrum” P/C Policy*, INS. J., June 18, 2007, at <http://www.insurancejournal.com/news/international/2007/06/18/80872.htm> (noting insurer’s “launch[ing]” of new policy which combines “range of P&C covers” and marketing it as insurance policy with coverage broader than that in “many traditional package wordings”).

64. See, e.g., *MyNewMarkets.com*, July 2, 2007, at [www.mynewmarkets.com](http://www.mynewmarkets.com) (advertising rental equipment dealers insurance “program” and yacht insurance that allows “customization of coverages, limits, and deductibles to meet individual needs and budgets”).

65. See *Baby Boomers Stay Loyal to Insurance Brand, Study Reveals*, INS. J., May 15, 2007, at <http://www.insurancejournal.com/news/national/2007/05/15/79724.htm>. Consumer loyalty broke down as follows in a study conducted by market research firm Focalyst. The highest brand loyalty exhibited was enjoyed by auto insurance (72 percent), home insurance (72 percent), medical insurance (67 percent), and life insurance (65 percent), followed by banks at 63 percent. The lowest brand loyalty was “enjoyed” by manufacturers of televisions (22 percent), computers (24 percent), clothing (27 percent), home appliances (30 percent), and prepared foods (36 percent). According to a Focalyst marketing director, “[b]oomers are most loyal when companies give customized service, a natural reflection of Boomers’ desire for personalized attention and rewarding brand experiences.”

However, the Focalyst study, at least as portrayed in news reports, may be overlooking some significant advantages held by insurance companies in the struggle for brand loyalty. Simply put, it is much harder to change insurance policies than to try out a new brand of shirt or new type of food. For example, changing insurers involves higher search costs and more difficult comparisons, as well as substantially more paperwork, including the comparative hassle of canceling former policies.

Insurance also tends to automatically renew, which is likely to keep consumers with the same carrier. By contrast, some of the items with low brand loyalty tend to be hard goods that eventually wear out or break down. When this happens, the consumer is essentially starting from scratch. Unless he or she is highly satisfied with the brand of machine that just stopped working, the consumer has a strong incentive to shop the market on the basis of price, model, or styling rather than brand name, per se.

Readers may also recall that beginning in 2006, State Farm was advertising (something it, like most major insurers, does constantly to promote its product in a manner more like a vendor than an entity engaged in contract offer, negotiation, and acceptance) by comparing its product to a first class airline in which passengers were pampered into a crowded coach class cattle car airline in which the same passenger (an attractive blonde woman) was sandwiched between two obese, obnoxious, inebriated male passengers. The State Farm pitch: why not pay a little more for better service from local, service-oriented agents rather than buying based on price alone.

In a second version of this type of advertisement, State Farm is analogized to the NFL linemen who protect Seattle Seahawks quarterback Matt

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Further, changing life insurance may involve loss of investment potential and higher premiums because the switching policyholder is, by definition, older and more expensive when approaching a subsequent life insurer. Perhaps, then, it is unsurprising that the non-insurance entities with highest brand loyalty are banks. Particularly where depositors have automatic deposit and automatic bill payment, switching banks, like switching insurers, entails higher transaction costs than buying a new TV from a different manufacturer, especially when the old TV needed to be replaced in any event.

Marketing and brand loyalty aside, the important point for purposes of this article is that insurance appears not to be regarded as a contractual agreement so much as a type of retail good that is designed, assembled, sold, and serviced by the insurer. In addition, it appears that, even in the high brand loyalty world of insurance, consumers will make changes when they have a bad experience with the insurer. See *75% of Auto Insurance Shoppers Who Met with Poor Service Switch Carriers, Survey Finds*, INS. J., June 27, 2007, at <http://www.insurancejournal.com/news/national/2007/06/27/81147.htm>. An "Insurance Shopping Study" by J.D. Power and Associates found that, when a policyholder had a bad claims experience with an insurer, the policyholder was willing to shop around for new coverage, with the average such consumer obtaining "three competitive quotes while shopping for a new provider," and one third of these shoppers ultimately switching carriers. The study also found that almost "40 percent of shoppers look for auto and homeowners insurance bundles" and that the percentage of policyholders reporting a satisfying insurance shopping experience ranged between 5 percent and 43 percent.

As these surveys indicated, policyholders appear to shop for insurance, not according to contractual analysis, but on the basis of pricing and the sales experience. For the bulk of policyholders, it appears that they—like the insurance industry—really do regard the insurance policy as a thing more than a contract.

Interestingly, this study concerning consumer brand loyalty to insurance products, which is consistent with previous data regarding policyholder loyalty, was the second-most accessed story for the electronic version of *Insurance Journal* during the week of June 26, 2007, outpacing even the imminent opening of Michael Moore's movie *Sicko* and the House of Representatives passage of surplus lines insurance reform. See *Weekly Reader Picks*, INS. J. (July 2, 2007). Clearly, the insurance industry is very interested in the branding and marketing of its products. See also Schwarcz, *supra* note 29, at 1413–15 (summarizing studies and concluding that policyholders are generally quite loyal to insurer regardless of whether insurer is likely to provide necessary coverage for large risks of significance or whether policies purchased are appropriate to consumer needs). See, e.g., Ins. Research Council, *Public Attitude Monitor 2000*, Issue 2, at 5 (only 7 percent of homeowners' or renters' policyholder changed insurers during five-year period); Ins. Research Council, *Public Attitude Monitor 2001*, Issue 2, at 6 (majority of consumers rely on word of mouth referrals, insurer advertisements (23 percent for auto insurance), television (10 percent), and yellow pages (14 percent) for information on insurance; no significance attached to familiarity with policy content itself).

Hasselbeck (remember, these ads ran before the team's disastrous 2008 season) while other insurers are compared to a Pee Wee team unable to stop marauding defenders (resulting in an unpleasant sack of Hasselbeck). Although this ad campaign was selling the service component of insurance, it is also consistent with the idea that insurance is a thing (i.e., access to better service like a service agreement with a reputable appliance repair operation) rather than a detailed bilateral contract between insurer and policyholder.

The status of insurance policies as products is further cemented by the longstanding ISO practice of copyrighting its standard insurance forms, a practice followed by many insurers as well. Further, insurers may be able to successfully sue one another for copyright infringement based on one insurer's use of another's structure, design, and language of the policy, on the theory that the insurance policy is a copyrightable expression of an idea that may be infringed upon.<sup>66</sup> Although courts historically have disfavored such copyright infringement actions, the tide may be turning<sup>67</sup> as part of a trend of a general expansion of the reach of intellectual property law and its protection.<sup>68</sup> For example, insurers not only seek to copyright insurance products, but even to patent them, as if the insurance policy or annuity program were an electronic device or computer.<sup>69</sup>

66. See Martin J. Bishop, *Copyright Protection for Insurance Policies*, RISK MGMT., May 2006, at 42. See, e.g., *Am. Family Life Ins. Co. of Columbus v. Assurant, Inc.*, 2006 U.S. Dist. LEXIS 8781 (N.D. Ga. Jan. 11, 2006). See also David G. Luetgen, *Supreme Court Decides Two Patent Cases That May Shape Intellectual Property Landscape Faced By Insurers*, June 14, 2007, at [www.mondaq.com/article.asp?articleid=49336&email\\_access=on](http://www.mondaq.com/article.asp?articleid=49336&email_access=on) (discussing insurer interest in patenting insurance products and implications of *KSR Int'l Co. v. Teleflex Inc.*, 550 U.S. 398 (2007), and *Microsoft Corp. v. AT&T Corp.*, 550 U.S. 437 (2007) ("It is anticipated that most insurance companies will not change their approach to filing patent applications in response to *KSR*, at least not right away. . . . For insurance companies with business in other countries outside the United States, the *Microsoft* decision means that the foreign operations of such companies are less likely to get ensnared in a dispute relating to U.S. patents.")).

67. See Bishop, *supra* note 66.

68. Remember, we live in a world where the letters between author J.D. Salinger (*The Catcher in the Rye*) and Judge Learned Hand have been copyrighted and protected by judicial enforcement (see *Salinger v. Random House, Inc.*, 811 F.2d 90 (1987)) and where an NBA basketball coach successfully copyrighted the term "three-peat" to describe efforts of the Los Angeles Lakers to win the NBA title in three successive years (see Todd D. Kantorczyk, *How to Stop the Fast Break: An Evaluation of the "Three-Peat" Trademark and the FTC's Role in Trademark Law Enforcement*, 2 UCLA ENT. L. REV. 195 (1995)).

69. See Luetgen, *supra* note 66:

Twenty years ago, a Supreme Court decision on patents would have drawn collective yawns from many segments of the business community. In recent years, however, interest in intellectual property has increased as the percentage of corporate value that is tied up in intangible assets has increased. Insurance companies are at the forefront of this trend, with things like underwriting techniques and innovative product features often being considered the "crown jewels of the company." As a result, intellectual property now may play a significant role in the future fortunes of insurers.

Although patent/copyright and contract are not necessarily inconsistent, the copywriting of insurance policies, at least if taken seriously, is further evidence of the degree to which insurance has become some-“thing” rather than merely a bilateral contractual agreement. Copyrighted words are generally part of something sold and read on a mass market basis, such as a book. A patent usually concerns a product or method and not a deal between parties. One does not ordinarily think of one’s contracts as being something to read or purchase as a possession. Although contractual rights have value and constitute a type of property, that value has historically been thought to stem from the contracting parties’ commitment rather than characteristics of the contract itself. In the modern world of insurance, however, the policies not only seem more like things, they are treated as things by insurers and marketed that way as well.<sup>70</sup>

A simple hypothetical illustrates the manner in which an interpreter’s set of presumed tools for construction can have a powerful impact on the meaning attached to a contract or the liabilities associated with a product. If one buys something called a “hammer,” one would expect that the device would not disintegrate upon impact with nails, wood, or other building material. Imagine if the “hammer” were packaged in a box that stated that the “name of this product is for identification purposes only; this product should not be considered capable of pounding nails or surviving impact with other building materials.” The purchaser of the now disintegrated-on-impact “hammer” would be entitled to a refund and probably would

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70. See Steven Plitt, *A Systematic Approach to Coverage Analysis*, IN-HOUSE DEFENSE Q., Winter 2007, at 56, 56–59 (urging coverage counsel to “[p]erform a policy inventory” and to “[k]now the policy architecture” as well as to “[u]nderstand what is being insured and why”). According to Plitt, a well-known insurer attorney and co-author of *Couch on Insurance 3d*:

Coverage analysis involving standardized policy forms can become routine and coverage counsel sometimes take shortcuts in coming to the ultimate coverage determination. Shortcuts are often the product of preconceived assumptions on the part of coverage counsel leading counsel to not carefully and methodically review a new coverage assignment. Proper coverage analysis, however, requires a dedication to the performance of routine analytic steps that must be completed for each coverage assignment.

*Id.* at 56.

Although Plitt and I would probably disagree somewhat about the degree to which the precise text of a policy defines the product as opposed to the degree to which the product informs the construction of its text, his advocacy of a systemic approach to coverage analysis is consistent with the insurance as product approach and flows from this perspective. It also suggests that agents, brokers, and lawyers dealing with insurance policies are in many ways similar to salespersons and consultants dealing with particular products.

For example, a pharmaceutical company’s “detail” persons inform doctors about the company’s drugs (and strive for sales) by emphasizing the product as a whole and its function for particular cases. They do not regale doctors with information as to the drug’s chemical makeup and, if product liability litigation is any guide, appear not to dwell on textual warnings regarding the drugs.



have a successful product liability claim if injured during the disintegration. Even if the disclaimer on the package were quite conspicuous, it is unlikely a court would find it sufficient to overcome the presumption that something called a hammer is capable of surviving the type of impacts to which a hammer is ordinarily subjected.

A similar issue arises with insurance policies, although the discussion often focuses on the language of the insuring agreement itself rather than the title of the policy or any of its specific sections. This is the well-known rule that, although it is the policyholder's burden to prove coverage, an insurer relying on an exclusion bears the burden of persuasion to clearly show the applicability of the exclusion, which is strictly construed against the insurer. If the insurer shoulders that burden, a policyholder seeking to rely on an exception to the exclusion bears the burden of persuasion with respect to the applicability of the exclusion.<sup>71</sup> Applied to the disintegrating "hammer" example, this approach to insurance policies would first determine whether something called a hammer is something that should not shatter upon contact with building materials, a showing easily made by the consumer. In response, the manufacturer (like an insurer) would seek to eject (exclude) this understanding of the term "hammer" by pointing to the disclaimer (exclusion) on the package.

If a case like the disintegrating hammer is treated under a contract model, resolution of a dispute can be difficult. On the one hand, a hammer should be able to survive impact. On the metaphorical other hand, the vendor of the device did have a disclaimer. If the disclaimer were sufficiently clear and conspicuous, a contract approach standing alone might absolve the hammer-maker (and seller) of breach of warranty or liability. In the insurance context, a similar situation could arise if the homeowner's policy contained a broad insuring clause but then contained a fire exclusion. Even if the fire exclusion were in large print, it would be hard to imagine its enforcement unless it was specifically called to the attention of a prospective policyholder, agreed to prior to sale of the policy, and resulted in a price reduction relative to ordinary policies that provide basic fire protection.

But, as a matter of bare contract jurisprudence, certainly as a matter of textual analysis alone, the case is close. Traditional contract theory has several responses to assist in reaching the right result when a court is confronted with this jurisprudential/textual bind. The court could find that, in selling a "hammer," the vendor had made a misleading representation that it was now estopped to avoid.<sup>72</sup> The court could also apply a "strong"

71. See OSTRAGER & NEWMAN, *supra* note 1, § 1.01; STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 2.06[C]; FISCHER, SWISHER & STEMPER, *supra* note 1, § 2.11.

72. See MARTINEZ & WHELAN, *supra* note 1, at 154-72; STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 5.02; ANDERSON, STANZLER & MASTERS, *supra* note 1, § 12.02.

version of the reasonable expectations doctrine and hold that the hammer user had an objectively reasonable expectation that it would pound nails and survive, and that even a clear disclaimer could not negate this expectation. The court could also escape the problematic text of the disclaimer by terming its application as bringing about an “absurd” result.

Under the extreme circumstances of the hammer hypothetical, any of these extratextual means of avoiding the impact of the disclaimer seems justified and would not constitute impermissible judicial disregard of contract text or a “voluntary agreement” of the parties. Certainly, there was no mutual intent to facilitate use of a disintegrating hammer and no shared purpose in obtaining such an instrument. An eclectic, nuanced contract doctrine that does not become myopically enamored of the “plain language” of a contract’s text can escape the folly of the disintegrating hammer or the homeowner’s policy that does not cover fire loss.

However, consideration of the product-like aspects of an insurance policy as well as its contract attributes, makes it easier to render an opinion in the case of the disintegrating hammer. Considering the product-like status of insurance provides a sound adjunct to conventional contract analysis in avoiding the absurdity of the home policy that provides no fire coverage, just as viewing the hammer as a product rather than merely the object of a contractual exchange makes it cleaner and easier to declare that the vendor of the disintegrating hammer should not be compensated and should have to pay reasonably foreseeable damages caused by its defective composition.<sup>73</sup>

Insurance policy construction and resolution of coverage disputes could well profit from more self-conscious appreciation of the degree to which an insurance policy is much like a product sold with a particular purpose in mind. Even if the product’s packaging, label, and instruction booklet does not specifically delineate the contours of the product’s use, knowing the type of product in question can assist in determining what the product can reasonably be expected to do in a particular context.

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73. In my view, even the clearly worded disclaimer of the disintegrating hammer hypothetical should not constitute an effective warning that relieves the vendor of responsibility for injury proximately flowing from the product, although the question is one better suited for torts specialists. Warning based defenses to product liability claims make sense as a means of apprising the user of dangers associated with typical use of the ordinary, properly named product. For example, a warning that cautioned against the airborne debris that can be created through typical use of a hammer (e.g., in tearing out sheetrock) would probably be effective to preclude a claim by a worker who got hit by a flying piece of a wall being torn down. But a warning should not logically be effective to negate liability where the thing sold is intrinsically something other than the product it is purported to be and where ordinary use in the manner of the intended product produces injury because the product does not measure up to minimum standards.

Viewing the insurance contract as a product as well as an “agreement” can help courts and counsel synthesize the various stands of mainstream contract theory. For example, appreciating the product-like function of an insurance policy informs the meaning of policy text, not only clarifying ambiguous text but also providing context for assessing the meaning of words that may or may not mean what they seem to mean in the absence of context. Similarly, knowing the attributes of the insurance product prevents inquiry into party intent or contract purpose from becoming a mere exercise in sifting through self-serving, party-presented evidence of what they thought or sought in connection with a policy sale. A sense of the contours of the insurance product also serves to set parameters on the asserted reasonable expectations of policyholders and insurers.

The real “contract” made by the parties is their agreement and the written documentation of the agreement is just that—“mere” documentation and not the agreement itself. Although lawyers and judges refer to the piece of paper memorializing an agreement as “the contract,” it really is a “contract document” that endeavors to record the agreement. Because commercial contracts and insurance policies are frequently lengthy and detailed, these contract documents often address matters not actually discussed by the parties. This tends to give the text of contract documents more interpretative influence in these situations than would exist, for example, in a one-page agreement reflecting the sale of an old kitchen table to a neighbor. Nonetheless, the principle remains: the memorialization of the contract is not the contract. As well put by three contracts scholars:

People often use the word “contract” to refer to the writing that embodies the agreement or deal.

....

But the piece of paper is not a “contract.” . . . At most, the piece of paper is a memorialization of the contract. . . .

....

[T]here is a tendency to confuse the written paper signed by the parties with the contract that binds them. It is an easy mistake to make; everyone calls the signed paper “the contract.” But that paper is, at best, only evidence of the contract. That is, the contract is represented by that paper; it is not that paper. . . .

....

[A contract is] “a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty.”<sup>74</sup>

74. See DAVID G. EPSTEIN, BRUCE A. MARKELL & LAWRENCE PONOROFF, MAKING AND DOING DEALS: CONTRACTS IN CONTEXT 1, 458 (2d ed. 2006) (citing *Restatement (Second) of Contracts* § 1). To underscore their point, the authors note that if the contract documents really were “the contract,” then

The importance of intent, purpose, and expectations factors in contract construction is reflected in cases considering the parties course of performance and course of dealing, as well as the industry's usage in trade as part of determining meaning and construing text.<sup>75</sup> In addition, contract meaning will often be fleshed out through the application of implied terms.<sup>76</sup>

if you tore the paper up (or spilled coffee on it) you would also tear up or water down the parties' obligations. While that may be the case with some types of obligations (such as checks or other negotiable instruments), that is not the case with regular, every day contracts.

*Id.* at 458. There is an insurance application of this concept. A policyholder may prove entitlement to coverage even if it no longer has a copy of the policy (even in the face of an insurer's denial it ever sold insurance to the policyholder) if the policyholder has other credible evidence that it purchased insurance from the insurer. See OSTRAGER & NEWMAN, *supra* note 1, §§ 17.02–17.04; FISCHER, SWISHER & STEMPEL, *supra* note 1, § 4.10.

75. See FARNSWORTH, *supra* note 5, § 7.13; EPSTEIN, MARKELL & PONOROFF, *supra* note 74, Ch. 4. See, e.g., *Threadgill v. Peabody Coal Co.*, 526 P.2d 676 (Colo. Ct. App. 1974) (court decides question of responsibility for damage to equipment based on industry norms rather than text of contract documents or invocation of ambiguity doctrine) (excerpted in EPSTEIN, MARKELL & PONOROFF, *supra* note 74, at 459–62).

These concepts of intra-party or intra-industry understanding as determining contract meaning can be seen as a movement from the general to the specific. Usage in trade refers to the custom, practice, and general understanding of an industry as a whole. Course of dealing refers to the history of contracting relations between the parties to the instant dispute. Course of performance refers to the history of the parties' understandings and behaviors regarding a particular contract. See FARNSWORTH, *supra* note 5, § 7.13; EPSTEIN, MARKELL & PONOROFF, *supra* note 74, Ch. 4.

In general, as in textual interpretation, the specific tends to have more authority than the general. The parties' course of performance is usually more important to a court than their course of dealing, which is in turn more influential than overall industry or trade custom. See FARNSWORTH, *supra* note 5, § 7.13; EPSTEIN, MARKELL & PONOROFF, *supra* note 74.

Because commercial actors may be involved in a stream of similar interactions over time, with "relational" contracts with one another, the line between course of performance and course of dealing may be a bit blurred. For example, are two shipments of widgets two separate contracts (course of dealing) or part of the same contract (course of performance)? In most cases, the answer does not affect the interpretative outcome. See generally Stewart MacCauley, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963) (scholarly article generally credited with first articulating "relational contract" concept); Ian MacNeil, *The Many Faces of Contracts*, 47 S. CAL. L. REV. 691 (1974). See also FARNSWORTH, *supra* note 5, § 7.13; EPSTEIN, MARKELL & PONOROFF, *supra* note 74 at 198–201; IAN MACNEIL, *THE NEW SOCIAL CONTRACT* (1980).

For purposes of insurance, the analogous point largely occurs with renewal of insurance policies or when a policyholder regularly purchases insurance through a particular insurer or agent. In insurance law, a body of precedent has grown up which limits the force of exclusionary text contained in renewal or rolling insurance policies if adverse changes are not drawn to the policyholder's attention. See STEMPEL ON INSURANCE CONTRACTS, *supra* note 1, § 4.09[D][2]. See, e.g., *Canadian Universal Ins. Co. v. Fire Watch, Inc.*, 258 N.W.2d 570, 572 (Minn. 1977).

76. See FARNSWORTH, *supra* note 5, §§ 2.13, 7.17; EPSTEIN, MARKELL & PONOROFF, *supra* note 74, at 542–603. Perhaps the most famous implied terms case is then-Judge Benjamin Cardozo's opinion in *Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214 (N.Y. 1917), a staple of contract course casebooks, in which the court held that it was implied, as part of distribution and sales agreement or franchise, that the holder of contract rights would make reasonable best efforts to in fact sell and distribute the merchandise to which the contract party had rights.

Further, the concept of good faith and fair dealing can provide additional meaning to a contract by requiring that the parties make certain reasonable efforts or refrain from conduct that deprives other parties of the benefit of the bargain.<sup>77</sup>

Notwithstanding that “the paper is not the contract,” there is a strong presumption that the text of the contract documentation reflects the agreement of the parties. This presumption becomes particularly strong where the contract is long and complex because the written contract documents may address, in detail, aspects of the arrangement that were not directly addressed in negotiations. However, even in the absence of specific discussion, there may be an established understanding of the basic contours of coverage because of the nature of the policy, business community understanding, or past practices.

### *C. Existing Recognition of the Product-Like Aspects of Insurance Policies*

The “Insurance Contract as Thing” or “Insurance Policy as Product” approach has obvious similarities to the reasonable expectations approach to insurance policy construction. Under the reasonable expectations approach in its strongest form, coverage disputes are resolved by providing coverage consistent with the objectively reasonable expectations of the policyholder even though “painstaking” study of the policy text may have negated those expectations.<sup>78</sup> In its more common and more moderate form, the reasonable expectations approach requires that uncertain contract language be interpreted in a manner consistent with the reasonable expectations of the disputants, with more solicitude given to the understanding of the policyholder.<sup>79</sup> Like the reasonable expectations approach, the insurance-contract-as-thing approach will tend to be less literalist and

77. See STEMPER ON INSURANCE CONTRACTS, *supra* note 1, §§ 10.01, 10.02; *Market Street Assocs. Ltd. P'ship v. Frey*, 21 F.3d 782 (7th Cir. 1994) (applying Wisconsin law).

78. See STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 4.09; Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, (1990); Keeton, *supra* note 16.

79. See STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 4.09. Some scholars describe the reasonable expectations approach as considering only the policyholder's reasonable expectations. See, e.g., OSTRAGER & NEWMAN, *supra* note 1, § 1.03[b]; ALAN I. WIDISS, *INSURANCE: MATERIALS ON FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES AND REGULATORY ACTS* Ch. 6 (1989); Kenneth Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151, 1154 (1981) (finding reasonable expectations principle invoked with some frequency for consumer policyholders but seldom for commercial policyholders. However, for reasons set forth at greater length elsewhere, I view the reasonable expectations doctrine as applicable to both policyholders and insurers and find that courts frequently consider the reasonable expectations of insurers regarding their contractual commitments to policyholders, even if cases taking this into account do not always use reasonable expectations terminology. See STEMPER ON INSURANCE CONTRACTS, *supra*, § 4.09; Jeffrey W. Stempel, *Assessing the Coverage Carnage: Asbestos Liability and Insurance*

less worshipful of the text of contract documents as well as prompting a broader interpretative focus. Consequently, like the reasonable expectations approach, it is likely to be an interpretative construct opposed (at least officially) by most insurers, which have an inherent advantage over policyholders in that insurers are repeat players that can recur to the drafting table after litigation losses and amortize such losses across books of business and years of risk.

In taking this position, insurers and their counsel tend to cast themselves in the role of principled defenders of cautious jurisprudence and opponents of “judicial activism” that results in the “rewriting” of contract language. Textualism, of course, can be defended as more objective and less likely to lead to the improper imposition of a court’s personal preferences in adjudication. But textualism, like inflexible formalism, can be a false god that leads to incorrect or bad outcomes when construing contracts or statutes and giving them the force of law.

In addition, the insurance industry position of purporting to favor text and regarding most other means of contract construction as illegitimate stems from historical and sociological factors affecting insurers. As noted above, insurance policies are heavily standardized. This is most obvious in the mainstream property and casualty market, where policies sold to individuals and Fortune 500 corporations alike are largely patterned on set forms authored by the ISO. If the standard policies are altered, it is usually by way of an ISO-drafted endorsement rather than through any customized or newly created contract language.

ISO essentially works for the insurance industry and attempts to issue forms that meet the needs of mainstream property and casualty insurers. Although many insurers (e.g., the St. Paul Companies’ plain language forms; the standard forms of Bermuda-based carriers such as ACE and XL; those of Lloyd’s or London Market entities) use their own standardized forms, the variance in form language and coverage offered is not substantial. For the most part, insurance policies are industrywide products that are sold in the manner of manufactured goods. Certainly, this is the situation for most insurance sales to consumers or small businesses. Insurance policies for larger businesses or wealthy individuals may be negotiated in

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*After Three Decades of Dispute*, 12 CONN. INS. L.J. 349, 440–64 (2006) (noting insurer victories in long-running asbestos coverage wars that appear to result more from judicial solicitude for insurer expectations and financial burdens more than strict reading of policy language); Jeffrey W. Stempel, *Unmet Expectations: Undue Restriction of the Reasonable Expectations Approach and the Misleading Mythology of Judicial Role*, 5 CONN. INS. L.J. 181, 245–72 (1998) (same observation regarding other types of coverage disputes). See also Swisher, *supra* note 17, at 733–35 (finding that fusion of reasonable expectations thinking and ambiguity analysis dominates insurance coverage law, with reasonable expectations of parties used to construe unclear policy text but not to overcome clear policy text).

the manner of contracts, but the negotiation proceeds under the initial framing provided by standardized insurance products.

The same situation largely holds for life, health, and disability policies, although there exists more variance in this area because of the absence of a central drafting organization such as the ISO. Nonetheless, almost all of life/health/disability policies look alike and use the same terminology, with only modest variance that is usually itself part of a standard menu of options similar to the manner in which ISO policies are varied by preprinted endorsement much more often than by particularized negotiation. Because of this history, custom, and “capital investment” in standardized or common policy language by insurers, they are reluctant to support any contract construction methodology that does not give dominant or exclusive focus to the text on the face of the policy documents.<sup>80</sup>

However, insurers frequently make arguments against coverage that are not text-based and may even contradict policy text. For example, in an important California Supreme Court case, insurers and their amici argued that the policyholder’s CGL policy only provided defense and coverage of tort claims because this was the understanding about and design of the CGL. However, the court properly rejected this view, both because the policy text stated that it covered suits alleging “property damage” against the policyholder, and because the reality of the nature of the plaintiff’s claim was more important than its technical legal characterization in view of the CGL policy’s role in providing general liability protection to policyholders. The case involved a “breach of lease” claim that was centered on the defendant policyholder’s despoiling and polluting of the plaintiff owner’s land.<sup>81</sup>

Insurers tend to dislike the ambiguity doctrine as much or more than the reasonable expectations doctrine. In most cases, of course, the insurer is the drafter of policy language and likely to lose a dispute over unclear policy language—unless the insurer can convince the court that there are extrinsic factors supporting the insurer’s construction of the disputed term. When arguing against application of the ambiguity approach against them, insurers frequently make implicit insurance-contract-as-thing/insurance-as-product arguments in that they argue that the policy in question was never designed to provide the type of coverage sought by the policyholder (or its assignee).

One example is the liability insurer mantra that “a CGL policy is not a performance bond,” which regularly accompanies insurer briefs in cases

80. See Boardman, *supra* note 50, regarding insurer tendency to retain standardized language, even if problematic.

81. See *Vandenberg v. Superior Ct.*, 982 P.2d 229 (Cal. 1999).

seeking to avoid coverage in construction defect cases and is regularly repeated in court decisions.<sup>82</sup> The notion underlying this aphorism is that liability policies are designed to provide protection to the policyholder in cases of fortuitous events leading to third party claims of injury but are not intended to provide coverage where a policyholder is simply accused of shoddy work and asked to redo the work or refund the purchase price to a dissatisfied customer. But nowhere does the standard CGL policy state that it is not a performance bond. To be sure, insurers attempt to memorialize this concept in the various business risk exclusions found in the typical CLG policy (e.g., the “your work,” “your property,” “care, custody or control,” and “impaired property” exclusions).<sup>83</sup> But, in arguing for the applicability of some or all of these textual exclusions to coverage, liability insurers regularly attempt—frequently with often deserved success—to persuade courts of their position by attempting to convince the courts that the CGL policy simply is not a product designed to cover the type of customer dissatisfaction characteristic of many construction defect cases.<sup>84</sup>

In similar fashion, crime and fidelity bond insurers frequently note that a crime policy is not a liability policy and that it consequently provides coverage only for direct loss of the policyholder’s property—not the attenuated consequences of theft or employee dishonesty.<sup>85</sup> As with insurer arguments against CGL coverage for construction defects suits against the policyholder, crime insurers can point to policy language favoring their position. But, in addition to invoking favorable portions of policy text, crime insurers frequently make a more conceptual argument based on the idea

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82. See, e.g., *Burlington Ins. Co. v. Oceanic Design & Constr., Inc.*, 383 F.3d 940, 948 (9th Cir. 2004) (applying Hawaii law); *Peterson v. Dakota Molding, Inc.*, 738 N.W.2d 501, 508 (N.D. 2007); *Kvaerner Metals Div. v. Commercial Union Ins. Co.*, 908 A.2d 888, 899 (Pa. 2006); *Knutson Constr. Co. v. St. Paul Fire & Marine Ins. Co.*, 396 N.W.2d 229, 233 (Minn. 1986). See Roger C. Henderson, *Insurance Protection for Products Liability and Completed Operations—What Every Lawyer Should Know*, 50 NEB. L. REV. 415, 441 (1971) (CGL policy is designed to provide coverage for “tort liability for physical damages to others and not for contractual liability of the insured for economic loss because the product or completed work is not that for which the person bargained”). See also STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 25.05[B] (reviewing business risk exclusion in CGL in connection with construction defect claims).

83. Regarding the “business risk” exclusions typically found in the standard CGL policy, see STEMPER ON INSURANCE CONTRACTS, *supra* note 1, §§ 14.01, 25.05[B][2].

84. *Id.* § 25.03. See, e.g., *Wm. C. Vick Constr. Co. v. Pa. Nat’l Mut. Cas. Ins. Co.*, 52 F. Supp. 2d 569 (E.D.N.C. 1999); *Koch Eng’g Co. v. Gibraltar Cas. Co.*, 878 F. Supp. 1286 (E.D. Mo. 1995); *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651 (Tex. App. 2006); *Truck Ins. Exch. v. Vanport Homes, Inc.*, 58 P.3d 276 (Wash. 2002); *Lerner Corp. v. Assurance Co. of America*, 707 A.2d 906 (Md. 1998); *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788 (N.J. 1979).

85. See, e.g., *Se. Bakery Feeds, Inc. v. Ranger Ins. Co.*, 974 S.W.2d 635 (Mo. Ct. App. 1998); *La. Dep’t of Transp. & Dev. v. Acadia Parish Police Jury*, 631 So. 2d 611 (La. Ct. App. 1994). See STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 22.05.



that the crime policy is simply not the type of product that covers policyholder problems that emerge indirectly or consequentially from theft or employee dishonesty.

Insurance policies also frequently contain “intentional act” or “expected or intended” exclusions that bar coverage where the policyholder can be said to have willfully brought about a loss or injury for which it now seeks insurance coverage.<sup>86</sup> Notwithstanding such policy language, insurers frequently also argue that insurance cannot apply to a situation unless loss or liability-causing events are “fortuitous.”<sup>87</sup> Insurer refusals to pay for claims involving a “known loss,”<sup>88</sup> a “loss-in-progress”<sup>89</sup> or wear-and-tear are similarly based not so much on policy language but upon the notion of the nature and essence of insurance as a concept and as a product. Defenses of this type are not based on exclusionary language per se, but instead argue that the very nature of insurance as a product requires that covered claims are only those where the policyholder has not intended the harm at issue. In making these types of defenses, often too sweepingly, insurers are, in essence, arguing that the insurance product is by design and definition limited in scope to only fortuitous losses (even in the absence of specific language to that effect).

Similarly, when insurers argue that there has not been a sufficiently accidental “occurrence” triggering liability coverage,<sup>90</sup> they are arguing that the facts of the loss are inconsistent with the manner in which insurance works—in effect, arguing that insurance policies are not products designed to cover such claims. When liability insurers make this argument, they are arguing that the nature of insurance as a product requires a certain type of policyholder conduct or state of mind as a prerequisite to coverage and that merely showing a loss or liability event is not enough. As with the fortuity defense, insurers frequently overdo the “no accident” or “no occurrence” defense. But whether rightly or wrongly invoked, it is not so much a textual defense as a defense based on an argument that the insurance policy is a product or thing that simply does not provide coverage for policyholder problems that are not sufficiently accidental.

The typical liability policy does not specifically address the question of whether punitive damages judgments against a policyholder are within coverage or excluded from coverage (although there are increasing exceptions to this norm as insurers and sophisticated policyholders try to clarify the situation prior to a loss or liability event). When a policyholder with

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86. See *STEMPEL ON INSURANCE CONTRACTS*, *supra* note 1, § 1.06[B][1].

87. *Id.* § 1.06[A].

88. *Id.* § 1.06[B][2].

89. *Id.* § 1.06[B][3].

90. *Id.* §§ 1.06[B][1][g], 14.01[A][2], 25.05[B][3].

an open-ended policy seeks coverage for punitive damages, insurers predictably argue that punitives are not within the scope of the policy's coverage. But when insurers make these arguments without benefit of a written exclusion or definitional language excluding punitive damages, they are in essence arguing that punitives should be excluded because of the inherent nature of the insurance product, perhaps coupled with an argument that conduct giving rise to punitive damages is inherently within the expected and intended exclusion.<sup>91</sup>

The latter argument, of course, is largely incorrect. In many jurisdictions, a policyholder may be held liable for punitive damages even where it did not intend to injure a third party, but was merely willfully indifferent to its rights, acting in reckless disregard, or (in some states) grossly negligent. Consequently, the insurer defense to punitive damage coverage is at bottom premised on the notion that insurance coverage for punitive damages violates public policy. Why, according to insurers, does it violate public policy? The standard insurer argument is that it is inconsistent with public policy values to permit a punitive damages wrongdoer to have the punishing and deterring impact of a punitive award subsidized by insurance or inflicted upon others through the risk-spreading aspects of insurance. In other words, insurers frequently argue that coverage of punitive damages is inconsistent with the nature and intended purpose of the insurance product.

These types of public policy defenses to punitive damage coverage appear to succeed somewhat less than half the time, at least where the award of punitive damages is a form of vicarious liability or where there is no court finding of intent to injure. However, liability insurers have been remarkably successful in avoiding coverage for child sex abuse claims against policyholders, even when plaintiffs' complaints style these claims as "innocent" battery or negligent supervision actions. Insurers have argued, and courts have generally agreed, that when a child is sexually abused, even by a perpetrator who does not subjectively think of the act as wrongful, harm to the child is so practically certain to occur that intent to injure must be found as a matter of law. Courts have also largely accepted the insurer argument that a failure to supervise claim against a policyholder that was not the actual perpetrator of sexual abuse is nonetheless in reality a claim for sexual abuse that must fall outside policy coverage. When all the rhetoric is pared away, the insurer in these cases is essentially arguing that coverage for child sexual abuse is not only too inherently abhorrent to merit insurance coverage, but also that it is conduct so deviant that coverage of its consequences would be inconsistent with the insurance product.

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91. *Id.* § 1.06[B][5][b].

### III. APPLYING THE INSURANCE POLICY AS THING CONCEPT: SOME EXAMPLES

#### A. "Visible Marks" Definition of Burglary

Use of the insurance policy as product concept provides useful insight into other coverage issues that have divided courts. One is the matter of whether the "visible marks of entry" requirement in a burglary policy is to be strictly enforced as written. This coverage question was involved in a leading reasonable expectations case, *Atwater Creamery Co. v. Western National Mutual Insurance Co.*,<sup>92</sup> as well as in *C & J Fertilizer, Inc. v. Allied Mutual Insurance Co.*,<sup>93</sup> another leading reasonable expectations case that more self-consciously viewed the burglary policy as an insurance product that would not be fit for its intended purpose if the "visible marks of entry" provision were strictly enforced as a prerequisite to coverage. Applying this product liability construct to *Atwater*, Professor Schwarcz notes that the case

featured a common clause in commercial burglary policies that excluded coverage for burglaries when there were no visible marks of forced entry on any external doors or windows. The clause encouraged employers to hire trustworthy employees, because it tended not to cover "inside jobs," where external marks of entry would be less likely to exist. It also encouraged insureds to properly lock all windows and doors. Based on these underwriting purposes, the *Atwater* court concluded that the clause should not apply in the case before it because the evidence strongly suggested that the specific insured's loss was attributable neither to an inside job nor to insufficient care. Although intuitively attractive, this reasoning would not support the finding of an insurance harm [as defined in the Schwarcz article]. The visible marks clause served a legitimate underwriting purpose in *Atwater* because it reduced juridical hazard. [Problems of fit between the exclusion and its purpose were] only clear to the court after it examined all of the evidence at hand, and concluded that the burglary was not an inside job and that *Atwater* [Creamery] had taken an adequate amount of care. But such ex post factual investigation is costly, and, for that reason, providing coverage that would require it may well be inefficient.<sup>94</sup>

Although Schwarcz stops short of a firm finding that his proffered product liability model of insurance would not find for the policyholder in cases like *Atwater* (or *C & J Fertilizer*, which involved similar facts), he is close to siding with insurers on this issue and repudiating the application of the reasonable expectations approach to these types of cases, a perhaps unsurprising result in view of his negative assessment of the reasonable expectations

92. 366 N.W.2d 271 (Minn. 1985) (en banc).

93. 227 N.W.2d 169 (Iowa 1975).

94. See Schwarcz, *supra* note 29, at 1451-52 (footnotes omitted).

concept.<sup>95</sup> Courts also appear to harbor similar difficulty with this issue and with the reasonable expectations doctrine, as reflected in subsequent Minnesota and Iowa decisions that trimmed the reach of the doctrine.<sup>96</sup>

The ineffectiveness of the narrower Schwarcz product liability model of insurance or its support of noncoverage in these types of cases is a strong brief in favor of the broader “insurance-policy-as-thing” perspective advanced in this article. *Atwater* and *C&J Fertilizer* were correctly decided not only because the strong version of reasonable expectations advocated by Keeton appears applicable, but also because a confluence of other interpretative factors and the notion of an insurance policy as some-“thing” purchased by policyholders strongly argues in favor of finding coverage.

Admittedly, the text of the burglary policies at issue is more favorable to insurers. The policy form (which represents a part of the contract documents but is not necessarily an accurate representation of “the contract” between the parties) states that a burglary must be one involving visible marks of forced entry to be within coverage. But as emphasized by the *Atwater* and *C&J Fertilizer* courts, this language is imbedded within the definitions section of the policy, where it is unlikely to be noticed by most policyholders. Even sophisticated policyholders aware of this limitation on coverage are most likely aware of it because of their experience and sophistication, not because they actually read the policy form with care.<sup>97</sup>

Allayed against the text are a number of contract interpretation factors supporting the policyholder’s argument for coverage. Clearly, the intent of the policyholder in purchasing the policy was to enjoy coverage for any non-fraudulent burglary that might befall it. The insurer can be said to have intended its visible marks exclusion to achieve the same goal as well. On a

95. *Id.* at 1435–39.

96. See Bd. of Regents of the Univ. of Minn. v. Royal Ins. Co., 517 N.W.2d 888 (1994) (where exclusions are not hidden in the “Definitions” section of policy or otherwise obscured, objectively reasonable policyholder expectations cannot trump clear policy language limiting scope of coverage); Farm Bureau Mut. Ins. Co. v. Sandbulte, 302 N.W.2d 104 (Iowa 1981); Rahdert, *supra* note 15. See also Cochran v. MFA Mut. Ins. Co., 271 N.W.2d 331 (Neb. 1978) (rejecting reasonable expectations perspective entirely and enforcing “visible marks of entry” requirement against policyholder to preclude coverage for apparently legitimate burglary that was not an inside job).

97. For that reason, the subsequent retreat from the reasonable expectations doctrine by the Minnesota Supreme Court (*Regents*, 517 N.W.2d at 888) and Iowa Supreme Court (*Sandbulte*, 302 N.W.2d at 104) is not particularly persuasive. Although placing a limitation on coverage in a segregated “exclusion” is less hidden than if the limitation is interwoven with definitions or conditions, the fact remains that most policyholders will simply not read or appreciate the exclusionary text. And, to cite a well-known axiom, it is the effect of the language, not its placement, that determines whether it is an exclusion. If that is so, it should be strictly construed against the insurer, who must bear the burden of persuasion to clearly show that the limiting language is applicable. See STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 2.06[C].

more substantive level, the insurer's intent was to avoid paying for losses from inside jobs and from policyholder carelessness (e.g., not locking up at night). This broader insurer intent can be satisfied by the *Atwater/C&F Fertilizer* results so long as the loss was not in fact the product of an inside job. However, as Schwarcz points out, determining this imposes some juridical costs on the insurer—but also imposes them on the policyholder as well, making it less likely that the policyholder will seek coverage unless the loss was legitimate. If nothing else, a policyholder making a burglary claim surrounded by suspicious circumstances suggesting an inside job is at risk for becoming the target of a criminal investigation by drawing greater scrutiny to the suspicious loss and giving the insurer incentives to expose possible policyholder involvement in fraud.

On a broader level, the purpose of a burglary policy is to transfer the risk of burglary loss from the policyholder to the insurer and to spread the risk throughout the pool of policyholders assembled by the insurer. The risk is further spread by the insurer's purchase of reinsurance. This purpose would seem adequately served as long as failure to satisfy the visible marks of entry requirement does not become a loophole through which the insurer's risk pool unravels. Admittedly, this may involve some greater transaction costs in investigating, adjusting, and litigating claims than would an inflexibly formal application of the visible marks text of the policy. But these additional costs are likely to be minor and can be spread through a modest increase in premium.

Moreover, as noted above, if insurers aggressively challenge suspect claims, unscrupulous policyholders are unlikely to bring many of them. In addition to the risk of loss in the coverage action and its attendant cost, the policyholder risks being exposed as a perpetrator of insurance fraud that can lead to criminal prosecution and penalties. When one adds the insurance policy as product perspective to the mix of traditional contract interpretation considerations, the case for coverage in *Atwater* and *C&F Fertilizer* situations moves from persuasive to nearly inarguable. The burglary policy is not a simple contract and is certainly not one in which the parties dickered over the definition of burglary, with any discussion or shared understanding regarding the visible marks definition. Rather, the burglary policy is a risk management product the policyholder buys to provide contingent protection, should it be burglarized. A product of this type is worth substantially less if it does not cover all real burglaries that may befall the policyholder. In my view, the product is not even minimally adequate if the visible marks requirement is strictly enforced as this would result in too many cases in which there is no coverage for actual, non-fraudulent, outside job burglaries.

A burglary policy limited to cases where tangible evidence of breakage exists would be incomprehensive and incomplete. It would fail to

achieve the risk management objective of the policyholder, would fail to transfer and distribute all the risk intended, and would not facilitate prediction of exposures so that the policyholder would be able to adequately plan its business activities. In addition, unless all courts uniformly take a literalist, pro-insurer stance regarding visible marks, there will continue to be substantial juridical costs imposed on the policyholder, insurers, and society due to more frequent litigation of the issue, as well as time lost during informal claims adjustment and compromise that does not produce reported litigation.

In short, it simply is easier and more efficient to treat the visible marks requirement as something more like a “standard” or “guideline” rather than a fixed command or rule mandating proof of visible injury to the premises as a requirement for burglary coverage. The impact on insurance cost is likely to be minimal and, in return, the burglary insurance product becomes more valuable and dependable in serving its intended purpose. Finding coverage in *Atwater* and *C&J Fertilizer* situations also prevents the visible marks language from becoming an instrument of socially negative behavior. Strict enforcement of the language does not necessarily lead to more care, less policyholder fraud, or more certainty. For example, an unscrupulous policyholder can burglarize his or her own property and still obtain coverage by simply breaking a window pane or snapping a lock while leaving the premises with stolen merchandise. Although this bit of larceny may raise the possibility of detection (e.g., a klutzy policyholder could sustain an incriminating cut), the impact is likely to be trivial. Strict application of the visible marks test, then, encourages a situation in which really bad policyholders can nonetheless scam insurers while policyholders unfortunate enough to be victimized by slick burglars are left without insurance.

Finding coverage in such situations—either by construing the visible marks language as a guideline rather than a rule in light of the purpose of the product or by mandating coverage to prevent the product from being defective—is reminiscent of the argument legitimately and successfully made in product liability tort cases where the manufacturer is found liable if it could have made the product safer and more effective through a cheap or convenient modification of the product. In punch press cases, for example, the manufacturer is often found liable where it failed to install a hand guard or safety switch that prevents workers from placing their fingers in danger while the machine is capable of working (and severing digits because the worker extended an arm too far). Similarly, in swimming pool product liability cases, the manufacturer has been found liable where it could have prevented a child from being sucked into the pool drain with the addition of a simple, cheap piece of plastic to reduce potentially deadly suction.

### B. *Pollution Exclusion*

Another area in which consideration of the insurance policy as a product designed to serve a purpose can illuminate coverage questions involves the absolute or total pollution exclusion. Here again, the Schwarcz product liability model of judicial regulation of insurance has potential applicability. The exclusion bars coverage for claims "arising out of . . . discharge, dispersal, seepage, migration, release, or escape of . . . any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acid, alkalis, chemicals, and waste."<sup>98</sup>

The underwriting purposes of this clause are to limit the risks of adverse selection and moral hazard inherent to gradual pollution that suddenly became significant after the passage of [CERCLA]. But the clause's sheer breadth means that insurers often invoke it to deny coverage, even when the nature of the loss makes clear that doing so does not advance these underwriting purposes. In one case, for example, an insured's employees accidentally spilled ammonia from a blueprint machine in the course of moving equipment. In another case, a construction worker applied a sealant to a warehouse floor that immediately contaminated the food stored in the building. In each of these instances, an insurer's reliance on the absolute pollution exclusion to deny coverage would be considered an insurance harm because, from an ex post perspective, it is self-evident from the nature of the loss that the clause's purpose would not warrant the denial of coverage; both cases involve sudden accidents that do not implicate the adverse selection or moral hazard problems of gradual pollution. Nor can the absolute pollution clause be justified in these cases on grounds that it reduced juridical hazard: the very character of the losses described above indicated that the core underwriting purposes of reduced moral hazard and adverse selection did not apply.<sup>99</sup>

Professor Schwarcz's assessment is correct so far as it goes. However, a broader application of insurance-as-product analysis makes the case for coverage in such situations even clearer and provides guidance to courts in cases involving carbon monoxide poisoning, lead paint poisoning, and workplace incidents involving gasoline discharge or industrial fumes. In cases of this type, courts have split regarding application of the pollution exclusion, producing several outcomes that are distinctly unfair to policyholders by depriving them of coverage that logically falls squarely within the product description of the CGL form.

The absolute pollution exclusion became part of the standard CGL policy in 1986, more than forty years after the dawn of the basic CGL form, which was crafted as a more comprehensive and expanded general liability

98. See STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 14.11[C].

99. See Schwarcz, *supra* note 29, at 1450–51 (footnotes omitted).

policy extending beyond the Public Liability insurance and Owners, Landlords, and Tenants Liability insurance that was in widespread use prior to the design of the CGL.<sup>100</sup>

Viewed in historical context, it is quite clear that the CGL policy was designed to provide broad coverage for the types of general liability claims that were likely to confront commercial policyholders as a consequence of their normal operations. Insurers were properly concerned that CGL coverage should not apply merely because a policyholder was accused of substandard work or where the policyholder intentionally caused injury. The former concern was addressed through business risk exclusions, while the latter concern was addressed through the expected or intended exclusion.

Although the original CGL form may have been premised on the notion that an injury-causing event leading to litigation was isolated in time and space, court decisions eventually gave a broad interpretation to the word "accident" such that the CGL form applied to injuries and events taking place over a more extended period of time. In 1966, the insurance industry modified the CGL form to base it on damage caused by an "occurrence" rather than an "accident," with the specific intent that gradual injury-causing conduct implicating the policyholder would be within coverage. This, in turn, made the prospect of insurance coverage for pollution activity more likely at a time when the United States was becoming more environmentally conscious (e.g., Earth Day first appeared in 1970).

Concerned about pollution, insurers first considered complete exclusion, but then moved to a qualified exclusion that made an exception where the pollution-related claim involved "sudden and accidental" release of the pollutant, with insurers taking the position that "sudden" meant "abrupt" rather than merely being another way of saying "unintentional." In opposition, many policyholders argued that the word "sudden" was too unclear to be construed against them and that any unintentional pollution was covered. When courts split on this interpretative issue, insurers were predictably concerned, prompting use of the absolute pollution exclusion and its inclusion in the 1986 standard CGL form.<sup>101</sup>

As reflected in the Schwarcz analysis, this history makes clear that abrupt and isolated discharges were not what the insurance industry had in mind when it adopted the absolute pollution exclusion. In addition, the background of the exclusion and the means by which it was introduced to regulators makes clear that insurers wanted to avoid liability for the type of widely dispersed, long-tail, hard to detect, and expensive-to-litigate

100. See STEMPER ON INSURANCE CONTRACTS, *supra* note 1, § 14.01 (describing the advent and history of CGL policy).

101. *Id.* §§ 14.11[B], 14.11[C].



injuries associated with pollution and contamination claims.<sup>102</sup> The cases alluded to in the Schwarcz article (i.e., the spilled ammonia from the blue-print machine and food adulteration because of careless treatment of construction chemicals) are not within the intended scope of the pollution exclusion not only because they took place abruptly, but also because they were episodic events that were not part of a global pattern and, they did not lead to the type of widely dispersed, decades-long injury associated with historical pollution claims. As a result, these sorts of claims fall comfortably within CGL coverage and outside the pollution exclusion under both the Schwarcz approach and the insurance-as-thing interpretative perspective outlined in this Part III of this article.

Considering the insurance policy as a product and the pollution exclusion as a component of that product makes assessment of coverage disputes easier and strengthens the already strong case (based on drafting history, party intent, policy purpose, policyholder expectations, and avoidance of absurd results) for coverage in such situations as a matter of contract analysis. A CGL policy that fails to cover the ordinary business mishaps leading to litigation is a woefully defective risk management product that should not be sold, perhaps not even with the type of clear warnings required under the Schwarcz product liability model of judicial regulation of insurance policies. It is almost inevitable that a reasonably kinetic business will have equipment break at the office and that this might occasionally have consequences to a third party. It is also possible that a company using sealant, paint, or other chemical products may make errors that result in damage from fumes or chemicals in the particular vicinity of the error. These sorts of typical business risks must be within the scope of the CGL form or the policy is not a product fit for the policyholder that purchases it.

Similarly, if the policyholder is a furnace contractor that unwittingly allows carbon monoxide fumes to injure a family, this is the type of injury that falls within the concept of the CGL product, particularly as that product was "launched" by the insurance industry during the mid-20th Century.<sup>103</sup> Likewise, if a contractor fails to protect subcontractors from sealant fumes or an exterminator applies chemicals incorrectly, claims stemming from these events should be covered under any reasonable concept of the CGL product. If a worker is harmed by spurting gasoline due to malfunctioning equipment or negligent maintenance, this is not the type of pollution to be excluded from CGL coverage, notwithstanding that the plaintiff is

102. See Jeffrey W. Stempel, *Reason and Pollution: Correctly Construing the "Absolute" Exclusion in Context and in Accord with Its Purpose and Party Expectations*, 34 TORT & INS. L.J. 1 (1998); Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942 (1988).

103. See STEMPEL ON INSURANCE CONTRACTS, *supra* note 1, § 14.01.

hurt in substantial part because of the irritating qualities of the gasoline rather than from pressure or slipperiness alone. Rather, it is the type of run-of-the-mill mishap that one knows can strike a business at any time. It is the type of mishap that the CGL was designed to protect against. The inclusion of the pollution exclusion in 1986 was not intended to change the design of the CGL policy so much that it would eliminate this type of basic coverage. If a policyholder's activities create smoke that obscures the vision of nearby drivers, the resulting injuries and claims are not the result of pollution, but of policyholder negligence of the type typically within the scope of CGL coverage.

Events such as those described above are not only abrupt, but also relatively confined in space, time, and impact. They do not involve long-running or wide-ranging pollution that raises the prospect that the insurer will be forced to pay for unduly coordinated risk. Rather, they involve more or less typical (but sometimes tragic) workplace mishaps that only incidentally involve chemicals. The policyholder could have accidentally allowed the furnace to start a fire, failed to shut a pipe valve tightly, left sharp tools within reach of small children, or broken a pipe on the way to eradicating a cockroach. All of these types of events are classic instances for CGL coverage. When the CGL form is viewed as a product as well as a contract, it becomes clear that the mere presence of some limited chemical "discharge" should not alter the coverage outcome. Further, these types of cases involve none of the complex and expensive juridical and litigation costs that may be presented by true pollution or toxic tort litigation.

Appreciating the nature of the CGL insurance as a product also reinforces the common sense notion that, when insurers used words like "discharge" and "release" in the CGL form, they were not intending a highly literal reading that would apply whenever any chemical of any type was outside its confines of storage under any set of circumstances. For example, the ammonia from the blueprint machine case discussed above was not discharged or released except in the most literal sense. Rather, the ammonia was spilled. Sealant fumes produced as a result of construction or painting work are not discharged or released as much as they simply are a byproduct resulting from the policyholder's ordinary commercial activity—the consequences of which was to be insured under the CGL product.

A number of recent cases reflect quite well the implicit judicial view that insurance policies are products designed to provide a particular type of coverage. In such cases, efforts by a litigant to focus solely on isolated text are ineffective if the court finds that the insurance policy's design and intended purpose is to the contrary. Even where text-based arguments can be rebutted by reference to other contrary text, a concept regarding the nature of the policy at issue can provide additional solid ground for a decision on coverage.

### C. Policy Periods and Available Limits

A sometimes vexing issue is the amount of insurance available for set time periods when a policy is sold for less than a year or for a multiyear period. Where a policy is sold for a one-year policy period and states policy limits, the obvious conclusion is that the policy limits apply to any claims arising out of an occurrence (or the total number of occurrences as respects an aggregate limit) during that one year. But what about policies sold for a three-year period? Does the policy limit apply to each year or to the three-year period as a whole. And what about a policy period of less than one year? Should the policy limit be prorated (e.g., a six-month policy has half the limits stated on the declarations sheet)?

Courts have divided on this issue, particularly in the case of a multiyear policy period. Although some cases realize that the policy limits must be annualized to make sense of the insurance product, other cases have taken a narrow textual view to read the policy limit as “clearly” being a three-year policy limit. The latter view is incorrect. Fortunately, it has largely been corrected by the language of the modern liability policy, which states

[t]he limits of this Coverage Part apply separately to each consecutive annual period, and to any remaining period of less than 12 months, starting with the beginning of the policy period shown in the Declarations, unless the policy period is extended after issuance for an additional period of less than 12 months. In that case, the additional period will be deemed part of the last preceding period for purposes of determining the Limits of Insurance.<sup>104</sup>

104. See Insurance Services Office, CGL Policy Form CG 00 01 10 01 (2000). Section III, reproduced in DONALD S. MALECKI & ARTHUR L. FLITNER, CGL: COMMERCIAL GENERAL LIABILITY: COMMERCIAL LINES COVERAGE GUIDE 150 (8th ed. 2005). Commenting on this language, Malecki and Flitner observe:

Although this section is largely self-explanatory, an example may be useful. Say that an insured purchases a policy with a three-year policy period beginning July 1, 2004, and ending July 1, 2007. The above provision makes it clear that even if the stated policy limits are depleted by claims during the first year of the policy period, the full stated limits will again be applicable beginning on July 1, 2005 (and again on July 1, 2006).

The provision also address situations when an annual policy period is shortened, as might be the case if a policy with an inception date of July 1, 2004, was cancelled on January 1, 2005, instead of expiring on July 1, 2005. Despite the shortening of the last annual period, the full stated limits would apply to claims covered under that period.

If, however, a policy is extended for a period of less than one year—say the insured requests a one-month extension of the policy, after the regular policy term has expired—the limits will not be renewed for that additional period. That is, if the policy limits had been reduced by claims paid during the preceding annual policy period, the reduced amounts of insurance would apply to the extension period, and not the full limits stated in the policy.

*Id.* at 150.

The “extended” policy situation could prove a trap for unwary policyholders in that extensions for more than a brief time period hold the potential to leave the policyholder with lower policy limits than intended. For example, if the policyholder extended coverage for eleven months, a literal reading of the application of limits language would effectively cut the policy’s

Although this change is welcome, it could perhaps have been unnecessary if courts had consistently considered the insurance policy as a product and not merely the sum of its verbiage. Taking this perspective requires that policy limits be annualized not only because this is the objectively reasonable expectation of most policyholders (in the absence of specific discussion to the contrary), but also because the historical tradition of insurance and risk management is to structure an insurance program on an annual basis. It is estimates of a company's exposure during a particular year that drives the company's risk management and purchasing decisions. Sales of insurance policies are typically for time periods of one year, unless the policy is a replacement policy or uses a different length of time in order to get back on a yearly basis of policy administration.

The three-year insurance policy was not sold as a product providing less protection to the policyholder. Rather, the policy was sold as evidence of greater protection that gave the policyholder a longer period of "guaranteed" insurance regardless of market changes and which obviated a company's need to shop for insurance each year. Conversely, insurers wanted to sell the three year policy in order to lock customers into a longer period of loyalty to the insurer, which also gave the insurer a guaranteed premium no matter what happened in the market and which obviated the insurer's need to sell the policy every year, lowering the insurer's marketing expenses. Although either insurer or policyholder may cancel, the inertia of the situation makes it less likely that the policyholder will do so, even if the market softens and cheaper liability insurance is available. Thus, when viewing the liability insurance contract in historical perspective as a product, it becomes apparent that three-year time periods are marketing and administrative in nature—they are not efforts to reduce the limits of coverage by a third. Such a result would be completely at odds with the nature of what was sold to policyholders.

The cases regarding the policy limits applicable to "stub" insurance policies of less than a year are more consistently and correctly decided in favor of the policyholder.<sup>105</sup> In part this is because in these cases there usually is no language similar to the three-year policy period juxtaposed with a single dollar figure on the declarations sheet that an insurer may invoke

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aggregate annual limit in half. In such circumstances, an insurance-as-product court may be freed from strict application of the literal language in order to mandate the policy function as intended. This would be particularly true if the insurer were charging commensurate premiums as a condition of extending the policy.

105. See, e.g., *Bd. of Trs. of Univ. of Ill. v. Ins. Corp. of Ireland, Ltd.*, 969 F.2d 329 (7th Cir. 1992) (applying Illinois law); *Sybron Transition Corp. v. Security Ins. Co.*, 158 F. Supp. 2d 906, 909-10 (E.D. Wis. 2000); *Stonewall Ins. Co. v. Nat'l Gypsum Co.*, 1992 U.S. Dist. LEXIS 11093 (S.D.N.Y. July 22, 1992) (applying New York and Texas law). *But see* *Lac D'Amiante du Quebec, Ltee v. Am. Home Assurance Co.*, 864 F.2d 1033, 1037, n.7 (3d Cir. 1988) (applying New York law); *In re Midland Ins. Co.*, 709 N.Y.S.2d 24 (App. Div. 2000).

to argue for limited coverage nor do the cases involve the modern policy language that makes a stub period of insurance (e.g., one month) subject to the annualized policy limit to which it is attached. But, in addition, courts in stub policy and related cases seem to have a better appreciation of the manner in which an insurance policy with reduced policy limits for stub periods would be a defective product unfit for the reasonable needs of a commercial policyholder.

For example, in *OneBeacon Insurance Co. v. Georgia-Pacific Corp.*, the court held that the policyholder was entitled to the full policy limits of \$10 million per annum in a 1967-70 CGL policy for asbestos-related injury taking place while the policy was in effect, even though the policy was cancelled after only three months.<sup>106</sup> After purchasing the policy in question (originally from Employers Surplus Lines Insurance Co., which subsequently became OneBeacon) for the period from January 1, 1967, to January 1, 1970, Georgia-Pacific "found its interests better served by a new policy from the Insurance Company of the State of Pennsylvania" and canceled the OneBeacon policy, obtaining a refund of almost 90 percent of the \$10,000 premium.<sup>107</sup>

Decades later, Georgia-Pacific presented OneBeacon . . . with \$10 million of asbestos product-liability losses allegedly covered. . . . OneBeacon maintained that its liability was capped at \$2.5 million since the policy was in effect for one-quarter of the year. . . .

....

On language alone, looking at both the policy and the cancellation endorsement, Georgia-Pacific has the better case. The policy, although in effect for

106. 474 F.3d 6 (1st Cir. 2007) (applying Massachusetts law).

107. See *id.* at 6-7 (\$8,700 of the \$10,000 premium was refunded). Yes, liability insurance really was that cheap during the good old 1960s. No wonder insurers felt burned when long-tail liabilities like asbestos, pollution, or product liability became claims from 1970 to the present. They had sold liability insurance cheap without taking into account the possibility of mass tort liability that would later come home to roost at higher prices. But, in spite of that, liability insurer profits appear to only have been modestly drawn down by the asbestos mass tort claims, perhaps by as little as 3 percent.

Liability insurers held up financially in the face of asbestos because liability insurers, of course, made money on many of their risks and, even as respects asbestos risks, have been able to generate considerable investment income, while the long-tail asbestos tort took time to develop. The slow pace of tort and coverage litigation further elongated the insurers' time for payment, permitting them to continue to enjoy the time value of money, even if they, in retrospect, undoubtedly wished they had charged higher premiums. In addition, some policyholders were unable to sustain claims because they neglected to keep old occurrence policies on file and were unable to prove their insurance coverage, resulting in windfalls for those insurers. When policy proceeds were finally paid, they were paid in dollars worth less than the original premium dollars because of inflation. Thus, the rising cost of tort awards over time is not as hurtful to insurers as is commonly supposed. See Jeffrey W. Stempel, *Assessing the Coverage Carnage: Asbestos Liability and Insurance After Three Decades of Dispute*, 12 CONN. INS. L.J. 349, 363-65, 464-76 (2006).

only three months, explicitly provides \$10 million in both per occurrence and aggregate annual coverage. Further, the cancellation endorsement stated that the only consequences of the cancellation were the shortened period of coverage and the refund of part of the premium: it said nothing about modifying the aggregate limit of \$10 million and substituting a \$2.5 million figure.

[It is not] possible to read the phrase “for each annual period” as implying that the aggregate limit should be mechanically prorated by the day, week, month or quarter. Counsel for OneBeacon has conceded that the insurer would be liable for \$10 million—not \$2.5 million—if a single catastrophic loss (say, a single explosion) had occurred on January 2, 1967. This is so even if the policy were cancelled a week after the event. The concession was inevitable since no one would want \$10 million per occurrence coverage with an aggregate limit one quarter that size.

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[OneBeacon’s argument that the policyholder receives a windfall if able to enjoy the entire per annum limit] looks to the reasonable expectations of the parties, which—absent extrinsic evidence of intent—means the help that context, inferred purpose and common sense may give in determining what the parties intended or would have been likely to intend if they had focused on the issue. Courts, whatever tributes they may pay to plain language, tend to be interested in such arguments, although the weight accorded turns on the circumstances. Here, the circumstances are unhelpful to OneBeacon[,] . . . [which argues that the policyholder] sought \$10 million in per-occurrence and aggregate coverage from Employers and a smaller aggregate [for a stub period, which makes no sense.] The windfall argument therefore reduces to the question whether [the insurer] would have charged [the policyholder] a higher monthly premium for such coverage had the policy been sought only for three months.

The decision as to how much of the premium to refund was within Employers’ control, presumably governed by policy language which Employers drafted or adopted. In fact, the refund was not strictly pro rata; instead, the cancellation penalty amounted to 5 percent of the total premium paid. If Employers conferred any windfall on Georgia-Pacific by granting a refund on these terms, it was a self-inflicted wound.

....

Policy language, surrounding circumstances and equitable concerns are likely to vary a good deal from case to case. It is enough for us to say here that the policy language favors Georgia-Pacific, that the most pertinent case law helps its position and that OneBeacon has not shown that its [advocated] outcome—reducing aggregate coverage from \$ 10 million to \$2.5 million—produces a result that is either fairer or closer to reasonable expectations.<sup>108</sup>

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108. See *Georgia-Pacific Corp.*, 474 F.3d at 7-10 (citations omitted). One important citation was to WILLISTON ON CONTRACTS, § 49:20 (4th ed. 2006), for the proposition that “context, inferred purpose, and common sense” are important factors in judicial construction of contracts. Williston is generally considered more of a formalist and textualist contracts scholar

The *OneBeacon* opinion is based on eclectic consideration of a number of contract interpretation factors, but in its reading of the language and assessment of party purpose and expectations, the opinion also appreciates that the general liability policy is a risk management product purchased by commercial actors. When the *OneBeacon* court is noting that it would make no sense to have an aggregate limit subject to proration that reduced the limit to amounts less than the annual per-occurrence limit, the court is, in effect, viewing the policy as something purchased by the policyholder that must be construed in a manner that gives the policyholder the thing for which it paid. In *OneBeacon*, the product was \$10 million of liability protection for liability-producing events that caused damage during the year. Permitting the insurer to reduce the value of the product just because it was returned for a refund did not make sense and would have resulted in the product becoming something less than what was sold.<sup>109</sup>

#### D. Vacancy and Occupancy

The California Supreme Court's decision in *TRB Investments, Inc. v. Fireman's Fund Insurance Co.*<sup>110</sup> provides another good illustration of the value of understanding the insurance policy's function as a protective product rather than merely staring relentlessly at the text of a term in dispute. In *TRB Investments*, the policyholder sought coverage under a property insurance policy insuring a facility in Bakersfield that was rented to the Salvation Army, which abandoned the location in late 2000, leaving the building tenantless. The landlord policyholder retained an architectural firm and general contractor

to transform the building into a "leasable shell," in which many of the interior nonsupporting walls would be removed so that the space could be refashioned to suit a particular tenant's needs. In April 2001, plaintiffs began negotiating

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(as compared to functionalists Arthur Corbin and Allan Farnsworth, who resisted construction based on text standing alone), but even Williston was at least implicitly receptive to the constellation of interpretative factors brought to bear when an insurance policy is assessed as a product as well as a contract.

109. The *OneBeacon* case is more complicated than a typical or simple stub policy period case in that it involves long-tail asbestos injury triggering multiple, consecutive policy periods. For this reason, the insurer perhaps had a stronger case for proration of policy limits because of precedent supporting such proration among strings of full-year policies. See *STEMPEL ON INSURANCE CONTRACTS*, *supra* note 1, § 14.13. See also *One Beacon*, 474 F.3d at 8 ("[t]he present case differs from the hypothetical case of an explosion because the asbestos claims do not comprise a single loss caused by a single event. The asbestos injuries likely are continuing occurrences that straddle the effective periods of the Employers policy and the replacement ICSOP policy, probably extending to periods before and after both policies.") (emphasis removed). However, as the *OneBeacon* court also noted, "the problem of allocating a continuing loss among the many insurers who were on the risk for the loss is not peculiar to short term policies, nor is it an excuse for a court to alter express policy limits." See *OneBeacon*, 474 F.3d at 8.

110. 145 P.3d 472 (Cal. 2006).

with Goodwill Industries for a long-term “build to suit” lease. . . . On or around July 2, 2001, Goodwill entered into a lease agreement for the property.<sup>111</sup>

During June and July 2001, the building saw considerable construction activity, including electrical contracting and heating, ventilation, and air conditioning work. On Monday, July 16, workers discovered water damage from a burst heater or waterline that had taken place sometime the preceding weekend (July 14–15 or during the early hours of the 16th). Work on the building continued, with the landlord policyholder spending more than \$1.2 million on improvements and Goodwill eventually taking occupancy as tenant.<sup>112</sup>

The policyholder submitted a property loss claim for the July 16 water damage, which the insurer denied, citing the vacancy exclusion in the policy, which read:

If loss or damage occurs to a building that has been vacant for more than 60 consecutive days prior to the occurrence of that loss or damage, we will:

a. not pay for any loss or damage caused by:

1. Vandalism;
2. Sprinkler leakage, unless you have protected the system against freezing;
3. Building glass breakage;
4. Water damage;
5. Theft, or
6. Attempted theft

. . . .

A building is vacant when it does not contain enough business personal property to conduct customary operations.

Buildings under construction are not considered vacant.<sup>113</sup>

In addition, a cancellation provision of the policy stated that the insurer could cancel the policy if the building was vacant or “unoccupied 60 or more days,” but that the provision did not apply to buildings that were “in the course of construction, renovation, or addition.”<sup>114</sup>

Not surprisingly, the policyholder argued that the vacancy exclusion did not apply because the building was “under construction” at the time of the water damage. But both the trial court and the intermediate state appellate court sided with the insurer, holding that the term “under construction” was restricted to only the building of a new structure and that the building was “vacant” at the time of the water loss. The California Supreme

111. *Id.* at 475.

112. *Id.*

113. *Id.* at 474.

114. *Id.*



Court unanimously reversed, remanding for further proceedings.<sup>115</sup> The California Supreme Court's *TRB Investments* opinion is soundly reasoned not only as a matter of textual interpretation and appreciation of the intent, purpose, and expectations of the parties, but also because it appreciated the role of property insurance as a product sold to property owners in order to fulfill a particular function.<sup>116</sup>

To be sure, the court engaged in what might be termed the standard mainstream analysis of examining the policy wording, assigning burdens of persuasion and being alert to ambiguity and its resolution. In particular, the *TRB Investments* court attempted to give a "common sense" construction to the word "construction," including reference to statutory use of the term as well as everyday use of the word. Of particular importance to the court was reading the policy as a whole and attempting to reconcile the vacancy-exclusion-construction exception with the cancellation provisions of the policy, which treated renovation as a subset of construction—and consequently undermined the lower court view that "construction" must mean "new" construction or erecting a building rather than remodeling it.<sup>117</sup> Certainly, one could characterize *TRB Investments* as simply a broad-based contract interpretation opinion. However, the court's focus on the structure and function of the vacancy exclusion to a property policy brings it within the realm of insurance-as-product analysis as well.

[B]oth the vacancy exclusion and the cancellation endorsement serve to protect the insurer against the increased risks of loss that occur when premises are unoccupied for an extended period of time. Likewise, the construction exception to the vacancy exclusion serves the same function as the construction exception in the cancellation endorsement. If a building is regularly occupied during normal business hours, as is usually contemplated for commercial structures, then an insurer can assess risk based upon such occupancy. When there is substantial construction activity on the premises, the risk of loss becomes roughly equivalent to that of an occupied building, thus giving the insurer the benefit of its prior risk assessment.

The Court of Appeal's focus on whether the term "under construction" encompasses only the erection of new structures or also includes renovations

115. *Id.* at 473–74, 480.

116. The *TRB Investments* opinion is consistent with decisions of other courts regarding the scope of the "under construction" exception to the vacancy exclusion. *See, e.g.,* Warren Davis Prop. V, LLC v. United Fire & Cas. Co., 111 S.W.3d 515, 522 (Mo. Ct. App. 2003); Brouillette v. Phoenix Assurance Co., 340 So. 2d 667, 670–71 (La. Ct. App. 1976). However, there are prominent cases siding with the trial and appellate court opinion in *TRB Investments* that "construction" does not include repairs or renovations on existing buildings. *See, e.g.,* Myers v. Merrimack Mut. Fire Ins. Co., 788 F.2d 468, 472 (7th Cir. 1986) (applying Illinois law); Jerry v. Ky. Cent. Ins. Co., 836 S.W.2d 812, 814–16 (Tex. App. 1992); Travelers Indem. Co. v. Wilkes County, 116 S.E.2d 314, 317 (Ga. Ct. App. 1960).

117. *See TRB Invs.*, 45 P.3d at 477–78.

thus fails to take into account the rationales underlying the vacancy exclusion and the construction exception. We believe the proper inquiry for determining whether a building is “under construction” for purposes of defining an exception to the vacancy exclusion is whether the building project, however characterized, results in “substantial continuing activities” by persons associated with the project at the premises during the relevant time period. Under that test, “sporadic entry” would be insufficient to find a substantial continuing presence of workers required for a finding of “construction.” We believe this test better serves the purposes underlying the vacancy exclusion and more accurately reflects the reasonable expectations of an insured than any test turning upon technical distinctions between “construction” on [the] one hand and “renovation” or “remodeling” on the other.<sup>118</sup>

The court gave some solace to the insurer by remanding the case for further proceedings rather than entering judgment for the policyholder. Although the basic facts were undisputed and they tended to show that the building was getting the same sort of scrutiny on Mondays through Fridays that an occupied building would receive, the court took the view that, in this case of first impression, the parties had not been given an opportunity to “elicit key facts which might have a bearing on the relevant inquiry, i.e., whether the construction project here was such that there were substantial continuing activities on the premises during the relevant period.”<sup>119</sup>

In *TRB Investments*, the California Supreme Court identified the issue as one of first impression in the nation’s largest state and also regarded existing precedent as not having “engaged in the sort of thorough examination of the policy language” performed by the California courts in the instant

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118. *Id.* at 478–79 (citations omitted).

119. *Id.* at 479. Continued the court:

The record reflects that electrical and HVAC subcontractors engaged in various activities at the building, and that various other personnel, such as the contractor and the architect, also spent time there in the weeks prior to the loss at issue. But, the record does not disclose the number of people associated with the construction project, how many hours per day or days per week they were in the building, and how much of the building was occupied by these persons at any given time. Those and similar facts would be needed to determine whether there was a substantial continuing presence of construction personnel.

*Id.*

With this directive for inquiry on remand, the court is perhaps being excessively generous to the insurer. If sustained occupancy is the risk-reducing, premium-calculating objective underlying the vacancy exclusion and its construction exception, it is of course important that construction activity not be unduly rare. But the nature of construction often has a “hurry-up-and-wait” quality. A job site may be nearly empty one day and buzzing with activity the next, depending on the availability of materials and subcontractors. But the property is “under construction” even on the slow days of a renovation project. A policyholder should not be required to prove the constant presence of workers on site to satisfy the under construction exception to the vacancy exclusion. If the insurer wanted a twenty-four-hour security guard, it could have insisted on this as a condition of coverage.

case.<sup>120</sup> Certainly, the *TRB Investments* courts made a thorough examination of the language at issue. But, more important perhaps, the court did not rely on linguistic analysis alone in reaching its sensible conclusion that the water damage was covered if the property was at no greater risk while being renovated than would be the case if it had been fully occupied as an office building.<sup>121</sup> The court appreciated the design, function, and purpose of the property insurance product, which informed the court's interpretation of the words "under construction." The *TRB Investments* ruling sought to have property insurance function as the product was intended, in a manner protecting the legitimate interests of the product's manufacturer (the insurer) and its user (the policyholder).

#### E. Scope of EPL Coverage and Labor Law Violations

Another example where insurance-as-product thinking helped to clarify a coverage decision is *Farmers Automobile Insurance Ass'n v. St. Paul Mercury Insurance Co.*<sup>122</sup> In *Farmers v. St. Paul*, an employer (Farmers, in its capacity as a policyholder rather than an insurer) sought coverage under an EPL (Employment Practices Liability) policy issued by St. Paul when Farmers faced a class action suit by claims adjusters seeking overtime pay pursuant to the Illinois Minimum Wage Law. The trial court and a unanimous Seventh Circuit agreed with St. Paul's denial of coverage based on what might be termed the "labor law" exclusion of the policy, which exempted from coverage

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Furthermore, the occasional on-again, off-again quality of construction is not significantly different for risk management purposes than what takes place in a fully occupied building. Recall that the water damage in *TRB Investments* took place on a weekend, a time during which the problem was unlikely to be detected. Unless a worker in the affected area happened to be logging some weekend overtime, the water was just as likely to be undetected until Monday, as would be the case for construction (and was the case in *TRB Investments*).

If the construction crew working on the Bakersfield building in *TRB Investments* was not on site until Wednesday, the water damage would most likely have been worse, but this type of delay in discovery could occur in an office building as well if the workers closest to the problem were on outside assignment, or if the tenant company was holding a retreat or planning session offsite. None of these situations presents the type of heightened risk of destruction to property that takes place when a structure is completely devoid of human activity for the thirty- or sixty-day periods that property insurance policies usually use to define vacancy.

Similarly, the vacancy exclusion of a homeowner's policy is not triggered by a family's absences for vacation or business travel. But in such cases, the home may be without human occupancy for far longer than the time at issue in *TRB Investments*.

120. *Id.* at 476.

121. The fully operational office building probably would have been empty on the weekend that the pipe in question burst. Further, presence of a night watchman or security guard would have been unlikely to ensure prompt detection of the pipe incident. Security details can be pretty effective at keeping intruders out or noticing when they breach a building, but night watchmen are not expected to scour the premises in search of water damage from leaking pipes.

122. 482 F.3d 976 (7th Cir. 2007) (applying Illinois law).

any actual or alleged violation of the Fair Labor Standards Act (except the Equal Pay Act), the National Labor Relations Act, the Worker Adjustment and Retraining Notification Act, the Consolidated Omnibus Reconciliation Act of 1983, the Occupational Safety and Health Act, any workers' compensation, unemployment insurance, social security, or disability benefits law, other similar provisions of any federal state or local statutory or common law or any rules or regulations promulgated under any of the foregoing.<sup>123</sup>

The Seventh Circuit found that, because the Illinois Minimum Wage Law was "the state's counterpart to the Fair Labor Standards Act," it fell comfortably within the "other similar provisions of any state law" portion of the various labor law causes of action excluded from the scope of St. Paul's EPL coverage.<sup>124</sup> In reaching this conclusion, the court was unmoved by the policyholder's attempt to invoke the *contra proferentem* principle (ambiguities are construed against the drafter of the contract) because the meaning of the words "other similar provisions" of state law were sufficiently clear in the context of the type of insurance policy at issue.<sup>125</sup>

The court did not base its decision on the almost delicious irony of a major insurer pleading for application of the ambiguity approach,<sup>126</sup> but instead viewed the EPL policy as a type of product in which the intended audience of the product, i.e., employers, would be well aware of the nature of the limitations on coverage imposed in the labor law exclusion. The court emphasized that construction of policy terms must be made with an appreciation of the intended audience and also suggested that the meaning of policy terms must accord with the nature of the insurance policy.

Farmers cites us to Illinois cases which say that words left undefined in an insurance policy should be interpreted with reference to the average person's understanding. But that is a blind guide in the present case because the average person has no understanding of the exclusion of claims based on the Fair Labor Standards Act and similar statutes. The language is not addressed to the average person, but to employers, and they know what the Fair Labor Standards Act is, know there are state counterparts, and could not think they'd

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123. *Id.* at 977 (emphasis removed).

124. *Id.* at 977-79.

125. *Id.*

126. The *Farmers v. St. Paul* court observed that it did not

buy Farmers' contention that the word "similar" is so hopelessly vague that it cannot be given any effect in an insurance-policy exclusion. The contention is astonishing because of its implications for Farmers' use of the word in exclusions in its own policies, and in any event unsound because of its neglect of context. Standing alone, the word "similar" partakes of the vagueness of other verbal signifiers of matters of degree, such as "substantial," "significant," and "probable." But context can give it a precise meaning, as this case illustrates.

*Id.* at 978 (citation omitted) (emphasis removed).

bought insurance that would enable them to disregard the state overtime provisions. The interpretation of a document is relative to the understanding of the intended readership, not to the average Joe. It is no more relevant that he would not understand the exclusion of claims based on the Fair Labor Standards Act and similar statutes than that someone ignorant of the English language wouldn't understand it either.<sup>127</sup>

The court appreciated that the EPL policy is designed primarily to protect employers when sued under the antidiscrimination laws. Its focus is race, gender, and age discrimination litigation, including sexual harassment cases. These types of risks are potentially difficult, but relatively cabined, and in turn demand a corresponding premium relative to the risk. Wage and hour claims such as the Fair Labor Standards Act and its cousins or other types of employee benefits claims present quite different risks that would command a correspondingly higher premium. In addition, as quoted above, the court would not accept as credible the idea that an employer could expect to purchase a policy that would subsidize the employer's violations of overtime payment law.

In addition, the types of wage and hour, employee benefits claims excluded in the St. Paul EPL policy can be said to be the type of claims that either have an uncomfortable element of volition or present risks more clearly within the arguable control of the policyholder. Employers should be able to comply with the law regarding wages and compensation. These are more akin to the contract-like risks that are often outside the scope of liability policies. By contrast, the risk of race or gender discrimination, particularly sexual harassment, is less subject to policyholder control. A lecherous foreman or a racist office manager can create an EPL claim in spite of upper management's best efforts to avoid such exposures. By contrast, employee compensation and working hours are more readily subject to central supervision, control, and risk management.

By taking a broader contextual view sensitive to the nature of the EPL insurance product and the differing nature of wage and hour claims as compared to discrimination claims, the court rendered a decision that is consistent with the insurance-as-product approach as well as to intent and purpose based contract construction. By bringing the Illinois state wage claim within the scope of the Fair Labor Standards Act exclusion, the *Farmers v. St. Paul* court was simply making the EPL policy function as the type of product it was intended to be.

#### F. CGL Policies and Spoliation of Evidence Claims

In another case reflecting insurance-as-product thinking, the policyholder attempted to argue that its CGL policy provided coverage for a spoliation

127. *Id.* at 979 (citations omitted).

of evidence claim made by a third party. Brian Wright died when the Ford Bronco he was driving rolled over. Policyholder O'Hare Auto Recycling acquired the Bronco from a towing company that removed it from the scene of the accident. Counsel for Wright's estate paid O'Hare to store the vehicle until it could be analyzed for purposes of a possible product liability claim by Wright's estate against Ford or others. O'Hare mistakenly crushed the Bronco, substantially reducing or eliminating its evidentiary value for the Wright wrongful death/products liability claim. Wright's estate in turn sued O'Hare for spoliation, arguing that O'Hare's negligence had dramatically reduced or eliminated a potential claim arising out of Wright's death (and, apparently, that the uncrushed vehicle itself had some value that was eliminated when the car was crushed; presumably, the estate also wanted its money back).<sup>128</sup>

Both the trial court and the Illinois Court of Appeals found no coverage. The appellate court based its decision, in part, on the language of the policy, which contained a common exclusion for claims of property damage to "personal property in the care, custody or control of the insured" (often referred to as the CCC exclusion).<sup>129</sup> But the court's rejection of the claim was not based solely on the text of the exclusion. Rather, the court discussed, in some detail, the background and purpose of the exclusion, which is part of CGL policy design intended to avoid coverage for damage caused by faulty workmanship. "The 'care, custody or control' exclusion 'prevent[s] the general liability insurer from becoming a guarantor of the insured's workmanship in his ordinary operations. Failures of workmanship are a normal business risk which the insured is in the best position to prevent.'"<sup>130</sup> Had it wanted to adopt a more pro-policyholder orientation, the *Wright* court could have differentiated damage to property being "worked on" by a policyholder (e.g., a watch left for repair or pants ruined by poor dry cleaning) and the type of loss at issue in *Wright*: the policyholder's negligent destruction of property that it was supposed to preserve. A highly pro-policyholder court might have even cited a case like *Vandenberg*<sup>131</sup> to argue that the grant of damage claims of physical injury to property was not sufficiently rebutted by the CCC exclusion, since O'Hare was not really "working on" the Bronco in question. However, the *Wright* court wisely rejected this course of construction, not only because of the literal clarity of the CCC exclusion, but also because of other factors tending to confirm that the CGL policy simply was not designed to provide coverage

128. See *Essex Ins. Co. v. Wright*, 862 N.E.2d 1194, 1195 (Ill. App. Ct. 2007).

129. *Id.*

130. *Id.* at 1196–97 (quoting *Stewart Warner Corp. v. Burns Int'l Sec. Servs., Inc.*, 527 F.2d 1025, 1030 (7th Cir. 1975) (applying Illinois law)).

131. *Vandenberg v. Superior Ct.*, 982 P.2d 229 (Cal. 1999).

for spoliation claims or similar claims that policyholder conduct caused a third party to have a less viable lawsuit against a separate defendant.

For example, the *Wright* court noted that the uncontested facts of the case established “at least a constructive bailment” of the Bronco and that negligent bailment claims are in essence business risk claims that were not designed to be covered by the CGL policy.<sup>132</sup> The appellate court implicitly concurred with the trial court’s observation that the estate’s claim was one alleging breach of a contractual duty, which is normally outside the tort-based orientation of general liability policies.<sup>133</sup> As noted above and emphasized in the California Supreme Court’s *Vandenberg* decision, the shorthand rule that general liability insurance exists to cover tort claims against the policyholder rather than contract claims against the policyholder is not so literally true that it overrides policy language when a breach of contract claim involves property damage perpetrated by the policyholder. However, in *Wright*, it was clear that a contract-based, bailment-based, custody-based claim was in fact a claim that the policyholder had delivered poor services to its customer. It was not a claim that the policyholder’s negligence had reached out to harm the customer in ways beyond the contractual relationship.

In addition, the *Wright* court found that a claim of damage to the estate’s potential lawsuit was too intangible to constitute property damage within the meaning of a CGL policy.<sup>134</sup> Implicitly, the *Wright* court also found that a spoliation claim was simply too remote from the type of bodily injury/property damage claims that the CGL policy was intended to cover. The *Wright* holding can be supported as a matter of textual analysis alone. But, when coupled with a structural analysis of the CGL and the situation in light of the purpose, intent, and function of the CGL product, the correctness of the *Wright* holding becomes dramatically clearer and eliminates the prospect that the policyholder could win undeserved coverage from application of the ambiguity approach or a reasonable expectations analysis. Even small business policyholders cannot have an objectively reasonable expectation of coverage for their business errors since these losses lie outside the contemplation of the CGL policy as a product.

132. See *Wright*, 862 N.E.2d at 1197–98.

133. *Id.* at 1194–95 (quoting trial transcript on grant of summary judgment to insurer). See STEMPER ON INSURANCE CONTRACTS, *supra* note 1, §§ 14.13, 25.05, regarding business risk exclusions to liability insurance coverage.

134. See *Wright*, 862 N.E.2d at 1196–97 (“a cause of action does not qualify as tangible property. Thus, O’Hare’s policy does not cover the diminution in the value of appellant’s products liability claim.”), citing *Iowa Mut. Ins. Co. v. Hennings*, 2006 U.S. Dist. LEXIS 74640 (C.D. Ill. Oct. 13, 2006) (CGL policy does not cover claim that policyholder conduct caused plaintiff to suffer diminution in value of workers compensation claim).

### G. Anti-Stacking Provisions

Another example where viewing the insurance policy as a product may have been helpful is *Roberts v. American Family Mutual Insurance Co.*,<sup>135</sup> in which the court held that anti-stacking provisions of automobile insurance policies and a motorcycle policy did not apply where the policies were issued by separate insurers. Stacking occurs when a policyholder with several policies is permitted to aggregate the limits of each policy into one larger limit in order to obtain more coverage than the face value of a vehicle's policy when the vehicle is the subject of a claim.

Stacking litigation was a major source of coverage litigation during the 1970s and 1980s, with results varying among the jurisdictions, prompting insurers to add specific anti-stacking language to their policies. Anti-stacking language is found in auto insurance policies in order to prevent a series of auto policies held by the same family or business from turning into one "mega-policy," providing huge policy limits disproportionate to the premiums paid. Perhaps the most dramatic example of this is a case in which a trucking company with low uninsured motorist policy limits of \$25,000 per truck was able to multiply this amount by its entire fleet of trucks in order to have nearly \$1.7 million of coverage when one of its trucks was involved in a serious collision.<sup>136</sup>

Insurers dislike stacking so much because it changes the nature of the risk insured. For example, if I purchase a \$25,000 liability policy for my Ford Expedition (an environmentally incorrect vehicle capable of inflicting substantial damage to others), I am assessed a commensurate premium based in part on the vehicle, as well as my driving records. (I would also

135. 144 P.3d 546 (Colo. 2006).

136. See *Rusthoven v. Commercial Standard Ins. Co.*, 387 N.W.2d 642 (Minn. 1986). The decision was largely driven by perceived ambiguities in the policy form, which was of course drafted by the insurer seeking to limit its exposure to \$25,000 because only one insured vehicle was involved in the accident. "It seems unlikely that the employer expected that it had purchased and paid for over a million dollars worth of uninsured motorist coverage for each of its employees. Should this fact have affected the result in the case?" See KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION* 41 (4th ed. 2005).

My answer to Abraham's perhaps rhetorical question is that it is legitimate for courts to consider actual expectations of the parties, even when this works against the policyholder. Consideration of actual and general understanding of a policy should be a two-way street for insurers and policyholders alike. But, where the policyholder legitimately holds an understanding not shared by the insurer, the policyholder's expectations should take precedence as between these two perspectives. But, under an insurance-as-product approach and an eclectic application of traditional contract construction norms, the policyholder's expectations may not always be determinative (although, if objectively reasonable, they are likely to be consistent with the intended function of the insurance policy "product"). Consumers may have misplaced expectations and a product may simply not be designed or intended to cover a particular situation or deliver a specific function—no matter how much one of the parties expected coverage.



be nuts to have so little coverage). Similarly, if the family also purchases a \$25,000 policy on my wife's much more sensible Honda Accord, the same pricing and risk distribution considerations apply. In effect, the insurer is making an estimate about the odds that either the Expedition or the Accord will be in an accident resulting in litigation and is willing to provide up to \$25,000 of coverage in return for a certain premium.

If the Expedition is in an accident and the two policies are stacked, there suddenly is \$50,000 worth of coverage, but no corresponding recalibration of the premium. At the margin, this hurts the insurer financially by raising its exposure for an Expedition-related crash but not extracting from me a correspondingly higher premium. If we plug in larger amounts (e.g., individual auto policy limits of \$500,000) or if my Clampett-like family were to have a score of low-limit policies on the fleet of autos parked in our yard, the potential loss to the insurer becomes clearer. Consequently, anti-stacking clauses make sense from the insurer's perspective.

They also make sense from the policyholder's perspective. As even a half-prudent consumer, I should not expect to be protected by aggregating policy limits of the family vehicles. Rather, I should pay a correspondingly higher premium and buy the per vehicle coverage I need to protect me from becoming an auto accident defendant. Where the insurance involved is not a batch of auto policies from the same insurer, but instead involves different products (motorcycle and automobile) from different insurers, the case for applying anti-stacking language arguably weakens, a factor that can be used to defend the *Roberts* result. But *Roberts*, despite the court's unanimity, appears wrongly decided.

The *Roberts* court based its decision on its finding that the anti-stacking language in question was a limitation on coverage that was insufficiently conspicuous and therefore not enforceable.<sup>137</sup> The opinion can be characterized as one based on reasonable expectations or fairness, founded on a theory that issuance of an auto policy suggests coverage, that limitations of coverage operate as exclusions and that like any exclusion, the insurer bears the burden of persuasion as to its applicability, a burden that logically includes showing that the limitation was not "snuck" into the policy in a nonvisible manner.

The problem with such a defense of *Roberts*, however, is that, as discussed above, prevention of stacking makes sense. As policyholders of six—count 'em, six—auto policies and a motorcycle policy, the *Roberts* family cannot seriously have viewed the cumulative policy limits as the per vehicle policy limits. Rather, the typical policyholder would ask the agent and read the

137. See *Roberts*, 144 P.3d at 551.

declarations page to determine the policy limits for each vehicle. Regardless of whether the anti-stacking language was conspicuous, a reasonable policyholder would look to the individual declarations sheet in order to determine the limits of coverage.

My criticism of the *Roberts* result is, of course, based in part on a different view of objectively reasonable expectations than that apparently held by the Colorado Supreme Court. But, in addition, an assessment of auto insurance policies as products supports my disagreement with the *Roberts* result. As discussed above, the risk calculation for issuing an auto policy involves determining the odds that a particular vehicle will be in an accident. Even a family of bad drivers is unlikely to have all the family cars crash simultaneously. The insurer in turn determines the premium to be charged per vehicle in relation to the policy limits per vehicle. That is the nature of the pricing for the particular insurance product at issue. Under these circumstances, the insurance as product approach illuminates the arguable error of the *Roberts* holding.

#### IV. CONCLUSION

Appreciating the product-like characteristics of insurance policies will improve analysis of insurance coverage disputes. Although the notion of an insurance policy as part chattel and part contract has been a brooding omnipresence for decades, courts have largely failed to date to enlist the concept in the concrete resolution of cases. Sound application of the insurance-policy-as-thing concept does not require complex economic analysis but merely adequate appreciation of the role played by various insurance products.

As the above discussion reflects, appreciating the product-like characteristics of the insurance contract does not inevitably lead to victory for either insurers or policyholders in coverage battles. Rather, consideration of the insurance policy's intended use and implicit warranty can favor either side, depending on the nature of the coverage claim in relation to the policy's function. Sometimes, appreciation of the insurance policy as a thing designed to achieve a particular objective can even save insurers from drafting errors that could otherwise require the imposition of the *contra proferentem* principle.

Regardless of whether the notion of insurance policies as things provides proportionately greater assistance to insurers or policyholders, it holds the promise of illuminating policy meaning and avoiding the occasional arbitrary results that can result from excessive fixation on policy text in isolation.

