
Article

Coverage Information in Insurance Law

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Introduction	1458
I. Three Types of Coverage Information: Purchaser information, Policy information, and Judicial Information	1466
A. Insurance Law and Purchaser Information	1467
B. Insurance Law and Policy Information	1471
C. Insurance Law and Judicial Information	1476
II. Rationales for Laws and Regulations that Promote the Three Types of Coverage Information	1480
A. Rationales for Promoting Purchaser Information in Insurance Markets	1481
1. Promoting More Efficient Insurance Policies..	1481
2. Promoting Matching Between Policyholders and Policies, and Limiting Adverse Selection .	1484
3. Impacting Policyholder Behavior and Reducing Moral Hazard	1486
B. Rationales for Promoting Policy Information in Insurance Markets	1490
1. Promoting More Efficient Insurance Policies..	1491
2. Promoting More Effective Regulatory Form Review	1492
3. Preventing Unfair Claims Handling	1494
4. Conserving Judicial Resources	1498
C. Rationales for Promoting Judicial Information in Insurance Markets	1499

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1.	Facilitating Insurers' Control of Coverage and Limiting Correlated Risks to Insurers	1499
2.	Reducing the Cost and Risk of Resolving Claims Disputes	1502
III.	Conflicts Between Purchaser Information and Policy Information	1504
A.	The Use of Extrinsic Evidence To Disambiguate Policy Language	1505
B.	Policyholders' Reasonable Expectations of Coverage	1510
C.	Insurance Disclosures, Plain Language, and Policy Simplification	1514
IV.	Conflicts Between Policy Information and Judicial Information	1516
A.	Contra Proferentem Promotes Policy Information While More Specific Default Rules Promote Judicial Information	1517
B.	The Sophisticated Policyholder Exception to Contra Proferentem	1521
	Conclusion	1527

INTRODUCTION

A recent Liberty Mutual advertisement explains: “Your car insurance policy is twenty-two pages long. Did you read every word? Nope. Only lawyers do that. So when you got rear-ended and you needed a tow, your insurance company told you to look at page five on your policy. Did it say, ‘great news, you’re covered’ on page five? No. It said, ‘blah blah, blah blah blah, blah blah.’”¹ The advertisement’s effectiveness lies in its recognition of the obvious: ordinary people do not read their insurance policies when they purchase coverage.² And when an insurer denies

1. See Liberty Mutual, *Insurance TV Commercial – Coverage Compass :30*, YOUTUBE (Oct. 24, 2016), <https://www.youtube.com/watch?v=Ci40Z0osr0E>.

2. See Florencia Marotta-Wurgler, *Does Contract Disclosure Matter?*, 168 J. INSTITUTIONAL & THEORETICAL ECON. 94, 96–97 (2012) (finding that the vast majority of consumers do not read their contracts even when they have access to the contract). This is particularly likely to be true in insurance, as policyholders generally do not receive their insurance policy until after they have purchased or renewed their coverage. See KENNETH S. ABRAHAM & DANIEL SCHWARCZ, *INSURANCE LAW AND REGULATION: CASES AND MATERIALS* 38 (6th ed. 2015).

a claim on the basis of specific policy terms, that language is often indecipherable.³

Despite these facts, a central goal of insurance law and regulation is to clarify insurers' coverage obligations to policyholders.⁴ Thus, the "first rule" of insurance law, *contra proferentem*, directs courts to interpret ambiguities in insurance policies against the drafter in the hope that doing so will induce insurers to draft their insurance policies more clearly.⁵ Similarly, insurance law's mercurial reasonable expectations doctrine is, in most of its various incarnations, intended at least in part to help ensure that policyholders have accurate information about the essential features of their coverage.⁶ State insurance statutes and regulations also aim to clarify coverage information by, for instance, prohibiting deceptive advertising and marketing,⁷ and requiring insurance policies to meet quantitative measures of word and sentence complexity.⁸

3. See, e.g., Michelle Boardman, *Insuring Understanding: The Tested Language Defense*, 95 IOWA L. REV. 1075, 1077 (2010); Christopher C. French, *The Illusion of Insurance Contracts*, 89 TEMP. L. REV. (forthcoming 2017); Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. INS. L.J. 107, 125 (2007).

4. Of course, insurance law is also concerned about the accurate transmission of various other types of information. The most obvious example involves information about policyholders' risk levels, which is promoted by state laws governing insurers' right to rescind coverage on the basis of policyholder misrepresentations. See ABRAHAM & SCHWARCZ, *supra* note 2, at 15–20.

5. See Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 531 (1996); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 120–21 n.147 (1989); Michelle Boardman, *Penalty Default Rules in Insurance Law*, 40 FLA. ST. U. L. REV. 305, 305 (2013).

6. See Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 825 (1990); Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 966–67 (1970); see also Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653, 660 (2013) (noting the structural barriers that otherwise diminish policyholders' abilities to give informed assent); Daniel Schwarcz, *A Products Liability Theory of the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389, 1394–95 (2007) (observing the widespread notion that the reasonable expectations doctrine promotes greater transparency from insurers). To be sure, the reasonable expectations doctrine can also serve non-informational goals, such as leveling the playing field between insurers and policyholders.

7. Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 UCLA L. REV. 394, 414–15 (2014).

8. See NONPERSONAL LINES PROP. AND CAS. INS. POLICY SIMPLIFICATION MODEL REGULATION (NAT'L ASS'N OF INS. COMM'RS 1997), <http://www.naic.org/>

Why is insurance law and regulation so fixated on promoting coverage information despite the fact that so little of this information seems to filter down to ordinary consumers? This question motivates what follows. Despite the centrality of coverage information to insurance law and regulation, the extant literature examines this issue predominantly through the lens of specific doctrines, such as the ambiguity rule or the reasonable expectations doctrine. By contrast, this Article explores how insurance law and regulation as a whole seek to promote coverage information, and what broader efficiency goals this information can and does serve. In taking up this challenge, this Article strives not only to illuminate the broader structure of insurance law and regulation, but also to provide new insights on various thorny doctrinal and regulatory issues.

Towards these ends, this Article distinguishes among three different types of coverage information that insurance law and regulation affirmatively seek to promote: (1) “purchaser information”; (2) “policy information”; and (3) “judicial information.” The first type of coverage information, purchaser information, consists of coverage information that is communicated to policyholders throughout the sale and purchase process. In the context of a typical homeowners insurance policy, for instance, purchaser information might include the fact that the policy protects the designated home and most personal possessions against fire and other perils, excludes damage stemming from floods and earthquakes, includes a five hundred dollar deductible, and covers some potential lawsuits against the homeowner. Purchaser information might be shaped by policyholders’ conversations with insurance agents or friends or exposure to insurers’ marketing materials and advertisements. By contrast, purchaser information does not generally include information in the insurance policy itself because most policyholders do not read their policies at any point prior to finalizing their purchase.

Purchaser information can promote product quality, facilitate informed consumer selection of products, and encourage effective product use. But these latter two benefits are particularly notable in the insurance setting because they allow insurers to use contract design to efficiently counteract the twin insurance evils of moral hazard and adverse selection.⁹ When

store/free/MDL-732.pdf.

9. See Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263, 1283 (2011).

policyholders lack purchaser information, exclusions aimed at counteracting moral hazard simply shift these costs onto policyholders, rather than actually reducing or eliminating the costs of moral hazard.¹⁰ To take a simple example, deductibles obviously cannot influence policyholder behavior and thus limit moral hazard if policyholders are unaware that their coverage includes a deductible or do not know what a deductible means in the first place. Insurers' efforts to combat adverse selection through policy exclusions also rely in part on purchaser information: by excluding difficult to detect and unusual risks, insurance policies can induce policyholders to reveal their high-risk status to insurers and secure appropriately priced additional coverage. When policyholders lack purchaser information, the result of these exclusions is that insurers avoid adverse selection only by denying high-risk purchasers insurance protection for which they would have been willing to pay.

Second, insurance law and regulation aim to improve "policy information," which is information in the insurance policy itself—divorced from any relevant extrinsic evidence or judicial case law—about the scope of coverage that is available for specific types of losses. As the Liberty Mutual advertisement reminds us, remarkably few ordinary consumers read and understand their policies at any point during the purchase and sale process, meaning that policy information does not directly promote purchaser information in many insurance markets.¹¹ Despite this fact, policy information can serve a number of important consumer protection goals by providing coverage information to non-contracting parties, including regulators, lawyers, and market intermediaries. For instance, policy information can facilitate state regulators' review and approval of insurance policy forms, which most states mandate for consumer-oriented insurance coverage.¹² This is because more detailed and specific insurance policies allow insurance regulators to better interrogate whether coverage will be limited in ways that consumers do not expect or that insurers cannot convincingly justify.

10. To be sure, insurers have mechanisms at their disposal other than contract design to attempt to address these phenomena, such as underwriting and experience rating. See KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY* 14–16 (1986).

11. See Abraham, *supra* note 6 ("For virtually all individuals, insurance policies are complex documents with terms they neither read nor understand.").

12. See *infra* Part II.B.2.

Specific and clear policy information also plays an important and generally unappreciated role in limiting the risk that insurers will exploit policyholder ignorance to delay or deny valid insurance claims.¹³ It does so by allowing policyholders—with the help of family, insurance agents, lawyers, or regulators—to independently assess the strength of an insurer’s coverage denial *at the time of that determination*. By contrast, policyholders are effectively shut out of this process if the policy language invoked to justify an insurer’s claims determination reads to the consumer and those from whom she seeks assistance as “blah, blah, blah,” as in the Liberty Mutual commercial. This power of specific and clear policy information to discipline insurers’ claims handling is importantly enhanced by two common rules of insurance law: (1) state regulations requiring insurers to explain coverage denials or reservations by reference to the relevant policy language;¹⁴ and (2) the availability of extra-contractual damages for policyholders whose coverage is delayed or denied by an insurer that does not have a reasonable basis for its actions.¹⁵

The third type of coverage information that insurance law promotes is “judicial information,” which consists of information regarding insurers’ coverage obligations that is ascertainable only after researching judicial opinions resolving coverage disputes. Such judicial information includes both default rules that fill in gaps in insurance policies, as well as judicially crafted tests for applying policy provisions. Examples include the “efficient proximate cause rule” for defining the cause of an insured loss,¹⁶ the “eight corners rule” for determining whether

13. JAY M. FEINMAN, DELAY, DENY, DEFEND: WHY INSURANCE COMPANIES DON’T PAY CLAIMS AND WHAT YOU CAN DO ABOUT IT 202 (2010).

14. See *infra* note 154.

15. See Jay M. Feinman, *The Law of Insurance Claim Practices: Beyond Bad Faith*, 47 TORT TRIAL & INS. PRAC. L.J. 693, 738–39 (2012). In some of her work, Michelle Boardman has acknowledged the potential for unambiguous contract language to limit the risk of unfair claims practices. See Boardman, *supra* note 3, at 1106.

16. Coverage issues may arise in property insurance when more than one peril caused or contributed to the loss, and one of these perils is covered under the policy while the other is excluded. The default “efficient proximate cause” rule dictates that a loss is covered under a policy if the covered peril was the predominant cause of the loss. Erik S. Knutsen, *Confusion About Causation in Insurance: Solutions for Catastrophic Losses*, 61 ALA. L. REV. 957, 971 (2010); Joseph Lavitt, *The Doctrine of Efficient Proximate Cause, The Katrina Disaster, Prosser’s Folly, and the Third Restatement of Torts: Cracking the Conundrum*, 54 LOY. L. REV. 1, 11 (2008).

a liability insurer has a duty to defend a policyholder,¹⁷ and the “manifestation test” for assessing when coverage is triggered under an occurrence-based liability policy.¹⁸ While judicial information is not unique to insurance law, it is unusually common in this domain because of the consistency of policy language across different insurers and policy types.¹⁹ Moreover, unlike ordinary gap-fillers in contract law, which tend to rely on broad standards such as “commercial reasonableness,”²⁰ judicial information in insurance law is often surprisingly specific and detailed.²¹

Of course, the intended audience for judicial information does not include policyholders. Instead, judicial information is directed toward insurers, market intermediaries, lawyers, and judges. This information allows insurers to more accurately price their policies notwithstanding uncertainty in future loss experience, to avoid non-diversifiable legal risk, and to adjust their contractual obligations so that untenable interpretations of policy language have a limited long-term effect on results.²² Meanwhile, it enables lawyers to advise insurers and policyholders regarding coverage issues, and it allows judges to resolve coverage cases more quickly and consistently.

Distinguishing among purchaser information, policy information, and judicial information and clearly identifying the potential market benefits of each form of coverage information

17. Under the “eight corners rule,” a liability insurer’s duty to defend a claim is determined by reviewing the four corners of the plaintiff’s complaint plus the four corners of the policy, without reference to extrinsic matters. See RESTATEMENT OF LIAB. INS. § 13 (AM. LAW INST., Tentative Draft No. 1, 2016).

18. The “manifestation test” requires an injury to occur, or manifest, during the policy period to trigger coverage under an occurrence-based liability policy. See *id.* § 33.

19. Even with the most careful drafting (or, in the case of insurance policies, the use of standardized forms), no contract can fully explain every risk or circumstance that may occur pursuant to an agreement. Default rules tell courts how to fill in gaps or holes created by missing, under-defined, or unclear terms in a contract. Unlike mandatory rules, parties may contract around these rules. See Tom Baker & Kyle D. Logue, *Mandatory Rules and Default Rules in Insurance Contracts*, in RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW 377, 379–83 (Daniel Schwarcz & Peter Siegelman eds., 2015).

20. For various examples, see U.C.C. art. 2 (AM. LAW INST. & UNIF. LAW COMM’N 2002).

21. See Abraham, *supra* note 6, at 665–66; see also Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 610 (1992) (marking on the differing difficulty of learning about laws crafted by the legislature compared to precedents established by courts).

22. See *infra* Part II.C.

not only helps illuminate the underlying structure of insurance law; it also sheds new light on various long-standing disputes in the field, which often require prioritization and trade-offs among the three different types of coverage information. Indeed, in some cases promoting one form of coverage information directly and proportionally undermines another form of coverage information. Appreciating the potential benefits of each type of information can help judges and regulators optimize this tradeoff.

Consider one doctrinal debate involving a conflict between purchaser information and policy information: whether insurers should be allowed to admit extrinsic evidence to clarify ambiguous policy language. Courts generally take into account extrinsic evidence of the parties' intent when interpreting ambiguous contracts. But adopting this approach in the insurance setting may reduce policy information by blunting insurers' incentives to draft their policies clearly; insurers are less likely to incur the costs of revising ambiguous policy language if they can introduce extrinsic evidence in coverage disputes to clarify their intended meaning.

This Article suggests that there are indeed good reasons for courts to resist the ordinary practice of admitting extrinsic evidence to clarify insurance policy language, at least in disputes involving consumer policyholders. Extrinsic evidence may well suggest that an aggrieved policyholder knew, or should have known, at the time of purchase that her policy would not cover the loss at issue, even if the policy language on point is ambiguous. But this fact alone should not be dispositive, because policy information can benefit insurance markets for reasons having nothing to do with purchaser information. For instance, policy information can facilitate regulators' review of policies. By contrast, clarifications conveyed to policyholders orally at the time of purchase cannot promote this regulatory process for the simple reason that regulators conducting form review do not observe this purchaser information. Similarly, specific and clear policy information can facilitate policyholders' capacity to independently assess the legitimacy of coverage delays or denials. By contrast, oral statements conveyed to policyholders at the time of purchase may not serve this function because they are not necessarily easily recalled by policyholders *at the time that a claim is denied* and are not reliably ascertainable by lawyers and other potential coverage advisors. These benefits of policy information are amplified in consumer

insurance settings, where form review is particularly important and the risk of unfair claims denials is heightened. All this suggests that courts should be wary of allowing insurers to clarify the meaning of ambiguous policy language with extrinsic evidence in personal lines disputes.

This Article's framework can also illuminate clashes between policy information and judicial information. For instance, a perennial question in insurance law is whether there should be a "sophisticated policyholder" exception to the ambiguity rule.²³ This Article provides new arguments in favor of such an exception by suggesting that the ambiguity rule results in less robust judicial information than more specific default rules.²⁴ Robust judicial information is key for insurance markets populated by sophisticated policyholders, as it helps counteract the risk that these policyholders will exploit the same unintended or unanticipated ambiguity in policy language. The risk of such correlated claim contestation is heightened when policyholders are sophisticated and capable of making long-term investments in coverage litigation. Although specific default rules tend to undermine policy information, this result is tolerable in insurance markets populated by sophisticated policyholders. Many of the central benefits of policy information—including its role in promoting more effective regulatory form review and its ability to empower policyholders to independently scrutinize claim delays or denials—are simply less applicable or important in insurance markets populated principally by sophisticated policyholders.

This Article proceeds in four parts. Part I disentangles the three different types of coverage information: purchaser information, policy information, and judicial information. It shows how insurance law and regulation foster each type of coverage information. Part II then explores the ways in which each of the three forms of coverage information can potentially promote the efficient operation of insurance markets. Part III applies these concepts to a number of disputes in insurance law and regulation that involve tensions between purchaser information

23. Under this exception, the ambiguity rule is not applied to cases with wealthy, powerful, or otherwise "sophisticated" policyholders. See Jeffrey W. Stempel, *Reassessing the "Sophisticated" Policyholder Defense in Insurance Coverage Litigation*, 42 *DRAKE L. REV.* 807, 832 (1993); see also Hazel Glenn Beh, *Reassessing the Sophisticated Insured Exception*, 39 *TORT TRIAL & INS. PRAC. L.J.* 85, 89 (2003).

24. See *infra* Part III.A.

and policy information. Finally, Part IV uses this Article's framework to examine insurance law disputes that pit policy information against judicial information.²⁵

I. THREE TYPES OF COVERAGE INFORMATION:
PURCHASER INFORMATION, POLICY INFORMATION,
AND JUDICIAL INFORMATION

One important goal of insurance law and regulation is to promote accurate information among consumers, market intermediaries, and insurers themselves about the scope of coverage that is afforded by different types of insurance products. For most types of insurance policies, this is hardly a simple task. Not only are insurance policies themselves immensely complex legal documents, but numerous different parties—including insurance agents and brokers, insurers, regulators, and judges—regularly communicate to actual and prospective policyholders, as well as among themselves, regarding the precise scope of coverage that is afforded by different types of insurance policies.

To better illuminate how insurance law and regulation play a part in the complex series of information flows regarding coverage information, this Part distinguishes among three different types of coverage information. The first form of coverage information is “purchaser information,” which consists of information communicated to policyholders about the terms of coverage at any point during the time period when they are purchasing that coverage. This encompasses the entire sales

25. While Part III focuses on conflicts between purchaser information and policy information, Part IV focuses on conflicts between policy information and judicial information. Omitted from the analysis are doctrinal disputes involving conflicts between purchaser information and judicial information. The explanation for this omission is straightforward: in practice, there are few, if any, conflicts between doctrines that promote these sources of information. One exception may be when judicial information and policy information conflict, and policy information itself influences purchaser information. As described below, this is likely only to be the case in markets involving very sophisticated policyholders. In any event, though, it is not clear that anything is gained analytically by separately considering purchaser information in this setting. Another way in which purchaser information and judicial information may interact is that certain judicially crafted default rules, such as the efficient proximate cause rule, may be designed in part to match policyholders' reasonable expectations of coverage. This approach to crafting default rules may improve purchaser information by making that information more likely to be accurate, in much the same way as the strong form of the reasonable expectations doctrine. *See infra* Part I.

process, including completion of the policy application, delivery of the policy, and payment of the initial premium. Second, insurance law and regulation attempt to promote “policy information,” which is information within the insurance policy itself about the coverage that is available for different losses. For the vast majority of policyholders who do not read and understand their insurance policies at the time of purchase, policy information and purchaser information are generally non-overlapping categories. Third, insurance law directly creates “judicial information,” which consists of information regarding insurers’ coverage obligations that is ascertainable only after researching information outside of the insurance policy, particularly judicial opinions and sources describing or synthesizing these opinions.

A. INSURANCE LAW AND PURCHASER INFORMATION

The most familiar form of coverage information consists of “purchaser information,” which can be defined as information about the general terms of coverage that is communicated to policyholders during the purchase process, either when coverage is first acquired or when it is renewed.²⁶ For the vast majority of policyholders, purchaser information is generally based on information received from insurance agents or brokers, insurers’ marketing, general media sources, and information from family, friends, and colleagues.²⁷ For a small percentage of policyholders, particularly those that are relatively sophisticated commercial enterprises or who are advised by sophisticated brokers, the specific language in the policy may also provide purchaser information.²⁸

Numerous rules in insurance law and regulation are specifically designed to promote accurate and robust purchaser information. For instance, under the doctrine of estoppel, a party to an insurance policy who “makes a promise or representation that can reasonably be expected to induce detrimental reliance by another party to the policy is estopped from denying the promise or representation if the other party does in fact reasonably and detrimentally rely on that promise or representa-

26. See Schwarcz, *supra* note 6, at 1412–19.

27. *Id.*

28. See *supra* note 23 and accompanying text; see also *infra* Part III.A.

tion.²⁹ The paradigmatic case of such estoppel involves a statement of an insurance agent made to the policyholder in the course of the sales process.³⁰ Many courts historically refused to apply estoppel where the agent's statements were being used to expand coverage beyond that provided in the underlying insurance policy, but the recent trend has been to reject this approach.³¹ The doctrine thus promotes purchaser information by inducing insurers and agents to take more care in how they describe policies in the sales process.³²

Another insurance law doctrine that is aimed principally at promoting purchaser information is the so-called "strong" form of the reasonable expectations doctrine, which has been adopted in approximately ten states.³³ This doctrine provides that "[t]he 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."³⁴ It thus allows courts to refuse to honor unambiguous policy terms where doing so would undermine policyholders' reasonable expectations of coverage.³⁵ Courts are rarely explicit about what factors are relevant to determining policyholders' "reasonable expectations of coverage."³⁶ But aside from the insurance policy itself, relevant factors generally include various forms of purchaser information, such as insurers' marketing methods, agents' oral

29. RESTATEMENT OF LIAB. INS. § 6 (AM. LAW INST., Tentative Draft No. 1, 2016).

30. See, e.g., ABRAHAM & SCHWARCZ, *supra* note 2, at 64–65, 74–78.

31. See RESTATEMENT OF LIAB. INS. § 6 (AM. LAW INST., Tentative Draft No. 1, 2016); ABRAHAM & SCHWARCZ, *supra* note 2, at 77–78.

32. See Daniel Schwarcz & Peter Siegelman, *Insurance Agents in the Twenty-First Century: The Problem of Biased Advice*, in RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW, *supra* note 19 at 61.

33. James Fischer, *The Doctrine of Reasonable Expectations Is Indispensable, If We Only Know What For?*, 5 CONN. INS. L.J. 151, 155 (1998). For further discussion of the reasonable expectations doctrine, see generally ROBERT H. JERRY II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW § 25D (5th ed. 2012) (discussing the origins, versions, and development of the reasonable expectations doctrine); Mark C. Rahdert, *Reasonable Expectations Revisited*, 5 CONN. INS. L.J. 107 (1998). For one recent attempt to disentangle the various different streams of the doctrine, see YONG QIANG HAN, POLICYHOLDER'S REASONABLE EXPECTATIONS (2016).

34. Keeton, *supra* note 6, at 967.

35. See Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151, 1153–54 (1981).

36. See Schwarcz, *supra* note 6, at 1428–30.

statements, the product name of the insurance policy, and general knowledge among consumers regarding insurance.³⁷

The strong form of the reasonable expectations doctrine can theoretically promote purchaser information through two different channels. First, the doctrine can promote purchaser information by altering the scope of coverage provided by insurance policies to match the information that is available to policyholders at the time of purchase. This mechanism does not directly impact consumers' purchaser information, but instead increases the accuracy of that information by adjusting the scope of insurance coverage to match this information.³⁸ Second, the doctrine could impact policyholders' purchaser information by inducing insurers and agents to alter the information they convey to policyholders at the time of purchase in order to avoid or limit the application of the doctrine.³⁹ For instance, an insurer might ask a prospective policyholder to initial a specific exclusion that courts had previously suggested reasonable policyholders would not ordinarily expect.

Although both estoppel and the strong reasonable expectations doctrine can thus promote purchaser information, they simultaneously run the risk of undermining policy information. Both doctrines tend to undermine the reliability of policy information by allowing it to be trumped by contrary purchaser information.

Other elements of insurance law may promote purchaser information in ways that do not directly conflict with policy information. For instance, state laws and regulations governing the content of insurance policies can promote purchaser information in a manner that parallels the strong form of the reasonable expectations doctrine without directly undermining policy information.⁴⁰ Depending on the line of coverage, insurance laws in virtually every state prohibit some specific policy terms and mandate others.⁴¹ These rules are sometimes designed to prevent insurance policies from containing surprising

37. *See id.* at 1393–94.

38. Of course, a major challenge with this approach is that it assumes that policyholders have actual and coherent expectations of coverage at the time of purchase, which may not always be true. *See* Jeffrey E. Thomas, *An Interdisciplinary Critique of the Reasonable Expectations Doctrine*, 5 CONN. INS. L.J. 295 (1998) (relying on consumer psychology research to investigate and challenge this assumption).

39. *See* Schwarcz, *supra* note 6, at 1432.

40. *See id.* at 1398–99.

41. *See* ABRAHAM & SCHWARCZ, *supra* note 2, at 142–43.

or unusual terms. Depending on the state and line of coverage, state regulators can also prohibit insurers from using insurance policies that they deem objectionable because they contain terms that are “unfair,” “unreasonable,” “contrary to public policy,” or some combination of these broad standards.⁴² Some have suggested that regulators can and should operationalize these laws to help ensure that insurance policies contain terms that are consistent with policyholders’ reasonable expectations of coverage.⁴³ State laws and regulations that do, in fact, prohibit insurance policies from containing unreasonably surprising or unexpected terms promote purchaser information in a parallel manner to the strong form of the judicial doctrine: they increase the accuracy of purchaser information by requiring insurance policies to provide coverage consistent with that information.

Insurance laws and regulations requiring certain disclosures and prohibiting misleading or deceptive sales practices can also promote purchaser information without interfering with policy information.⁴⁴ Depending on the underlying coverage line and jurisdiction, state laws or regulations require insurers to provide consumers with disclosures at the time of policy issuance describing certain specific features of their coverage.⁴⁵ For instance, a number of insurance regulations mandate that certain forms of disclosure—such as warnings that flood-related losses are not covered by most homeowners policies—be provided to the policyholder prior to purchase or at the time of policy delivery.⁴⁶ Similarly, state laws and regulations both broadly prohibit misleading or deceptive sales and marketing practices, and also more specifically regulate mar-

42. See, e.g., ALA. CODE § 27-14-9 (1975); GA. CODE ANN. § 33-24-10 (2013); NEB. REV. STAT. § 44-7513 (2000).

43. See Kenneth S. Abraham, *The Expectations Principle as a Regulative Ideal*, 5 CONN. INS. L.J. 59, 61–62 (1999).

44. To be sure, the effectiveness of these efforts to promote purchaser information may, in many cases, be limited. See OMRI BEN-SHAHAR & CARL E. SCHNEIDER, *MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE* 7–10 (2014). For a slightly less pessimistic view about the power of mandated disclosure in insurance, see Schwarcz, *supra* note 7 (discussing the benefits of increased transparency-oriented consumer protection regulations and arguing for an increase in those regulations).

45. See Schwarcz, *supra* note 7, at 401.

46. See *id.* at 420 n.144. Although policy delivery is typically several weeks after purchase, state laws typically give the policyholder a period of time within which to cancel their purchase without cost after receiving these documents.

keting techniques that insurers or agents have historically used to mislead prospective policyholders, such as illustrations of how savings in certain life insurance policies may grow over time.⁴⁷

B. INSURANCE LAW AND POLICY INFORMATION

A second central goal of insurance law and regulation is to promote more specific and clear information in the insurance policy itself about the precise scope of coverage that is available for specific types of losses. This form of coverage information can be referred to as “policy information.” Of course, for those policyholders who read and understand their insurance policies prior to or contemporaneous with purchasing coverage, policy information is merely a subset of purchaser information. The vast majority of insurance purchasers, however, generally do not fall within this category,⁴⁸ rendering policy information and purchaser information largely independent categories.

The first rule of insurance law—*contra proferentem* or the ambiguity rule—is insurance law’s most important effort to promote policy information.⁴⁹ This rule provides that ambigu-

47. See Douglas R. Richmond, *Liability Issues in the Sale of Life Insurance*, 40 TORT TRIAL & INS. PRAC. L.J. 877 (2005).

48. See ABRAHAM & SCHWARCZ, *supra* note 2; Marotta-Wurgler, *supra* note 2.

49. To a lesser degree, the ambiguity rule also may promote purchaser information: it is more likely that policyholders who actually read their policies will understand them if insurers are drafting unambiguous policy language. This is most obvious for those policyholders who actually read their insurance policy at or shortly after the time of purchase, a category of policyholders that is almost certainly likely to be quite small and heavily weighted towards more sophisticated commercial purchasers. See *supra* note 46. Less ambiguous policy language may also promote purchaser information indirectly, to the extent that it facilitates market intermediaries’ capacity to inform policyholders about the specific contours of coverage related to that information. On the other hand, it is entirely possible that the ambiguity rule unintentionally undermines purchaser information by increasing the length and complexity of insurance policies. As insurance policies evolve, they tend to become longer and more complex to specifically address coverage issues that courts have found to be ambiguous, or that litigants have argued are ambiguous. See Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171, 207–08 (1995) (arguing the ambiguity rule actually creates contracts that are more difficult to read). As insurance policies increase in length and complexity, the extent to which policyholders are inclined to review the underlying insurance policy will likely decrease, as does the likelihood that policyholders will extract relevant information from that policy when they do review it. See *id.*

ous policy language in an insurance policy should be interpreted against the drafter.⁵⁰ An insurance policy is generally considered ambiguous when “there is more than one meaning to which the language of the term is reasonably susceptible when applied to the claim in question, without reference to extrinsic evidence regarding the meaning of the term.”⁵¹ The central justification for the ambiguity rule is that it induces insurers to draft policy language more clearly.⁵² In this sense, the rule operates as a “penalty default rule”—a rule that encourages the more informed party (the insurer) to convey information to the less informed party (the policyholder) by filling in contractual gaps (ambiguities) in a way that is less favorable to the more informed party.⁵³

The ambiguity rule does indeed promote better policy information, as evidenced by the numerous instances in which insurers have redrafted their policies to address court-found ambiguities. For example, property insurance policies commonly provide coverage for the collapse of an insured building, which they define to require “an abrupt falling down or caving in of a building.”⁵⁴ In 2009, a court found this language to be ambiguous due to its confusing formatting, and thus extended coverage to a hotel that had dropped between three and six inches as a result of wood decay.⁵⁵ The updated 2010 version of

50. ALLAN D. WINDT, 2 INSURANCE CLAIMS & DISPUTES § 6:2 (6th ed. 2013).

51. JEFFREY W. STEMPER & ERIK S. KNUTSEN, STEMPER AND KNUTSEN ON INSURANCE COVERAGE 4-101 (4th ed. 2016) (quoting RESTATEMENT OF LIAB. INS. § 4(1) (AM. LAW INST., Discussion Draft 2015)).

52. *Cf. supra* note 50. This is not effective as a consumer protection vehicle, however, because there is no reason to think that ambiguous terms are those that are substantively problematic. *See Rappaport, supra* note 49, at 224.

53. On penalty default rules generally, see generally Ian Ayres, *Ya-HUH: There Are and Should Be Penalty Defaults*, 33 FLA. ST. L. REV. 589 (2006); Ayres & Gertner, *supra* note 5. On the ambiguity rule as a type of penalty default rule, see Abraham, *supra* note 5, at 545–46; Baker & Logue, *supra* note 19, at 389–90; Boardman *supra* note 5, at 316. *Contra proferentem* is clearly a default rule in the sense that insurers are typically permitted to respond to a court’s determination that policy language is ambiguous by redrafting the language to clearly exclude the loss at issue in a particular case. It is a much more complicated and unsettled question whether *contra proferentem* is also a default rule in the sense that an insurer could instruct in the contract that courts should not apply the rule to resolve coverage disputes. *See Baker & Logue, supra* note 19, at 389–90.

54. INS. SERVS. OFFICE, INC., HO 00 03 10 00, HOMEOWNERS 3 – SPECIAL FORM (1999).

55. *Malbco Holdings, LLC v. AMCO Ins. Co.*, 629 F. Supp. 2d 1185, 1196–

the Insurance Services Office (ISO) Homeowners Policy thereafter changed the formatting of the collapse section by separating the definition of collapse from the exclusions to collapse.⁵⁶ Similarly, in *Owners Insurance Co. v. Clayton*,⁵⁷ a liability insurer refused to cover a policyholder-employer who was successfully sued by a terminated employee for malicious prosecution, slander, and negligence.⁵⁸ The insurer relied on an “employer-related practices” exclusion in its policy, which limited coverage for liability relating to employment practices such as hiring and firing.⁵⁹ The court rejected this claim, reasoning that the exclusion did not clearly exclude coverage for suits involving statements made after an employee’s termination to her new business associates regarding the circumstances of her earlier termination.⁶⁰ After this case, the 2007 Commercial General Liability (CGL) policy was revised to exclude coverage for wrongful employment practices even if the injury causing event occurs before, during, or *after employment*.⁶¹

To be sure, the ambiguity rule is not always successful in inducing insurers to clarify the terms of their insurance policies. Indeed, there are numerous well-known instances in which insurers have been notably reluctant to redraft insurance policy language that courts have found to be ambiguous.⁶² In such instances, insurers have presumably decided that they can live with a pro-coverage result for the subset of policyholder claims that closely resemble cases where the relevant policy

97 (D. Or. 2009) (“Viewing subsection (a) in the context of the other three subsections does not [add clarity] . . . [B]oth subsections (c) and (d) exclude certain conditions . . . rendering [subsection (a)] ambiguous.”).

56. INS. SERVS. OFFICE, INC., H0 00 03 05 11, HOMEOWNERS 3 – SPECIAL FORM (2010).

57. *Owners Ins. Co. v. Clayton*, 614 S.E.2d 611, 613 (S.C. 2005).

58. *Id.*

59. *Id.* at 614–15.

60. *Id.* at 615.

61. INS. SERVS. OFFICE, INC., CG 00 01 12 07, COMMERCIAL GENERAL LIABILITY COVERAGE FORM (2007). Even though the ambiguity rule can result in insurance contracts containing more information, this does not necessarily mean the insured will get a better outcome. In *Clayton*, the court held the insurance company was responsible for paying the claim. *See Clayton*, 614 S.E.2d at 615. An insured would not likely receive coverage under the same circumstances with the new 2007 CGL policy.

62. *See Michelle E. Boardman, Contra Proferentem: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105, 1115 (2006) (discussing how insurance companies frequently do not redraft policy language once it has been interpreted by a court, but instead rely on the court’s interpretation in the future).

language was deemed ambiguous.⁶³ Moreover, as with more specific penalty default rules, an insurer can simply price the cost this rule produces into its coverage.⁶⁴ This option might be particularly attractive to the extent that an insurer believes that courts or regulators would rebuff insurers' attempts to clarify policy language that was previously found to be ambiguous.

Although the ambiguity rule likely does improve policy information, it also has the potential to undermine purchaser information, a possibility that is rarely, if ever, recognized by courts. This is because the ambiguity rule tends to increase the length and complexity of insurance policy language as insurers include more and more information in their policies to address specific scenarios to which courts have extended coverage on the basis of *contra proferentem*. Longer and more complex contracts are obviously less likely to be read and understood by purchasers.

The ambiguity rule is not the only potential "penalty default" rule in insurance law that can promote clearer and more specific policy information. As noted in the introduction, insurance law includes a large number of quite specific default rules.⁶⁵ In some (but not all) cases, these doctrines can be understood to constitute penalty default rules because they are generally unfavorable to the insurer and part of courts' justification for these rules is that insurers can choose to alter their policy language to produce an alternative result. For instance, many insurance policies do not contain any language discussing whether the insurer's subrogation rights allow it to recover from a policyholder's judgment against a tortfeasor when this would result in the policyholder not being fully compensated for her loss.⁶⁶ As its name suggests, the "make-whole" rule requires that the policyholder be made whole before the insurer can recover in subrogation. One rationale for this pro-policyholder rule is that insurers can redraft policy language to clarify that they are entitled to first-dollar subrogation if, in fact, the make-

63. This might be because they would ultimately choose to draft language that matches the result reached by application of the ambiguity rule, or else because the benefits that would flow from their preferred language would be outweighed by the costs and uncertainty associated with redrafting the policy language.

64. See Boardman, *supra* note 62, at 1118.

65. See *supra* text accompanying notes 16–18.

66. See Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263, 1294 (2011).

whole rule is not efficient or consistent with the parties' true preferences.

In addition to *contra proferentem* and other penalty default rules, various "weak" forms of the reasonable expectations doctrine are also designed primarily to enhance policy information. In contrast to the "strong" form of the doctrine described above, courts applying a weak version of the doctrine consider policyholders' reasonable expectations of coverage only after determining that the relevant policy language is ambiguous.⁶⁷ Courts applying this version of the doctrine typically emphasize that it requires policy language to "be construed as laymen would understand [it] and not according to the interpretation of sophisticated underwriters."⁶⁸ Relevant considerations include whether the operative terms are "hidden" within the policy or contained in portions of the policy that are not obviously related to the underlying coverage issue, such as the definitions section.⁶⁹

Weak versions of the reasonable expectations rule promote policy information not by eliminating ambiguities, but by discouraging undue complexity that could impede a reader's capacity to understand the meaning of an insurance policy. Theoretically, the doctrine encourages insurers to draft their policies more clearly so that a reasonable policyholder who is motivated to read it can discern its meaning.⁷⁰ This is because, to the extent that insurers instead use hyper-technical language that ordinary individuals would misunderstand or not be able to understand one way or another, the insurer's preferred meaning is less likely to prevail.

Certain state insurance laws and regulations also are primarily designed to promote policy information. Most states require insurance policy language to meet a specific quantitative measure of word and sentence complexity, which is typically

67. See, e.g., *Burton v. Ky. Farm Bureau Mut. Ins. Co.*, 326 S.W.3d 474, 476 (Ky. Ct. App. 2010) (holding that the reasonable expectation doctrine applies only when a policy is susceptible to two different interpretations).

68. See, e.g., *id.*; *Vt. Mut. Ins. Co. v. Walukiewicz*, 966 A.2d 672, 672 (Conn. 2009).

69. See *Atwater Creamery Co. v. W. Nat. Mut. Ins. Co.*, 366 N.W.2d 271, 276 (Minn. 1985) (finding coverage for insured where "the burglary definition at issue . . . constitute[d] a rather hidden exclusion from coverage").

70. See, e.g., *Lancaster v. U.S. Shoe Corp.*, 934 F. Supp. 1137, 1159 (N.D. Cal. 1996) ("[A]pplication of the reasonable expectations doctrine to the same plans promotes the goal of giving insurers sufficient incentives to clearly communicate meanings of policy clauses and exclusions to insureds.").

based on the Flesch-Kincaid Reading Ease Score.⁷¹ To varying degrees, state laws also require that policies contain a table of contents, “self-contained and independent” sections, be written in no less than ten-point font, and “use everyday, conversational language.”⁷² State regulators typically enforce these rules—and similar prohibitions on “misleading,” “ambiguous,” or “confusing”⁷³ policy language—by individually reviewing and approving insurance policies.⁷⁴ According to state regulators, these rules ensure “that [policyholders’] rights and responsibilities, and those of the insurance company, are clearly stated” in the underlying policy.⁷⁵

C. INSURANCE LAW AND JUDICIAL INFORMATION

In addition to promoting “purchaser information” and “policy information,” a third fundamental goal of insurance law is to promote “judicial information,” which can be defined as information regarding the scope of insurers’ coverage obligations that is only ascertainable from judicial opinions or secondary sources summarizing these opinions. Judicial information includes the various insurance-specific default rules that indicate how issues that are not explicitly addressed in an insurance policy should be resolved.⁷⁶ But it also includes judicially crafted tests for how particular policy terms or phrases should be applied, so long as these tests or definitions are not themselves readily apparent from the insurance policy itself. Examples of this type of judicial information include the “efficient proximate

71. See NONPERSONAL LINES PROP. AND CAS. INS. POLICY SIMPLIFICATION MODEL REGULATION: 732-1 (NAT’L ASS’N OF INS. COMM’RS 1997), <http://www.naic.org/store/free/MDL-732.pdf>.

72. See Schwarcz, *supra* note 7, at 421.

73. See *id.* at 406–07.

74. See Stephen P. D’Arcy, *Insurance Price Deregulation: The Illinois Experience*, in DEREGULATING PROPERTY-LIABILITY INSURANCE: RESTORING COMPETITION AND INCREASING MARKET EFFICIENCY 248, 256–58 (J. David Cummins ed., 2002).

75. NAT’L ASS’N OF INS. COMM’RS, A CONSUMER’S GUIDE TO HOME INSURANCE (2010), http://www.naic.org/documents/consumer_guide_home.pdf.

76. The scope of a liability insurer’s duty to defend would fit in this category of default rule, as the issue is largely unaddressed in many liability insurance policies. In almost all cases, these rules are default rules rather than mandatory rules, as courts generally permit insurers to contract around these defaults, particularly when the policyholder is sophisticated. For an excellent discussion of the limited circumstances in which the rules of insurance law should operate as mandatory rules rather than default rules, see Baker & Logue, *supra* note 19.

cause rule” to determine whether a peril “caused” a loss, or the “unfortunate event” test for determining the number of “occurrences” in a liability insurance case.⁷⁷

Judicial information regarding contracting parties’ obligations is unusually robust in insurance.⁷⁸ This is because insurance policies that are issued by any single company often contain similar language and structure as insurance policies issued by other companies.⁷⁹ Property/casualty insurance policies, for instance, incorporate a substantial amount of content that is derived from the collective drafting efforts of competing insurers.⁸⁰ Some property/casualty insurers simply use these collectively drafted documents for their policies, whereas many others use altered versions.⁸¹ Even outside of the property/casualty context, insurance policy terms are often standardized to some extent due to state regulatory rules as well as historical trends.⁸² For instance, virtually every health insurance policy in the country only covers care that is “medically necessary.”⁸³

The common evolution and structure of insurance policies means that a court’s development of default rules or tests in one dispute can provide concrete guidance for the resolution of other disputes implicating similar or identical issues. In this way, judicial opinions resolving insurance disputes are similar

77. See ABRAHAM & SCHWARCZ, *supra* note 2, at 493.

78. See RESTATEMENT OF LIAB. INS. § 2 (AM. LAW INST., Discussion Draft 2015); *id.* § 2 cmt. b (“Judicial decisions regarding the interpretation of standard-form terms provide guidance regarding the application of the terms in other cases.”); see also Abraham, *supra* note 6, at 664–65. Judicially created rules used to resolve disputes in insurance contracts are regulatory in nature and go beyond what is used to interpret non-insurance contracts. *Id.*

79. See ABRAHAM & SCHWARCZ, *supra* note 2, at 36 (noting that the Insurance and Services Organization (ISO) permits member organizations to use—in part or in full—any of their collectively drafted forms in operation).

80. See JEFFREY W. STEMPER, 1 LAW OF INSURANCE CONTRACT DISPUTES § 4.06[b] (2d ed. & Supp. 2005); Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. INS. L.J. 107, 124 (2007). Operating under an express exemption from federal antitrust law, insurers routinely collaborate under the auspices of third-party organizations such as the Insurance Services Organization (ISO) to collectively draft and update various insurance policy forms. *Id.*

81. See Schwarcz, *supra* note 9, at 1342.

82. See ABRAHAM & SCHWARCZ, *supra* note 2, at 36–37.

83. Timothy P. Blanchard, “Medical Necessity” Determinations: A Continuing Healthcare Policy Problem, 37 J. HEALTH L. 599, 600 (2004). (“[Most plans] require that services in the potentially covered categories be ‘reasonable’ and ‘necessary’ (or similar terms) for the particular patient’s medical condition.”).

to cases involving the meaning of contested statutes: in both instances, the operative language applies to countless potential disputes beyond the specific fact pattern facing the court.⁸⁴ All this might be of little importance if insurance coverage disputes were rare. But, of course, quite the opposite is true: at least outside of the context of life insurance, coverage disputes are quite common.⁸⁵ For these reasons, extensive case law is typically available that is relevant to assessing how any particular loss should be assessed under any particular type of insurance policy.⁸⁶

To be sure, judicial information exists in ordinary contract law, generally in the form of default rules that rely on broad standards such as “commercial reasonableness.”⁸⁷ But judicial information is often much more specific in insurance law.⁸⁸ In that sense, judicial information in insurance is analogous to the approach used in code countries, where various default terms and definitions are specified in code and do not need to be incorporated into contract.⁸⁹ Indeed, the various default rules and judicially crafted tests of insurance law have recently been distilled into a draft Restatement of Liability Insurance Project, which is scheduled for completion in 2017.⁹⁰ Although not itself law, the project moves American insurance law even closer to a code-based system, by crystallizing the judicial information insurance law generates so that this information can operate as a common frame of reference for courts, scholars, regulators, and lawyers.⁹¹ As discussed at length in Part IV, strategies designed

84. See PRINCIPLES OF THE LAW OF LIAB. INS. § 3 cmt. d (AM. LAW INST., Discussion Draft 2012) (“Adjudication of the meaning of a standard form term in one case has consequences for the scope of the risks insured under all similar policies.”); see generally Jeffrey Stempel, *The Insurance Policy as Statute*, 41 McGeorge L. Rev. 203 (2010).

85. See Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735, 751 (2009).

86. See, e.g., *Freidberg v. Chubb & Son, Inc.*, 691 F.3d 948, 952 (8th Cir. 2012); *Macheca Trans. v. Phila. Indem. Ins. Co.*, 649 F.3d 661, 670–72 (8th Cir. 2011); *Nathe Bros., Inc. v. Am. Nat. Fire Ins. Co.*, 615 N.W.2d 341, 344 (Minn. 2000).

87. See Allan Schwartz & Robert Scott, *The Common Law of Contract and the Default Rule Project*, 102 VA. L. REV. 1523, 1577 (2016).

88. See Abraham, *supra* note 6, at 665–66.

89. See Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1586 (2004).

90. See RESTATEMENT OF LIAB. INS. (AM. LAW INST., Tentative Draft No. 1, 2016).

91. See *id.*

to improve judicial information often directly undermine policy information, a reality that has important and generally unrecognized implications for the structure of insurance law.⁹²

The three types of coverage information—purchaser information, policy information, and judicial information—are summarized below in Table 1. Table 1 also describes the primary sources of each type of information. For policy information and judicial information, these sources follow naturally from the definitions of these terms. By contrast, the sources of purchaser information are quite variable, as the definition of purchaser information is based on the intended audience for that information (the purchaser), rather than the source of that information. Finally, Table 1 summarizes the various ways in which insurance law and regulation seek to promote each form of coverage information.

92. See *infra* Part IV.

Table 1: Types of Coverage Information

	Purchaser Information:	Policy Information:	Judicial Information:
Definition	Information about the scope of coverage that is communicated to policyholders at any point during the purchasing process.	Information about the scope of coverage that is in the insurance policy.	Information about the scope of coverage that is available only after legal research.
Primary Sources of Information	(i) Insurance agent; (ii) friends and family; (iii) experience and background assumptions; (iv) insurer advertising and marketing.	(i) Insurance policy; (ii) secondary sources quoting or describing policy language.	(i) Judicial decisions regarding coverage disputes; (ii) secondary sources describing judicial decisions.
Laws and Regulations Promoting	(i) Estoppel; (ii) strong reasonable expectations doctrine; (iii) form regulation; (iv) disclosure and false marketing/advertising.	(i) Ambiguity rule; (ii) weak reasonable expectations doctrine; (iii) form review; (iv) readability rules.	(i) Insurance-specific default rules; (ii) judicially crafted tests for applying policy terms.

II. RATIONALES FOR LAWS AND REGULATIONS THAT PROMOTE THE THREE TYPES OF COVERAGE INFORMATION

Each of the three forms of coverage information described in Part I—purchaser information, policy information, and judicial information—serve potentially important and underappreciated roles in promoting the efficient operation of insurance markets. For this reason, insurance law and regulation can, in a variety of settings, potentially improve insurance markets by promoting coverage information. Yet limited analysis exists in the extant literature systematically laying out the

rationales for these rules. This Part seeks to fill this gap by illuminating the various potential market benefits that insurance law and regulation can achieve by affirmatively promoting purchaser information, policy information, and judicial information. As Parts III and IV aim to demonstrate, this is not simply a theoretical exercise. Instead, appreciating the potential market benefits of rules promoting different types of coverage information can provide new insights on a number of important doctrinal and regulatory issues.

A. RATIONALES FOR PROMOTING PURCHASER INFORMATION IN INSURANCE MARKETS

Information about coverage that is provided to policyholders during the purchasing process plays a vital role in all insurance markets. As with any product market, purchaser information can promote product quality, facilitate consumer choice, and encourage effective product use. The first of these benefits—its capacity to promote more efficient coverage—is more theoretical than real in insurance markets involving individual purchasers, though it is likely quite important in insurance markets where most purchasers are represented by sophisticated insurance brokers. The latter two benefits of purchaser information provide broader, and more insurance-specific, payoffs. By facilitating policyholder selection of policy types and features, purchaser information allows insurers to use contract design to counteract adverse selection. And by promoting the effective use of insurance, purchaser information can reduce moral hazard by inducing policyholders to avoid decisions or behaviors that can jeopardize their coverage. After briefly discussing the capacity of purchaser information to promote generally efficient coverage, this Section focuses on these two more insurance-specific benefits of purchaser information.

1. Promoting More Efficient Insurance Policies

Purchaser information has long been understood to be a potentially important tool for ensuring that contracts of adhesion are drafted to maximize the welfare of the contracting parties.⁹³ According to standard law and economic models, drafters

93. Purchaser information is also important for assent-based theories of contractual assent. *See, e.g.*, KARL LLEWELYN, *THE COMMON LAW TRADITION — DECIDING APPEALS* 370–71 (1960); Todd D. Rakoff, *Contracts of Adhesion:*

of contracts of adhesion will have an incentive to draft relatively efficient contracts if a sufficiently large number of consumers are informed about the content of those contracts at the time they agree to them and drafters cannot differentiate between sophisticated and unsophisticated purchasers.⁹⁴ Of course, substantial debate exists regarding how large an informed minority is needed in order for firms to draft efficient terms and how often these conditions are met in different commercial contexts.⁹⁵ Moreover, recent work in behavioral law and economics suggests that even fully informed individuals may make systemic errors when processing relevant information, which can incentivize drafters to increase complexity and devise strategies to capture consumer surplus.⁹⁶

All of these issues are directly applicable to insurance policies, which are one type of contract of adhesion.⁹⁷ Although the contract of adhesion label is most apt for insurance policies that are sold to individuals, even insurance policies that are sold to relatively sophisticated businesses generally meet the basic parameters of a contract of adhesion.⁹⁸ At the very least, such policies usually contain language that is not individually negotiated between the two parties and is offered by insurers on a take-it-or-leave-it basis.⁹⁹

An Essay in Reconstruction, 96 HARV. L. REV. 1173, 1226–27 (1983).

94. *But cf.* Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1390 (1983) (“If consumers are instead ignorant of market opportunities, firms may respond by degrading contract quality.”).

95. *See* R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother’s Keeper: The Inability of an Informed Minority To Correct for Imperfect Information*, 47 HASTINGS L.J. 635, 675 (1996). The percentage of consumers needed for insurers to draft efficient terms could range from one percent to ninety percent. *Id.* Additional factors of significance in drafting efficient terms are “the cost savings to the producer of the inefficient terms and the amount of profit that the producer makes on informed consumers given an efficient set of terms.” *Id.*

96. *See* OREN BAR-GILL, *SEDUCTION BY CONTRACT: LAW, ECONOMICS, AND PSYCHOLOGY IN CONSUMER MARKETS* 18 (2012).

97. *See, e.g.*, ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, *UNDERSTANDING INSURANCE LAW* 141 (5th ed. 2012); JEFFREY W. STEMPEL, *STEMPEL ON INSURANCE CONTRACTS* § 4.06[b] (3d ed. 2011); Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 631 (1943); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 545–46 (1971) (identifying insurance policies as paradigmatic contracts of adhesion).

98. *See* Slawson, *supra* note 97, at 539 (defining a contract of adhesion).

99. *See* Posner, *supra* note 89; *see, e.g.*, *Farmers Auto. Ins. Ass’n v. St. Paul Mercury Ins. Co.*, 482 F.3d 976, 978 (7th Cir. 2007) (“Any insured, whether large and sophisticated or not, must enter into a contract with the

In practice, purchaser information likely has only a limited capacity to promote efficient insurance policies in markets characterized by individual purchasers. This is for a variety of reasons, including the pervasiveness of consumer biases regarding insurance and the capacity of insurers to offer different products to sophisticated and unsophisticated policyholders.¹⁰⁰ But perhaps the most important reason is that consumers will inevitably only have limited purchaser information about a few key features of their coverage.¹⁰¹ After all, many consumers bypass market intermediaries entirely when purchasing coverage, or else use market intermediaries who only sell coverage from a single carrier.¹⁰² And those consumers that do secure coverage through independent market intermediaries often receive limited amounts of information about competing coverage options, in part because these intermediaries generally do not owe any legal obligations of loyalty or care to consumers with respect to the selection of coverage options.¹⁰³ Finally, almost no ordinary insurance consumer actually reads and understands his or her policy at the time of purchase.¹⁰⁴

By contrast, purchaser information likely has greater potential to promote efficient insurance policies in markets characterized by relatively sophisticated commercial policyholders. These purchasers typically acquire coverage through “insurance brokers,” who are usually very well informed about the details of different coverage options and the potential alternatives that are available in the marketplace.¹⁰⁵ Moreover, unlike ordinary insurance agents, the brokers that serve commercial poli-

insurer which is written according to the insurer’s pleasure by the insurer. Generally, since little or no negotiation occurs in this process, the insurer has total control of the terms and the drafting of the contract.”).

100. See Schwarcz, *supra* note 6, at 1412–13 (describing the ways in which consumers determine which insurance policies to purchase).

101. See *id.* (“At the same time, these informational sources are limited in their capacity to convey nuanced policy information to consumers.”).

102. See *id.* at 1415–16 (citing studies that show that less than half of people relied on agents to learn about different insurance coverage options).

103. See *id.* at 1417 (“They therefore have a tendency to focus on the positive elements of coverage, telling ‘stories’ that, while technically accurate, gloss over many of the less salient ways in which a policy limits coverage.”).

104. Moreover, more recent work in behavioral law and economics suggests that even fully informed individuals may make systemic errors when processing relevant information that incentivizes drafters to increase complexity and devise strategies to appropriate consumer surplus. See BAR-GILL, *supra* note 96, at 19; Marotta-Wurgler, *supra* note 2, at 98.

105. See Jeffrey W. Stempel, *Reassessing the “Sophisticated” Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807, 808 (1993).

cyholders are generally legally obligated to provide their clients with unbiased and competent advice.¹⁰⁶

2. Promoting Matching Between Policyholders and Policies, and Limiting Adverse Selection

In addition to promoting efficient contracts, purchaser information can help ensure that individuals select contracts that best match their preferences and needs. This generic benefit of purchaser information is particularly important in insurance markets. One important way that insurance policies attempt to counteract the risk of adverse selection is by limiting coverage for risks that are unusual or highly variable and cannot be easily identified and assessed *ex ante* through standard underwriting techniques.¹⁰⁷ Assuming that policyholders have purchaser information about these exclusions, they are forced to either forego insurance for losses associated with any non-standard risks they face, or to seek out particularized coverage for these risks via an endorsement or additional policy.¹⁰⁸ In the latter case, policyholders indirectly reveal to their insurer that they potentially pose non-standard risks associated with the particular supplemental coverage sought. This, in turn, prompts the insurer to engage in more specific and detailed underwriting appropriate for that risk, and to allocate the costs of such underwriting only to the subset of policyholders for whom it is truly necessary.¹⁰⁹

But this logic simply does not work when policyholders do not have any purchaser information about the relevant exclusion. In such cases, policyholders presenting non-standard risks do not seek out supplemental coverage simply because they are ignorant that their non-standard risks are not covered in the

106. See Hazel Beh & Amanda M. Willis, *Insurance Intermediaries*, 15 CONN. INS. L.J. 571, 579–81 (2009).

107. See, e.g., *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788, 792 (N.J. 1979) (noting that one rationale for a CGI policy to exclude liability stemming from faulty work product is to prevent adverse selection).

108. See ABRAHAM & SCHWARCZ, *supra* note 2, at 232; see also George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1315 (1981) (describing the ways in which risk adjusters seek to eliminate differences in risk, which forces people at the margins to face coverage decisions).

109. See Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q. J. ECON. 629, 642 (1976). Although the Rothschild and Stiglitz model produces self-sorting as a result of different deductible levels, insurers generally implement this basic approach through the more direct method of limiting coverage for specific high-risk activities that are difficult to underwrite uniformly.

purchased policy. This can result in risk-averse policyholders that pose unusual or non-generalizable risks foregoing coverage for which they would be willing to pay and which insurers would be willing to sell after enhanced underwriting.¹¹⁰

Consider an example. Standard homeowners insurance policies generally contain a dollar cap on the amount of coverage that is available for theft of jewelry.¹¹¹ Policyholders who own and wish to insure expensive jewelry can simply purchase an endorsement to extend their coverage. This structure protects the insurer against adverse selection, because policyholders vary greatly in the amount of expensive jewelry they own, and insurers' standard underwriting techniques could not reliably and cheaply identify such jewelry ownership. Without the coverage exclusion, adverse selection could result in those who do not own expensive jewelry selecting a different insurer or deciding to forego insurance altogether rather than paying insurance premiums used, in part, to subsidize the losses of those who own expensive jewelry. Insurers avoid such adverse selection by simply excluding coverage for expensive jewelry, and relying on policyholders with such jewelry to affirmatively seek coverage and reveal their high-risk status.¹¹² But if policyholders are unaware of the exclusion in the base policy, then those with expensive jewelry end up without insurance protection for which they would have been willing to pay.

To be clear, none of this is to suggest that purchaser information relating to adverse selection is systematically concealed or unavailable to policyholders. To the contrary, both insurers and insurance agents often have good reason to provide policyholders with this type of purchaser information.¹¹³ For insurers, this may allow them to sell additional coverage to individuals who present non-traditional risks, and for insurance agents this may generate additional commissions. At the same time, however, it is hardly clear that these incentives are sufficient to produce optimal investments in providing purchasers with accurate purchaser information that is linked to adverse selection

110. See Rothschild & Stiglitz, *supra* note 109, at 629 (“[I]f individuals were willing or able to reveal their information, everybody could be made better off.”).

111. See, e.g., INS. SERVS. OFFICE, INC., HO 00 03 05 11 4, HOMEOWNERS 3 – SPECIAL FORM (2011) (limiting losses for jewelry theft to \$1500).

112. Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, 9 CONN. INS. L.J. 371, 381 (2003).

113. See *id.* at 378.

concerns. Insurers, for instance, can still charge low premiums to those who don't buy supplemental coverage even if those individuals are in fact high-risk, because their coverage does not extend to their high-risk activities.¹¹⁴ Moreover, insurers face obvious countervailing pressures to present the image to prospective customers that their coverage is as broad as possible.¹¹⁵ Similarly, insurance agents who try to sell prospective policyholders on purchasing additional supplemental coverage may risk losing customers to competing carriers/agents who offer cheaper coverage.¹¹⁶ And, of course, insurance agents may be neglected or bypassed entirely in the purchasing process.¹¹⁷ For all these reasons, law and regulation have a legitimate interest in promoting purchaser information to ensure that insurers' efforts to combat adverse selection do not leave policyholders without coverage for which they would be willing to pay.

3. Impacting Policyholder Behavior and Reducing Moral Hazard

Another generic benefit of purchaser information for all contracts of adhesion is that such information can allow consumers to effectively adjust their behavior in light of their rights and obligations under the contract. Once again, this issue is particularly important in the insurance context, where a core purpose of many insurance policy terms is to counteract moral hazard.¹¹⁸ Insurance policies typically seek to limit moral hazard by excluding coverage for risks that are substantially within policyholders' control, or losses that are highly correlated with these activities.¹¹⁹ Doing so, the argument goes, induces policyholders to take appropriate levels of care by forcing them to bear the costs of failing to do so, at least in particularly extreme or easily identifiable cases.¹²⁰

114. *See id.* at 381.

115. *See* Schwarcz, *supra* note 6, at 1410.

116. *See* Schwarcz, *supra* note 7, at 432.

117. *See* Schwarcz, *supra* note 6, at 1416 ("In 2001, 40% of consumers relied on insurance agents to learn about automobile insurance.").

118. *See* ABRAHAM & SCHWARCZ, *supra* note 2, at 7.

119. For example, many auto policies will not cover damage to cars that are used for a pre-arranged race or competitive speed contest because it is an unusually risky activity. *See, e.g.,* Detroit Auto. Inter-Ins. Exch. v. Bishop, 180 N.W.2d 35, 37 (Mich. Ct. App. 1970).

120. *See* ABRAHAM & SCHWARCZ, *supra* note 2, at 7 ("[T]hey fashion the terms so that unusual risks are not insured by standard policies and so that the results of inordinately dangerous behaviors are not insured.").

But policyholders' levels of care or activity obviously cannot be impacted by coverage exclusions about which policyholders are unaware at the time they select their levels of activity or care. One particularly nice illustration of this point is a recent study demonstrating that valued policy laws—which allow policyholders to profit from total losses on over-insured property—do not, in fact, create moral hazard.¹²¹ The best explanation for this finding is that these laws do not impact policyholder incentives for the simple reason that the vast majority of policyholders are ignorant of their existence.¹²²

Because the risk of moral hazard only exists when the insurer does not observe policyholder levels of activity or care after purchase, the only clear opportunity for the insurer to inform policyholders of coverage exclusions that might impact these decisions is at the time of purchase. To be sure, there may certainly be cases when potential changes in policyholders' activities prompt policyholders to check their coverage after purchase, either by directly consulting their policy or inquiring about their coverage with their agent or insurer. But policyholders will only be prompted to check their insurance coverage if they have a preexisting awareness of the possibility that specific activities might not be covered.¹²³ Purchaser information, therefore, serves a critical role in helping to ensure that coverage exclusions designed to counteract moral hazard have their intended effect.

When an individual policyholder is unaware of a coverage exclusion aimed at moral hazard, the impact of that exclusion is not to reduce moral hazard at all, but simply to shift the costs of moral hazard onto the policyholder rather than the insurer.¹²⁴ However, this makes little sense from an insurance economics perspective: to the extent that moral hazard cannot be ameliorated by an exclusion because consumers do not have purchaser information about the exclusion, then it is the insurer, rather than the policyholder, that should bear this risk. This is because the insurer can at least spread the moral hazard risk among policyholders, and thus eliminate the risk, if not the cost, of moral hazard.

121. See Peter Molk, *Playing with Fire: Testing Moral Hazard in Homeowners Insurance*, 2018 UTAH L. REV. (forthcoming 2018).

122. See *id.* at 19 (“[P]olicyholder understanding of insurance agreements is notoriously poor.”).

123. See Schwarcz, *supra* note 66, at 1268.

124. See Schwarcz, *supra* note 7, at 425.

For example, suppose that a homeowners insurance policy excludes losses for vandalism and malicious mischief that occurs while the home is vacant.¹²⁵ One purpose of this exclusion might be to counteract the prospect that insured individuals will not take prudent precautions when they leave their home vacant, such as having a neighbor check on the home periodically and maintaining the appearance that the home is occupied. By excluding coverage for vacant homes altogether, the insurer can counteract this moral hazard risk and induce policyholders to take appropriate levels of care. But in any individual case, this logic will only work if the policyholder is aware of the underlying exclusion. Otherwise, the policyholder's level of care cannot be affected by the terms of coverage and, to the extent that she takes less care under the mistaken assumption that she is insured, this will continue to be true notwithstanding the coverage exclusion. Because the insurer cannot directly detect when a policyholder may choose to leave her home vacant and send a specific warning at that time, the primary time when the insurer can communicate this exclusion is when the policyholder purchases coverage. If a policyholder fails to take prudent precautions in ignorance of the exclusion, the result is simply that the costs of moral hazard have been shifted on to that policyholder; the exclusion has done nothing to mitigate the moral hazard risk.

In most cases this logic is complicated by the fact that purchaser information varies among policyholders. In the example above, some homeowners might have sufficient purchaser information to anticipate the possibility of a coverage exclusion for vandalism while their home is vacant, while others may not. The net effect of the exclusion will therefore be to reduce moral hazard for some subset of policyholders, while simply shifting this risk of moral hazard on to the remaining policyholders.¹²⁶ Whether such a policy provision is ultimately sensible from a social welfare perspective would thus turn largely on the breadth of purchaser information across the policyholder population.

Purchaser information may also serve an important role in changing policyholder behavior in ways that are completely independent of moral hazard. First, policyholders' purchaser in-

125. See, e.g., *Langill v. Vt. Mut. Ins. Co.*, 268 F.3d 46 (1st Cir. 2001).

126. See *Schwarcz*, *supra* note 66, at 1308 ("The exclusion simply shifts the moral hazard cost to policyholders without limiting it.").

formation may conceivably impact their savings and investment strategies. For instance, a policyholder who understands that her deductible is the largest loss she might have to incur might make sure to have at least that amount in her savings account or available via a line of credit. The impact of purchaser information on savings and investment is more salient for life insurance policies, which often function more as an investment and savings vehicle rather than as a risk-protection vehicle.¹²⁷ Second, particularly in the health insurance context, purchaser information can be vitally important to ensuring that policyholders access their benefits appropriately.¹²⁸ For instance, a policyholder who does not understand that her insurance policy includes a limited network of providers may inadvertently seek care from an out-of-network provider and be liable for much greater expenses than anticipated. But even outside of health insurance, purchaser information can be useful to helping policyholders access their coverage. To take one example, homeowners insurance policies often cover losses to food spoiled as a result of a power outage, but many policyholders who experience this event outside of the context of a broader loss¹²⁹ may never make a claim because they are unaware of the possibility of such coverage.

Purchaser information thus serves a number of central goals in insurance markets. Importantly though, purchaser information need not always be highly specific in order for it to achieve its aims. For instance, so long as policyholders have broad awareness of the possibility that certain categories of losses might not be covered by their insurance policy, then policy exclusions geared towards moral hazard and adverse selection will generally tend to serve their purpose. This is because policyholders generally have the capacity to consult their in-

127. See Susan Lorde Martin, *Betting on the Lives of Strangers: Life Settlements, STOLL, and Securitization*, 13 U. PA. J. BUS. L. 173, 173 (2010) (“Over time, life insurance has become a much more sophisticated financial product incorporating savings plans, mutual fund investments, and securitizations.”).

128. See Schwarcz, *supra* note 7, at 407.

129. Policyholders that experience a broader loss often do not need to rely on purchaser information to take advantage of all of their policy’s benefits because they make a claim, which in turn triggers a process (often facilitated by an agent) that helps ensure that the policyholder recovers all of the benefits to which he is entitled.

surer or agent regarding the terms of their coverage if they pose unusual risks *ex ante* that may require supplemental coverage (in the case of adverse selection), or if they are considering taking on new or non-standard risks *ex post* (in the case of moral hazard).¹³⁰ Thus, a key feature of purchaser information in insurance is that it need only be specific enough to prompt particular types of policyholders, or policyholders considering certain types of activities, to consult their insurer or agent. For certain types of activities or risks—such as intentionally burning down one's home or insuring a hovercraft—policyholders' background assumptions regarding the nature of their insurance coverage likely contain sufficient purchaser information to effectively combat moral hazard and adverse selection without respect to any information affirmatively conveyed by an insurer or its agent.

B. RATIONALES FOR PROMOTING POLICY INFORMATION IN INSURANCE MARKETS

Insurers obviously have many important reasons for specifying their coverage obligations to policyholders in great detail in their insurance policies. Producing such policy information allows insurers to define the scope of their obligations to policyholders, which facilitates the accurate pricing of coverage, limits the risk of policyholder lawsuits, and promotes the efficient resolution of claims. Insurance laws and regulations that limit the enforceability of policy language, and thus undermine policy information, can jeopardize these important benefits to insurers.

But these policy information benefits to insurers do not (and cannot) explain the various laws and regulations canvassed in Part I that seek to affirmatively promote more specific and clear policy information. Aside from the background legal rule that contracts are enforceable as written, insurers do not need the intervention of laws and regulations to supply policy information that meets their own contracting goals.¹³¹ Thus,

130. To be sure, some policyholders may be reluctant to ask these questions of their insurer because insurers will make negative inferences about the policyholder on this basis. But this possibility is ameliorated by the existence of independent insurance agents and brokers, who can provide policyholders with coverage information without the insurer being able to make any negative inferences about the inquiring policyholder. See Bruce L. Hay, *Procedural Justice – Ex Ante vs. Ex Post*, 44 UCLA L. REV. 1802, 1834–36 (1997).

131. See Eric A. Posner, Essay, *The Parole Evidence Rule, the Plain Mean-*

insurance laws and regulations that affirmatively promote policy information beyond that which is supplied by insurers must be premised on the interests of non-insurer audiences, including policyholders, market intermediaries, regulators, judges, and lawyers. As this Section shows, there are indeed a variety of potential benefits of clear and more specific policy information to these varied actors in insurance marketplaces.

1. Promoting More Efficient Insurance Policies

Like purchaser information, more specific and clear policy information can help prompt insurers to draft more efficient insurance policies. This is true even in the vast majority of cases when policyholders do not read their insurance policies at the time of purchase.¹³² Policy information can accomplish this by facilitating the capacity of market intermediaries—including insurance agents and brokers, journalists, academics, and regulators—to police the terms of insurance policies for unusual or unfairly one-sided terms.¹³³ Such policing of insurance policies by market intermediaries can help steer quality-conscious customers away from low-quality insurers through intermediaries' overarching recommendations or by having a broader impact on insurers' reputations.¹³⁴ Importantly, the prospect of these market forces operating can discourage insurers from overreaching in their drafting of insurance policies in the first place.¹³⁵

As with purchaser information, enhanced policy information is more likely to promote high-quality insurance policies in insurance markets characterized by policyholders who are

ing Rule, and the Principles of Contractual Interpretation, 146 U. PA. L. REV. 533, 533–34 (1998).

132. When policyholders do read their insurance policies at issuance, the policy information can promote market discipline and efficient insurance policy terms through the same mechanism as that described under purchaser information. *See supra* Part I.A.

133. *See* PRINCIPLES OF THE LAW: SOFTWARE CONTRACTS § 2.02 cmt. e (AM. LAW INST. 2009) (“Transferors will also be mindful of watchdog groups that can easily access the standard form and can spread the word about the use of unsavory terms.”); Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimizing Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 53–54 (2004) (“Consumer-oriented groups, such as the Consumers Union, act as informers and watchdogs on behalf of consumers.”).

134. *See* Schwarcz, *supra* note 7, at 418.

135. Of course, the extent to which any of this occurs even when policy information is high depends on a number of factors, including the pervasiveness of market intermediaries and the quality consciousness of consumers.

advised by sophisticated market intermediaries. By contrast, it is much harder to gauge when and how well policy information can promote market discipline in insurance markets geared primarily towards individuals and small businesses. The answer to this question may well depend on how accessible policy information is to market intermediaries, consumer watchdogs, and academics. If different carriers' contracts cannot be easily accessed by these entities, then they also cannot be easily scrutinized. At least until recently, it was incredibly difficult for most potential market intermediaries and watchdogs to easily access competing carriers' insurance policies.¹³⁶

2. Promoting More Effective Regulatory Form Review

In addition to promoting more efficient insurance policies, policy information can play an important role in insurance markets by facilitating more effective form review of insurance policies by state regulators.¹³⁷ As described in Part I, most insurance policies that are geared towards individual purchasers and small businesses must be reviewed and approved by state insurance regulators before they can be sold.¹³⁸ Any changes to previously approved insurance policies must also be reviewed and approved.

Regulators engaged in this process are supposed to assess whether proposed insurance contracts comply with various specific state requirements and prohibitions.¹³⁹ Additionally, many state regulators have broad authority to determine whether filed contracts meet more general standards of fairness and clarity.¹⁴⁰ In many ways, this process of regulatory form review

136. In recent years, states such as California have improved the ability of market intermediaries and watchdogs to compare personal lines policies by posting all of these policies online. *See* Schwarcz, *supra* note 7, at 412–13.

137. The Restatement of the Law of Liability Insurance recognizes this point in the context of explaining why the default rule should be that insurers should not be allowed to recoup defense costs when it defends under a reservation of rights due to a legal uncertainty, and it is subsequently determined that the insurer does not owe coverage. As the Restatement explains, “A default no-recoupment rule better informs insurance regulators of the coverage that the insurer intends to provide under the policy form, facilitating informed administrative review of insurers’ intent to seek recoupment, and, once the form permitting recoupment is approved, better informs insurance purchasers of the more limited defense coverage provided by the policy.” *See* RESTATEMENT OF LIAB. INS. § 21 cmt. a (AM. LAW INST., Tentative Draft No. 1, 2016).

138. *See infra* Part I.B.

139. *See* Baker & Logue, *supra* note 19, at 402.

140. *See id.* at 398.

is meant to fill the role of market discipline, described above, which is often lacking or uncertain in insurance markets geared towards individuals and small businesses.¹⁴¹ Although many commentators are skeptical of the effectiveness of such form review, there is limited empirical evidence on point.¹⁴²

Irrespective of the quality of states' form review, such regulation is undoubtedly improved by clearer and more specific policy information. This is because such policy information allows regulators to better understand, solely on the basis of the proposed policy forms insurers submit for approval, what coverage insurers will actually provide to consumers.¹⁴³ This, in turn, enhances regulators' capacity to question whether such coverage is generally consistent with basic principles of insurance economics and policyholders' reasonable expectations of coverage, as well as the state's more specific laws and regulations.¹⁴⁴ By contrast, insurance regulators confronted with insurance policies containing vague, unclear, or limited policy information cannot be expected to fully anticipate the potential coverage issues that might arise or how insurers would respond to those coverage issues. Indeed, many insurance regulators reviewing policy forms are not themselves lawyers, nor do they have the time or resources to extend their review of policy forms well beyond the submitted documentation.¹⁴⁵

141. Only recently have commentators begun to acknowledge that this process of regulatory form review has important implications for courts' process of interpreting and construing these policies. ABRAHAM & SCHWARCZ, *supra* note 2, at 145 (noting various questions about the relationship between state form review and the role of courts in "regulating" insurance policies); *see also* Baker & Logue, *supra* note 19, at 402 (noting the fact that "terms used in insurance contracts are subject to the approval of a public regulator . . . has gone largely ignored in the insurance contract law literature, [but] has important implications for insurance law").

142. TOM BAKER & KYLE D. LOGUE, *INSURANCE LAW AND POLICY: CASES, MATERIALS, AND PROBLEMS* 46 (2003); Schwarcz, *supra* note 6, at 1424–26.

143. Baker and Logue hint at this point at various times, perhaps most clearly in their suggestion that a regulator may be unlikely to approve insurance policy forms that explicitly attempt to contract around implied terms. *See* Baker & Logue, *supra* note 19, at 402–08.

144. To be sure, none of this is to suggest that policy information is the only or even the primary obstacle to effective regulatory form review. To the contrary, there are a number of additional relevant factors—including the possibility of regulatory capture as well as the limitations in applicable state law and regulatory resources—that may well tend to reduce the effectiveness of form review. Unfortunately, "[n]o systematic empirical evidence exists on the effectiveness of state form regulation." ABRAHAM & SCHWARCZ, *supra* note 2, at 145.

145. *See* sources cited in Schwarcz, *supra* note 6, at 1424–25.

To better appreciate how policy information can facilitate regulatory review, consider the question of whether an insurer should be able to recover in subrogation when a policyholder has not been fully compensated by the sum of her insurance recovery and settlement in a lawsuit. To make the issue a bit more concrete, suppose that a person incurs \$100,000 in medical bills after being punched by a neighbor. Suppose further that \$50,000 of this amount is covered by her health insurance, and she receives \$25,000 from the tortfeasor in a settlement. Should the health insurer be permitted to claim the \$25,000 settlement on the basis of subrogation? Many insurance policies do not directly deal with this issue. The omission of any relevant information on point in most insurance policies means that regulators reviewing insurance policy forms never contemplate the issue one way or the other—it is far too obscure for a non-lawyer regulator facing resource constraints to plausibly identify and, on that basis, hold up review of a filed policy.

Now suppose that courts routinely reject insurer efforts to claim first-dollar priority over settlement dollars when the insurance policy is silent on the issue. This, in turn, might well trigger some insurers to explicitly change their policy language to establish their entitlement to first-dollar subrogation, generating specific policy information on this issue. But before that altered language can be implemented in the marketplace, it must be filed and approved with the state regulator.¹⁴⁶ The same regulator who would never have spotted the first-dollar subrogation issue when it was omitted from the insurance policy will now be squarely confronted with the issue as a result of the enhanced policy information on point. How the regulator responds, of course, will depend on the relevant state laws and extent to which the regulator has the resources and desire to push back against the filing insurer. But at the very least, insurance laws promoting policy information will have ensured that the issue will receive at least some regulatory review and consideration.

3. Preventing Unfair Claims Handling

Another important benefit of policy information is that it can empower policyholders to independently assess the legitimacy of an insurer's claim denial, thereby mitigating the risk

146. See NAT'L ASS'N INS. COMM'RS, STATE INSURANCE REGULATION (2011), http://www.naic.org/documents/topics_white_paper_hist_ins_reg.pdf.

that an insurer will unreasonably delay or deny a claim.¹⁴⁷ The risk of unfair claims behavior by insurers stems from the fact that insurance policies are aleatory contracts, meaning that the performance obligations of one party (the insurer) is entirely contingent upon the uncertain occurrence of a future event (a particular type of loss to the policyholder).¹⁴⁸ Meanwhile, once a loss does occur—whether or not it is covered—it is “too late for the policyholder to take other meaningful steps to obtain the purchased protection.”¹⁴⁹ These features of insurance policies can potentially incentivize insurers to unreasonably delay or deny claims notwithstanding their contractual obligation to provide coverage.¹⁵⁰ Doing so directly enhances the profitability of the insurer, at least in the short term and potentially in the long term. For these reasons, a central concern of insurance law and regulation is to prevent and remedy unfair claims handling by insurers.¹⁵¹

Policy information plays an under-appreciated role in limiting this risk of unfair claims handling because it empowers policyholders—with the help of their insurance agents, family, or regulators—to independently assess insurers’ claims determinations. When insurance contracts are ambiguous or incomplete regarding the precise character of an insurer’s coverage obligations, it is easy for the carrier—or, more to the point, an adjuster—to deny coverage.¹⁵² Most policyholders will not have any basis to decide whether the insurer acted reasonably, precisely because the policy language that the insurer invokes to justify its decision will be unclear or indecipherable, as in the Liberty Mutual advertisement discussed at the outset of this Article.

By contrast, when the applicable insurance policy language is relatively clear and on point—in other words, when policy language is relatively robust—then policyholders can inde-

147. See Boardman, *supra* note 3, at 1075.

148. Bob Works, *Excusing Nonoccurrence of Insurance Policy Conditions in Order To Avoid Disproportionate Forfeiture: Claims-Made Formats as a Test Case*, 5 CONN. INS. L.J. 505, 553–57 (1999).

149. See RESTATEMENT OF LIAB. INS. § 2 cmt. h (AM. LAW INST., Tentative Draft No. 1, 2016).

150. See FEINMAN, *supra* note 13; Schwartz & Wilde, *supra* note 94, at 1394.

151. See ABRAHAM & SCHWARCZ, *supra* note 2; TOM BAKER & KYLE D. LOGUE, *INSURANCE LAW AND POLICY: CASES, MATERIALS, AND PROBLEMS* (3d ed. 2013).

152. See ABRAHAM & SCHWARCZ, *supra* note 2, at 179.

pendently assess the appropriate treatment of their claims. Even if the policyholder is uncertain about the meaning of the policy language, she can seek the help of advisors such as insurance agents or regulators, who will generally be capable of applying clear and unambiguous policy language to a particular case, even if they are not willing to opine on a bona fide legal dispute.¹⁵³

To be sure, many policyholders will no doubt fail to hold insurers accountable for questionable coverage denials even when policy information is relatively clear. But improving the ability of aggrieved policyholders to independently, or with assistance, assess the reasonableness of insurers' coverage decisions nonetheless tends to improve the reliability and promptness of insurers' claims handling operations. This is for several reasons. First, virtually all states require insurers, in the case of claims denials or reservations of rights, to promptly provide a reasonable and accurate explanation of the basis for their actions, which includes quotations of the relevant policy language.¹⁵⁴ As a result, insurers routinely highlight relevant policy information when they choose to deny a claim or reserve their right to do so in the future, even if that language is buried within a long and complicated insurance policy. Of course, this means little when ordinary people read this language as "blah, blah, blah" as in the Liberty Mutual advertisement. But when the relevant policy information is clear and on point, this requirement limits the capacity of an insurer to deny a clearly meritorious claim: it is one thing for an insurer to quote ambiguous or nebulous policy language to justify denying a claim, but it is

153. State insurance regulators often play an important role in resolving coverage disputes, at least when there is not an interpretive issue that they deem to raise "legal" rather than "regulatory" issues. *See* Schwarcz, *supra* note 85, at 757–58 (2009).

154. *See* UNFAIR CLAIMS SETTLEMENT PRACTICES ACT § 4 (NAT. ASS'N. INS. COMM'RS 1997) (defining as unfair claims settlement practices "[m]aking claims payments to an insured or beneficiary without indicating the coverage under which each payment is being made" and "failing, in the case of claims denials or offers of compromise settlement to promptly provide a reasonable and accurate explanation of the basis for such actions"). Although the NAIC model regulation does not explicitly require insurers to quote the policy language, most states require insurers to provide a reasonable explanation of the basis *in the insurance policy* for the denial. *See, e.g.*, ARK. CODE ANN. § 23-66-206 (2015); COLO. REV. STAT. § 10-3-1104 (2015); FLA. STAT. ANN. § 626.9541 (West 2012). Other states, such as Minnesota, explicitly require insurers to provide the language in the policy when denying a claim based on a specific policy provision. *See* MINN. STAT. § 72A.201, subdiv. 8 (2015).

quite another for it to justify denying a claim by quoting policy language that is either irrelevant or that unambiguously requires coverage. To the extent that an insurer attempted this, policyholders and those advising them—such as agents, regulators, friends, or lawyers—would be reasonably well situated to challenge the claims determination in court or with the state regulator.

A second, and related, reason that insurers can generally be expected to pay claims promptly when the relevant policy language is relatively clear and on point is that many states allow aggrieved policyholders to receive extra-contractual damages when insurers violate their coverage obligations in bad faith.¹⁵⁵ Bad faith is defined differently in different states, but it generally requires an insurer to knowingly or recklessly refuse to provide coverage when there is no reasonable argument for doing so.¹⁵⁶ The power of this rule to discourage unreasonable behavior by insurers is clearly directly linked to the clarity of applicable policy information: to the extent that an insurance policy is clear that it provides coverage for a specific loss, any refusal by an insurer to promptly provide that coverage would presumptively constitute bad faith.

Third, an insurer's refusal to cover a claim notwithstanding clear policy language requiring coverage could also prompt regulatory scrutiny under the relevant state's unfair claims handling practices statutes. By contrast, regulators do not, and generally cannot, use unfair claims settlement statutes to resolve interpretive questions regarding the application of insurance policies.¹⁵⁷ When insurance policies contain limited policy information, then coverage disputes are much more likely to be classified by regulators as legal or interpretive disputes, and thus to avoid potential regulatory scrutiny.

To illustrate the power of policy information to limit the risk of unfair claims handling, consider exclusions in some property insurance policies for losses "occurring . . . while the hazard is increased by any means within the control or knowledge of the insured."¹⁵⁸ Although such increase-of-hazard

155. John J. Aromando, *The Surety's Liability for "Bad Faith": Claims for Extra-Contractual Damages by an Oblige Under the Payment Bond*, 47 ME. L. REV. 389, 390 (1995).

156. See ABRAHAM & SCHWARCZ, *supra* note 2, at 91–92.

157. See Schwarcz, *supra* note 85, at 745–46.

158. *St. Paul Fire & Marine Ins. Co. v. Bachmann*, 285 U.S. 112, 114 (1932).

clauses are designed to limit the risk of moral hazard, they provide limited policy information because they are vague and indeterminate. As a result, an insurer could conceivably invoke such a clause to exclude coverage in a wide variety of cases. For instance, an insurer might refuse to provide coverage to a homeowner whose house was damaged by a fallen tree limb, on the grounds that the tree became dangerously overgrown with the insured's knowledge. A policyholder whose coverage was denied on this basis, and who was quoted the increase in hazard clause, would face various barriers to challenging the insurer's determination. Unless she consulted an informed lawyer, she would have no way of knowing that courts interpret these clauses much more narrowly than did her insurer.

In fact, however, increase-of-hazard clauses are rare, particularly in personal lines insurance policies, because courts are generally hostile to broad applications of these clauses.¹⁵⁹ As a result, most property insurers, particularly in the personal lines arena, have moved away from excluding coverage for generalized negligence or insufficient care, and have instead sought to exclude coverage for specifically described risk-increasing activities, such as freezing pipes while a home is left vacant. This results in increased policy information and decreased risk of unfair claims handling. Thus, an insurer using a standard ISO HO3 policy would simply have no credible basis in the policy to deny coverage to the homeowner whose overgrown tree fell on his house. Because any attempt to do so would need to be backed up by specific policy language in the claims communication, and there is no clearly applicable language on point, it is very unlikely that an insurer would attempt to deny coverage in these circumstances. If it did, by attempting to distort the policy language, it would likely trigger the scrutiny of certain policyholders, which would increase the risk of both enhanced regulatory inquiry and bad-faith litigation.

4. Conserving Judicial Resources

Another virtue of robust policy information in insurance is that it can conserve judicial resources by decreasing the frequency of coverage suits and facilitating judgments without the

159. See *D & S Realty, Inc. v. Markel Ins. Co.*, 789 N.W.2d 1, 11–13 (Neb. 2010) (“[I]ncreased hazard conditions . . . are often so broad that an insured’s violation of them is not causally relevant to the loss.”).

need for extensive discovery or evidentiary hearings. Limited policy information will generally increase both the likelihood of coverage suits and the prospect that these suits will not be settled by the parties. This is because limited policy information creates greater uncertainty about the appropriate outcome, opening up the inquiry to potentially include issues such as relevant precedent and extrinsic evidence. Whenever uncertainty increases, parties are more likely to sue and less likely to settle.¹⁶⁰

C. RATIONALES FOR PROMOTING JUDICIAL INFORMATION IN INSURANCE MARKETS

Judicial information regarding the scope of insurers' coverage obligations has multiple audiences, including market intermediaries, coverage attorneys, and insurers. As this Section makes clear, the potential benefits associated with developing this form of coverage information—which clarifies, supplements and expands on the information embedded within insurance policies—varies across these different audiences. For insurers, judicial information is a crucial tool for facilitating their control over the scope of their exposures. Meanwhile, coverage information helps streamline the claims-handling process and reduce the risk of protracted disputes, a benefit that accrues to insurers, policyholders, and the judicial system.

1. Facilitating Insurers' Control of Coverage and Limiting Correlated Risks to Insurers

For insurers, the risk of unanticipated adverse coverage determinations can pose substantial challenges. Insurers are generally able to take on numerous individual risks that are uncorrelated, meaning that any one policyholder's experience of a loss will not impact the probability that other policyholders will experience a loss. As a result of the law of large numbers, insurers can rest assured that policyholder losses in the aggregate will tend to follow a stable and predictable pattern.¹⁶¹ But the binding/persuasive nature of legal precedent plus the common evolution of insurance policies means that a single adverse ruling in one case can have a dramatic impact on insurers' cov-

160. See Stephen McG Bundy, *The Policy in Favor of Settlement in an Adversary System*, 44 HASTINGS L.J. 1, 13–15 (1992).

161. See ABRAHAM & SCHWARCZ, *supra* note 2, at 4.

erage obligations for an entire subset of potential losses or policyholders.

The likelihood that an individual case will generate correlated losses of this type for insurers is directly proportionate to the amount of judicial information that exists with respect to a particular policy and type of loss. When a large amount of judicial information exists regarding a particular policy type, then any individual adverse coverage decision is not likely to alter the aggregate legal landscape with respect to highly consequential issues. Most such issues will already be the subject of a large body of precedent that will not be substantially impacted by any single case. But even for long-standing policies, novel types of losses can re-introduce the prospect that an adverse coverage decision will produce large correlated losses. That risk decreases as judicial information on novel losses increases over time. The prospect that legal risk can produce correlated losses is particularly acute for long-tail insurance policies, such as where coverage is based on the date of an “occurrence” or loss rather than the time at which a claim is submitted to an insurer.¹⁶² In these cases, the correlated losses produced by adverse coverage decisions can only be partially limited by altering the relevant language in later insurance policies.

Consider one recent illustration of these points involving cyber-insurance. Liability insurers attempt to avoid covering cyber-related liability in their general liability policies, principally for adverse selection reasons.¹⁶³ But until recently, very little judicial information existed on the question of what coverage a CGL policy might provide for cyber-risk, as this risk has only recently emerged as a major threat. As a result, some general liability insurers are now discovering that they inadvertently insured a number of different forms of cyber liability in their CGL policies. For instance, one recent case reasons that a firm’s inadvertent publishing of medical records constitutes “publication” and thereby triggers coverage under the personal and advertising injury coverage of an older version of

162. See generally Ronen Avraham, *The Economics of Insurance Law—A Primer*, 19 CONN. INS. L.J. 29 (2012) (providing an introduction to insurance law and the economy).

163. In particular, companies vary tremendously in their susceptibility to cyber liability and the potential magnitude of such liability. Thus, insurers generally prefer to offer such coverage only in specialized insurance policies, which force policyholders to “reveal” their exposure, thus triggering enhanced underwriting by insurers. See *Cybersecurity*, NAT’L ASS’N INS. COMM’RS (Jan. 25, 2016) http://www.naic.org/cipr_topics/topic_cyber_risk.htm.

a CGL policy.¹⁶⁴ Another recent case found potential coverage when a plaintiff alleged that a policyholder's product caused his computer to "freeze up," as this claim included an allegation of "property damage."¹⁶⁵

If judicial information about CGL policies' coverage of cyber liability had been robust at the time the insurer issued the policy, then insurers could have avoided this correlated loss by either pricing it into coverage or explicitly limiting coverage. But the lack of relevant judicial information at the time has resulted in significant losses for CGL insurers: they are now being held liable for losses that they did not anticipate that they were covering when they issued those policies. Importantly, the nature of this miscalculation is significant because the exposures are correlated: these cases effectively change the scope of coverage that CGL insurers provide to every single one of their policyholders.¹⁶⁶ Moreover, because most CGL policies provide occurrence-based coverage, insurers' capacity to respond to these holdings by changing their coverage language is limited: notwithstanding any redrafting of new policies, insurers are still on the hook under their old policies for a subset of cyber liability losses that are deemed to have occurred when those earlier policies were in force. These dynamics tend to undermine well-functioning insurance markets by exposing insurers to potentially large and correlated losses, thus increasing the cost of coverage as well as its cyclicity.¹⁶⁷

More generally, judicial information in insurance markets allows insurers to better control their coverage obligations, and

164. *Travelers Indem. Co. of Am. v. Portal Healthcare Sols., L.L.C.*, No. 14-1944, 2016 WL 1399517, at *2 (4th Cir. Apr. 11, 2016).

165. *Eyeblaster, Inc. v. Fed. Ins. Co.*, 613 F.3d 797, 799-800 (8th Cir. 2010).

166. Scott E. Harrington & Patricia Danzon, *The Economics of Liability Insurance*, in HANDBOOK OF INSURANCE (Georges Dionne ed., 2000) (defining "socio-legal risk" as the possibility that changes in legal precedent will simultaneously impact multiple policies and potential claims).

167. Environmental liability insurance provides a historical example of how an insurance market can be disrupted by unanticipated uncertainty in judicial interpretation. The passage of the Federal Superfund Act in 1980 (CERCLA), which imposed retroactive clean-up liability regardless of when the pollutants were deposited, combined with inconsistent and underdeveloped judicial interpretations of the relevant insurance policy language, made it difficult for insurers to predict the frequency and severity of future claims. In turn, this resulted in insurers limiting the availability and level of coverage provided for environmental liability insurance. See Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942, 955-59 (1988).

thus to price that coverage competitively. This enhances the efficiency of insurance markets even apart from the issue of correlated losses, by allowing insurers to focus their underwriting and pricing of coverage on the risks they truly understand and intend to cover. For these reasons, both the ISO and individual insurers routinely update insurance policy forms in response to interpretive disputes.¹⁶⁸ Thus, as judicial information has suggested that traditional CGL policies might well cover certain forms of cyber liability, insurers have adjusted by redrafting their policies to clearly exclude such coverage.¹⁶⁹ Although this does not address insurers' exposures to occurrences that had already taken place prior to the policy change, over time it has allowed insurers to shed themselves of this exposure. As a result, insurers need not consider the cyber-risk exposures of businesses seeking CGL coverage unless these businesses also seek cyber-insurance policies.¹⁷⁰

2. Reducing the Cost and Risk of Resolving Claims Disputes

A second virtue of judicial information for insurers is that it reduces the costs of administering claims by providing certainty regarding how different types of claims should be handled. Over time, this allows insurers to forego using lawyers and other highly trained personnel to resolve claims. Instead, they can translate judicial information into clear guidelines to be applied by adjusters.¹⁷¹ Not only does this produce cost-savings for the insurer, but it also decreases the time it takes to resolve claims, which directly benefits policyholders as well as insurers.

Robust judicial information also reduces the risks of coverage litigation. Policyholders who are denied claims will tend to

168. See *supra* text accompanying notes 166–67.

169. *Cybersecurity*, *supra* note 163.

170. *Id.*

171. To be sure, there can often be gaps between the law as stated in judicial opinions and the internal guidelines that individual firms generate to implement the law. See H. LAURENCE ROSS, SETTLED OUT OF COURT: THE SOCIAL PROCESS OF INSURANCE CLAIMS 98–101 (1970) (describing how negligence law in the context of auto accidents was translated into a rule that in a rear-end collision, the driver in back loses); see also John Rappaport, How Private Insurers Regulate Public Police (unpublished draft) (on file with author) (arguing that liability insurance influences police behavior). See generally Tom Baker, *Liability Insurance as Tort Regulation: Six Ways that Liability Insurance Shapes Tort Law in Action*, 12 CONN. INS. L.J. 1 (2005) (outlining how liability insurance has impacted tort law).

have much less basis for fighting a (correct) claims denial to the extent that there is robust judicial information on point validating the insurer's coverage denial. And even when a particularly aggressive policyholder (or policyholder's attorney) does fight a legitimate claim denial, the suit is more likely to be quickly dismissed or settled if the relevant judicial information was robust and consistent with the insurer's initial determination. These benefits accrue not only to insurers, but also to policyholders and the court system more broadly. For policyholders, robust judicial information tends to reduce the risk associated with litigating a denied claim. And, reduced litigation over coverage denials decreases the overall caseload for courts.

Table 2, below, outlines both the primary intended audiences of different types of coverage information as well as the various different types of benefits that can flow from such information.

Table 2: Benefits of Each Type of Coverage Information

	Purchaser Information:	Policy Information:	Judicial Information:
Definition	Information about the general terms of coverage that is communicated to policyholders at any point during the purchasing process.	Information about the scope of coverage that is in the insurance policy.	Information about the scope of coverage that is available only after sustained legal research.
Primary Audience(s) for Information	Purchaser during the purchasing process.	(i) Regulators conducting form review; (ii) market intermediaries; (iii) courts; (iv) purchasers at time of denied claim; (v) coverage attorneys.	(i) Insurers; (ii) market intermediaries; (iii) courts; (iv) coverage attorneys.
Primary Benefits of Each Type of Coverage Information	(i) Reduces moral hazard and impacts ex post behavior more broadly; (ii) limits adverse selection and promotes matching of coverage with insurance needs; (iii) promotes more efficient policy terms.	(i) Promotes effective regulatory form review; (ii) prevents unfair claims handling; (iii) conserves judicial resources; (iv) promotes more efficient policy terms.	(i) Limits correlated risks to insurers; (ii) reduces cost of coverage litigation; (iii) promotes efficient changes in coverage obligations.

III. CONFLICTS BETWEEN PURCHASER INFORMATION AND POLICY INFORMATION

Appreciating the three types of coverage information that insurance law and regulation promote, and the distinct efficiency benefits that can flow from each form of information, helps to illuminate the basic structure of insurance law and

regulation. But, the payoff of this framework is not just theoretical. Instead, it also provides a helpful structure for analyzing many of the most important and controversial disputes in insurance law and regulation, which often implicate a tradeoff between different types of coverage information.

This Part illustrates this point by applying the framework developed in Parts I and II to a number of long-standing controversies in insurance law and regulation that pit purchaser information against policy information: (1) the use of extrinsic evidence to disambiguate policy language; (2) the “strong” reasonable expectations doctrine; and (3) the design of rules governing insurance policy readability and disclosure.

A. THE USE OF EXTRINSIC EVIDENCE TO DISAMBIGUATE POLICY LANGUAGE

A common issue in insurance law involves the relationship between *contra proferentem* and the use of extrinsic evidence to resolve interpretive disputes. Most courts allow insurers to introduce extrinsic evidence to help “disambiguate” otherwise ambiguous policy language.¹⁷² In doing so, these courts relegate the *contra proferentem* rule to a secondary status, holding that it applies only after the ordinary tools of contract interpretation, which include consideration of relevant extrinsic evidence, are exhausted.¹⁷³ Other courts reject this approach, holding that the *contra proferentem* rule has special status in insurance law such that extrinsic evidence is not admissible to clarify ambiguous policy language.¹⁷⁴ For these courts, *contra proferentem* applies immediately after all textual tools of interpretation are exhausted.¹⁷⁵

This doctrinal dispute involves a tradeoff between purchaser information and policy information. A rule that allows insurers to introduce extrinsic evidence to disambiguate policy language generally prioritizes purchaser information over policy information. This is because it allows insurers or their agents to imbue the insurance policy with meaning through

172. See *Stone Container Corp. v. Hartford Steam Boiler Inspection & Ins. Co.*, 165 F.3d 1157, 1161 (7th Cir. 1999).

173. *Id.*

174. See *Wash. Nat'l Ins. Corp. v. Ruderman*, 117 So. 3d 943, 949 (Fla. 2013). Other courts may implicitly adopt this approach without clearly disclosing this fact. See David S. Miller, Note, *Insurance as Contract: The Argument for Abandoning the Ambiguity Doctrine*, 88 COLUM. L. REV. 1849, 1860 (1988).

175. *Id.* at 950.

sources that are external to the insurance policy itself, but that are conveyed to the policyholder prior to the time of purchase.¹⁷⁶ By contrast, a rule that prohibits the use of extrinsic evidence to disambiguate policy language prioritizes policy information over purchaser information by insisting that relevant coverage information be clearly contained in the policy, and thus creating incentives for insurers to draft or redraft their policies with this principle in mind.

Although the framework developed in this Article cannot definitively resolve this complex insurance law issue, it provides new support for the position that extrinsic evidence should be inadmissible to disambiguate insurance policy language, at least for individual policyholders.¹⁷⁷ To see why, recall from Part II that many of the benefits of policy information are distinct from the benefits of purchaser information, including (1) facilitating form review by regulators and (2) limiting the risk of unfair claims handling.¹⁷⁸ These benefits of policy information are particularly important for individual policyholders. By contrast, policy information almost certainly does not provide purchaser information for ordinary consumers, who only understand basic key features of their coverage at the time of purchase and do not read their insurance policies at this time.¹⁷⁹

Allowing ambiguous policy language to be disambiguated by extrinsic evidence—even if that evidence was known (or should have been known) to the policyholder prior to purchase—would undermine these two potential benefits of contra

176. Insurers can generally only admit such extrinsic evidence if the policyholder knew, or should have known, of that evidence at the time she agreed to the policy. *See* RESTATEMENT OF LIAB. INS. § 3 cmt. f (AM. LAW INST., Proposed Official Draft 2016).

177. For many of the same reasons as those canvassed in Part II.A, the analysis differs for sophisticated policyholders, or at least for policies that are predominantly sold to such policyholders. In such cases, the framework developed in this Article might suggest that extrinsic evidence should be admissible to disambiguate policy language, as such evidence helps the court better divine the parties' presumptive *ex ante* preferences, which is more important than ensuring accurate policy information when it comes to markets typified by sophisticated policyholders. Indeed, it may well be that courts should consider such information even if it was not readily available to the particular policyholder at the time of purchase, at least to the extent that this information helped establish the insurance-based rationale for the insurer's proposed interpretation.

178. *See supra* Part II.A.

179. *See supra* note 2 and accompanying text.

proferentem. First, this rule would tend to undermine the capacity of policy information to limit unfair claims handling. This is because relevant extrinsic evidence—such as an agent’s oral statement regarding coverage or an insurer’s marketing materials—is generally provided to policyholders prior to or at the time of purchase.¹⁸⁰ But coverage information is only capable of preventing unfair claims practices if it is reasonably available to the policyholder, or her advisor, at the time when the claim is actually delayed or denied, which may be months or (more likely) years after the policy is purchased. A policyholder who has just been denied coverage may well fail to remember conversations or marketing material reviewed years earlier when she purchased her policy. Nor would such extrinsic evidence be known to anyone advising a policyholder whose claim had just been denied, such as a family member or lawyer. Extrinsic evidence conveyed to the policyholder prior to purchase would thus end up doing little to limit insurers’ capacity to unreasonably deny claims because it does not promote the availability of coverage information at the relevant time—when a policyholder’s claim has been delayed or denied.

Second, most forms of extrinsic evidence made available to the policyholder at the time of purchase would do little to help facilitate regulators’ or market intermediaries’ review and assessment of the coverage provided by different carriers. The reason is simple: most forms of extrinsic evidence relevant to a specific insurance policy’s interpretation are not visible to market intermediaries and insurance regulators. These parties obviously do not hear what individual insurance agents say, nor do they typically review specific marketing materials or policy brochures in the context of examining competing insurers’ policy forms. By contrast, a penalty default approach that incentivizes insurers to spell out their understanding of specific coverage issues in the policy itself would allow regulators to look in a single place to review and analyze competing insurers’ coverage obligations.¹⁸¹

180. See RESTATEMENT OF LIAB. INS. § 3 cmt. f (AM. LAW INST., Tentative Draft No. 1, 2016) (“Because the objective of using the extrinsic evidence is to understand the meaning that a reasonable person in this policyholder’s position would ascribe to the term, such evidence may only be used against an insured when the policyholder could reasonably be expected to have been aware of it.”).

181. Many of these points may also apply to the capacity of policy information to promote market discipline through market intermediaries. Some market intermediaries—particularly those that are not embedded within the

Meanwhile, it is unlikely that limiting the admissibility of relevant extrinsic evidence to disambiguate policy language would substantially undermine insurers' interests. Extrinsic evidence that was known or should have been known by the policyholder at the time of purchase constitutes purchaser information. As explored in Part II, purchaser information can serve a number of important roles in insurance markets, including reducing adverse selection and moral hazard.¹⁸² But forbidding insurers from introducing such evidence to disambiguate policy language is unlikely to meaningfully interfere with their capacity to efficiently impact policyholders' levels of care or purchase of supplemental coverage. The reason is simple: the vast majority of ordinary policyholders obviously have no clue at the time of purchase whether extrinsic evidence conveyed to them by their agent or insurer would be admissible in a later coverage dispute. Thus, the applicable rule cannot impact those policyholders' incentives to take care or their willingness to "reveal" their high-risk status.

Consider an example to help concretize these arguments. In *Washington National Insurance Corp. v. Ruderman*, the primary issue before the court was the appropriate scope of an automatic benefit increase provision in a Home Healthcare Insurance policy.¹⁸³ According to the insurer, this automatic benefit increase applied only to the policy's daily limit amount, but not to its per occurrence limit or lifetime limit.¹⁸⁴ By contrast, the policyholder argued that the automatic benefit term applied to all three limits within the policy.¹⁸⁵ The court found that the insurance policy itself was ambiguous as both readings of its language were plausible.¹⁸⁶ It then confronted the question of whether the insurer could support its preferred interpretation by introducing into evidence marketing material that was used to sell the policy in support of its preferred interpretation.¹⁸⁷ The court ruled that the insurer was barred from admitting this extrinsic evidence to disambiguate the policy.¹⁸⁸

industry, such as academics or consumer-oriented magazines—also may not have extrinsic evidence available to them when they examine competing insurers' policy forms.

182. See *supra* Part II.

183. 117 So. 3d 943, 943 (Fla. 2013).

184. *Id.* at 946.

185. *Id.* at 946–47.

186. *Id.* at 949.

187. *Id.*

188. *Id.*

The reasoning above helps justify the *Ruderman* court's holding, and suggests that it should be embraced by more jurisdictions. First, it illustrates how allowing extrinsic evidence to disambiguate policy language can undermine a core benefit of policy information: promoting effective regulatory form review.¹⁸⁹ In particular, recognize that the Florida Insurance Department, on reviewing and approving the Home Healthcare Insurance Policy at issue in the case, did not review the marketing material used to sell the policy in conjunction with its form approval process.¹⁹⁰ It thus may well have believed that the automatic benefit increase term did indeed apply to all limits in the policy. Had the policy unambiguously stated that the automatic benefit increase provision applied only to the daily limit, but not the per occurrence and lifetime limits, the department might reasonably have questioned the rationale for this scheme: an automatic benefit increase provision such as that in the policy protects against medical inflation, which impacts the daily limit in the same way as it impacts the per occurrence and lifetime limits in the policy. A policy structure that only adjusts the daily limit, but not the per occurrence and lifetime limits, is thus seemingly incoherent.

Ruderman also illustrates how permitting extrinsic evidence to disambiguate policy language can undermine a second core benefit of policy information: preventing unfair claims handling. Recall that policy information can accomplish this by empowering policyholders and those advising them to use contract language to reliably distinguish between legitimate and illegitimate claims determinations.¹⁹¹ Admitting extrinsic evidence to clarify the meaning of contract language only advances this goal if that evidence is cognitively and physically available to policyholders and their representatives at the time that the insurer denies a claim. But this was not the case in *Ruderman*, where the policyholders likely saw any marketing relevant to the meaning of the automatic benefit increase provision years before any question arose about its applicability to per occurrence and lifetime limits. Policyholders would almost certainly not have recalled this portion of the marketing material years later, when their coverage was limited. And even if the policy-

189. See *supra* Part II.B.2.

190. The process of form review is generally independent of regulators' review of insurers' marketing material, which is not typically subject to any regime of prior approval. See ABRAHAM & SCHWARCZ, *supra* note 2.

191. See *supra* Part II.B.3.

holder had retained this marketing material—a possibility that seems increasingly unlikely as time passes—she would not generally look to these materials to scrutinize a claim, as the insurer itself focuses on the policy language in its explanation of its coverage denial. Allowing insurers like the defendant in *Ruderman* to invoke this type of evidence to justify their preferred reading of their policies would thus fail to empower policyholders and their representatives to accurately assess carriers' coverage obligations at the time a claim is denied. And this, of course, would tend to increase the risk of unfair claims handling.¹⁹²

Once again, the claim here is not that there are no legitimate arguments for allowing extrinsic evidence to disambiguate policy language for ordinary consumers. For instance, a critic might contend that this approach would tend to increase coverage litigation as policyholders found new ways to argue that policy language that everyone understood to mean one thing actually could be read to mean something else. Instead, the goal of this Section is merely to bring a new perspective on how the use of extrinsic evidence in disambiguating policy language may affect consumers by negatively impacting regulatory form review and by increasing the risk of unfair claims handling.

B. POLICYHOLDERS' REASONABLE EXPECTATIONS OF COVERAGE

A perennial issue in insurance law is the desirability of a "strong" form of the reasonable expectations doctrine, which allows courts to refuse to honor unambiguous policy language when doing so would undermine policyholders' reasonable expectations of coverage.¹⁹³ As described in Part I, one important justification for this doctrine is that it can promote purchaser information, either directly (by supplying coverage consistent with purchaser information) or indirectly (by inducing insurers to supply better purchaser information).¹⁹⁴ Meanwhile, many critics of the strong form of the reasonable expectations doc-

192. *Id.*

193. Consistent with the analysis in Part III.A, the doctrine does not apply to sophisticated policyholders. RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW, *supra* note 19, at 395 ("[T]hose (few) courts that apply the strong form of the doctrine of reasonable expectations have done so only in situations which the contracts are standard form personal or small business policies, which correlates with unsophisticated policyholders.").

194. *See supra* Part I.A.

trine tend to emphasize insurers' substantial interests in the reliability of policy information, which the rule tends to undermine.¹⁹⁵

Once again, the framework developed in this Article can help clarify, though not resolve, some of the key issues that are implicated in this debate. For instance, the coverage information framework suggests one important subset of cases where the argument for a strong reasonable expectations doctrine is at its zenith. To appreciate how, recall the point, developed in Part II, that purchaser information can be particularly important in insurance because it is necessary for an insurance policy to effectively combat moral hazard and adverse selection.¹⁹⁶ Recall also that purchaser information need not be highly specific to achieve these goals; it merely needs to put policyholders "on notice" that there might be an exclusion in their policy, at which point they can ask their insurer or agent about the precise scope of coverage.¹⁹⁷ In some cases, further inquiry will be triggered simply by background assumptions among ordinary policyholders regarding the types of losses that insurers do and do not cover.

All of this suggests that the case for a strong form of the reasonable expectations doctrine is particularly compelling when the policyholder did not have adequate warning—based on the insurer's marketing materials, agent's statements, or simply common sense—about policy exclusions that are designed to combat moral hazard or adverse selection. For instance, consider the well-known case of *Atwood v. Hartford*, which involved the application of a completed operations exclusion in a general liability policy that limited coverage for liability resulting from harms occurring after the insured's operations were completed.¹⁹⁸ The policyholder in the case was an

195. As noted in Part II.B, the benefits of policy language to insurers operates as a key rationale for rejecting rules of insurance law and regulation that would undermine policy information, even if it does not also operate as an independent rationale for promoting such information.

196. See *supra* Part II.A.3. Purchaser information is also important to ensure that suitable insurance policies are sold to individuals, such that their basic risks are covered. This issue, however, is already regulated to some degree by suitability laws for some life insurance products and by the professional obligations of agents to provide competent advice. Whether or not these are sufficient, it seems that the strong form of the reasonable expectations doctrine would not be the most efficient way to deal with this issue.

197. See *supra* Part II.A.3.

198. *Atwood v. Hartford Accident & Indem. Co.*, 365 A.2d 744 (N.H. 1976).

electrician who was sued because his alleged failure to properly fix a thermostat resulted in a baby dying of heat prostration.¹⁹⁹ The most plausible explanation for this exclusion is that it helped the insurer address adverse selection, by forcing policyholders whose work posed risks even after that work was completed to purchase a completed operations endorsement of coverage. But because the policyholder did not have even a generalized sense of this type of exclusion at the time he secured coverage, the exclusion could not achieve its goal of forcing the policyholder to purchase supplemental coverage.²⁰⁰ Thus, one way of appreciating the *Atwood* decision is that the court used the reasonable expectations doctrine to target an insurer's failed attempt to induce the policyholder to indirectly reveal his high-risk status, which was itself caused by the apparent lack of purchaser information regarding the exclusion.

One feature of this approach is that it suggests that policyholders wishing to invoke the strong form of the reasonable expectations doctrine could reasonably be required to show detrimental reliance as a result of their incorrect purchaser information.²⁰¹ In the case of an adverse selection based exclusion, such as that at issue in *Atwood*, such reliance would ordinarily consist of the policyholder unknowingly forgoing supplemental coverage that was available on the marketplace at the time of purchase. Alternatively, in the case of an exclusion principally aimed at moral hazard, the detrimental reliance would presumably consist of the policyholder taking limited amounts of care under the mistaken belief that she was covered for the underlying loss by her insurance. In the absence of these forms of reliance, there would be no direct harm to the consumer that resulted from the lack of purchaser information, and thus more limited reason to undermine the insurer's interest in policy information.

None of this, of course, resolves the larger debate about the desirability of the strong form of the reasonable expectations doctrine, which implicates a host of issues aside from coverage information ranging from the efficiency of insurance markets to the relative institutional capacities of judges and regulators.

199. *Id.* at 745.

200. *Id.* at 747.

201. See Abraham, *supra* note 35, at 1192 n.133 (“[I]n many cases in which the insurer appears to have created a misleading impression, reliance by the insured properly may be presumed; requiring proof of specific reliance might deny recovery in cases where there has been real injury.”).

But appreciating some of the key benefits of purchaser information in the insurance context provides new insight on a seemingly tired debate in insurance law.

Similar logic can also help illuminate insurance regulators' use of their authority to review and approve insurance policy forms. As described in Part II, one potential goal of policy form review is to ensure that insurance policies provide coverage that is consistent with policyholders' reasonable expectations.²⁰² Implementing this goal is hardly straightforward, however, for many of the same reasons that the reasonable expectations doctrine often proves difficult for courts to apply: the vast majority of individual policyholders have such a nebulous and ill-defined sense of what their policy covers that attempting to define insurers' coverage obligations by reference to those expectations typically proves unworkable.

The distinctive value of insurance purchaser information offers one solution to this problem. In particular, it suggests that regulators conducting form review should focus on exclusions that involve moral hazard and adverse selection concerns to ensure that the exclusions involve activities that would normally prompt a person to check on his or her coverage. Under this approach, for instance, a regulator might refuse to permit an exclusion in a homeowners insurance policy for liability stemming from the knowing illegal consumption of alcohol—an uncommon exclusion, but one that is contained in at least some major insurers' policies.²⁰³ The reason is that this exclusion is primarily aimed at limiting moral hazard—serving alcohol to an underage person—but it involves behavior that is quite common and that many people engage in without any thought as to the potential insurance implications of their actions.²⁰⁴

202. See *supra* Part II.B.2; Kenneth S. Abraham, *The Expectations Principle as a Regulative Ideal*, 5 CONN. INS. L.J. 59, 63–64 (1998).

203. See Schwarcz, *supra* note 9, at 1301 fig.21; see also, e.g., Van Zutphen v. Schemenauer, 445 N.W.2d 59 (Wis. Ct. App. 1989) (examining a Wisconsin homeowners policy containing a similar exclusion); AM. FAMILY MUT. INS. CO., NEVADA HOMEOWNERS POLICY BASIC FORM 1, at 10 http://doi.nv.gov/uploadedFiles/doinvgov/_public-documents/Consumers/Home/American_Family/16984a.pdf (“We will not cover bodily injury or property damage arising out of the insured’s knowingly permitting or failing to take action to prevent the illegal consumption of alcohol beverages by an underage person.”).

204. See, e.g., NAT’L CTR. ON ADDICTION AND SUBSTANCE ABUSE (CASA) AT COLUMBIA UNIV., NATIONAL SURVEY OF AMERICAN ATTITUDES ON SUBSTANCE ABUSE XI: TEENS AND PARENTS ii (2006) (reporting that nearly half of all seventeen-year-olds have attended house parties where parents are present and teens are drinking or taking drugs).

C. INSURANCE DISCLOSURES, PLAIN LANGUAGE, AND POLICY SIMPLIFICATION

As described in Part I, various insurance laws and regulations aim to promote consumers' ability to read and understand their insurance policies. For instance, the "weak" version of the reasonable expectations doctrine may discourage insurers from using unduly complex policy language.²⁰⁵ To similar effect are state regulations requiring insurance policies to meet quantitative readability measures, to include tables of contents, and to comply with certain formatting rules.²⁰⁶ By contrast, insurance regulations frequently do not require insurers to provide policyholders with any disclosures regarding the scope of coverage that are independent of the insurance policies themselves.²⁰⁷

This Article helps clarify that this regulatory approach fails to adequately distinguish between the benefits of purchaser information and the benefits of policy information. As emphasized in Part II, purchaser information and policy information often provide very different benefits in insurance markets.²⁰⁸ For this reason, the rules governing the information that should be provided to consumers at the time of purchase and the information that is contained in the insurance policy itself can, and should, be quite different. On one hand, laws and regulations designed to promote policy simplification can, if effective, meaningfully improve policy information. By making policy language more accessible to laypersons, these rules can facilitate the ability of policyholders and their representatives to independently assess an insurer's coverage determination and promote more effective regulatory form review.

But these benefits of enhanced policy information are unlikely to improve purchaser information or generate the associated benefits of such information, such as reduced moral hazard, reduced adverse selection, and improved insurance policy quality. To meaningfully promote purchase information, policy simplification and readability rules would have to eviscerate policy information in the process. As discussed above, the vast majority of policyholders simply do not read their insurance policies for a variety of reasons, including their length and the fact that these policies are only provided to consumers at the

205. See *supra* text accompanying note 70.

206. See *supra* text accompanying notes 71–75.

207. Schwarcz, *supra* note 7, at 397.

208. See *supra* Part II.C.2, Table 2.

end of the purchasing process.²⁰⁹ Although designing rules to promote policyholder reading at the time of purchase is notoriously difficult, at least one key to any such initiative would be to shorten that document to one or two pages at the most.²¹⁰ But reducing the insurance policy itself to anything close to this length would ultimately undermine specific and clear policy information, which often requires a great deal of detail as a result of the varied scenarios in which losses occur.²¹¹

All of this suggests that states should consider developing, in parallel with readability rules applicable to insurance policies, mandatory disclosures that are independent of insurance policies and are specifically designed to promote the most relevant forms of purchaser information. This approach would embrace the need for different regulatory regimes for purchaser information and policy information. To be sure, mandatory disclosures are often ineffective, and some have expressed skepticism of virtually any form of disclosure-based regulation.²¹² But designing even moderately effective disclosures geared towards promoting purchaser information is hardly an insurmountable goal, particularly since the basic content of these disclosures would not undermine insurers' interests.²¹³ Such a disclosure could be developed based on emerging best practices in the design of consumer disclosures that the Consumer Financial Protection Bureau has developed in recent years.²¹⁴ These underscore the importance of integrated and simplified documents that are consumer tested, provided to consumers before they emotionally commit to making a purchase, and emphasize only the most important pieces of information.

This Article's framework suggests that this type of disclosure should include at least three basic types of purchaser in-

209. See *supra* note 3 and accompanying text.

210. See NAT'L ASS'N OF INS. COMM'RS (NAIC), BEST PRACTICES AND GUIDELINES FOR CONSUMER INFORMATION DISCLOSURES 3 (2012), http://www.naic.org/documents/committees_b_senior_issues_141218_birnbaum_cd_bp.pdf ("If a disclosure includes more than a few pieces of information, then that disclosure typically will be ineffective.")

211. See *supra* note 49 and accompanying text.

212. OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE 144–46 (2014).

213. *Cf. id.* (emphasizing that one important barrier to effective disclosure is that firms or salespeople may have an incentive to undermine the disclosure).

214. See Leonard J. Kennedy, Patricia A. McCoy, & Ethan Bernstein, *The Consumer Financial Protection Bureau: Financial Regulation for the Twenty-First Century*, 97 CORNELL L. REV. 1141, 1159–60 (2012).

formation. First, it should include information regarding relative product quality, such as a numerical indication of how much an insurer's policy differs from the industry-standard Insurance Services Office form policy.²¹⁵ Such information could enhance the capacity of purchaser information to promote more efficient policies. Second, it should notify policyholders of excluded risks that could be covered through the purchase of supplemental coverage, thus facilitating insurers' efforts to use coverage variation to address adverse selection.²¹⁶ Third, it might include a generalized warning that certain risk-enhancing activities or behaviors over which policyholders exercise control could undermine coverage, with an illustrative list of such activities drawn from the policy itself and a warning to call one's agent if contemplating engaging in similar activities.²¹⁷

IV. CONFLICTS BETWEEN POLICY INFORMATION AND JUDICIAL INFORMATION

Conflicts between policy information and judicial information are not as easy to spot as conflicts between purchaser information and policy information. But this Part suggests that the tension between policy information and judicial information is reflected in the largely overlooked relationship between two of the core sets of rules in insurance law: the ambiguity rule, on the one hand, and more specific insurance default rules, on the other.

Section A of this Part explains this relationship between the ambiguity rule and more specific default rules in insurance law. In short, these two sets of rules often operate as alternatives to resolving coverage disputes. Courts that (implicitly) select the ambiguity rule rather than a more specific insurance default rule tend to promote policy information for the familiar reason that doing so incentivizes insurers to draft their policies more clearly. But in the process, these courts sacrifice judicial information by failing to develop more specific default rules that can play an important role in insurance law. By contrast, courts that (implicitly) apply specific default rules to resolve coverage disputes rather than the blunter ambiguity rule sacrifice policy information at the same time that they promote judi-

215. See *supra* Part II.A.1.

216. See *supra* Part II.A.2.

217. See *supra* Part II.A.3.

cial information. This is because they effectively allow insurance policies to incorporate a series of terms, derived from case law, that are not contained in the policy itself and that insurers need not incorporate into the policy in the future.

After exploring these points in more detail, Section B applies the coverage information framework to an important doctrinal dispute involving the ambiguity rule and more specific default rules: whether there should be a sophisticated policyholder exception to the ambiguity rule. Section B shows how this Article's framework can generate novel arguments in favor of such an exception.

A. CONTRA PROFERENTEM PROMOTES POLICY INFORMATION WHILE MORE SPECIFIC DEFAULT RULES PROMOTE JUDICIAL INFORMATION

A substantial number of coverage disputes implicate insurance policy language that is silent or unclear about how the policy applies to the particular loss at issue, as well as similar fact patterns. Broadly speaking, there are two approaches that insurance law uses to resolve these cases. First, and more straightforwardly, courts can hold that the policy is ambiguous and hence that the policyholder prevails. Second, courts can develop—based on precedent, the presumed *ex ante* preferences of the parties, or a variety of other considerations—more specific rules that effectively supplement the terms of the written insurance policy.

Consider a simple example. Numerous property coverage disputes turn on the meaning of the word “caused,” as property insurance policies often only cover losses caused by certain perils. Yet many insurance policies do not define this term, or else define it in one section but not another. Courts confronting coverage disputes where the causal link between a peril and a loss is unclear can adopt two basic approaches. First, they can simply rule for the policyholder on the basis of *contra proferentem*. Second, they can invoke a rule to fill in the meaning of “caused.” In fact, most courts uncritically adopt the latter approach, relying on precedent to define causation using the “efficient proximate cause rule,” which treats a peril as causing a loss only if it was the dominant or primary cause of that loss.²¹⁸

218. See Knutsen, *supra* note 16. To understand the implications of this approach, consider a policyholder whose home is damaged simultaneously by wind and water during a hurricane. Further assume that his homeowners in-

Although all cases resolving coverage disputes create judicial information, cases that rely on and develop specific gap-filling rules create more judicial information than cases that rely on *contra proferentem*. This is because specific default rules generally include information about how and when they apply to different types of coverage disputes. Perhaps even more importantly, the meaning and appropriate application of these specific default rules develops over time, as they are applied in subsequent cases. For instance, the eight corners rule for the duty to defend makes it clear that an insurer has a duty to defend whenever any claim in the complaint would, if true, be covered by any language in the policy.²¹⁹ As the doctrine has evolved, various uncertainties about its application—such as when the duty to defend can be terminated, or how information known to the insurer but not included in the complaint impacts the analysis—have been resolved, thus further developing the scope and specificity of the rule.²²⁰

By contrast, the ambiguity rule tends to create more limited judicial information than specific default rules.²²¹ Most importantly, this is because the scope of court decisions resolving a coverage case based on the ambiguity rule is quite often unclear. In such cases, the court determines that there are two reasonable interpretations of the relevant policy language as it applies to the particular claim under consideration. But such a holding inherently says little about whether the policy language would be ambiguous as applied to a slightly different fact pattern. For instance, suppose that a court determined that a homeowners insurer had a duty to defend a policyholder ac-

insurance covers losses “caused” by wind but not water. Ordinarily the policyholder would have a good argument that he is entitled to coverage for all his losses because his policy is ambiguous regarding its application to dual-cause losses. But as a result of the efficient proximate cause rule, the policyholder’s argument would almost certainly be unavailing, and the court would focus solely on the question of whether the wind or the water was the dominant cause of the loss.

219. See Robert P. Redemann & Michael F. Smith, 1 *LAW AND PRACTICE OF INS. COVERAGE LITIG.* § 4:15 (David L. Leitner et al. eds., 2015).

220. See, e.g., *Zurich Am. Ins. Co. v. Nokia, Inc.*, 268 S.W.3d 487, 497 (Tex. 2008) (discussing various judicially created exceptions states follow when analyzing the eight corners rule).

221. This argument is consistent with, but in at least some tension with, Boardman’s claim that insurers are often reluctant to redraft contract terms even when those terms have been deemed ambiguous by courts, because doing so would actually reduce coverage information. See Boardman, *supra* note 62, at 1117–18.

cused of punching someone else, notwithstanding an intentional acts exclusion, because the underlying insurance policy was ambiguous about how the exclusion applied to a punch thrown in self-defense. That holding would preserve substantial uncertainty about whether a liability insurer's duty to defend would be triggered by other types of disputes, such as a scenario where the policyholder incorrectly perceived the need to act in self-defense. By contrast, a court that resolved this case by adopting a specific default rule that reasonable acts of self-defense are not intentional conduct for purposes of an intentional acts exclusion would provide substantially more information about how this, and various other potential fact patterns, should be resolved.

Further limiting the judicial information created by the ambiguity rule is the fact that it is very hard to predict when a court will deem policy language to be ambiguous as applied to a particular claim. Ambiguity is a loose and subjective standard that is applied differently by different courts. Indeed, courts rely on numerous different types of arguments to assess whether or not policy language is ambiguous. A non-exclusive list includes the apparent purpose of the contested language, the contract language and structure surrounding the contested language, the policy implications of finding the language ambiguous, the "ordinary" meaning of the contested language, policyholders' reasonable expectations of coverage, whether the language could have been drafted more clearly by the insurer, and precedent finding the language ambiguous in similar contexts.²²² Most courts are not forthright about the relative hierarchy of these considerations in determining ambiguity. All this renders it extremely difficult to predict how a particular case finding policy language to be ambiguous may or may not be applied to different disputes. This, in turn, means that cases resolving coverage disputes via the ambiguity rule create limited amounts of judicial information.²²³

The enhanced judicial information that specific default rules generate relative to the ambiguity rule is even clearer

222. Abraham, *supra* note 5, at 537.

223. The indeterminacy of judicial determinations regarding when language is ambiguous extends well beyond the insurance domain. *See, e.g.*, Brett M. Kavanaugh, *Fixing Statutory Interpretation*, 129 HARV. L. REV. 2118, 2118 (2016) (arguing that the trigger for a variety of central principles of statutory interpretation is "an initial determination of whether a text is clear or ambiguous," but that "judges often cannot make that initial clarity versus ambiguity decision in a settled, principled, or evenhanded way").

when specific default rules are crafted solely to reflect the parties' presumed ex ante preferences (thus constituting "majoritarian" default rules), rather than to penalize the drafting party (thus constituting "penalty" default rules).²²⁴ Majoritarian default rules promote judicial information in much the same way that state regulatory requirements for policy terms consistent with policyholders' reasonable expectations promote purchaser information: insurers' coverage obligations are shaped by reference to the parties' presumed ex ante expectations or assumptions. Not only does this increase the likelihood that parties' expectations will be accurate, but it also makes it easier for insurers and other market actors to predict how case law might address future issues.²²⁵

Although specific default rules provide more judicial information than the ambiguity rule, the ambiguity rule better promotes policy information than more specific default rules. Specific default rules tend to undermine policy information by effectively creating portions of the policy that exist in the case law, rather than in the policy itself.²²⁶ To be sure, in some cases, insurers incorporate into their policies judicially developed default rules. But in many other cases, insurers never do adopt this strategy, effectively relegating a large amount of coverage information to case law. Indeed, the hundreds of default rules contained in the evolving Restatement of Liability Insurance Project—touching on central issues ranging from the duty to defend, to the duty to settle, to the allocation of coverage across multiple triggered policies—suggest that this equilibrium characterizes a substantial amount of liability insurance.²²⁷

Specific default rules are particularly likely to undermine policy information when they are designed as majoritarian de-

224. The majoritarian approach is similar to the "two islands" approach suggested by Ronen Avraham. See Avraham, *supra* note 162, at 29.

225. This is because insurance contracts of all types are presumptively concerned with managing a small handful of well-known insurance problems, such as moral hazard, adverse selection, correlated risks, and promoting easy-to-apply coverage rules. See Mark A. Geistfeld, *Interpreting the Rules of Insurance Contract Interpretation*, 68 RUTGERS U. L. REV. 371, 384–90 (2015).

226. To be sure, this point applies to contract law in general: for instance, one reason that parties may not include extensive damages-related provisions in their contracts is because the default rule of expectation damages suits both parties reasonably well. But the point has particular salience in the insurance setting because of the extensiveness and specificity of insurance-related default rules, which have no parallel in ordinary contract law.

227. See RESTATEMENT OF LIAB. INS. (AM. LAW INST., Tentative Draft No. 1, 2016).

fault rules that are based on the presumed *ex ante* preferences of the parties. Insurers have no reason to go through the cost and uncertainty of changing their policy language to the extent that they are satisfied with default rules adopted by courts.²²⁸ In the insurance context, redrafting costs include both regulatory compliance costs and the potential risk of inadvertently introducing new ambiguities into a policy. Indeed, the case law is littered with instances in which courts have rebuffed insurers' attempts to clarify policy language that was previously found to be ambiguous.²²⁹

But even specific default rules that are intended, at least in part, to operate as penalty default rules, can undermine policy information. This is because specific penalty default rules provide a policy term with a fixed and predictable (albeit pro-policyholder) meaning, which insurers can simply price into their coverage.²³⁰ To the extent that the resulting cost (in terms of moral hazard or adverse selection) is less than the costs of redrafting, insurers will simply opt for this alternative.²³¹

B. THE SOPHISTICATED POLICYHOLDER EXCEPTION TO CONTRA PROFERENTEM

Courts across the country have struggled with whether and how the central rule of insurance law—*contra proferentem*—applies to coverage disputes involving sophisticated policyholders. The majority of courts have concluded that *contra proferentem* is not limited to unsophisticated policyholders, so long as the policyholder did not directly draft any portion of the policy.²³² And one court has even claimed that it “can conceive of no compelling reason why even a sophisticated insured should not be entitled to a pro-coverage interpretation of a standard-

228. See Boardman, *supra* note 62, at 1117–18.

229. See Gaunt v. John Hancock Mut. Life Ins. Co., 160 F.2d 599, 602–03 (2d Cir. 1947) (noting the game of drafting and redrafting).

230. See Boardman, *supra* note 62, at 1117–18.

231. See *supra* Part I.

232. See, e.g., Farmers Auto. Ins. Ass'n v. St. Paul Mercury Ins. Co., 482 F.3d 976, 978 (7th Cir. 2007); Minn. Sch. Bds. Ass'n Ins. Tr. v. Emp'rs Ins. of Wausau, 331 F.3d 579, 581 (8th Cir. 2003); Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376, 390 (D. Del. 2002) (“Generally speaking, however, Delaware and Illinois courts continue to strictly construe ambiguities within insurance contracts against the insurer and in favor of the insured in situations where the insurer drafted the language that is being interpreted regardless of whether the insured is a large sophisticated company.”); Boeing Co. v. Aetna Cas. & Sur. Co., 784 P.2d 507, 514 (Wash. 1990).

ized ISO policy drafted by the insurance industry.”²³³ Moreover, a number of commentators have endorsed the uniform application of *contra proferentem* to all types of policyholders,²³⁴ as has the current draft of the Restatement of Liability Insurance.²³⁵ Nonetheless, a small handful of states either retain a “sophisticated policyholder” exception to *contra proferentem*,²³⁶ or else have indicated that courts ought to apply a less strict version of *contra proferentem* when the policyholder is a sophisticated entity.²³⁷

This Article cannot resolve this perennial issue of insurance law, which is too complex and multifaceted to be susceptible to reductionist logic. But framing this issue in terms of coverage information suggests novel arguments in favor of limiting the applicability of *contra proferentem* for insurance policies that are sold predominantly or exclusively to sophisticated policyholders.²³⁸ Under such an approach, courts would resolve the meaning of ambiguous policy language by developing specific, majoritarian default rules. For instance, a court facing a dispute about whether or not pollution was “sudden and acci-

233. *New Castle Cty. v. Hartford Accident & Indem. Co.*, 933 F.2d 1162, 1189 (3d Cir. 1991), *abrogated by* *N. Ins. Co. of N.Y. v. Aardvark Assocs., Inc.*, 942 F.2d 189 (3d Cir. 1991).

234. See Hazel Glenn Beh, *Reassessing the Sophisticated Insured Exception*, 39 TORT TRIAL & INS. PRAC. L.J. 85 (2003); Jeffrey W. Stempel, *Reassessing the “Sophisticated” Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807 (1993).

235. See RESTATEMENT OF LIAB. INS. § 4 (AM. LAW INST., Tentative Draft No. 1, 2016) (rejecting a sophisticated policyholder defense).

236. *Certain Underwriters at Lloyds London v. Perraud*, 623 F. App’x 628, 632 (5th Cir. 2015) (noting that Texas case law still hasn’t made a final black-and-white ruling on whether it would accept a sophisticated insured exception to *contra proferentem*); *W. Sling & Cable Co. v. Hamilton*, 545 So. 2d 29 (Ala. 1989); *Ins. Co. of N. Am. v. John J. Bordlee Contractors*, 543 F. Supp. 597, 602 (E.D. La. 1982) (“[The ambiguity] rule is apt when the insured is an innocent and naive party unfamiliar with the insurance field. But where the insured is a corporation, as here, represented by counsel on the same professional level as the counsel for insurers, then ambiguous provisions . . . should be construed *in favor* of what reason and probability dictate was intended by the parties with respect to coverage.”).

237. *Commercial Union Ins. Co. v. Walbrook Ins. Co.*, 7 F.3d 1047, 1053 (1st Cir. 1993).

238. The arguments developed in this Section would have particular force to the extent that an insurance policy issued to a sophisticated policyholder specifically attempted to disclaim the *contra proferentem* rule. In this case, the issue would not be whether *contra proferentem* is a good default rule, but instead whether it is a default rule or a mandatory rule. On this issue, see Baker & Logue, *supra* note 19.

dental,” as required for liability coverage under older versions of CGL policies, would eschew any argument that coverage should exist because the term is ambiguous as applied to the policyholder’s particular loss. Instead, the court would attempt to develop a workable principle to distinguish between covered and uncovered pollution, and would root that principle in the adverse selection and correlated risk concerns that motivated the exclusion in the first place.²³⁹

As suggested in Section A, this approach would increase judicial information while decreasing policy information for insurance markets characterized predominantly by sophisticated purchasers. Utilizing specific, majoritarian default rules rather than *contra proferentem* would decrease policy information by refusing to penalize insurers for drafting unclear or incomplete policy language. At the same time, it would increase judicial information by developing specific and predictable default rules that could be imbued with meaning over time. Using a majoritarian approach to develop these specific default rules would increase their predictability to both insurers and policyholders, without any need for the insurer to incorporate these judicially developed rules and clarifications into the insurance policy itself. In the example above, the term “sudden and accidental” would thus start to take on a developed meaning that was not apparent in the insurance policy itself, but could be understood through the relevant case law.

Once the sophisticated policyholder exception to *contra proferentem* is framed in terms of a tension between policy information and judicial information, the case for such an exception becomes both clearer and stronger, albeit still complicated. This is because there are good reasons to believe that judicial information is more important than policy information for insurance policies geared principally towards sophisticated policyholders. First, a core benefit of policy information—its capacity to deter unfair claims handling—is much less important for sophisticated policyholders than unsophisticated policyholders. Sophisticated policyholders are likely to routinely question an

239. Another example of this approach is the rule for allocation of long-tail harms in successive policies adopted by the Restatement. See RESTATEMENT OF LIAB. INS. § 44 (AM. LAW INST., Tentative Draft No. 1, 2016). Rather than embracing a mechanical rule of *contra proferentem* that would always maximize the policyholders’ recovery, this section adopts a “pro rata by years” approach to allocation on the basis that this is what the parties would presumptively prefer from an *ex ante* perspective. See *id.* at cmt. c.

insurer's denial of a claim or delay in payment and to have established relationships with lawyers or sophisticated brokers capable of assisting in these efforts. Those sophisticated policyholders that believe they have been treated unfairly in the claims handling process generally have credible options for exacting reputational penalties from the insurer. For instance, they can leverage their use of connected insurance brokers, who work primarily for them, to implicitly threaten insurers with reputational penalties.²⁴⁰ Perhaps even more importantly, they also have credible legal options for challenging an insurer's coverage decision: unlike unsophisticated policyholders—who often have limited access to lawyers and a high discount rate that leads them to settle too quickly²⁴¹—sophisticated policyholders have access to legal services as well as funding markets or capital to finance meritorious coverage litigation.

Not only is the underlying risk of unfair claims handling reduced when policyholders are sophisticated, but so too is the prospect that policy information can substantially limit this risk. Policy information serves this function for ordinary policyholders because it makes available clear language regarding how coverage disputes should be resolved at the time of a claims decision, without the need for legal research. But sophisticated policyholders—with the help of brokers, lawyers, and other risk management professionals—can determine insurers' coverage obligations even when those obligations are not clearly spelled out in the underlying contract.

Policy information is less important for policies sold predominantly to sophisticated policyholders for a second reason: there is little or no need for regulatory form review in this context. Indeed, many state regulators do not even review policy forms that are sold predominantly to sophisticated commercial actors, as many states exempt insurance policies from review if they are intended for policyholders who have a risk manager or whose premiums, net worth, or workforce exceeds specific thresholds.²⁴² And even when states do conduct this review, it is

240. Neil A. Doherty & Alexander Muermann, *Insuring the Uninsurable: Brokers and Incomplete Insurance Contracts* 5 (Ctr. for Fin. Studies Working Paper No. 2005/24, 2005), <https://www.econstor.eu/bitstream/10419/25461/1/515325678.pdf>.

241. See Alan O. Sykes, "Bad Faith" Refusal To Settle by Liability Insurers: Some Implications of the Judgment-Proof Problem, 23 J. LEGAL STUD. 77, 84 (1994).

242. See *The Partial Deregulation of Commercial Property and Casualty Insurance: Benefits and Challenges*, CPCU SOC'Y REG. & LEGIS. INT. GRP.

not generally important for ensuring the efficient operation of markets, as commercial actors can and do rely on sophisticated brokers to monitor policy forms and make coverage recommendations accordingly.²⁴³ The insurance brokers that provide this service are themselves highly sophisticated repeat players who—unlike most of the insurance intermediaries selling coverage to ordinary individuals—owe fiduciary obligations of loyalty and care to their clients.²⁴⁴ Sophisticated brokers' understanding of competing coverage forms generally extends well beyond the language contained in individual policies. Indeed, sophisticated brokers routinely keep up with court decisions on the policies they sell through industry publications and firm-generated research.²⁴⁵

While policy information is therefore comparatively less important for policies sold predominantly to sophisticated policyholders, judicial information is of paramount importance in this context. Sophisticated policyholders are much more likely than ordinary policyholders to consistently contest claims when the relevant judicial information is underdeveloped. This is for many of the reasons explored above: these policyholders have access to sophisticated attorneys and the willingness to expend funds on lawsuits that may take a substantial time to resolve. All this means that the lack of robust judicial information in markets populated by sophisticated policyholders creates a substantial possibility of extensive litigation costs and uncertainty regarding how different types of claims should be resolved. To illustrate, recall the example of court cases finding that CGL policies cover certain forms of cyber liability. Sophisticated policyholders who are advised by well-informed lawyers are much more likely than less sophisticated policyholders to seek to extend these holdings to new jurisdictions and new cyber liability losses.

Not only does this increased litigation risk from limited judicial information increase the costs to policyholders, insurers,

COMPLIANCE MATTERS, June 2013, at 3.

243. For a general overview of form regulation, see ABRAHAM & SCHWARCZ, *supra* note 2, at 142–45.

244. See Schwarcz & Siegelman, *supra* note 32.

245. See, e.g., BUS. INS., <http://www.businessinsurance.com> (last visited Mar. 12, 2017); NAT'L UNDERWRITER LIFE & HEALTH MAG., <http://www.lifehealthpro.com/National-Underwriter-Life-Health> (last visited Mar. 12, 2017). Sophisticated brokers may subscribe to these services, which routinely cover relevant court cases, market trends, and practice tips to assist them in their practice.

and courts of resolving disputes, but it also exposes insurers to the prospect of highly correlated losses. Recall that limited judicial information increases the risk that any particular case will substantially increase the scope of coverage provided by a policy. This risk is substantially elevated for sophisticated policyholders, for two reasons. First, they are more likely to seek to systematically exploit any shift in judicial information. Second, they are more likely to be covered by long-tail insurance policies, which are common in many policies that are sold to sophisticated policyholders, such as CGL policies.

Once again, none of this is to suggest that there are not plausible objections to a sophisticated policyholder exception to *contra proferentem*. Perhaps the most compelling such objection is that many types of policies—such as CGL policies—are sold both to highly sophisticated policyholders and less sophisticated policyholders.²⁴⁶ Enhanced policy information could thus benefit unsophisticated policyholders even when the policyholder suing for coverage is sophisticated.²⁴⁷ Additionally, policyholders cannot be easily and accurately segregated into “sophisticated” and “unsophisticated” groupings. Although it is possible to adopt a rules-based approach to this issue,²⁴⁸ any such approach would, of course, be both over- and under-inclusive. Ultimately, however, the core point here is that appreciating the nature and value of policy and judicial information helps provide a new perspective on an important issue in insurance law, even if it cannot unambiguously resolve the issue.

246. See, e.g., *Boeing Co. v. Aetna Cas. & Sur. Co.*, 784 P.2d 507, 514 (Wash. 1990) (“[S]tandard form polic[ies] ha[ve] been issued to big and small [insureds] throughout the state. Therefore it would be incongruous for the court to apply different rules of construction.”).

247. Cruz & Hinck, *supra* note 95, at 670. One judicial challenge from a sophisticated policyholder may be all that is necessary to dictate the inclusion of certain terms in a standard form contract. If judicial information becomes available through that challenge, unsophisticated policyholders using the same standard form policy will benefit as well. *Id.*

248. One promising approach—originally suggested for another purpose in early drafts of the Principles of Liability Insurance project, before it was converted to a “restatement” project—would be to use a net asset threshold of \$10 million, matching the threshold used in federal securities regulation, to distinguish between sophisticated and unsophisticated policyholders. See PRINCIPLES OF THE LAW OF LIAB. INS. § 1(4) (AM. LAW INST., Tentative Draft No. 1, 2013).

Although the focus here has been on the sophisticated policyholder exception to the ambiguity rule, there are numerous other doctrinal disputes that can be helpfully framed and analyzed in terms of the conflict between judicial information and policy information. For instance, some courts effectively use policyholders' reasonable expectations of coverage to constrain application of the ambiguity rule, reasoning that policyholders should not receive more coverage than they could reasonably expect even if the relevant policy language is, in fact, unclear. Whether this approach makes sense, or courts should instead use the ambiguity rule to penalize sloppy drafting, turns in part on the relative value of judicial information and policy information.

CONCLUSION

A central goal of insurance law is to clarify, produce, and disseminate information about the scope of insurers' coverage obligations to policyholders. Doctrines such as the reasonable expectations rule and estoppel, along with regulations governing insurer marketing and disclosure, aim to ensure that generally accurate coverage information is communicated to policyholders during the process of purchasing coverage (purchaser information). Meanwhile, the ambiguity rule, in concert with a bevy of insurance readability regulations, is concerned principally with promoting clear and more specific coverage information within the four corners of the insurance policy itself (policy information). Finally, insurance law produces a wealth of coverage information within judicial opinions, most clearly by specifying various default rules and definitions/tests that courts apply to vague or incomplete insurance policy terms (judicial information). Each of these three forms of coverage information serves a number of distinctive and potentially important roles in promoting the efficient operation of insurance markets. Appreciating these potential benefits sheds new light on a variety of perennial issues in insurance law, ranging from the sophisticated policyholder exception to the ambiguity rule, to the admissibility of extrinsic evidence to disambiguate policy language, to the optimal design of insurance disclosure and readability rules.