Insurance, Contract, and the Doctrine of Reasonable Expectations

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INSURANCE, CONTRACT, AND THE DOCTRINE OF REASONABLE EXPECTATIONS

Robert H. Jerry, II

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1. Missouri Endowed Floyd R. Gibson Professor, University of Missouri-Columbia School of Law. The author expresses his appreciation to Melissa Hilton and Daniel Lovett, both 1998 graduates of The University of Memphis School of Law, for their excellent research assistance. He also thanks the trusts of the Herff Chair of Excellence in Law at The University of Memphis and the Missouri Endowed Floyd R. Gibson Professorship for its support. In the interest of full disclosure, the author notes that he has occasionally consulted with attorneys for both policyholders and insurers regarding insurance contract interpretation and other issues.
INTRODUCTION

Legal rules, somewhat like laws of science,² await discovery by explorers whose prescience enables them to understand something others observed but could not comprehend. We honor the explorer’s achievements; if the discovery is important enough, we are likely to celebrate the discovery at periodic intervals and to re-examine where legal analysis or scientific discovery has taken us in the intervening years.

In the field of insurance law, Judge Robert Keeton is one of the grandest explorers of them all. In 1970, he published a prescient two-part article in the Harvard Law Review³ in which he identified “two broad principles [that] account for such a high percentage of what might otherwise appear to be deviant decisions that the remainder can be accepted as within the margin of error one should expect in the administration of any set of guidelines.”⁴ The first of these principles was that “an insurer will be denied any unconscionable advantage in an insurance transaction, and [the second was that] the reasonable expectations of applicants and intended beneficiaries will be honored.”⁵ With time, the second of the two principles became known as a “doctrine,” and the so-called “doctrine of reasonable expectations” (or “DRE”) is nearing almost three decades of evolution. During this period, insurance law scholars have followed the ritual of assessing the state of the doctrine in roughly ten-year intervals,⁶ and the calendar tells us it is time for another look.⁷

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². The metaphor is inspired by Roger Henderson, 5 CONN. INS. L.J. 69 (1998) who likens Professor Keeton to the discoverer of a comet. Id. at 70.
⁴. Keeton Part One, supra note 3 at 961.
⁵. Id.
This article examines the connections between the doctrine of reasonable expectations and the law of contract. Judge Keeton urged in his 1970 article that protecting the insured's reasonable expectations is a better justification for results in many reported cases than the rationales offered by judges. Without disagreeing with that point, it can be claimed, as this article does, that insurance law's efforts to explain outcomes that contradict the plain language of contractual text are appropriately viewed as a subset of a larger effort to rationalize contract law with the challenges presented by the widespread use of standardized forms in consumer transactions. When viewed from this different perspective, Judge Keeton's 1970 article was important not only for what it said about the contours of insurance law but also for what it suggested about the stance insurance law should take in an ongoing—and still continuing—battle for the soul of contract law.

Whether or not one embraces the doctrine of reasonable expectations, it is undeniable that Judge Keeton's doctrine has relevance well beyond the boundaries of insurance law. Indeed, reasonable expectations have long been the salient feature of the law of promissory obligations, as illustrated by the brief tour in the next section of some of contract law's familiar terrain.

I. REASONABLE EXPECTATIONS AND CONTRACT LAW

A fundamental purpose of contract law is protecting the expectations of contracting parties. Because our society views utility-increasing exchanges between consenting parties as something well worth promoting, contract law encourages such relationships by giving parties a predictable basis for relying upon and enforcing bargains. Expectations constitute, of course, the core of these relationships; whenever two parties exchange promised performances, the manifested commitments excite reciprocal expectations. If one side's expectation is disappointed, contract law entitles the aggrieved party to respond in a way that, at least in theory, restores that party to the position he or she


expected to occupy as a result of full performance of both sides’ contractual commitments.

Yet the protection afforded by contract law to disappointed expectations is not unlimited. Not all promises are or should be enforceable; accordingly, much of contract law is concerned with establishing the boundary between enforceable promises and promises that have no remedy if not performed or otherwise discharged. Stated otherwise, much of contract law explains whether it is reasonable or unreasonable for a promisee to expect the promisor to perform his or her promise. Some of the more prominent features of contract law where the reasonableness of expectations is the controlling concept are discussed in the following subsections.

A. Remedies

Perhaps the most obvious role expectations play in the law of contract is defining the remedy to which a party aggrieved by another’s breach is entitled. The formula taught in first-year contracts courses and applied in countless decisions puts the aggrieved promisee in the position he or she would have occupied if the promise had been performed. Compensating an aggrieved party for disappointed expectation ordinarily produces a damage recovery that is larger, and perhaps much larger, than what reimbursing the promisee’s reliance would require. Likewise, protecting the promisee by requiring the breaching party to disgorge benefits received under a restitution analysis would almost always produce a smaller recovery for the victim of a breach. By allowing aggrieved promisees to recover the broadest of the measures, contract law encourages wealth-producing transactions and provides a strong incentive for productive reliance on the commitments of others. Indeed, in a complex credit-oriented economy such as ours, protecting expectation is essential if investment capital is to be channeled toward wealth-producing activities.

Expectation, relative to reliance and restitution, is the broadest measure of recovery for breach of contract, but most of the remaining principles of contract remedies have the effect of limiting, rather than expanding, the obligation of the breaching party. These principles stand, in effect, for a set of rules that explain when an aggrieved party’s expectations are unreasonable

10. See id. §347 (articulating the expectation theory).
11. See Central Trust Co. v. Chicago Auditorium Ass’n, 240 U.S. 581, 591 (1916) (providing that “[c]ommercial credits are, to a large extent, based upon the reasonable expectation that pending contracts of acknowledged validity will be performed in due course”).
12. See also E. Allan Farnsworth, Contracts 871-946 (2d ed. 1990) (hereinafter Farnsworth Treatise); E. Allan Farnsworth, Legal Remedies for Breach of Contract, 70 Colum. L. Rev. 1145 (1970).
and therefore undeserving of protection. For example, the rule of Hadley v. Baxendale\textsuperscript{13} provides that the aggrieved party can recover only those consequential damages which naturally arise from the breach and which were foreseeable at the time of contracting. Under this rule, it is unreasonable to expect to recover consequential damages that were unforeseeable at the time of contracting. To state it otherwise, one cannot reasonably expect to recover damages that the other party could not know to guard against; to allow a greater recovery would risk placing a potentially crushing burden on the breaching party, a risk which would deter beneficial entrepreneurial activity.

To take another example, it is well settled that one cannot recover damages that could have been reasonably avoided. It is, to state the proposition otherwise, unreasonable to expect to recover damages that one could easily avoid with reasonable efforts. The same point can be made with respect to the rules governing whether an aggrieved promisee's expectation recovery should be measured by reference to the cost of finishing the uncompleted performance or the net economic loss occasioned by the promisor's breach. One cannot have a reasonable expectation of recovering the cost to finish an uncompleted performance if the diminution in value from the shortfall in completion is less than the cost of completion. But the answer changes if the promisee contracted for a specific outcome—even an economically inefficient one—in circumstances where the promisor knew or had reason to know of the promisee's expectation; in such an instance, even an economically detrimental expectation can be reasonable.

To summarize, the package of rules defining the breaching party's contract liability essentially describes what the aggrieved party can reasonably expect to recover on account of the promisor's breach.

\textit{B. Contract Formation and Validation}

Contract law also invokes reasonable expectations when determining whether a contract has been formed. Under classical bargain theory, contract formation requires a manifestation of mutual assent and consideration.\textsuperscript{14} To manifest mutual assent to a bargain, each party must make a promise; the beginning or rendering of a performance can be the equivalent of a promise if the beginning or rendering is conduct manifesting assent or if it is what the other party is seeking.\textsuperscript{15} Moreover, "promise" is defined as "a manifestation of intention to act or refrain from acting in a specified way, so made as to

\textsuperscript{13} 156 Eng. Rep. 145 (Ex. 1854).
\textsuperscript{14} See \textit{Restatement (Second) of Contracts} § 17 (1981).
\textsuperscript{15} See \textit{id.}, §§ 18, 19.
justify a promisee in understanding that a commitment has been made. Thus, when reduced to its essential ingredients, contract formation involves at least one promise and one promisee who has a reasonable expectation that the promise will be performed.

A depression-era case provides a useful illustration. In *In re Home Protection Building & Loan Ass’n Appeal of Harris*, appellant undertook to perform accounting services for a building and loan association from 1933 through 1936. He billed the association periodically, and payment was made by crediting the amount of each bill to a mortgage given by appellant to the association. When the association was liquidated by the state Secretary of Banking, the Secretary refused to compensate appellant, claiming that no express contract of employment existed. In finding an “implied contract” based on the conduct of the parties, the court explained that

[a] promise to pay the reasonable value of the service is implied where one performs for another, with the other’s knowledge, a useful service of a character that is usually charged for, and the latter expresses no dissent or avails himself of the service. A promise to pay for services can, however, only be implied when they are rendered in such circumstances as authorized the party performing to entertain a reasonable expectation of their payment by the party benefited.

There is nothing controversial about the idea that contract formation presupposes the parties’ mutual and reasonable expectations of being bound to each other. The cases tend to involve situations where a misunderstanding arises between the parties as to what their manifestations mean, or where one party does not intend legal consequences but either knows or has reason to know that the other party expects a binding relationship in the circumstances.

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16. *Id.*, § 2.
17. The use of older cases throughout this article to illustrate these ideas is deliberate. It is against the background of these cases that the early contracts scholars would have formed their views about contracts jurisprudence. See infra notes 39-41 and accompanying text.
19. *Id.* at 757 (emphasis added).
21. This limitation fits under the umbrella of Restatement (Second) of Contracts § 20; the most common illustrations involve the joker being bound to his or her word in circumstances where the other side had no knowledge or reason to know that the promisor was
In either situation, the question is what the parties understand or have reason to understand in the circumstances. Thus, the promisee who is aware the promisor is bluffing cannot reasonably expect the promisor to perform; but when the promisee is unaware of the "joke" and the promisor should reasonably know of the promissee's lack of knowledge, the promisor will be held to his or her word.

Even if the parties manifest mutual assent to be bound, a contract will not be enforced absent consideration or the presence of a recognized substitute. The consideration doctrine, although something of an historical accident, works as a proxy for societal norms that separate enforceable (typically, bargained-for exchanges) from non-enforceable agreements (e.g., promises to make future gifts, promises given in exchange for a pre-existing duty, promises to forbear asserting invalid claims). Although consideration is most often understood as a rule that distinguishes the enforceable agreement from the unenforceable one, it is appropriate to view it as furthering the unarticulated purpose of promoting reasonable expectations. Under the prevailing societal norms that the consideration doctrine promotes, one cannot reasonably expect to enforce another's promise if nothing of value is traded. Thus, if A convinces B to promise something of value in return for A's promise to forbear from doing something A had no legal right to do or to perform an act that A was already obligated to do, A should not reasonably expect to be able to enforce B's valuable promise.

When the doctrine of consideration is invoked either by a party in argument or by a court as the basis for a decision, the role that reasonable expectations plays is not typically explained or articulated. Reasonable expectations have played a more obvious role in the development of an alternative kind of contract which is enforceable without consideration. Under the doctrine of promissory estoppel, a promise is enforceable in the absence of a bargained-for exchange if the promisor should reasonably expect that the promise will induce the promisee's reliance. What distinguishes a contract enforceable by promissory estoppel from the garden-variety bilateral contract

joking, but the joker knew or had reason to know that the promisee would understand the words to be language of commitment.

22. That the consideration substitute—detrimental reliance—is a theory grounded in reasonable expectations shows, in and of itself, that the consideration doctrine has a direct, even if unarticulated, relationship to reasonable expectations.

23. See RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981) ("A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.").
is that the former has no agreement, no bargained-for exchange, no consideration, and only one promise instead of two. Yet, when a promise is enforceable under promissory estoppel, reasonable expectations must exist on both sides of the transaction, even if a promise exists on only one. The promisee relies on the promise because the promisee reasonably expects the promisor to fulfill the promise; the promisor is bound because he either reasonably expects or should reasonably expect the promisee to rely on the promise. Although the doctrine of promissory estoppel does not seem particularly radical from the perspective of the end of the twentieth century, historians may judge the emergence of the doctrine as the most significant contract law development of the last one hundred years, and subsequent generations may mark the advent of promissory estoppel as the beginning of the end for the centuries-old doctrine of consideration.

Whatever course this evolution takes, it is already apparent that reasonable expectations are at the core of promissory estoppel. Promissory estoppel originated as a response to a perceived deficiency in the way contract law’s bargain theory treated promises for future gifts. Under the rule that a bare promise to make a future gift was unenforceable for lack of consideration, the recipient of the promise was in a particularly difficult spot. Because the promise was not an offer seeking something in exchange, the promisee could not give an acceptance that would make the promise binding or prevent its revocation. In several early twentieth century cases involving charitable subscriptions,24 the promise of a gift was deemed binding by virtue of the reliance that the promised gift would foreseeably induce on the part of the promisee. Yet judges were uncomfortable enforcing promises in the absence of consideration, and it was therefore common for courts to find consideration somewhere in the transaction, even if the basis for recognizing it was extremely tenuous.25 Embedded in the holdings of these early cases was the promisee’s foreseeable reliance because of a reasonable expectation that the promisor’s promise would be performed. Chief Judge Cardozo recognized this in his celebrated opinion in Allegheny College v. National Chautauqua County Bank of Jamestown,26 where he stated, even as he found consideration for the donor’s promise in an implied promise by the college to set up a memorial fund:27

24. See FARNSWORTH TREATISE, supra note 13, at 93-94.
25. Id. at 94; see, e.g., I. & I. Holding Corp. v. Gainsburg, 12 N.E.2d 532 (N.Y. 1938); Allegheny College v. National Chautauqua County Bank of Jamestown, 159 N.E. 173 (N.Y. 1927).
27. Id. at 176.
There has grown up of recent days a doctrine that a substitute for consideration or an exception to its ordinary requirements can be found in what is styled "a promissory estoppel." Very likely, conceptions of public policy have shaped, more or less subconsciously, the rulings thus made. Judges have been affected by the thought that "defenses of that character" are "breaches of faith toward the public and especially toward those engaged in the same enterprise, and an unwarrantable disappointment of the reasonable expectations of those interested."  

In other words, the essential point of promissory estoppel was that the reasonable expectations of the relying promisee deserved protection when the promisor could foresee (i.e., reasonably expect) such reliance.

Whether a contract is formed by bargain or reliance, the reasonable expectations of the parties are fundamental to the creation of a contractual obligation. Indeed, it is apparent that the promissory estoppel doctrine emerged in response to the bargain theory's inability to prevent the disappointment of a promisee's reasonable expectations in some circumstances.

C. Modification of Agreements

The issue of contract modification is, in some respects, simply one facet of contract formation. To modify or rescind an existing contract, the parties must have mutual assent to do so, or one party must reasonably rely on the

28. Id. at 175 (emphasis added). The reasonable expectations underpinning for promissory estoppel was reiterated in other New York decisions. In Matter of First M.E. Church of Mount Vernon v. Estate of Howard, 233 N.Y.S. 451 (N.Y. Sup. Ct. 1929), aff'd, 250 N.Y.S. 906 (N.Y. App. Div. 1931), the court stated: "The Allegheny College case indicates the growth of the judicial process wherein the law is made to conform to the justice of the case, and wherein the law enforces the reasonable expectations arising out of conduct." Id. at 455 (emphasis added). See also Barnes v. Perine, 12 N.Y. 18, 24 (1854), wherein the court made the same point:

The objection of want of consideration for promises [of charitable subscriptions] has not always been regarded with favor; and judges, considering defences of that character as breaches of faith towards the public, and especially towards those engaged in the same enterprise, and an unwarrantable disappointment of the reasonable expectations of those interested, have been willing, nay apparently anxious, to discover a consideration which would uphold the undertaking as a valid contract.

12 N.Y. at 24 (emphasis added).
other's promise of a modification or rescission. Under bargain theory, the consideration requirement must also be met. Much like contract formation, situations arose where the requirements of a contract to modify were not met but the values of promoting fairness and preventing unfair surprise called for recognizing the validity of the attempted modification. Like the contract formation rules, the law in the area of modification of agreements has also been influenced by reasonable expectations.

This is particularly evident in those cases where the parties altered a contract in response to unforeseen or unexpected conditions and the technical requirements of the consideration doctrine were not met. William Lindeke Land Co. v. Kalman, a 1934 Minnesota Supreme Court decision, is illustrative. The lessee, like many tenants during the depression, was losing money in its operation of several eating establishments and faced the need to vacate its leased premises unless the lessor would agree to reduce the rent. The lessor agreed to a reduction of rent, but later denied the validity of the modification on the ground that no consideration was received for it. In finding the modification to be enforceable, the court stretched the consideration doctrine to prevent a finding of invalidity, holding that a good faith modification of a contract in response to unforeseen, substantially different circumstances was enforceable. In rejecting strict application of the consideration doctrine in such circumstances, the court described consideration "as a medieval doctrine" and referred to the no-settlement-without-consideration rule as one "responsible for the greater part of the objectionable applications of the doctrine of consideration, whereby the reasonable expectations of business men have been disappointed."

D. Contract Interpretation and Scope of Obligations

Reasonable expectations have long played a decisive role in contract interpretation. The principles approved by the court in Terrell v. Alexandria Auto Co. are representative of judicial sentiment:

29. The promise of rescission is functionally the equivalent of a promise to release the other party from his or her contract duties. This idea is also closely connected to the doctrines of waiver and estoppel.
30. 252 N.W. 650 (Minn. 1934).
31. Id. at 613 (emphasis added) (quoting James Barr Ames, Two Theories of Consideration, 12 Harv. L. Rev 515, 524-525). See also Watkins & Son v. Carrig, 21 A.2d 591 (N.Y. 1941) ("[c]hanges to meet changes in circumstances and conditions should be valid if the law is to carry out its function and service by rules conformable with reasonable practices and understandings in matters of business and commerce.").
32. 125 So. 757 (La. App. 1930).
In interpreting a contract not specific in its wording, it is necessary to take into consideration the custom of the place and the usual and customary manner of fulfilling like contracts in arriving at what was the reasonable expectation of the parties to the contract at the time it was made.\textsuperscript{33}

Implicit in the foregoing statement is the observation that a promisee is not entitled to receive whatever performance he or she subjectively desires; what the promisor reasonably expected must be given some account. Furthermore, the Anglo-American system of contract law sorts out disputes over the scope of contractual obligations by measuring rights and duties in predominantly objective terms: the scope of an obligation is measured not by what the speaker subjectively intends, but by what the speaker apparently manifests. Thus, when A speaks to B, the words A uses are given the meaning that B could reasonably understand the words to mean in the circumstances in which they were uttered.\textsuperscript{34} The rubric of plain meaning interpretation would seem to undercut this framework, but the essence of plain meaning is that the person to whom words are manifested should reasonably understand the words in accordance with their plain meaning because attaching any other meaning to them is unreasonable.\textsuperscript{35} Whatever significance one ultimately gives plain meaning,\textsuperscript{36} the fact remains that the predominantly objective system of contract law protects the reasonable expectations of contracting parties, even if there is some disagreement in the cases over what rules should be applied to determine what a promisee might reasonably expect in any particular set of circumstances.\textsuperscript{37}

These principles were recognized and applied by Judge Cardozo in \textit{Bird v. St. Paul Fire & Marine Insurance},\textsuperscript{38} the famous insurance causation case decided in 1918. The question in \textit{Bird} was whether a policy of fire insurance covered damage to a vessel, which was located about 1,000 feet away from a

\textsuperscript{33} \textit{Id.} at 758.


\textsuperscript{35} \textit{Id.} at 166.

\textsuperscript{36} The status of the so-called “plain meaning rule” is a subject of considerable dispute in contract law. See \textit{generally} FARNSWORTH TREATISE, supra note 12, at § 7.12 (providing more detailed discussion on the contract law dispute regarding the “plain meaning rule”).

\textsuperscript{37} See ARTHUR C. CORBIN, \textit{THE LAW OF CONTRACTS} § 1, at 2 (1950) (one-volume edition) (“The law does not attempt the realization of every expectation that has been induced by a promise; the expectation must be a reasonable one. . . . The expectation must be one that most people would have; and the promise must be one that most people would perform.”).

\textsuperscript{38} 120 N.E. 86 (N.Y. 1918).
fire which never reached the vessel, in circumstances where the loss resulted from a concussion accompanying an explosion that resulted from the fire. The case turned on whether the fire, a covered cause, was the "proximate cause" of the loss, and the court held that it was not. In reaching that result, the court framed the issue as one of contract and invoked reasonable expectation as the "guide:"

Our guide is the reasonable expectation and purpose of the ordinary business man when making an ordinary business contract. It is his intention, expressed or fairly to be inferred, that counts. There are times when the law permits us to go far back in tracing events to causes. The inquiry for us is how far the parties to this contract intended us to go. The causes within their contemplation are the only causes that concern us.39

Moreover, Cardozo viewed reasonable expectations as a two-way street; each party was as entitled to assert them as the other. Thus, in an insurance setting, Cardozo thought it as important to consider the reasonable expectations of insurers as it was to examine the expectations held by insureds. In Smith v. Northwestern Fire & Marine Ins. Co.,40 where the insurer sought to deny coverage on account of the insured's alleged breach of a warranty of seaworthiness, Cardozo wrote:

The primary purpose of a voyage policy is insurance of the risk during a voyage then in view. Whatever insurance attaches at the home port is incidental and preliminary. There can be little doubt that the reasonable expectations of the insurer are frustrated if the vessel starts on her voyage without suitable equipment.41

39. Id. at 87 (emphasis added). Cardozo must have been fond of this passage, for he quoted it in later cases. See World Exch. Bank v. Commercial Cas. Ins. Co., 173 N.E. 902 (N.Y. 1930) (citing both Bird and Silverstein); Silverstein v. Metropolitan Life Ins. Co., 171 N.E. 914 (N.Y. 1930). Cardozo also invoked "reasonable expectation" to help explain the meaning of the tort doctrine of proximate cause. See Perry v. Rochester Lime Co., 113 N.E. 529 (N.Y. 1916).

40. 159 N.E. 87 (N.Y. 1927).

41. Id. at 93. In other contexts, courts have used reasonable expectations to delineate the scope of contractual duties. For example, in Daggett & Graves v. Johnson, 49 Vt. 345 (1877), the court explained that a buyer who agreed to pay for milk pans "if satisfied with the pans" could not arbitrarily indicate his dissatisfaction and thereby refuse to pay for the pans. Instead,
The parol evidence rule, which receives more attention below, is a substantive doctrine that can be determinative in cases where the scope of contractual obligations is disputed. If the parties execute a writing and one party claims that a prior or contemporaneous oral statement or writing is part of their overall agreement, the parol evidence rule's machinery is triggered. If the court concludes that the writing sought to be supplemented or contradicted is an integration (either complete or partial), then the rule will be applied for the purpose of determining whether the collateral statement or writing is part of the parties' agreement. Those who have tried to justify the parol evidence rule usually explain its purpose as protecting the integrity of a writing intended by the parties to be a final, and perhaps complete, expression of their agreement. To state this purpose in other words, a party who enters into a complete integration should not reasonably expect to be able to contradict or supplement the writing with evidence of prior or contemporaneous negotiations or statements. Also, a party who enters into a partial integration should not reasonably expect to be able to contradict the writing with such evidence, although consistent supplementation is not outside the zone of reasonable expectation. From the opposite perspective, a party who stands on the writing and seeks the protection of the parol evidence rule will assert a reasonable expectation that the writing should be treated as final and perhaps complete as well.

To summarize, reasonable expectations set the coordinates for the process of identifying the terms of a contract, determining the meaning of disputed or ambiguous terms, and otherwise defining the scope of contractual duties.

E. Rights of Third-Party Beneficiaries

The reasonableness of a third party's expectations is important in determining whether that party has rights as an intended beneficiary of a contract. Although it is not essential that a beneficiary know of the contract

"[h]e must act honestly and in accordance with the reasonable expectation of the seller, as implied from the contract, its subject-matter, and surrounding circumstances." Id. at 348-49. See also Olympia Bottling Works v. Olympia Brewing Co., 107 P. 969 (Or. 1910) (approving Daggett & Graves). In Dunham, Carrigan & Hayden Co. v. Thermoid Rubber Co., 258 P. 663 (Cal. App. 1927), the court explained that a seller under an output contract could not recover damages from a buyer based on the buyer's failure to resell a large volume of tires; "The large volume now claimed essential by [seller] appears from the evidence to have been so far beyond all reasonable expectation at that time that it was never mentioned." Dunham, 258 P. at 665.

42. See infra note 58 and accompanying text.
made for his or her benefit to have a right to recover on it, whether a beneficiary has third-party rights is affected by whether "the beneficiary would be reasonable in relying on the promise as manifesting an intention to confer a right on him." This factor was recognized in *Trustees of the M.E. Protestant Church v. Adams*, an 1870 Oregon case. The court explained that

[t]he rule ordinarily is, that a mere stranger to an executory contract between third persons cannot avail himself of the benefits of its provisions, although named therein as a beneficiary; but where the contract is of such a nature and has been so far acted upon as to change the condition in life of the stranger, and to raise reasonable expectations in him, grounded upon the contract, it constitutes an exception to the general rule.

Thus, whether a party not in privity with the contracting parties has a reasonable expectation of receiving a benefit under the contract can affect whether the party has rights as a third-party beneficiary.

**F. Policing Doctrines**

Protecting expectations is a fundamental objective of contract law, but promoting fairness is no less important. Although the strength of judicial concern for fairness has varied across generations, the status-based, centuries-old capacity rules for infants, the infirm, and others provide ancient evidence of judicial regulation of contractual exchanges for fairness. In the late twentieth century, many doctrines serve a policing function, including the doctrines of duress, fraud, concealment, misrepresentation, unconscionability, mistake, impracticability, and supervening frustration. Professor Farnsworth's scholarship labels these doctrines as "policing doctrines," that is, doctrines pursuant to which courts "police" the fairness of contracts.
To some extent, the twin purposes of protecting expectations and promoting fairness conflate. When a court declares that an expectation asserted by a promisee is outside the zone of reasonableness, the application of the relevant contract law principle carries with it a corollary assertion: it would be unfair to the promisor if the promisee's expectation was protected. To illustrate the point, consequential damages outside the range of foreseeability are not part of a reasonable expectation that contract law will protect; yet implicit in that principle is a normative judgment that imposing unforeseen, and perhaps crushing, consequential damages on a breaching party would be unfair.

The policing doctrines, as applied by courts, regulate the allocation of risks in contractual exchanges and protect parties from conduct or substantive outcomes offensive to a sense of justice grounded in judicially-recognized collective norms. Because standardization has put pressure on the classical contract paradigm, the policing doctrines embraced by contract law have been put to frequent use when consumers have contested the implications of text in standardized forms, including insurance policies. This particular context is, of course, where Judge Keeton offered his insights.

II. JUDGE KEETON'S DOCTRINE OF REASONABLE EXPECTATIONS

In the first part of his 1970 article, then-Professor Keeton identified "two broad principles [that] account for... a high percentage of what might otherwise appear to be deviant decisions" in insurance jurisprudence. The first involved judicial disallowance of unconscionable advantage: "An insurer will not be permitted an unconscionable advantage in an insurance transaction even though the policyholder or other person whose interests are affected has manifested fully informed consent."49

In the fashion of contract law's substantive unconscionability doctrine, Keeton's first principle noted those cases in which the substantive unfairness of insurance contracts was regulated and observed that the principle operated without regard to the insured's expectations. In other words, a finding of unconscionability would not depend on the insured's expectation; the insured's expectation of something different from what the insurer promised was not a predicate to the application of the unconscionability principle. Even if the insured expected restrictive coverage by virtue of an accurate understanding of

49. Id. at 963.
clear language negating coverage, the plain language of the policy would not be enforced if to do so would give the insurer an "unconscionable advantage." In Keeton’s assessment,

...[i]his principle explains much that is called waiver or estoppel in insurance law, in circumstances involving neither voluntary relinquishment nor detrimental reliance — the essence of waiver and estoppel respectively. It also accounts for most of the distinctive controls over defenses based on warranty, representation or concealment... In addition, the principle underlies the formulation of the precise terms of choice imposed upon insurers in the most common applications of the doctrine of election...51

The second principle, which Keeton called “honoring reasonable expectations,” was articulated in the now-famous and oft-repeated formulation: “The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations.”52 In elaboration upon the principle, Keeton noted the historic inequality in bargaining power between insurer and insured, the adhesive nature of the contractual relationship, the absence of choice among standardized forms, and inert statutory and regulatory oversight. Though Keeton pointed out that “judicial regulation of contracts of adhesion... remains appropriate,” he concluded that embedded in the array of regulatory doctrines was “a principle broader than the separate bodies of doctrine it has sustained.”53

As a statement of principle, the doctrine of reasonable expectations articulated by Keeton overlapped with many other rules. Indeed, he said as much in the introduction to his article; he specifically observed that the principle purported to synthesize what was occurring in many insurance law cases.54 In particular, he acknowledged that the reasonable expectations principle overlapped in significant ways with the unconscionability principle. Because insureds do not expect insurers to seek unconscionable advantages, any effort by the insurer to constrain or deny coverage in substantively unfair ways is inconsistent with the insured’s reasonable expectations. By the same

51. Keeton, Part One, supra note 3, at 963-64.
52. Id. at 967.
53. Id.
54. See id. at 961-62.
token, the insured does not expect fine-print, or even some bold-print, exclusions or definitions that significantly constrain coverage. Thus, in many situations, pro-insured results could be obtained by resort to either the unconscionability or the reasonable expectations principle.

What seemed new about reasonable expectations, as articulated by Keeton, was its transcendence of contra proferentem. The widely recognized principle that contracts, when ambiguous, are to be construed against the drafter depended, by its own terms, on the existence of an ambiguity. The reasonable expectations principle, as articulated by Keeton, had no such limitation; on the contrary, the essential point was that the insured's reasonable expectations could be enforced even in the face of unambiguous policy language. This particular aspect of the Keeton formulation was important for at least two reasons.

First, when the Keeton formulation stated that plain, unambiguous text could be trumped by an insured's expectations, the formulation created an alarming challenge to insurers' efforts to draft and achieve predictability. It was not the case, of course, that insurers had never before confronted judicial regulation through waiver, estoppel, election, and other principles, all of which frequently did excuse the insured from the full consequences of unambiguous text. Each situation, however, tended to turn on the facts of the specific case, and while some statements of principle emerged from these cases (e.g., an insurer that delays investigating a claim might be estopped to deny the claim's validity), these principles would not operate to change the insurer's obligations for an entire category of cases. In fact, these principles created a right in variance with coverage only if the facts of the specific transaction seemed to justify it. The Keeton formulation went beyond these other kinds of regulation to which insurers had comfortably, if not willingly, adapted.

Keeton's formulation, unlike most other kinds of judicial regulation, seemed to present a frontal challenge to insurers' ability to control how they separated risks and priced policies. An insurance company's ability to calculate premiums depends on its ability to measure risk with some precision, even as it takes advantage of the laws of large numbers to facilitate distribution of the losses associated with random events. The delineation of coverage in the contract is intended, of course, to correlate closely with the risks the insurer is willing to assume in exchange for the insured's payment of a premium. To the extent the scope of the risk transferred in the insurance contract depends on the scope of the insured's expectation, the insurer confronts a variable in its pricing strategy that is difficult to measure, at least as unpredictable as jury verdicts or judicial findings, and hard to control. From the insurance industry's perspective, any insurer that succeeds in drafting clear, unambiguous text ought
to enjoy the benefit of that text, notwithstanding a different understanding or expectation held by the insured (assuming that the insurer or its agent did nothing to promote that different understanding and that the text is not unconscionable). The Keeton doctrine, however, challenged this assumption; from the insurer’s perspective, the doctrine put the insurer’s reasonable expectation at risk.

Second, implicit in the observation that the Keeton principle was stronger than *contra proferentem* was the notion that something beyond contract law was being invoked to create rights at variance with policy provisions. Keeton described the principle as one that synthesized many “doctrinal theories,” including waiver, estoppel, *contra proferentem*, reformation, rescission, modification rules in contract, and agency.55 Because the policyholder’s right was not recognized by the text of the contract, the unstated implication was that contract was not the source of the right. Treating the doctrine of reasonable expectations as extracontractual also coincided with the argument that an insurance policy, because of the “special relationship” at its core, is something more than a contract and should be viewed as a product or some kind of chattel or quasi-chattel.56

Ironically, at the same time Keeton’s reasonable expectation principle seemed new and dramatic, it also seemed to restate existing law. The cases Keeton cited and discussed did contain what he described as “compelling currents of principle,”57 even as they applied a wide variety of doctrinal theories. Yet the “compelling currents” he observed were also a shared current, in that running through the cases was a single shared principle. This singularity devolved from the fact that the courts in these cases were answering one common question:

Under what circumstances can unambiguous language in an insurance policy be disregarded in favor of an expectation of the insured that is inconsistent with or contradicted by the language of the policy?

55. See id. at 962.


57. Keeton, Part One, supra note 3, at 961.
The common answer Keeton saw in the cases was what he articulated as his second principle, which can be rephrased so that it answers the common question directly:

Unambiguous language in an insurance policy is disregarded when the policyholder has objectively reasonable expectations inconsistent with the policy language.

With respect to the common question being asked and answered by courts and by Judge Keeton, the contracts scholar would observe that the common question sounds very much like a very ordinary parol evidence rule question in contract law. An insurance policy is an integrated agreement; barring extraordinary circumstances, it is almost certainly a completely integrated agreement. The parol evidence rule does not forbid admitting evidence for the purpose of determining meaning, but the absence of ambiguity means no basis exists for invoking the rules of contract interpretation. The insured who has adhered to the form now wants to contradict the integration with different terms or to supplement the integration with additional consistent terms. These different or additional terms are, of course, those that are alleged to reflect the insured's reasonable expectations. If an ambiguity existed, there would be no need to worry about the parol evidence rule because any evidence could be

58. Keeton mentioned the parol evidence rule as something an insurer might assert as a defensive strategy when resisting a claim for a right at variance with policy language, but did not discuss it. See id. at 962. An early writer who saw the connection was Professor George Goble, who wrote in 1937:

A problem intensified by the wide use of standardized contracts is: To what extent should oral understandings inconsistent with a written contract be allowed to prevail? The parol evidence rule, which renders invalid oral agreements prior to or contemporaneous with a written agreement, seems entirely reasonable where the written document is the result of mutual bargain. But where the terms of the document are dictated by business practice or statute, the rule is not so just in application. This is because such documents are seldom read, or if read seldom understood by the public, and, therefore, there is a complete absence of assent to its provisions. The result is that the courts have frequently come to the rescue of the helpless or misled citizen, and have given effect to oral statements made by him or to him in his behalf, at the time he accepted the document, sometimes even in spite of an express provision that printed terms of the contract could not be waived or modified. This is especially true in contracts of insurance.

offered for the purpose of interpretation; by the same token, if an ambiguity existed, there would be no need to invoke the doctrine of reasonable expectations which refers to enforing objectively reasonable expectations despite unambiguous language to the contrary.

Even granting some disagreement among contracts scholars and courts about how parol evidence rule issues should be resolved, contract law provides an answer to the question posed. One formulation of contract law's answer is set forth in section 211 of the Restatement (Second) of Contracts, which addresses the parol evidence rule question when standardized forms are involved. Although this section was already in draft when Keeton's article was published in 1970 and during the time he must have been ruminating about the ideas that would become his famous article, it is interesting that the article does not acknowledge or refer to the deliberations of the American Law Institute. Section 211(1) states that the standardized form to which the consumer assents is an integration with respect to the terms included in the writing, assuming (as is likely to be the case) that the consumer has reason to believe that "like writings are regularly used to embody terms of agreements of the same type." Section 211(2) articulates a default premise: the writing is to be interpreted as treating all adherents alike and "without regard to their knowledge or understanding of the standard terms of the writing." As comment e to section 211 explains, "courts in construing and applying a standardized contract seek to effectuate the reasonable expectations of the average member of the public who accepts it." Thus, section 211(2) endorses an objective standard. Indeed, the text of comment e bears a striking resemblance to Keeton's reasonable expectation principle. This is probably not accidental; Keeton's article is cited in the Reporter's Note to the comment. Section 211(3) completes the framework by describing when terms are excluded from the contract: where the drafter has "reason to believe" that the adhered party would not have assented to the form "if he knew that the writing contained a particular term" that term is excluded from the agreement. As Professor Henderson has explained in more detail, § 211(3) treats the drafter's expectations as controlling; a drafter who does not expect (i.e., have reason to believe) that the adhered party would object does not lose the benefit of the term in question, even if the adhered party claims that his or her expectations are being disappointed. Under section 211(3), even the adhered party's reasonable expectations do not matter if the drafter did not have "reason to believe" that the adhered party would object.

59. See Henderson, supra note 6, at 848-53.
There are many nuances in section 211, as Professor Henderson's contribution to this symposium makes clear. If comment e is telling us that section 211(2) is, in effect, the Keeton doctrine of reasonable expectations, then sections 211(2) and 211(3) can be synthesized as follows: terms in the writing are to be interpreted in a manner consistent with the objectively reasonable expectations of the adhered party (see section 211(2)), except that terms in the writing will be excluded (and therefore not interpreted at all) if the drafter has reason to believe the adhered party would not manifest assent if he or she knew the particular terms were included in the writing (see section 211(3)).

Section 211 is controversial, and the content of the rule is being revisited and debated in the discussions of the proposed revisions of Articles 2, 2A, and 2B of the Uniform Commercial Code. But the important point for this discussion is that section 211, a contract law rule, answers the right question—under what circumstances unambiguous language in an insurance policy is trumped by an expectation of the insured that is inconsistent with or contradicted by the policy's language. Moreover, the answer given in section 211 applies to much more than insurance policies; section 211's answer is meant to be given whenever the same question is asked with respect to any standardized form. Indeed, there is no obvious reason why the question ought to have a different answer with respect to standardized insurance policies than with respect to standardized forms used in any other industry where standardized contracts with consumers are routine. If this point is granted, the common question addressed by Keeton and by courts in the insurance cases he discussed should be rephrased:

Under what circumstances can unambiguous language in a standardized form be disregarded in favor of an expectation of the adhering party that is inconsistent with or contradicted by the language of the form?

This rephrased common question has challenged contracts scholars for decades, and by 1970 it had received attention from some of the giants in that field. Some of this history is discussed in the next section.

60. See id.

III. STANDARDIZED FORMS AND REASONABLE EXPECTATIONS

The reasons for the widespread use of standardized forms in consumer transactions in the twentieth century do not need extended discussion here. Suffice it to say that the advantages of standardization are considerable. Mass production reduces per-unit costs, which benefits both parties to the transaction. When products are standardized, the number of alternative products is reduced, which tends to simplify the consumer’s selection process and make it easier for the consumer to compare alternatives based on the features of the product offered. With respect to standardized contracts, the cost advantages are much like those with standardized products, except that the advantage of cost savings produced by the elimination of negotiation over terms is counterbalanced by the potential for unfairness in circumstances where the drafter of the form imposes terms that the consumer does not expect. Courts have policed this unfairness in particular cases, and legislatures and administrative agencies have promulgated rules to deal with the risks of unfairness in particular kinds of contracts, including insurance policies.\(^6\)

Arguably the most famous of the early explorations of the challenges standardization poses to the principles of classical contract law was Friedreich Kessler’s famous 1943 article in the *Columbia Law Review* titled *Contracts of Adhesion—Some Thoughts About Freedom of Contract.*\(^3\) In the article’s opening paragraph, Kessler observed that contract law had evolved in recent centuries to become “a tool of almost unlimited usefulness and pliability,” giving order and rationality to the market system.\(^4\) He explained:

Rational behavior within the context of our culture is only possible if agreements will be respected. It requires that *reasonable expectations created by promises receive the protection of the law* or else we will suffer the fate of Montesquieu’s Troglodytes, who perished because they did not fulfill their promises. This idea permeates our whole law

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62. See *Restatement (Second) of Contracts* § 211 cmt. c (“The obvious danger of overreaching has resulted in government regulation of insurance policies, bills of lading, retail installment sales, small loans, and other particular kinds of contracts. Regulation sometimes includes administrative review of standard terms, or even prescription of terms.”).

63. Friedreich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 *Colum. L. Rev.* 629 (1943). This article was not cited or referenced in the Keeton article.

64. *Id.* at 629.
of contracts, the doctrines dealing with their formation, performance, impossibility, and damages.\textsuperscript{65}

In the next few pages, he discussed the increased reliance on standardized forms by businesses, the advantages of standardization, and the efforts of courts to protect the weaker party in such exchanges without appearing to modify the rules of classical contract law.\textsuperscript{66} To illustrate his point, Kessler used insurance policies.\textsuperscript{67} He referred to the "remarkable skill" of some courts "in reaching 'just' decisions by construing ambiguous clauses against their author even in cases where there was no ambiguity,"\textsuperscript{68} and how under the guise of interpretation courts "change[d] warranties into misrepresentations."\textsuperscript{69}

Kessler then took up the issue of the consequences of an insurer's delay in acting upon an application, noting that whatever skills courts had acquired in clever interpretations of policy language was useless in dealing with a problem of contract formation.\textsuperscript{70} Contract law, he reasoned, could not impose the duty to act promptly on applications because insurers would simply include language in applications negating any implied promise.\textsuperscript{71} He explained that many courts, however, had found in tort law a duty to act promptly:

Thus the courts pay merely lip service to the dogma that the common law of contracts governs insurance contracts. With the help of the law of torts they nullify those parts of the law of contracts which in the public interest are regarded as inapplicable. . . . This approach enables them to disregard the clause in the application by means of which the company attempted to avoid liability prior to the delivery of the policy.\textsuperscript{72}

Kessler noted that this judicial approach, applied inconsistently in the cases, was criticized for "undermining legal certainty and the stability of the insurance business."\textsuperscript{73} That criticism was not unlike the alarm that greeted the

\textsuperscript{65} Id. (emphasis added).
\textsuperscript{66} See id. at 629-33.
\textsuperscript{67} See id. at 633-36.
\textsuperscript{68} Id. at 633.
\textsuperscript{69} Id.
\textsuperscript{70} See id. at 634.
\textsuperscript{71} See id. at 635 (quoting Carl W. Funk, The Duty of an Insurer to Act Promptly on Applications, 75 U. PA. L. REV. 207, 214 (1927)).
\textsuperscript{72} Id.
\textsuperscript{73} Id. at 635-36.
Keeton formulation of reasonable expectations in some circles. After quoting at length from a 1933 Connecticut case, which identified the reasons that imposing a duty on insurers to act promptly on applications would create instability in the insurance business, Kessler put his finger on the fundamental issue:

This line-up of arguments [in the Connecticut case] brings out clearly the basic issue with which the courts in the insurance cases are confronted. It is: can the unity of the law of contracts be maintained in the face of the increasing use of contracts of adhesion? The few courts which allow recovery in contract and the many which allow recovery in tort feel more or less clearly that insurance contracts are contracts of adhesion, and try to protect the weaker contracting party against the harshness of the common law and against what they think are abuses of freedom of contract. The courts denying recovery, on the other hand, cling to the belief that an application for insurance is not different from any other offer, and they are convinced that efforts to build up by trial and error a dual system of contract law must inevitably undermine the security function of all law, particularly since courts are ill equipped to decide whether and to what extent an insurance contract has compulsory features.

One page later, he identified the engine that drives the results in cases allowing recovery for the policyholder:

The idea implicit in the cases which allow recovery seems very fruitful indeed. In dealing with standardized contracts courts have to determine what the weaker contracting party could legitimately expect by way of services according to the enterpriser's "calling," and to what extent the stronger party disappointed reasonable expectations based on the typical life situation.

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74. See supra notes 3-7 and accompanying text.
76. See Kessler, supra note 63, at 636.
77. Id.
78. Id. at 637 (emphasis added).
In the next two sentences, Kessler anticipated and addressed the argument that the rewriting of contract text in standardized forms is outside the judicial role: he stated that "the judge-made law in the field of constructive conditions is amply proving the opposite." Kessler did not explain this point in detail, and it is one that may not be obvious to those who have forgotten some lessons of contract law. By the beginning of the seventeenth century, English law recognized that a bilateral contract with executory promises on both sides was enforceable. Unless, however, the parties put language in the contract making each party's performance expressly conditional on the other's performance, one party could enforce the other's promise without showing that the party had given or tendered to the other what was promised in the exchange. In the famous eighteenth-century case of *Kingston v. Preston*, Lord Mansfield recognized the inherent dependency of promises exchanged in bilateral contracts and reasoned that the court—not the contract's text, although parties could still draft express conditions if they desired—decides whether the first party's performance is conditional upon the other side's prior performance. The law has since evolved to the point where the following default principle is unquestioned: each party's promise in a bilateral contract is constructively conditioned on the other side's promise, and a material breach of either side's promise will give the other a right to suspend performance, even if the contract does not expressly so provide.

The doctrine of constructive conditions is, of course, one that protects reasonable expectations: in a wholly executory bilateral contract between A and B, A reasonably expects that A will not have to perform if B commits a material breach, and vice versa. Whatever intentions the parties bring to a particular contract, it is an objectively reasonable expectation across all transactions that executory promises in a bilateral contract are dependent. This doctrine rewrites text in the sense that it adds terms to the contract that are simply not there; but no one seriously argues that courts, at least with respect to the doctrine of constructive conditions, should abstain from rewriting text to enable the reasonable expectations of the parties to be protected.

Kessler criticized courts that "prefer to convince themselves and the community that legal certainty and 'sound principles' of contract law should not be sacrificed to dictates of justice or social desirability." Indeed, as the

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79. Id.
81. For a more detailed discussion of *Kingston*, see *Farnsworth Treatise*, supra note 12, at 637.
law of constructive conditions demonstrates, courts have long regulated text in order to achieve justice. Kessler explained the point in this way:

[T]he rules of the common law are flexible enough to enable courts to listen to their sense of justice and to the sense of justice of the community. Just as freedom of contract gives individual contracting parties all the needed leeway for shaping the law of contract according to their needs, the elasticity of the common law, with rule and counter-rule constantly competing, makes it possible for courts to follow the dictates of "social desirability."

As important as Kessler's article was, he was not the first to appreciate the connection between standardized forms and the potential for impairment of the consumer's reasonable expectations. Professor Alan Schwartz has collected and analyzed the contracts and sales articles written by Karl Llewellyn between 1925 and 1940, and Schwartz's research shows that Llewellyn had focused on the link between reasonable expectations and standardization at least two decades before Kessler. In a 1925 article published in the *American Economic Review*, Llewellyn recommended that courts read contracts to contain what the weaker party would expect the contract to contain, and he used the example of insurance contracts to make his point. Specifically, he advocated giving "the insured . . . the protection he might decently believe he was buying, without too close regard to the exceptions of the policy." In so many words, this was the Keeton formulation of the reasonable expectations doctrine: plain language in the policy's exclusionary language should not be applied to eliminate coverage if the insured had a "decent" (i.e., objectively reasonable) understanding of the coverage his premium was purchasing. Llewellyn made

84. Id. at 638.
86. Karl Llewellyn, *The Effect of Legal Institutions Upon Economics*, 15 AM. ECON. REV. 665 (1925). This piece was Llewellyn's first major publication; the article urged reform of commercial law, suggesting that economics and the realities of modern business practices be used guide these reforms. He explicitly credited Roscoe Pound (and some others) as the originators of many of the ideas. See N.E.H. Hull, *Roscoe Pound and Karl Llewellyn: Searching for an American Jurisprudence* 139 (1997).
87. Llewellyn, *supra* note 86, at 673.
88. As Professor Schwartz observes, the proposed revisions to Article 2 of the Uniform Commercial Code adopt what Llewellyn was urging nearly 75 years earlier. Schwartz, *supra* note 85 (manuscript at 54). Proposed UCC 2-206(b) states that "a term in a . . . standard form
the point again in a 1939 book review published in the *Harvard Law Review*, where he argued that "when bargaining is absent in fact," courts should "read into" a form contract the terms "which a sane man might reasonably expect to find on that paper."

The common ground in the writing of Llewellyn, Kessler, and Keeton is striking. In his early sales scholarship, Llewellyn considered many of the same issues with respect to standardized sales contracts that Keeton considered with respect to insurance policies. Llewellyn urged in no uncertain terms that plain text in standardized sales contracts should be given a meaning that a reasonable consumer would expect in the circumstances. Kessler built upon these same points in his *Columbia Law Review* article. Almost fifty years after Llewellyn and approximately twenty-five years after Kessler, Keeton found evidence that courts were reaching exactly that conclusion in the decided insurance cases under a wide range of doctrinal theories. These common insights and shared principles should not surprise us; after all, insurance policies are but one kind of standardized form.

To the important work of Llewellyn and Kessler should be added the insights of Spencer Kimball, another of the great scholars in insurance law. He examined the shared currents of contract law and insurance law in a remarkable study of insurance regulation in Wisconsin, which was published as a book in 1960. Kimball discussed in several passages the protection of the insured's "reasonable expectations" as a regulatory objective. Kimball, utilizing the insights of the early twentieth-century realists, tended to view insurance law in contractarian terms. Building on the jurisprudence of Roscoe Pound, Kimball saw in the *laissez faire* era of the late nineteenth century a formal view

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90. Id. at 704.
92. Id. at 210 ("Underlying the tough taught dogma of contract law, against which the growth of insurance case law must be viewed. . . .").
of contract law in which individuals contracted freely for the objects of their wants. This public policy—contract freedom—meant that contracts "entered into freely and voluntarily shall be held sacred and shall be enforced by the courts of justice." The elevation of contract text over other values was, nevertheless, subject to judicial erosion by courts that "skillfully used the canons of construction to relieve the insured of various stipulations, and resorted often to the doctrine that ambiguity must be resolved against the draftsman of the contract." Interpretive techniques were accompanied by judicial disregard of insureds' nonsatisfaction of conditions to coverage under the reasoning that enforcement of the conditions would result in a forfeiture, which are abhorred in equity. The freedom of contract tradition remained predominant, however, until the twentieth century, and this simply encouraged insurers to draft explicit forms that would exceed the reach of judicial efforts to interpret them. This placed, he reasoned, two public policies in frequent conflict:

There was, first, the pervasive policy of giving effect to the reasonable expectations of contracting parties. Persons who took out insurance expected to obtain protection, and it was the concern of the law to assure them that protection. At the same time, however, it was the policy of the law to preserve the integrity of the [insurance] fund by preventing unwarranted raids on it by persons not entitled to share.

In this context, the securing of reasonable expectations to which Kimball referred was the product of a judicial process through which the literal terms of contractual relationships were adjusted to attain fairness between the contracting parties.

94. KIMBALL, supra note 91, at 210 (quoting Houlton v. Nichol, 67 N.W. 715 (Wis. 1896), in turn quoting Printing, etc., Co. v. Sampson, L.R. 19 Eq. 462).
95. Id. at 211.
96. See id.
97. See id.
98. Id.
99. Essentially the same point was made in another passage in the 1960 text. In explaining how courts regulate insurance, Kimball described one of insurance law's themes as determining who, within a pool of insureds, is entitled to draw from the insurance fund. This required balancing two competing public policies: "the preservation of the integrity of the insurance fund against improper raids by persons not entitled to participate and the satisfaction of the reasonable expectations of the insured." Id. at 7.
Kimball, like Keeton, also appreciated how judicial manipulation of the law of agency could produce results that protected the reasonable expectations of insureds. In discussing the efforts of insurers to circumscribe the authority of their agency force, Kimball noted that courts often found ways to circumvent the limitations and to enable "an agent [to] modify an insurance policy to conform to the needs of the insured." In analyzing an 1861 Wisconsin case where the court held that the contract modification was within the scope of the agent's apparent authority, Kimball explained that "[t]hough the result can be explained by an apparent authority doctrine, that is nothing but a rationalization of the victory of reasonable expectations over the principal's power to define the scope of the agency." In other words, the fairness inherent in protecting reasonable expectations trumped literal language in the contract between insurer and agent purporting to narrow the insurer's responsibility for acts of the agent.

To summarize, Llewellyn in the 1920s, Kessler in the 1940s, and Kimball in the 1960s understood reasonable expectations as more than a strict application of contra proferentem. Each of these scholars represented a school of thought that envisioned contract law in functional terms, where the objectively reasonable expectations of consumers or policyholders could trump unambiguous text that, if read and understood, would defeat those expectations. These scholars were not, however, writing in a vacuum. All of them were familiar with the work of those who proceeded them, and all were reacting in varying degrees to results in decided cases and judicial opinions in those cases. These scholars would have been familiar with the rhetoric of reasonable expectations in contract law and were undoubtedly intimately familiar with the contemporaneous debates over promissory estoppel as an alternative to consideration. They were also familiar with the important contracts and insurance cases of their times. Llewellyn, of course, had the smallest data set, but he would have been aware of Justice Cardozo's opinion in *Bird*, where reasonable expectations were used to set the parameters for causation under an insurance policy. Kessler had the benefit of Llewellyn's thinking plus the cases grappling with the scope of the insurer's duty to act

100. For an early article exploring how the acts of agent could bind the insurer in ways that contradict the language of the insurance policy, see Philo C. Calhoun, *The Liberal Construction of Insurance Contracts*, 1 CONN. B. J. 49 (Jan. 1927).
101. KIMBALL, supra note 91, at 224.
102. Id.
promptly on an application. Kimball was no doubt well familiar with *Gaunt v. John Hancock Mutual Life Insurance Co.*, where Judge Learned Hand declined to enforce literally the language of a conditional binder for life insurance under the reasoning that persons unacquainted with such receipts (i.e., ordinary consumers) would not understand the form in accordance with the narrow reading urged by the insurer. Kimball would have also been familiar with *Lacks v. Fidelity & Casualty Co.*, where the court not only found an airline travel insurance policy ambiguous despite clear text and prominent signage near the vending machine from which the policy was purchased but also paid homage to the fact that the decedent expected coverage and would not have purchased the policy had she been informed at the time of purchase that the policy provided no coverage for the trip on which she would meet her death.

No doubt these scholars also influenced the path of subsequent cases, even if it is impossible to quantify this effect. Two important cases involving reasonable expectations receive special treatment in the next section.

**IV. REASONABLE EXPECTATIONS, INSURANCE, CONTRACT, AND COURTS**

Several important cases invoked the rhetoric of reasonable expectations in the 1960s, but arguably the most notorious of these was the 1961 decision...
of the New Jersey Supreme Court in *Kievit v. Loyal Protection Life Insurance Company*. In *Kievit*, the insured purchased an accident policy providing coverage for loss “resulting directly and independently of all other causes from accidental bodily injuries,” and excluding loss “resulting from or contributed to by any disease or ailment.” The coverage-granting provision was common at the time, but not all policies contained the exclusionary language. One might speculate that the drafters thought the coverage-granting provision, even with its lack of any further exclusion, was clear enough; by its plain language, the policy covered loss due to accident, not loss caused by illness or disease. But courts in a number of cases had to apply the language in multiple causation situations, such as where the accident aggravated a dormant medical condition which, in turn, led to the loss. Insurers lost many of these cases; courts held that the coverage-granting provision articulated a requirement that the accident be the “efficient” or “proximate” cause of the loss, and this led to a finding of coverage in many situations even though a medical condition was operative to some extent at the time of the loss. To counter this trend, some insurers added exclusionary language, like that found in the policy at issue in *Kievit*, which purported to eliminate coverage as long as a medical condition or illness even “contributed” to the loss.

In *Kievit*, the insured’s disability was caused in part by Parkinson’s disease, which developed at the same time the insured’s accident occurred. The court concluded that the insured’s disability was covered, even though the policy’s language, applied literally, would have eliminated coverage. The court explained:

> When members of the public purchase policies of insurance they are entitled to the broad measure of protection necessary to fulfill their reasonable expectations. They should not be subjected to technical encumbrances or to hidden pitfalls and their policies should be construed liberally in their favor to the end that coverage is afforded “to the full extent that any fair interpretation will allow.” Francis, J., in *Danek v. Hommer*, 28 N.J.Super. 68, 76, 100 A.2d 198, 202 (App.Div. 1953), affirmed 15 N.J. 573, 105 A.2d 677 (1954). [Citations omitted.] Where particular provisions, if read literally, would largely nullify the insurance, they will be severely restricted so as to enable fair fulfillment of the stated policy objective.

*Kievit*. *Kievit* was decided nine years before Judge Keeton’s article, but one year after Professor Kimball’s book was published.

See Richards [on Insurance], supra, p. 742, where the author notes that the common clause to the effect that the death or disability must result from accident “independently of all other causes” would, if taken literally, be so unreasonable and repugnant to the main purpose of the policy “that the courts construe it very strictly against the insurers, and sometimes really seem to disregard it altogether.”

The first sentence of the passage sounded much like a robust reasonable expectations principle. But because the rest of the passage referred alternately to enforcing reasonable expectations, giving policy language fair interpretations, and construing text strictly against insurers, it was far from clear that this court’s opinion stood apart from other cases where courts found ambiguities where none existed. Moreover, the authorities cited in the passage fell short of endorsing a reasonable expectations principle. The reference to the Richards treatise, which stated that “sometimes” courts “really seem” to disregard plain text when construing language “very strictly” against the insurer, was hardly a ringing embrace of a reasonable expectations principle. Danek did not involve a situation where the court disregarded policy language; instead, the court in Danek utilized traditional interpretation principles to find that the insurer owed the insured a defense under the policy.

Later in the opinion, the Kievit court drew upon an appellate court’s opinion in Mahon v. American Casualty Company,114 which had been decided only three months earlier. In Mahon, the court stated that the judicial role is to interpret the policy’s text in light of the “reasonable expectations” of the insured in purchasing it.115 But in Mahon, there was no indication that text would be disregarded; rather, the court in Mahon seemed to be saying that the policy’s text would be interpreted to further reasonable expectations whenever ambiguities are present.

Near the end of the Kievit opinion, another passage more directly suggested that something beyond contra proferentem was being endorsed by the court. The court explained that it attached

little significance to the presence of the exclusionary clause in view of the primary provision limiting coverage to loss from accidental bodily injuries, directly and independently of all other causes. . . . the court’s goal in construing an accident

113. Id. at 26-27.
115. Id. at 196.
insurance policy is to effectuate the reasonable expectations of the average member of the public who buys it; he may hardly be expected to draw any subtle or legalistic distinctions based on the presence or absence of the exclusionary clause for he pays premiums in the strong belief that if he sustains accidental injury which results (in the commonly accepted sense) in his disability he will be indemnified and not left empty-handed on the company’s assertion that his disability was caused or contributed to by a latent disease or condition of which he was unaware and which did not affect him before the accident.116

By one reading, this passage simply reaffirmed the earlier discussion, stating that the court must interpret the policy language in question to effect the reasonable expectations of the policyholder. Yet the court in the later passage did not claim that the exclusionary language was ambiguous, and the court clearly stated that it attached “little significance to the presence” of the exclusion given the expectations that would be created by the coverage-granting section. If one emphasized this aspect of the passage, *Kievit* could be read as embracing a reasonable expectations principle along the lines of what Keeton would later articulate in his article.

However one reads *Kievit*, the case was at least an important milestone in the evolution of the reasonable expectations principle. But this case, like Judge Keeton’s 1970 article, must be read in a broader context. *Kievit* followed by only one year an even more prominent decision rendered by the New Jersey Supreme Court. In *Henningsen v. Bloomfield Motors, Inc.*,117 plaintiff Mr. Henningsen purchased a new 1955 Plymouth automobile from an authorized Plymouth dealer. The purchase order was a one-page standardized form with text of varied sizes and fonts on the front and back. The seventh paragraph on the back of the form, which contained sixty-five lines of type in ten separate paragraphs, purported to exclude all warranties on behalf the dealer and manufacturer, express or implied, except as set forth in the paragraph. Further, this paragraph limited the manufacturer’s warranty to repairing or replacing any defective parts which failed within ninety days after purchase or until the car had been driven 4,000 miles, whichever occurred first. Although the paragraph did not mention personal injury, under the plain terms of the text the manufacturer had no liability for anything else, including personal injury, resulting from any defect in the vehicle. Ten days after the purchase, something

failed in the steering mechanism while Mrs. Henningsen was driving the vehicle. This caused an accident, Mrs. Henningsen suffered physical injury, and the plaintiffs sued the dealer and the manufacturer for damages on account of her injuries. The defendants denied liability based upon, inter alia, the disclaimer of liability on the back of the purchase order.

In a lengthy opinion, the court canvassed many issues and ultimately affirmed the jury's verdict for the plaintiffs. At one point in the opinion, the court considered whether, assuming there were grounds to charge Mr. Henningsen with awareness of the text of the limitation of liability, it could "be said that an ordinary layman would realize what he was relinquishing in return for what he was being granted."\footnote{118} The court concluded that

only the abandonment of all sense of justice would permit us to hold that, as a matter of law, the phrase "its obligation under this warranty being limited to making good at its factory any part or parts thereof" signifies to an ordinary reasonable person that he is relinquishing any personal injury claim that might flow from the use of a defective automobile.\footnote{119}

In essence, the court reasoned that the limitation of liability was not binding on the buyer because the buyer would not reasonably expect this disclaimer to take away the claims for personal injury, notwithstanding the literal terms of the text. Furthermore, the court implied that the defendants knew or had reason to know that the recipient of the form would not reasonably expect this disclaimer to take away the personal injury claims. The court mentioned that the drafters and presenters of the form could have done more to inform buyers of their intention to disclaim liability for injury claims.\footnote{120} Also, the court cited evidence that Chrysler was aware of the terms of the warranty drafted by the Automobile Manufacturers Association, but that Chrysler did "nothing . . . to stimulate the idea that the intention of the warranty is to exclude personal injury claims."\footnote{121} In short, under the court's reasoning, it would not matter if the buyer were aware of the disclaimer because the buyer would not expect the disclaimer to reach as far as the defendants urged.
But the court's opinion went even farther than that. Because the court also held that the disclaimer was invalid on grounds of public policy, the result would not change if the buyer had read and understood the limitation of liability. The seller could not have obtained a safe harbor by bringing the disclaimer to the buyer's attention and explaining it. In other words, this standardized form was inconsistent with the objectively reasonable expectations of a member of the buying public, and these expectations trumped the clear, unambiguous language of the form that, if applied literally, would negate those expectations. This was, in effect, the reasonable expectations principle articulated by Judge Keeton, albeit in a contract for the sale of goods made pursuant to a standardized form.

Thus, both Kievit and Henningsen stand as cases that favor the consumer's reasonable expectations against unambiguous contract text that, if enforced literally, would negate those expectations. That one case involves an insurance policy and the other a limitation of liability in a contract for the sale of goods does not seem to matter, for the cases have a shared current of principle. The law of contract, apart from whatever insurance law might require, is flexible and pliable enough to embrace the proposition that a consumer's reasonable expectations has the potential to trump unambiguous text. This invites us to view Judge Keeton's discovery in 1970 of a new principle or doctrine in a broader context, as the next and final section explains.

CONCLUSION

Throughout most of the twentieth century, courts and scholars have battled for the soul of contract law. On one side are the formalists or classicists, whose champions are Professor Williston and the first Restatement of Contracts. The formalists care mightily about texts and the four corners of documents. They believe that words often have a plain meaning that exists independently of any sense in which the speaker or writer may intend the words. They insist that a court or a party can discern the meaning of contractual language without asking about the intentions or expectations of the parties. They contend that interpretation is appropriate only if an ambiguity appears on the face of the document, which means that the parties by their own testimony about what they intended or expected cannot create an ambiguity where none exists. Because they feel strongly about the integrity of writings intended as final expressions, they approve of the parol evidence rule. Thus, if a contract appears complete on its face, they would have the parol evidence rule keep out

122. Id. at 95.
123. See supra notes 111-12, 117 and accompanying text.
evidence of inconsistent or additional terms regardless of whether the parties actually intended the document to speak finally or completely to their agreement. In the world of the formalists, an insurer that drafts a clear form should be entitled to rely on that form in setting rates without worrying that a court will disregard the finely tuned, clear language. In this world, Judge Keeton's 1970 article is radical and dangerous. Even if the principles stated in the article are not new to the contract formalist, they are to be reckoned with, given the extraordinary articulateness, cogency, and incisiveness with which Judge Keeton presented his ideas.

The other contestants in the battle for the soul of contract law are the functionalists, who are sometimes also labeled as the progressives, the realists, or the post-classicists. The champions of this side are Professor Corbin and the Restatement (Second) of Contracts. The functionalists care less about the text of contracts, believing it to be most useful as an articulation of the objective manifestations of the contracting parties and as a means to understanding their intentions and expectations. They concede that contracting parties normally intend words in their customary usages, but the more important question to the functionalist is what the parties intend by the words, and, in situations where disputes over meaning arise, what the party who utters or uses a word knows or has reason to know the other party is likely to understand from the party's expression of the word in the context in which it is used. Text does not have inherent meaning, but text means what the drafter or speaker knows or should know the other side will understand those words to mean in context. In negotiated bargains where misunderstandings arise after the parties agree upon a common text, this system protects the expectations of the party who has less knowledge or reason to know what the other side means. Where a form is standardized, the functionalists substitute objectively reasonable expectations for whatever the particular recipient of the form understood, given that the recipient has less reason to know what the drafter means, while the drafter has insights into what the ordinary, reasonable recipient of the form is likely to understand. In the functionalists' world, Judge Keeton's doctrine of reasonable expectations is far from threatening. Indeed, insurance law's doctrine of reasonable expectations simply restates for insurance lawyers what contract law is (or should be) saying to all lawyers.

From this perspective, one of the important contributions of Judge Keeton in his 1970 article was that he took sides in an ongoing battle for the soul of contract law. His article was descriptive when it told us where insurance law, as it stood in 1970, was leaning in this battle. His article was normative to the extent it suggested that insurance law should ally itself with the functionalist view of contract law. Given that the battle for contract law's future is far from
settled, it should not be surprising that courts are presently divided in their receptivity to Judge Keeton's formulation. And, as Professor Henderson describes in more detail, the battle between the formalists and functionalists is particularly intense on the field where proposed revisions of Articles 2, 2A, and 2B of the Uniform Commercial Code are being considered. This means that Judge Keeton's article is not just about insurance law; it speaks to consumers and businesses in any industry where standardized forms are used. Thus, the debate over reasonable expectations is not just an insurance law debate. It is a contract law debate, and the prize to the winner is ownership of a major piece of the soul of contract law.

124. See Henderson supra note 88 at 80-105.