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An Analysis of Interpretation of Insurance Contracts: Common Law Versus Strict *Contra Proferentem*

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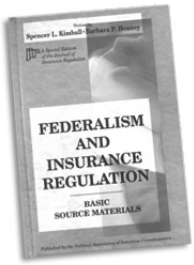

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An Analysis of Interpretation of Insurance Contracts: Common Law Versus Strict *Contra Proferentem*

Randy D. Henry *

I. Introduction

The majority of states recognize insurance policies as contracts of adhesion, in which the applicant must either accept the terms of the policy as written by the insurance company or reject the terms and accept similar terms from another insurance company (Plitt, 2010). As of June 2014, 44 states have adopted special rules interpreting insurance contracts to balance unequal bargaining power.[1] One common alternative to traditional contract law is strict *contra proferentem*, which interprets ambiguous terms against the drafter without reviewing extrinsic or parol evidence. A second alternative, known as the reasonable expectations doctrine, interprets unambiguous policy language using the reasonable person standard.

Maryland is part of the majority of states that still interprets ambiguous consumer insurance contracts using standard contract law principles, including extrinsic and parol evidence.[2] In February 2015, the Maryland Court of Appeals,

1. Brief for Petitioner, *People's Ins. Counsel Div. v. State Farm Fire and Cas. Ins. Co.*, 2014 WL 4147804, at * 14 (Md. 2014) (hereinafter "Brief for Petitioner).

2. See, e.g., *Cheney v. Bell Nat'l Life Ins. Co.*, 315 Md. 761, 766-68 (1989) (holding that "the intention of the parties is to be ascertained is reasonably possible from the policy as a whole. In the event of an ambiguity, however, extrinsic and parol evidence may be considered.").

Maryland's highest court, heard arguments on *People's Insurance Counsel Division v. State Farm Fire and Casualty Insurance Co.* ("*People's Insurance*").[3] Despite the case's potential impact on thousands of Maryland homeowners, the court declined to decide whether to change its nearly 200-year-old practice of interpreting insurance contracts using traditional contract law principles. As a result, the court did "nothing to clarify or advance [Maryland's] insurance laws."[4] However, the case did bring to light the differences that still exist among states as it relates to interpreting insurance contracts.

This article provides a discussion of the methods available to courts as it relates to interpreting ambiguous insurance contracts. The next section reviews various states' common law approaches, interpreting insurance contracts using contract law principles and strict *contra proferentem*. This is followed by sections discussing the arguments for interpreting insurance contracts using standard contract law and strict *contra proferentem*. The final section discusses the potential implications for the insurance industry that could result from changing methods interpreting insurance policies.

II. Legal Background

A typical insurance policy contains coverage-granting provisions, coverage exclusions and limitations (policy terms that say certain types of losses are not covered), definitions and sometimes warranties (facts or circumstances the insured "warrants" to be true), and claims-processing provisions (Baker, 2013). Generally, courts interpret insurance policies based on general contract law principles, strict *contra proferentem* (interpretation against the drafter) or reasonableness.

Though the reasonable expectations doctrine will not be reviewed in detail, essentially the rule provides insureds with coverage using an insured's reasonable expectation of coverage. American courts reason based on equity and fairness, not contract law principles.[5] An insured may be entitled to coverage despite unambiguous language in the policy to the contrary.[6] Furthermore, courts excuse policyholders from reading the insurance policy.[7]

Less commonly, courts also have regulated the insurer-insured relationship using extra-contractual doctrines of equitable estoppel and negligent misrepresentation (Fridman, 1974). In *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*,[8] the Supreme Court of Arizona applied equitable estoppel and negligent misrepresentation to find coverage when an insurance agent

3. *People's Ins. Counsel Div. v. State Farm Fire and Cas. Co.*, 442 Md. 55 (2015). See the appendix for a detailed summary of the case.

4. *Id.* at 64 (Adkins, J., dissenting).

5. *C&J Fertilizer, Inc. v. Allied Mutual Ins.*, 227 N.W.2d 169 (1975).

6. *Id.* at 176.

7. *C&J Fertilizer*, 227 N.W.2d at 176.

8. *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, 140 Ariz. 383 (1984).

negligently gave the lessor erroneous information about the policy coverage. The court stated, "There are strong reasons to recognize a rule which allows an insured to raise the issue of estoppels to establish coverage contrary to the limitations in the boiler-plate policy when the insurer's agent had represented the coverage greater than the language found in the printed policy." In reaching its conclusion, the court observed that courts struggle to apply contract rules to standardized agreements "as if they were traditional agreements reached by bargaining between the parties." Thus, the estoppel and negligent misrepresentation doctrines evidence judicially created doctrines to enforce insurance contracts in favor of the insured.

As a preliminary matter, when interpreting insurance contracts, the primary purpose is to effectuate the parties' mutual intention by looking at the contract's written provisions.[9] In ascertaining the parties' intent, the court will look to the plain meaning of the contract language[10]—that is, the ordinary meaning a lay person would use.[11] When the insurance provisions are unambiguous, the court will go no further; it must interpret the language according to the plain and ordinary meaning.[12] But when contract language is ambiguous or unclear, then a different analysis is required.

A. The Basics of General Contract Law Interpretation Principles

Most state courts rely on general contract law to interpret ambiguous insurance contracts and do not follow the minority of jurisdictions that strictly interpret ambiguous policy terms against the insurer.[13] Automatic construction against the insurer goes against contract law principles by removing the consideration of extrinsic evidence.[14] A Maryland court applied contract law principles in holding that only if there is no extrinsic or parol evidence or if a term remains ambiguous after the examination of any extrinsic or parol evidence should courts construe an ambiguous term against the insurer.[15] As Judge Glenn Harrell explained in *Empire Fire & Marine Insurance Co.*:

9. *McEvoy v. Sec. Fire Ins. Co. of Baltimore*, 110 Md. 275 (1909).

10. *Id.*

11. 45 C.J.S. *Insurance* § 575 (2015).

12. *Id.*

13. Jurisdictions applying *contra proferentem*: Texas (*Carrizales v. State Farm Lloyds*, 518 F.3d 343, 346 (5th Cir. 2008) (applying Texas law); Virginia (*Granite State Ins. Co. v. Bottoms*, 243 Va. 228, 234 (1992); Indiana (*Am. Nat'l Fire Ins. Co. v. Rose Acre Farms, Inc.*, 1007 F.3d 451, 457 (7th Cir. 1997) (applying Indiana law); Oregon (*Andres v. Am. Standard Ins. Co. of Wisconsin*, 205 Or. App. 419, 424 (2006); Florida (*Washington Nat. Ins. Corp. v. Ruderman*, 117 So. 3d 943, 952 (Fla. 2013); Mississippi (*J&W Foods Corp. v. State Farm Mut. Auto. Ins. Co.*, 723 So. 2d 550, 552 (Miss. 1998); New Jersey (*see* 1 David L. Leitner, Regan W. Simpson & John M. Bjorkman, Law and Practice of Insurance Coverage Litigation § 1:11 (2012); Idaho (*Moss v. Mid-America Fire and Marine Ins. Co.*, 103 Idaho 298 (1982); and Pennsylvania (*Mohan v. Union Fidelity Life Ins. Co.*, 207 Pa. Super. 205 (1966).

14. *Empire Fire & Marine Ins. Co. v. Liberty Mut. Ins. Co.*, 117 Md. App. 72, 97 (1997).

15. *Cheney*, 315 Md. at 767.

> Essentially, Maryland courts apply the majority rule, but do so at a different point in the analytical process. Maryland courts first ascertain the intent of the parties from the policy as a whole, considering extrinsic and parol evidence to construe any ambiguity. Only if either no extrinsic or parol evidence is introduced or if an ambiguity still remains after the examination of extrinsic evidence will Maryland courts construe a policy against an insurer.[16]

Moreover, contractual language is ambiguous if it is general and may suggest two meanings to a reasonably prudent person.[17] The court refers to a reasonably prudent person as one not trained in the legal technicalities.[18]

B. The Basics of Strict Contra Proferentem

An alternative to general contract law interpretation principles is known as strict *contra proferentem* (Rappaport, 1995). Strict *contra proferentem* jurisdictions first interpret insurance contracts by the terms of the contract itself, giving effect to the parties' intents through the contract language.[19] Under strict *contra proferentem*, when insurance policy terms are susceptible to more than one meaning, the court will favor the non-drafting party without considering extrinsic evidence.[20] When an insurer asked the court to consider extrinsic circumstances to resolve a policy ambiguity, the court responded that it "cannot look to extrinsic evidence where the language is ambiguous."[21] When rejecting additional clarification, courts often reason that "had that been what the insurer meant in the policy, certainly it was easy to say so."[22]

The essential difference between general rules of contract interpretation and strict *contra proferentem* is the consideration of extrinsic evidence to clarify an ambiguity (Randall, 2007). In the former, when the ambiguity remains after reviewing extrinsic evidence—i.e., prior negotiations, conduct after policy issuance and industry standard practices—the court construes the ambiguous term in favor of the insured.[23] Contract law gives the insurer a second shot to provide a

16. *Empire Fire & Marine Ins. Co.*, 117 Md. App. at 98 n.10.
17. *St. Paul Fire & Marine Ins. Co. v. Pryseski*, 292 Md. 187, 198 (1981).
18. *Ohio Cas. Ins. Co. v. Lee*, 62 Md. App. 176, 183 (1985).
19. *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132, 133 (Tex. 1994).
20. See *Washington National Insurance Corporation v. Ruderman*, 117 So. 3d 943 (Fla. 2013). Some commentators have also discussed a concept called modern *contra proferentem*; see, e.g., Bjorkman, Leitner & Simpson, 1 Law and Prac. of Ins. Coverage Litig. § 1:12 (2014) (though policy language is ambiguous, courts first attempt to remove ambiguity by considering relevant evidence of the parties' intent). Substantively, modern *contra proferentem* is nothing more than an application of traditional contract law.
21. *Life Insurance Co., v. Spradlin*, 526 S.W.2d 625, 629 (2nd Dist. 1975).
22. *Gaunt v. John Hancock Mutual Life Insurance Co.*, 160 F.2d 599 (2d Cir. 1947).
23. *Pacific Indem. Co. v. Interstate Fire & Cas. Co.*, 302 Md. 383, 389 (1985).

reasonable interpretation. In the latter, when the court finds a term ambiguous, it construes the term without reviewing extrinsic evidence (Nardoni, 2013). Strict *contra proferentem* jurisdictions give no additional opportunity for insurance companies to clarify their unclear policy terms.

C. Interpreting Insurance Contracts Using Contract Law

At one point, every American jurisdiction interpreted insurance contracts using contract law (Johnson, 2004). Today, most jurisdictions still interpret insurance contracts using contract law principles, including extrinsic and parol evidence. (See, for example, California, New York, Vermont and Virginia.) A burgeoning number of jurisdictions, however, has supplemented its use of contract law with doctrines such as reasonable expectations. (See, for example, California, Kentucky, Louisiana, New York and Ohio.)[24] Pro-insured advocates erroneously view this as drastic movement in the law favoring strict *contra proferentem* over contract law.

City of N.Y. v. Evanston Ins. Co.[25] provides an example of the application of contract law principles to the insurance contract. In this case, the named insured contracted with the City of New York to perform sidewalk repair work. The insured named the City an additional insured under a "solely negligent" endorsement. While at the worksite, a contractor employee sustained injuries when he was struck by two motorcyclists. After being sued, the City sought coverage under the sidewalk contractor's insurance policy. The insurer denied coverage under the additional insured endorsement until there was a court ruling that the sidewalk contractor was 100% responsible for its employee's injuries. The City claimed that the term "solely" was ambiguous and maintained that it would be an additional insured under the policy if the sidewalk contractor bore some responsibility for the accident and the City itself was faultless. Agreeing with the City, the court found "as used in the policy's blanket additional-insure endorsement, the word 'solely' … ambiguous," and acknowledged that extrinsic evidence could aid in ascertaining its intended meaning. Furthermore, the court noted that insurance contracts would be interpreted according to the reasonable expectations and purposes of ordinary businesspeople when making ordinary business contracts.

California courts also use contract law principles with reasonable expectations to interpret the ambiguous terms. For example, in *Am. Alternative Ins. Corp. v. Superior Court*,[26] the insurance policy at issue covered a private airplane owned by the insured. The policy provided coverage for physical damage to the aircraft. The policy also included an exclusion for physical damage caused by governmental seizures. However, the insured purchased an endorsement, which eliminated the

24. After applying contract law principles to interpret an ambiguity, courts often use reasonable expectations to determine whether the insured reasonably expected the coverage sought.

25. 39 A.D.3d 153 (2007).

26. 135 Cal.App.4th 1239 (2006).

exclusion. The court held that the addition of an endorsement removing an exclusion based on damage caused by government seizures created an ambiguity with result to coverage. While deciding the case based on the four corners of the insurance policy, the court confirmed that the second step in interpreting an ambiguous policy involves reviewing credible extrinsic evidence and, if ambiguity still exists thereafter resolving in the insureds' favor, consistent with the insureds' reasonable expectations.

In some jurisdictions like Virginia, courts distinguish between patent and latent ambiguities and apply different interpretation rules depending on the type of ambiguity within the insurance policy. Virginia courts construe patent ambiguities—ambiguities apparent on the face of the policy[27]—without the aid of parol evidence, against the insurer.[28] On the other hand, Virginia courts construe latent ambiguities—ambiguities apparent only after discovering or developing facts[29]—using contract law, including extrinsic evidence.[30] All Virginia court decisions, however, do not clearly distinguish between patent and latent ambiguities as they relate to the admission of extrinsic evidence.[31] This lack of specificity regarding ambiguity type has caused and likely will continue to cause confusion over which rule Virginia courts use when interpreting insurance policies.[32]

Another interesting application of contract law principles came in *Equinox on Battenkill Mgmt. Ass'n. Inc. v. Philadelphia Indem. Ins. Co.*,[33] which involved structurally damaged balconies that the insurer refused to cover because, although there was decay, the balconies had not "collapsed." The 2012 insurance policy between the management association and insurer provided that the insurer "will not pay for 'loss' caused by or resulting from … faulty, inadequate, or defective … design, specifications, workmanship, repair, construction, renovation, remodeling, grading [or] compaction." In the endorsement entitled "Additional Coverage-Collapse," the policy provided, "We will pay for 'loss' caused by or resulting from risks of direct physical 'loss' involving collapse of 'buildings' or any part of 'buildings' caused only by one or more of the following … [h]idden decay." The policy defined "loss" as "accidental loss or damage" and "buildings" as "buildings or structures." The policy did not define "collapse," except to exclude "settling, cracking, shrinkage, bulging or expansion." Though remanding the case, the court strongly suggested the insurance policy was ambiguous. With that, the court's

27. For example, a contract with a price written "$500 (five hundred fifty)".

28. See *Granite State Ins. Co. v. Bottoms*, 243 Va. 228, 234 (1992).

29. For example, an insurance policy covering "red Corvette" when the insured owned two red Corvettes.

30. *S. Ins. Co. of Va. v. Williams,* 263 Va. 565, 570, 561 S.E.2d 730 (2002). ("It is well established that insurance contracts, like other contracts, generally are to be construed according to their terms and without reference to parol evidence. However, resort to parol evidence is proper where a latent ambiguity exists in a particular insurance contract.")

31. See, e.g., *State Farm Mut. Auto. Ins. Co. v. Justis*, 168 Va. 158 at 167 (1937).

32. *SunTrust Mortg., Inc. v. AIG United Guar. Corp.*, 784 F. Supp. 2d 585, 593 (E.D. Va. 2011).

33. 200 Vt. 33 (2015).

concurring justice would have applied contract law but stipulated that the court could consider only "limited extrinsic evidence, including the circumstances surrounding the making of the agreement as well as the object, nature and subject matter of the writing." This is an application of contract law, but "limited extrinsic evidence" might suggest that the court preferred a relaxed version of strict *contra proferentem.*

D. Interpreting Insurance Contracts Using Strict Contra Proferentem

Contra Proferentem is "a primary rule of interpretation of insurance policies" (Thomas, 2012). Most jurisdictions apply this rule of interpretation after applying the general rules of contract interpretation including extrinsic evidence; however, a small minority of jurisdictions interprets ambiguous insurance contracts without reviewing any extrinsic evidence. In *Washington Nat. Ins. Corp. v. Ruderman*,[34] the Florida Supreme Court rejected an insurer's attempt to introduce extrinsic evidence purporting to show the insureds' understandings about their benefits under home health care insurance policies. This evidence might have resolved a policy ambiguity in the insurer's favor concerning which benefits increased annually. Rejecting this approach, the court reasoned that the insurer "as the writer of an insurance policy, is bound by the language of the policy" and that where "one reasonable interpretation of the policy provisions would provide coverage, that is the construction which must be adopted."

Similarly, in *Andres v. Am. Standard Ins. Co. of Wisconsin*,[35] the Oregon Court of Appeals reiterated the Oregon Supreme Court's *Hoffman* rule that "the interpretation of insurance policies…[is] not one that is resolved by reference to evidence extrinsic to the policy itself." While noting that the Supreme Court of Oregon did not justify its departure from the usual analytic sequence using contract law principles to interpret insurance policy ambiguities, the court reasoned that resolving ambiguities without extrinsic evidence furthers state policy promoting indemnity.

Idaho also employs strict *contra proferentem* without resorting to extrinsic evidence to determine the meaning of unclear insurance policy terms. In *Moss v. Mid-American Fire & Marine Ins. Co.*,[36] the insured's policy included a "radius endorsement," which rendered the liability coverage ineffective if the insured made "regular or frequent" business trips outside a 300-mile radius of his or her home. Finding that reasonable minds could differ on whether the insured's number of trips were "regular or frequent," the Idaho Supreme Court held the policy language to be ambiguous and that the insurer did not meet its burden to use clear

34. 117 So. 3d 943 (Fla. 2013).
35. 205 Or. App. 419 (2006).
36. 103 Idaho 298 (1982).

and precise language to restrict the scope of coverage. Accordingly, the court reversed the lower court's grant of summary judgement in favor of the insurer.

III. Arguments for Contract Law

"Insurance policies are contracts" is often used as a rationale for using general rules of contract interpretation to clarify ambiguous insurance contracts (Wilkerson, 2011). Courts and commentators also offer other justifications for using contract law: First, contract law is a flexible and interpretative device for the foundation of the insurance business, the standard form contract (Miller, 1988). Second, general rules of contract interpretation offer adequate protection for individual consumers with unequal bargaining power by finding terms unconscionable or against public policy (Miller, 1988). More specifically, contract law does not absolve drafters from liability since ambiguities will be interpreted against the drafter even after reviewing extrinsic circumstances (Nardoni, 2013). Third, flaws of strict *contra proferentem* suggest that contract law is preferable from the standpoint of arriving at a construction that is fair and efficient.[37]

A. Benefits of Standardized Agreements

Proponents of contract law argue the benefits of standardized agreements (Cogan Jr., 2010). That is, standardizing agreements fosters reliability, consistency and predictability (Cogan Jr., 2010). In *Sharon Steel Corp. v. Chase Manhattan Bank*,[38] for example, the court recognized that standardized agreements result in "better and quicker understanding of provisions," "substantial savings of time" and lower transaction costs for consumers. Similarly, a court's reluctance to accept automatic construction of ambiguities in favor of coverage implicitly acknowledges that insureds benefit from more cost-effective standard form policies and the reality that some degree of imprecision is necessary to embrace a wide array of situations (Bjorkman, Leitner & Simpson, 2014). Insurance experts also argue that "[s]tandardization is critical because the insurance industry pools claims data to predict future losses and price policies accordingly; accuracy in this important endeavor requires that insurance companies offer uniform coverage." (Abraham, 2005). Thus, offering non-standard, highly customized policies likely would cause

37. See *Empire Fire and Marine Ins. Co.*, 117 Md. App. 72, 97 (1997) (stating that "the ordinary standards of contract construction govern in order to achieve an equitable and just construction");(Millerargues that "Contract law stands as a desirable alternative to the ambiguity doctrine because it would construe insurance policies in a more equitable and efficient fashion, yet still protect vulnerable insured individuals from overreaching insurance companies.") (1988).

38. 691 F.2d 1039 (2d Cir. 1982).

consumer insurance to become unaffordable for average consumers and inhibit insurance market efficiency.

B. Protecting Insurance Consumers

Another rationale for applying general contract law principles is the importance of protecting vulnerable insurance consumers (Miller, 1988). Commentators argue that modern contract law is the best approach because it protects consumers against potential oppression by preventing unconscionable terms (terms that no reasonable person would agree to) (Miller, 1988). More specifically, both the Uniform Commercial Code (UCC) and the *Restatement* (*Second*) *of Contracts* provide courts with flexibility to interpret standardized agreements in favor of consumers (Miller, 1988).[39] For example, in *Bishop v. Washington*,[40] a seminal case involving Pennsylvania insurance law, the Superior Court of Pennsylvania found the UCC concept of unconscionability also applied to insurance contracts and noted an insured's unawareness of policy terms as a factor contributing to a finding of unconscionability.[41]

What is more important is that contract law is flexible enough to interpret ambiguous and unambiguous terms against the drafter. In *Ebert v. Miller Mutual Fire Ins. Co.*, after citing that Maryland does not construe insurance policies most strongly against the insurer, the court held that the term "fence" reasonably included the wall surrounding the building.[42] In that case, contract law protected the insured without regard to extrinsic evidence. In another case favoring the policyholder, *Clendenin Bros., Inc. v. U.S. Fire Ins. Co.*,[43] the Maryland Court of Appeals held that the insurance policy's pollution exclusion provision was ambiguous. In so holding, the court relied on the evolution of the insurance industry's treatment of pollution exclusion clauses. This case shows that contract law also protects consumers by reviewing extrinsic circumstances.

In *People's Insurance,* the court could have reached the same outcome as *Clendenin Bros.*, using traditional contract law as would occur under strict *contra proferentem* if it found the disputed term ambiguous.[44] While arguing to exclude extrinsic circumstances, such evidence helps the Taylors, the plaintiff—and similarly situated plaintiffs—since conduct after policy issuance and industry

39. But see Randalladvances that general rules of contract law do not afford adequate protections and that legislative reform has not gone far enough. (2007).

40. 331 Pa.Super. 387 (1984).

41. See also *Markline Co., Inc. v. Travelers Ins. Co.*, 384 Mass. 139, 142 (1981) (acknowledging the oppressive nature of standard forms and noting similarities in the protections offered by the UCC unconscionability doctrine and the Restatement's reasonable expectations doctrine).

42. *Ebert v. Miller Mutual Fire Insurance Company*, 220 Md. 602, 612 (1959).

43. *Clendenin Bros., Inc. v. U.S. Fire Ins. Co.*, 390 Md. 449 (2006).

44. Alternatively, the court could also protect the Taylors by finding the term unambiguous based on a broad interpretation, ignoring extrinsic circumstances and holding that the policy did cover carports based on its plain meaning.

standards suggests the parties most likely intended coverage under the policy.[45] In this context, therefore, the result obtained under general contract law could provide the court with a more substantiated finding of coverage grounded in the parties' intentions because contract law provides a process under which the court evaluates circumstances surrounding the contract. The end result would be that the extrinsic circumstances protected the insureds and clarified the ambiguous policy terms. Strict *contra proferentem* would not consider insights provided by these relevant extrinsic circumstances.[46]

C. Fairness and Efficiency

The main benefit of contract law is the reliance on objective principles to evaluate contracts.[47] This is best illustrated by examining the drawbacks to the use of strict *contra proferentem*. Drawbacks include inefficient interpretations, uncertainty and decreased policy readability (Rappaport, 1999).

Strict *contra proferentem* often results in inefficient and often misinformed court interpretations (Rappaport, 1999). For example, Judge Charles Clark criticized the inefficiency of an approach automatically favoring consumers by causing "continuous litigation in a field of law where certainty was essentially indispensable, since it stimulated judicial interpretation to resolve the 'ambiguity' against the company, followed by [insurers'] renewed attempts to revise and refine the technical words."[48] He concluded that an equity-based approach, rather than interpretation, would eliminate continuing uncertainty in the law of insurance contracts.[49] Applying *contra proferentem* rather than contract law principles also prevents courts from discerning the parties' intent (Wilkerson, 2011). As a result, the court ignores the importance of context, language and extrinsic evidence to clarify ambiguities (Rappaport, 1999). Indeed, though more difficult to apply, commentators agree that contract law principles discern the parties' true intent better than *contra proferentem* (Rappaport, 1999) and (Miller, 1988).[50]

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45. After the homeowner's policy was in effect, the Taylors' claimed that prior to installing the carport, State Farm's agent confirmed that the carport would be covered under the policy. Also, regarding industry standard, the International Building Code section 202 defines building as "any structure used or intended for supporting or sheltering any use or occupancy."

46. *Contra proferentem* would protect consumers by interpreting ambiguous terms against the insurer, but it would reach that conclusion without acknowledging extrinsic circumstances such as negotiations, conduct after policy issuance and trade usage. That is, after its initial attempt to ascertain the parties' intents, the court would totally disregard both the insurer and insured's intentions. Theoretically then, insurers would only get one shot during policy drafting to explain its policy terms.

47. *Ragin v. Porter Hayden Co.*, 133 Md. App. 116, 135 (2000).

48. *Gaunt*, 160 F.2d 599, 603 (2d Cir. 1947).

49. *Id.*

50. Miller notes that the inflexible nature of strict construction against insurers causes courts to give standard-form language an interpretation at odds with the actual intentions of the parties at hand.

As noted by Rappaport (1999), strict *contra proferentem* turns "the practice of forming a contract into a gamble fraught with uncertainty" (Rappaport, 1999). Uncertainty about both how judges will interpret the contract terms and the chance judges may broaden policy coverage limits increases insurance company risks.[51] A New Jersey court rejected extending coverage for the benefit of the insured and to the detriment of the insurance company in holding "[the court] will not make a better contract for a party than the one it made for itself."[52] Furthermore, the uncertainty is exacerbated since even the extension of coverage is indeterminable (Miller, 1988). The end result is insurance market inefficiency and, consequently, higher insurance premiums (Miller, 1988).

A third argument is that insurance contracts are long documents that contain hundreds of provisions. Most insurance consumers do not read their contracts, at least not until a loss occurs, and cannot understand their contracts after reading them (Rappaport, 1999).[53] Strict *contra proferentem* forces insurance companies to attempt to eliminate ambiguities, which usually requires more technical language.[54] Insurance companies revise and refine insurance policies to more clearly exclude a risk where courts have used *contra proferentem* and other interpretive tools to cover in previous versions of insurance policies (Baker, 2013). This language takes the form of longer clauses and additional clauses and definitions (Rappaport, 1999). This process may produce better informed consumers. In addition, some commentators argue that excluding evidence to resolve ambiguity provides insurance companies little incentive to explain or interpret policy provisions to consumers orally (Miller, 1988; Boardman, 2006).[55] As Chief Justice William Holohan observed, "every insurance agent will be required to do a complete review of the policy with the insured and establish some form of record to support the conclusion that the insured was advised and understood the nature, extent and limitations of the policy which was purchased."[56] Consequently, the rule of strict *contra proferentem* tends to exacerbate the problem of consumer ignorance.

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51. *Bausch & Lomb Inc. v. Utica Mut. Ins. Co.*, 330 Md. 758, 782 (1993).

52. *Flynn v. Hartford Fire Ins. Co.*, 146 N.J. Super. 484, 488 (App. Div. 1977).

53. But see NRS 657B.124 (Nevada enacted legislation with the intent to protect consumers from lengthy and complicated insurance policies. For example, the statute requires specific Flesch-Kincaid readability level; an index or table of contents; and minimum font size); NRS 657B.130 (disapproves policies with misleading provisions).

54. For example, a New York court found the following exclusionary clause not conspicuous enough: "the policy excludes from coverage damage or loss arising out of the: discharge, dispersal, seepage, migration, release or escape of 'pollutants' unless the discharge, seepage, migration, release or escape is itself caused by any of the 'specified causes of loss.' But if the discharge, dispersal, seepage migration, release or escape of 'pollutants' results in a 'specified cause of loss,' we will pay for the loss or damage caused by that 'specified cause of loss.'" (*Herald Square Loft Corp. v Merrimack Mutual Fire Ins.*, 344 F Supp. 2d 915, (SD NY 2004)).

55. Companies have little incentive to revise ambiguous insurance policies, as long as they can live with the pro-policyholders result of the few instances in which policyholders take the insurer to court.

56. *Darner Motor Sales, Inc.*, 682 P.2d 388, 402 (1994).

IV. Arguments For Strict *Contra Proferentem*

As Professor Kenneth Abraham notes, "Courts commonly remind the parties that an insurance policy is, after all, a contract, and that departures from the contract must be limited if the contract is to have any meaning (Abraham, 2013)." In the face of such arguments, there are three common arguments against contract law that can be viewed as support for strict *contra proferentem*: 1) disadvantages of standardized agreements; 2) lack of insured's subjective assent; and 3) need for a level playing field.

A. Disadvantages of Standardized Agreements

Those who argue against using contract law to interpret insurance contracts emphasize that modern insurance contracts do not fit within the traditional elements of a contract. As Professor Susan Randall notes, general rules of contract law fail in insurance disputes because insurance contracts are offered on a take-it-or-leave-it basis (Randall, 2007). In fact, generally, claimants' attorneys argue that applying general rules of contract interpretation "produce dramatically anti-consumer results" due to the adhesive nature of insurance policies.[57] This claim tends to focus on the nature of insurance contracts' standard form characteristic. Ironically, in the 19th century, standard form contracts originated to protect policyholders (Hardy, *et al.*, 1922). One commentator noted that "no two [policies] were alike" and that "holders of policies were generally unaware of many of the important conditions which affected their business so materially, and thus, after losses, there were many disagreeable surprises, much indignation and many litigations (Hardy, *et al.*, 1922)." As a result, legislators required that insurance companies draft policies on standard forms with consistent language (Hardy, *et al.*, 1922). Non-standard, less uniform insurance contracts or perhaps proposed terms drafted by consumers would be less desirable alternatives. Therefore, the crux of the argument against standard forms must be the insured's inability to individually negotiate contract terms.

B. Insurance Contracts are Non-Negotiated Agreements

The second argument lists the key missing component in insurance contracts of the insured's subjective assent to terms (Abraham, 2013). This point is correct since insureds have no role in drafting or negotiating insurance contract terms. Yet, Professor Randall similarly argues that insurance companies also lack freedom to contract because of state administrative controls on the insurance business (Randall, 2007). For example, the Maryland Insurance Administration (MIA) pre-approves policy terms, and the People's Insurance Counsel Division (PICD) reviews policy

57. Brief for Petitioner, *supra* note 1, at 14.

rates of policies already being sold or proposed to be sold in the state.[58] Though the MIA and PICD are consumer protection entities created to level the playing field between insureds and insurers, the restriction on both policyholders and the insurance company's ability to contract freely is undeniable (Randall, 2007). Admittedly, there are differences in degree to which insurer and insureds are contractual constrained. In the case of policy terms, insurers purchase standard policy terms from the Insurance Services Office (ISO) and then propose the same or similar policy terms to administrative agencies like the MIA. Coverage provisions are generally accepted as proposed, but exclusion clauses are given a more rigorous review (Baker, 2013). This suggests a need for better proposals by the ISO or closer scrutiny of provisions by the MIA during approval process, and not necessarily reliance on judiciary consumer protection at contract interpretation. Approving clear and unambiguous contract terms on the front end likely alleviates litigation on the back end.

C. Purpose of Insurance, Clarity and Efficiency

The main argument for rules other than contract law is to level the playing field for individual consumers against overreaching insurance companies in a quasi-monopolistic market.[59] As Judge Charles Clark pointed out in *Gaunt v. John Hancock Mutual Life Insurance Co.,*[60] "Had … bargaining occurred between parties with equal knowledge of the business and on equal terms, there could be little difficulty in supporting the condition precedent … ."[61] In addition, consumers may not be as informed about their insurance policies because these lengthy documents contain technical terms that are unfamiliar to average consumers.[62] Furthermore, most consumers do not read their contracts and receive their policy only after the contract is made (Rappaport, 1999). Thus, the claim is that pro-insured rules like strict *contra proferentem* promote the purpose of insurance, permit clear contracts and promote efficiency.

What is more important, however, is that strict *contra proferentem* does not automatically ensure adequate protection for insureds.[63] For example, a court may find a term unambiguous to prevent clear injustices against the insurer, or exclude

58. Md. Code Ann., State Gov't § 6-306 (West); see also *People's Ins. Counsel Div. v. Allstate Ins. Co.*, 2010 WL 2589634, at *2 (Md.App. 2010). Though the PICD reviews policy rate increases of 10% or more filed with the MIA Commissioner by a medical professional liability insurer and homeowners' insurers issuing policies in Maryland, it has no authority to set policy rates.

59. *See generally* Brief for Petitioner, *supra* note 2 (PICD argues while consumers might have several insurance companies to choose from, most insurance policies are standardized forms, used industry-wide, and offered to consumers on a "take-it-or-leave-it" basis).

60. *Gaunt v. John Hancock Mut. Life Ins. Co.*, 160 F.2d 599 (1947).

61. *Id.* at 603.

62. Brief for Petitioner, *supra* note 1, at 22.

63. *Keene Corp. v. Insurance Co. of North America*, 597 F.Supp. 946, at 954 (1984).

extrinsic evidence as irrelevant or discount its weight.[64] In those cases, this result-driven approach might actually create judicially inefficiency where judges will search the ends of the earth for consistent understandings of terms or phrases. On the other hand, assuming strict *contra proferentem* became law, an insurer might be motivated to specify terms that are reasonably susceptible to more than one interpretation. However, quasi-regulators like the ISO and regulators like the MIA already attempt to alleviate bait-and-switch concerns by proposing and approving standard homeowner policy language.

Courts and commentators also contend that strict *contra proferentem* advances the purpose of insurance, which is to provide protection from claims and losses.[65] Thus, courts often give policy terms an interpretation consistent with that purpose, absent the insurance policy's express exclusions or limitations suggesting otherwise.[66] Judge Richard Posner's economic analysis charges that ambiguity rule protects risk-averse insureds against the possibility that they might misinterpret their insurance policy's coverage (Posner, 1992). Supporting the purpose of insurance argument, the Maryland Court of Appeals, in *Shirer*, rejected an insurance company's denial of coverage under an exclusion provision.[67] There, the court explained that "if [the insurer's] argument is taken literally, operation of the rig would almost never" trigger coverage under the automobile policy. Another common argument for strict *contra proferentem* is promoting clear insurance contracts.

As the drafter, the insurance company controls the contract language, and construing ambiguities against the drafter encourages clear contracts (Rappaport, 1999). Even proponents for contract law appear to agree on this point, "Placing the onus on the drafter of insurance policies and adhesion contracts makes sense...." (Horton, 2009). For example, in *Eli Lilly and Co. v. Home Ins. Co*.,[68] the court determined whether an insurance company could proffer evidence of what the policy language meant to say. The court concluded that the insurance company as drafter of the policy cannot rely on extrinsic evidence to clarify its obscure terms. Such a rule encourages insurers to carefully draft clear contract terms and clauses (Rappaport, 1999). Moreover, insurance companies, whose carefully trained lawyers draft the policy language, are discouraged from using imprecise terms to

64. See, for example, *Pennsylvania Threshermen & Farmers' Mut. Cas. Ins. Co. v. Shirer*, 224 Md. 530 (1961); *Megonnell v. United Servs. Auto. Ass'n.*, 368 Md. 633 (2002) (decisions dismissing industry custom as irrelevant).

65. See *Wallis v. Superior Court*, 207 Cal. Rptr. 123, 129 (Ct. App. 1984) (noting special characteristics of insurance distinguishing them from the general class of contracts such as the insured's motivation to "secure peace of mind, security, [and] future protection."); *Foley v. Interactive Data Corp.*, 765 P.2d 373, 390 (Cal. 1988) (recognizing that insureds obtain insurance to "seek protection against calamity."); *Norem v. Iowa Implement Mut. Ins. Ass'n.*, 196 Iowa 983, 988 (1923) ("The insured may generally, at least in taking out insurance, rely upon the company to issue a policy payable to the proper person and in a form to carry out its purpose."); see also Policyholder's Guide to Insurance Coverage § 20.03 (2004).

66. *Weinstein v. Prudential Property and Cas. Ins. Co.*, 149 Idaho 299 (2010).

67. *Shirer*, 224 Md. 530, 537 (1961).

68. 482 N.E.2d 467 (Ind. 1985).

lure potential policyholders and then later argue for a narrow interpretation of the term (Rappaport, 1999).[69] Strict *contra proferentem* might also dissuade some insurers from attempting to attract insureds with policy terms. However, those favoring strict *contra proferentem* may not be considering the fact that the time value of money does not motivate insurers to deny claims because: 1) prejudgment interest is routinely awarded in breach of contract cases; 2) insureds may routinely challenge wrongful denials of coverage; and 3) a reputation for denying reasonably valid claims will lead to loss of business (Sykes, 1996).

Another rationale for *contra proferentem* rather than contract law is that it promotes efficient risk allocation (Rappaport, 1999). From a judicial resources perspective, one commentator explains that strict *contra proferentem*, which rejects an examination of extrinsic evidence, eliminates unjustifiable expense and delay in coverage proceedings (Abraham, 1996). United Policyholders argued in its amicus brief, "Trial courts confronted with ambiguous policy language will have to give parties an opportunity to submit evidence." Courts must then determine the admissibility and weight of such evidence.[70] The Supreme Court of Florida seemingly agreed by strictly construing an ambiguous health care coverage policy against the drafter who failed to specify whether automatic benefit increases applied to daily benefits or to all benefits.[71] A similar efficiency argument concerns distributive justice or risk spreading—essentially that strict *contra proferentem* places the financial burden on the party in the better position to handle the risk of loss (Horton, 2009). Insurers, as the contract drafter, can avoid unclear policy terms at the lowest cost (Burke, 2000). Undeniably, the insurance company is in a better financial position than most consumers (Burke, 2000) and can avoid the increased risk by shifting cost increases to its pool of insureds. Ultimately, any financial benefit to insureds resulting from strictly construing insurance policies against insurers may result in higher insurance premiums.

V. Courts Primarily Create Rules Interpreting Insurance Contracts

Insurance regulation has two major categories (Baker, 2013). The first is a set of judicially created doctrines that manage the relationship between an insurer and

69. See, for example, *Brownstein v. New York Life Ins. Co.*, 158 Md. 51 (1930) (noting that the conspicuously printed words "Life Income to Insured" were bound to attract the attention of the insured.).

70. Brief for United Policyholders, as Amici Curiae Supporting Respondent, *Washington National Insurance Corporation v. Ruderman*, 117 So. 3d 943 (No. SC 12-323). United Policyholders also argue that the cost of insurance coverage litigation will significantly increase, which affects not only policyholders' ability to obtain competent coverage counsel, but also the insurance industry's exposure to a successful policyholders attorney's fees.

71. *Washington Nat. Ins. Corp. v. Ruderman*, 117 So. 3d 943, 952 (Fla. 2013).

its insured (Baker, 2013). This branch of insurance law is predominantly a sophisticated application of contract law, though tort law and agency law principles, as well as some statutes and administrative code, are relevant (Baker, 2013). The second major category focuses on regulating entities that engage in the insurance business (Baker, 2013). This aspect of insurance law is primarily a body of statutes enacted by state legislatures and administrative regulations developed by quasi-federal agencies and state agencies, and sometimes influenced by judicial decisions (Baker, 2013).

Though contract interpretation is usually a court function, some state legislatures have codified rules of interpretation (Baker, 2013). Courts like the *People's Insurance* court contemplating changing its reliance on contract law could invite its state legislatures to change the law.

In California, for example, the legislature determined that contract law best promotes public policy and "in case of uncertainty not removed by the preceding rules, the language of a contract should be interpreted most strongly against the party who caused the uncertainty to exist."[72] Similarly, North Dakota enacted legislation favoring contract principles but also expressly requiring that *contra proferentem* be used as a rule of last resort.[73] South Carolina's Senate body introduced a similar bill that would have broadly construed in favor of coverage liability insurance policies covering construction professionals.[74] That legislation came after a legal dispute over a general liability policy that ultimately reached the South Carolina Supreme Court, which decided in favor of the insurance company (Workman, 2015). The South Carolina Senate Committee's primary concern was protecting homeowners from insurance companies that claimed faulty construction work was not covered under their policy (Workman, 2015). Other legislatures have taken a similar approach with health insurance policies, noting "all policies … are to be interpreted broadly … in favor of the insured or beneficiaries of such policy."[75] Notably, these health care proposals followed Congress' decision to regulate the health care industry and not by a court's urging.

These instances support permitting legislatures to determine the best interpretation approach that serves broader public policy considerations. Few states, however, have proposed—much less enacted—legislation interpreting insurance contracts. For example, there have been no state legislative actions regarding the

72. Cal. Civ. Code § 1654 (West 2014).

73. N.D. Cent. Code Ann. § 9-07-19 (West).

74. S.B. 431, 119th Leg., 1st Sess. (Sc. 2011); see also H.B.10-1394 (Co. 2010), codified at CRS §§ 10-4-110.4 and 13-20-808: (confirming that faulty workmanship claims are eligible for coverage, unless insurance policy wording specifically excludes them (with a "your work" exclusion, for example)).

75. See, for example, H.B. 924, 26th Leg., Reg. Sess. (Haw. 2011) (All policies and certificates which are submitted for approval under RSA 420-L:6 are to be interpreted broadly so as to find coverage unless plainly and clearly excluded, and in favor of the insured or beneficiaries of such policy or certificates); H.B. 1541, 163rd Leg., 2d. Sess., (N.H. 2013) (same).

construction of insurance contracts in Maryland.[76] This could suggest that the legislative policy in Maryland and similarly situated states is to retain the construction of insurance contracts using contract law, or more likely that legislative inaction cannot appropriately be construed as legislative approval of the status quo (Hart and Sacks, 1958).

Even assuming, *arguendo*, that legislatures adopt an interpretation rule favoring policyholders, it is likely to use reasonable expectations—not strict *contra proferentem*—to protect insurance consumers. In South Carolina, for example, the legislature proposed:

> "A court may consider the objective and reasonable expectations of a [policyholder] in interpreting the policy" and "If an insurer disclaims or limits coverage under a liability insurance policy issued to a [policyholder], the insurer shall bear the burden of proving by a preponderance of the evidence that: (1) a policy limitation, exclusion, or condition bars or limits coverage for the legal liability of the insured in an action or notice of claim made pursuant to this section…; and (2) an exception to the limitation, exclusion, or condition in the insurance policy does not restore coverage under the policy."

Legislative activism adopting the reasonable expectations test has merit since theoretically it is not an application of contract law interpretation, which is traditionally a court function (ALI, 2013). In addition, legislatures may be more inclined to use the legislative process to enact reasonable expectations since it has been adopted by the courts in nearly every American jurisdiction. Nevertheless, while a possibility for legislative action, research shows no state enacting the reasonable expectations doctrine. Only courts have adopted the rule in those 39 jurisdictions construing insurance policies according to the insured's reasonable expectations.[77] A few jurisdictions such as Utah expressly reject the doctrine of reasonable expectations, while others jurisdictions, such as Oregon, have not expressly adopted, nor expressly rejected, the reasonable expectation approach.

76. Brief for Petitioner, *supra* note 1, at 24.

77. State courts created rule of reasonable expectations: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Massachusetts, Minnesota, Missouri, Montana, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, South Carolina, South Dakota, Tennessee, Texas, Vermont, Washington, West Virginia, Wisconsin and Wyoming.

VI. Implications

A change to Maryland's or similarly situated states' reliance on contract law when interpreting insurance contract could affect the insurance industry, including courts, insurance practitioners and insurance consumers. The following sections review the economic and behavioral consequences of maintaining the status quo contract law and changing to strict *contra proferentem*.

A. Economic Effects

The goal for contract interpretation is to minimize contractual transaction costs, generally understood as barriers to efforts voluntarily to transfer resources to their most valuable use (Posner, 2005). The entire purpose of insurance is to disperse costs by transferring risk onto a larger group of insured parties (Baker, 2013). Against this backdrop, the primary economic consequences of interpreting insurance contracts can be broadly categorized under administrative costs, insurance premiums, liability payments and economic contraction. Though little attention has been paid to the economics of contract interpretation, a recent study found that insurance firms prefer an objective approach to contract interpretation and that courts should use narrow evidentiary bases when interpreting contracts but with the flexibility to broaden the base when necessary (Hardy, 2011). This study suggests that insurance firms recommend a mix of contract law's objective standard with something more than strict *contra proferetem*'s absolute bar of extrinsic circumstances.[78] States' application of contract law that interprets ambiguities against the drafter as a rule of last resort meets the insurer preference, which presumably results in an efficient insurance market for consumers. Though contract law is preferable, arguments claiming that strict *contra proferentem* will significantly increase insurance costs, specifically insurance premiums and claims payments, are not well supported. Contract interpretation likely has minimal impact on the cost of insurance. Thus, there is little economic incentive to change from traditional contract law to strict *contra proferentem*.

1. Administrative Costs

In rationally choosing between these possible legal rules, one also should consider the costs of administering the rule chosen. From the court's perspective, administrative costs of adhering to contract law principles is likely greater than using strict *contra proferentem* (Schwartz, 2008). Contract law principles often require the court to determine the admissibility of extrinsic circumstances by addressing issues such as relevancy, authentication and hearsay (Imwinkelried, 2006). Compared with strict *contra proferentem*, the court's in-depth, uncertain evidentiary inquiry under standard contract law is more significant in terms of both time and money (i.e., salary and other expenses of a high-quality tribunal) (Posner,

78 *See supra* Section 2.C.

2005). Rarely, however, do insurance contract interpretation disputes involve extrinsic circumstances that courts must evaluate.

The alternative interpretation, strict *contra proferentem*, enables the court to disregard extrinsic evidence and the process of evaluating the fairness of such evidence. The court would refer to the contract policy itself and then determine ambiguity based on only the policy language. Without reviewing extrinsic circumstances, the court would minimize scarce judicial resources (Lash, 2015).

For the insurance company, administrative costs appear less expensive under contract law than *contra proferentem*. At policy drafting, contract law principles could incentivize some insurance companies to use broad language and then once a dispute arises, argue a more precise usage of the term. Under contract law, arguably, the insurance company may not be as careful when drafting terms because it would have a second chance during litigation to explain the unclear terms. Thus, administrative costs for drafting and reviewing policies are low. At the dispute stage, however, administrative costs (i.e., litigation costs) could be higher for insurance companies because they would have to gather data and information, prepare agents for testimony and interview expert witnesses to bolster their interpretation of the disputed policy term (Posner, 2005). The apparently greater costs at the dispute stage reduce the slight incentive of drafting ambiguous terms in the first instance. Of course, such reasoning ignores that insureds rarely challenge coverage denials (Rose, 2013). With that understanding, some insurance companies might rationally decide not to consider the greater dispute costs, preferring to economize on drafting costs (Posner, 2005). In summary, administrative costs for insurers under contract law are less during drafting but more expensive with a litigated dispute.

On the other hand, under strict *contra proferentem*, insurance companies would necessarily draft more conspicuous contract terms. Insurance policies will take longer to draft and become lengthier documents since they will require greater explanation of terms that might be reasonably susceptible to more than one meaning (Posner, 2005). Though policies will inevitably require more resources to draft, there might be fewer disputes over contract interpretation (Posner, 2005). Firms and practitioners, including some drafters, may argue against increasing consumer costs associated with marginally improved drafting, saying that precision is infinitely more costly and that providing for every possible contingency in a contract is prohibitive (Posner, 2005). They likely will argue spending more resources on careful contract drafting is useless given that insurance consumers generally do not read their policies. Under strict *contra proferentem*, it would appear that administrative costs are more expensive at drafting and less expensive during a dispute since courts will only examine the policy language. Nonetheless, the insurer assumes the increased transaction cost and then redistributes the increased premiums to insurance consumers. In sum, the higher transaction costs under *contra proferentem* result in higher administrative costs to insurance firms.

For the insured, administrative costs (i.e., litigation costs) will be higher under contract law than strict *contra proferentem*. Yet in some cases, the administrative

cost for insureds will be nearly equal under contract law and *contra proferentem*. For example, in *People's Insurance*, the PICD, a state agent, intervened on the insured's behalf as an advocate for consumer protection. Thus, the insured realizes lower litigation costs, with the exception of time, because services provided by the PICD are free of charge. These consumer protection cases are the exception, and most insureds will assume significant administrative costs by challenging coverage denials in court.

2. Insurance Premiums

Insurance premiums are the charges to insureds for insurance coverage (NAIC, 2015). Studies illustrate that uncertainty about losses and ambiguity about probability often lead to higher premiums (Kunreuther, Hogarth and Meszaros, 1993). Under traditional contract law interpretation, insurance premiums likely will remain unchanged since there would be no change in the legal regulation of insured-policyholder relationship. Similarly, increased premiums under the alternative strict *contra proferentem* likely will be minimal.

Proponents of contract law argue that the potential increase in insurance premiums is the adverse economic effect that could occur when the insurer takes on additional risks under strict *contra proferentem* compared with contract law. However, it is the strict *contra proferentem*—not traditional contract law—interpretations that assure insurance companies that any ambiguity will be resolved against them without the need for a costly evidentiary inquiry. Strict *contra proferentem* also might curb uncertainty about losses through more careful drafting and consideration of covered and excluded property. However, it does not, nor does contract law for that matter, settle the unknown issue of when a court will consider a term ambiguous.

One statistical report provides some insight into this issue (NAIC, 2015). In 2012, the National Association of Insurance Commissioners (NAIC) published a report on countrywide and state-specific premium and exposure information for non-commercial dwelling fire insurance and for homeowners' insurance package policies (NAIC, 2015). In general, the report concluded that factors affecting home insurance premiums and loss include real estate values, building and construction costs, vulnerability to catastrophes, and the level of urbanization (NAIC, 2015). Legal (in the form of rate and form filing laws) and economic (inflation and interest rates) also cause wide variations in premiums (NAIC, 2015). Table 1 shows insurance premiums of the most common policy type, HO-3, and the most common insurance coverage amount, $200,000–$299,999. Across six jurisdictions in the same geographic area, the data shows minor differences in insurance premiums.

In the traditional contract law jurisdictions selected, the average insurance premiums are marginally lower than in jurisdictions using strict *contra proferentem.* Accordingly, switching interpretation methods in Maryland will not necessarily lower insureds' premiums. The fact that strict *contra proferentem* jurisdictions have marginally higher average premiums does not conclusively suggest that contract interpretation type results in a higher average premium price, however. A more reasonable interpretation of this data, and one consistent with the

NAIC report, is that judiciary regulation is one of many factors affecting the cost of home insurance. For these reasons, it is unlikely that either contract interpretation approach will increase premiums above a nominal amount, if at all.

Table 1

Jurisdiction	Contract Interpretation Method	Disaster Declarations Since 2011	Average Premium Price
Delaware	Contract Law	2	$619
Maryland	Contract Law	5	$754
New Jersey	Contra Proferentem	7	$807
Pennsylvania	Contra Proferentem	5	$780
Virginia	Contra Proferentem	5	$804
Washington, DC	Contract Law	4	$856

*Compare Average Premium Price for Contract Law Jurisdictions=$743 with Average Premium Price for *Contra proferentem* Jurisdictions=$797

3. Claims Payments

What insurance companies pay out for their policyholders' legal defense and any judgments against them is directly linked to the cost of liability insurance premiums (Insurance Information Institute, 2014). Table 2 summarizes information obtained from the NAIC published *Report on Profitability by Line by State* (2013). For each line and each state, the publication presented aggregate statistics such as premiums earned, losses incurred, loss adjustment expenses, general expenses, investment income and estimated profits for the 2012 calendar year (NAIC, 2013). The data for incurred losses and loss adjustment expenses suggests that the average claim payments are similar between states employing traditional contract law and *contra proferentem.*

4. Economic Contraction

The final step in the adverse economic effects argument is that a strict regulatory environment (i.e., employing *contra proferentem*) could create economic contraction since insurers would be less likely to provide coverage (Born, 2013). Insurance "redlining" occurs when insurers identify geographic regions in which an insurance company prefers not to issue policies (Baker, 2013). In theory, a redlined area is a more risky place for banks to lend (Baker, 2013). Without available financing opportunities, fewer people invest in the area, and without investment, the area becomes a riskier place for banks, causing further economic contraction (Baker, 2013).

Table 2

Jurisdiction	Contract Interpretation Method	Losses Incurred as Percent of Direct	Loss Adjust Expense as Percent of Direct Premium Earned	Total Loss as Percent of Direct Premium Earned
Delaware	Contract Law	50.2	7.6	57.8
Maryland	Contract Law	66.5	9.9	76.7
New Jersey	Contra Proferentem	126.4	20.7	147.1
Pennsylvania	Contra Proferentem	62.2	10.1	72.3
Virginia	Contra Proferentem	55.1	8.0	63.1
Washington, DC	Contract Law	48.2	6.7	54.9

*Compare Average Total Loss % for Contract Law Jurisdictions=63.13 with Average Total Loss % for *Contra proferentem* Jurisdictions=67.7. (New Jersey results not included in average since 2012 Hurricane Sandy causes significant distortion.)

Strict *contra proferentem* working alone likely would not cause redlining, but coupled with catastrophe-prone areas and other state regulatory and judicially created doctrines, the possibility becomes greater of less insurers issuing policies. In a 2012 report, the PICD already expressed concern to the governor and general assembly about the unavailability of homeowners insurance in coastal and bay areas (Maryland Attorney General, 2012). In one instance, Allstate discontinued writing new policies in all coastal areas of Maryland (Maryland Attorney General, 2012). In another, State Farm did not renew more than 1,200 of its policyholders living in Ocean City (Maryland Attorney General, 2012). At least in catastrophe-prone areas, such as Maryland's coastline, strict *contra proferentem* might cause other insurers to withdraw coverage or decline renewals, thereby creating significant economic contraction. For this limited reason, traditional contract law might be the better interpretation approach rather than *contra proferentem*.

B. Insured and Insurer Responsibility

Moral and morale hazard, behavior changes when people or businesses are insured against losses, affects both insureds and insurers. Theoretically, insurance reduces incentives to: 1) protect against loss; and 2) minimize the cost of a loss (Baker, 2013). For example, pre-claim, an individual might choose to drive more carelessly since the insurer would pay if the car is damaged, or post-claim, the individual chooses more expensive repair costs as long as the insurer pays for it (Baker, 2013). In addition, insureds may intentionally cause a claim or exaggerate the value of a claim in order for monetary gain. These behavioral changes exist in insurance without regard to the application of interpretation rules. However, a court

or legislature's preferred method of interpreting insurance contracts could further affect insureds' and insurers' behavior. If viewing contract interpretation on a continuum from most to least pro-policyholder, the order is reasonable expectations, strict *contra proferentem* and then contract law. Rules allowing a broader interpretation of arguably ambiguous contract terms might encourage this type of behavior since an insured might presume additional coverage, even when that presumption is erroneous. The problem then arises that with higher potential claims, the insurer will charge higher premiums (Baker, 2013).

Insurer moral hazard also constrains the insurance market (Baker, 2013). Insurance creates a principal-agent relationship, wherein the insured (principal) appoints the insurer (agent), who is responsible for insured losses (Baker, 2013). For example, in deciding whether to pay a claim, or how much to pay, the insurer cannot help but be affected by getting to keep whatever money it does not payout for losses (Baker, 2013). Legal rules (i.e., duty to settle and damages for bad faith breach) that promote the enforcement of insurance contracts attempt to reduce such instances of insurer moral hazard (Asmat and Tennyson, 2010). Similarly, contract interpretation principles also could reduce insurers' incentives to attract insureds with broad, inconspicuous language and then deny coverage once a loss occurs. Thus, strict *contra proferentem*, which promotes the purpose of insurance by broadly favoring insureds when a policy term is unclear, should reduce insurer moral hazard in policy drafting.

VII. Conclusion

This article discusses the advantages and drawbacks of the various ways in which insurance contracts can be interpreted. There are compelling arguments for both contract law and strict *contra proferentem*. With regard to administrative costs, neither approach appears to be universally more efficient than the other. For example, what is most efficient for the court tends to be less efficient for the insurance company. While acknowledging the possibility of increased premiums and claims payments under strict *contra proferentem*, the data suggests that any increases would be nominal. Moreover, economic contraction is unlikely to result solely from a chosen contract interpretation method. Finally, a switch to strict *contra proferentem* could reduce insurer moral and morale hazard, but at the expense of increasing insured moral hazard.

Appendix: The People's Insurance Case

During a blizzard in the winter of 2010, Moira and Gregory Taylor's carport in West River, Anne Arundel County, collapsed under the weight of snow and ice.[79] The Taylors filed a claim under their homeowners insurance policy with State Farm Fire and Casualty Insurance.[80] State Farm denied the claim on the ground that the carport was not a "building" and that the insurance policy only covered losses due to a collapse of buildings.[81] The Taylors filed a complaint with the Maryland Insurance Administration (MIA) alleging that State Farm had committed unfair claim settlement practices and violated Maryland insurance law[82] "by refus[ing] to pay [their] claim for an arbitrary or capricious reason based on all available information" or by "fail[ing] to act in good faith" in settling their claim.[83]

The People's Insurance Counsel Division (PICD), the appellant, intervened on behalf of the Taylors. Following an investigation, the MIA's Property and Casualty Complaint Unit concluded that State Farm's denial of the Taylor's claim did not violate Maryland Code Section 27-303.[84] The Taylors challenged this determination and requested a hearing before the Associate Deputy Commissioner of the MIA. The state insurance commissioner ruled that State Farm did not violate the law because State Farm's decision to deny the Taylor's claim was based on a correct legal interpretation of the policy language.[85]

The PICD filed a petition for judicial review of that decision in the Circuit Court for Baltimore City.[86] On Aug. 9, 2012, the circuit court affirmed the MIA final decision, reasoning that "the word 'building' as used in the [State Farm] Policy is plain and unambiguous and means a structure that has a roof and walls."[87] The Maryland Court of Appeals granted the PICD's petition for a writ of certiorari to determine, in part, whether it should "reexamine Maryland common law constructing insurance contracts and, recognizing that such contracts are not the product of equal bargaining, hold that terms contained in an insurance policy

79. *People's Ins. Counsel Div. v. State Farm Fire & Cas. Ins. Co.*, 214 Md. App. 438, 440 (2013).

80. *Id.*

81. *Id.* at 441.

82. Md. Code Section 27–303.

83. The MIA has jurisdiction over this administrative proceeding, but lacked jurisdiction to determine whether State Farm breached its contract with the Taylors. Also, State Farm could have breached the insurance contract but not have violated the unfair claim settlement practices. Lastly, the Taylors might have been more successful pursuing a breach of contract claim and challenging the common law interpretation of insurance contracts at a circuit court rather than filing a complaint with the MIA.

84. Brief for Petitioner, *supra* note 1.

85. *Id.*

86. *Id.*

87. *Id.*

must be strictly construed against the insurer."[88]

After oral arguments, the court issued a written opinion dismissing the writ of certiorari improvidently granted without any explanation.[89] The dissenting justice, however, provided several reasons supporting when the court should dismiss a writ of certiorari as improvidently granted: 1) there was no issue of public importance in the case; 2) the issue was not preserved during lower level court proceedings; or 3) the record provided an inadequate basis for rendering useful guidance.[90] More importantly for purposes of this article, the dissent noted that the dismissal missed the opportunity to refine the issue of Maryland's law on interpreting ambiguous insurance policies.[91]

Also, while acknowledging subtle distinctions between strict *contra proferentem* and Maryland's reliance on general contract law principles to interpret insurance contracts, the dissent noted that the case could have been resolved relying on the court's "well-settled rules of contract interpretation."[92]

88. *People's Ins. Counsel Div. v. State Farm Fire and Cas. Ins. Co.*, 436 Md. 501 (2014).

89. See *supra* note 3. Perhaps the court's reason was simply to reaffirm its longstanding precedent that relies on contract law principles without drafting another decision acknowledging the state of the law.

90. See *supra* note 3, at 59.

91. *Id.* at 61.

92. *Id.* at 63.

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