

# Reevaluating Standardized Insurance Policies

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*Abstract: This Article empirically debunks the common claim that homeowners insurance policies do not vary across different insurance carriers. It demonstrates that different carriers' homeowners policies differ radically with respect to numerous important coverage provisions. It also reports that a substantial majority of these deviations produce decreases in the amount of coverage relative to the presumptive industry standard, though some deviations increase coverage. Additionally, the Article describes the surprising absence of any mechanisms by which even informed and vigilant consumers could comparison shop among carriers on the basis of differences in coverage. It closes by reviewing various regulatory and judicial options for responding to this lack of transparency in homeowners insurance markets. It also considers the broader theoretical implications of the findings for regulatory theory and scholarship on standardized form contracts.*

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## Introduction

Insurance policies are prototypical contracts of adhesion: they are standard forms offered to ordinary consumers by sophisticated firms on a take-it-or-leave-it basis.<sup>1</sup> But consumer insurance policies in property/casualty insurance markets (or “personal lines”) are often described as “super contracts of adhesion.”<sup>2</sup> This label refers to the claim that these insurance policies are collectively drafted by insurers via an industry organization known as the Insurance Services

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<sup>1</sup> See Friedrich Kessler, *Contracts of Adhesion-Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 629 (1943); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1226 (1983); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 546 (1971). Interestingly, one might contest the true “take it or leave it” nature of insurance policies given the wealth of potential endorsements that are available to policyholders. This feature of insurance policies effectively gives policyholders a wide range of potential contracting options, along with set prices for each option.

<sup>2</sup> See, e.g., JEFFREY W. STEMPEL, LAW ON INSURANCE CONTRACT DISPUTES, § 4.06[b], at 4-37 (2d ed., 1999) (“In a sense, the typical insurance contract is one of ‘super-adhesion’ in that the contract is completely standardized and not even reviewed prior to contract formation.”)

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Organization (ISO), resulting in standardization of policy language *across* different insurers.<sup>3</sup> In a world of super contracts of adhesion, comparison-shopping on the basis of policy language makes no sense.

Legal commentary, regulatory practice, and consumer behavior have all been shaped to varying degrees by this conventional wisdom that personal lines insurance policies are roughly uniform. Various law review articles, casebooks and treatises offer explanations for policy standardization, ranging from historical practice, economies of scale, network effects, coordination, and insurers' partial immunity from antitrust laws.<sup>4</sup> They also build normative arguments about the ideal

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<sup>3</sup> See Ins. Servs. Office, Inc., *ISO: Enhancing Competition in the World's Insurance Markets* (1997), reprinted in KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION: CASES AND MATERIALS* 33-34 (3d ed. 2000) ("A very substantial percentage of the standard-form policies that the [property/casualty] industry uses are prepared by the Insurance Services Office."). The ISO does have one moderately-sized competitor – the American Association of Insurance Services (AAIS) – that often gets ignored in the literature. The AAIS is the only countrywide competitor to ISO in providing standardized policy forms. See <http://www.aaisonline.com/company/who.html>

<sup>4</sup> See Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. INS. L. J. 1 (2007) ("[I]n some lines of insurance, all insurance companies provide identical coverage on the same take-it-or-leave-it basis"); Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 Mich. L. Rev. 531, 534 (1996); KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION: CASES AND MATERIALS* 31 (5th ed. 2010) ("Although the fact that insurance policies are contracts of adhesion is important to an understanding of the law governing their operation, it is equally important that the same standard-form policies often are used by many insurance companies. Thus, standardization in insurance not only involves a take-it-or-leave-it offer of the same policy by one company to all its customers, but (in the extreme case) a take-it-or-leave-it offer of the same policy, to all customers, by all companies"); Stempel, *supra* note 2, § 4.06[b], at 4-37; Jonathan Macey & Geoffrey Miller, *The McCarran Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 NYU L. REV. 13 (1993) ("Similarly, accurate information cannot be developed-and consumers cannot easily comparison shop on the basis of price-unless firms in the industry have access to standardized forms."). Jeffrey Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?: Text versus Context*, 24 ARIZ ST L J 995 (1992) ("the insurance industry collects judicial data (court decisions) and uses them to draft standardized language for industry contracts. These standard forms are then made available to insurance companies throughout the United States in the form of specimen policies. The only part of the standard contract that is generally customized to the consumer is the declarations sheet... there is little if any freedom to negotiate the standardized language of the insurance contract that determines the scope of coverage."); Kent D. Syverud, *The Duty To Settle*, 76 VA. L. REV. 1113, 1116 (1990) ("But automobile and property owner's liability insurance contracts are standardized across insurers in a form few insureds have the power or experience to bargain around"); Robert H. Jerry II, *The Antitrust Implications of Collaborative Standard Setting by Insurers Regarding the Use of Genetic Information in Life Insurance Underwriting*, 9 CONN. INS. L.J. 397, 400 (2003) ("Insurers have long cooperated in drafting standardized policy forms, sharing data regarding the identification and quantification of risks, and collecting and disseminating loss and expense data."); Michelle Boardman, *Insuring Understanding: The Tested Language Defense*, 95 IOWA L. REV. 1027 (2010) (describing the "hyperstandardization" of insurance policies). In previous work, I too have echoed this conventional understanding. See, e.g., Daniel

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content of insurance law on the basis of presumed industry-wide uniformity of policy forms.<sup>5</sup> Insurance regulation is also importantly influenced by this conventional wisdom, as state regulators have historically done nothing to inform consumers about potential differences in coverage among different insurers despite various other regulatory efforts to improve consumers' insurance knowledge.<sup>6</sup> Finally, outside of a narrow market for high-value homes, consumer shopping is driven by the assumption that policy forms do not matter: ordinary consumers shop among competing insurers based almost exclusively on price, service, and general reputation.<sup>7</sup>

This Article demonstrates that the conventional wisdom is no longer accurate with respect to a core area of personal lines coverage, homeowners insurance.<sup>8</sup> Some of the most prominent national insurers employ language in their policies that is systematically less generous than that provided in the standard ISO policy. These downward deviations are not limited to policy terms that are designed to avoid judicial determinations of ambiguity, but also include unambiguous and purposeful reductions in coverage.<sup>9</sup> Moreover, while some of these coverage reductions certainly involve risks that have become prominent in recent years, such as mold, pollution and lead, others involve substantial reductions in more traditional coverages. These span the gamut of the types of issues addressed in the prominent insurance law casebooks, including subrogation rights, concurrent causation, intrinsic loss, increase of hazard clauses and numerous other issues. At the same time, several insurers (though fewer) have policy forms that are more generous than the ISO form in important ways. These more generous forms do not simply involve "bells and whistles," but key coverage provisions, such as liability protection for emotional distress claims and coverage for mold/fungus remediation.

Although these empirical results disrupt conventional wisdom among academics, lawyers, regulators, and even insurance agents, they would perhaps have uncertain normative implications were it not for the

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

<sup>5</sup> See, e.g., Randall, *supra* note 4; Schwarcz, *Products Liability Theory*, *supra* note 4, at 1404-12; Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholders' Objectively Reasonable Expectations of Insurance Coverage*, 5 CONN. INS. L.J. 335, 359, 365 (1998).

<sup>6</sup> See Part III, A, *infra*.

<sup>7</sup> See Part III, B, *infra*.

<sup>8</sup> See Part II, *infra*.

<sup>9</sup> Existing scholarship has generally assumed that changes to policy terms are not only implemented on an industry wide basis, but also tend to focus on "fixing" terms that courts have found ambiguous. See, e.g., Michelle E. Boardman, *Contra Proferentem: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105, 1113-14, 1117 (2006).

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present state of insurance policy transparency. Despite massive marketing campaigns by insurers emphasizing the importance of coverage in addition to premiums, it is currently virtually impossible for ordinary consumers to compare the scope of coverage that different carriers provide.<sup>10</sup> Insurers do not make their policy language available to consumers on their websites or elsewhere until after they purchase coverage. Apart from several high-end carriers, insurers' marketing materials almost never describe policy coverage in ways that might facilitate an assessment of their comparative breadth. And preliminary evidence suggests that many insurance agents are both unaware of potential differences in coverage among carriers and unfamiliar with many details of the coverage they sell.

Even more disturbing, state insurance regulators currently do essentially nothing to fill this informational void.<sup>11</sup> They provide consumers with virtually no information that would allow them to compare the relative breadth of different insurers' policies. In fact, in many cases, state insurance regulators do not even have partial copies of the policies that different homeowners insurers are using. In many other cases, states have on file partial copies of insurers' forms, but have no idea which forms are being used or which endorsements among hundreds of filed forms the insurer requires to be included with basic homeowners forms. And with the exception of only four states, the limited information about different insurers' policy forms that regulators do possess is virtually impossible for an ordinary consumer to access. Even with respect to the four states that make form filings available online, only a seasoned expert with a substantial amount of time and patience can wade through these to locate *partial* copies of the forms that *some* companies use.

Collectively, these findings demonstrate that state insurance regulators have failed to evolve along with the marketplaces they are regulating.<sup>12</sup> While insurers have experimented significantly with their own distinctive policy language – usually secretly and in ways that limit coverage – insurance regulation has remained structured in a way that can only be defended on the assumption that insurance policies remain completely uniform. This Article calls on insurance regulators to rectify this situation by implementing a robust and comprehensive regime to facilitate insurance policy transparency.

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<sup>10</sup> See Part III, *infra*.

<sup>11</sup> See Part III, *infra*.

<sup>12</sup> See generally Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 73 N.C. L. REV. (forthcoming 2011) (exploring the role that regulatory contrarians can play in promoting more effective adaptation by financial regulators to changes in the marketplaces they are regulating).

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Fortunately, preliminary versions of this Article, along with the focused efforts of several consumer representatives, have already convinced the National Association of Insurance Commissioners (NAIC) – the national organization of state insurance regulators – to form an “Insurance Policy Transparency Working Group” to study this issue and propose solutions.<sup>13</sup> In order to correct the problems described herein, that Working Group must implement broad-ranging and comprehensive reform designed to promote transparency. Such reform should go beyond traditional mechanisms for promoting transparency, relying on the power of sticky default rules to improve consumer decision-making. To the extent that true transparency proves impossible, states should impose mandatory floors on homeowners policies in much the same way they historically did with fire insurance policies.

The empirical findings presented in this Article also have a number of implications beyond insurance policy transparency. First, they suggest that courts should not defer to insurance policy terms that deviate from standardized ISO language. Second, they illustrate

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<sup>13</sup> The findings detailed in this paper were initially presented to insurance regulators at the August, 2010 meeting of the NAIC. See Daniel Schwarcz, *Presentation on Deficient Consumer Protection in Form Regulation*, National Association of Insurance Commissioners, Consumer Liaison Meeting, Seattle, WA., 8/13/10; Mark E. Ruquet, *Insurance Policies Do not Serve Consumers’ Needs, Advocate Says*, P & C NATIONAL UNDERWRITER (8/19/10). Prior to the next tri-annual meeting of the NAIC, Robert Hartwig, President of the Insurance Information Institute, wrote an op-ed in an industry trade journal arguing that differences in insurance policies reflected healthy competition. Robert Hartwig, *Greater Choice Key to Homeowners Market*, P & C NATIONAL UNDERWRITER (10/11/10). At the winter NAIC meeting, the author presented updated data reflected to the Property/Casualty Committee of the NAIC and simultaneously published an op-ed responding to Hartwig. See Daniel Schwarcz, *The Need for Insurance Policy Transparency*, P & C NATIONAL UNDERWRITER (10/25/10). The Property/Casualty Committee then voted to adopt a charge to establish an Insurance Policy Transparency Working Group. See Mark E. Ruquet, *NAIC to Review Personal Lines Contract Transparency*, P & C NATIONAL UNDERWRITER (10/21/10). The charge reads as follows: “Appoint a Coverage Transparency Working Group to study and evaluate actions that will improve the capacity of consumers to comparison shop on the basis of differences in coverage provided by different insurance carriers offering personal lines products. Review the three NAIC property and casualty policy simplification model acts for currency and recommend changes to them, if appropriate. Examine current industry practices and state laws and regulations relevant to this topic, then develop findings and/or recommended action items to the committee. Examine approaches to (1) systematize and improve pre-sale disclosures of coverage; (2) increase consumer accessibility to different carriers’ policy forms on a pre-sale basis; and (3) facilitate consumers’ capacity to understand the content of insurance policies and assess differences in insurers’ policy forms. In examining the second of these issues, the Working Group should consider all possible avenues of accessibility, including state insurance department websites, the NAIC, insurance companies, and the possibility of pre-sale provision of complete policy language. In examining the third of these issues, the Working Group should consider (i) implementing new readability rules as suggested by the Consumer Connections Working Group of the D Committee; (ii) promoting consistent, clear and logical formatting and organization of all policies; and (iii) any other measures that would improve the intellectual accessibility of policy forms.”

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important limitations in the capacity of insurance regulators in particular, and financial regulators in general, to evolve along with the markets they regulate. Finally, the Article contributes to the broader literature on standard form contracts, providing new insights on the relevance of informed minorities and salient contract terms and further emphasizing the importance of context-specific, empirically-oriented scholarship.

Part I of this Article begins by providing an overview of the standardization of policy forms in the property/casualty insurance industry, with a focus on the homeowners market. It explores both why insurers historically employed the same forms as well as why explanations for this practice may no longer apply. Part II then uses simple empirical methods to assess the variation in policy forms that do exist in several different states. It focuses on two related questions: (i) how do carriers' policies differ, and (ii) to what extent do the policies that different carriers sell differ in the total amount of coverage they provide. Part III presents evidence gathered from various different sources showing that homeowners insurance markets operate with consumers having access to virtually no information concerning crucial deviations in homeowners insurance policy forms. Part IV offers some common-sense solutions for regulators to improve consumer information regarding differences in policy language. It also discusses some broader implications of this research for contract law scholarship beyond insurance law.

## **I. The Super-Standardization of Property/Casualty Insurance Policies**

### **A. A Brief History of Policy Standardization in Insurance**

The standardization of property/casualty insurance policies in the United States dates back to the late nineteenth century, when Massachusetts promulgated a mandatory policy form for fire insurers.<sup>14</sup> The state's goal was to address a classic "race to the bottom" among companies who had sought to save money by ratcheting back coverage

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<sup>14</sup> See Charles Gobel, *The Moral Hazard Clauses of the Standard Fire Insurance Policy*, 37 Colum. L. Rev. 410, 410 (1937). As Gobel states, "[b]efore the advent of the standard fire insurance policy there were in use in the United States almost as many policy forms as there were companies." Id. Apparently, the standardization of policy forms actually dates back to sixteenth century Florence, when special administrative agencies had "the power to disapprove clauses ' . . . which were not in the standard form of policy'-the general and universal policy at present in use.'" See generally Thomas L. Wenck, *The Historical Development of Standard Form Policies*, 35 J. RISK & INS. 537, 537 (1968).

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without informing consumers.<sup>15</sup> Various states followed Massachusetts' lead, but by far the most influential was New York, whose mandatory standard fire insurance policy was widely – but not universally – copied by other states.<sup>16</sup>

Standardization of insurance policy forms gained further traction in the early Twentieth Century with the advent of legally-sanctioned rate making bureaus.<sup>17</sup> These bureaus arose in response to a wave of insurance company failures after the great San Francisco Earthquake of 1906.<sup>18</sup> According to the Merritt Committee – a prominent commission established by the New York legislature to study the issue – the cause of these insolvencies was “ruinous competition” among insurers.<sup>19</sup> In particular, individual insurers lacked adequate information to predict future losses, especially when they were relatively new in the industry or simply wrote business in a new region.<sup>20</sup> At the same time, these insurers could profitably adopt a high-risk strategy of setting excessively low premiums: insurers profited if losses were light, but policyholders ultimately bore the risk that losses would exceed premiums collected.<sup>21</sup> Taken together, these forces resulted in systematically inadequate premiums and, consequently, mass insurer insolvencies in the wake of a large disaster.

In order to address these problems, the Merritt Committee suggested the establishment of state-sanctioned rate-making bureaus.<sup>22</sup> Rate-making bureaus would collect and aggregate insurers' loss data and then set rates that, after approval by the state regulator, would be used by all companies.<sup>23</sup> To accomplish these functions, member-insurers would be required to use the same standardized policy forms.<sup>24</sup> Such

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<sup>15</sup> Wenck, *supra* note 14, at 539-41; KENNETH J. MEIER, *THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* 54 (1998); TOM BAKER, *INSURANCE LAW AND POLICY* 7 (2d Ed.).

<sup>16</sup> Gobel, *supra* note 14, at 410; Wenck, *supra* note 14, at 542-44. Standardization in automobile insurance policies followed a similar trajectory, with companies initially using their own distinctive policy forms but eventually finding that this created substantial consumer confusion. *See* Wenck, *supra* note 14, at 546. Unlike with fire insurance, however, insurers tackled this problem on their own by developing through collaboration various “standard provisions” that insurers could voluntarily insert in their policies. *See id.* at 547.

<sup>17</sup> MEIER, *supra* note 15, at 59-61 (describing the establishment of the Merritt Committee, which led to the recognition of rate making bureaus in 1911).

<sup>18</sup> *Id.*

<sup>19</sup> *See id.*

<sup>20</sup> *See* ABRAHAM, *supra* note 4, at 31-32.

<sup>21</sup> *See* MEIER, *supra* note 15, at 59-60.

<sup>22</sup> Numerous states, including New York, adopted this plan in response to the Merritt Committee's findings. *See* MEIER, *supra* note 15, at 60.

<sup>23</sup> *See id.* 60.

<sup>24</sup> *See* Clarence W. Hobbs, *State Regulation of Insurance Rates*, 11 *PROCEEDINGS OF THE CASUALTY ACTUARIAL SOCIETY* 218, 255 (1925) (reviewing the various rules governing



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uniformity of policy terms allowed insurers to share and pool their historic loss data by ensuring that this data was based on the same underlying coverage obligations.<sup>25</sup> Additionally, requiring uniform policy terms may also have prevented individual insurers from cheating from the collectively set rate indirectly, by altering the scope of their coverage.

Although explicit rate-setting is now largely understood as anti-competitive,<sup>26</sup> the role of industry organizations in aggregating and distributing collective loss data has generally continued to be lauded as pro-competitive. Not only does aggregating and distributing loss data improve the accuracy of insurance pricing, but it also reduces barriers to entry that would otherwise severely limit the ability of a new entrant to price its policies.<sup>27</sup> For these reasons, the dominant explanation for standardized policy language in property/casualty insurance markets continues to be that it facilitates the collection and aggregation of insurers' loss data.<sup>28</sup>

## B. Alternative Explanations and Justifications for Policy Standardization

Of course, various justifications and explanations for policy standardization other than facilitating loss sharing also exist. First, many continue to emphasize the consumer benefits of such standardization, which allow consumers to more easily comparison shop

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different rating bureaus, and noting that some of these bureaus were allowed to insist that companies were “required to use the policy forms established by the Commission.”); *id.* at 267 (noting increasing recognition of the principle that “to secure equal treatment there must be standardization of policy provisions” and observing that this “may take the form of approval of policy forms or the fixing of definite, uniform standard forms.”); Herbert C. Brook, *Public Interest and the Commissioners’ --- All Industry Laws*, 15 LAW & CONTEMP. PROBS. 606, 612 (1950) (Noting that “bureau companies. . . in general, had to use standard bureau forms”).

<sup>25</sup> See ABRAHAM, *supra* note 4, at 31-32.

<sup>26</sup> See, e.g., MEIER, *supra* note 15, at 60. Price setting remained remarkably persistent, with the ISO publishing “advisory rates” as late as the 1980s. See ABRAHAM, *supra* note 4, at 34.

<sup>27</sup> See, e.g., Macey & Miller, *supra* note 4, at 20–26 (“[C]asualty and liability insurance firms need to be able to share loss information in order to facilitate accurate pricing of insurance products. Therefore, cooperative efforts at sharing and analyzing historical loss cost information should be protected against antitrust scrutiny. Similarly, accurate information cannot be developed-and consumers cannot easily comparison shop on the basis of price-unless firms in the industry have access to standardized forms.”); ABRAHAM, *supra* note 4, at 32-34; Paul Jaskow & Linda McLaughlin, *McCarran-Ferguson Act Reform: More Competition or More Regulation*, 4 J. RISK & UNCER. 373, 383 (1991) (emphasizing the “need for joint activities associated with loss costs and insurance forms”).

<sup>28</sup> See ABRAHAM, *supra* note 4, at 33-34.

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on the basis of price and service.<sup>29</sup> This is hardly surprising, given the race to the bottom in fire insurance policies that prompted the earliest regulatory efforts to standardize forms. Improved comparison shopping through standardization not only prevents a race to the bottom, but it also arguably limits competition among insurers on the basis of “misleading comparisons, fringe coverages, and other non-price considerations.”<sup>30</sup>

Collective policy drafting has also been explained as a mechanism for promoting economies of scale and limiting regulatory costs.<sup>31</sup> The policy drafting process is unusually resource-intensive.<sup>32</sup> Unlike most consumer contracts, insurance policies must be filed and – to varying degrees – “approved” by state regulators and must comply with various state laws and regulations regarding their content.<sup>33</sup> By collectively drafting their policies, insurers can limit these expenses by incurring them only once on a collective basis.

Yet another explanation for policy standardization involves the network effects generated by judicial interpretations of property/casualty insurance policies.<sup>34</sup> Unlike insurance policies in the life insurance context, for instance, property/casualty insurance policies attempt to categorize a tremendous range of potential future scenarios. A wealth of case law has gradually developed applying this contract language to these scenarios.<sup>35</sup> Only by employing the same language

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<sup>29</sup> See Macey & Miller, *supra* note 4, at 20–26; Jaskow & McLaughlin, *supra* note 27, at 383; ISO, *supra* note 3 (“[I]f standardized coverages did not exist, consumers would face an unintelligible array of different forms”).

<sup>30</sup> See Wenck, *supra* note 14, at 550.

<sup>31</sup> Jeffrey Stempel, *Unmet Expectations: Undue Restriction of the Reasonable Expectations Approach and the Misleading Mythology of Judicial Role*, 5 CONN. INS. L.J. 181, 257 (1998) (“it is generally agreed that the use of standardized forms and the marketing mechanism of insurance facilitates the operation of the primary, excess, and reinsurance systems as well as providing economies of scale that should (at least in theory) lower the cost of insurance.”). David Horton, *Flipping the Script: Contra Proferentem and Standard Form Contracts*, 80 U. COLO. L. REV. 431, 461 (2009); Daniel Schwarcz, *A Products Liability Theory* *supra* note 4, at 1405.

<sup>32</sup> JEFFREY W. STEMPEL, STEMPEL ON INSURANCE CONTRACTS § 2.06[j] (3d ed. 2006) (“Changing the standard form insurance policy is a somewhat arduous process, requiring contributions from legal, claims, actuarial, and other industry personnel, as well as from customers and state insurance regulators.”)

<sup>33</sup> See generally HOLMES' APPLEMAN ON INSURANCE §§ 2.10, *Regulation of Policy Forms* (2d ed. 1996).

<sup>34</sup> Michelle E. Boardman, *Contra Proferentem: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105, 1113-14, 1117 (2006); ISO, *supra* note 3, at 33-34.

<sup>35</sup> The absence of a comparable amount of case law in the health arena is also attributable to two other sources. First, ERISA case law allows employers to utilize discretionary clauses that relegate the role of courts simply to arbitrary and capricious review. Second, coverage disputes in the health insurance arena take place in an ever-changing landscape of medical knowledge and treatment protocols. Third, and perhaps most importantly of all, there is

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that insurers have historically employed can insurers effectively tap into this pool of precedent. This, in turn, lends insurers an important degree of certainty about how their contract language applies, which helps them to price their policies accurately.

### C. The Mechanics of Standardization in Homeowners Insurance

Today the dominant industry organization that facilitates collective policy drafting among property/casualty insurers – as well as the collection and dissemination of loss data – is the Insurance Services Organization (ISO).<sup>36</sup> The ISO maintains various different types of standard forms for different lines of coverage. In the homeowners insurance arena, the most commonly used form for stand-alone homes (rather than condominiums or mobile homes) is the “HO3” policy.<sup>37</sup> The distinguishing features of this policy are that it provides “all risk” coverage for one’s home and other structures (known as Coverages A and B in the ISO policy), but “named peril” coverage for personal property (known as Coverage C in the ISO policy).<sup>38</sup> All risk coverage protects property against all perils except for those that are explicitly excluded, whereas named peril coverage protects property only against specifically enumerated perils.<sup>39</sup> In many states, insurers bear the burden of proof with respect to the cause of loss and its exclusion from coverage when coverage is all-risk, whereas the insured bears the burden of proof to establish coverage under a named-peril policy.<sup>40</sup> The HO3 policy also provides coverage for certain liability risks.

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unique degree of factual specificity concerning appropriate treatment options for a given patient, meaning that health insurance cases often turn much more on the individual circumstances of the patient and expert testimony than on the availability of applicable precedent.

<sup>36</sup> See ISO, *supra* note 3, at 33-34.

<sup>37</sup> See Grace, et al., *Homeowners Insurance with Bundled Catastrophe Coverage*, 71 J. RISK & INS. 351, 355 (2004) (reporting that 93% of policies sold in Florida and 72% of policies sold in New York correspond to the HO3 form).

<sup>38</sup> See INSURANCE SERVICES OFFICE, HO3 POLICY FORM, *reprinted in* Abraham, *supra* note 4.

<sup>39</sup> Jeffrey Stempel, *A Mixed Bag for Chicken Little: Analyzing Year 2000 Claims and Insurance Coverage*, 48 EMORY L.J. 169, 196 (1999) (“[A]ll risk first party policies are particularly advantageous to policy-holders because the carrier bears the burden of establishing some limit to the coverage obligations by specifically proving the applicability of an express exclusion.”).

<sup>40</sup> See HOLMES' APPLEMAN ON INSURANCE §§ 1.10–.11 (2d ed. 1996) (stating that while the American rule in all states except Texas is that “the insurer has the burden of proof to prove no coverage under an all-risks policy,” under a named peril policy, “the majority American rule requires the insured to prove that the insured event has transpired, that is, the specified risk (fire, windstorm, lightning, etc.) was the cause . . . of the loss.”). See, e.g., *Strubble v. United Services Auto. Assn.*, 35 Cal.App.3d 498 (1973); *Battishill v. Farmers Alliance Ins. Co.*, 139 N.M. 24, 26 (2006); *Betz v. Erie Ins. Exch.*, 2008 PA Super 221, 957 A.2d 1244, 1256 (Pa. Super. Ct. 2008).

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The ISO also maintains several alternative insurance policies that cover stand-alone homes. The “HO5” policy is similar to the “HO3” policy, except that it provides all risk coverage for personal property as well as structures and replacement cost for personal property.<sup>41</sup> By contrast, the “HO2” policy does not provide any coverage for personal property and provides only named perils coverage on one’s dwelling.<sup>42</sup> Finally, the “HO8” policy covers both dwellings and personal property, but only on a named perils basis.<sup>43</sup>

In addition to these various base policy forms, the ISO also maintains numerous different endorsements.<sup>44</sup> Endorsements simply amend policy language, and they can either expand coverage or restrict it. In some cases insurers will require that all policies be accompanied with an endorsement, whereas in other cases the company will sell, or offer a refund, in exchange for a particular endorsement. Some insurers only make certain types of endorsements available to policyholders. The extent to which ordinary policyholders are actually offered the option to customize their policies is a function of both the insurance agent and the carrier. Some of the most commonly purchased endorsements change loss settlement procedures for personal property damage, cover specifically scheduled valuable items, and provide coverage for sewer back up.<sup>45</sup>

#### **D. The Questionable Persistence of Policy Standardization**

The current state of insurance policy standardization is much less clear than its historical legacy, supporting institutional architecture, and long list of justifications would suggest. In fact, courts and

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<sup>41</sup> See INSURANCE SERVICES OFFICE, HO5 POLICY FORM, p. 10 (“We insure against risk of direct physical loss to property described in Coverages A, B and C.”). Grace and his coauthors incorrectly describe the differences between the HO3 and HO5 form as based on the difference between “repair” coverage and “replacement.” See Grace, *supra* note 37, at 453. In fact, the ISO HO5 policy provides ACV loss settlement for personal property, just like the HO3 policy. See HO5 Policy Form, *supra*, at 14. It is true that some individual company’s versions of the HO5 form include replacement cost settlement, and it seems likely that this is what misled Grace et al.

<sup>42</sup> Grace et al, *supra* note 37, at 354.

<sup>43</sup> *Id.*

<sup>44</sup> In 1999, these included 73 country-wide endorsements and 113 state-specific endorsements. See ISO, *supra* note 3, at 33-34.

<sup>45</sup> See BAKER, *supra* note 15, at 312 (“[T]he difference between replacement cost and actual cash value may be one of the few aspects of property insurance coverage that is actually explained to consumers by insurance agents.”). In some cases these choices are made by adding endorsements to a base policy, whereas in other cases insurers simply maintain different base policies for different combinations of loss settlement. Most consumers opt for replacement cost coverage on their home for obvious reasons, though there may be more variability with respect to loss settlement on personal property.

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commentators in recent years have sporadically observed that some companies have particularized language in their policies that deviates from the industry norm.<sup>46</sup> And the last systematic attempt to examine the content of different insurance policies was in a 1937 article examining the moral hazard clauses of standard fire insurance policies.<sup>47</sup>

At the same time, the various theoretical arguments explaining policy standardization are quite contestable, especially given recent regulatory and technological innovations. First, insurers today may have much less need than they historically did to rely on aggregate loss data. Many insurers today are quite large, and consequently have at their disposal a tremendous amount of loss data that is specific to their company.<sup>48</sup> Irrespective of policy language, this data is likely more accurate than collective insurer data in predicting future losses to that company. This is because company-specific data reflects not just policy language, but also an insurer's particular claims paying culture and practice. And "the vast majority of insurance claims are resolved according to the insurance law of the insurance adjustor."<sup>49</sup> At the same time, advances in information technology now enhance insurers' capacity to predict future losses based on historical loss data. To some degree, these models are even capable of extrapolating loss patterns to new situations.

Second, even if an insurer did need to rely on aggregate loss data (as some small insurers no doubt do), it is unclear why this would compel it to use the standardized policy form on which the data was based. An individual insurer could presumably start from the aggregate loss data associated with a standard form such as the ISO H03 policy, and then make adjustments to these data to take into account its own

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<sup>46</sup> This practice has most frequently been recognized in the context of concurrent causation, which concerns the coverage available when a covered peril and an excluded peril contribute in causing a loss. *See, e.g.,* Erik Knutson, *Confusion about Causation in Insurance*, 61 ALA. L. REV. (2010); BAKER, *supra* note 15, at 277 ("Some insurance companies were sufficient upset" about court determinations concerning concurrent causation that "they attempted to rewrite their policies so that the efficient proximate causation doctrine would not apply."); Tom Baker, *Liability Insurance at the Tort-Crime Boundry*, 7 in FAULT LINES: TORT LAW AND CULTURAL PRACTICE, (David M. Engel and Michael McCann, eds., Stanford Univ. Press 2009) ("many liability insurance contracts contain additional clauses that specifically state that the insurer will not pay for tort claims arising out of criminal acts, whether the resulting injuries were intentional or not.") *id.* at 441 (noting that "Allstate and some other companies... have added 'criminal acts' exclusions to their policies").

<sup>47</sup> *See* George Gobel, *The Moral Hazard Clauses of the Standard Fire Insurance Policy*, 37 COLUM. L. REV. 410 (1937).

<sup>48</sup> *See* NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, PROPERTY AND CASUALTY INSURANCE INDUSTRY, 2009 MARKET SHARE REPORT – TOTAL PREMIUM – HOMEOWNERS MULTI-PERIL 101 (2009) (In 2009, top five insurers in homeowners arena had direct premiums written of approximately 15 billion, 7 billion, 5 billion, 3.5 billion and 3 billion).

<sup>49</sup> BAKER, *supra* note 15, at 54.

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contractual deviations. This strategy might be sensible to the extent that the impact of the insurers' deviations were predictable. Alternatively, an insurer might insert various exclusions that clearly made its policy less generous than the standard form and simply use the collective loss data to set an upper bound on expected losses. To be sure, insurers might collectively suffer if many of them followed this path, as the usefulness of the collective data would decrease. But from the perspective of any single insurer, deviating from the standard form might offer profits, whereas the marginal cost of degrading collective data would be felt equally by all its competitors.<sup>50</sup>

Third, the regulatory burdens faced by insurers who utilize their own forms appear no longer to be particularly substantial. Insurers who wish to submit their policy forms to individual states can now do so quickly and efficiently through an electronic platform known as SERFF.<sup>51</sup> Although a deviant policy must nonetheless be approved individually by each state to which it is submitted, this process is hardly arduous in many states. Anecdotal evidence suggests that state regulators rarely use their admittedly broad discretion to disapprove policy forms because they are unfair, ambiguous, unreasonable, or contrary to public policy.<sup>52</sup> Rather, the author's informal conversations with various state regulators suggest instead that review of policy filings is focused almost exclusively on ensuring that policy forms are technically compliant with states statutes and regulations.<sup>53</sup> These requirements are uneven across states. However, many states have very few specific constraints on the content of homeowners policies, aside from rules governing cancellation, non-renewal, and the prompt payment of claims.<sup>54</sup>

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<sup>50</sup> See Daniel Schwarcz, *Regulating Insurance Sales or Selling Insurance Regulation? Against Regulatory Competition in Insurance*, 94 MINN. L. REV. 1707, 1738 (2010) (arguing that a similar collective action problem could negatively impact insurers' selections among competing regulators).

<sup>51</sup> See Serff Website, About Serff, available at <http://www.serff.com/about.htm>.

<sup>52</sup> BAKER, *supra* note 15, at 47 (noting that while "[t]here has been no systematic, scholarly study of the effectiveness of state regulation of insurance forms," most commentators assume that such regulation is inadequate); Robert Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970) ("Regulation is relatively weak in most instances, and even the provisions prescribed or approved by legislative or administrative action ordinarily are in essence adoptions, outright or slightly modified, of proposals made by insurers' draftsmen."); Schwarcz, *Products Liability Theory*, *supra* note 4, at 1424-26.

<sup>53</sup> One regulator reported that insurers challenged the department's use of discretion as the exercise of rule-making authority, meaning that the department had to back off on this approach because it could not afford to devote resources to hearings and developing a formal record. Another simply explained that his office has a "check list" of requirements that they go through for each form.

<sup>54</sup> See NAIC product tool, available at <https://eapps.naic.org/prl/do/search/dialog> (allowing users to review the product requirements for specific states in specific lines of insurance).

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Finally, although it is possible that network effects lend some value to historical language, the extent of this value is not clear. One provocative article, for instance, suggests that the network effect benefits of historical policy language are substantial for insurers, because they “care more that a clause have a fixed meaning than a particular meaning.”<sup>55</sup> This is because, once policy language has a fixed meaning, insurers can simply include the cost of the associated coverage in the premiums they charge.<sup>56</sup> Although certainty about the legal meaning of policy language is indeed valuable to insurers, it is likely not as valuable as this argument suggests. Some types of coverage create various underwriting problems – such as moral hazard or adverse selection – such that the increase in coverage they provide to policyholders is not worth the increase in premiums that they generate.<sup>57</sup> To the extent that a judicial opinion creates a certain meaning that generates an underwriting problem, it will likely harm insurers more than it helps them. Additionally, policyholders may frequently focus more on the nominal cost of insurance (i.e. the premiums they are charged) than the true price of insurance, which takes into account the expected value of the coverage provided.<sup>58</sup> If so, then coverage expansions, and corresponding rate increases, may decrease profits irrespective of underwriting concerns, by decreasing consumer demand.

## II. Empirically Assessing Homeowners Policies

Motivated by the uncertain persistence of policy form standardization, this Part seeks to answer two related empirical questions. First, it asks whether homeowners insurance policies differ and, if so, with respect to what types of provisions. Part A shows that there are indeed substantial deviations among different carriers’ policies within individual states, and that these deviations involve various important, though often esoteric, terms. Readers with limited interest in the precise details of how insurers’ policies vary may wish to skim Part A, paying some attention to the various figures.

Second, Part B asks whether deviations in policy terms are randomly spread among insurers, or whether some carriers’ policies are

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<sup>55</sup> Boardman, *supra* note 34 at 1107.

<sup>56</sup> *See id.*

<sup>57</sup> *See* Schwarcz, *Products Liability Theory*, *supra* note 4, at 1448.

<sup>58</sup> Although insurance markets are generally thought to be competitive with respect to nominal pricing, it is hardly clear that they are competitive with respect to policy content and design (and thus “true” price). Schwarcz, *Products Liability Theory*, *supra* note 4, at 1397–98.

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substantially less generous, in the aggregate, than other carriers' policies. This analysis reveals that heterogeneity in policy terms is concentrated among a subset of large, national carriers. Most of the carriers have insurance policies that are substantially worse than the presumptive industry default of the ISO HO3 form. However, a small number of carriers maintain policies that are more generous than the ISO HO3 form. Notably, the carriers who employ the least generous policy forms disproportionately rely on captive agents to distribute their policies, whereas the companies with the most generous policies tend to rely on independent agents to distribute their policies.

## A. How Do Homeowners Policies Differ?

### 1. Data and Methodology

In order to assess how homeowners policies differ, I compared policies from carriers in six states: North Dakota, South Dakota, Pennsylvania, Illinois, California, and Nevada.<sup>59</sup> For reasons discussed more completely in Part III, the only reliable method for gaining access to complete copies of different carriers' homeowners forms was to convince state insurance regulators to demand or request these documents directly from insurers. Insurance regulators in each of the six identified states were willing to do this in response to my requests. Importantly, in convincing state insurance regulators to spend time and resources on this, I invoked my status not only as an academic researcher, but also as a "funded consumer representative" to the National Association of Insurance Commissioners.<sup>60</sup> Additionally, I made use of various informal connections with state regulators and insurance commissioners, to whom I have privileged access because of my status as an NAIC funded consumer representative. Due to resource constraints, I did not contact all states and I focused on states where I had informal connections. The majority of states that I contacted either explicitly refused my request (almost always citing resource constraints) or did not respond to repeated inquiries.<sup>61</sup>

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<sup>59</sup> I also was able to acquire policies in Texas. However, Texas has a unique history of market evolution that made it very difficult to compare Texas policies with the policies of other states, as the ISO HO3 policy does not operate as the presumptive baseline. *See infra*, TAN XX-YY. If anything, though, policies in Texas seem to be more varied than policies in other states. See <http://www.opic.state.tx.us/hoic.php>, Described in Part III, B.

<sup>60</sup> *See generally* NAIC Appoints 2011 Consumer Representatives, available at [http://naic.org/Releases/2010\\_docs/2011\\_consumer\\_liaison\\_representatives.htm](http://naic.org/Releases/2010_docs/2011_consumer_liaison_representatives.htm).

<sup>61</sup> This includes Iowa, New York, Arkansas, Colorado, Michigan, Minnesota, Wisconsin, and New Mexico.



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For each state, I focused on the top ten insurance groups in the state, as measured by premium volume for homeowners policies.<sup>62</sup> This approach means that a single insurance group was often included in the data from multiple states. To take an extreme example, a policy from a State Farm affiliated company was included in the sample from all six states.<sup>63</sup> This approach proved necessary because the policies of a single insurance group did occasionally differ across state lines.<sup>64</sup> In total, policies from 24 different insurance groups were examined.<sup>65</sup> These groups included the top thirteen insurance groups in the country, which cumulatively represent over 2/3 of the market.<sup>66</sup>

For each insurance group within a state, I attempted to collect copies of its homeowners forms covering stand-alone structures.<sup>67</sup> This includes both the “base” policy as well as any mandatory endorsements.<sup>68</sup> A mandatory endorsement was defined as a form that amends the terms of a policy and which the insured has no option to

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<sup>62</sup> See 2009 MARKET SHARE REPORT, *supra* note 48. The top ten groups are as follows. In California they are State Farm, Zurich (Farmers), Allstate, California State Auto, Liberty Mutual, Auto Club Enterprises, United Service Auto (USAA), Nationwide (AMCO), Mercury, and Travelers. In Illinois they are State Farm, Allstate, Country Insurance (Countrywide), Zurich (Farmers), American Family, Liberty Mutual, Travelers, Metropolitan Group, USAA, and Chubb. In Nevada they are Zurich (Farmers), State Farm, Allstate, California State Auto, Hartford, American Family, Liberty Mutual, USAA, Travelers, and Country Insurance (Countrywide). In North Dakota they are State Farm, American Family, Farmers Union, Auto Owners, Nodak, Zurich (Farmers), North Star, EMC Insurance, State Auto, and Country Insurance. In Pennsylvania they are State Farm, Allstate, Erie, Nationwide, Travelers, Liberty Mutual, Chubb, USAA, Zurich (Farmers), and Donegal. Finally, in South Dakota, they are State Farm, American Family, Zurich (Farmers), De Smet, Nationwide, Auto Owners, North Star, USAA, and Iowa Farm Bureau.

<sup>63</sup> See *id.* (State Farm among the top insurers in every state sampled).

<sup>64</sup> In some cases this variation was obviously a result of differing state regulatory requirements. In other cases, however, differences in policy terms appeared attributable either to the specific risks of the state at issue or simply to different approaches of the companies in different states.

<sup>65</sup> These are: State Farm, Zurich (Farmers), Allstate, California State Auto, Liberty Mutual, Auto Club Enterprises, United Service Auto (USAA), Nationwide, Mercury, Travelers, Country Insurance (Countrywide), American Family, Metropolitan Group, Chubb, Hartford, Farmers Union Insurance, Auto Owners, Nodak, North Star, EMC Insurance, State Auto Mutual, Erie, De Smet, and Iowa Farm Bureau

<sup>66</sup> See 2009 MARKET SHARE REPORT, *supra* note 48.

<sup>67</sup> The ISO designation of homeowners forms covers condo policies, policies for renters, and policies covering mobile homes. I did not systematically collect these policies.

<sup>68</sup> Most regulators made roughly the same request of insurers, using language that I proposed. This language was as follows: “Please provide us with the most current version of each homeowners’ insurance policy form covering stand-alone homes offered in [State] by any company within your insurance group. Please also provide the most current versions of any ‘mandatory amendatory endorsements’ applying to each homeowners’ insurance policy offered in [State] by any company within your insurance group. A ‘mandatory amendatory endorsement’ is a form that amends the terms of a policy and which the insured has no option to reject. It encompasses both endorsements that are mandatory as a result of law and endorsements that are required as a result of a business decision by the insurer.”

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reject. It encompasses both endorsements that are mandatory as a result of law and endorsements that are required as a result of a business decision by the insurer. I isolated only those policies that were currently being issued by the company to new policyholders.<sup>69</sup> In some cases, insurers maintained several such forms, often corresponding to differences in ISO HO3/HO5 forms or to differences in loss settlement procedures. In such cases, I isolated forms corresponding to the ISO HO3 form, meaning that I selected the policy that provided all perils coverage for structures and named peril coverage for personal property.<sup>70</sup> In some cases, companies maintained forms that differed with respect to loss settlement. In such cases, I selected the policy that corresponded to the HO3 form in providing replacement loss settlement for structures and Actual Cash Value Loss Settlement for personal property.<sup>71</sup> In several instances, a company did not maintain a form meeting these specifications, in which case I used the form that came closest to these criteria.<sup>72</sup>

In several instances, fewer than ten policies were examined in a state. With respect to the property coverage sections of the homeowners policies, this was true of two states – California (9 policies)<sup>73</sup> and Pennsylvania (7 policies).<sup>74</sup> In both instances, my regulatory contacts limited their requests to the top ten insurance companies in their state, even when two or more of those companies were part of the same insurance group.<sup>75</sup> This produced fewer than ten different policies either because the two companies within the same group used the same forms, or because one of the companies was no longer actively writing business. With respect to the liability coverage sections of the homeowners policies, several additional data points were excluded – with an additional decrease of one policy in Pennsylvania (6 policies)

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<sup>69</sup> In many cases, insurers continue to issue old policies to old customers, but have discontinued use of those policies for new customers. Conversations with some agents revealed that some insurers have had concerns with trying to switch long time customers to new forms, at least partially for “legal” reasons. See Part III.B, *infra*.

<sup>70</sup> See Part I.C, *supra*.

<sup>71</sup> See *id*.

<sup>72</sup> In particular, one company maintained only a form providing all risk coverage for personal property. Another company apparently only offered ACV coverage for personal property through an endorsement (along with a refund).

<sup>73</sup> In California, Traveler’s policy was not collected because Zurich/Farmers owns both Mid-Century Insurance Company and Fire Insurance Exchange, which were both counted among the top ten companies.

<sup>74</sup> In Pennsylvania, the policies of Donegal, Zurich/Farmers, and USAA were not collected.

<sup>75</sup> Insurance “groups” include all insurers within the same corporate family. Typically the publicly-known name of a company is the group name. For instance, Allstate and State Farm are both insurance groups. Each insurance group typically has numerous insurance companies, each licensed to do business in a different state. Even within a state, an insurance group may have multiple insurance companies (i.e. Allstate Indemnity Company, Allstate Insurance Company, Allstate Property and Casualty Company).

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and South Dakota (9 policies).<sup>76</sup> In these cases, insurers provided only copies of their property coverage forms in response to the data request and follow up communications with regulators did not yield the liability sections of these policies.

Having isolated the relevant set of homeowners policies from each of the six states, I then identified approximately thirty provisions to analyze for discrepancies in coverage. I identified provisions for one of two reasons. First, I isolated terms that figure prominently in insurance litigation or are otherwise important, as reflected in the leading insurance law casebooks. Second, I examined several policies informally, and included terms where informal review suggested that some differences might exist on a systematic basis. Having isolated a term for analysis, I then defined several ways in which that term might be drafted. In each case, one possibility was that a policy term would match its articulation in the HO3 ISO policy. In some cases, only one alternative to the ISO form suggested itself, whereas in others I identified two or more broad alternatives.

## 2. Results: Property Coverage

Homeowners insurance policies package together property insurance and liability insurance. This Section reports results for the property insurance section of the homeowners policy, which includes coverage for one's home (Coverage A), other structures on the residence premises (Coverage B), personal property (Coverage C), Loss of Use (Coverage D) and various Additional Coverages (Coverage E).

### a. Concurrent Causation

Concurrent causation involves losses that are the product of both covered and excluded perils. The most well known example is from Hurricane Katrina, where wind (a covered peril) and flood water (an excluded peril) both contributed to produce massive damage to property throughout the Gulf Coast.<sup>77</sup> Concurrent causation is one of the most commonly litigated insurance coverage issues.<sup>78</sup> In most jurisdictions, the default rule is the efficient proximate cause rule ("EPC rule"), which states that a loss is covered if the "dominant" or "primary" cause of the loss is a covered peril. Most states, however, permit insurers to opt out of this rule through specific language in their policies.<sup>79</sup> In the 1999 ISO

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<sup>76</sup> The Chubb liability insurance policy was not included in the Pennsylvania data and the DeSmet liability insurance policy was not included in the South Dakota data. In both cases, the insurers did not provide these policies – which were contained in separate documents – in response to the data call, and my follow ups with state regulators did not result in me receiving these documents.

<sup>77</sup> See, e.g., *Broussard v. State Farm*, 523 F.3d 618 (5th Cir. 2008).

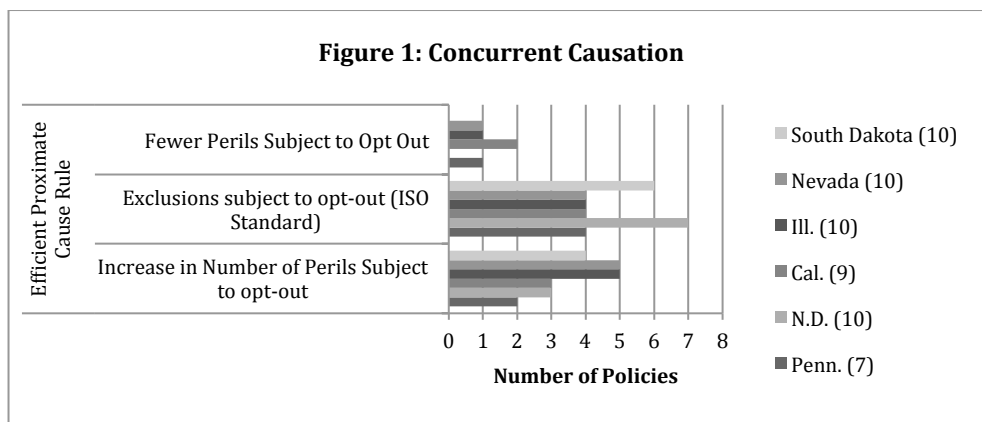
<sup>78</sup> See Knutson, *supra* note 46.

<sup>79</sup> 7 Couch on Insurance § 101:45 (3d ed. 2010) ("The majority of jurisdictions permit the parties to an insurance contract to contract out of the efficient proximate cause doctrine.

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HO3 policy, the default EPC rule applies for most perils, with one set of important exceptions.<sup>80</sup> The prefatory paragraph to the nine “exclusions” in the ISO policy attempts to opt out of the EPC rule, specifying that there is no coverage if an exclusion contributes in any way to a loss.<sup>81</sup>

Figure one tabulates different carriers’ policy forms with respect to concurrent causation in all of the states I examined. As with all subsequent figures, the vertical axis reflects potential variations in a policy term (with the ISO HO3 option specified) and the horizontal axis represents the numbers of policies falling into that category, organized by state. The numbers in parenthesis next to the individual states represent the total number of policies reviewed for that state.



As Figure One suggests, in every state studied there is substantial variation among different carriers with respect to concurrent causation. In most states, about half of the carriers followed the approach in the ISO HO3 policy by only opting out of the default rule for the policy exclusions. Most of the remaining insurers expanded the scope of the EPC opt out by increasing the number of perils that would produce

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However, there are a few jurisdictions which have statutory provisions which specifically prohibit an insurer from contracting out of the efficient proximate cause doctrine.”); Colo. Intergovernmental Risk Sharing Agency v. Northfield Ins. Co., 207 P.3d 839 (Colo. App. 2008), cert. granted, 2009 WL 1485804 (Colo. 2009) (“Almost all courts that have considered this issue have found that efficient proximate cause is merely a common law default rule which can be eliminated by contract. Four jurisdictions disagree.”).

<sup>80</sup> The ISO HO3 policy also provides that, with respect to the perils excluded from Coverages A and B (covering structures rather than personal property), any ensuing loss that involves a covered peril is covered. See BAKER, *supra* note 15, at 251, 277. Thus, if “wear and tear” – an excluded peril – causes a fire – a covered peril – then there is coverage because the “ensuing loss” of the fire is covered. This is technically more expansive than the EPC rule, as an ensuing loss may not always be the efficient proximate cause of a loss. However, it is likely that it would almost always produce the same result as the EPC rule, because a covered peril causing an ensuing loss would usually be designated as the dominant cause of the loss.

<sup>81</sup> See ISO HO3, *supra* note 38, at 11.

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coverage if they contributed in any way to a loss. In some cases insurers accomplished this by shifting “perils not insured” into the exclusion section, whereas in others insurers simply included the prefatory opt out to the EPC rule at the start of the “Perils not Insured” section as well as the “Exclusions” section. Notably, some carriers actually were more generous than the ISO HO3 policy by subjecting fewer causes of loss to the EPC opt out. Where this occurred, it was usually accomplished by moving certain “exclusions” elsewhere in the policy so that they were not subject to the EPC opt out.

b. Affirmative Coverage Grants

One of the most important features of HO3-based homeowners forms is that they covers one’s home and other structures on an “all risk” basis, meaning that any loss where a peril harms a building structure is covered unless it is explicitly excluded.<sup>82</sup> The ISO HO3 policy conveys this concept through the simple statement that “We insure against risk of direct physical loss to property described in Coverages A and B” but “we do not insure for loss... caused by” specifically enumerated perils.<sup>83</sup>

Figure 2 shows that many insurers substantially alter the affirmative “all risk” coverage grant for buildings and other structures.<sup>84</sup> First, many carriers provide that “We insure against risk of *accidental* direct physical loss to property described in Coverages A and B.” (Emphasis added). Taken to the extreme, one could read this to foreclose coverage for damage caused by vandalism and arson. Even if one understood this provision to mean “accidental from the standpoint of the insured,” it is easy to see how this type of provision could be used to justify expansive claims denials. The provision can best be understood to increase the scope of the “intentional loss provision,” which generally excludes “loss arising out of an act an insured commits or conspires to commit with the intent to cause a loss.”<sup>85</sup> There may be a range of losses that do not involve acts “intended to cause a loss” but which are nonetheless arguably not “accidental.” Consider, for instance, an improperly installed air conditioner that falls from a window, causing substantial property damage. Alternatively, consider a water spout pulled out of a sink by a rambunctious young child.

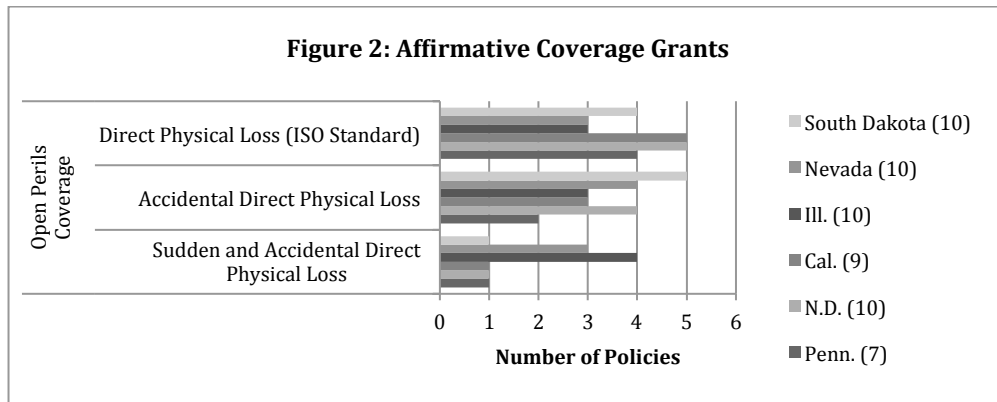
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<sup>82</sup> Stempel, *supra* note 39, at 196.

<sup>83</sup> See ISO HO3, *supra* note 38, at 8.

<sup>84</sup> In most cases, the qualifier found in the open perils statement for Coverages A and B is also used to limit Coverage C (coverage for personal property). Thus, while the ISO policy provides coverage for personal property resulting from “direct physical loss” caused by an enumerated peril, policies that adds the “accidental” or “sudden and accidental” qualification for Coverages A and B adds the same qualification for Coverage C. This sloppy drafting results in an oddity: such policies require that certain enumerated perils, such as “sudden and accidental tearing apart, cracking, burning or bulging,” be “sudden and accidental” in two different places.

<sup>85</sup> See ISO HO3, *supra* note 38, at 12.



Other policies are even more restrictive, providing coverage only for “sudden and accidental” direct physical loss. There is extensive caselaw interpreting the meaning of the phrase “sudden and accidental” in the context of pollution liability exclusions in insurance policies.<sup>86</sup> But it is quite surprising to find this coverage limitation for all losses that a homeowners policy covers. Various losses could easily be affected by this clause. Consider structural decay, mold growth, and gradual falling down of a tree. All of these perils might be covered by the ISO HO3 policy to the extent that the gradual damage was hidden or not easily identifiable by the policyholder. Yet the supposed all risk nature of some carriers’ policies suggests at the outset that this is not so: that these losses do not even fall within the realm of potential coverage, because they are not “sudden and accidental.” Relatedly, these policies may also shift the burden of proof onto policyholders to the extent that there is a dispute regarding the sudden and/or accidental nature of property damage.<sup>87</sup>

c. Increased Risk

One of the central aims of insurance policies is to reduce the risk of moral hazard, or the prospect that policyholders will take less care knowing that they are insured.<sup>88</sup> At the same time, many, if not most, losses, are at least partially the result of carelessness or thoughtlessness. These competing facts create an “irreducible minimum of tension.”<sup>89</sup> Traditionally, insurers have dealt with this tension by excluding coverage for specific losses that inherently or predominantly involve moral hazard – such as theft from a vacant home.<sup>90</sup> By contrast, the

<sup>86</sup> See Kenneth Abraham, *The Rise and Fall of Commercial General Liability Insurance*, 87 V.A. L. REV. 85, 97-98 (2001).

<sup>87</sup> See note 39, *supra*.

<sup>88</sup> See generally Tom Baker, *The Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1997).

<sup>89</sup> ABRAHAM, *supra* note 4, at 224-225.

<sup>90</sup> *Id.* (“The insurance solution has been to place no general limitation on coverage of losses caused in whole or in part by such insufficient care, but to exclude losses caused by or occurring during certain generally described or specifically excluded risk-increasing actions.”).

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conventional wisdom is that there is an “absence of any general exclusion in standard policies of coverage for harm caused by the insured’s own negligence.”<sup>91</sup> The one exception is that insurance policies do indeed broadly exclude coverage for losses exacerbated by ex post moral hazard: the failure to mitigate a loss after it occurs.<sup>92</sup> This distinction is easy to understand: whereas most everyone is subject to taking less care than optimal in ordinary conditions, once a loss occurs ordinary care is to be expected because the loss places one on notice of the need for enhanced care.

In fact, though, Figure Three shows that various carriers’ policies do not adhere to this historic distinction. Instead, many carriers require policyholders to take care not just at the time of a loss, but also once property is endangered. The import of this type of provision depends substantially on how it is applied. But it is certainly possible that property might be endangered even though an insured was not reasonably on notice of this fact. Consider again the improperly installed air conditioner or the tree on the verge of collapse. In any event, the fact that some insurers plausibly have the discretion to exclude coverage in such scenarios is troubling.



Much more distressing, however, is the fact that a number of carriers place no temporal restrictions on insureds’ obligations to take care, requiring simply that the insured do nothing to increase the risk of hazard *at any time*. Several policies accomplish this by denying coverage whenever there has been “any substantial change or increase in hazard, if changed or increased by any means within the control or knowledge of the insured.” Others state that there is not coverage “for any loss occurring while hazard is increased by a means within the control or knowledge of the insured.” These provisions upend the conventional wisdom about how homeowners policies manage moral hazard,

<sup>91</sup> *Id.* at 259.

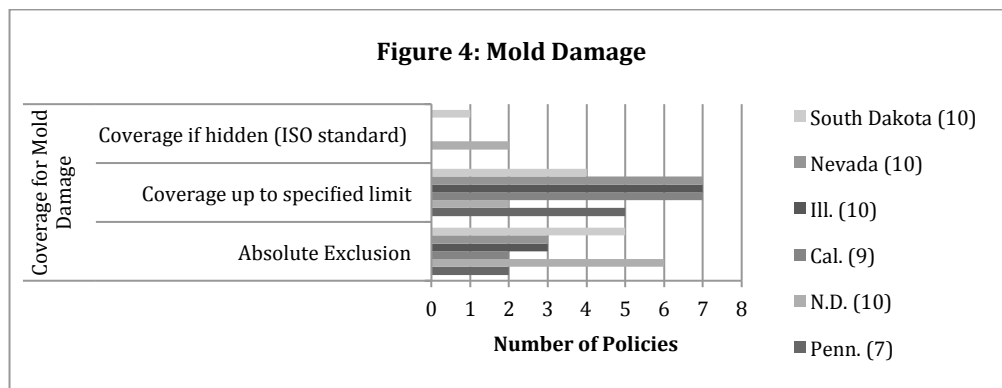
<sup>92</sup> See ISO HO3, *supra* note 38, at 12. (excluding coverage for “neglect of an insured to use all reasonable means to save and preserve property at and after the time of loss”).

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essentially contractually reestablishing the defense of “barratry,” which limited property insurance when a loss was the result of negligence or ignorance of the policyholder.<sup>93</sup>

d. Mold and Water Damage to Insured Property

Several years ago, controversy erupted over the extent to which homeowners insurers must cover mold damage.<sup>94</sup> Although several insurance departments took action to regulate this coverage, most did not.<sup>95</sup> The ISO HO3 form excludes coverage for mold or fungus unless that mold/fungus is (i) hidden within the walls, floors or ceilings and (ii) caused by an accidental discharge or overflow of water or steam.<sup>96</sup> As Figure 4 reveals, existing policies differ substantially on this issue. Several carriers in South and North Dakota retain the ISO language on mold, but most carriers in most states have abandoned this language. The alternative they have selected, however, differs dramatically among carriers. Figure four captures only some of this variation, demonstrating a roughly even split between insurers that completely exclude property damage as a result of mold and those who place monetary caps on such losses.<sup>97</sup> Both the size of the monetary cap – which ranged from \$2,500 to \$50,000 – and the precise language describing the mold damage that enjoyed this limited protection varied by carrier.



<sup>93</sup> KENNETH S. ABRAHAM, *THE LIABILITY CENTURY: INSURANCE AND TORT LAW FROM THE PROGRESSIVE ERA TO 9/11*, at 21-16 (2008)

<sup>94</sup> See generally John T. Waldron, III & Timothy P. Palmer, *Insurance Coverage for Mold and Fungi Claims: The Next Battleground?*, 38 *TORT TRIAL & INS. PRACTICE L. J.* 149 (2002).

<sup>95</sup> As of 2006, six states had regulated mold coverage in some fashion. 3 *Envtl. Ins. Litig.: L. and Prac.* § 24:3 (2010) (“In addition to California, New Jersey, Florida, Maryland, Ohio, and New York, are among the states that have enacted either statutes or state insurance commissioner rules/regulations on mold coverage.”).

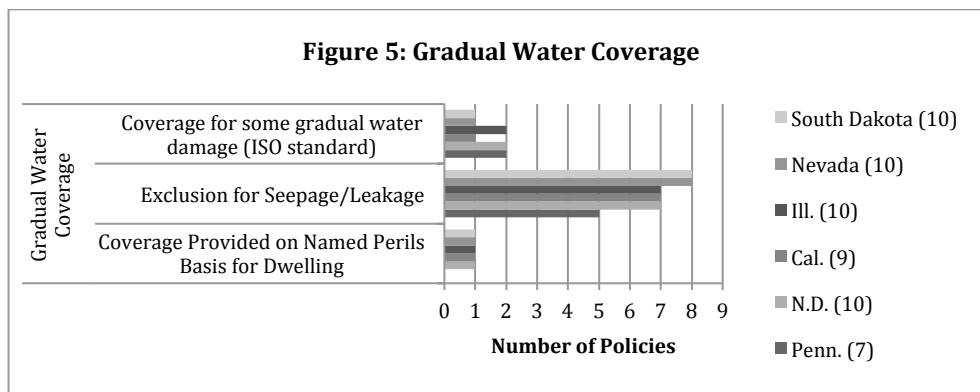
<sup>96</sup> See ISO HO3, *supra* note 38, at 9.

<sup>97</sup> Some policies completely excluded mold except to the extent that it resulted from a covered fire loss. See *Liritis v. American Family*, 204 Ariz. 140 (2002) (discussing coverage for mold caused by water used to put out a fire). Such policies were coded as providing an “absolute exclusion” for mold.



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Insurance policies also differ with respect to the related issue of whether they cover loss to property caused by gradual water damage. The ISO HO3 policy covers this risk, so long as the water involves the “accidental discharge” of water or steam.<sup>98</sup> As Figure 5 shows, although a few carriers retain the ISO language regarding gradual water damage, most insurers now absolutely exclude coverage for any seepage or leakage of water.<sup>99</sup> Moreover, five companies associated with a single insurance group radically transform coverage for water damage to one’s structure from all risk to named peril, in the process excluding both gradual water damage and various other forms of water damage.



e. Pollution Damage to Insured Property

The extent to which Commercial General Liability (CGL) policies cover pollution liability has been the subject of extensive litigation and debate.<sup>100</sup> But the issue has received less attention in the context of first party insurance, and virtually no attention in the context of the property coverage that homeowners insurance policies provide. Although the issue may seem arcane, it can be quite important given the breadth of the definition of “pollutants” found in virtually all policies: these include “any solid, liquid, gaseous, or thermal irritant or contaminant, including smoke, vapor, soot, fumes, alkalis, chemicals and waste.”<sup>101</sup> The ISO policy excludes any loss to a home or other structure caused by “the discharge, dispersal, seepage, migration, release or escape of pollutants unless... caused by a Peril Insured Against under coverage C.”<sup>102</sup> Under

<sup>98</sup> ISO HO3, *supra* note 38, at 9.

<sup>99</sup> Policies also differed with respect to the interaction between a seepage exclusion and limited mold coverage. Whereas the seepage exclusion did not impact the limited mold coverage in some policies, in others it appeared to circumscribe this coverage, thus presumably creating coverage only for mold resulting from a sudden discharge of water or steam.

<sup>100</sup> See generally Kenneth Abraham, *Cleaning Up the Environmental Liability Insurance Mess*, 27 VAL. U. L. REV. 601 (1993).

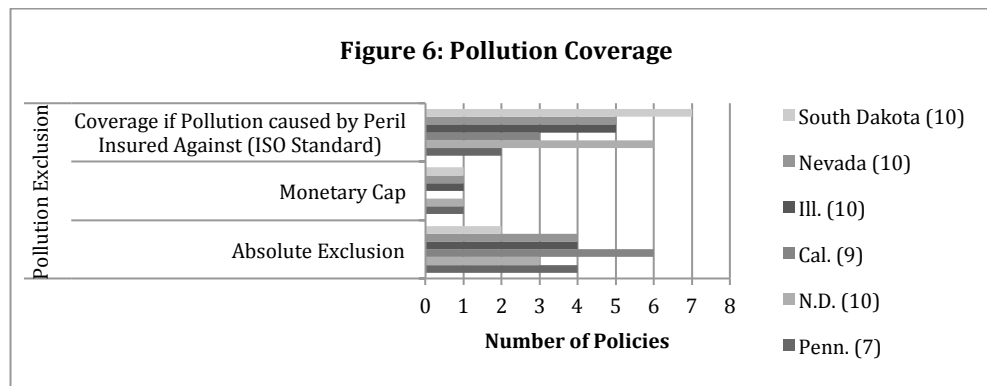
<sup>101</sup> See Jeffrey W. Stempel, *Reason and Pollution: Correctly Construing the "Absolute" Exclusion in Context and in Accord with its Purpose and Party Expectations*, 34 TORT & INS. L.J. 1 (1998).

<sup>102</sup> ISO HO3, *supra* note 38, at 9.

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this provision, for instance, property damage resulting from a fire that caused a fuel tank to explode would be covered, as fire is a peril insured against.

As Figure 6 shows, homeowners policies differ substantially in their coverage of property damage caused by pollution damage. While approximately half of all carriers retain the ISO language, the other half employ an absolute exclusion that purports to not cover any damage whatsoever arising out of pollution.<sup>103</sup> A small number of carriers cover pollution damage up to a specified internal limit. In almost all cases, policies use the same language as the ISO policy both to define “pollution” and to describe the scope of pollution damage.



f. Theft Coverage

One of the most basic protections a homeowners policy provides to policyholders is coverage against the risk that covered property will be stolen. In many cases, of course, property can be stolen without obvious evidence of such theft. Historically, commercial property insurers occasionally attempted to exclude coverage in such cases by requiring that there exist “visible marks ... or physical damage ... to the exterior” of a covered building. However, several courts held that such clauses violated policyholders’ reasonable expectations of coverage.<sup>104</sup> Perhaps for this reason, such an exclusion apparently did not migrate into homeowners policies; the ISO HO3 policy specifically covers “loss of property from a known place when it is likely that it has been stolen.”<sup>105</sup> Although the policy contains certain limitations for theft that occurs away from home or in a rented portion of one’s home, it does not limit coverage for particular types of theft.

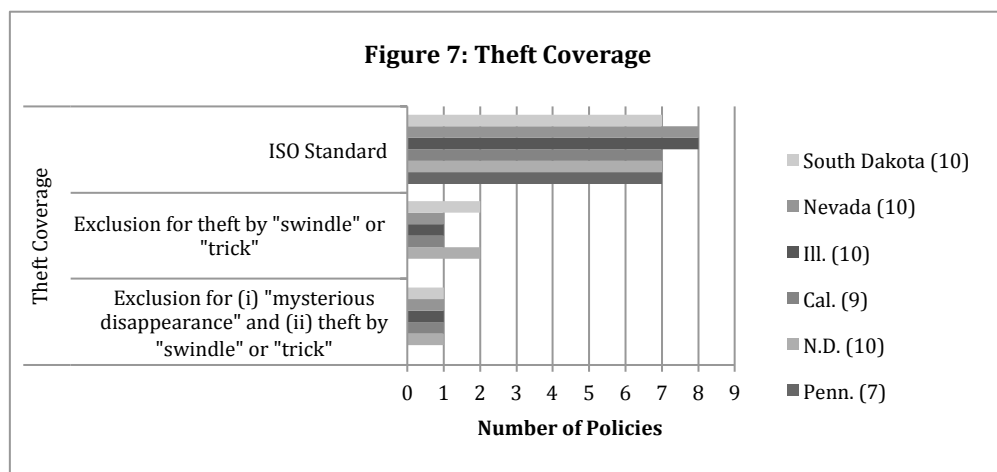
<sup>103</sup> In several instances, a policy contained an absolute exclusion, but exempted smoke damage caused by a covered fire. Such policies were coded as containing an “absolute exclusion.”

<sup>104</sup> See, e.g., *C & J Fertilizer v. Allied Mutual*, 227 N.W.2d 169 (1975).

<sup>105</sup> ISO HO3, *supra* note 38, at 10.

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Several insurers, however, have dramatically altered the nature of coverage for theft in their policies, as reflected in Figure 7. First, several insurers now exclude coverage for theft that is the result of “swindle” or “trick.” These exclusions could be interpreted quite broadly, extending not only to email frauds but also to classical burglaries in which the burglar gains entrance through surreptitious means. Second, the policies of five companies associated with one insurance group specifically exclude coverage for the “mysterious disappearance” of covered property (as well as for theft by swindle or trick). In doing so, they arguably exclude coverage well beyond the “visible marks” exclusion that courts have found to violate the reasonable expectations of *commercial* property policyholders.



g. Collapse Coverage

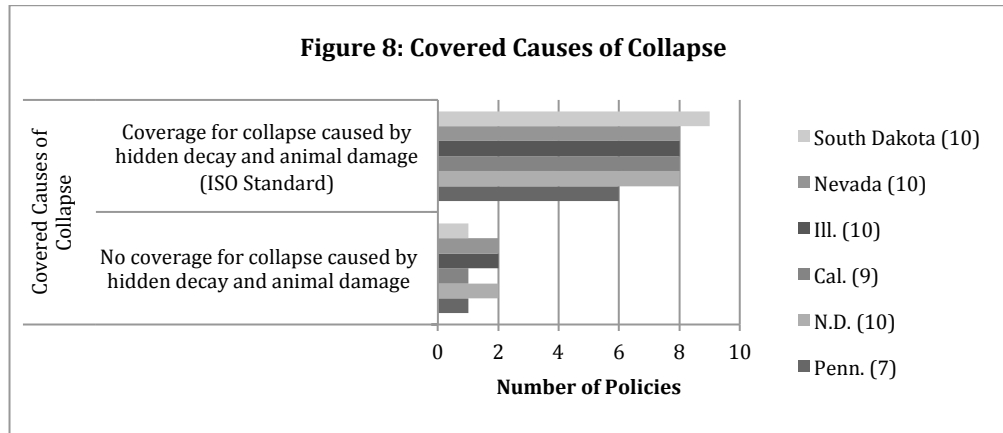
All homeowners policies reviewed provide coverage against the risk that a covered structure will collapse. However, unlike most forms of coverage for one’s home and other structures, this coverage is provided on a named perils basis, meaning that loss from collapse is only covered to the extent it is caused by a specifically enumerated peril.<sup>106</sup> In this context, covered perils include all of the standard perils that protect personal property, such as fire and falling objects. But they also include a number of additional, collapse-specific, perils, including collapse of a structure resulting from hidden decay and animal damage.<sup>107</sup> As Figure 8 shows, however, some policies in the sample

<sup>106</sup> This is accomplished by excluding collapse as a covered loss, except to the extent such coverage is provided in the “additional coverages” section. The additional coverages section then provides coverage for collapse on a named perils basis. ISO HO3, *supra* note 38, at 7, 8. Typically “collapse” is defined as “the abrupt falling down or caving in of a building or structure,” *see id.* at 7.

<sup>107</sup> *See id.* at 7.

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excluded from coverage collapse caused by hidden decay and/or animal damage.<sup>108</sup>



#### h. Damage to Personal Property from Artificially Generated Electrical Current

All homeowners insurance policies cover the risk of loss to personal property resulting from artificial changes in electrical current. The ISO HO3 policy, however, excludes from this coverage any damage to “electronic components or circuitry.”<sup>109</sup> Depending on how this clause is interpreted, this could be a surprisingly expansive carve-out, especially as the number of electrical devices that homeowners own increases.

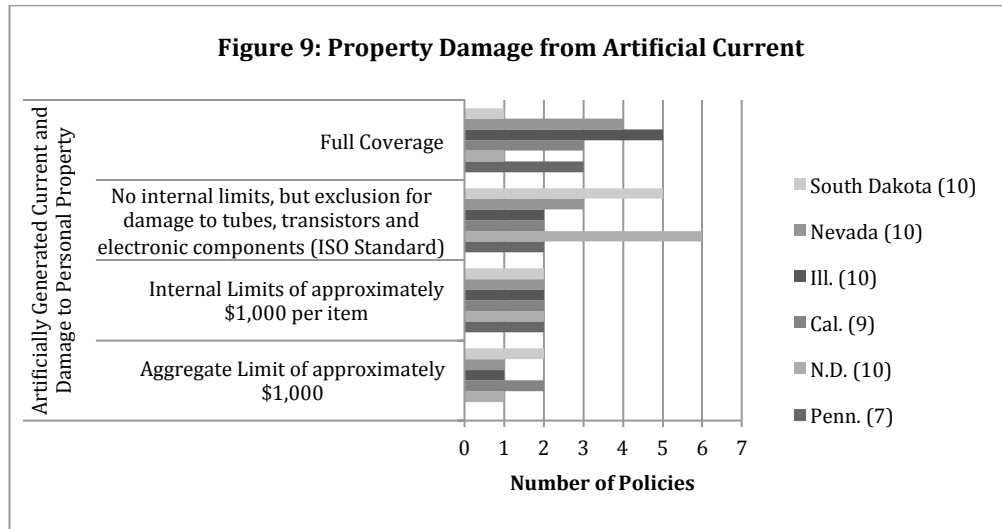
As Figure 9 demonstrates, different carriers’ homeowners policies vary significantly with respect to these issues. Unlike in many other cases, these differences go in different directions, with some carriers unambiguously expanding coverage, other carriers unambiguously decreasing coverage, and still others adopting an alternative approach to limiting the extent of this coverage. A surprising number of carriers simply eliminate the ISO carve out for damage to “electronic components and circuitry,” suggesting either the difficulty of applying this restriction or the lack of a large underwriting concern with respect to such losses. Other insurers impose an internal limit on this coverage, usually approximately \$1,000 per property item. Whether this is more or less generous, or more or less efficient, than the ISO approach

<sup>108</sup> There was substantial variation in the sample regarding whether the weight of ice and snow were also explicitly included as covered causes of loss in the collapse section. Although the ISO HO3 policy does not include this as a covered cause of loss, *see id.*, many policies reviewed did. However, assessing the impact of this difference is quite difficult, as “weight of ice and snow” is a named peril in Coverage C, suggesting that the ISO policy covers collapse from weight and snow simply by covering collapse caused by named perils. The difficulty with this interpretation is that the ISO policy’s definition of “weight of ice, snow or sleet” does not seem to encompass collapse. *Id.* at 10.

<sup>109</sup> ISO HO3, *supra* note 38, at 11.

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is difficult to say. Notably, however, several carriers (again, five of them being affiliated with a single insurance group) rather dramatically limit coverage by applying the \$1,000 cap to all property damage stemming from a change in artificial changes in electrical current. Given that such an event is highly likely to damage numerous items of personal property simultaneously, this subtle shift in coverage can have dramatic effects.



i. Internal Limits for Specific Types of Property

In addition to the aggregate coverage limits that apply to a homeowners policy, there also exist various internal limits within policies for specific *types* of property. A core purpose of these limits is to improve risk classification by forcing those with particularly valuable types of property – including jewelry, furs, china, and art – to separately purchase coverage for these items through specific riders. Additionally, these internal limits help to reduce moral hazard by limiting coverage for losses that can be guarded against through increased vigilance. This helps to explain why some internal limits apply only to the risk of theft of a particular item.<sup>110</sup>

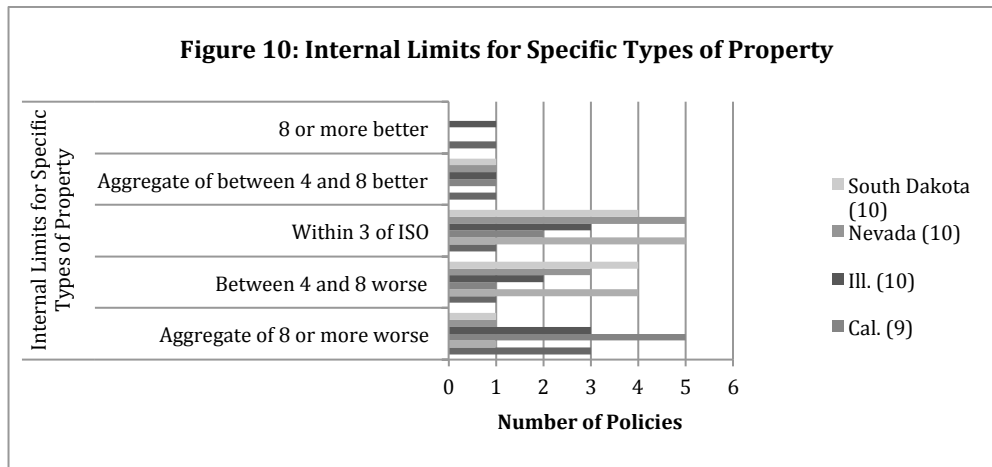
In order to assess how the internal limits in various policies compared to those found in the ISO HO3 policy, I compared each internal limit for a specific type of policy to the corresponding internal limit in the ISO policy. For each property type, I noted whether the comparison policy contained a higher limit, a lower limit, or the same limit. I then aggregated these limits, counting as (-1) limits that were less generous, (+1) limits that were more generous, and (0) as limits that were the same. Where a comparison policy imposed a limit on a new type of property I added (-1) to its score, whereas if the comparison policy did

<sup>110</sup> ISO HO3, *supra* note 38, at 3-4.

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not impose a limit on a type of property that was limited in the ISO policy, I scored a (+1).<sup>111</sup>

The aggregate scores of the sample policies are reported in Figure 10, which once again reflects substantial heterogeneity in the marketplace. As in most instances, the predominant trend appears to be downward, with a large number of carriers including internal limits in their policies that are systematically less generous than those contained in the ISO HO3 policy. Several carriers depart from this trend.<sup>112</sup>



Unlike all of the other terms described to this point (which cannot be changed via endorsement), specific internal limits within policies can be changed by endorsements. Most individuals, however, have only a limited amount of scheduled property with their homeowners policy – most commonly a valuable piece of jewelry. Moreover, specifically-scheduled property does not eliminate the relevance of the internal limit to which that property belongs. For instance, a policyholder with a scheduled anniversary ring would still be subject to the internal limit on jewelry for all other jewelry that he or she owned.

#### j. Coverage for Increased Costs due to an Ordinance or Law

When buildings or structures are rebuilt or repaired after they are damaged, they are sometimes subject to building codes or

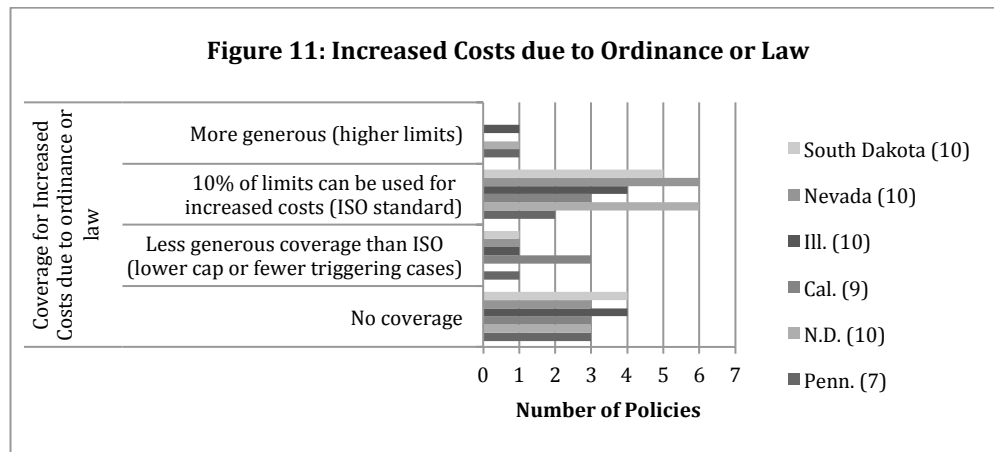
<sup>111</sup> In some cases, a comparison policy applied separate limits to two types of property that were grouped together in the ISO HO3 policy. In such cases, I scored the ISO policy as more generous if the sum of the separate limits was less than the sum of the ISO policy. If, on the other hand, either of the separate limits was the same, or more generous, than the combined ISO policy, I scored the comparison policy as more generous. If the two limits were both less than the ISO policy, but the sum was more than the ISO policy, I scored zero, given that the comparative generosity of the policy would depend on the particular nature of the loss.

<sup>112</sup> A single carrier generated the two data points in the “8 or more better” category. In at least some states, this carrier refuses to insure homes worth less than \$500,000.

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ordinances that were not in effect when they were constructed. Whether the increased costs associated with complying with such building codes and ordinances are covered by homeowners policies became a significant source of dispute in the early 1990s.<sup>113</sup> The ISO HO3 policy resolves this issue by specifying that up to 10% of the limit of liability can be used for any increased costs resulting from the need to comply with an ordinance or law.<sup>114</sup>

As Figure 11 shows, different carriers vary with respect to whether they follow the ISO approach to increased costs due to an ordinance or law. While roughly half of the policies in the sample replicated the ISO approach, the majority of the remainder absolutely excluded from coverage these costs.<sup>115</sup> Several carriers take an in between approach, either limiting the percentage of the limits that can be used for these costs to less than 10% or verbally limiting the scenarios in which this coverage is available.<sup>116</sup> Three policies in the sample adopt a more generous approach than the ISO HO3 by increasing the percentage of limits that can be used for these costs. Notably, at least some carriers that do not include this coverage in the base policy do indeed offer it as a voluntary endorsement.



k. Water Damage from Off-Premises Sources

Property damage resulting from flooding is excluded from all homeowners policies. The reason is that floods can produce extensive

<sup>113</sup> See generally Hugh L. Wood, Jr., *The Insurance Fallout Following Hurricane Andrew: Whether Insurance Companies are Legally Obligated to Pay for Building Code Upgrades Despite the “Ordinance or Law” Exclusion Contained in Most Homeowners Policies*, 48 U.MIAMI L.REV. 949 (1994).

<sup>114</sup> ISO HO3, *supra* note 38, at 8.

<sup>115</sup> This approach can theoretically be justified on moral hazard grounds, as an insured is arguably better off after a loss if the damaged property is “upgraded” so that it complies with new building codes or ordinances.

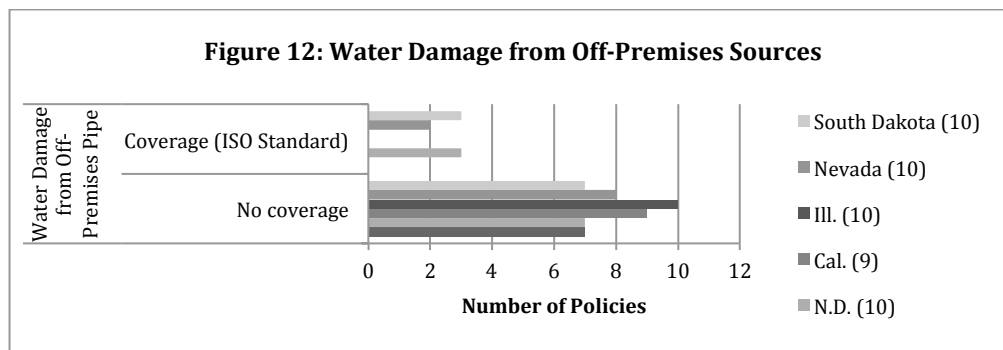
<sup>116</sup> Several carriers limited this coverage to 5% of the limits.

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damage across numerous different households in the same geographic area. This type of correlated loss is relatively difficult to insure, as insurers cannot mitigate aggregate losses simply by insuring a large number of different households in the same region.<sup>117</sup>

Given this underwriting explanation for the flood exclusion, it is perhaps not surprising that, notwithstanding its general exclusion for flood damage, the ISO HO3 policy does indeed cover “accidental discharge or overflow of water or steam from within a (i) storm drain, or water, steam or sewer pipe, off the ‘residence premises...’”<sup>118</sup> This species of “flood” damage is likely to be centralized to a relatively small geographic area given the amount of water carried in pipes and sewers and the fact that a water break would presumably be contained relatively quickly by city officials. Moreover, unless a particular geographic area has a systematically faulty pipe and sewer system, this type of flood damage is not likely to be particularly correlated across time, even if, when it does occur, it does so in the immediate aftermath of a large storm.

As figure 12 demonstrates, however, a substantial majority of carriers no longer cover this form of property damage. The complete absence of such coverage in Illinois, Pennsylvania, and California may reflect the possibility of genuinely correlated losses in certain parts of these two states. But it is harder to understand the fact that a not insubstantial number of carriers in South Dakota, North Dakota, and Nevada retain the ISO approach to water damage from off-premises sources, while the majority of carriers do not. In any event, the result is once again consistent with substantial and important heterogeneity in coverage terms among different carriers.



#### L. Subrogation Priority

<sup>117</sup> See Michele Boardman, *Known Unknowns: The Illusion of Terrorism Insurance*, 93 GEO. L. J. 783 (2005).

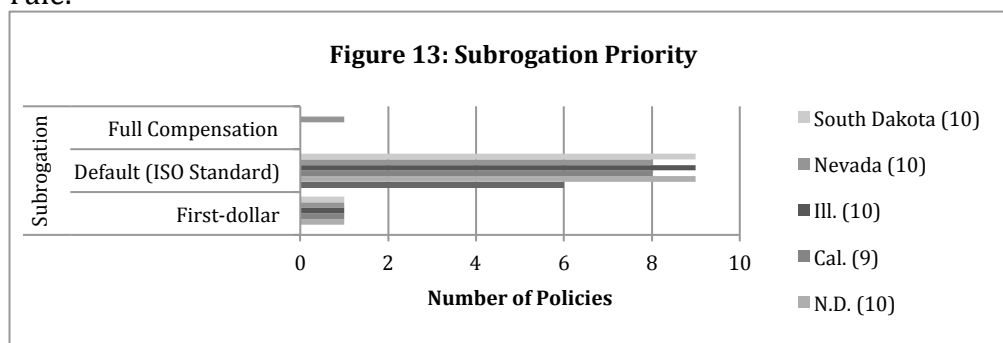
<sup>118</sup> ISO HO3, *supra* note 38, at 9-10.



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Subrogation is the right of a first-party insurer to recoup any payments it has made to a policyholder from a person who is liable in tort to that policyholder for causing the underlying harm.<sup>119</sup> Most agree that subrogation is sensible, as it prevents accident victims from recovering from both their own insurer and their injurer for the same loss, thereby keeping insurance costs low and fulfilling the principle that policyholders should not benefit from a loss. But subrogation can become quite controversial when a plaintiff's tort recovery is not fully compensatory, either because the defendant is partially judgment proof or because a settlement is under-compensatory as it reflects the probability of having lost at trial on liability.<sup>120</sup> In such cases, subrogation dollars can be used either to compensate the policyholder by tort standards or to subrogate the insurer, but it cannot completely accomplish both goals. First dollar subrogation entitles the insured to full subrogation irrespective of the degree to which a policyholder is fully compensated. The Make-whole rule, by contrast, entitles the insurer to subrogation only after the policyholder is fully compensated for a loss by insurance payments and tort recovery.<sup>121</sup>

The vast majority of homeowners insurance policies – including the ISO HO3 policy – do not specify how this issue should be resolved, leaving resolution of this type of issue to the courts.<sup>122</sup> But, as Figure 13 shows, some carriers do indeed resolve this issue. Once again, five companies from a single underwriting group depart from the trend, explicitly adopting the insurer-favorable first-dollar rule. By contrast, one Nevada carrier specifies the policyholder-favorable make whole rule.<sup>123</sup>



<sup>119</sup> See generally STEMPEL, *supra* note 2, at 11.01.

<sup>120</sup> See generally Alan Sykes, *Subrogation and Insolvency*, 30 J. LEG. STUDS. 383 (2001) (arguing that first-dollar subrogation is likely optimal and that, for this reason, courts should refrain from interfering with contract terms that specify this type of subrogation).

<sup>121</sup> See *id.*

<sup>122</sup> ISO HO3, *supra* note 38, at 22.

<sup>123</sup> Interestingly, this company's underwriting group is also included in the data from several other states, but these policies do not specify resolution of this issue. This is true even though Nevada law explicitly permits opting out of the default make whole rule. *Canfora v. Coast*

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### 3. Results: Liability Coverage

Differences in the content of homeowners policies are not cabined to the first-party property insurance that these policies provide. Much to the contrary, they also extend to the liability insurance contained in these policies. All of the policies examined provide coverage if a claim is made or a suit is brought against an insured for damages because of "bodily injury" or "property damage" caused by an "occurrence" to which the policy applies. But as the first three sub-section show, the policies differed in important ways with respect to each of the three elements of the affirmative grant of coverage. Moreover, as the subsequent sub-sections reveal, policies also differ meaningfully with respect to exclusions from this general coverage grant. Most notably, policies differ substantially with respect to the most important exclusion in the liability policy – the exclusion for intentional or expected injuries.

#### a. Bodily Injury

One of the two core liability coverages in homeowners policies covers liability stemming from "bodily injury." The definition of such harm is thus of crucial importance for assessing the overall scope of coverage. The ISO HO3 policy defines "bodily injury" as "bodily harm, sickness, or disease including required care, loss of services and death that results."<sup>124</sup> A commonly litigated issue is whether this definition encompasses psychological harms that rise to the level of a "sickness or disease."<sup>125</sup> In a minority of jurisdictions, this question is resolved in favor of coverage on the basis of *contra proferentem* – the principle that ambiguities are interpreted against the drafter.<sup>126</sup> But as Figure 14 shows, while many carriers continue to retain the ISO definition of bodily injury, a slim majority of policies in the sample explicitly define "bodily injury" to exclude any mental, emotional, or psychological harm that does not itself arise out of physical harm to one's body. Consequently, lawsuits alleging only psychological or emotional harm would not be covered by these policies.

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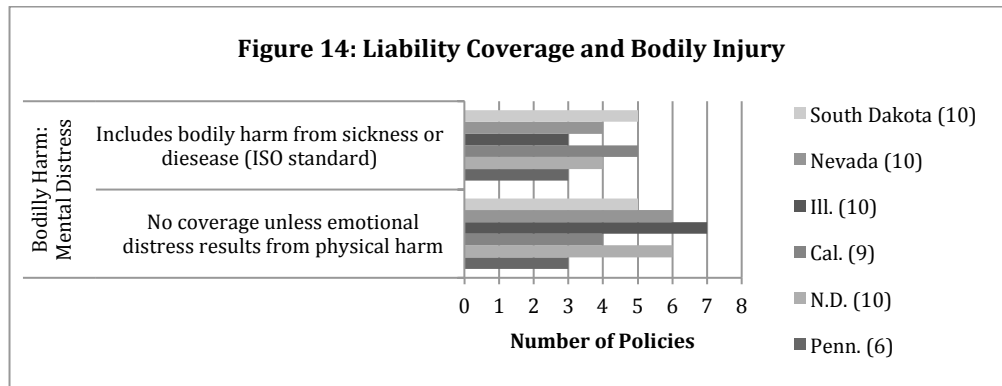
Hotels & Casinos, Inc., 121 Nev. 771, 777 (2005) ("Unless it is explicitly excluded, the make-whole doctrine operates as a default rule that is read into insurance contracts.").

<sup>124</sup> ISO HO3, *supra* note 38, at 1.

<sup>125</sup> See generally 3-18 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 18.02[3]; STEMPEL, *supra* note 2, §14.03.

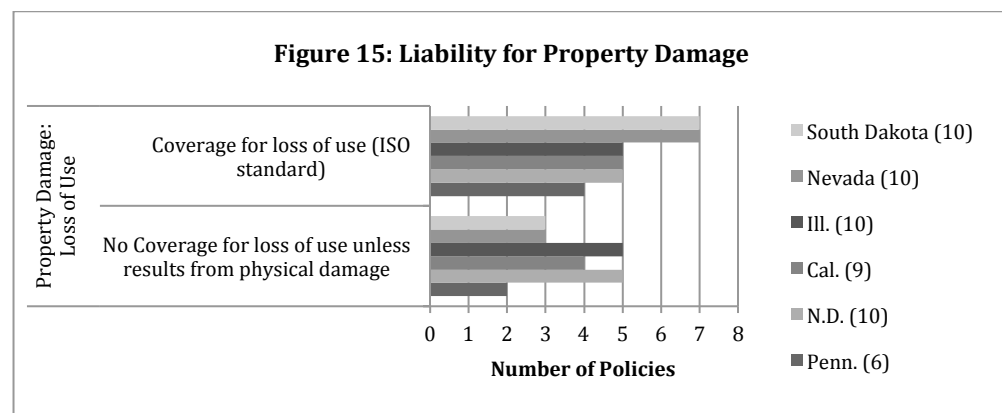
<sup>126</sup> See *id.*

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**b. Property Damage**

In addition to liability stemming from bodily injury, homeowners policies also cover liability stemming from “property damage.” Here too, then, the precise meaning of this term is important in assessing the extent of overall liability coverage.<sup>127</sup> The ISO HO3 policy defines “property damage” to mean “physical injury to, destruction, or loss of use of tangible property.”<sup>128</sup> But many insurance policies subtly, but importantly, shift this definition so that “loss of use” of property does not constitute property damage unless it results from physical damage or destruction to that property. Under this definition, lawsuits based on the inability of a plaintiff to occupy her home or business or to use property such as an automobile would not be covered. Consider, for instance, a homeowner who is sued by neighbors who allege that they needed to abandon their home for a period of time because of a noxious smell, loud noise, or dangerous living conditions.<sup>129</sup> This is reflected in Figure 15.



<sup>127</sup> See generally APPLEMAN, *supra* note 125, § 18.02[4]; STEMPEL, *supra* note 2, §14.04.

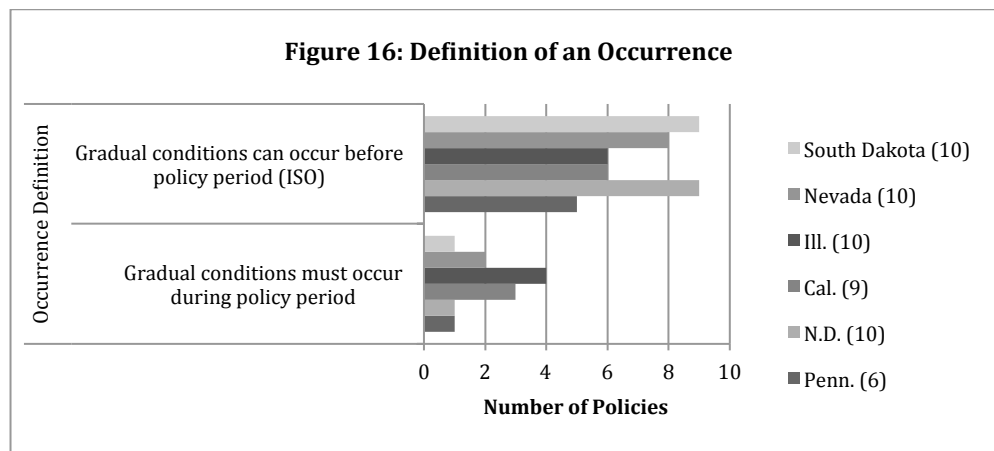
<sup>128</sup> ISO HO3, *supra* note 38, at 2.

<sup>129</sup> See, e.g., *Continental Ins. Co. v. Bones*, 596 N.W.2d 552, 556–58 (Iowa 1999) (lawsuit for loss of use of leased premises resulting from wrongful eviction did not result from property damage and thus was not covered) *Guelich v. Am. Prot. Ins. Co.*, 772 P.2d 536, 537–38 (Wash. App. 1989) (lawsuit for obstruction of a neighbor’s view does not qualify for coverage under a homeowners insurance policy because the loss of use did not involve physical damage).

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c. Occurrence Definition

Irrespective of whether a policyholder’s potential liability stems from “property damage” or “bodily injury” harming a third party, homeowners insurance policies only provide coverage if the injury resulted from an “occurrence.” The definition of this term consequently constitutes yet a third key component to the overall liability insurance coverage that a homeowners policy provides. The ISO HO3 policy defines an “occurrence” as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions, which results, during the policy period, in (a) ‘bodily injury’ or (b) ‘property damage.’”<sup>130</sup> This definition extends coverage to scenarios in which continuous or repeated conditions begin prior to the policy period, so long as the resulting bodily injury or property damage occurs during the policy period. By contrast, as reflected in Figure 16, below, several homeowners policies define an occurrence so as to require that any “continuous or repeated exposure to substantially the same general harmful conditions” itself occur during the policy period. Liability insurance in these policies does not, consequently, extend to any scenarios in which the potentially liability-inducing conditions began prior to the policy period. Although this type of scenario has been litigated most extensively in the context of asbestos damage in commercial liability policies,<sup>131</sup> it could plausible extend to a variety of more commonplace scenarios. For instance, consider a homeowner who is sued for damage caused by a dog that continuously escapes the backyard, or for tree damage that has long encroached on a neighbor’s property.



d. Expected or Intended Injury Exclusion

<sup>130</sup> ISO HO3, *supra* note 38, at 2.

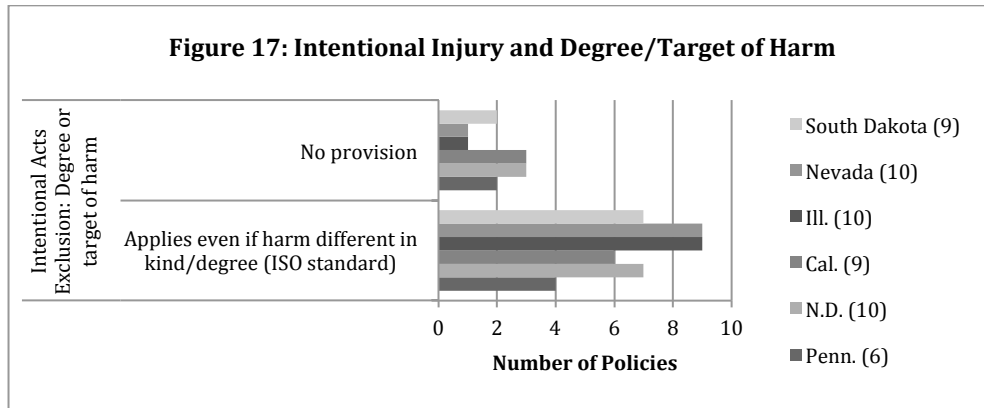
<sup>131</sup> See generally APPLEMAN, *supra* note 125, § 18.02[6]; STEMPEL, *supra* note 2, §14.02.

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Perhaps the most important term in any liability insurance policy involves the exclusion for injury that is intentional or expected. Almost all acts that generate liability can, to some degree, be framed to involve intentional conduct or expected harm – indeed, that is often one of the key reasons for why that act generates liability in the first place. As such, a broad exclusion for expected or intended injury can largely gut liability coverage.<sup>132</sup>

The ISO HO3 policy provides no coverage for liability when bodily injury or property damage is “expected or intended by an insured even if the resulting bodily injury or property damage (a) is of a different kind, quality, or degree than initially expected or intended; or (b) is sustained by a different person, entity, real or personal property, than initially expected or intended.”<sup>133</sup> However, the policy exempts from this exclusion “bodily injury resulting from the use of reasonable force by an insured to protect persons or property.”<sup>134</sup>

The corresponding exclusions in the sampled homeowners policies differ in multiple respects from this ISO language. First, as noted in Figure 17, some policies appear to be more generous than the ISO policy in that they do not resolve the question of coverage when the liability-generating act is substantially different than initially intended or expected.



Once again, though, the broad trend was largely in the other direction, with most deviations from the ISO policy restricting, rather than expanding, coverage. First, as shown in Figure 18, many policies do not contain the carve-out for intentional or expected acts that are the

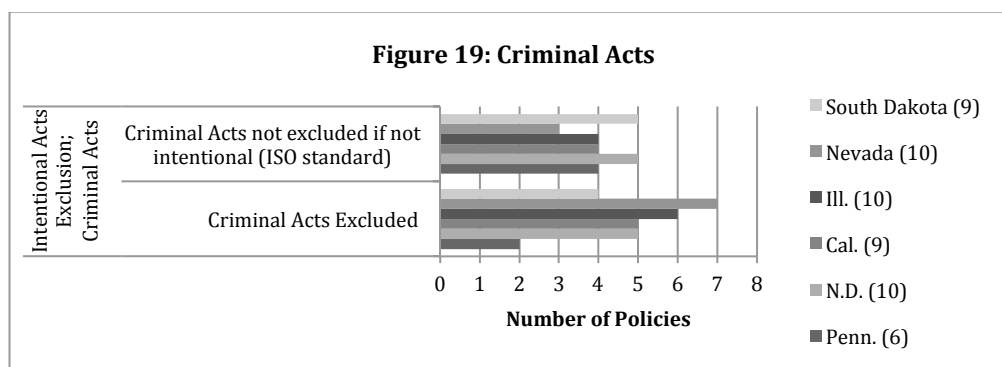
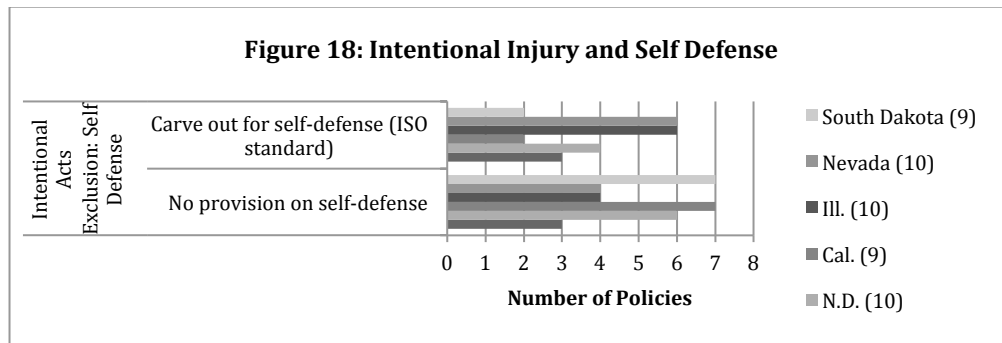
<sup>132</sup> See James Fischer, *The Exclusion from Insurance Coverage of Losses Caused by the Intentional Acts of the Insured: A Policy In Search of a Justification*, 30 SANTA CLARA L. REV. 95, 124-27 (1990).

<sup>133</sup> ISO HO3, *supra* note 38, at 17.

<sup>134</sup> *Id.*

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result of self-defense.<sup>135</sup> Second, Figure 19 reports that many policies exclude coverage for liability stemming from criminal acts, even if those acts do not otherwise constitute intentional or expected injury.<sup>136</sup>



e. Contractual Assumption of Liability

Standard form contracts are omnipresent in the modern world. In a variety of contexts, such contracts require individuals to assume a liability risk, often by specifying that one party will indemnify the other for any liability relating to the contract. Such provisions, for instance, are a common condition when real or personal property is rented, with the lessor agreeing to indemnify the lessee for any liability arising out of the rental.<sup>137</sup> Given the pervasiveness of these types of agreements, it is not surprising that the standard ISO policy covers liability resulting from the assumption of another’s liability in a standard form contract, so long

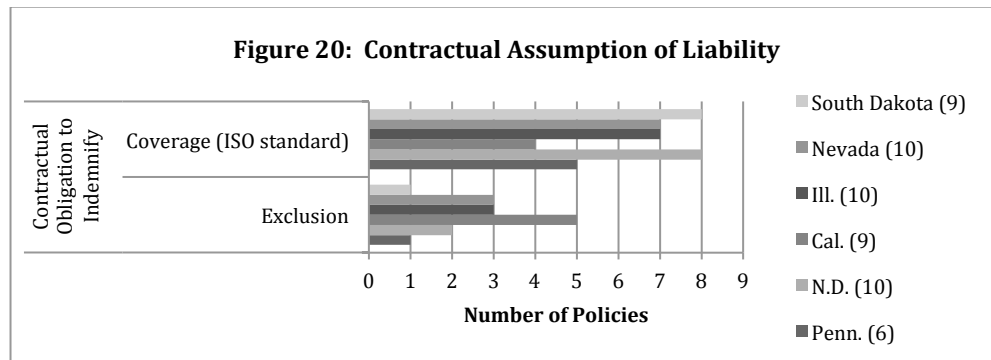
<sup>135</sup> See *Gray v. Zurich Ins. Co.*, 419 P.2d 168 (1966) (insurer refuses to defend insured sued for assault, despite claim he was acting in self-defense, because insured’s acts were nonetheless intentional).

<sup>136</sup> See generally *Baker*, *supra* note 46.

<sup>137</sup> See, e.g., *Martin v. Thrifty Rent a Car*, 145 F.3d 1332 (6th Cir. 1998) (Thrifty’s standard rental agreement required renter to indemnify Thrifty against any and all losses, liabilities, and expenses); *Hertz Corp. v. Zurich Am. Ins. Co.*, 296 F. Supp. 2d 668, 671–72 (E.D. Va. 2007) (Hertz’s equipment rental contract required renter to indemnify rental company); *Armoneit v. Elliott Crane Service, Inc.*, 65 S.W.3d 623, 626 (Tenn. Ct. App. 2003) (rental agreement required lessee to indemnify lessor against claims arising from use of rental property).

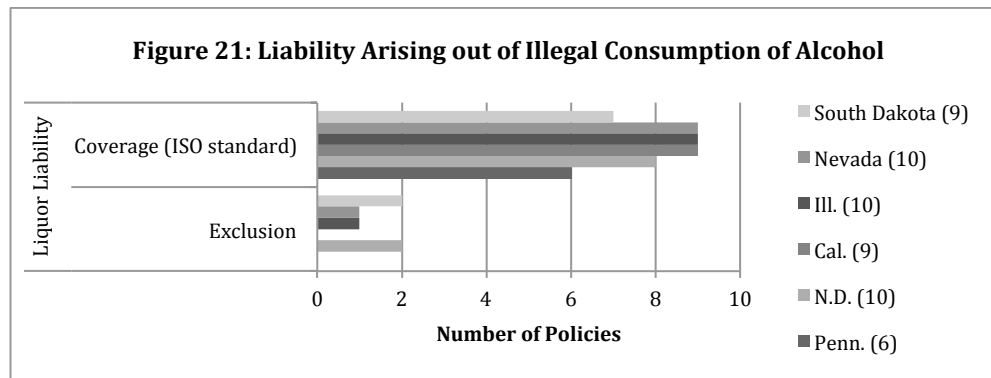
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as this occurs prior to the liability-generating occurrence.<sup>138</sup> As reported in Figure 20, however, this is not true of many homeowners policies in the current marketplace.



f. Liability Stemming from Illegal Consumption of Alcohol

Liability related to the illegal consumption of alcohol poses an obvious risk for households that include teenage (and twenty year old) individuals. Perhaps for this reason, the ISO HO3 policy does not exclude this type of liability. Nor, as Figure 21 shows, do most other insurers. Surprisingly, though, Figure 21 shows that several insurers do indeed contain these exclusions in their policies. One insurance group accounts for the data points in four of the states (South Dakota, Nevada, Illinois and North Dakota), with a second insurance group accounting for the additional data points in North and South Dakota.



g. Lead, Pollution, and Mold Liability

As noted above, one of the major coverage issues of the twentieth century involved the degree to which commercial liability insurance policies cover pollution-related liability.<sup>139</sup> Presently, most general

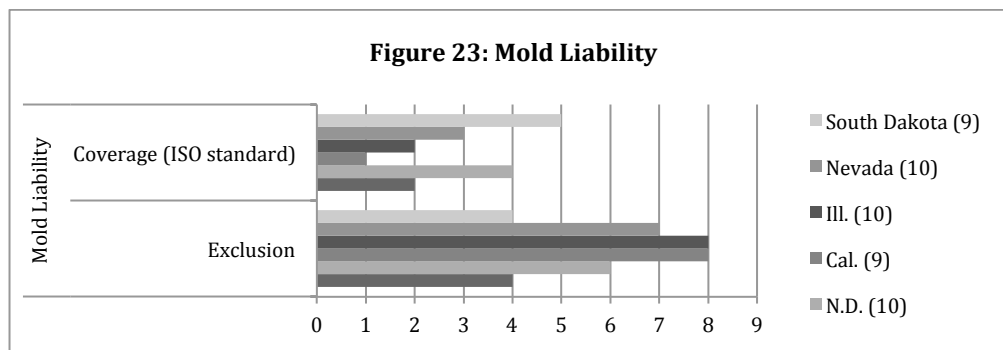
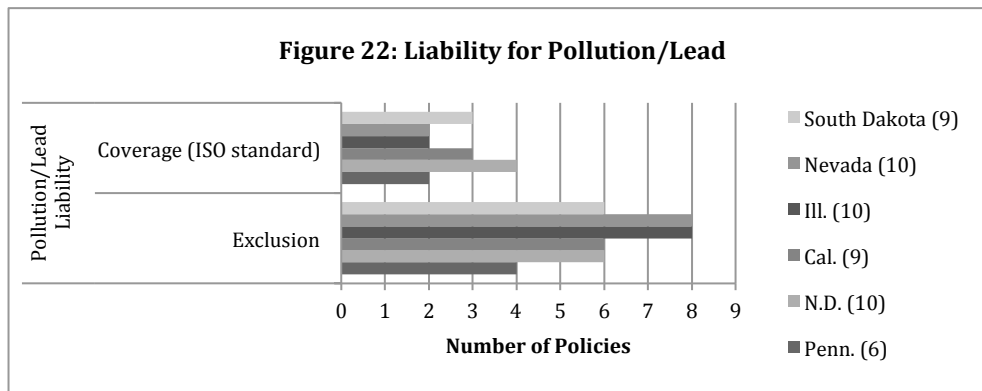
<sup>138</sup> ISO HO3, *supra* note 38, at 18; See STEMPER, *supra* note 2, § 14.14 (noting that this coverage does not violate the principle of fortuity).

<sup>139</sup> See Note 100, *supra*.

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commercial liability policies contain an “absolute pollution exclusion.”<sup>140</sup> But the insurance problems that exist in providing businesses with pollution liability coverage do not necessarily apply to homeowners. Most obviously, homeowners generally do not maintain and make use of large amounts of chemicals and other potential pollutants on their residential premises. Even more importantly, unlike commercial businesses, homeowners are exempt from any federal liability for contamination that occurred prior to their ownership of property, at least so long as they performed a title search, did not find any cause for concern, and did not have independent knowledge of contamination.<sup>141</sup>

The ISO policy does not contain any exclusions for liability involving lead, pollution, or mold. However, the ISO does include in its library of policy forms various endorsements that can be added on to the HO3 policy to exclude or limit these sources of liability.<sup>142</sup> Figures 22 and 23 report that a majority of homeowners insurers do indeed explicitly exclude coverage for these forms of liability. However, they also suggest that there are a not insubstantial number of insurers that continue to cover these sources of liability risk.



<sup>140</sup> See Stempel, *supra* note 101.

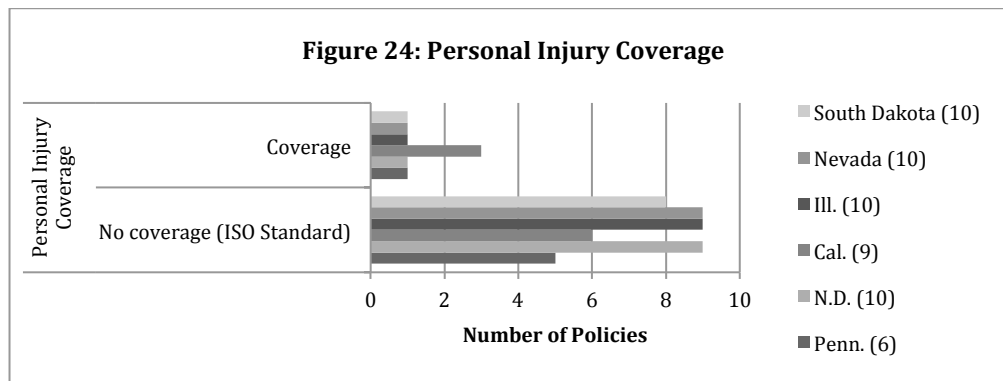
<sup>141</sup> See 42 U.S.C. § 9601(35)(A)(i), (35)(B), (40)(B)(iii) (2006) (outlining the “innocent owner” defense to CERCLA liability); *Bonnieview Homeowners Ass’n v. Woodmont Builders, LLC*, 655 F. Supp. 2d 473, 498–99 (D.N.J. 2009) (dismissing CERCLA claims against homeowners under innocent owner defense).

<sup>142</sup> See ISO, endorsement.



h. Liability for Personal Injury

As suggested at the outset of this Section, standard homeowners policies cover only liability involving bodily injury and property damage.<sup>143</sup> By contrast, most homeowners policies do not automatically cover liability stemming from harms such as mental anguish, false imprisonment, humiliation or reputational harms. Rather, these potential sources of liability are typically grouped together under the heading “personal injury” and offered as an optional endorsement or as an add-on to umbrella coverage. As reflected in figure 24, however, several companies include protection from this form of liability in their base policy. Policyholders have the option to elect this coverage for an increase in premiums with most carriers.



**4. Interpretation, Limitations and Qualifications**

The data reported above clearly establish that, in the states studied, there is substantial variation among the top homeowners carriers with respect to numerous important policy terms. But they do not represent a definitive or complete account of where and how homeowners policies differ. As described above, the specific terms identified for study were hardly a random sample – they were chosen because they are (i) commonly litigated (ii) particularly important, or (iii) reflective of initially-observed variability.<sup>144</sup> Numerous terms in the sample policies varied even though they were not isolated for study.<sup>145</sup> At the same time, the data may obscure the fact that there does indeed remain some degree of standardization with respect to certain terms and

<sup>143</sup> See TAN, supra notes 123-124.

<sup>144</sup> See Part II.A.1.

<sup>145</sup> A highly incomplete list of such variation includes: coverage for land stabilization; coverage for students’ property; definitions of “vacancy;” additional coverage for ID theft, refrigerated products, and damage to grave markers; exclusions for damage from root and tree pressure; coverage for mine subsistence; liability coverage for dog bites; explicit liability coverage of prejudgment interest; and articulations of the duty to defend.

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exclusions, and that some carriers do indeed use the ISO H03 form, or a mostly identical document.<sup>146</sup>

Additionally, the results must be understood in light of the fact that the sampled policies came from a non-random group of states that were willing to devote resources to fulfilling my data requests. It is possible that the sampled states have more extensive regulatory resources or more pro-consumer dispositions, which could in turn impact the degree of variability in policy terms (although this would presumably reduce such variability). At the same time, the similarity in results across the six sampled states provides reason to suspect that they are indicative of a general national trend. Indeed, the sample included policies from 24 different insurance groups, including the top thirteen insurance groups in the country, which cumulatively represent over 2/3 of the market.<sup>147</sup> Moreover, affiliated insurance companies operating in different states almost always used remarkably similar forms and often used identical forms with state-specific amendments that made only minimal adjustments to terms not involving cancellation and non-renewal.

An additional qualification applies with respect to those policy terms that can be changed by endorsement: law and ordinance exclusions, personal injury liability coverage, and – to some degree – internal limits for specific types of property.<sup>148</sup> The variability reflected in these categories simply involves the setting of a default by the insurer. Indeed, carriers that do not include these coverages in their base policy may simply be offering consumers enhanced choice. They may also be improving their own risk classification by allowing consumers to self-select into different groups.<sup>149</sup> Interpretation of these issues depends at least in part on how often agents make policyholders aware of these endorsements as well as how often consumers who comparison shop take into account the different defaults when making decisions among different companies.

A final qualification is that differences in policy terms are only imperfectly indicative of differences in coverage generosity. It is well known that companies occasionally give agents discretion to waive

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<sup>146</sup> For instance, all observed policies included all of the named perils for personal property and property exclusions from the ISO H03 form, even if they occasionally shifted the language of some of these terms.

<sup>147</sup> See TAN 65-66.

<sup>148</sup> See Part II.A.1.i.j & 2.h.

<sup>149</sup> See Daniel Schwarcz & Amy Monahan, *Will Employers Undermine Health Care Reform by Dumping Sick Employees*, 96 VA. L. REV. (forthcoming 2011) (describing indirect risk classification).

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contractual violations.<sup>150</sup> This could be particularly true in the insurance context, where policy language is applied by trained adjusters with substantial discretion.<sup>151</sup> At the same time, though, much of the variability described above is potentially relevant precisely because it impacts the discretion afforded to adjusters and their claims handling superiors. And it is well known that the sequential, contingent structure of the insurance relationship can create incentives for insurers to overreach in claims handling.<sup>152</sup> Finally, variability in policy language ought to be relevant to policyholders even if it is not presently generating differences in claims handling approaches, as broad policy exclusions afford insurers discretion to approach claims handling differently in the future. Were this irrelevant to policyholders, there would be no need for an insurance contract in the first place.

A more tentative implication of the data – which is explored further in the next section -- is that some carriers may be exploiting consumer ignorance to ratchet back their coverage obligations. Although there are exceptions, a substantial majority of the observed variability in policy terms represents downward deviations in insurers' policy forms from the presumptive baseline of the ISO HO3 form. Some of these deviations – such as “increase in hazard” clauses and global requirements that covered losses be “sudden and accidental” – appear to grant insurers excessive discretion in making claims decisions. In other cases – such as liability coverage restrictions for pollution, mold, and lead – coverage restrictions from the commercial liability sphere are imported into the personal liability sphere even though they arguably present limited underwriting concerns in that context.<sup>153</sup>

## **B. Does the Quality of Different Homeowners Policies Differ Substantially in the Aggregate?**

Section A conclusively refutes the myth that all personal lines insurance policies are the same. But it leaves largely unanswered the important related question of whether some carriers' policies are systematically worse or better than others. This Part seeks to answer that question.

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<sup>150</sup> Jason Scott Johnston, *The Return of Bargain: An Economic Theory of How Standard-form Contracts Enable Cooperative Negotiation Between Businesses and Consumers*, 104 MICH. L. REV. 857, 864-76 (2006) (describing a number of situations in which firms grant their agents authority to extend the benefits of standard-form contracts ex post).

<sup>151</sup> Jeffrey W. Stempel, *The Other Intermediary*, 15 CONN. INS. L. J. 599, 618-19 (2009).

<sup>152</sup> 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 (2009).

<sup>153</sup> Yet other deviations – such as those purporting to preserve the insurers' right to first dollar subrogation and opting out of the efficient proximate cause rule with respect to concurrent causation – raise difficult issues regarding optimal coverage design. See Sykes, *supra* note 120.

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## 1. Data and Methodology

As explored more fully below, the coding required for this section is much more resource intensive than the coding required for Part A. For this reason, I limited the sample to the policies collected from North Dakota and Pennsylvania.<sup>154</sup> I select these states for several reasons. First, both of these states have very few, if any, product requirements for homeowners insurance policies.<sup>155</sup> As a result, they provide a good set of test cases for the variation in insurance policies that exists in the absence of regulatory/statutory intervention. Second, homeowners in these states are exposed to a relatively similar set of perils. These two factors justify collectively treating carriers that operate in these states. Third, these states have only a single overlapping carrier among the policies I collected, meaning that they produce a set of sixteen unique policies from distinctive underwriting groups.<sup>156</sup> Finally, North Dakota includes several relatively small regional insurers,<sup>157</sup> which helps provide some information about the types of carriers that deviate from standardized forms.

With this set of sixteen insurance policies in place, I attempt to assign each policy a score that reflects its aggregate generosity. To do so, I compare approximately 200 individual terms in these policies with the corresponding provisions in the 1999 ISO HO3 form. For each term, I assess how sample policy compares to the 1999 ISO HO3 policy with respect to that term. After identifying the language in the sample policy that corresponds to the defined term, I assess whether that term is (i) more generous to the policyholder than the ISO term, (ii) less generous to the policyholder than the ISO term, (iii) or neither of the above. In the first set of cases, the term in the sample policy is assigned a “difference

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<sup>154</sup> As reflected in the data in Part II, I had incomplete data for one carrier, who did not provide either (i) its enumerated perils property coverage, or (ii) its liability coverage in response to the Pennsylvania data call. Rather than eliminate this carrier, I supplemented these missing pieces of its policy with the corresponding pieces from the same group’s Illinois policy. Although Illinois has more extensive content regulation than Pennsylvania, none of it is likely to influence these portions of the policy. This is confirmed by the fact that the dwelling coverage for these two states was very similar, with differences confined to (i) coverage of mine subsistence, (ii) description of all risk coverage, and (iii) inclusion of alternative deductibles.

<sup>155</sup> For a list of their product requirements in homeowners insurance, see NAIC Product Requirements tool, *supra* note 54. Apart from regulations governing cancellation, declination and non-renewal, North Dakota has a valued-policy law, Section 26.1-39-05 and coverage for innocent co-insured who are the victims of domestic abuse Section 26.1-39-24. The North Dakota Insurance Department has also taken two formal departmental positions that influence coverage: it requires only limited pollution exclusions and requires that prejudgment interest must be paid in addition to the limits of liability. Pennsylvania’s product requirements are also limited, and include after-death continuation of coverage, 40 P.S. § 636.1 and coverage for innocent co-insured who are the victims of domestic abuse, Pennsylvania Protection From Abuse Act.

<sup>156</sup> The one exception is State Farm, whose policy is essentially identical in the two states.

<sup>157</sup> See 2009 MARKET SHARE REPORT, *supra* note 48.

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value” of “1”. In the second set of cases, the term in the sample policy is assigned a “difference value” of “-1”. In any instances where the sample policy and the ISO policy are substantially similar with respect to the term, or the relative generosity of the terms is ambiguous, it is grouped in the third category and assigned a “difference value” of “0”. A value of “0” is also assigned whenever a sample policy’s language appears to differ from the ISO policy merely by clarifying its scope or setting out examples of its applicability. Thus, the assignment of a positive or negative value is meant to capture clear differences in the intended scope of particular terms.

This approach is relatively objective and largely mirrors the methodology of the leading empirical studies of consumer contracts.<sup>158</sup> Nonetheless, it obviously involves some degree of subjectivity by the coder. For instance, defining the terms to compare inherently admits of some subjectivity, as much depends on how particular sentences and clauses are grouped together to form terms. Similarly, identifying the language in a sample policy that corresponds to a defined term is not always straightforward.<sup>159</sup> Nor is determining how a sample policy term compares to the corresponding ISO term.<sup>160</sup> I attempt to manage these

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<sup>158</sup> See generally Florencia Marotta Wurgler, *What's in a Standard Form Contract? An Empirical Analysis of Software License Agreements*, 4 J. EMP. LEG. STUDS. 677 (2007); Florencia Marotta Wurgler, *Competition and Standard Form Contract Quality*, 5 J. EMP. LEG. STUDS. 447, 475 (2008); Florencia Marotta Wurgler, *Are “Pay Now, Terms Later” Contracts Worse for Buyers? Evidence from Software License Agreements*, 38 J. LEG. STUDS. 309 (2009). Marotta Wurgler’s important empirical work is based on a sample of about 600 software license contracts from various sectors of the industry. From these contracts, she selecting 24 important terms, and coded them according to whether each term was the same, more, or less favorable than the UCC default. These consumer-friendliness scores figure prominently in much of her work. See, e.g., *Competition and Standard Form Quality*, *supra*, (relying on scores to conclude that there was no correlation between a firm’s market power and the extent to which it included more or less consumer friendly terms). Marotta Wurgler’s approach for selecting terms mirrors my approach in Part A, as she selects “important and common” terms in software license agreements. See *id.* In this Section, by contrast, I rely on the contract’s internal structure to define each term.

<sup>159</sup> Occasionally a term that is in one place in the ISO policy is contained in an entirely different place in the sample policy. For instance, some insurance policies place restrictions on the coverage of emotional distress liability in the definition of “bodily harm” whereas other policies contain such limitations in the grant of liability coverage in Section II of the policy. In other cases, a term in the ISO policy is split into several different places in the comparison policy. For instance, the ISO policy contains a single term exempting from several exclusions liability owed to a residence employee. By contrast, other policies exempt liability to residence employees within each of the exclusions.

<sup>160</sup> This is particularly true with respect to policy language that is structured differently in the ISO policy than in the sample policy. For example, the ISO policy contains an exceptionally complex term excluding “motor vehicle liability” from liability coverage. The exception contains (i) three affirmative conditions that trigger its applicability and, (ii) in the event none of these conditions are met, five other conditions, one of which must be met in order for the exclusion not to apply. By contrast, many other policies contain a much simpler exclusion from liability coverage. In some cases, determining the relative generosity of these provisions is immensely difficult even though one term may be logically more

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limitations by adhering to specific criteria in defining terms<sup>161</sup> and by doing all the coding myself, using a Research Assistant only to perform spot checks on my consistency over time. Additionally, the fact that all policies evolved from a common ISO HO3 form substantially simplifies many of these tasks.

Although this approach is reasonably objective, it is also inherently limited. First, it does not capture the degree to which sample insurance policy terms deviate from the corresponding HO3 policy term. For instance, a policy that contains a term which is slightly less generous than the HO3 form will be coded the same way as a policy whose corresponding terms is much less generous than the HO3 form. Second, this approach largely ignores differences in the relative importance of different policy terms. Some insurance policy terms are obviously vastly more important than others.

To address these limitations, I employ several additional coding approaches that rely on more explicitly subjective judgments. First, in addition to assigning each term a “difference value” of 1, 0, or -1, I also assign each term a “departure value” ranging from -3 to +3, reflecting my subjective assessment of the degree to which the sample policy term differs from the corresponding ISO term. Thus, small deviations from the ISO form are assigned a “1” or “-1”; moderate deviations are assigned a “2” or a “-2”; and large deviations are assigned a “3” or -3.” Second, in order to capture the relative importance of different terms, I assign each term an “importance value” from 1 to 10 depending on my own subjective judgment of how important it would be to a reasonable and informed policyholder.

This approach allows me to construct four different metrics of contract quality. The most objective, but least robust, simply aggregates the “difference values” of 0, +1, and -1 for each of the approximately 200 terms in a policy. The second metric is similarly constructed, but uses the “departure values” that range between -3 and 3. This metric introduces additional subjectivity, but also captures the degree of deviation in each term. Two additional measures of contract quality are generated by multiplying either the difference values or departure

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generous than the other (to the extent that structural differences create ambiguity about which term is more generous, as is often the case, the sample term is coded as a 0).

<sup>161</sup> I defined terms using the following principles: (i) Logical or organizational breaks within the policy were respected., (ii) All provisions at the same outline level of the policy were similarly treated, (iii) Specific language that has been litigated frequently is separately defined as a term to the extent necessary to isolate the relevant issue, (iv) Language with no appreciable impact on coverage is not included, (v) Definitions or concepts employed elsewhere are not treated as separate terms unless their impact on coverage is clear-cut, (vi) Approximately twenty terms are included that, in the course of initial investigation, I found in non- ISO policies and which can substantially impact coverage.

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values by the “importance values” of each term. These four measures of contract quality are summarized in the chart below

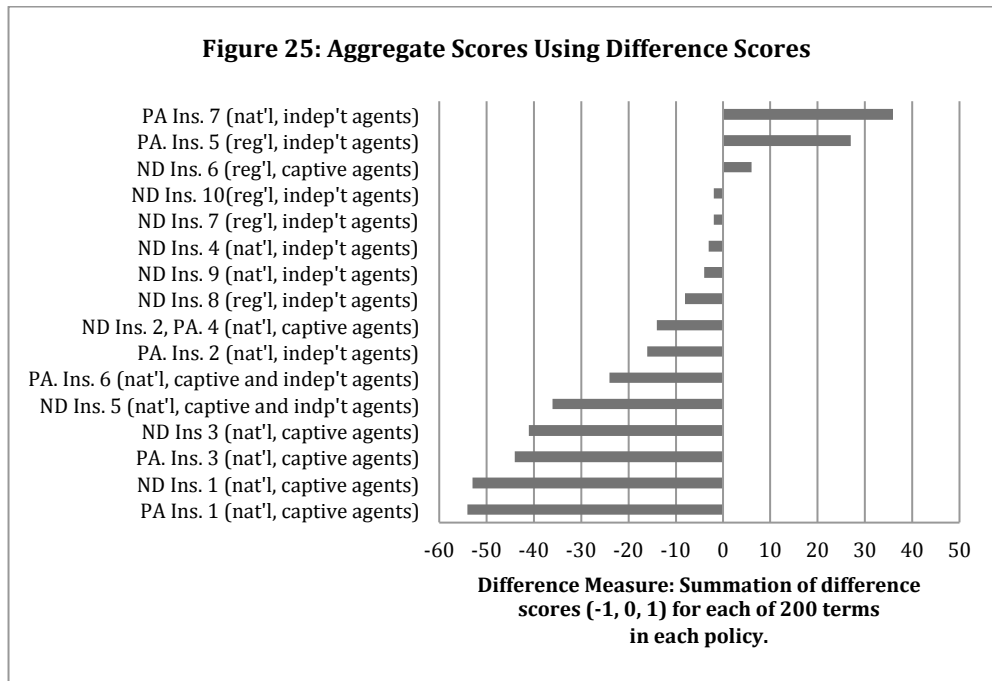
	Calculation Method	Benefits	Drawbacks
Measure 1	Summation of Difference Score (0, 1, -1) for each of 200 terms	Most objective, follows literature	Does not capture either importance of terms or extent of deviation
Measure 2	Summation of Departure Score (-3 to +3) for each of 200 terms	Captures extent of difference between HO3 policy and comparison	Assigning values to degree of departure is inherently subjective
Measure 3	Summation of Difference score (0, 1, -1) multiplied by importance score (1 to 10) for each of 200 terms	Captures relative importance of terms	Assigning values to importance of terms is inherently subjective.
Measure 4	Summation of Departure Score (-3 to +3) multiplied by importance score (1 to 10) for each of 200 terms	Captures both extend of difference between terms and degree of importance	Introduces the most subjectivity

Ultimately, of course, each of these measures must be understood as an inherently crude measure of a sample policies’ generosity relative to the HO3 policy. At the same time, large deviations in scores clearly reflect something about the relative consumer friendliness of different policies.

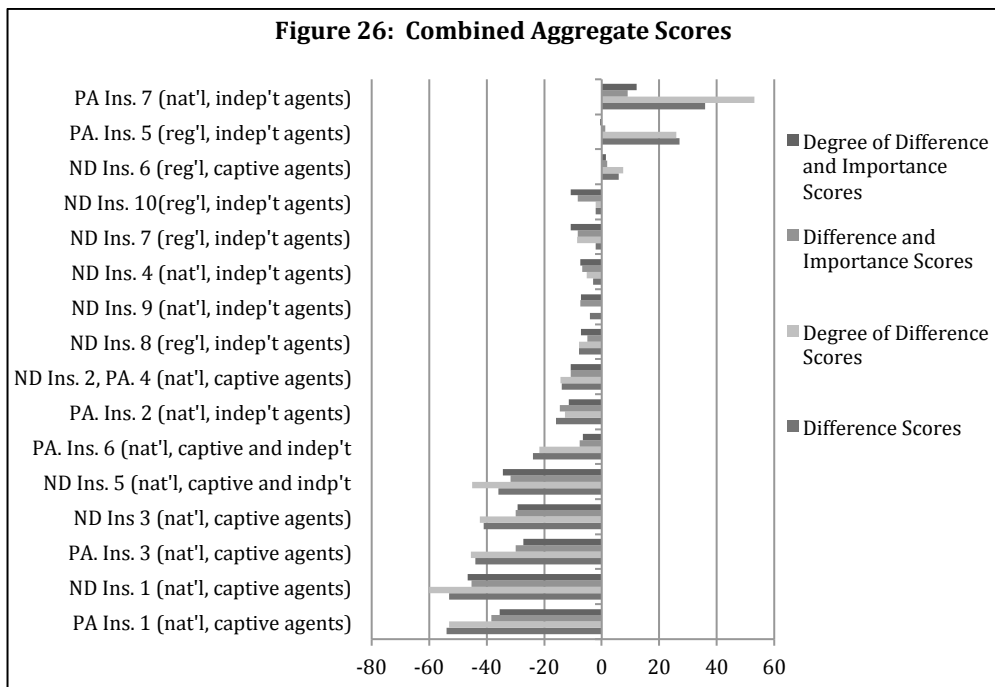
## 2. Results

Figure 25, below, reports the results of the aggregate “difference scores” of the sixteen unique insurers in the data set. Scores above zero indicate that the sample policy is more generous than the ISO HO3, whereas scores below zero indicate the opposite. Although individual insurers are not named, both their distribution system and their geographic reach are identified. The figure clearly conveys that a select few carriers have policies that are more generous than the ISO HO3 policy, as measured by Measure One. At the same time, as suggested by the data reported in Section A, many more insurers appear to have policies that are substantially worse than the ISO HO3 policy. Finally, many insurers do indeed have policies that appear to be close to the HO3 policy in terms of overall generosity.

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These results are not sensitive to which of the various measures of contract quality are used. Figure 26 reports each of the four scores for each insurer, after scaling each of the measures to correspond to Measure One.<sup>162</sup>



<sup>162</sup> In particular, I simply multiplied Measures two, three and four by the average Measure One score over the average of Measures two, three and four, respectively.



### 3. Implications, Limitations, and Qualifications

Irrespective of the various approaches used to measure contract generosity, there are substantial deviations among different carriers. These deviations suggest that roughly five carriers among the sixteen studied employ homeowners policies that are consistently less generous in the coverage they provide relative to other carriers. All five carriers are national in scope, with four exclusively employing a captive agency system and the fifth using a mixed distribution system of captive and independent agents. By contrast, three carriers – two of which rely exclusively on independent agents – have policies that are more generous than the industry norm. Only one of these carriers is national in scope and it specifically markets itself as providing high-end insurance. Finally, the remaining seven carriers have policies that are relatively close to one another as well as the ISO HO3 policy. Of course, it should be emphasized that the scores represents a rough and imperfect measure of contract generosity.<sup>163</sup>

Standing alone, these data do not necessarily reflect differences among carriers in contract quality or efficiency.<sup>164</sup> It is possible that the five carriers with the least generous policies actually offer the most efficient policies because they eliminate coverages that some consumers do not want given the price of supplying them.<sup>165</sup> Alternatively, heterogeneity in policy terms may simply reflect heterogeneity in consumer preferences and characteristics.<sup>166</sup>

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<sup>163</sup> Armed with more data, it might be possible to quantify the expected cost-savings to insurers of deviant policies. But even so, such information would only partially reflect the impact on consumers of policy deviations.

<sup>164</sup> See Marotta Wurgler, *Standard Form Contract Quality*, *supra* note 158, at 475. *But cf.* George Priest, *A Theory of the Consumer Product Warranty*, 90 *YALE L. J.* 1297 (1981) (arguing that a sample of consumer product warranties suggests that these warranties efficiently allocate responsibility between manufacturer and consumer so as to maximize life of products and insure against loss).

<sup>165</sup> Future work might test this by assessing whether the carriers with less generous policies offer lower premiums. Unfortunately, it is hard to get meaningful data on differences in price, as price in the insurance context reflects not only the product itself, but also the characteristics of policyholders. Price differences, even in the aggregate, may therefore represent either differences in the policyholder pool or differences in the underwriting approaches of different carriers. Moreover, even if carriers with less generous policies did indeed charge lower prices, this would only be partially suggestive of an answer to the efficiency question.

<sup>166</sup> See George L. Priest, *A Theory of the Consumer Product Warranty*, 90 *YALE L. J.* 1297, 1347 (1981); Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 *U. COLO. L. REV.* 1, 71-72 (2009) (explaining heterogeneity in sub-prime mortgage terms may be explained simply by heterogeneity of sub-prime borrowers).

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At the same time, the data presented in this Section, when considered in combination with the results from Part A, do raise substantial *concern* that individual carriers are indeed exploiting consumer ignorance to ratchet back their coverage obligations. Although term heterogeneity may indeed reflect heterogeneity in consumer preferences, it is also consistent with market scenarios in which some firms “specialize” in exploitation via non-salient contract terms.<sup>167</sup> This interpretation seems to better explain the data for several reasons. First, Part A suggested various specific instances where deviations in terms were seemingly based on shaky underwriting justifications and endowed insurers with excessive discretion.<sup>168</sup> Second, the explanation that firms are appealing to heterogeneous consumer preferences is hard to square with the results presented in Part III, which show that insurers are actively seeking to shroud differences in product attributes.<sup>169</sup>

Third, the exploitation hypothesis is more consistent with the fact that all five companies with substantially less generous policies utilize a captive agency system, whereas two of the three carriers providing the most generous policy forms use independent agents. In particular, insurers are likely to be much better able to exploit consumer ignorance of company-specific differences if those consumers do not have access to an intermediary that is informed about these differences.<sup>170</sup> Captive agents, who only work for such companies, are substantially more likely than independent agents to meet this specification. By contrast, the heterogeneity theory would be more consistent with the prediction that firms deviating from the standardized form in either direction would utilize independent agents. Of course, there are various alternative explanations for this correlation. Most notably, large insurers are both

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<sup>167</sup> See Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1237-38, 1243-44 (2003) (noting that standard models suggest that term heterogeneity reflects different consumers’ perspectives, but that “heterogeneity of terms is also possible if buyers have identical preferences for the content of certain terms but those terms are salient for some buyers and non-salient for others” and that “if the heterogeneity of the terms’ content reflects heterogeneity as to which terms are salient, however, contracts will only be efficient for customers for whom the terms are salient, while customers for whom the terms are non-salient will receive inefficient contracts”); Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 MINN. L. REV. 749 (2008) (if sellers offer “different terms to different consumers, tailoring their contracts in response to consumer heterogeneity” and “if some consumers are imperfectly informed and imperfectly rational and sellers design their contracts in response to mistakes made by these consumers, the resulting contracts might be welfare-reducing.”).

<sup>168</sup> See Part II.A.

<sup>169</sup> See Part III, *infra*.

<sup>170</sup> See Daniel Schwarcz, *Differential Compensation and the Race to the Bottom in Consumer Insurance Markets*, 15 CONN. INS. L. J. 723 (2009). This intuition is supported by the relative knowledge of captive and independent agents regarding policy variability, reported in Part III. See *infra*.

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more likely to utilize captive distribution systems<sup>171</sup> and more likely to find deviating from standard forms to be economically feasible.<sup>172</sup>

To be sure, the data clearly demonstrates that the marketplace is not currently at the end of a race to the bottom, such as that which precipitated the standard fire insurance policy. Many insurers do, in fact, largely match the coverage found in the HO3 ISO policy, and some companies offer substantially more generous policies. All this suggests that there continue to be meaningful – if potentially insufficient – restraints on coverage restrictions in the status quo. Some carriers may have shied away from cutting coverage because of the fear of reputational consequences, whereas others may have been deterred by the prospect of regulatory or judicial push-back. Still other carriers – particularly smaller carriers with less loss data and fewer resources – would likely face various costs from deviating too far from the standard form, as outlined above.

### III. The Lack of Insurance Policy Transparency

Recent marketing campaigns for large national insurers emphasize the generosity of the coverage they offer. One national insurer promises “more coverage, less spendage.”<sup>173</sup> Another warns in a series of amusing commercials featuring various personified perils that “cut-rate insurance” may not cover certain losses.<sup>174</sup> Yet a third notes that “[y]ou need the best homeowners insurance coverage available – at a reasonable price.”<sup>175</sup> Given these exhortations by insurers for consumers to consider coverage along with premiums, one might think carriers would do all they could to facilitate comparison-shopping among consumers on the basis of coverage.

As this Part details, nothing could be further from the truth.<sup>176</sup> Even an incredibly informed and vigilant consumer would face virtually insurmountable obstacles in attempting to comparison shop on the basis of different insurers’ policy terms. As Part A describes, consumer access to insurance policy forms is woefully deficient. Consumers simply

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<sup>171</sup> See generally Laureen Regan & Sharon Tennyson, *Agent Discretion and the Choice of Insurance Marketing System*, 39 J. L. & ECON. 637, 639 (1996) (describing the factors that lead insurers to select a captive or independent distribution system).

<sup>172</sup> See Part I, *supra*.

<sup>173</sup> See State Farm Advertisement (on file with author).

<sup>174</sup> See Allstate Advertisements (on file with author).

<sup>175</sup> See Farmers Advertisements (on file with author).

<sup>176</sup> This is quite consistent with Tom Baker’s observation that insurers tell radically different “sales stories” and “claims stories.” See Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395 (1994).

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cannot access insurance policy forms on a pre-purchase basis, and when they do receive their policies after purchase, they are virtually indecipherable. Part B demonstrates that alternative sources of information about differences in coverage – including insurance agents, marketing materials, and reputational information – are insufficient to allow consumers to select coverages that reflect their genuine preferences. Considered in combination with Part II, this Part demonstrates the failure of both market and regulatory mechanisms to evolve to meet consumers’ needs. The entire market for personal lines insurance continues to operate as if the conventional wisdom of insurance policy super-standardization remained operative.

## A. Consumer Access to Insurance Policy Forms

### 1. Physical Availability of Forms on a Pre-purchase Basis

#### (a) *Why Pre-purchase Availability Matters*

Modern law and economics scholarship on standard form contracts emphasizes that standard form contracts will tend to be efficient – matching the preferences of consumers – to the extent that a sufficient percentage of consumers are informed about the content of these terms and rationally maximize their self-interest on the basis of that information.<sup>177</sup> Traditionally, most assumed that informed minorities that did police the content of standard form contracts would do so through ordinary, pre-purchase, comparison shopping.<sup>178</sup> Starting with the famous case *ProCD v. Zeidenberg*,<sup>179</sup> however, several scholars suggested that an informed minority can protect the interests of consumers even in the case of “rolling contracts” that are not made available to consumers until after they purchase a contract.<sup>180</sup> Others, not surprisingly, questioned the effectiveness of market mechanisms in this context, arguing that rolling contracts present special risks of consumer exploitation.<sup>181</sup>

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<sup>177</sup> See generally Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PENN. L. REV. 630 (1979).

<sup>178</sup> See *id.*

<sup>179</sup> 86 F.3d 1447.

<sup>180</sup> See Marotta-Wurgler, *Pay Now, Terms Later Contracts*, *supra* note 158 (reviewing literature and providing empirical evidence that demonstrates that software license agreements provided on a post-purchase basis are no less generous than software license agreements provided on a pre-purchase basis). See also Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WISC. L. REV. 679 (reviewing literature).

<sup>181</sup> See Korobkin, *supra* note 167, at 1265; Robert Hillman, *Rolling Contracts*, 71 FORDHAM L. REV. 743 (2002).

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In light of the findings presented in Part II, the pre-purchase availability of insurance policies is crucially important to the efficiency of insurance markets irrespective of which side is correct in the larger rolling contracts debate associated with *ProCD*. First, and most importantly, the pre-purchase availability of policy terms is important to promote consumer choice. The extant rolling contracts literature focuses on the degree to which these contracts raise particular efficiency concerns. But efficiency is not a monolithic concept – different contracts can be efficient for different consumers depending on the preferences and situations of that consumer. This is particularly true in the insurance context, where degrees of risk aversion are heterogeneous, insurance needs vary greatly, the value of insurance can be quite particular and idiosyncratic and the contract is the sole product that the consumer is purchasing.<sup>182</sup> Even if all existing insurance policies were theoretically efficient for some consumers, their lack of availability on a pre-purchase basis would almost certainly produce inefficient matching of consumers with policies, with some consumers purchasing coverage more generous than they truly desire and with other consumers purchasing coverage less generous than they truly desire.<sup>183</sup>

Second, there is an important distinction between rolling contracts as they have been defined in the literature and the specific situation facing homeowners insurance markets. As detailed below, it is essentially impossible even for a highly informed and motivated consumer to acquire different carriers' policy terms on a pre-purchase basis. By contrast, the literature on rolling contracts often assumes that motivated consumers at least *could* acquire the contract on a pre-purchase basis.<sup>184</sup> Indeed, in the leading empirical study on rolling contracts, the author was able in almost all cases to collect the data set of software license contracts directly from the firms with a simple request.<sup>185</sup> This assumption arises out of the fact that the reason most consumers do not so acquire rolling contracts is simply that practical features of the purchasing context make pre-purchase provision of terms cumbersome, as in the case of an over-the-phone purchase of a

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<sup>182</sup> On the heterogeneity of consumer preferences, see Daniel Schwarcz, *Regulating Consumer Demand in Insurance Markets*, 3 ERAS. L. REV. 23 (2010) (exploring various features of consumer demand in insurance markets) and Joshua Teitelbaum, Levon Barseghyan & Jeffrey Prince, *Are Risk Preferences Stable Across Contexts? Evidence from Insurance Data*, AM. ECON. REV. (forthcoming) (Showing differences in consumers' risk aversion in different contexts). On the distinctive nature of the insurance policy as a product, see Schwarcz, *Products Liability*, *supra* note 4.

<sup>183</sup> In the terms of Gillette, there is no reason to suspect homogeneity in the preferences of readers and non-readers in the context of insurance policies. See Gillette, *supra* note 180, at 691.

<sup>184</sup> See Marotta-Wurgler, *Pay Now, Terms Later Contracts*, *supra* note 164, at 315; Gillette, *supra* note 180, at 691.

<sup>185</sup> See Marotta-Wurgler, *Pay Now, Terms Later Contracts*, *supra* note 164, at 315.

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product.<sup>186</sup> This distinction is not trivial – one of the key arguments for why rolling contracts do not present unique efficiency concerns is that motivated and informed consumers could comparison shop on the basis of differences in terms if they were so inclined.<sup>187</sup>

Third, the insurance context is importantly distinctive from other contracting scenarios because of the costs that consumers would face in cancelling coverage if they were dissatisfied with a policy when they ultimately received it. Unlike most contracting scenarios, policyholders are usually practically required to maintain homeowners insurance as a condition of their mortgage.<sup>188</sup> A consumer who was dissatisfied with a contract they received in the mail could not, therefore, simply cancel coverage. Rather, he or she would first have to purchase coverage elsewhere. Yet such a consumer would have no basis for determining whether the alternative insurer's policy was any better or worse than the insurer that she is seeking to leave. Moreover, purchasing coverage from a new carrier is hardly trivial. The policyholder may already have invested resources in finding an agent with whom he is comfortable and in providing all of the necessary information to that agent. Unless the initial agent was independent, switching carriers would include the costs of switching agents as well.<sup>189</sup> All of these switching costs must be considered in light of the intellectual inaccessibility of insurance policy forms on a post-purchase basis, which are discussed in detail below.<sup>190</sup> Once again, this distinctive feature of the insurance context is crucially important: aside from accessing policy forms on a pre-purchase basis, the core mechanism by which theory suggests that informed minorities can influence the efficiency of rolling contracts is through post-purchase return.<sup>191</sup>

In sum, the pre-purchase availability of insurance policy forms is crucially important in light of the findings in Part II that such policies are quite heterogeneous. This is true irrespective of whether rolling contracts more generally present unique risks of inefficient standard form contracts. As such, this Article does not take a stance on that larger debate on rolling standard form contracts. At the same time, the lack of

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<sup>186</sup> See *Hill v. Gateway*, 105 F.3d 1147, 1149 (7th Cir. 1997) (Easterbrook, J.) (emphasizing the difficulty that over-the-phone sellers would have in disclosing their contract terms).

<sup>187</sup> See, e.g., Gilette, *supra* note 180, at 691; Robert Hillman, *Online Boilerplate: Would Mandatory Website Disclosure of E-Standard Terms Backfire?*, 104 Mich. L. Rev. 837, 843-45 (2006).

<sup>188</sup> See Jeffrey E. Thomas, *An Interdisciplinary Critique of the Reasonable Expectations Doctrine*, 5 CONN. INS. L.J. 295, 314 (1998).

<sup>189</sup> A substantial majority of personal lines insurance products are, in fact, sold through captive rather than independent agents. See Schwarcz, *Differential Compensation*, *supra* note 170.

<sup>190</sup> See Part III.B, *infra*.

<sup>191</sup> See, e.g., Gilette, *supra* note 180, at 691; Marotta-Wurgler, *Pay Now, Terms Later Contracts*, *supra* note 164, at 315; *Gateway*, 105 F.3d at 1149.

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pre-purchase availability of policy forms described below raised even larger concerns to the extent that rolling contracts do indeed present substantial efficiency concerns.

*(b) The Lack of Pre-Purchase Availability*

There are three basic ways that a consumer might plausibly acquire an insurer's policy forms on a pre-purchase basis: through an insurance agent, through the insurer itself, or through the state insurance regulator. Each of these is examined in turn.

*i. Accessibility of Policy forms through insurers' Websites/ other online Sources*

The most obvious method an information-seeking consumer might use to try to access insurers' policy forms is to look for forms on insurers' websites. To test the effectiveness of this method, I had a Research Assistant comprehensively search the websites of the top twenty national homeowners insurance providers. The Research Assistant was instructed to be exhaustive, clicking both intuitive-seeming and less intuitive links within the site, and searching terms such as "homeowners policy" and "policy form" in sites' internal search bars. These searches did not produce a single homeowners insurance policy form.

But perhaps the best evidence that, indeed, insurers do not make their personal lines policy forms available on the internet comes from a website run by an independent third party. That website, available as of the time of this writing at "uclaim.com"<sup>192</sup> sells copies of 91 different policy forms to the public. To download a single policy, the user must pay \$9.95.<sup>193</sup> Clearly no business person would invest the required resources into developing and maintaining a website that sells documents that can be easily accessed for free.

*ii. Accessibility of Policy form through Insurance Agents*

A second potential source of insurance policies is from insurance agents. The key question in assessing the availability of competing insurers' policy forms through insurance agents is whether those agents are willing to provide policy forms to consumers with whom they do not already have a relationship. Although one might well be able to acquire an insurance policy through one's long time agent, that fact reveals nothing about whether a determined shopper could easily acquire competing insurers' policy forms on a pre-purchase basis. In order to

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<sup>192</sup> See <http://www.uclaim.com/products.asp> (last visited January 4, 2011).

<sup>193</sup> See *id.*

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determine whether agents would provide unfamiliar consumers with policy forms on a pre-purchase basis, I called twenty randomly selected agents in two states (Minnesota and Pennsylvania) and, posing as a consumer, asked them whether it would be possible to acquire a copy of a homeowners insurance policy form.<sup>194</sup>

These calls suggest that it is very difficult, but not impossible, for an ordinary consumer to acquire homeowners policy forms from insurance agents. In total, two agents – one from Pennsylvania and one from Minnesota – provided me with blank homeowners forms.<sup>195</sup> The other eighteen either explicitly refused to provide me with a policy form or repeatedly deflected requests for such a form. Approximately half of the agents explained that it would either violate company policy to provide a customer with a policy form on a pre-purchase basis or that it was technically not feasible to do so. Many of the agents explained that it was not necessary to acquire a policy form before purchasing coverage because all insurers offer the same (or “essentially” the same) HO3 policy. Several agents mentioned that their company differed from others in that it offered an HO5 policy form or provided the option of endorsements that other companies would not sell. In general, though, the agents suggested that my attempt to compare insurers on the basis of policy forms was misguided, and emphasized that I should base my purchasing decision entirely on price, financial rating, reputation and/or service.

### *iii. Accessibility of Policy forms through State Insurance Regulators*

All states require that insurers file personal lines policy forms with state regulators.<sup>196</sup> Moreover, the vast majority of states require that

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<sup>194</sup> A research assistant contacted the agents in Minnesota whereas the author contacted the agents in Pennsylvania. Both captive and independent agents were contacted. In each case, the caller introduced himself and stated that he was interested in homeowners insurance. He explained that he was looking to buy a home in the near future, and that as part of the home-buying process he was doing some research into various potential insurance carriers. Further, he explained that as part of this research he was hoping to look over the insurer’s basic policy form and compare it to other insurer’s policy forms. Then he would ask the agent (or agent’s employee) if there was any way he could obtain a copy of their most popular homeowners form. If asked, he would explain to the agent that he was a first-time homebuyer, that he was not a current customer (e.g., he did not have auto insurance with the insurer), and that he did not have a closing date, purchase agreement, or preapproved mortgage loan.

<sup>195</sup> The Minnesota agent mailed me a copy of a blank form, which did not include the Minnesota mandatory endorsement, which substantially changes that insurer’s policy language. The Pennsylvania agent e-mailed me a copy of the blank policy form.

<sup>196</sup> See HOLMES’ APPLEMAN ON INSURANCE § 2.10, *Regulation of Policy Forms* (2d ed. 1996). The most stringent states employ prior approval, meaning that an insurer cannot use an insurance policy form unless it is first approved by the state. Many states that formally have prior approval schemes also have provisions allowing an insurer to begin to use a form



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these filings be made available to the public upon request.<sup>197</sup> Taken together, these two facts might suggest that consumers could easily compare different insurers' homeowners insurance policies via state insurance regulators. In fact, though, nothing could be further from the truth.

The most fundamental problem with acquiring an insurer's homeowners policy from a state insurance regulator is that regulators often do not even have these policies in their records. A detailed assessment by North Dakota's own personnel determined that it had in its records the policies of only two of the top ten homeowners insurers in the state.<sup>198</sup> South Dakota's personnel similarly reported that many of the policy forms of the top ten insurers were not available in their records.<sup>199</sup> Michigan apparently did not have any of the top ten carriers' policy forms in their records, as it only recently began requiring insurers to file such forms with the department.<sup>200</sup> Ohio – which is generally reputed to have excellent public access laws – provided me with numerous insurer filings, but these ultimately contained policies from only approximately half of the top ten carriers in their state, many of which may not have included mandatory endorsements.<sup>201</sup> Illinois was able to secure partial copies of the policy forms of seven of the top ten carriers in the state without performing a data call, but required a data call to determine which policies were presently in use and to identify

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if they have received no response from an insurance regulator within a set period of time, though regulators typically have authority to extend that time period. *See id.* Other states employ a file and use scheme, in which insurers can begin to use policy forms as soon as those forms are filed. Finally, some states require simply that insurance policies be filed with the state, but do not review these forms. In some cases insurers must certify that their policies comply with state law. *See id.*

<sup>197</sup> In a recent survey of state insurance business departments, 89% of states responding to a survey reported having such a requirement. *See* Survey, Filing Access Working Group, SERFF (June 30, 2010) (in file with author).

<sup>198</sup> *See* Letter from Larry Musklowski, North Dakota Department of Insurance, to Daniel Schwarcz (May 3, 2010) (on file with author).

<sup>199</sup> *See* Email from Randy Moses, South Dakota Department of Insurance, to Daniel Schwarcz, (May 6, 2010) (on file with author).

<sup>200</sup> *See* E-Mail from Curt Wallace, Michigan Department of Insurance, to Daniel Schwarcz, (June 4, 2010) (on file with author). Michigan ultimately was able to provide me with filings from the top ten homeowners insurers, but none of these filings were filings of their insurance policy forms. This is not surprising, as prior to February of 2010, insurers were not required to file their policy forms with the Michigan Department of Insurance. *See Order of Ken Ross, Commissioner of Michigan's Office of Financial and Insurance Regulation*, available at [www.michigan.gov/documents/dleg/Order\\_Rescinding\\_Exempt\\_308923?7.pdf](http://www.michigan.gov/documents/dleg/Order_Rescinding_Exempt_308923?7). This policy was rescinded at that time for new or revised insurance documents in personal lines, but apparently no company has filed their revised form since that time.

<sup>201</sup> *See* Telephone Interview with Maureen Motter, Ohio Department of Insurance (April 22, 2010); Letter from Christi Washburn, Ohio Department of Insurance, to Daniel Schwarcz (on file with author).

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mandatory endorsements.<sup>202</sup> In the case of Minnesota, a *ten-hour* search at the Insurance division within the Minnesota Department of Commerce by a Research Assistant did not turn up a single "base" insurance policy for any of the top five homeowners insurers in the state. Correspondences with regulatory officials in Pennsylvania,<sup>203</sup> California,<sup>204</sup> Wisconsin,<sup>205</sup> and Nevada<sup>206</sup> similarly suggested that these states had, at best, quite incomplete copies of insurers' homeowners policy forms on record in the absence of a targeted data call.

There are several explanations for why regulators' records are so incomplete with respect to insurers policy forms. First, state record retention laws generally require states to maintain records, including insurers' forms filings, only for a specific period of time – often five years. After this time, records are usually destroyed. Yet insurers only submit filings to regulators when they change their policy forms. This alone would not be problematic were it not for the fact that insurers only file with state regulators the specific language they are altering in their forms, but do not generally file a new copy of the policy form. As a result, regulators typically only have at their disposal various amendments to an underlying policy, *but not the policy that is being amended*. Second, some state insurance departments apparently do not require insurers to note whether or not an amendatory endorsement is optional or mandatory, in the sense that a policyholder has no choice but to accept the endorsement. As a result, regulators themselves often could not determine either whether specific amendments that had been filed were mandatory or whether all of the mandatory endorsements used by a carrier could be accounted for. Many insurers, however, maintain numerous mandatory endorsements that substantially change the terms of their policies.

Even the information that states do possess is incredibly difficult to access. As of August 30, 2010 insurers' filings are not available online in any states other than Wisconsin, Washington, Arkansas and North Carolina.<sup>207</sup> In many cases, these documents must be accessed either by physically visiting the insurance department or hiring a private company

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<sup>202</sup> See Emails from Kathi Armstrong, Illinois Department of Insurance, to Daniel Schwarcz (May 11, 12; Oct. 13).

<sup>203</sup> See E-mails from Carolyn Morris, Pennsylvania Department of Insurance, to Daniel Schwarcz (June 18-23) (on file with author).

<sup>204</sup> See Telephone Interview with Joel Laucher, California Department of Insurance (May 13, 2010).

<sup>205</sup> See Emails from Roger Frings, Wisconsin Department of Insurance, to Daniel Schwarcz (April 21, 2010) (on file with author).

<sup>206</sup> See Emails from Gennady Stolyarov, Nevada Department of Insurance, to Daniel Schwarcz (August 20, 2010) (in file with author).

<sup>207</sup> SERFF Survey, *supra* note 197.

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to do so.<sup>208</sup> Irrespective of whether filings are available online or only by physically visiting a regulator's office, they are incredibly difficult to search. Insurers' filings are almost universally contained in a complicated electronic filing system known as SERFF, which is very poorly designed from the standpoint of recalling specific types of filings.<sup>209</sup> For instance, while the system distinguishes between rate and form filings, it does not distinguish between different types of form filings, such as optional endorsements, mandatory endorsements, base forms, and amendments to any of these. In order to determine the content of a form filing, the consumer must therefore click on the document link to assess it. Similarly, while searches can be conducted by carrier, it is often difficult even to isolate the relevant insurance company, as a single insurance group typically has numerous insurance companies licensed to do business in a single state.<sup>210</sup> A curious consumer may therefore have to search through numerous different companies' filings before identifying the company of interest. None of this is surprising: SERFF was designed only to facilitate the electronic submission of filings, not to facilitate public records searches.<sup>211</sup>

In some states, a consumer can obtain copies of policies by submitting a request for records directly to regulators.<sup>212</sup> Departments typically charge a per-page copying fee, an hourly records-searching fee, or both for requests by mail.<sup>213</sup> The individual within the department

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<sup>208</sup> This was the case in Iowa and Indiana, for instance. See Email from Kate Kixmiller, Indiana Department of Insurance, to Daniel Schwarcz (May 13, 2010) (on file with author); Email from Tom O'Meara, Iowa Department of Insurance, to Daniel Schwarcz (April 21, 2010).

<sup>209</sup> See American Association of Insurance Services, *Information from Filings Moves on to Public Websites*, 32(2) VIEWPOINT (Fall 2007) ("While public access is intended to benefit consumers and citizens, few non-specialists can navigate through the categories of filing documents and make sense of the technical information found therein."). For a general explanation of SERFF, see its website at <http://www.serff.com>.

<sup>210</sup> Often, only a subset of these companies may be licensed to provide homeowners insurance. And among these, it is often the case that only one of these companies typically issues new policies, with other companies retaining the business of renewing policyholders. For instance, one company introduced a quite aggressive new insurance policy form, but apparently did not attempt to move existing customers on to the new form. Instead, it formed a new underwriting company wherein it wrote new business. An interview with one insurance agent suggested that the company informed agents that there might be "legal problems" with switching existing companies from the old form to the new form.

<sup>211</sup> See Information from Filings, *supra* note 209.

<sup>212</sup> For instance, this was true in Illinois, Michigan, and Ohio.

<sup>213</sup> For instance, in Michigan a labor costs to process/comply with a request was quoted to me at \$24.30/hr, along with a charge of \$.25/page for photocopying and mailing costs. See E-mail from Curt Wallace, Michigan Department of Insurance, to Daniel Schwarcz (6/3/10) (on file with author). Similarly, North Dakota charged \$.25 per impression for copies of public records, postage fees, and \$25 per hour, excluding the initial hour, for locating records. See Email from Melissa Hauer, North Dakota Department of Insurance, to Daniel Schwarcz (4/22/10) (in file with author); N.D.C.C. § 44-04-18.10.

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who is tasked with fulfilling this records request must, like the consumer, do so through SERFF. As a result, they face the same limitations in using this system to pull up desired records that a consumer would face. Although they are likely to be more familiar with the basic SERFF interface and search features, pulling up desired policy forms can take these officials a significant amount of time (and hence money for the consumer). For instance, one insurance department estimated that it would take 3 hours for an official to locate the available policy forms of the top ten insurers in its state.

## 2. Intellectual Accessibility of Policy Forms on a Post-Purchase Basis

Consumers typically receive their insurance policies in the mail several weeks after they purchase coverage. Although the lack of pre-purchase availability of policy forms is nonetheless problematic,<sup>214</sup> this concern might be mitigated to the extent that post-purchase disclosure of policy terms were meaningful. For instance, a consumer who realized that he had inadvertently purchased an insurance policy containing unusually broad theft and water exclusions might well cancel coverage or inform neighbors or friends of his dissatisfaction with his company. This, in turn, could exert a disciplining force on insurers and help to ensure that large mismatches between a consumer's preferences and the insurance they actually purchased could be remedied.

Yet every facet of the post-purchase delivery of policy forms inhibits consumer comprehension of the coverage that is purchased. First, the timing of the delivery of policy forms could not be worse from the standpoint of promoting consumer comprehension. Whereas insurers typically mail the entire policy to consumers shortly after purchase, they often do not mail the policy to consumers at the time of renewal.<sup>215</sup> Rather, at renewal they often only send a copy of the declarations page and various required notices. All of this means that the sole instance when a consumer receives a homeowners policy for review is several weeks after the consumer purchases coverage for the first time. This is quite likely to correspond to a stressful and busy time in that person's life, when he or she is likely purchasing a new home and/or moving to a new geographic region.<sup>216</sup> Under such circumstances, it can be expected few consumers will devote substantial

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<sup>214</sup> See Part III.A. *supra*.

<sup>215</sup> Some insurers, such as Allstate, allow policyholders to access copies of their policies online.

<sup>216</sup> See Schwarcz, *Consumer Dispute Resolution*, *supra* note 152, at 744.

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attention to reading the fine print of their insurance policies, especially given that they have already purchased that policy.<sup>217</sup>

Second, and more importantly, even motivated consumers are ill-equipped to comprehend the meaning of typical homeowners policies, which are, in many ways, uniquely poorly drafted from the standpoint of promoting consumer understanding.<sup>218</sup> The structure of homeowners insurance policies renders them incredibly difficult to understand, notwithstanding the basic table of contents that sometimes accompanies policy forms.<sup>219</sup> Consider just the property insurance section of a typical homeowners policy. This portion of the contract is sub-divided into four sub-sections: (i) Property Covered, (ii) Perils Insured Against, (iii) Exclusions, and (iv) Conditions. Although most policies do not clearly sub-divide these four sub-sections in outline form,<sup>220</sup> a policyholder who has suffered property damage is only entitled to coverage if the provisions in all four sections are satisfied: (i) the property damaged must be described in the “Property Covered” section of Section I; (ii) the peril that damaged the property must be described in the “Perils Insured Against” portion of Section I; (iii) no provision from the “Exclusions” sub-section can apply; and (iv) the policyholder must comply with all terms in the “Conditions” Section. Frequently terms in these sections are defined at the outset of the policy in the “Definitions” section in a way that restricts coverage. Additionally, the policyholder must also comply with a second “Conditions” Section contained at the end of the policy. Thus, to understand whether a policy provides coverage for any type of property damage, the policyholder must look at and understand the relationship among six different portions of the contract located throughout the policy.<sup>221</sup>

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<sup>217</sup> See Korobkin, *supra* note 167, at 1226.

<sup>218</sup> Of course, many consumer contracts are quite impenetrable. However, it is not uncommon to single out insurance policies as being uniquely indecipherable. See generally Boardman, *Allure of Ambiguous Boilerplate*, *supra* note 34, at 1107 (quoting a recent South Carolina Supreme Court decision as stating that “[a]mbiguity and incomprehensibility seem to be the favorite tools of the insurance trade in drafting policies”).

<sup>219</sup> See Daniel Schwarcz, Testimony to NAIC Readability Committee (March 2010); Brenda Cude, Testimony to NAIC Readability Committee (March 2010); Amy Bach, Testimony to NAIC Readability Committee (March 2010); *available at* [http://www.naic.org/documents/committees\\_d\\_ccwg\\_100328\\_testimony\\_consumer.pdf](http://www.naic.org/documents/committees_d_ccwg_100328_testimony_consumer.pdf).

<sup>220</sup> Most policies have these terms under headings such as “Section I – Property Covered” and “Section I – Perils Insured Against.” These policies would be much clearer if the headings read: “Section I.A. Property Covered” and “Section I.B Perils Insured Against.” This is obviously a small example, but it illustrates a much larger point.

<sup>221</sup> This is just the tip of the iceberg. The “Conditions” sub-section of Section I actually contains various provisions that are not conditions at all, such as loss settlement rules. The “Perils Insured Against” sub-Section contains numerous exclusions, even though they are not listed in the exclusions section. Understanding this is crucial because the rules governing concurrent and sequential causation are different from the exclusions in the Exclusions sub-section than for the exclusions in the Perils Insured Against sub-section. The

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Perhaps even more importantly, insurance policies are notoriously indecipherable for another reason – the individual terms in homeowners policies rely on verbose and confusing grammatical structures and word choices. To be sure, many states require insurance policies to meet minimum “readability” scores, which they define based on objective, quantitative metrics that attempt to measure the literacy level required to read and understand written information.<sup>222</sup> Yet the typical requirement is that insurance contracts be written so that they achieve a 40 on the Flesch-Kincaid scale, which equates to the reading level of an early college student. Yet most Americans read below their grade level -- high school graduates typically read at the eight-grade level and college graduates typically read at the tenth grade level.<sup>223</sup> In any event, anyone who has attempted to comprehend even a small part of an insurance policy will recognize that crudeness of quantitative readability scores.

The immense complexity and opaqueness of insurance policies is not surprising. Absent regulation, insurers have very little reason to care about the clarity of their contracts to consumers, as the intended audience of their drafting efforts is the courts.<sup>224</sup> In fact, holding precision constant, insurers may even benefit from impenetrable contracts. That way, consumers will not challenge coverage denials and ordinary lawyers will not have the skill or expertise to fight with insurance company lawyers who are intimately familiar with these forms. Additionally, because insurers add to and change the homeowners policy in response to judicial decisions,<sup>225</sup> they occasionally are required to insert language into awkward places in the organizational structure of the policy so as to maintain its basic structure. This further confuses the ultimate results.

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property coverage sub-section itself contains five different sub-divisions, which are labeled “Coverages.” And the application of all the other sub-sections – such as Perils Insured Against and Exclusions – depends on which of these Coverages one is looking at. Finally, just to top it all off, the policy completely departs from this structural logic within Coverage E of the Property Coverage sub-section

<sup>222</sup> See Cude Testimony, *supra* note **Error! Bookmark not defined.**; Edward B. Fry, *The Varied Uses of Readability Measures Today*, 30 J. READ. 338, 340 (1987) (“The insurance industry is also a prominent user of readability formulas. As of March 1984, 28 U.S. states required that personal auto and home- owners' policies must have a Flesch Reading Ease Score between 40 and 50, or about a 10th grade level.”).

<sup>223</sup> CECILIA CONRATH DOAK, LEONARD G. DOAK, & JANE H. ROOT, *TEACHING PATIENTS WITH LOW LITERACY SKILLS* (2d ed. 1996).

<sup>224</sup> Boardman, *Allure of Ambiguous Boilerplate*, *supra* note 34, at 1107 (“Evidence supports the proposition advanced here, that the insurers' audience from start to finish is the courts, a practice that leaves policyholders by the wayside, and one that courts unwittingly encourage.”).

<sup>225</sup> *Id.*

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## **B. Availability of Information that Proxies for the Generosity of Insurance Policy Forms**

Various forms of information clearly proxy for the generosity of coverage that particular insurers offer. For instance, an insurer whose policy form provided zero coverage would presumably soon find a corresponding number of willing customers as its reputation began to reflect that fact. This Section explores various potential informational proxies for the relative generosity of different carriers' policy terms. It provides preliminary evidence that various informational proxies, including insurance agents, marketing material, and general reputation do a poor or limited job of informing consumers of potential differences in policy form language.

### **1. Information from Agents and Insurers**

The most important informational proxy that consumers have for the content of their policies is their insurance agent.<sup>226</sup> Most consumers rely on insurance agents to describe the basic features of the coverage they are purchasing and advise them as to any necessary endorsements. This is true irrespective of whether they purchase coverage through a captive agent who works for a single company or an independent agent who can bind coverage with multiple different companies.<sup>227</sup> In earlier work, however, I suggested that agents are likely to be limited proxies for coverage details such as those at issue in this article, because they "generally tend to focus on basic coverage terms and avoid coverage nuances that cannot be altered with supplemental coverage."<sup>228</sup>

In order to gather some preliminary empirical evidence about the accuracy of this claim, I interviewed eleven insurance agents in four different states. Five interviews were conducted in person with Minnesota insurance agents, with the remaining six interviews conducted over the phone with non-Minnesota agents.<sup>229</sup> Eight of the interviews were with captive agents, and three were with independent agents. Pursuant to IRB protocol, all interviews were conducted on an anonymous basis. Interviewees were selected randomly, with some effort to interview a range of captive agents from different companies as well as independent agents. The vast majority of agents contacted refused to be interviewed.<sup>230</sup> Many captive agents initially agreed to be

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<sup>226</sup> See Schwarcz, *Products Liability Theory*, *supra* note 4, at 1415-16.

<sup>227</sup> See Schwarcz, *Differential Compensation*, *supra* note 170, at 727-29.

<sup>228</sup> Schwarcz, *Products Liability Theory*, *supra* note 4, at 1416; *see also* Abraham, *supra* note 3, at 56.

<sup>229</sup> Most of the non-Minnesota agents were located in Illinois. However, I also interviewed a Nevada agent and a Pennsylvania agent.

<sup>230</sup> An Assistant initially contacted agents to gauge their willingness to be interviewed. Although records were not kept about how many agents refused, my Assistant estimates that over a hundred agents were contacted. This does create the potential problem of selection effect. If anything, however, this bias seems to work against the interview results described

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interviewed, but later declined after receiving an IRB disclosure form. In several cases, agents told me that they were explicitly instructed by their affiliated insurer not to speak with me.

Interviews were semi-structured, centering around the two basic ways that information and guidance from agents might proxy for differentials in coverage details. First, agents might directly inform consumers of the importance of comparison-shopping based on differences in coverage. To assess this, I attempted to determine whether the agent believed that different carriers sold different policy forms and how often that issue came up in discussions with consumers. Second, agents might inform consumers about specific policy details, such that a consumer independently motivated to comparison shop on the basis of coverage could do so by speaking with multiple different agents. To assess this, I attempted to determine the degree to which agents were familiar with how the policy forms they sold treated the various coverage issues described in Part II.A, as well as whether the types these issues figured significantly in conversations with consumers at the point of sale.

All eight of the captive agents interviewed were unfamiliar with the variation in policy language described in Part I, though their precise beliefs about insurance policy variability ranged along a spectrum. Four of the eight agents indicated that all homeowners policies are “standard on the market” or “the same across the board,” because they are all based on the ISO HO3 policy.<sup>231</sup> Among these, several did suggest that an individual carrier could add “bells and whistles” onto the standard ISO HO3 policy, such as identity theft. Two of the remaining captive agents indicated uncertainty about whether different carriers’ policies differed.<sup>232</sup> These agents both explained that they were only familiar with their own carriers’ coverage and that they had not examined or studied the coverage of other carriers. Finally, the remaining two captive agents indicated that there were indeed differences in different carriers’ policy language, but that they did not know what those differences were.<sup>233</sup>

All eight of the captive agents indicated that customers looking to purchase coverage do not ask questions about potential differences in carriers’ policy language. Several of the agents who acknowledged the possibility of differences in carriers’ policy language affirmatively indicated that precise contract terms should not figure into a customer’s

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below – agents who were willing to speak with me were presumably more confident in their knowledge base and interested in my perspective.

<sup>231</sup> Interview with Agent 2 (MN); Interview with Agent 3 (MN), Interview with Agent 6 (IL); Interview with Agent 11 (NV) (quotations from Agents 6 and 11).

<sup>232</sup> Interview with Agent 5 (MN); Interview with Agent 7 (IL).

<sup>233</sup> Interview with Agent 8 (IL); Interview with Agent 9 (IL).



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decision-making among different carriers.<sup>234</sup> Instead, they emphasized service from the agent and their carrier's reputation. As one of these agents put it: "A contract is a contract. They are all going to do the same thing."<sup>235</sup>

The captive agents ranged in their knowledge of the coverage that their carrier's policy provided with respect to the issues described in Part II. On one end of the spectrum, none of the interviewed agents were familiar with how their carrier's policy dealt with issues such as concurrent causation or liability arising out of a contractual agreement to indemnify another. With respect to issues such as mold damage, pollution damage, and damage from artificial electrical current, the agents often provided a basic explanation of coverage that was almost always incomplete and, in several instances, incorrect. For instance, several agents told me that their policies covered all loss from changes in artificial current, even though their carriers' policies contained sublimits or limits on types of damages covered. In virtually every case, captive agents indicated to me that the types of detailed questions about policy language were claims issues rather than sales issues.<sup>236</sup> One such agent explained "I know just enough to be dangerous, but that's all the insurance company wants me to be."<sup>237</sup> Another explained his lack of knowledge about precise terms by noting that "agents tend to be generalists – we sell home, car, life, health, lots of policies."<sup>238</sup>

The three independent agents I interviewed varied substantially in their knowledge about different carriers' policy forms. On one end of the spectrum, one independent agent was quite knowledgeable about the policy language variation in the homeowners market.<sup>239</sup> This agent, whose clientele consisted of "high-end clients" who were usually referred to him by financial advisors, explained that the policy forms of "high end" companies are usually systematically better than the standard HO3 forms. Indeed, he explained that the first thing he did with new clients was to compare, side-by-side, the differences between a standard policy form and the policy forms that one of his high-end carriers provided. This agent indicated familiarity with a broad range of issues, including concurrent causation and mold coverage. He indicated that the high-end companies tend to match one another in terms of coverage terms.

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<sup>234</sup> Interview with Agent 5 (MN); Interview with Agent 7 (IL).

<sup>235</sup> Interview with Agent 7 (IL).

<sup>236</sup> See Baker, *Claims Stories*, *supra* note 176.

<sup>237</sup> Interview with Agent 6 (IL).

<sup>238</sup> Interview with Agent 9 (IL).

<sup>239</sup> Interview with Agent 1 (MN).

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The second independent agent similarly explained that carriers' forms differ in important ways with respect to their basic design.<sup>240</sup> Relative to the first agent, this agent was more familiar with broad differences in policy design than differences in specific policy language. For instance, he noted that policies differed with respect to whether they built into the base form options like guaranteed replacement coverage, sewer back-up coverage, I.D. theft, and ordinance or law coverage. He indicated less familiarity with how the different policies that he sold differed in specific policy language. He was not personally familiar with how his carriers' policies differed with respect to issues such as concurrent causation, mold, pollution, and coverage for liability arising out of contract. However, he indicated that the agency maintained a "cheat sheet" that laid out the major differences in different policies.

The third independent agent echoed the notion that different carriers' policies differ in important ways, such as whether they cover I.D. theft, provide replacement cost, or provide coverage on a named peril or all perils basis. However, this agent indicated that all policies – both those that he sold and those sold by all other carriers – were identical with respect to the core "cookie cutter" coverages. These coverages, he explained, were all taken from the standard HO3 policy, meaning that there were no differences in the details of the language. This agent indicated lack of familiarity with how many of the issues canvassed in Part II were dealt with in the policies, echoing the notion that these involved "claims issues" rather than sales issues.

Not surprisingly, these results appear to be consistent with insurers' marketing materials, which serve a similar function to insurance agents.<sup>241</sup> A comprehensive review of these materials is beyond the scope of this article.<sup>242</sup> But to get a preliminary sense of these materials, I instructed a Research Assistant to comprehensively search the websites of the top twenty homeowners insurers nationally. For each insurer, the RA described the explanatory materials available on these websites regarding the coverage details of homeowners insurance.

This effort suggests that insurers' marketing materials generally explain coverage in high-level terms that are not sufficiently detailed to allow for cross-company comparison.<sup>243</sup> The sampled websites differed

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<sup>240</sup> Interview with Agent 4 (MN).

<sup>241</sup> Schwarcz, *Products Liability Theory*, *supra* note 4, at 1419 (describing role and importance of marketing information).

<sup>242</sup> For good, recent review of insurers' marketing of their coverage, see Boardman, *Insuring Understanding*, *supra* note 4, at 1093-98 (concluding that "a consumer looking to learn about insurance and insurers should turn off the television").

<sup>243</sup> See Schwarcz, *Products Liability Theory*, *supra* note 4, at 1419 ("Because written literature must be accessible and relevant to a wide range of readers, it can explain only the

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substantially with respect to the specificity of information available about the content of their homeowners coverage. Although the better websites provided a good amount of basic information about their policies, this information was generally not sufficiently detailed to allow for comparisons in coverage across companies. Information available on these websites includes an explanation of the difference between all risk coverage for dwelling/structures and named peril coverage for personal property; a description of replacement cost and ACV; a listing of some sub-limits for specific types of property; a list of basic exclusions (i.e. flood, earth movement, etc.); a list of covered perils for personal property (i.e. fire, lightning, etc.); and a one to two sentence description of liability insurance and guest medical coverage.<sup>244</sup> In some cases, websites do an admirable job explaining whether or not certain typical losses are covered.<sup>245</sup> These websites also tend to provide some detail about available supplemental coverages, such as back up sewer coverage, contents replacement, guaranteed replacement, personal injury protection, flood coverage and scheduled personal property.<sup>246</sup>

Most websites provide less detailed information. For instance, rather than listing the various covered perils for one's personal property, one website simply explains that, with the standard policy, insureds have "[c]overage for many types of damage and for many causes of loss or damage (subject to exclusions) to . . . home and separate structures, such as a detached garage."<sup>247</sup> Along these lines, another insurer promises simply that it provides "Broad, flexible protection for your home, possessions and YOU!"<sup>248</sup> These websites often make generalizable statements such as "[w]e protect the roof over your head

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most basic coverage exclusions and endorsement options."). *See also* Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171, 240 n.187 (1995) (noting concern that insurers' marketing materials may be misleading).

<sup>244</sup> An example from the American Family website, which was comparatively quite comprehensive, follows: "If you are legally responsible for a covered accident that injures another person or damages someone else's property, your policy will provide liability coverage up to the amount specified in your policy. We are also required to defend you against a suit for damages payable under the policy until your liability limit has been offered or paid." The "Liability Coverage" tab also provides several examples of losses that liability coverage "may" protect the insured against, including "[l]iability to others such as sports activities" and "[a]cts of pets." *See* [www.amfam.com](http://www.amfam.com). By comparison, the Nationwide website explains simply that the policy includes "Protection against claims you're legally obligated to pay", "Payment of the cost of defending claims against you", "Medical expenses of others", and "Accidental death benefits." *See* [www.nationwide.com](http://www.nationwide.com).

<sup>245</sup> *See, e.g.*, [www.metlife.com](http://www.metlife.com); [www.libertymutual.com](http://www.libertymutual.com). The FAQ in the Liberty Mutual website includes a lot more details as to what the policy covers (the questions detail some interesting coverages: bursting pipes, freezing pipes, vandalism, living expenses, damaged trees, debris removal, and items not covered by the personal property coverage). *See id.*

<sup>246</sup> *See, e.g.*, [www.travelers.com](http://www.travelers.com).

<sup>247</sup> *See, e.g.*, [www.farmers.com](http://www.farmers.com).

<sup>248</sup> *See, e.g.*, [www.auto-owners.com](http://www.auto-owners.com).

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and everything under it, especially your sense of security.” Specifics are often cabined to basic examples, such as if “something like fire” causes the insured to lose use of the dwelling, we “cover the increased costs of a place to live.”<sup>249</sup>

The websites and other marketing materials of the companies with the most generous forms do, to some extent, tout that fact. One company with a relatively strong overall policy score explains on its website that its policy contents “50 Xtra features” and lists seven of them.<sup>250</sup> Another company with a form that scores very well provides that its policy contains features “not usually found in other policies” such as a complimentary home appraisal, extended replacement cost option, rebuilding to code, additional living expense, and replacement cost settlement options.<sup>251</sup> A quick Google search for this company pulled up marketing material which describes in more detail the various ways in which the company’s policy is more generous than the standard HO3 form.<sup>252</sup>

In sum, insurers’ marketing materials largely matched the limited information that was available from insurance agents. Nonetheless, these results are only suggestive, given the limited number of interviews conducted and websites reviewed as well as the semi-structured, qualitative methodology employed. At the very least, though, there is good reason to believe that the information available from insurance agents and insurers is generally not sufficient to allow consumers to comparison shop on the basis of differences in policy language.<sup>253</sup> The one exception is that a small number of insurers, which tend to serve high end clients, seem to specifically emphasize the generosity of their policies in their marketing and to employ independent agents who are informed about these differences.<sup>254</sup>

As I have explored at length in earlier work, however, even independent insurance agents who are quite informed about differences in carriers’ policies are not properly incentivized to fully inform

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<sup>249</sup> See, e.g., [www.statefarm.com](http://www.statefarm.com).

<sup>250</sup> See [www.erieinsurance.com](http://www.erieinsurance.com). The extra features listed include “up to \$3,000 for jewelry, furs, and watches, payment for stolen automatic garage door transmitters.” *Id.*

<sup>251</sup> See [www.chubb.com](http://www.chubb.com).

<sup>252</sup> See Chubb Marketing Material, available at <http://www.mullerinsurance.com/resources/ChubbHomeownerComparison.pdf> (last accessed 1/18/11).

<sup>253</sup> See also Boardman, *Insuring Understanding*, *supra* note 4, at 1093-98; Baker, *Claims Stories*, *supra* note 176.

<sup>254</sup> This is consistent with the earlier finding that the carriers with the worst forms employ a captive distribution system whereas the carriers with the better forms tend to employ an independent distribution system. See Part II.B, *supra*.

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consumers about these differences.<sup>255</sup> That is because independent insurance agents typically receive different amounts of compensation based on the insurers to which they refer policyholders. This can consist either of contingent compensation or differentials in flat premiums. Of course, most independent agents nonetheless provide quality guidance to their clients, especially with respect to basic issues, such as acquiring proper endorsements, securing appropriate discounts, and recommending reliable carriers. But, whether consciously or subconsciously, the financial incentives that independent agents face to refer clients to particular carriers are likely to influence their advice, particularly with respect to issues that customers are not likely ever to notice, irrespective of whether they have a claim. Nuanced differences in policy language between carriers are precisely such a difference.

## 2. Information from Regulators

Only one state provides its consumers with any information at all that specifically attempts to proxy for the relative generosity of different carriers' policy forms. The Texas Office of Public Insurance Council – an independent agency from the Texas insurance regulator charged with representing Texas consumers as a class regarding insurance-related issues<sup>256</sup> – maintains an excellent website that allows consumers to compare the coverage that different insurers provide along twenty-one pre-specified dimensions.<sup>257</sup> Unfortunately, even this website only partially and imperfectly captures differences in different carriers' policies, and it does not provide consumers with the capacity to actually acquire different companies' forms on a pre-purchase basis.

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<sup>255</sup> See Schwarcz, *Differential Compensation*, *supra* note 170; Daniel Schwarcz, *Beyond Disclosure Beyond Disclosure: The Case for Banning Contingent Commissions*, 25 YALE L. & POL'Y REV. 289 (2007).

<sup>256</sup> See OFFICE OF PUBLIC INSURANCE COUNSEL, SUNSET SELF-EVALUATION REPORT 3 (August 24, 2007), available at [http://www.opic.state.tx.us/docs/487\\_sunet\\_self\\_evaluation.pdf](http://www.opic.state.tx.us/docs/487_sunet_self_evaluation.pdf). OPIC was created by Tex. Ins. Code Ann. § 501, et seq. For discussion of the value that institutions such as OPIC can provide to the regulatory Process, see McDonnell & Schwarcz, *Regulatory Contrarians*, *supra* note 12.

<sup>257</sup> See <http://www.opic.state.tx.us/hoic.php>. These are: (i) Dwelling, (ii) Personal Property, (iii) Sudden and Accidental discharge or overflow of water or steam from a plumbing, heating, air conditioning system, (iv) Continuous or Repeated leakage from plumbing, heating, air conditioning, (v) Backup of sewers/drains, (vi) Freezing of plumbing or heating system, (vii) Flood/Surface water, (viii) Mold, Fungi or Other Microbes, (ix) Cost of Testing, Remediation, and Living Expenses due to Mold, Fungi or Other Microbes (x) Damage to Foundation/Slab, (xi) Falling Objects, including Trees, (xii) Weight of Ice, Snow and Sleet, (xiii) Collapse, (xiv) Damage by Animals, (xv) Glass Breakage, (xvi) Damage by Vehicles, (xvii) Damage resulting from Deterioration, (xviii) Damage resulting from Construction Defects, (xix) Additional Living Expenses (ALE) for perils other than mold, (xx) Claims Settlement, Dwelling, (xxi) Claims Settlement, Personal Property.

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There are two reasons why Texas is so distinctive in its provision of this type of information. First, Texas is one of the few states to maintain an independent entity such as OPIC that solely operates to protect consumers' interests.<sup>258</sup> Second, and even more importantly, Texas has a unique background with respect to the regulation of insurance policy forms. Prior to 2003, all insurers in Texas were required to offer one of three state-approved insurance policy forms.<sup>259</sup> In response to a perceived mold crisis, the state overhauled its system for regulating insurers, allowing them to offer any policy form they wanted. It was in response to this sudden and publicly visible change in the regulation of homeowners policy forms that OPIC established its website for the comparison of policy forms.<sup>260</sup>

Most insurance regulators do, however, provide consumers with company-specific consumer complaint information. Although this information continues to be inconsistent and difficult to interpret, recent and ongoing reforms at the NAIC hold the promise of making company-specific complaint information more accurate and reliable.<sup>261</sup> But even assuming that consumer complaint information will indeed significantly improve in the near future, this is a very poor proxy for the generosity of insurance policy forms. In part, this is because most of these complaints involve claims handling, cancellation, or non-renewal decisions.<sup>262</sup> And while a company's deficiencies in claims handling may correlate to the underlying extent of coverage, it will also capture many other variables as well. Complaint-based data is also limited for the same reasons that insurers' general reputations only imperfectly reflect the generosity of the coverage they offer, a topic discussed in the next Section.

### 3. Reputation and Cost Signals

Carriers' reputations clearly are an important constraint on their capacity to limit the scope of coverage in their policy forms. Indeed, this is likely the primary explanation for why many insurers have not followed the lead of some of the most aggressive companies in cutting back on the scope of coverage.<sup>263</sup> But carriers' reputations are an imperfect proxy for the quality of the coverage that they offer as insurance is a classic "credence good," which most consumers cannot

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<sup>258</sup> See McDonnell & Schwarcz, *Regulatory Contrarians*, *supra* note 12.

<sup>259</sup> See TEXAS WATCH, A BRIEF SUMMARY OF HOMEOWNERS INSURANCE IN TEXAS, available at <http://www.texaswatch.org/wordpress/wp-content/uploads/2010/02/Overview-of-Texas-Homeowners-Policy-Coverage1.pdf>.

<sup>260</sup> See *id.*

<sup>261</sup> See Schwarcz, *Redesigning Dispute Resolution*, *supra* note 152, at 756.

<sup>262</sup> See *id.*

<sup>263</sup> Path dependence and the prospect of regulatory scrutiny are also important potential explanations.

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evaluate even after purchase.<sup>264</sup> This is for two reasons: most insureds do not experience a large claim at all (when insurance is most important) and, even when they do, they are ill equipped to judge the quality of insurers' claims-handling.<sup>265</sup> It is perhaps for these reasons that insurers spend so much on establishing their reputation through advertising.<sup>266</sup> An additional limitation of reputation in this context is that it is unlikely to discourage insurers from employing terms that afford them substantial *discretion* to deny claims. The mere fact that an insurer retains such discretion hardly obligates it to deny claims where it stands to lose more reputational capital than it stands to gain. Of course, the principal value of a contract to a consumer is precisely to limit an insurer's capacity to make this cost-benefit analysis at the point of claim.

A second potential proxy for coverage generosity also faces unique obstacles in the insurance context. In many markets, consumers can reasonably assume that products that cost more are also higher quality.<sup>267</sup> Not so insurance markets.<sup>268</sup> Insurance is unique in that its cost is contingent on the characteristics of the purchaser and each carrier uses proprietary approaches to assessing those characteristics. As a result, differences in price across companies are often just as reflective in differences in those companies' underwriting methodologies as they are to differences in the quality of the underlying products that consumers are purchasing.

#### IV. Implications and Recommendations

The practical and theoretical implications of Parts II and III of this Article are wide ranging. Because of space limitations, this Part

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<sup>264</sup> See generally Richard Craswell, *Interpreting Deceptive Advertising*, 65 B.U.L. Rev. 657, 720-25 (1986) (providing overview). A credence good is a good whose value is difficult or impossible for the consumer to assess, even after he or she purchase the goods. They are contrasted with experience goods, which can be evaluated after purchase, and search goods, which can be evaluated prior to purchase. See *id.* For a broader discussion of the limits of reputation in consumer insurance markets, see Schwarcz, *Products Liability*, *supra* note 4, at 1413-1415; Schwarcz, *Redesigning Dispute Resolution*, *supra* note 152, at 743. For a contrary view, see Alan O. Sykes, "Bad Faith" Breach of Contract by First-Party Insurers, 25 J. LEGAL STUD. 405, 418 (1996).

<sup>265</sup> See Korobkin, *supra* note 167, at 1240 ("In the large majority of transactions in which the content of the boilerplate never becomes an issue, there is no reason to believe a non-salient term would suddenly become salient to a repeat buyer, or to anyone with whom the buyer communicates.").

<sup>266</sup> See Boardman, *Insuring Understanding*, *supra* note 4, at 1093-98.

<sup>267</sup> See CASS SUNSTEIN & RICHARD THALER, *NUDGE* 78 (2008) ("Most of the time, Competition ensures that price serves as a good signal of quality").

<sup>268</sup> *But cf. id.* (suggesting that price may be a reasonable proxy of quality in some insurance markets).

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considers, on a preliminary basis, several of the most significant of these implications. Perhaps the most obvious ramification of the evidence reviewed in this Article, discussed in Part A of this Section, is that insurance regulators should act quickly to substantially improve the transparency of insurance policies in personal lines markets. Also briefly discussed in Part A is the argument that insurance regulators should set a mandatory minimum floor for coverage in homeowners policies or otherwise go beyond mere transparency in responding to the findings of this Article. Part B, in turn, briefly considers the implications of this Article for coverage litigation, arguing that courts should refuse to enforce policy terms that decrease coverage relative to the HO3 ISO form unless insurers can establish that consumers were sufficiently informed, on a pre-purchase basis, of the existence of those terms. Finally, Part C considers the theoretical implications of this Article with respect to regulatory design and the efficiency of standard form contracts.

## A. Implications for the Content of Insurance Regulation

### 1. Insurance Policy Transparency

Part III reveals a surprising lack of transparency in personal lines insurance markets. Such transparency is vital for markets to operate effectively – for consumers to select carriers that match their preferences and for firms to have appropriate incentives in drafting these policies in the first place. Improved transparency can have these effects through several different mechanisms. First, at the level of the individual consumer, improved transparency can help consumers understand the available range of coverage options so that they select carriers consistent with their insurance preferences.<sup>269</sup> Second, improved transparency can enhance comparison shopping among active and informed consumers, which, in turn, can have positive externalities that benefit consumers as a whole.<sup>270</sup> Third, improved transparency can more tightly link insurers' reputations to the quality of their products by facilitating the efforts of third parties such as Consumer Reports.

As noted at the outset of this Article, a working group of state regulators has recently formed to study ways to improve transparency in personal lines insurance markets.<sup>271</sup> If this Working Group is to successfully modernize insurance regulation to reflect current market conditions, it must avoid easy, but ineffective, solutions. For instance, recent evidence suggests that simple disclosure mandates are typically

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<sup>269</sup> See Part II.B., *supra*.

<sup>270</sup> See Schwartz & Wilde, *supra* note 177.

<sup>271</sup> See Introduction, *supra*.



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not effective in remedying market problems.<sup>272</sup> While disclosure may nonetheless be desirable for non-consequentialist reasons, a mere requirement that firms provide consumers with policies on a pre-purchase basis would therefore likely do little to improve matters. Rather, what is needed is a comprehensive suite of reforms that can improve transparency on multiple levels.

Some reforms are obvious and should be embraced immediately. Most notably, regulators should collect and make easily available via the Internet competing insurers' policy forms.<sup>273</sup> This should include all mandatory endorsements as well as optional endorsements. This information must be presented in a simple and straightforward way that allows consumers to access a basic summary of each carrier's homeowners program along with searchable, pdf files of carrier's forms. Insurers have no plausible proprietary interest in these policies given that they are mailed to millions of consumers and define the content of the product that insurers are selling.

Second, and perhaps even more importantly, regulators should develop tools that would allow consumers and information intermediaries to easily compare carriers' policy forms. The admirable website of the Texas Public Insurance Council, described earlier, would be an excellent starting point.<sup>274</sup> However, the Working Group should substantially expand the number of different dimensions along which consumers can compare policy forms. In doing so, it should pay particular attention to policy terms that empirical research suggests deviate from the standard ISO policy. To avoid substantial costs, regulators should require insurers to populate these comparison charts initially.

Third, regulators should require insurers to provide effective disclosures to consumers about the content of their policies. These disclosures should be publicly available on insurers' websites and should focus on the ways in which a carrier's policy form differs from the ISO HO3 baseline.<sup>275</sup> They should be tested for effectiveness and agents

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<sup>272</sup> See generally Omri Ben-Shahar & Carl E. Schneider, The Failure of Mandated Disclosure, available at <http://ssrn.com/abstract=1567284>. The limitations of disclosure as a solution to market problems has traditionally held substantial weight in the insurance domain. See Howell E. Jackson, *Regulation in a Multisectoral Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319, 330–31 (1999).

<sup>273</sup> Cf. Hillman, *supra* note 187. Hillman suggests that online boilerplate may do little to correct market failures, but insulate companies from claims of procedural unconscionability. See *id.* at 855. This is a reasonable concern, and is a legitimate reason for considering some of the more interventionist reforms discussed *infra*.

<sup>274</sup> See Part III.B, *supra*.

<sup>275</sup> See Schwarcz, *Products Liability Theory*, *supra* note 4, at 1440-45 (arguing that adequate disclosure requires disclosure of “the basic ways in which [insurers’] policies deviate from any existing industry norms.”)

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should be required to provide consumers with these disclosures early in the sales process. These disclosures should not replicate the basic coverage information that insurers already have an incentive to communicate to consumers.

Fourth, the Working Group should explore various reforms that would enhance the intellectual accessibility of the insurance policy itself. This might well include increased readability scores, but this alone would be insufficient. Regulators should also require insurers to devote more effort to properly formatting their policies and to simplifying policy language. These are admittedly difficult tasks, as insurance policy language has indeed evolved over time in response to judicial decisions.<sup>276</sup> Tinkering with the evolved language might consequently increase coverage in ways that are not efficient or introduce new uncertainty into insurer's coverage obligations. Regulators should be sensitive to this legitimate concern of insurers in promoting the intellectual accessibility of policy forms.<sup>277</sup>

One promising option that straddles disclosure and intellectual accessibility of the contracts themselves is to build on the model of transparency found in ERISA, the primary federal statute governing employee benefits. ERISA requires the plan administrator to provide each participant with "a summary plan description."<sup>278</sup> Under the statute, this description must be "written in a manner calculated to be understood by the average plan participant and shall be sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of their rights and obligations under the plan."<sup>279</sup> Although this plan description is not itself the contract that defines the plan's precise obligations, it is binding on the plan to the extent that it either conflicts with the underlying contract or is misleading.<sup>280</sup>

## 2. Mandatory Minimum Floors

Ultimately, insurance policy transparency may not be a sufficient response to the findings described in this article. Rather, it may be

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<sup>276</sup> See Boardman, *Allure of Ambiguous Boilerplate*, *supra* note 34, at 1107

<sup>277</sup> See Jesse A. Hamilton, *Property/Casualty Concerns Mount at NAIC's Seattle Meeting* AMBEST (8/16/10) (quoting David Snyder, vice president and associate general counsel at the American Insurance Association, as stating that "[t]he policies themselves are legal instruments that reflect case law and statute. In many ways, it's impossible to make them simple.").

<sup>278</sup> 29 USCS § 1024 (b)(1).

<sup>279</sup> 29 U.S.C. § 1022(a).

<sup>280</sup> See, e.g., *Hansen v. Continental Ins. Co.*, 940 F.2d 971, 982 (5th Cir. 1991) ("[T]he summary plan description is binding, and that if there is a conflict between the summary plan description and the terms of the policy, the summary plan description shall govern.").

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sensible for regulators to impose mandatory floors on homeowners policies in much the same way they historically did with fire insurance policies.<sup>281</sup> In this respect, it is notable that fire insurance policies still do provide a mandatory minimum floor in many states with respect to the peril of fire.<sup>282</sup> The lack of a coverage floor in these states is therefore attributable to the market evolution towards a comprehensive homeowners policy and away from a fire insurance policy.

Whether or not mandating a minimum coverage floor is sensible depends on several related factors. First, it depends on the degree to which insurance regulators are able to facilitate true transparency. To the extent that industry impedes genuine transparency, regulators shy away from comprehensive reform, or true transparency proves impossible given the cognitive limitations of consumers and the complexity of the underlying contractual documents, then mandatory minimum floors may be an effective second-best solution. Second, the desirability of mandatory minimum floors turns on the extent to which such floors could be well-designed. It may be that regulators could effectively collaborate with the ISO, which has substantial experience generating standard form contracts, to set a minimum floor. Third, the desirability of mandatory minimum floors depends on the extent to which some carriers are currently exploiting consumer ignorance to inefficiently ratchet back their coverage obligations. As discussed earlier, assessing whether or not specific deviant contract provisions are efficient or exploitative is notoriously difficult, particularly in the insurance context. At the same time, there is preliminary evidence to suspect that some large national carriers may be exploiting consumer ignorance to draft overly-restrictive coverage exclusions.<sup>283</sup> To the extent that further research or evaluation confirms this suspicion, the case for mandatory coverage floors is substantially increased.

### 3. Default Policies

One alternative to mandating minimum coverage floors is to attempt to nudge consumers towards standard policy provisions by requiring that all insurers initially provide consumers with a state-approved default policy.<sup>284</sup> Insurers would then be free to offer

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<sup>281</sup> See Part I, *supra*.

<sup>282</sup> See, e.g., *Watson v. USAA*, 566 N.W.2d 683 (1997) (reprinted in BAKER, *supra* note 15, at 322-327).

<sup>283</sup> See Part II, *supra*.

<sup>284</sup> See generally SUNSTEIN & THALER, *supra* note 267, at 103-116 (exploring the importance of defaults generally); Schwarcz, *Regulating Consumer Demand*, *supra* note 182, at 38-45 (exploring a range of libertarian paternalistic interventions in insurance markets, including setting defaults consistent with the prescriptions of Expected Utility Theory).

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consumers a company-specific package of amendments to this policy in exchange for an increase or decrease in premiums. Empirical studies have repeatedly shown that individuals generally tend to stick with defaults.<sup>285</sup> This phenomenon has been shown specifically in the insurance context. In New Jersey, consumers who wished to purchase complete UIM coverage, which would include emotional distress damages, could do so through an endorsement. Only 20% of drivers opted out of the default to full UIM coverage. In Pennsylvania, by contrast, the default was set at full UIM coverage, such that consumers who did not want full UIM coverage were required to select an endorsement in exchange for a partial refund. Required to opt out in order to select the more limited coverage, 75% of consumers stuck with the default of full UIM insurance.<sup>286</sup> By requiring that insurers only offer company-specific provisions in the form of endorsements, regulators could thus simultaneously nudge consumers towards a presumptively reasonable policy while preserving choice for consumers who genuinely preferred a different package of policy options.

Requiring insurers to only offer company-specific policy provisions via an endorsement would have a second, information-forcing benefit as well. This is because it would effectively create a penalty-default rule.<sup>287</sup> Given that many insurers currently depart significantly from the presumptive default of the ISO policy, these insurers would presumably have reason to convince consumers to opt out of the default in this alternative regime. To do so, however, they would have to convince consumers of the benefits of opting out and provide them with sufficient information about the content of the company-specific policy. Thus, setting the default in this case to penalize the more informed party could well result in better-informed consumers by affirmatively encouraging firms to sell consumers on their particular package of policy amendments.

## B. Implications for Coverage Litigation

In past work, I have argued that courts could profitably draw from the parallels between insurance policies and ordinary consumer products to develop a products liability framework for understanding how and why courts should depart from the unambiguous language of

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<sup>285</sup> See Schwarcz, *Regulating Consumer Demand*, *supra* note 182, at 44-45.

<sup>286</sup> See *id.*

<sup>287</sup> See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1990). *But cf.* Eric Posner, *There are No Penalty Default Rules in Contract Law*, 33 FLA. ST. L. REV. 563 (2006) (arguing that the positive claim that penalty default rules exist in contract law is incorrect).

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insurance policies.<sup>288</sup> In particular, I suggested that insurance law could implement both a defective warnings doctrine and a defective design doctrine that was patterned on products liability law. The defective warnings doctrine would “impose insurance coverage for risks that insurers do not ‘adequately disclose’ to consumers.”<sup>289</sup> The findings in this Article provide renewed support for this proposal.

Courts not inclined to embrace a new doctrinal structure could easily accomplish this result within the confines of more traditional contract law. For instance, under the reasonable expectations doctrine, the objectively reasonable expectations of policyholders will be honored even though painstaking review of policy would have negated those expectations.<sup>290</sup> Although the indeterminacy of this doctrine has been criticized by numerous scholars,<sup>291</sup> one effective way to operationalize it in practice would be note that, in the present market environment, consumers cannot reasonably expect coverage terms that differ from the ISO standard policy. Insurers could rebut this presumption with specific evidence that they sufficiently informed consumers about the deviant terms in their policies.<sup>292</sup>

Even jurisdictions that refuse to enforce the reasonable expectations doctrine could reasonably find deviant terms in insurance policies that reduce coverage to be unconscionable. Without a doubt, these terms are procedurally unconscionable in the status quo, with insurers going to remarkable lengths to conceal these terms from consumers.<sup>293</sup> The substantive unconscionability of individual terms would obviously depend on the specifics of the term. But many jurisdictions employ a sliding scale test, such that minimal levels of

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<sup>288</sup> See Schwarcz, *Products Liability Theory*, *supra* note 4. For extensions of this work, see Jeffrey Stempel, *The Insurance Policy as Thing*, 44 TORT TR. & INS. L. J. 813 (2009); Kenneth Klein, *Following the Money - The Chaotic Kerfuffle When Insurance Proceeds Simultaneously are the Only Rebuild Funds and the Only Mortgage Collateral*, 46 CAL. W. L. REV. 305 (2010).

<sup>289</sup> Schwarcz, *Products Liability Theory*, *supra* note 4, at 1441.

<sup>290</sup> See Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 *Harv. L. Rev.* 961 (1970);

<sup>291</sup> See, e.g., Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 *Va. L. Rev.* 1151, 1152-54 (1981); Thomas, *Interdisciplinary Critique*, *supra* note 188; Schwarcz, *Products Liability Theory*, *supra* note 4, at 1426-35.

<sup>292</sup> *Cf.* Boardman, *Tested Language Defense*, *supra* note 4, at 1099 (proposing that “If an insurer uses consumer research to test policy language before adopting it, the insurer can present the results of the research to rebut a finding of ambiguity”).

<sup>293</sup> Robert Hillman & Jeffrey Rachlinski, *Standard Form Contracting in the Electronic Age*, 77 *NYU L. REV.* 429, 492- 93 (2002) (noting that best case for procedural unconscionability is when sellers employ strategies to discourage buyers from becoming aware of terms).

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substantive unconscionability can be offset by large degrees of procedural unconscionability.<sup>294</sup>

### C. Theoretical Implications

#### 1. Regulatory Theory

The failure of state insurance regulators to provide some modicum of transparency in personal lines insurance markets is troubling. Perhaps the least controversial element of consumer protection regulation is that it should promote transparency so that consumers understand the products they are purchasing. To be sure, insurance regulation has traditionally gone beyond mere transparency and disclosure in protecting consumers.<sup>295</sup> But such efforts certainly do not eliminate the need for keeping consumers informed about their options in the market place. How can it be that regulators ignored this basic feature of regulation for so long?

There are at least two answers, both of which have important implications for how best to structure financial regulation more generally. First, the heterogeneity in insurance policies and lack of transparency in the market place are not the types of market problems that will produce consumer complaints. Indeed, in opposing transparency-oriented reforms, one important insurance lobbyist emphasized just this point, suggesting that designated consumer representatives were pursuing pointless regulations.<sup>296</sup> Unlike issues such as premiums, cancellation, and prompt claims-payment, consumers do not know what they do not know when it comes to lack of insurance policy transparency. But just as this is precisely why regulation is so necessary, it also means that the political pressures on regulators to address this problem are limited.<sup>297</sup> Less cynically, it also means that regulators are not particularly likely to learn about this issue, as regulators often rely on consumer complaints to identify market problems.<sup>298</sup>

The second key explanation for the failures of state insurance regulators in this context is historical. The regulatory regime of state regulators makes perfect sense in a world where insurance policies are

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<sup>294</sup> See Hillman, *supra* note 187, at 854.

<sup>295</sup> See Jackson, *supra* note 272.

<sup>296</sup> See Hamilton, *supra* note 277 (noting that David Snyder, Vice President and Associate General Counsel at the American Insurance Association, emphasized the lack of consumer complaints in arguing against enhanced readability protections).

<sup>297</sup> See McDonnell & Schwarcz, *Regulatory Contrarians*, *supra* note 12.

<sup>298</sup> See Schwarcz, *Consumer Dispute Resolution*, *supra* note 152, at 753.

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indeed completely standardized, as they used to be. It is therefore no wonder that, in initially designing insurance regulation, policymakers did not develop any mechanisms for keeping consumers abreast of the content of different insurers' policies. As with all financial markets, however, insurers evolved over time such that it is no longer necessary, or apparently desirable, for many large insurers to simply use the standardized ISO policy. Insurance regulators failed to evolve along with this market change.<sup>299</sup>

## 2. Theory on Standard Form Contracts

Although this Article obviously focuses on insurance markets, it also contributes to the larger literature on the efficiency of standardized consumer contracts. In particular, the Article suggests that the theoretical literature – which focuses on the degree to which an “informed minority” of consumers can discipline firms to draft “efficient” contracts – may have under-appreciated the extent to which mass segmentation of consumers among different firms can undermine the efficiency of standard form contracts.<sup>300</sup> Indeed, this is one compelling way to understand the current insurance market place, with some individual insurers appealing to informed consumers who desire enhanced coverage but with a separate tranche of insurers free to substantially reduce coverage without meaningful scrutiny from their policyholders.<sup>301</sup>

Second, the Article provides some modest evidence in support of the behavioral claim that standard form contracts may tend to be less efficient with respect to non-salient terms.<sup>302</sup> One striking feature of most of the terms reviewed in Part II, where some insurers decrease coverage, is that these terms are complicated and difficult to explain, in many cases requiring deep familiarity with insurance law.<sup>303</sup> By contrast, the marketplace seems to continue to embrace uniformity with

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<sup>299</sup> See McDonnell & Schwarcz, *Regulatory Contrarians*, *supra* note 12 (discussing the various reasons why financial regulators have difficulty evolving along with the markets they regulate).

<sup>300</sup> See Schwartz & Wilde, *supra* note 177, at 662-65 (rejecting the notion that firms may discriminate among consumers on a mass basis because price would ultimately reflect quality). To be sure, the risk of mass segmentation may be elevated in the insurance context, where price is not necessarily a good proxy for quality. See Part III.B.3. *supra*.

<sup>301</sup> See Part II, *supra*.

<sup>302</sup> See Korobkin, *supra* note 167, at 1234 (“non-salient attributes are subject to inefficiencies driven by the strategic behavior of sellers attempting to increase their profits at the expense of unknowing buyers”). One interesting distinction between insurance policies and other standard form contracts is that the insurance policy is the product in the insurance context. See Schwarcz, *Products Liability Theory*, *supra* note 4, at 1397-98. For this reason, more of its terms are likely to be salient to the ordinary consumer. See Korobkin, *supra*. These are likely to terms that are listed on the declarations page, as well as certain other basic terms.

<sup>303</sup> See Part II.A, *supra*.

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respect to many other more salient terms. For instance, every policy examined included every single covered peril for personal property listed in the ISO policy. The reason, one suspects, is that these terms are easy to understand – if one policy covered loss due to lightning or theft, but another did not, one suspects that consumers would eventually learn about this fact.<sup>304</sup> Indeed, many of the insurer websites samples above specifically listed each of the covered perils for personal property.<sup>305</sup>

A final implication of this study is that, with respect to standard form contracts, context matters.<sup>306</sup> Some markets may work well in protecting consumers from exploitation through standard form contracts.<sup>307</sup> But others do not. Indeed, this fact has started making important inroads in modern contract law scholarship, with some of the best scholarship focusing on specific contract markets, such as warranties, software licenses, and credit cards.<sup>308</sup> For this reason, the frontier in standard form contract law scholarship is likely best understood not in terms of further argumentation about general theory, but instead in terms of careful study of individual markets.

## Conclusion

The current personal lines insurance marketplace is largely organized around a myth. That myth is that personal lines insurance policies are completely uniform. This myth explains regulatory rules that do nothing to promote insurance contract transparency. It explains the ignorance of most information intermediaries about the details of contract terms. And, to a substantial degree, it explains the willingness of courts to treat insurance policies as ordinary contracts. As this Article has shown, this myth is false. Not only does there exist substantial heterogeneity in insurance policy terms, but most of this heterogeneity reflects the efforts of carriers to limit coverage relative to the presumptive industry baseline. These insurers have actively hidden and obscured this trend, in notable contrast to the comparatively transparent marketing of the few carriers who have departed from standardized policies to improve coverage. If regulators do not act to

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<sup>304</sup> See Korobkin, *supra* note 167, at 1225 (“purchase decisions involving products with form contracts are sufficiently complex that buyers usually will be selective in their consideration of product attributes. That is, at least some attributes will be non-salient.”).

<sup>305</sup> See Part III, *supra*.

<sup>306</sup> See Bar-Gill, *supra* note 167.

<sup>307</sup> See Richard Epstein, *The Neoclassical Economics of Consumer Contracts*, 92 MINN. L. REV. 803 (2008).

<sup>308</sup> See, e.g., Marotta Wurgler, *Standard Form Contract Quality*, *supra* note 158; Oren Bar-Gill, *Seduction by Plastic*, 98 NW L. REV. 1373 (2004); Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORN. L. REV. 1073 (2009).



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substantially improve consumer protection in this domain, then it can be expected that coverage will continue to degrade for most carriers, in a modern-day reenactment of the race to the bottom in fire insurance that triggered the first-wave of standardized insurance policies.