The Automobile Liability Coverage Step-Down Clause: The Real Deal or Merely the Calm Before the Storm?

Johnny Parker
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INTRODUCTION

"For every action there is an opposite and equal reaction." The relationship of Sir Isaac Newton’s third law of motion to the drafting of insurance contract provisions may not be readily apparent. The reality is that due to the economic significance of insurance transactions for individual insureds, insurers, and society, the dominant feature of the industry’s landscape is a continuous and unabated flow of litigation. Courts have used insurance litigation as a forum for considering issues of important public concern. Thus, it has been observed that:

[T]he quest during most of this century for an adequate and appropriate approach to providing indemnification for persons injured in automobile accidents has been an almost classic case study in the interactions of (1) the public interest in providing compensation for accident victims, (2) the needs and capacities of the insurance industry, and (3) various attempts by state legislatures to develop better approaches to using insurance to provide compensation.

The above observation is apropos—an insurance policy embodies more than an agreement between private parties. Unlike other types of pri-

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* Professor of Law, University of Tulsa College of Law. B.A., University of Mississippi, 1982; J.D., University of Mississippi Law School, 1984; LL.M., Columbia University Law School, 1987.

1 SIR ISAAC NEWTON, MATHEMATICAL PRINCIPLES OF NATURAL PHILOSOPHY AND HIS SYSTEM OF THE WORLD 13 (Andrew Motte trans., Florian Cajor ed. 1934) (1668).

2 Much of this litigation can be attributed to the nature of insurance contracts. Insurance policies are standardized contracts of adhesion. The term “standardized” describes those provisions of insurance contracts that are required to be included in every policy of insurance of a specific type. The language used in these provisions is sometimes also statutorily prescribed and is thus referred to as standardized. Typically, contracts are thought to be freely negotiated by parties of equal bargaining power. However, this belief is far from the reality of the insurance industry. The insured—though he can choose from a number of available policies—has absolutely no bargaining position in terms of the substance of the contract with the insurer. The policy provisions—even if required by statute or other regulation—are drafted by industry experts. Thus, the policy is offered to the insured on a take-it-or-leave-it basis. The phrase “adhesion contract” basically describes the manner by which the contract is formed. The insurer having superior bargaining power imposes its choice of terms on the insured. See SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS 19-20 (3d ed. 1973). Because insurance policies are viewed as contracts of adhesion, a greater likelihood exists that the party with less bargaining power will be subjected to oppressive and unjust terms. Consequently, courts interpreting insurance policies are free to engage in interpretative techniques that counterbalance the unequal bargaining position of the insured.

vate contracts, insurance policies are considered to have a large public interest component. This public interest justifies constant judicial scrutiny into the substantive and procedural fairness of the agreement. Consequently, despite the fact that insurance companies enjoy the same rights as others to limit their liability and impose whatever conditions they please upon their obligation to insure, they are constrained by the requirement that the exercise of the right to freely contract not violate public policy.

The insurance industry's struggle to draft policy provisions that are both consistent with fundamental legal doctrines and with the industry's economic interests is further frustrated by the fact that courts from different jurisdictions frequently interpret similar provisions inconsistently. Consequently, the primary industry reaction has been to redraft provisions that fail judicial review to avoid or rectify pitfalls identified in the litigation and to merely recast provisions that have not been subjected to legal challenge to better reflect the industry's ever changing interests. The validity of particular provision is also suspect until subjected to regulatory action. The insurance industry's haphazard reaction to judicial and legislative action has, in a few rare instances, led to the development of provisions that have withstood legal challenge on a national scale. One such provision is the "step-down" clause.

Step-down clauses are slowly becoming common features in automobile liability policies. They are designed to reduce the level of liability coverage provided in certain situations. Typically, step-down provisions follow the liability coverage insuring agreement and the omnibus clause, respectively.

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5 See supra note 2.


7 See infra note 26.

8 The model automobile liability coverage insuring agreement provides:

Insuring Agreement
While the language used varies from policy to policy, step-down provisions generally are drafted using one of two patterns. The first pattern provides that automobile liability coverage for an insured person, other than the named insured or a family member, is limited to a specified dollar amount that is less than that stated in the liability coverage section of the declaration sheet. The specified dollar amount is usually the minimum amount of liability coverage required by law. The second pattern provides that automobile liability insurance for an insured party, other than the named insured or a family member, is limited to an amount not to exceed the limits of the Financial Responsibility Law of the state in which the accident occurs. Insurance companies seemingly favor the latter approach.

A. We will pay damages for "bodily injury" or "property damage" for which any "insured" becomes legally responsible because of an auto accident. Damages include prejudgment interest awarded against the "insured." We will settle or defend, as we consider appropriate, any claim or suit asking for these damages. In addition to our limit of liability, we will pay all defense costs we incur. Our duty to settle or defend ends when our limit of liability for this coverage has been exhausted. We have no duty to defend any suit or settle any claim for "bodily injury" or "property damage" not covered in this policy.

9 "Insured" as defined in the above omnibus clause does not require a determination of whether someone other than the named insured or a family member had permission to use the covered auto for purpose of extended coverage. In egregious cases, such as where a permittee was engaged in conversion or the like, the issue of permission for purposes of the extended coverage under the model omnibus clause would probably surface. Because of the liberal nature of the model omnibus clause, the majority of insurance companies have opted to ignore it and instead provide extended coverage to anyone using the vehicle with the "permission of the named insured." Id.

10 A typical automobile insurance policy provides four types of coverages or protections. Those protections are: (1) liability coverage; (2) medical payment coverage; (3) uninsured motorist coverage; and (4) comprehensive and collision coverages. Each coverage contains an insuring agreement which defines the scope of the protection afforded. Each insuring agreement is in turn followed by an omnibus clause and exclusion provisions.

It is not uncommon for insurers to define "person insured" or "definition of insureds" differently for purposes of the various coverages. However, insurers are prohibited from defining the term "insured" or its equivalence in Uninsured Motorist Coverage more restrictively than it is defined in the omnibus provisions of the Liability Coverage. See, e.g., State Farm Auto. Ins. Co. v. Reaves, 292 So.2d 95 (Ala. 1974); Farmers Ins. Co. v. Schiller, 597 P.2d 238 (Kan. 1979); Pennsylvania Nat'l Mut. Cas. Ins. Co. v. Gartelman, 405 A.2d 779 (Md. Ct. Spec. App. 1979), aff'd, 416 A.2d 734 (Md. 1980).


12 Windsor, 24 S.W.3d at 154.


14 See supra note 13.
Both approaches, however, are industry attempts to comply with compulsory automobile or motor vehicle liability insurance statutes and case law.

The vast majority of state legislatures have enacted compulsory automobile or motor vehicle liability insurance laws.\textsuperscript{15} These laws employ either one or a combination of two statutory methods to mandate the inclusion of omnibus clauses in every policy of automobile or motor vehicle insurance. The methods most often employed by state legislatures to mandate the inclusion of omnibus clauses in liability policies affecting motor vehicles are Motor Vehicle Safety Responsibility Statutes (MVSRS) and Compulsory or Mandatory Liability Statutes (MLS). MVSRS and MLS are not inconsistent. Consequently, it is not unusual to find both statutes in a single jurisdiction.\textsuperscript{16} The statutes do, however, serve different purposes and to some degree complement each other.\textsuperscript{17} MLS ensure that vehicles are insured at all times, while MVSRS come into play after an accident has occurred and create leverage in favor of an individual injured by an uninsured driver. Together MLS and MVSRS are designed to plug any holes that might otherwise exist in compulsory liability insurance law. The vast majority of jurisdictions, however, have ignored MLS and utilize MVSRS to require the inclusion of omnibus clauses in motor vehicle liability policies.\textsuperscript{18} The statutory language, whether MVSRS or MLS, prescribes only

\textsuperscript{15} "Currently, 42 states and the District of Columbia require every person registering a motor vehicle in the state to present a certificate stating that he or she has liability insurance in at least a specified amount." \textsc{Robert H. Jerry, II, Understanding Insurance Law} 949 (2d ed. 1999).

Some jurisdictions recognize a legal distinction between "automobile liability policies" and "motor vehicle liability policies." The former policies are said to be matters of individual choice and voluntarily purchased. The latter policies, however, are typically required in compliance with Motor Vehicle Safety Responsibility Statutes and purchased as proof of financial responsibility. Because "automobile liability policies," unlike "motor vehicle liability policies" are not required to be certified they are not subject to the requirements of the financial responsibility laws. \textit{See}, e.g., Gray v. Md. Cas. Co., 152 F. Supp. 520 (D.C. Ill. 1957); Hearty v. Harris, 574 So.2d 1234 (La. 1991); Perkins v. Perkins, 284 S.W.2d 603 (Mo. Ct. App. 1955); Lewis v. Mid-Century Ins. Co., 449 P.2d 679 (Mont. 1968); U.S. Fid. & Guar. Co. v. Walker, 329 P.2d 852 (Okla. 1958); Novak v. State Farm Mut. Auto. Ins. Co., 293 N.W.2d 452 (S.D. 1980).


\textsuperscript{17} \textit{See} \textsc{Jerry, supra} note 15, at 949-51.

the minimum amount of liability coverage that must be purchased. Consequently, an individual seeking automobile liability insurance can procure an amount in excess of that prescribed by law.

The inclusion of a step-down provision in an automobile liability policy reduces the amount of liability coverage for a non-relative insured to the minimum amount required by law. This result follows despite the fact that the named insured purchased liability coverage in excess of the statutorily required amount. The following example best illustrates the meaning and effect of a step-down clause.

Assume that Insured purchased $300,000 worth of automobile liability coverage in a jurisdiction that requires that every vehicle on its roads and highways be insured to the minimum extent of $20,000 per person and $40,000 per accident. The jurisdiction also requires that every policy of automobile liability coverage sold within its boundaries contain an omnibus clause that extends the liability coverage to anyone driving the insured vehicle with the implied or express permission of the named insured. The insured vehicle is involved in an accident while being operated by Bill, a permittee. The accident resulted solely from Bill’s negligence. The automobile liability policy contains a step-down provision that states that, “We will provide insurance for an insured person, other than you or a family member, up to $20,000 per person/$40,000 per accident.” Despite the fact that Insured purchased $300,000 of liability coverage, the step-down provision in effect reduces the amount of coverage allocable to Bill—a permittee—to the minimum amount of liability coverage required by law.

Step-down provisions were developed to prevent permittees—those driving an insured vehicle with the permission, express or implied, of the named insured at the time of an accident—from obtaining the broadest protection afforded by the policy. Thus, a step-down clause furthers the insurance industry’s interest in defining the scope of the coverage provided by the insurance contract. These clauses achieve this function by defining not who is entitled to coverage under the policy, but by limiting the extent of


19 See supra notes 16, 18.

20 Step-down provisions in certain situations can affect the amount of coverage afforded the name insured and resident family members. For example, step-down language contained in valid household or family member exclusions totally eliminates the liability coverage afforded a named insured or resident family member who, while driving the insured vehicle, causes an accident in which a family member/passenger is injured. In essence, the named insured becomes an uninsured motorist. See, e.g., Home Ins. Co. v. McGovern, 837 F. Supp. 661, 669 (E.D. Penn. 1993); Krause v. Krause, 589 N.W.2d 721, 723 (Iowa 1999).
liability coverage available. In return, the named insured is able to obtain the desired protection for a lower premium.

This Article examines the development, effect, and validity of step-down clauses. Part I discusses the drafting history of step-down clauses. Drafting history is especially important in insurance litigation because most courts treat it, subject to the parol evidence rule, as admissible.\(^{21}\) Part II examines the case law and discusses the rationales used by courts in addressing whether step-down clauses are legal. Part III examines the theories that have been used to challenge the validity of step-down clauses and considers the residual consequences of a successful challenge to a step-down provision.

I. DRAFTING HISTORY

Several events influenced the development of step-down provisions. The first event was the invention of the automobile. Throughout its history, the automobile has represented a very expensive and risk oriented res. Due to the nature of automobiles, the insurance industry—once it concluded that automobiles could be insured profitably—was confronted with the task of drafting policies consistent with acceptable levels of risk tolerance.\(^{22}\) This task proved very difficult given that automobiles possess certain inherent qualities that make them unlike any other insurable property. Automobiles are expensive consumer goods, mobile, capable of sustaining and causing injury of enormous proportion, and subject to constant risk of loss.\(^{23}\)

The second event, also influenced by the advent of the automobile, was the change in judicial and legislative policy regarding the traditional role of liability insurance.\(^{24}\) Liability insurance was initially designed to

\(^{21}\) See JERRY, supra note 15, at 136-37.

\(^{22}\) See KEETON & WIDISS, supra note 3, at 385-410 (describing the various mechanisms used by automobile insurers).


It has also been observed that when coverage issues arise in automobile insurance, that a number of factors are important; consequently, it is "relatively difficult to predict with certainty either exactly who will be insureds or under what circumstances persons will be entitled to coverage benefits." KEETON & WIDISS, supra note 3, at 386. See also infra note 24.

\(^{24}\) One of the most significant developments of the twentieth century is the widespread ownership and use of automobiles and other vehicles. During roughly the first half of the century, nearly one million Americans lost their lives in automobile accidents. In 1992, 40,300 people died on the nation's highways; this large number is actually a substantial decline from the 56,300 highway deaths that occurred in 1972. In 1992, over 5.4 million personal injuries and $98 billion in economic loss were suffered in the 31.8 million auto accidents that occurred in the United States. Because Americans crash
protect the insured against economic losses that arose out of his legal liability for any accidental act. This observation was, and continues to be, true in the case of automobile insurance. However, insurance regulators, as a result of their perceptions of the societal benefits and interests served by liability insurance, slowly began to expand and redefine the traditional view and role of liability insurance to also encompass a victim oriented philosophy. The enactment of compulsory motor vehicle insurance laws reinforced and encouraged these perceptions. Compulsory insurance laws, especially motor vehicle financial responsibility statutes, profoundly altered the traditional manner in which accident victims are compensated, as well as how courts view automobile liability insurance. There is no doubt that "[t]he coverage provided by omnibus clauses in liability insurance policies obviously serves the interests of accident victims.

These events—the advent of the automobile and the changing view of the role of liability coverage—had a profound impact on the development and application of legal standards used in coverage disputes involving one

their cars into other vehicles, property, and persons so frequently, automobile insurance in many respects has both a history and a set of governing principles of its own. JERRY, supra note 15, at 843; see also KEETON & WIDISS, supra note 3, at 413.

KEETON & WIDISS, supra note 3, at 411.

The term "regulators" is commonly used in reference to legislatures and administrative agencies exercising power pursuant to legislative authority. This view is quite accurate but equally incomplete. "(C)ourts, through the development and application of common law principles in case-by-case adjudication and by the interpretation and application of state statutes in the course of such adjudication, also perform a regulatory function." JERRY, supra note 15, at 123.

See, e.g., Bass v. Horizon Assurance Co., 562 A.2d 1194, 1196 (Del. 1989); see also JERRY, supra note 15, at 843-49.

See JERRY, supra note 15, at 843-65; KEETON & WIDISS, supra note 3, at 413-17.

See, e.g., Nationwide Mut. Ins. Co. v. Roberts, 134 S.E.2d 654 (N.C. 1964). Therein the court observed:
The primary purpose of compulsory motor vehicle liability insurance is to compensate innocent victims who have been injured by financially irresponsible motorists. Its purpose is not, like ordinary insurance, to save harmless the tortfeasor himself. Therefore, there is no reason why the victim's right to recover from the insurance carrier should depend upon whether the conduct of its insured was intentional or negligent. In order to accomplish the objective of the law, the perspective here must be that of the victim and not that of the aggressor for whom the law provides criminal penalties calculated to minimize any profit he might derive from the insurance. The victim's rights against the insurer are not derived through the insured as in case of voluntary insurance. They are statutory and become absolute on the occurrence of an injury covered by the policy.


KEETON & WIDISS, supra note 3, at 357.
particular class of omnibus insureds—permittees. Courts, relying on public policy, struggled to identify principles, theories, and doctrines which would justify extending omnibus coverage to individuals who, at the time of an automobile accident, were operating a non-owned insured vehicle in excess of the permission granted by the named insured.

The events that influenced the development of the step-down clause must also be considered in the context of overriding principles of insurance contract interpretation. Most significantly, insurance contracts are interpreted like any other contract.\(^3\) In this context, the supreme rule of contract interpretation to which all other rules are subservient\(^3\) is that "[a]n insurance contract should be construed to carry out the intention of the parties, and that intention should be ascertained, if possible, from the language in the policy alone."\(^33\) For purposes of this discussion, however, this principle


\(^32\) 13 APPLEMAN & APPLEMAN, supra note 4, at § 7385.

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of interpretation must also be considered in the context of the pertinent language contained in the liability coverage omnibus clause. That language, which has been variously stated, usually defines additional insureds to include "any person using your covered vehicle with your permission."\textsuperscript{34}

The insurance industry has extensive experience with disputes involving extended omnibus clause coverage.\textsuperscript{35} These disputes are factually unique, and, in a significantly disproportionate number of instances, the named insured denied that permission to operate the insured vehicle had been granted or otherwise supported the insurer in its denial of extended coverage.\textsuperscript{36} Despite this, the issues involved in extended omnibus coverage disputes usually concern: (1) whether permission to operate the insured vehicle existed for purposes of omnibus coverage; or (2) whether omnibus coverage extends to situations where the permittee exceeded the scope of the permission granted either in terms of purpose or time.\textsuperscript{37}

Judicial reaction to litigation regarding extended omnibus coverage has taken the shape of a number of imprecise legal standards that, in varying degrees, reflect a victim-oriented philosophy. These legal standards are as diverse and eclectic as the factual contexts in which the issue of extended omnibus coverage arise. Still, they are useful to explain the holding in the vast majority of cases. These standards can be classified as: (1) the liberal or "initial permission" rule;\textsuperscript{38} (2) the moderate or "minor deviation" rule;\textsuperscript{39} (3) the strict or "conversion" rule;\textsuperscript{40} (4) the broad statutory ap-

\textsuperscript{34} See supra note 9.
\textsuperscript{35} See infra notes 38-43.
\textsuperscript{36} See infra notes 38-43.
\textsuperscript{37} See infra notes 38-43.
\textsuperscript{38} This rule provides that if a person has permission to use an automobile in the first instance, any subsequent use while it remains in her possession though not within the contemplation of the parties is a permissive use within the terms of the omnibus clause. The only limitation on this rule is that the subsequent use must not be equivalent to theft or the like. States that adhere to this view include Arkansas, see, e.g., Commercial Union Ins. Co. v. Johnson, 745 S.W.2d 589 (Ark. 1988); California, see, e.g., Jordan v. Consol. Mut. Ins. Co., 130 Cal. Rptr. 446 (Cal. Ct. App. 1976); Florida, see, e.g., Susco Car Rental Sys. v. Leonard, 112 So.2d 832 (Fla. 1959); Illinois, see, e.g., Visintin v. Country Mut. Ins. Co., 222 N.E.2d 559 (Ill. App. Ct. 1966); Indiana, see, e.g., Hartford Ins. Co. v. Vernon Fire & Cas. Ins. Co., 485 N.E.2d 902 (Ind. Ct. App. 1983); Louisiana, see, e.g., Carey v. Ory, 421 So.2d 1003 (La. Ct. App. 1982); Minnesota, see, e.g., Milbank Mut. Ins. Co. v. U.S. Fid. & Guar. Co., 332 N.W.2d 160 (Minn. 1983); Montana, see, e.g., Cascade Ins. Co. v. Glacier Gen. Ins. Co., 479 P.2d 259 (Mont. 1971); Nebraska, see, e.g., Barry v. Tanner, 547 N.W.2d 730 (Neb. 1996); Nevada, see, e.g., U.S. Fid. & Guar. Co. v. Fisher, 494 P.2d 549 (Nev. 1972); New Hampshire, see, e.g., GEICO v. Johnson, 396 A.2d 331 (N.H. 1978); New Jersey, see, e.g., Rutgers Cas. Ins. v. Collins, 730 A.2d 833 (N.J. 1999); New Mexico, see, e.g., Kitchen v. Houston Gen. Ins. Co., 896 P.2d 479 (N.M. 1995); Oregon, see, e.g., Ryan v. W. Pac. Ins. Co., 408 P.2d 84 (Or. 1965); Tennessee, see, e.g., Estate of Adkins v. White Consol. Indus., 788 S.W.2d 815 (Tenn. Ct. App. 1989); and West Virginia, see, e.g., Universal Underwriters Ins. Co. v. Taylor, 408 S.E.2d 358 (W. Va. 1991).
\textsuperscript{39} The minor deviation rule provides that a permittee is covered under the omnibus clause so long as her deviation from the permissive use is minor in nature. States that adhere to this view include
The insurance industry initially responded to these standards by substituting the phrase “within the scope of such permission” for the phrase “with your permission,” used in earlier policies. This, however, did little to stem the tide in favor of extending omnibus coverage to permittees. Rather, courts continued, in all but the most factually egregious cases, to adhere to the view that an insurance company could not avoid liability by claiming that a motorist’s use of the insured’s automobile exceeded the scope of authority granted by the insured.

Industry efforts to stem the tide of judicial decisions in favor of expanded omnibus coverage by changing the pertinent policy language proved unsuccessful for the most part. This failure was largely due to the prevalence of mandatory omnibus clause statutes that were construed by courts to manifest a strong public policy in favor of providing compensation to accident victims. These same statutes, however, would ultimately prove useful in later industry efforts to limit liability exposure.


40 The strict or “conversion” rule provides that any deviation from the time, place, or purpose specified by the person granting permission is sufficient to take the permittee outside the coverage of the omnibus clause. States adhering to this view include Maine, see, e.g., Johnson v. Am. Auto. Ins. Co., 161 A. 496 (Me. 1932); and Michigan, see, e.g., Gray v. Sawatzki, 289 N.W. 227 (Mich. 1939).

41 The broad statutory approach allows courts to liberally construe the omnibus clause to provide coverage. One state that expressly follows this approach is Alaska. See, e.g., Johnson v. U.S. Fid. & Guar. Co., 601 P.2d 260 (Alaska 1979).

42 The presumption of permission provides that permission will be presumed. However, the party asserting that permission did not exist may rebut the presumption. States that adhere to this view include Hawaii and Vermont. See, e.g., AIG Haw. Ins. Co. v. Vincente, 891 P.2d 1041 (Haw. 1995); Am. Fid. Co. v. N. British & Mercantile Ins. Co., 204 A.2d 110 (Vt. 1964). But see Columbia Cas. Co. v. Hohului, 437 P.2d 99 (Haw. 1968) (applying initial permission rule).

43 States that have adopted the contract-by-contract basis recognize that the terminology employed in omnibus clauses vary to such a degree that extended coverage should be determined on a policy-by-policy basis. Maryland adheres to this view. See, e.g., Nat’l Grange Mut. Ins. Co. v. Pinkney, 399 A.2d 877 (Md. 1979).


46 KEETON & WIDISS, supra note 3, at 357.
II. DECISIONAL LAW

As noted earlier, insurance companies enjoy the same rights as others to limit their liability and impose whatever conditions they please upon their obligation to insure, as long as the exercise of the right to freely contract does not violate public policy. Thus, in the absence of a violation of public policy, an insurance contract, like any other contract, should be enforced according to its terms. Consequently, the relevant question regarding step-down provisions is whether a two-tier policy not expressly authorized by law is legal. The answer to this question, in the absence of legislation to the contrary, depends entirely upon some cogent argument that the owner of a vehicle should be precluded from insuring itself against liability at a higher limit than the limit it provides for permissive users.

The vast majority of courts recognize that two-tier or step-down coverage is not per se illegal. These courts have generally relied on a combination of two rationales: (1) the right of the parties to freely contract; and

47 See supra note 2.

(2) compliance with the minimum limits of coverage required by law.\textsuperscript{50} Courts have manifested a predisposition to take judicial notice of the increasing cost of liability insurance with respect to the first rationale.\textsuperscript{51} Consequently, negotiations directed at obtaining a lower premium because of the exclusion of a high risk, which do not result in a provision in contravention of public policy, constitute a legitimate interest.\textsuperscript{52} Considered in conjunction with the fact that the vast majority of states have enacted comprehensive compulsory motor vehicle laws, it is not surprising that courts have deferred to legislative mandates as embodiments of public policy. Therefore, step-down provisions, in all but two jurisdictions,\textsuperscript{53} do not violate public policy as long as they provide the minimum limits of coverage required by law. "If the minimum limits provided by law are inadequate, that is a matter [for] the legislature."\textsuperscript{54}

Significant implications flow out of the fact that step-down provisions are not per se violations of public policy. First, the clauses are not totally immune from legal challenges on other grounds. Most challenges to the validity of step-down provisions are asserted as one or a combination of three theories. These theories are that the clause is invalid because it: (1) does not comply with statutory requirements other than providing the minimum limits of coverage;\textsuperscript{55} (2) violates the reasonable expectation of the parties;\textsuperscript{56} and (3) is ambiguous either because of the language used or organization of the policy.\textsuperscript{57}

A. Violation of Statutory Requirements Other Than Providing the Minimum Limits of Coverage

Even in jurisdictions in which step-down clauses are not per se illegal because they provide the minimum level of statutory coverage, two-tiered coverage may be challenged for violating other statutory mandates. Statutes frequently dictate what provisions a motor vehicle liability insurance policy must contain.\textsuperscript{58} However, it is not uncommon for statutes to prescribe the

\textsuperscript{50} See, e.g., Balboa, 496 P.2d at 149; Patton, 415 So.2d at 45; Gen. Accident Group, 468 A.2d at 433; Am. Tours, 338 S.E.2d at 98; Windsor, 24 S.W.3d at 153.

\textsuperscript{51} See, e.g., Bowers, 671 A.2d at 699. Gerald L. Walter, Jr., Note, 21 LA. L. REV. 835, 836 (1961) ("Certain limitations are imposed for the purpose of enabling the insurer to set premiums which will not make the cost of such a policy prohibitive.").


\textsuperscript{54} Gen. Accident Group, 468 A.2d at 433.

\textsuperscript{55} See discussion infra Part II.A.

\textsuperscript{56} See discussion infra Part II.B.

\textsuperscript{57} See discussion infra Part II.C.

\textsuperscript{58} See supra notes 16, 18.
method in which insurance policies must be drafted. Consequently, challenges based on violations of other statutory requirements can be classified into disputes involving contract form as well as contract substance.

*Cullum v. Farmers Insurance Exchange* and *Mid-Century Insurance Co. v. Lyons* are excellent examples of challenges based on form or failures to follow statutorily prescribed drafting protocol. In *Cullum*, the plaintiffs were injured when a car driven by Richard Smith struck the motorcycle on which they were riding. Smith was driving the car with the permission of the daughter of the named insured—Melvin Fish. Farmers Insurance Exchange insured the car and was the defendant in the case. The policy provided liability coverage up to $50,000 per person or $100,000 per accident. It also contained a step-down clause which stated: "We will provide insurance for an insured person, other than you or a family member, up to the limits of the Financial Responsibility Law only." Richard Smith was not a family member of Mr. Fish's household.

Plaintiffs sought to recover from the insurer. However, Farmers Insurance Exchange refused to pay more than $40,000—the minimum per accident limit required by law at the time. Plaintiffs subsequently filed an action for declaratory relief seeking to recover $100,000—the full amount of liability coverage provided by the policy. The trial court, in response to motions for summary judgment from both parties, granted the defendant's motion and held that the "[d]efendant . . . has no further obligation to the Plaintiffs to provide coverage for sums under its policy in excess of . . . $20,000 per person." Plaintiffs appealed.

On appeal, the plaintiffs argued that the step-down clause (1) violated section A-22-303 of the Utah Insurance Code, which permits an insurer to provide step-down coverage only in certain circumstances; (2) violated section A-21-106, which directs that an insurance company may not incorporate any provision by reference; and (3) is ambiguous and should therefore be construed against the insurer. The court, relying on the language of section A-22-303, concluded "that the legislature did not intend to limit

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59 See discussion supra notes 15-19 and accompanying text.
60 857 P.2d 922 (Utah 1993).
61 562 N.W.2d 888 (S.D. 1997).
62 *Cullum*, 857 P.2d at 923.
63 Id.
64 Id.
65 Id.
66 Id.
67 Id.
68 Id.
69 Id.
70 Id.
71 Id.
72 Id.
step-down coverage" to specific types of insureds.\textsuperscript{73} Hence, the court rejected the plaintiffs' argument based upon section A-22-303 and held "that the statute does not prohibit insurers from providing step-down coverage for permissive users, as long as the coverage satisfies the statutory minimums . . . ."\textsuperscript{74}

The plaintiffs contended in their second argument that the reference in the step-down clause to "the limits of the Financial Responsibility Law" violated section A-21-106 of the Utah Insurance Code, which prohibits incorporation of provisions not appearing in the insurance policy or in attached documents. Section A-21-106(1) provides: [a]n insurance policy may not contain any agreement or incorporate any provision not fully set forth in the policy or in an application or other document attached to and made a part of the policy at the time of its delivery . . . .\textsuperscript{75} The \textit{Cullum} court, after rejecting the merits of defendants' arguments for the use of the phrase "the limits of the Financial Responsibility Law," observed that the policy limited the coverage provided to permissive users but failed to identify the limits.\textsuperscript{76} Thus, reference to undefined "limits of the Financial Responsibility Law" constituted an incorporation of coverage from an outside source,\textsuperscript{77} which blatantly violated the statutory language and purpose of section A-21-106.\textsuperscript{78}

The court in \textit{Cullum} clearly articulated that the phrase "the limits of the Financial Responsibility Law" did not pose a problem of contract interpretation because section A-21-106 addresses "the method of drafting insurance contracts."\textsuperscript{79} "It directs that all provisions must be physically present in the written contract itself or in other documents attached to the contract at time of delivery."\textsuperscript{80} According to the court, the purpose of the statute:

\begin{quote}

is to insure that the entire insurance contract is contained in one document so that the insured can determine from the policy exactly what coverage he or she has. . . . This goal would be defeated by allowing incorporation of substantive statutory provisions just as it would by allowing incorporation of other written materials.\textsuperscript{81}

\end{quote}

\textit{Mid-Century Insurance Co. v. Lyons}\textsuperscript{82} illustrates a challenge to a step-down clause based on a failure to follow drafting protocol from an entirely different perspective than in \textit{Cullum}. In \textit{Mid-Century}, Carl Benedict was

\begin{itemize}
\item \textsuperscript{73} Id. at 924.
\item \textsuperscript{74} Id.
\item \textsuperscript{75} UTAH CODE ANN. § 31A-21-06 (2001).
\item \textsuperscript{76} \textit{Cullum}, 857 P.2d at 925.
\item \textsuperscript{77} Id.
\item \textsuperscript{78} Id.
\item \textsuperscript{79} Id.
\item \textsuperscript{80} Id.
\item \textsuperscript{81} Id.
\item \textsuperscript{82} 562 N.W.2d 888 (S.D. 1997).
\end{itemize}
driving a car with the permission of its owner when he collided with Rebecca Waack. Benedict's negligence caused the collision. The vehicle was insured by Mid-Century Insurance Company. The Mid-Century policy carried a bodily injury liability limit of $50,000 per person and $100,000 per accident. The policy also contained a step-down provision that limited the insurer's liability to the "requirements of the South Dakota Financial Responsibility Law"—set at $25,000. Consequently, Mid-Century contended that it was only obligated to provide $25,000 of coverage in this instance.

The South Dakota Division of Insurance was contacted regarding the validity of the step-down provision. It ruled that the clause was invalid because it constituted a restrictive endorsement that was required to be on a separate page attached to, rather than part of, the policy itself. This ruling was ultimately appealed to the Supreme Court of South Dakota for final disposition.

The Division of Insurance relied on the language of section 11-9.3 of the South Dakota Insurance Code. That statute provides that:

An insurance policy covering a private passenger automobile or other motor vehicle registered or principally garaged in this state may by written agreement with the named insured exclude a named individual from coverage. The policy may also contain a restrictive endorsement reducing the limits of liability or collision coverage when the vehicle is operated by a named person or class of persons. However, if the policy does not provide liability coverage to a person or persons named in the restrictive endorsement, the liability coverage may not be less than the minimum prescribed by chapter 32-35.

On appeal, the Division of Insurance argued that the legislature, when it failed to define the term "restrictive endorsement" in the statute, contemplated that the term would be accorded its common industry meaning. Consequently, because the step-down provision constituted a restrictive endorsement, it had to be placed on a separate page or piece of paper apart from the body of the policy.

The court agreed that in the absence of a statutory definition, "restrictive endorsement" should be construed to convey its ordinary popular

83 Id. at 889.
84 Id.
85 Id.
86 Id.
87 Id.
88 Id.
89 Id.
90 Id.
91 Id. at 890.
92 Id.
93 Id. at 889.
94 Id. at 890.
Relying upon legal treatises and encyclopedias, the court concluded that "endorsements of any type in an insurance context are attached to policies and are not part of the policy proper." The court further found this definition to be consistent with the legislative intent and purpose of the statute.

_Cullum_ and _Mid-Century_ demonstrate that challenges to step-down provisions based on failures to follow drafting protocol can result from one of two perspectives. The first perspective, illustrated by _Cullum_, occurs when the step-down provision contained in the policy does not contain information sufficient to satisfy the statutory requirements. The second perspective, illustrated by _Mid-Century_, results when the policy itself contains a step-down provision that is statutorily required to be separately stated and attached to the policy.

Challenges to the validity of step-down provisions can also be based upon substantive violations of compulsory automobile statutes other than the minimum limits of coverage requirement. These violations usually occur when insurers place conditions on the statutory limits of coverage. Unlike in _Cullum_ and _Mid-Century_, resolution of the issue in this context involves principles of contract interpretation.

For example, in _Rao v. Universal Underwriters Insurance Co._, Anita Rao, while driving a vehicle leased by her husband, struck Lena Paglucci, a pedestrian. The vehicle had been leased by Mr. Rao from Open Road Leasing. The lease agreement required Mr. Rao to obtain liability insurance on the vehicle. A policy was obtained by Mr. Rao from Allstate Insurance and provided coverage in the amount of $100,000/$300,000. The policy also named Open Road as an additional insured. Allstate deposited the proceeds of this policy with the court.

Open Road also had an automobile liability insurance policy that it purchased from Universal Insurance Underwriters. This policy contained a step-down provision that conditioned coverage up to the statutorily required minimum on the lessee’s failure to secure sufficient liability insur-
The automobile liability coverage step-down clause

To comply with the statutory mandate. Essentially, while the Universal policy provided higher amounts of coverage for vehicles operated by Open Road's employees, a lessee was provided coverage only to the extent of the statutory minimums, and that coverage arose only if the lessee failed to procure sufficient liability coverage to satisfy the statutory minimums. In essence, the step-down provision in Universal's policy contained a contingency upon which the statutorily required coverage was conditioned.

The court in Rao reviewed the New Jersey Safety Responsibility Law. Following a careful examination of the language, purpose, and intent of the statute, the court concluded that the statute "insures that a lessor will provide such insurance coverage irrespective of whether a lessee does so." Consequently, any provision that attempts to preclude coverage entirely based on an agreement with a lessee is contrary to the law and constitutes an illegal escape clause.

In challenges based on statutory violations other than the minimum limits of coverage, ascertainment of the legislative intent and purpose of a statute serves two functions. It is initially used to determine whether a violation has occurred and correspondingly whether the step-down provision is enforceable. If the court concludes that the provision is unenforceable because it violates a statutory mandate, these considerations are subsequently used to determine whether an exception to the statute should be recognized. In the event the statute violated is construed to manifest a strong policy, an exception to the statutory requirement should not be recognized.

B. Reasonable Expectations Doctrine

The reasonable expectations doctrine is a recent development in the law of insurance. The doctrine is used to describe a combination of equitable principles and has proven useful in explaining the results of disparate insurance law decisions that appear to be based on a number of different rationales. Since the intellectual foundations of the doctrine were first laid down, courts throughout the country have attempted to shape these varied principles into definitive rules through decisional law. This effort

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107 Id.
108 Id. at 1262.
110 Id.
111 Id. at 1263.
113 See, e.g., id. at 922; Mid-Century Ins. Co. v. Lyon, 562 N.W.2d 888, 888 (S.D. 1997).
115 Id.
has only increased the uncertainty regarding the theoretical underpinnings, scope, and details of application of the doctrine. It has, however, culminated in the development and recognition of different versions of the doctrine.\textsuperscript{116}

One commentator classified these versions and the rules applicable thereto as: (1) construction of an ambiguous term in the insurance contract to satisfy the insured’s reasonable expectations; (2) refusal to enforce the “fine print” of an insurance contract because it limits more prominent provisions giving rise to the insured’s expectations; and (3) refusal to enforce an insurance contract provision when it would frustrate the reasonable expectations of coverage created by the insurer outside of the contract.\textsuperscript{117} These versions of the doctrine can be further refined. Decisional law suggests that versions (1) and (2) are merely variants of the doctrine of ambiguity and are not separate approaches to which entirely distinct rules are applicable.\textsuperscript{118} Version (3) is distinguishable because, at least in terms of application, it reflects kinship to the doctrines of estoppel and unconscionability.\textsuperscript{119} The existence of multiple versions of the doctrine of reasonable expectations does not change the fact that only two competing decisional approaches to interpreting insurance contracts have developed. These interpretive methods have been articulated as the “traditional” or “formalist” approach and the “functional” or “reasonable expectations” approach.\textsuperscript{120}

\begin{itemize}
\item \textsuperscript{116} Id. at 838; see also Mark C. Rahdert, Reasonable Expectations Reconsidered, 18 CONN. L. REV. 323, 345, 370-71 (1986).
\item \textsuperscript{117} Stephen J. Ware, A Critique of the Reasonable Expectations Doctrine, 56 U. CHI. L. REV. 1461, 1467 (1989).
\item \textsuperscript{118} See infra Part III.C.
\item \textsuperscript{119} For a discussion of estoppel and unconscionability in the context of insurance, see Johnny Parker, Replacement Cost Coverage: A Legal Primer, 34 WAKE FOREST L. REV. 295, 323-328 (1999).
\item \textsuperscript{120} Collins v. Farmers Ins. Co., 822 P.2d 1146, 1159 (Or. 1991) (Unis, J., dissenting). Justice Unis explained the similarities and distinctions between the interpretative approaches as:
\end{itemize}

Under the “traditional” or “formalist” approach, the court looks to the “four corners” of the insurance policy and interprets it by applying rules applicable to all contracts in general. The insured is held to have read and to have understood the clear language of the policy. Extrinsic evidence relating to the insurance contract may be examined for the purpose of determining the parties’ intentions to an objective analysis of the “four corners” of the contract.

The rationale behind the “formalist” approach is that contracts of insurance rest upon and are controlled by the same principles of law that apply to other contracts, and the parties to an insurance contract may provide such provisions as they deem proper as long as the contract does not contravene law or public policy.

The competing approach to insurance contract interpretation—the “functional” or “reasonable expectation” approach—is that the policyholder’s reasonable expectations to coverage under the insurance policy should be honored even though those expectations vary from the policy provisions.

The “functional” or “reasonable expectation” approach is supported by the notion that insurance contracts are not ordinary contracts negotiated by parties with
Despite the uncertainty that remains regarding the scope and details of application of the reasonable expectations doctrine, some generally accepted definitive rules have evolved with regard to each version. A majority of jurisdictions adhere to a narrow version of the doctrine, treating the doctrine as a corollary to the rule of ambiguity. Pursuant to the narrow version, the doctrine is treated as a tool of contract interpretation and is applicable only if an ambiguity exists in the policy. Consequently, the narrow version would honor objectively reasonable expectations of the insured even though painstaking study of the policy provisions has negated those expectations when: (1) the policy is ambiguous; (2) the policy contains exclusions that are masked by technical or obscure language; or (3) exclusions are stated in such a way that they are separated from the remainder of the policy and are not noted as exceptions.

Roughly equal bargaining strength. Rather, they are largely contracts of adhesion, where the insurance company, in preparing a standardized printed form, has the superior bargaining position, and the insured has to accept such policy on a “take-it-or-leave-it” basis if the insured wants any form of insurance protection. . . .

Restatement (Second) of Contracts, §211 (1981), “[r]epudiates the ‘four-corners’ [‘traditional’ or ‘formalist’] approach to contract interpretation in the standardized agreement setting and in effect approves a doctrine of ‘reasonable expectations.’”

A growing number of courts use the “functional” approach to protect the “reasonable expectations” of the insured policyholder from possible denial of coverage that might result under the “traditional” or “formalist” contractual analysis of an insurance policy.

There is no disagreement between the “formalist” and the “functional” approaches whenever the insurance policy is ambiguous or susceptible to two or more reasonable interpretations.

sions are hidden in policy provisions.\textsuperscript{123} Any of these circumstances, in isolation or combination, would support a finding of a latent or patent ambiguity.\textsuperscript{124} The narrow version of the reasonable expectations doctrine is in keeping with the "traditional" or "formalist" approach to contract interpretation.\textsuperscript{125}

The broad version of the doctrine, which is consistent with the "functional" or "reasonable expectations" approach, permits application of the doctrine even in the absence of a finding of ambiguity.\textsuperscript{126} Furthermore, unlike the narrow version,\textsuperscript{127} the broad version permits application of the doctrine based solely upon the fact that an insurance policy is a contract of adhesion.\textsuperscript{128} Pursuant to the broad version, courts are justified in rewriting

\textsuperscript{123} See sources cited supra note 121.


A patent ambiguity exists when the language on its face is capable of more than a single interpretation and arises from the use of defective or obscure, or insensible language. Crown Mgmt. Corp. v. Goodman, 452 So.2d 49, 52 (Fla. Dist. Ct. App. 1984) ("Extrinsic evidence is inadmissible if the ambiguity is patent, because such evidence would, in effect, allow the court to rewrite the contract for the parties by supplying information the parties themselves did not choose to include."). A latent ambiguity exists when patently unambiguous language becomes ambiguous when applied. \textit{id.} ("A latent ambiguity . . . is said to exist where a contract fails to specify the rights or duties of the parties in certain situations and extrinsic evidence is necessary for interpretation or a choice between two possible meanings."). Although there appears to be some divergence of opinion as to when parol evidence is properly admitted because of the latent ambiguity–patent ambiguity dichotomy, the distinction between the type of ambiguity involved is one of form over substance. The growing and better reasoned trend of authority indicates that the introduction of parol evidence to probe the true intent of the parties is proper, irrespective of any technical classification of the type of ambiguity present.


\textsuperscript{127} See Rahdert, supra note 116, at 338. See also Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co., 682 P.2d 388, 395 (Ariz. 1984) ("[M]ost insureds develop a 'reasonable expectation' that every loss will be covered by their policy."); \textit{Allen}, 839 P.2d at 803 n.6 ("[F]orm contracts are essential to the economic vitality of the insurance industry.").

\textsuperscript{128} See, e.g., Stordahl v. Gov't Employees Ins. Co., 564 P.2d 63, 65-66 (Alaska 1977). The reasonable expectations doctrine is closely akin to the doctrine of contracts of adhesion. According to the
an otherwise clear and unambiguous policy if: (1) the insurer knew or should have known of the insured’s expectations; (2) the insurer created or helped to create those expectations; or (3) the insured’s expectations are objectively reasonable in light of the circumstances and facts of the case.¹²⁹

The primary issues in challenges based upon the reasonable expectations doctrine are: (1) whether the doctrine has been adopted in the respective jurisdiction;¹³⁰ and (2) whether it is applicable in light of the facts of the case. Thus, in Krause v. Krause,¹³¹ the court, in the context of a step-down provision contained in the uninsured motorist coverage, observed that Iowa law recognizes the doctrine.¹³² However, in terms of application:

The doctrine is carefully circumscribed and does not contemplate the expansion of coverage on a general equitable basis. It can only be invoked when an exclusion “(1) is bizarre or oppressive, (2) eviscerates terms explicitly agreed to, or (3) eliminates the dominant purpose of the transaction.” A preliminary criterion must be satisfied before we apply the doctrine. The policy must either be such that an ordinary layperson would misunderstand its coverage, or there must be circumstances attributable to the insurer which would foster coverage expectations.¹³³

The plaintiff in Krause failed to present any evidence of overt actions or misrepresentations on the part of the insurer.¹³⁴ Instead, plaintiff contended that the policy’s use of the phrase “financial responsibility law of Iowa” was so vague that an ordinary person would be unable to ascertain the coverage provided.¹³⁵ The court rejected this argument as a substitute for the requisite evidence and concluded that the reasonable expectations doctrine was inapplicable.¹³⁶

C. Ambiguity

The doctrine of ambiguity is one of the oldest and most used variance principles. It differs significantly from the principle of honoring the reasonable expectations of the insured in many respects, not the least of which is that it often produces results that are more favorable to the insured than would a decision based on reasonable expectations.¹³⁷ The rule of ambiguity provides that an ambiguity in a contract will be construed against its...

¹²⁹ See supra note 126.
¹³⁰ See supra note 126.
¹³¹ 589 N.W.2d 721 (Iowa 1999).
¹³² Id. at 727.
¹³³ Id. (citations omitted).
¹³⁴ Id. at 728.
¹³⁵ Id.
¹³⁶ Id.
¹³⁷ See infra note 157.
draft and in favor of the non-drafting party.\textsuperscript{138} A contract is ambiguous when a word, phrase, or provision in the contract has, or is susceptible to, more than one reasonable interpretation when the policy is read as a whole.\textsuperscript{139} Ambiguity in an insurance policy can arise from inconsistent policy provisions, policy organization, or ambiguous language. A number of jurisdictions also take the position that ambiguity can arise from inconsistent judicial interpretations.\textsuperscript{140} Whether a provision is ambiguous is a question of law for the court to resolve.\textsuperscript{141} Determining whether inconsistent policy provisions or poor policy organization creates ambiguity requires little more than an examination of the entire policy and application of the controlling rule.\textsuperscript{142} Charges of ambiguity based on the use of ambiguous language requires the application of a detailed legal analysis.\textsuperscript{143}

Challenges to step-down provisions based on the use of ambiguous language have universally failed.\textsuperscript{144} \textit{Universal Underwriters Insurance Co. v. Metropolitan Property & Life Insurance Co.}\textsuperscript{145} is the seminal case involving a challenge based on ambiguous language. In \textit{Universal Underwriters}, respondent Universal Underwriters was the insurer of Morris Motors—a car dealership.\textsuperscript{146} An employee of the dealership, Mr. Pulcino, was injured while riding as a passenger in a car owned by Morris Motor and being test-driven by a customer of the dealership.\textsuperscript{147} Pulcino sued the customer, who was insured by Metropolitan Property & Life Insurance Company.\textsuperscript{148} The customer was also a permissive insured under the policy is-

\textsuperscript{138} KEETON \& WIDISS, supra note 3, at 628.


\textsuperscript{140} See supra note 6.

\textsuperscript{141} See generally 17A AM. JUR. 2D Contracts § 339 (2000); RESTATEMENT (SECOND) OF CONTRACTS § 212 cmt. d (1981).

\textsuperscript{142} For a detailed discussion, see Johnny Parker, \textit{The Wacky World of Collision and Comprehensive Coverages: Intentional Injury and Illegal Activities Exclusions}, 79 NEB. L. REV. 75, 101 (2000).

\textsuperscript{143} See sources cited supra note 139.


\textsuperscript{146} Id. at 859.

\textsuperscript{147} Id.

\textsuperscript{148} Id.
sued to Morris Motors by Universal.\textsuperscript{149} Both insurers were called upon to defend.\textsuperscript{150} Universal contended that its liability was limited to $15,000—the minimum mandated by the South Carolina Motor Vehicle Financial Responsibility Act.\textsuperscript{151} The trial court agreed with Universal and Pulcino appealed.\textsuperscript{152}

One of the two issues addressed by the court on appeal was whether the trial court erred in ruling that no ambiguity existed in the policy and that, therefore, coverage is limited to the statutory minimum.\textsuperscript{153} In affirming the trial court’s decision, the appellate court observed that: “Written in the turgid vernacular typical of insurance policies, the language of the policy issued by Universal is stylistically inelegant but, when carefully read, unmistakable in its meaning.”\textsuperscript{154} Courts throughout the country rely on this passage when addressing challenges based upon ambiguous language.\textsuperscript{155}

\section*{III. Consequence of a Successful Challenge}

Application of the doctrines of reasonable expectations or ambiguity usually result in the policy being construed against the insurer and in favor of coverage.\textsuperscript{156} In terms of practical application, this generally means that the insured or person claiming coverage is entitled to the full protection afforded by the policy.\textsuperscript{157} This rule is controlling in nature and generally, but not necessarily, negates the need for further analysis.\textsuperscript{158} In cases involv-

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{149} Id.
\item \textsuperscript{150} Id.
\item \textsuperscript{151} Id.
\item \textsuperscript{152} Id.
\item \textsuperscript{153} Id. at 860.
\item \textsuperscript{154} Id.
\item \textsuperscript{156} Universal Underwriters’ policy, like most comprehensive insurance policies, does not make for easy reading, especially when the relevant portions of the policy are taken from a number of different sections of the contract. Although walking through these various provisions is cumbersome and stylistically inelegant, it does not seem that a reasonable person would be misled as to the policy limits for permissive users.
\item \textsuperscript{157} Id. at 1337. See also Windsor v. Lucas, 24 S.W.3d 151 (Mo. Ct. App. 2000).
\item \textsuperscript{158} See supra Parts II.B, II.C.
\item \textsuperscript{159} Keeton & Widiss, supra note 3, at 628 n.4.
\end{enumerate}
\end{footnotesize}
ing a successful challenge based upon violation of a statute, the issue of what policy limits apply to permissive users—those required by law or the full limits of the policy—arises and must be subjected to further analysis. How this issue is resolved is as important as the initial issue of whether the step-down provision is enforceable.

For example, in *Rao v. Universal Underwriters Insurance Co.*, the court concluded that the step-down provision was unenforceable.159 Nevertheless, the court held that the insurer, for policy reasons, was only liable for the statutory minimum limits of coverage.160 This result is not as absurd as it appears because enforcement of the step-down provision in *Rao* would have allowed the insurer to avoid responsibility entirely. Furthermore, some courts have adopted the statutory minimum limits of coverage as the applicable rule in a variety of circumstances.161

Adoption of the statutory minimum limits of coverage as the applicable rule when a step-down provision is deemed unenforceable is consistent with two general principles of contract interpretation. The first principle is the rule of contract severability. Pursuant to this rule, if it is possible to sever an unenforceable portion of a contract or provision from an otherwise enforceable portion of the contract or provision, the court may nevertheless enforce the remainder of the agreement.162 The second principle is the right to freedom of contract.163 Insurers, exercising their right to contract freely, uniformly include in insurance policies a clause that provides that “if any part of this policy is in conflict with local, state or federal law, those provisions in conflict will automatically change to conform to the law.”164

Neither of these principles, however, is without limits. “A court may treat only a part of a term as unenforceable . . . if the party who seeks to enforce the term obtained it in good faith and in accordance with reasonable standards of fair dealing.”165 Furthermore, despite the cliché that insurance contracts are said “to be like any other contract to which general rules of contract interpretation are applicable” the reality is that they are not.166

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160 *Id.*


163 *See sources cited supra note 48.


166 Though the rule that insurance contracts are to be interpreted like any other contract is universally accepted, decisional law certainly supports the view that insurance contracts are inherently different from other types of private contracts. This difference supports the application of a higher standard of judicial review or alternative interpretive principles. “Because an insurance policy is an adhesion contract and is not generally the result of an arms-length negotiations, courts have developed rules of construction which differ from those applied to most other contracts.” *Hallowell v. State Farm Mut. Auto. Ins. Co.*, 443 A.2d 925, 926 (Del. 1982). *See also supra* note 2. It has been observed that:
One does not have "liberty of contract" unless organized society forbears and enforces, forbears to penalize him for making his bargain and enforces it for him after it is made. . . . There are many contract transactions that are definitely forbidden by the law, forbidden under pains and penalties assessed for crime and tort; and there are many more such transactions that are denied judicial enforcement, even though their makers are not subjected to affirmative pains and penalties.167

Consequently, any rule that encourages insurers to attempt to gain advantage from their superior bargaining position should be discouraged.168

These limitations suggest that the better view, in the absence of statutory authority to the contrary, is that the insurer should be liable for the full policy limits available.169 The full policy limits remedy is also more pragmatic than the statutory minimum remedy because it prevents an insurance company from receiving the benefits of an otherwise unenforceable provision.

A significant number of state legislatures have enacted, as a part of their motor vehicle safety responsibility laws, statutes that seemingly support the adoption of the statutory minimum limits as the applicable rule in cases involving successful challenges to step-down clauses.170 The statutory

Although the notion that an insurance contract should be interpreted by reference to the principles that govern the interpretation of any contract is alive and well, it is also clear that many decisions cannot be explained cogently by reference to ordinary principles of contract interpretation. In these cases, courts have either explicitly or implicitly recognized that insurance policies have special characteristics and must be construed with reference to special, perhaps unique standards. Professor James Fischer has described the rules of insurance contract interpretation as ones that "build on general rules applicable to all contracts" but which "are... more than simplistic extensions of the basic rules of contract" and which "often have a significant twist." Further he identifies three rules of insurance contract interpretation found in some cases that have no contract law counterpart: coverage terms are interpreted liberally while exclusions are interpreted narrowly; insurance policies are to be interpreted consistently with a layperson's understanding; if possible, policies are to be construed so to achieve the purpose of providing indemnity. All of this adds up to a decidedly pro-insured bias in insurance policy interpretation, and invites the question as to whether giving insurance policies special treatment is appropriate.

JERRY, supra note 15, at 135-36.


168 RESTATEMENT (SECOND) OF CONTRACTS § 184 cmt. a.


170 ALA. CODE § 32-7-22(g) (2000); ALASKA STAT. §§ 28.20.440(g) (Michie 2000); id. § 28.22.121(a) (Michie 2000); ARIZ. REV. STAT. ANN.§ 28-4009(D) (West 2000); ARK. CODE ANN. § 27-19-713(g) (Michie 2000); DEL. CODE ANN. tit. 21, §2902(g) (1999); HAW. REV. STAT. § 287-30 (2000); IDAHO CODE § 49-1212(6) (Michie 2000); IOWA CODE ANN. § 321A.21(7) (West 2000); LA. REV. STAT. ANN. § 32:900(G) (West 2000); MICH. COMP. LAWS § 257.520 (g) (1999); MISS. CODE ANN. §§ 63-15-43(7) (2000); MO. ANN. STAT. § 303.190(7) (West 1999); MONT. CODE ANN. § 61-6-103(8) (1999); NEB. REV. STAT. § 60-539 (2000); NEV. REV. STAT. 485.3091(6) (2000); N.C. GEN. STAT. § 20-279.21(g) (1999); N.D. CENT. CODE § 39-16.1-11(7) (2000); OHIO. REV. CODE ANN. § 4509.55(A) (West 2000); OKLA. STAT. tit. 47, § 7-324(g) (1999); OR. REV. STAT. § 742.464 (1999);
language in these jurisdictions provides that a policy that grants the coverage required for a motor vehicle liability policy may also grant lawful coverage in excess of or in addition to the coverage specified for a policy and the excess or additional coverage is not subject to other statutory provisions. With respect to a policy that grants excess or additional coverage, the term "motor vehicle liability policy" applies only to that part of the coverage that is required by the statute. Statutes of this nature support a number of rationales for limiting recovery to the statutory minimum in a variety of situations.

CONCLUSION

The success that the insurance industry has experienced regarding step-down provisions is unequaled in the annals of automobile insurance litigation. Much of this success is attributable to compulsory automobile liability insurance statutes. The industry has only recently come to understand that public policy is a paradigm composed of diverse private interests. In many instances, ascertainment and protection of these interests fall within the exclusive domain of the judicial branch. However, as has been the case with compulsory liability insurance, these interests are at times ascertained and expressed in statutory form. When this is the case, much of the uncertainty regarding what constitutes public policy and how it is to be protected is removed. In essence, statutory expressions of policy can, and in many instances do, effectively eliminate judicial discretion and short circuit the application of equitable principles such as the doctrine of ambiguity and honoring the reasonable expectation of the insured.

For every action there is an opposite and equal reaction. However, as has been demonstrated by this discussion of the step-down clause, equilibrium, even in a turbulent environment, can be achieved. It is important to remember that equity is the exclusive domain of the judiciary and cannot be totally abrogated. Consequently, the possibility that the courts will do an about face and renew its pro-insured course across the turbulent sea of insurance litigation remains a viable possibility.

R.I. GEN. LAWS § 31-32-24(g) (2000); S.C. CODE ANN. § 56-9-20(5)(d) (Law. Co-op. 1999); S.D. CODIFIED LAWS § 32-35-75 (Michie 2000); TENN. CODE ANN. § 55-12-122(f) (1999); TEX. TRANSP. CODE ANN. § 601.078(b)-(c) (Vernon 2000); WASH. REV. CODE § 46.29.490(7) (2000); W. VA. CODE § 17D-4-12(g) (2000); WYO. STAT. ANN. § 31-9-405(g) (Michie 2000).

See sources cited supra note 170.