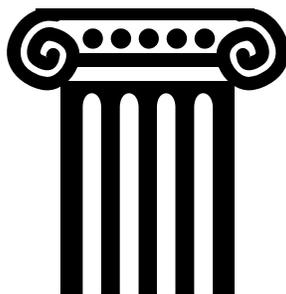


University of Minnesota Law School

Legal Studies Research Paper Series
Research Paper No. 10-65



Reevaluating Standardized Insurance Policies

Daniel Schwarcz

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Reevaluating Standardized Insurance Policies

Daniel Schwarcz[†]

UNIVERSITY OF CHICAGO LAW REVIEW (Forthcoming December, 2011)

Abstract: This Article empirically debunks the common claim that homeowners insurance policies do not vary across different insurance carriers. In fact, carriers' homeowners policies differ radically with respect to numerous important coverage provisions. A substantial majority of these deviations produce decreases in the amount of coverage relative to the presumptive industry standard, though some deviations increase coverage. Despite this substantial variability in policy terms, even informed and vigilant consumers are currently unable to comparison shop among carriers on the basis of differences in coverage. The Article reviews various regulatory and judicial options for responding to this lack of transparency in homeowners insurance markets. It closes by considering the broader theoretical implications of the findings for regulatory theory and the efficiency of standardized form contracts.

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[†] Daniel Schwarcz (schwarcz@umn.edu) is an Associate Professor of Law at University of Minnesota Law School. For helpful feedback and comments, I thank Kenneth Abraham, Ronen Avraham, Amy Bach, Tom Baker, Omri Ben-Shahar, Brian Bix, Tom Cotter, Prentiss Cox, Brenda Cude, Allan Erbsen, Claire Hill, Alex Klass, Brett McDonnell, Amy Monahan, and Charlie Silver. I also thank participants in the Canadian Law and Economics Annual Meeting and University of Texas Law and Economics Workshop for helpful feedback. Special thanks to Bert Kritzer for extensive assistance on empirical elements of this project. For exceptional research assistance, I thank Carl Engstrom, Richard Sarhodia, and Tim Sullivan. Finally, thanks to the Pennsylvania, North Dakota, South Dakota, California, Ohio, Illinois, and Nevada Insurance Departments, the Office of Public Insurance Council of Texas, and United Policyholders.

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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.¹ But consumer insurance policies in property/casualty insurance markets (or “personal lines”) are often described as “super contracts of adhesion.”² This label refers to the claim that these insurance policies are collectively drafted by insurers via an industry organization known as the Insurance Services Organization (ISO), resulting in standardization of policy language *across* different insurers.³ In a world of super contracts of adhesion, comparison-shopping on the basis of policy language makes no sense.

¹ 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). One might plausibly contest the true “take it or leave it” nature of insurance policies given the wealth of potential endorsements that are available to policyholders

² 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.”).

³ 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. See <http://www.aaisonline.com/company/who.html>

Legal commentary, regulatory practice, and consumer behavior have all been shaped to varying degrees by this conventional wisdom that personal lines insurance policies are 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.⁴ They also build normative arguments about the ideal content of insurance law on the basis of presumed industry-wide uniformity of policy forms.⁵ Insurance regulation is similarly influenced by this conventional wisdom, as state regulators have historically done nothing to inform consumers about potential differences in coverage among different insurers.⁶ 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.⁷

This Article demonstrates that this conventional wisdom is no longer accurate with respect to a core area of personal lines coverage, homeowners insurance.⁸ Some of the most prominent national insurers employ policy

⁴ 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) (“[T]he 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 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 Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance*, 48 WM & MARY L. REV. 1389 (2007).

⁵ 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).

⁶ See Part III, A, *infra*.

⁷ See Part III, B, *infra*.

⁸ See Part II, *infra*.

language 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.⁹ Moreover, while some coverage reductions certainly involve risks that have become prominent in recent years, such as mold, pollution and lead, others involve substantial reductions in traditional coverages. These span the gamut of issues addressed in prominent insurance law casebooks and treatises, 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 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.¹⁰ Insurers do not make their policy language available to consumers until after they purchase coverage. Apart from several high-end carriers, insurers’ marketing materials do not describe policy coverage with sufficient specificity to allow for 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, providing consumers with virtually no information regarding the comparative breadth of different insurers’ policies.¹¹ In fact, in many cases, state insurance regulators do not even have on file partial copies of the policies that different homeowners insurers are using. In many other cases, states have 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 a small handful of states that make insurers’ filings available online, 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 states that make form filings available online, only a seasoned expert with a substantial amount of time and patience can wade through this material to locate *partial* copies of the forms that *some* companies use.

⁹ Existing scholarship has generally assumed that changes to policy terms are implemented on an industry wide basis to “fix” 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).

¹⁰ *See* Part III, *infra*.

¹¹ *See* Part III, *infra*.

Collectively, these findings demonstrate that state insurance regulators have failed to evolve along with the marketplaces they are regulating. 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.

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.¹² In order to correct the problems described herein, that Working Group must propose broad-ranging and comprehensive reform designed to promote transparency. Such reform should go beyond historic mechanisms for promoting transparency in insurance, such as quantitative readability scores, and rely on modern regulatory theory – such as 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.

Judicial doctrines governing the interpretation and construal of insurance policies are also importantly impacted by this Article’s findings. The core doctrines of insurance law – *contra proferentem* and the reasonable expectations doctrine – are designed primarily to promote consumer awareness of policy terms. Yet these doctrines have clearly failed to achieve these goals. For this reason, this Article provides further support for revised rules of insurance law that more directly limit the capacity of insurers to deny coverage in ways that surprise policyholders and undermine their reasonable expectations of coverage.

The empirical findings presented in this Article also have a number of implications beyond insurance law and regulation. First, they have important implications for the efficiency of standard form contracts – one of the central

¹² 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 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).

issues in contract law scholarship. In particular, the Article provides some of the first empirical evidence that firms may be exploiting consumer ignorance to draft inefficiently one-sided contracts. It reveals that various specific terms in deviant policies raise obvious efficiency concerns and that insurers using the least generous policy forms are actively and successfully shrouding that fact. Nonetheless, further study and better data is needed before any conclusions regarding efficiency can be reached, as policy form variability may simply reflect consumers' heterogeneous insurance preferences. But at the very least, the evidence raises reason for concern regarding the efficiency of standard contracts in personal lines insurance markets.

Second, the Article's findings illustrate important limitations in the capacity of insurance regulators in particular, and financial regulators in general, to evolve along with the markets they regulate. Financial markets evolve constantly, often in ways that are specifically designed to reduce regulatory burdens. Meanwhile, financial regulators often operate based on models and assumptions that are inherently tethered to the world as it existed when the regulatory scheme was initially developed and implemented. At the same time, the Article's findings illustrate the capacity of independent, consumer-oriented, "regulatory contrarians" to promote regulatory adaptation despite political economy factors pushing in the opposite direction.¹³

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 variation in policy forms 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 sources showing that homeowners insurance markets operate with consumers having access to virtually no information concerning crucial deviations in homeowners insurance policy forms. Finally, Part IV offers some common-sense solutions for regulators and courts to improve consumer information regarding differences in policy language. It also discusses some broader implications of this research for contract law scholarship and regulatory theory.

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.¹⁴ The state's goal was

¹³ 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).

¹⁴ See Charles Gobel, *The Moral Hazard Clauses of the Standard Fire Insurance Policy*, 37 Colum. L. Rev. 410, 410 (1937) ("Before 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."). Outside of the United States, the standardization of policy forms dates back to

to address a classic “race to the bottom” among companies who had sought to save money by secretly ratcheting back coverage.¹⁵ 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.¹⁶

Standardization of insurance policy forms gained further traction in the early Twentieth Century, when numerous insurance companies failed after a massive earthquake. According to the Merritt Committee – a prominent commission established to study the issue – the cause of these insolvencies was “ruinous competition” among insurers.¹⁷ 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.¹⁸ 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.¹⁹ Taken together, these forces resulted in systematically inadequate premiums and, consequently, mass insurer insolvencies in the wake of a large disaster.

To address these problems, the Merritt Committee proposed establishing state-sanctioned rate-making bureaus.²⁰ As their name suggests, the central concern of these bureaus was insurers’ premium rates rather than their policy forms. In particular, bureaus would set premiums based on the aggregate loss experiences of all insurers. Such collective rate-making would prevent ruinous competition among insurers and ensure that premiums reflected the best estimate of future losses.²¹ But in order to pool insurers’ loss experiences and set rates accordingly, member-insurers would be required to use the same standardized policy forms.²² Only by using the same policies could rate-making bureaus meaningfully pool insurers’ loss data and set their

sixteenth century Florence. *See generally* Thomas L. Wenck, *The Historical Development of Standard Form Policies*, 35 J. RISK & INS. 537, 537 (1968).

¹⁵ 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. 2007).

¹⁶ Gobel, *supra* note 14, at 410. 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 independently developed various “standard provisions” that could be voluntarily inserted into policies. *See id.* at 547.

¹⁷ MEIER, *supra* note 15, at 59-60.

¹⁸ *See* ABRAHAM, *supra* note 4, at 31-32.

¹⁹ *See* MEIER, *supra* note 15, at 59-60.

²⁰ MEIER, *supra* note 15, at 59-61 (describing the Merritt Committee’s endorsement of rate making bureaus in 1911).

²¹ *See id.*

²² *See* Clarence W. Hobbs, *State Regulation of Insurance Rates*, 11 PROCEEDINGS OF THE CASUALTY ACTUARIAL SOCIETY 218, 255, 267 (1925) (noting that some bureaus were allowed to insist that companies “use the policy forms established by the Commission” and that “to secure equal treatment there must be standardization of policy provisions”); 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”).

rates accordingly. Otherwise, different insurers' loss data would be based on different contractual definitions of loss and the prices that the bureaus set would not reflect the degree of coverage provided by each insurer.²³

Although explicit rate-setting is now largely understood as anti-competitive,²⁴ 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.²⁵ 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.²⁶

B. Alternative Explanations and Justifications for Policy Standardization

Of course, there are various justifications and explanations for policy standardization other than facilitating data sharing. First, many continue to emphasize that standardization allows consumers to more easily comparison shop on the basis of price and service.²⁷ 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."²⁸

Collective policy drafting has also been explained as a mechanism for promoting economies of scale and limiting regulatory costs.²⁹ The policy drafting process is unusually resource-intensive.³⁰ Unlike most consumer contracts, insurance policies must be filed and – to varying degrees –

²³ See ABRAHAM, *supra* note 4, at 31-32.

²⁴ 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.

²⁵ See, e.g., Macey & Miller, *supra* note 4, at 20–26 ("[A]ccurate 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").

²⁶ See ABRAHAM, *supra* note 4, at 33-34.

²⁷ See Macey & Miller, *supra* note 4, at 20–26; Jaskow & McLaughlin, *supra* note 25, at 383; ISO, *supra* note 3 ("[I]f standardized coverages did not exist, consumers would face an unintelligible array of different forms").

²⁸ See Wenck, *supra* note 14, at 550.

²⁹ 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) ("[I]t 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.

³⁰ 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.")

“approved” by state regulators. They must also comply with various state laws and regulations regarding their content.³¹ 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.³² 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.³³ Only by employing the same language as others 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).³⁴ 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.³⁵ 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).³⁶ 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. In many states, insurers bear the burden of proof with respect to the cause of loss and its exclusion when coverage is all-risk, whereas the insured bears the burden of proof to establish coverage under a named-peril policy.³⁷ The HO3 policy also provides coverage for certain liability risks.

³¹ See generally HOLMES' APPLEMAN ON INSURANCE §§ 2.10, *Regulation of Policy Forms* (2d ed. 1996).

³² 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.

³³ Several other factors contribute to the absence of a comparable network effects in the health arena. First, ERISA 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 against an ever-changing landscape of medical knowledge and treatment protocols. Third, there is unique degree of factual specificity in the health insurance arena, meaning that cases often turn more on individual circumstances and expert testimony.

³⁴ See ISO, *supra* note 3, at 33-34.

³⁵ 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).

³⁶ See INSURANCE SERVICES OFFICE, HO3 POLICY FORM, *reprinted in* Abraham, *supra* note 4.

³⁷ See HOLMES' APPLEMAN ON INSURANCE §§ 1.10–.11 (2d ed. 1996) (in all states except Texas is that “the insurer has the burden of proof to prove no coverage under an all-risks policy,” whereas 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,

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.³⁸ By contrast, the “HO2” policy provides only named perils coverage on one’s dwelling.³⁹

In addition to these various base policy forms, the ISO maintains numerous different endorsements that amend policy language.⁴⁰ In some cases insurers require that all policies be accompanied with an endorsement, whereas in others the company sells, or offer a refund, in exchange for a particular endorsement. Some insurers only make certain types of endorsements available to policyholders. Examples of commonly purchased endorsements include enhanced loss settlement procedures for personal property, coverage for specifically scheduled valuable items, and sewer back up coverage.⁴¹

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 commentators in recent years have sporadically observed that some companies have particularized language in their policies that deviates from the industry norm.⁴² And the last systematic attempt to examine the content of different insurance policies was a 1937 law review article.⁴³

At the same time, the various theoretical explanations of policy standardization are quite contestable, especially given recent regulatory and technological innovations. First, insurers today have less need than they historically did to rely on aggregate loss data. Many modern insurers are quite large, and consequently have at their disposal a tremendous amount of loss

windstorm, lightning, etc.) was the cause . . . of the loss.”); *See also* Jeffrey Stempel, *A Mixed Bag for Chicken Little: Analyzing Year 2000 Claims and Insurance Coverage*, 48 EMORY L.J. 169, 196 (1999).

³⁸ *See* INSURANCE SERVICES OFFICE, HO5 POLICY FORM, p. 10. 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 35, 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. Grace et al were likely misled by the fact that some individual company’s versions of the HO5 form include replacement cost settlement.

³⁹ Grace et al, *supra* note 35, at 354.

⁴⁰ In 1999, these included 73 country-wide endorsements and 113 state-specific endorsements. *See* ISO, *supra* note 3, at 33-34.

⁴¹ *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 insurers simply maintain different base policies that provide different loss settlement procedures.

⁴² *See, e.g.*, Erik Knutson, *Confusion about Causation in Insurance*, 61 ALA. L. REV. (2010) (variations in terms dealing with concurrent causation); BAKER, *supra* note 15, at 277 (same); Tom Baker, *Liability Insurance at the Tort-Crime Boundary*, 7 in FAULT LINES: TORT LAW AND CULTURAL PRACTICE, (David M. Engel and Michael McCann, eds., Stanford Univ. Press 2009) (variation in criminal acts exclusions for liability coverage).

⁴³ *See* George Gobel, *The Moral Hazard Clauses of the Standard Fire Insurance Policy*, 37 COLUM. L. REV. 410 (1937).

data that is specific to their company.⁴⁴ Irrespective of policy language, this data is likely more accurate than collective data in predicting future losses, as it reflects the insurer's particular claims paying culture and practice. This is significant, as "the vast majority of insurance claims are resolved according to the insurance law of the insurance adjustor."⁴⁵ Advances in information technology also enhance insurers' capacity to use limited historical data to predict future losses.

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, and then make adjustments to the data based on its own contractual deviations. This strategy might be particularly sensible if the insurer's contract deviations all reduced coverage, as collective loss data would still 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 the public good nature of collective loss data means that no single insurer would be deterred by this risk in choosing whether to deviate from standardized forms.⁴⁶

Third, the regulatory burdens faced by insurers who utilize their own forms have decreased substantially in recent years. Insurers can now submit their policy forms quickly and easily through an electronic platform known as SERFF.⁴⁷ Although deviant policies must nonetheless be approved individually by each state where they are used, 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.⁴⁸ Rather, the author's informal conversations with state regulators suggest that review of policy filings is often focused exclusively on ensuring that policy forms are technically compliant with states statutes and regulations.⁴⁹ These requirements are uneven across states. However, many states have very few

⁴⁴ 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).

⁴⁵ BAKER, *supra* note 15, at 54.

⁴⁶ See Daniel Schwarcz, *Regulating Insurance Sales or Selling Insurance Regulation? Against Regulatory Competition in Insurance*, 94 MINN. L. REV. 1707, 1738 (2010) (noting similar collective action problem could negatively impact insurers' selections among competing regulators).

⁴⁷ See Serff Website, About Serff, available at <http://www.serff.com/about.htm>.

⁴⁸ 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); Schwarcz, *Products Liability Theory*, *supra* note 4, at 1424-26.

⁴⁹ One regulator reported that insurers challenged the department's use of discretion in reviewing policy forms as an exercise of rule-making authority, forcing the department 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.

specific constraints on the content of homeowners policies, aside from rules governing cancellation, non-renewal, and the prompt payment of claims.⁵⁰

Finally, although network effects may lend some value to historical language, the extent of this value is not clear. One provocative article suggests that the network effect benefits of historical policy language are substantial, because insurers “care more that a clause have a fixed meaning than a particular meaning.”⁵¹ Insurers can then simply include the cost of that coverage in the premiums they charge.⁵² But this argument overstates the value of historical policy language. Some types of coverage create underwriting problems – such as moral hazard or adverse selection – such that the increase in coverage they provide is not worth the increase in premiums they generate.⁵³ To the extent that policy language is construed to provide such coverage, insurers would be unable to pass this cost on to policyholders completely. In any event, insurers’ profits will suffer from passing on the cost of judicially-created insurance if policyholders focus on the nominal cost of coverage in their purchasing decisions.⁵⁴

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 policies differ and, if so, with respect to what provisions. Part A shows that there are substantial deviations among 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, focusing on the interpretation, limitations and qualification towards the end.

Second, Part B asks whether some carriers’ policies are substantially less generous, in the aggregate, than others. This analysis reveals that heterogeneity in policy terms is concentrated among a subset of large, national carriers. Most of these carriers’ policies are substantially worse than the presumptive industry default of the 1999 ISO H03 form (“H03 policy”). However, a small number of carriers maintain policies that are more generous than the H03 policy. Notably, the carriers who employ the least generous policy forms disproportionately use captive agents to distribute their policies, whereas the companies with unusually generous policies tend to rely on independent agents.

A. How Do Homeowners Policies Differ?

1. Data and Methodology

In order to assess how homeowners policies differ, policies from carriers in six states were compared: North Dakota, South Dakota,

⁵⁰ See NAIC product tool, available at <https://eapps.naic.org/prl/do/search/dialog> (providing product requirements of specific states for various insurance lines).

⁵¹ Boardman, *supra* note 32 at 1107.

⁵² See *id.*

⁵³ See Schwarcz, *Products Liability Theory*, *supra* note 4, at 1448.

⁵⁴ 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.

Pennsylvania, Illinois, California, and Nevada.⁵⁵ 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 author requests.⁵⁶ The majority of states contacted either explicitly refused to cooperate or did not respond to repeated inquiries.⁵⁷ Section 4 addresses the degree to which this raises selection-effect concerns.⁵⁸

For each state, policies were collected from the top ten insurance groups⁵⁹ in the state, as measured by premium volume for homeowners policies.⁶⁰ Consequently, a single insurance group was often included in the data from multiple states. To take an extreme example, a State Farm policy was included in the sample from all six states.⁶¹ This approach proved necessary because the policies from a single insurance group occasionally varied across state lines.⁶² In total, policies from 24 different insurance groups were

⁵⁵ I also acquired policies in Texas. However, Texas's market made it difficult to compare carriers' policies with those found in other states, as the HO3 policy does not operate as the presumptive baseline in Texas. See *infra*, Part III.B.2. However, policies in Texas seem more heterogeneous than policies in other states. See <http://www.opic.state.tx.us/hoic.php>.

⁵⁶ In convincing state insurance regulators to spend time and resources on this, the author invoked his status as a "funded consumer representative" to the National Association of Insurance Commissioners ("NAIC"). Additionally, he made use of various informal connections with state regulators and insurance commissioners. Due to resource constraints, only some states were contacted.

⁵⁷ This includes, among others, Iowa, Rhode Island, New York, Arkansas, Colorado, Michigan, Minnesota, Wisconsin, and New Mexico.

⁵⁸ See Part II.A.4, *infra*.

⁵⁹ 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).

⁶⁰ See 2009 MARKET SHARE REPORT, *supra* note 44. 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.

⁶¹ See *id.* (State Farm among the top insurers in every state sampled).

⁶² In some cases this variation reflected differing state regulatory requirements. In others, differences in policy terms appeared attributable either to state-specific risks or idiosyncratic variation of related companies.

examined.⁶³ This includes the top thirteen insurance groups in the country, which cumulatively represent over 2/3 of the market.⁶⁴

For each insurance group within a state, the homeowners forms covering stand-alone structures were collected.⁶⁵ This includes both the “base” policy as well as any mandatory endorsements that the insured has no option to reject.⁶⁶ Only those policies currently being issued to new policyholders were analyzed.⁶⁷ Where insurers maintained multiple forms corresponding to ISO distinctions, forms corresponding to the HO3 form were isolated for review.⁶⁸ In some cases, companies maintained multiple forms that did not correspond to ISO distinctions. In those cases, the policy that most closely corresponded to the HO3 form was selected.⁶⁹

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)⁷⁰ and Pennsylvania (7 policies).⁷¹ In both instances, regulators limited their requests to the top ten insurance companies rather than insurance groups. This produced fewer than ten distinct policies because multiple companies within the top ten were from the same underwriting group.⁷² With respect to the liability coverage sections of the homeowners policies, there was an additional decrease of one policy in Pennsylvania (6 policies) and South Dakota (9 policies).⁷³ In these cases, insurers provided only copies of their property coverage forms and follow up requests were unsuccessful.

Having isolated these policies, various provisions were analyzed for discrepancies in coverage. Terms that figure prominently in insurance

⁶³ 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

⁶⁴ See 2009 MARKET SHARE REPORT, *supra* note 44.

⁶⁵ The ISO designation of homeowners forms covers condo policies, policies for renters, and policies covering mobile homes. I did not systematically collect these policies.

⁶⁶ Mandatory endorsements include endorsements that are mandatory as a result of law or required as a result of a business decision by the insurer.

⁶⁷ 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*.

⁶⁸ See Part I.C., *supra*. In two cases, a company apparently did not offer a form corresponding to the ISO3 policy. One only offered all risk coverage for personal property and the other apparently offered only replacement coverage for personal property.

⁶⁹ Typically this meant selecting the form that provided Actual Cash Value Loss Settlement for personal property. See *id*.

⁷⁰ 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.

⁷¹ In Pennsylvania, the policies of Donegal, Zurich/Farmers, and USAA were not collected.

⁷² These companies either used the same form, or used different forms because one of the companies was no longer writing new business.

⁷³ 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.

litigation or are otherwise important were isolated for analysis. So too were several terms where informal review of policies suggested potential deviations in policy language.

2. Results: Property Coverage

Homeowners insurance policies package together property and liability insurance. This Section reports results for the property insurance section of the homeowners policy.

a. Concurrent Causation

Concurrent causation is one of the most commonly litigated insurance coverage issues.⁷⁴ It 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 (an excluded peril) both contributed to produce massive damage to property throughout the Gulf Coast.⁷⁵ 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 was a covered peril. Most states, however, permit insurers to opt out of this rule through specific language in their policies.⁷⁶ However, two states in the sample – California and North Dakota – require by statute that insurers provide coverage broadly consistent with the EPC approach.⁷⁷ In the HO3 policy, the default EPC rule applies for most perils, with several important exceptions.⁷⁸ Most importantly, the prefatory language to the nine “exclusions” opt outs of the EPC rule, specifying that there is no coverage if an exclusion contributes in any way to a loss.⁷⁹

Figure one tabulates different carriers’ policies with respect to concurrent causation in each state. As with all subsequent figures, the vertical axis reflects potential variations in a policy term, with more favorable terms situated above less favorable terms. The term in the HO3 policy is indicated in parenthesis next to the applicable term. 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.

⁷⁴ See Knutson, *supra* note 42.

⁷⁵ See, e.g., Broussard v. State Farm, 523 F.3d 618 (5th Cir. 2008).

⁷⁶ 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.”).

⁷⁷ NDCC Section 26.1-32 & §§ 530-33

⁷⁸ The HO3 policy also provides that, with respect to the perils excluded from Coverages A and B, any ensuing loss that involves a covered peril is covered. See BAKER, *supra* note 15, at 251, 277. This is technically more expansive than the EPC rule, as an ensuing loss may not always be the efficient proximate cause of a loss.

⁷⁹ See HO3, *supra* note 36, at 11.

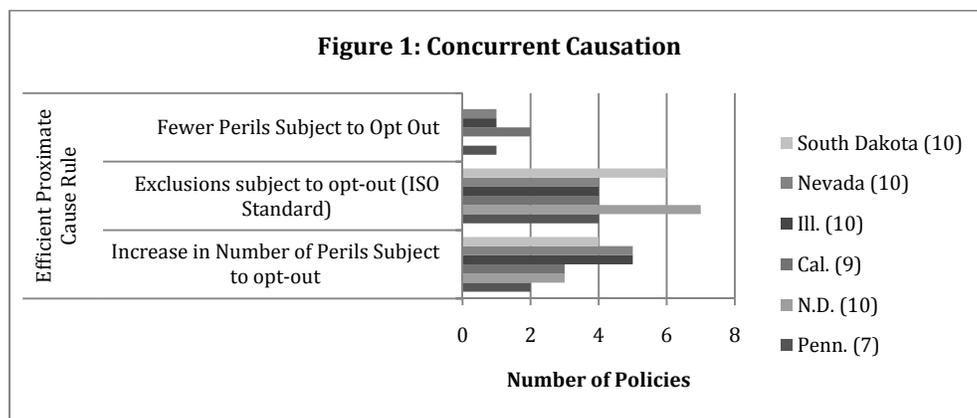


Figure One reports substantial variation among different carriers with respect to concurrent causation. In most states, about half of the carriers followed the HO3 approach by only opting out of the default rule for policy exclusions. The remaining insurers generally decreased coverage by expanding the scope of the EPC opt out, thus increasing the number of perils that cannot contribute in any way to a covered loss.⁸⁰ Some carriers were more generous than the 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. Notably, there was variation in policy terms even among carriers in California and North Dakota, which purport to mandate the EPC approach.

b. Affirmative Coverage Grants

The HO3 form covers one’s home and other structures on an “all risk” basis, meaning that all perils are covered unless they are explicitly excluded.⁸¹ The HO3 policy conveys this concept by stating “We insure against risk of direct physical loss to property” but “do not insure for loss... caused by” specifically enumerated perils.⁸² Figure two shows that many insurers substantially alter this affirmative “all risk” coverage grant.⁸³ First, many carriers provide that “We insure against risk of *accidental* direct physical loss.” (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 could easily be used to justify expansive claims denials. This is because it effectively increases the scope of the “intentional loss provision,” which excludes “loss arising out of an act an insured commits or conspires to commit with the intent to cause a loss.”⁸⁴

⁸⁰ In some cases insurers shifted perils into the exclusion section from the “perils not insured” section, whereas in others insurers redrafted the prefatory language to the “Perils not insured” section.

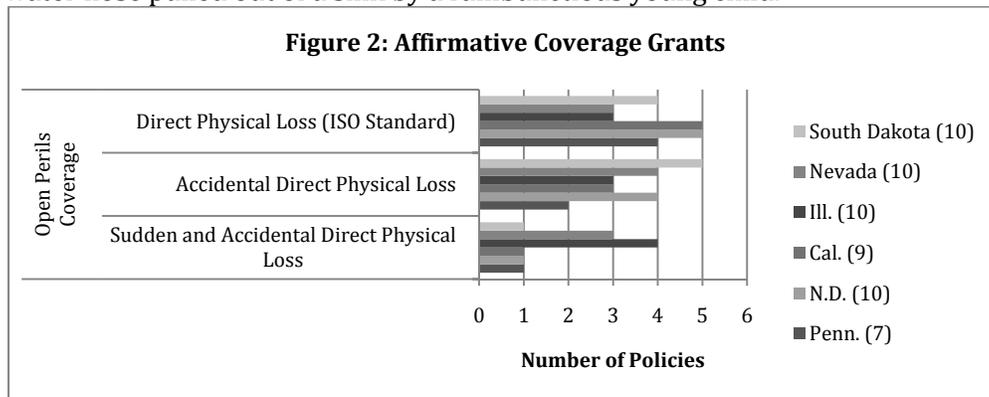
⁸¹ Stempel, *supra* note 37, at 196.

⁸² See HO3, *supra* note 36, at 8.

⁸³ 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, policies that provide coverage for “sudden and accidental” direct loss for Coverages A and B also provide for “sudden and accidental” direct loss caused by the specified perils in Coverage C. Because some Coverage C perils include the terms “sudden” and “accidental,” this results in these policies containing duplicative coverage restrictions.

⁸⁴ See HO3, *supra* note 36, at 12.

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 or a water hose pulled out of a sink by a rambunctious young child.



Other policies are even more restrictive, providing coverage only for “sudden and accidental” direct physical loss. There is extensive caselaw interpreting the meaning of this phrase in the context of pollution liability exclusions.⁸⁵ But it is quite surprising to find this coverage limitation for *all* losses that a homeowners policy covers. Various losses that might be covered by an HO3 policy would be excluded by this clause, including structural decay, mold growth, and gradual falling down of a tree. Alternatively, this language might well shift the burden of proof onto policyholders in the event of a dispute regarding the sudden and/or accidental nature of a loss.⁸⁶

c. Increased Risk

One of the central aims of insurance policies is to reduce moral hazard, or the prospect that policyholders will take less care knowing that they are insured.⁸⁷ At the same time, many losses are at least partially the result of carelessness or thoughtlessness. These competing facts create an “irreducible minimum of tension.”⁸⁸ The HO3 policy deals with this tension by excluding coverage for specific losses that inherently or predominantly involve moral hazard – such as theft from a vacant home.⁸⁹ Unlike some commercial property policies as well as historic fire insurance policies, it does not contain “any general exclusion ... of coverage for harm caused by the insured’s own negligence.”⁹⁰ The one exception is that insurance policies do indeed broadly exclude coverage for losses exacerbated by ex post moral hazard: the failure to

⁸⁵ See Kenneth Abraham, *The Rise and Fall of Commercial General Liability Insurance*, 87 VA. L. REV. 85, 97-98 (2001).

⁸⁶ See note 37 *supra*.

⁸⁷ See generally Tom Baker, *The Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1997).

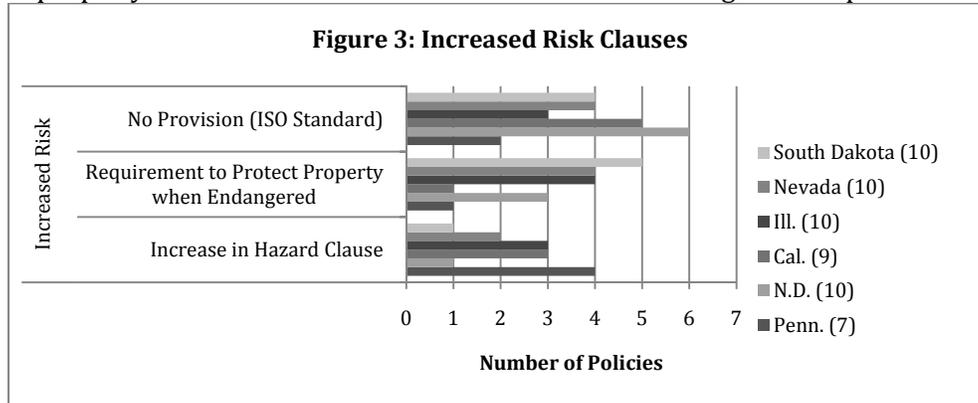
⁸⁸ ABRAHAM, *supra* note 4, at 224-225.

⁸⁹ *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.”).

⁹⁰ *Id.* at 265-66 (“The increase-of-hazard provision is notably absent from standard homeowners policies and often is not included in Commercial property Insurance policies either... Obviously the omission of this provision from a Homeowners policy makes that policy more favorable to the policyholder.”).

mitigate a loss after it occurs.⁹¹ This distinction is easy to understand: whereas most people suffer from lapses in care on occasion, ordinary care is to be expected once a loss occurs because the loss places the insured on notice of the need for enhanced care.

Figure Three shows that various carriers' policies do not adhere to these distinctions. 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 requirement depends on whether 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.



Much more distressing, however, is the fact that a number of carriers place no temporal restrictions on insureds' obligations to take care, requiring that policyholders 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."

Read literally, these clauses "would result in the elimination of coverage for trivial increases in risk."⁹² Such an approach – which was historically available through the defense of "barratry" – resulted in excessive uncertainty for policyholders and discretion for insurers.⁹³ For this reason, courts confronting these clauses in commercial property policies (where they are not uncommon) often substantially cabin their scope, requiring that the increase in risk involve a "substantial change in circumstances materially increasing the risk."⁹⁴ Even assuming these efforts at judicial regulation of insurance are effective,⁹⁵ these provisions nonetheless upend the conventional wisdom about how homeowners policies manage moral hazard

d. Mold and Water Damage to Insured Property

⁹¹ See HO3, *supra* note 36, 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").

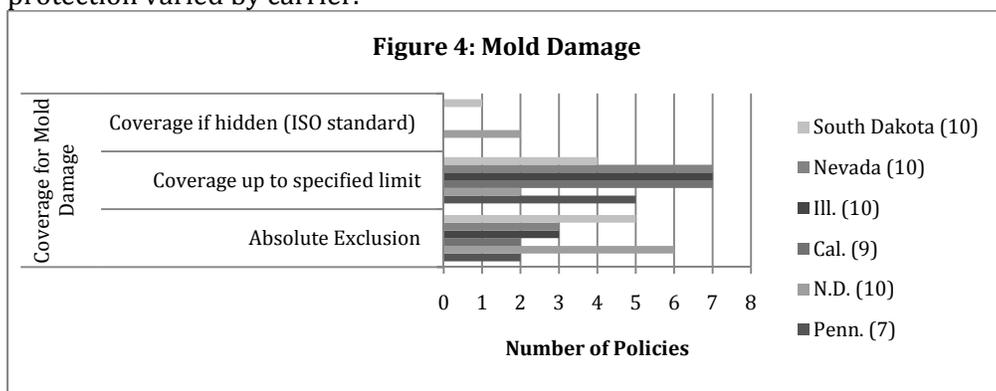
⁹² ROBERT H. JERRY & DOUGLAS RICHMOND, UNDERSTANDING INSURANCE LAW 424 (4th Ed.).

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

⁹⁴ ABRAHAM, *supra* note 4, at 263; Jerry & Richmond, *supra* note 92, at 424.

⁹⁵ See Part II.A.4, *infra*, for discussion of this issue.

Several years ago, controversy erupted over the extent to which homeowners insurers must cover mold damage.⁹⁶ Although several insurance departments took action to regulate this coverage, most did not.⁹⁷ The HO3 form excludes coverage for mold or fungus unless it is (i) hidden within the walls, floors or ceilings and (ii) caused by an accidental discharge or overflow of water or steam.⁹⁸ As Figure 4 reveals, existing policies differ substantially on this issue. Several carriers in South and North Dakota retain the HO3 language on mold, but most carriers in most states have abandoned this language. The alternative they have selected differs dramatically among carriers. Figure four shows a roughly even split between insurers that completely exclude mold-related property damage and those that place monetary caps on such losses.⁹⁹ 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.



Insurance policies also differ with respect to the related issue of whether they cover gradual water damage to property. The HO3 policy covers this risk, so long as the water is the result of “accidental discharge.”¹⁰⁰ As Figure 5 shows, although a few carriers retain this language, most absolutely exclude coverage for any seepage or leakage of water.¹⁰¹ Moreover, five companies associated with a single insurance group radically transform coverage for water damage to structures from all risk to named peril, in the

⁹⁶ 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). The controversy stemmed from a case, *Ballard v. Fire Insurance Exchange*, Ballard v. Fire Ins. Exchange, 2001 WL 883350 (Tex. Dist. 2001), where a jury awarded a massive award in response to Farmer’s refusal to cover toxic mold.

⁹⁷ See 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.”).

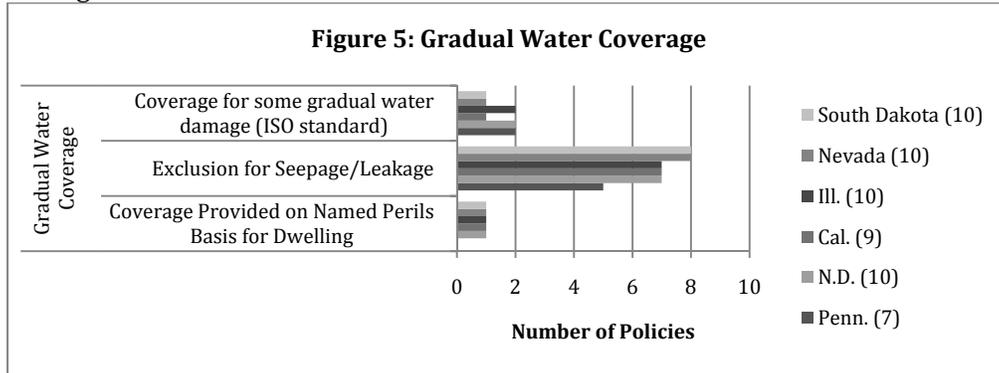
⁹⁸ See HO3, *supra* note 36, at 9.

⁹⁹ 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). Such policies were coded as providing an “absolute exclusion” for mold.

¹⁰⁰ HO3, *supra* note 36, at 9.

¹⁰¹ Policies 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.

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.¹⁰² But the issue has received less attention in the context of first party insurance. Although the issue may seem arcane, it can be quite important given the breadth of the “pollutants” definition found in most policies: pollutants include “any solid, liquid, gaseous, or thermal irritant or contaminant, including smoke, vapor, soot, fumes, alkalis, chemicals and waste.”¹⁰³ The HO3 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.”¹⁰⁴ Under 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.

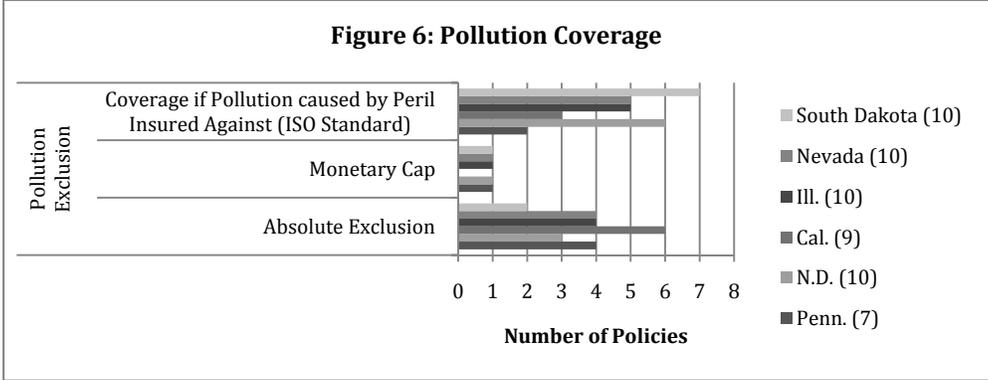
As Figure 6 shows, homeowners policies differ substantially in their coverage of property damage caused by pollution damage. While approximately half of all carriers retain the HO3 language, the other half employ an absolute exclusion of pollution damage.¹⁰⁵ A small number of carriers cover pollution damage up to a specified internal limit.

¹⁰² See generally Kenneth Abraham, *Cleaning Up the Environmental Liability Insurance Mess*, 27 VAL. U. L. REV. 601 (1993).

¹⁰³ 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). For evidence of the importance of this exclusion in homeowners insurance cases, see www.uphelp.org/library/amicus, which contains numerous amicus briefs discussing insurers’ use of the pollution exclusion to deny coverage.

¹⁰⁴ HO3, *supra* note 36, at 9.

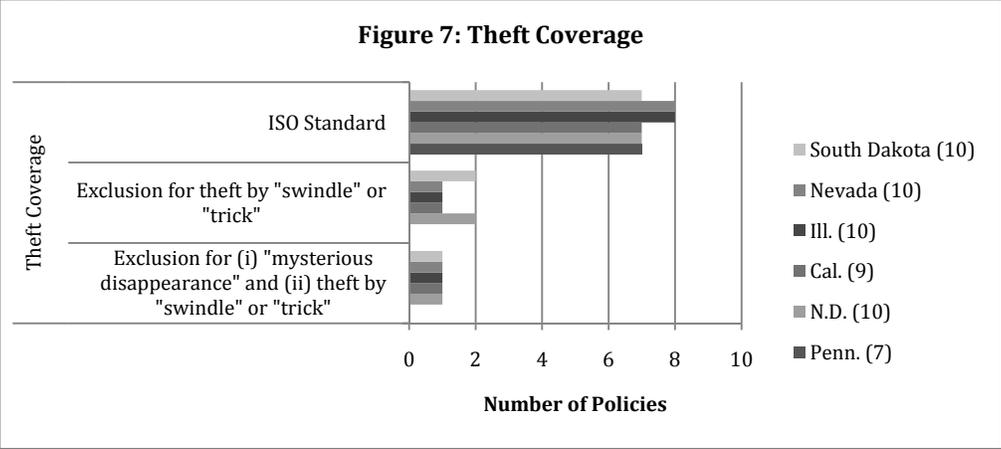
¹⁰⁵ In several instances, a policy contained an absolute exclusion, but exempted smoke damage caused by a covered fire. Such policies were coded as containing an “absolute exclusion.”



f. Theft Coverage

One of the most basic protections a homeowners policy provides is coverage against the risk of theft. In many cases, of course, property can be stolen without obvious evidence of theft. Some commercial property insurers historically 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 these exclusions violated policyholders’ reasonable expectations of coverage.¹⁰⁶ Perhaps for this reason, this exclusion apparently did not migrate into homeowners policies; the HO3 policy specifically covers “loss of property from a known place when it is likely that it has been stolen.”¹⁰⁷

Figure Seven shows that several insurers have reestablished exclusions for theft when there is limited physical evidence of the theft. First, several insurers exclude coverage for theft resulting from “swindle” or “trick.” These exclusions could be interpreted quite broadly, extending not only to email frauds but also to classical burglaries in which entrance is gained 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.

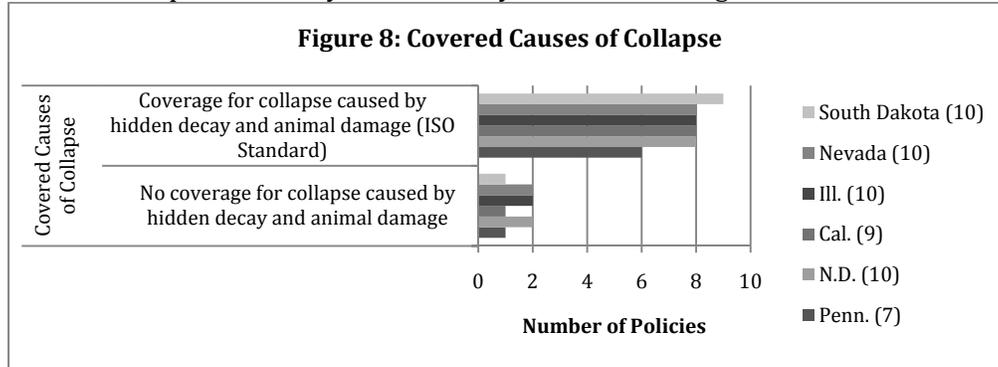


¹⁰⁶ See, e.g., C & J Fertilizer v. Allied Mutual, 227 N.W.2d 169 (1975).

¹⁰⁷ HO3, *supra* note 36, at 10.

g. Collapse Coverage

All homeowners policies reviewed provide coverage against the risk that a covered structure will collapse. However, unlike most coverage for building structures, this coverage is provided on a named perils basis, meaning that loss from collapse is only covered if it is caused by a specifically enumerated peril.¹⁰⁸ Covered perils include all of the standard perils covered for personal property, such as fire and falling objects. But they also include several additional collapse-specific perils, including collapse resulting from hidden decay or animal damage.¹⁰⁹ As Figure 8 shows, however, some policies exclude collapse caused by hidden decay or animal damage.¹¹⁰



h. Damage to Personal Property from Artificially Generated Electrical Current

All homeowners policies reviewed cover the risk that personal property will be damaged by artificial changes in electrical current. However, under the HO3 policy, this coverage does not include damage to “electronic components or circuitry.”¹¹¹ Depending on how this restriction is interpreted, it could be quite broad given the increasing prevalence of electronics in personal property.

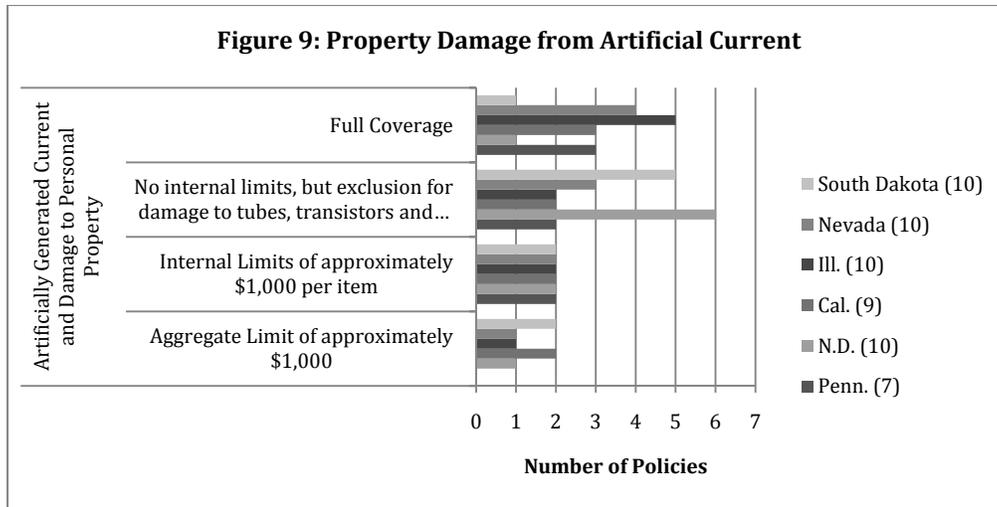
As Figure Nine demonstrates, carriers’ policies vary significantly with respect to this issue. Many carriers simply eliminate the HO3 exclusion for damage to “electronic components and circuitry,” thus increasing coverage. Other insurers follow this approach, but add an internal limit to damage from this peril, usually approximately \$1,000 per property item. Whether this is more or less generous than the HO3 approach is difficult to say. Finally, several carriers (again, five affiliated with a single insurance group) dramatically limit coverage by applying a \$1,000 cap to all property damage from a change in electrical current. Given that such an event is likely to damage numerous items simultaneously, this subtle shift in coverage can have dramatic effects.

¹⁰⁸ This is accomplished by excluding collapse as a covered loss, except to the extent such coverage is provided as an “additional coverage.” The additional coverage then provides coverage for collapse on a named perils basis. HO3, *supra* note 36, at 7, 8. Typically “collapse” is defined as “the abrupt falling down or caving in of a building or structure,” *see id.* at 7.

¹⁰⁹ *See id.* at 7.

¹¹⁰ There was substantial variation regarding whether the weight of ice and snow were covered causes of a collapse. Although the HO3 policy does not specifically include these as covered causes of loss, many policies did. However, “weight of ice and snow” is a named peril in Coverage C of the HO3 policy, suggesting that the HO3 policy covers this peril by covering collapse caused by named perils.

¹¹¹ HO3, *supra* note 36, at 11.



i. Internal Limits for Specific Types of Property

In addition to aggregate coverage limits, homeowners policies also contain various internal limits for specific *types* of property. These limits 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 riders. They may also help to reduce moral hazard by limiting coverage for losses that can be prevented through increased vigilance, such as theft of valuable jewelry.¹¹²

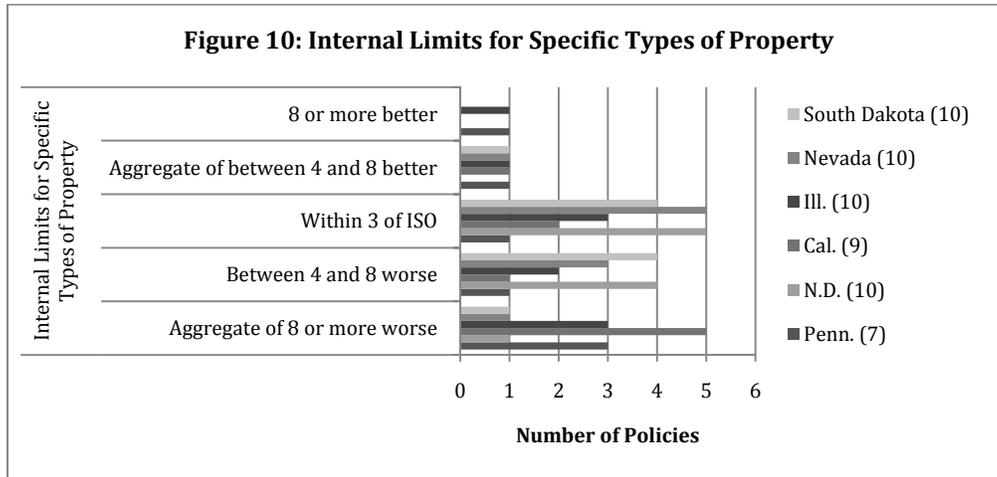
In order to assess variability in internal policy limits, each internal limit in each policy was compared to the corresponding limit in the HO3 policy. Where a policy limit was less generous than the HO3 limit, it was scored as (-1). If the policy’s limit was more generous, it was scored as (+1). A limit received a (0) if it matched the HO3 policy. Where a policy imposed a limit on a new type of property a (-1) was added to its score. Correspondingly, a (+1) was added to the policy’s score if it did not impose a limit on a type of property that was limited in the HO3 policy.¹¹³ These scores were then aggregated for each policy.

The aggregate scores of the sample policies are reported in Figure 10. As above, there is substantial heterogeneity in the market place. The predominant trend appears to involve decreases in coverage, with many carriers incorporating into their policies internal limits that are systematically less generous than those contained in the HO3 policy.¹¹⁴

¹¹² HO3, *supra* note 36, at 3-4.

¹¹³ Some policies applied separate limits to property that was grouped together in the HO3 policy. For instance, the HO3 policy has a \$1,500 limit on “securities, accounts, deeds, evidences of debt, letters of credit, notes other than bank notes, manuscripts, personal records, passports, tickets and stamps.” But some policies had separate limits for “securities” and “manuscripts,” for instance. 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 the sum of the separate limits was the same or more than the combined HO# limit, I scored the comparison policy as more generous. If the two limits were both less than the HO3 policy limit, but the sum was more, I scored zero as the comparative generosity of the policy would depend on the particular nature of the loss.

¹¹⁴ A single carrier generated the two data points in the “8 or more better” category.



Unlike all of the other terms described to this point, specific internal limits within policies can be changed by endorsement. 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 internal limits. For instance, a policyholder with a scheduled anniversary ring would still be subject to the internal limit on jewelry for all other jewelry that 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 often subject to building codes or ordinances that were not in effect when they were constructed. Whether the increased costs of complying with such rules are covered by homeowners policies became a significant source of dispute in the early 1990s.¹¹⁵ The HO3 policy resolves this issue by specifying that up to 10% of the liability limit can be used for increased costs resulting from compliance with new building ordinances or laws.¹¹⁶

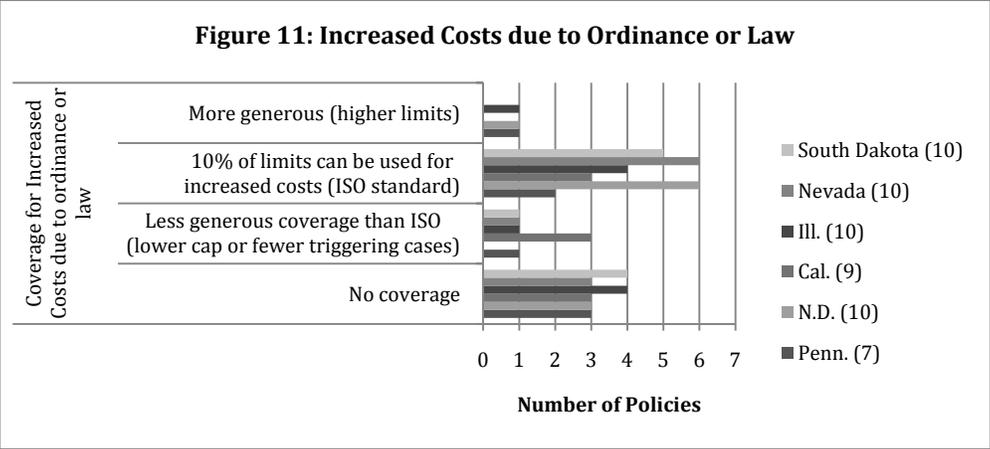
As Figure 11 shows, carriers vary significantly with respect to this issue. While roughly half of the policies in the sample replicated the ISO approach, many policies absolutely excluded these costs from coverage.¹¹⁷ Several carriers take an in between approach, either limiting the percentage of the limits that can be used for these costs or verbally limiting the scenarios in which this coverage is available.¹¹⁸ Three policies in the sample offer more generous coverage than the HO3 policy, 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 an endorsement.

¹¹⁵ See generally Hugh L. Wood, Jr., *The Insurance Fallout Following Hurricane Andrew*, 48 U.MIAMI L.REV. 949 (1994).

¹¹⁶ HO3, *supra* note 36, at 8.

¹¹⁷ This exclusion can be justified on moral hazard grounds, as an insured is arguably better off after a loss if the damaged property is “upgraded” to comply with new building codes or ordinances.

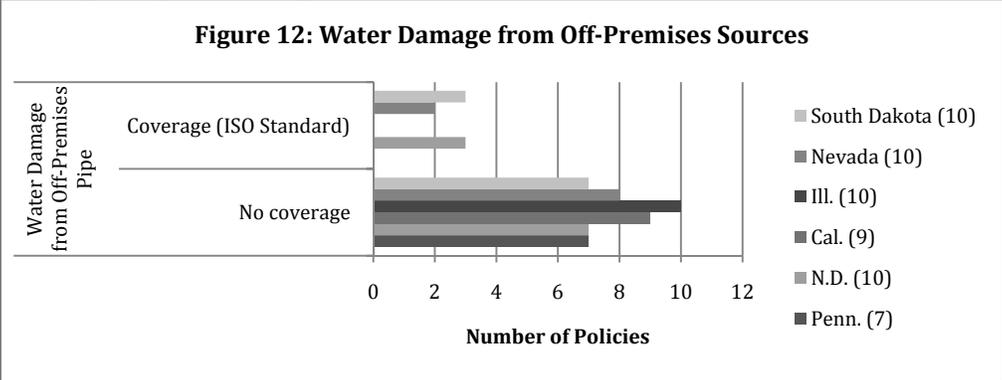
¹¹⁸ Several carriers limited this coverage to 5% of the limits.



k. Water Damage from Off-Premises Sources

Property damage from flooding is excluded from all homeowners policies. Floods can produce extensive damage to numerous households in the same geographic area. This type of correlated risk is difficult to insure, as insurers cannot mitigate risk simply by insuring multiple homes and relying on the law of large numbers.¹¹⁹ Given this explanation for flood exclusions, it is perhaps not surprising that the 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...’”¹²⁰ This species of water damage is likely to be centralized to a relatively small geographic area given the amount of water carried in pipes and the fact that such problems are typically contained relatively quickly by city officials.

As figure 12 demonstrates, however, a substantial majority of carriers no longer cover this risk. The complete absence of such coverage in Illinois, Pennsylvania, and California may reflect the possibility of genuinely correlated losses in certain parts of these states. But it is harder to understand the fact that a some carriers in South Dakota, North Dakota, and Nevada retain the HO3 approach to water damage from off-premises sources, while the majority of carriers do not. In any event, the data again suggest substantial and important heterogeneity in coverage terms.



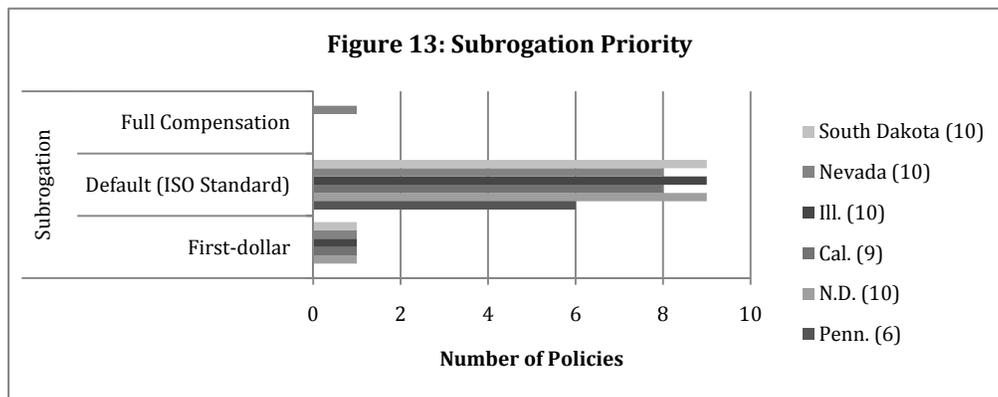
L. Subrogation Priority

¹¹⁹ See Michele Boardman, *Known Unknowns: The Illusion of Terrorism Insurance*, 93 GEO. L. J. 783 (2005).

¹²⁰ HO3, *supra* note 36, at 9-10.

Subrogation is the right of a first-party insurer to recoup insurance payouts from anyone who is liable to the policyholder for causing the underlying harm.¹²¹ Subrogation prevents accident victims from recovering twice 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 policyholder's legal recovery is not fully compensatory, either because the defendant is partially judgment proof or because a settlement reflects the possibility of losing at trial on liability.¹²² In such cases, subrogation dollars can be used either to fully compensate the policyholder or to subrogate the insurer, but they cannot completely accomplish both goals. First dollar subrogation prioritizes full subrogation of the insurer over complete compensation of the policyholder. The make-whole rule, by contrast, allows the insurer to recover in subrogation only after the policyholder is fully compensated for a loss.¹²³

The vast majority of homeowners policies – including the HO3 policy – do not specify how this issue should be resolved, leaving the issue to the courts.¹²⁴ 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.¹²⁵



3. Results: Liability Coverage

Differences in the content of homeowners policies are not cabined to first-party property insurance. 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

¹²¹ See generally STEMPER, *supra* note 2, at 11.01.

¹²² 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 specifying this rule).

¹²³ See *id.*

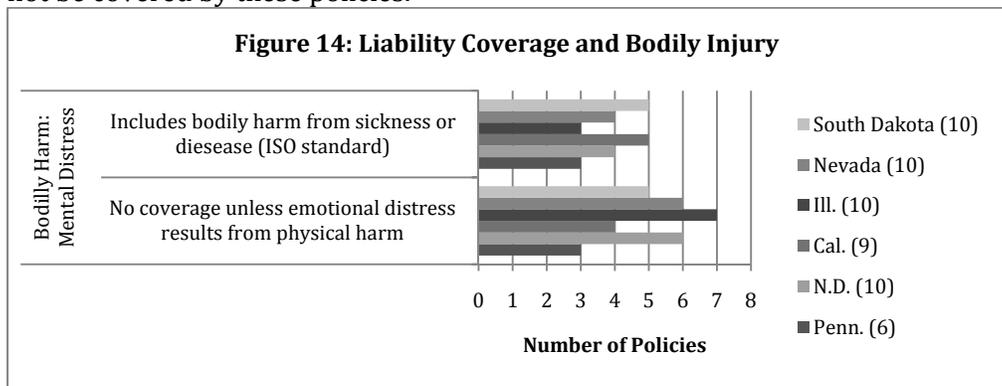
¹²⁴ HO3, *supra* note 36, at 22.

¹²⁵ Interestingly, several related companies from the same underwriting group, but operating in different states, do not resolve this issue. This is true even though Nevada law explicitly permits opting out of the default make-whole rule. *Canfora v. Coast Hotels & Casinos, Inc.*, 121 Nev. 771, 777 (2005).

"occurrence" to which the policy applies. But as the first three sub-sections show, the policies differ in important ways with respect to each of these three elements of the affirmative grant of liability coverage. Moreover, as the subsequent sub-sections reveal, policies also differ meaningfully with respect to various exclusions from this affirmative coverage grant.

a. Bodily Injury

One of the two core liability coverages in homeowners policies covers liability stemming from "bodily injury." The definition of such injury is thus crucially important. The HO3 policy defines "bodily injury" as "bodily harm, sickness, or disease including required care, loss of services and death that results."¹²⁶ A commonly litigated issue is whether this definition encompasses psychological harms that rise to the level of a "sickness or disease."¹²⁷ 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.¹²⁸ But as Figure 14 shows, while many carriers 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.



b. Property Damage

Homeowners policies also cover liability stemming from "property damage."¹²⁹ The HO3 policy defines this as "physical injury to, destruction, or loss of use of tangible property."¹³⁰ But Figure 15 shows that 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 use property such as an automobile would not be covered. Consider, for instance, a homeowner who is

¹²⁶ HO3, *supra* note 36, at 1.

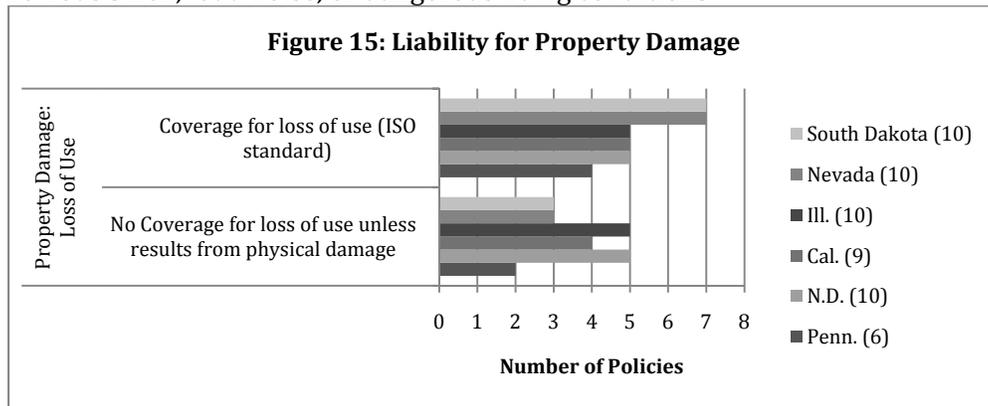
¹²⁷ See generally 3-18 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 18.02[3]; STEMPEL, *supra* note 2, §14.03.

¹²⁸ See *id.*

¹²⁹ See generally APPLEMAN, *supra* note 127, § 18.02[4]; STEMPEL, *supra* note 2, §14.04.

¹³⁰ HO3, *supra* note 36, at 2.

sued by neighbors alleging that they needed to abandon their home due to a noxious smell, loud noise, or dangerous living conditions.¹³¹



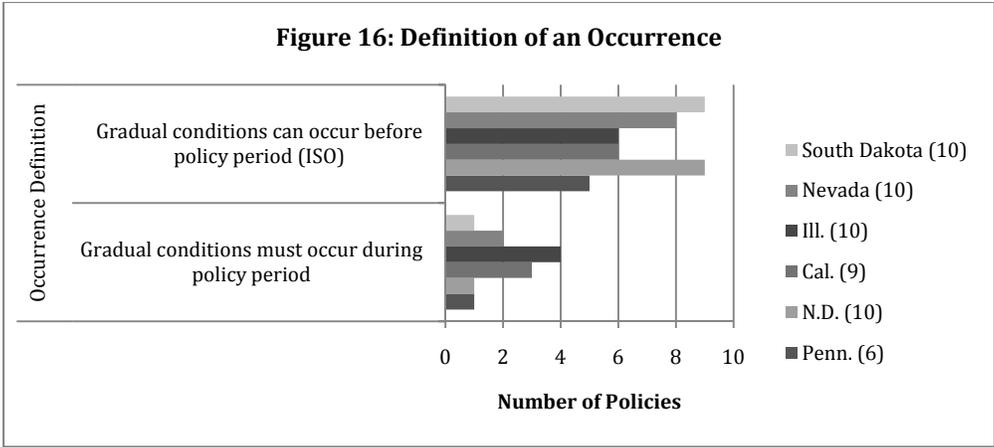
c. Occurrence Definition

Irrespective of whether a policyholder’s potential liability stems from “property damage” or “bodily injury”, homeowners policies only provide coverage if the injury resulted from an “occurrence.” The definition of this term consequently constitutes yet a third key component of the liability insurance that a homeowners policy provides. The 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.’”¹³² 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, several homeowners policies define an occurrence to require that any “continuous or repeated exposure to substantially the same general harmful conditions” itself occur during the policy period. These policies do not cover liability stemming from any conditions that began prior to the policy period. Although this scenario has been litigated most extensively in the context of asbestos liability of commercial entities,¹³³ it could plausibly extend to a variety of scenarios more relevant to a homeowner. For instance, consider a homeowner who is sued for damage caused by a dog that continuously escapes the back yard, or for tree damage that has long encroached on a neighbor’s property.

¹³¹ 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 policy because the loss of use did not involve physical damage).

¹³² HO3, *supra* note 36, at 2.

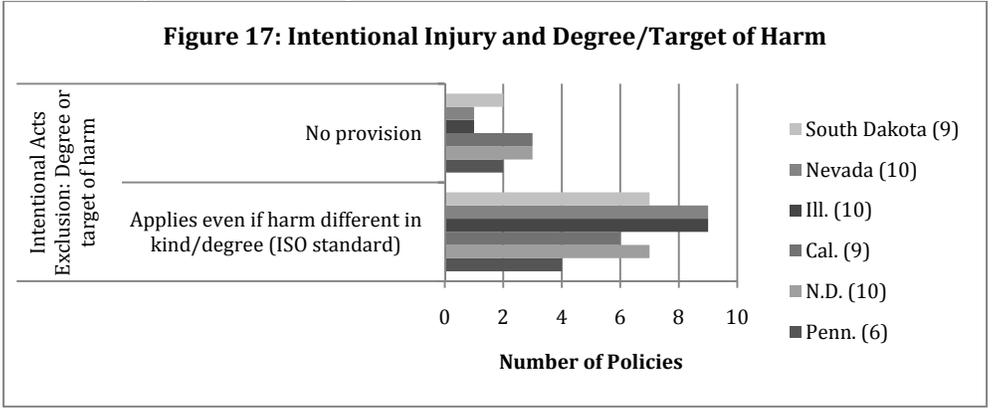
¹³³ See generally APPLEMAN, *supra* note 127, § 18.02[6]; STEMPEL, *supra* note 2, §14.02.



d. Expected or Intended Injury Exclusion

Perhaps the most important term in any liability insurance policy is the exclusion for injury that is intentional or expected. Almost all acts that generate liability can be framed as involving intentional conduct or expected harm – indeed, these factors are often key elements of liability. As such, a broad exclusion for expected or intended injury can largely gut liability coverage.¹³⁴ The HO3 policy provides no coverage for liability when bodily injury or property damage was “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.”¹³⁵ However, the policy exempts from this exclusion “bodily injury resulting from the use of reasonable force by an insured to protect persons or property.”¹³⁶

The corresponding exclusions in the sampled homeowners policies differ in multiple respects from this language. First, as reported in Figure 17, some policies appear to be more generous than the HO3 policy in that they do not address coverage when the liability-generating act is substantially different than initially intended or expected.

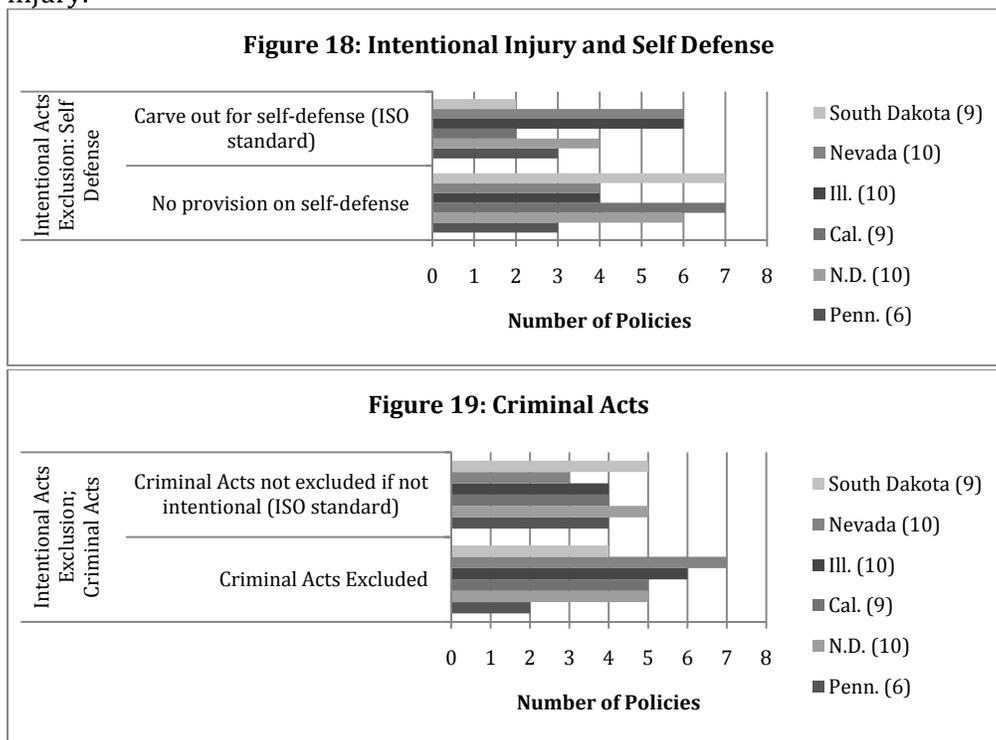


¹³⁴ See James Fischer, *The Exclusion from Insurance Coverage of Losses Caused by the Intentional Acts of the Insured: A Policy In Search of a Justification*, 30 SANTA CLARA L. REV. 95, 124-27 (1990).

¹³⁵ HO3, *supra* note 36, at 17.

¹³⁶ *Id.*

Once again, though, the broad trend was largely in the other direction, with most deviations from the HO3 policy restricting, rather than expanding, coverage. First, as shown in Figure 18, many policies do not carve-out intentional or expected acts that are the result of self-defense.¹³⁷ Second, Figure 19 reports that many policies exclude coverage for liability stemming from criminal acts that do not otherwise constitute intentional or expected injury.¹³⁸



e. Contractual Assumption of Liability

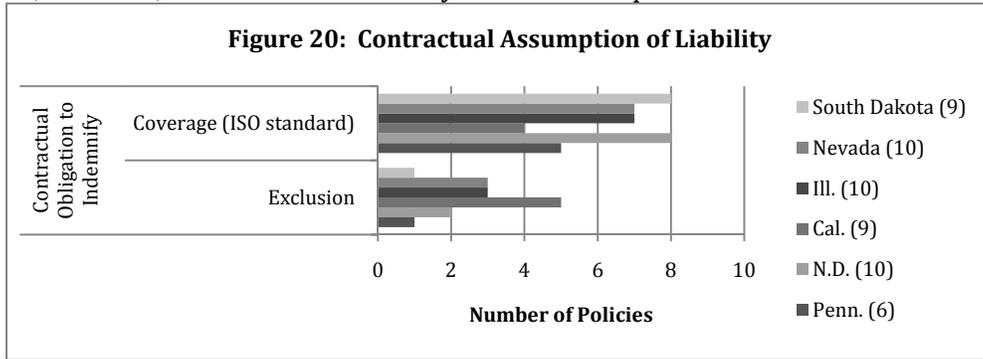
Standard form contracts are omnipresent in the modern world. In a variety of contexts, such contracts require individuals to assume liability risk, often by specifying that the signor will indemnify the other for any liability relating to the contract. Such provisions, for instance, are a common condition when real or personal property is rented, with the lessor agreeing to indemnify the lessee for any liability arising out of the rental.¹³⁹ Given the pervasiveness of these types of agreements, it is not surprising that the standard HO3 policy covers liability resulting from the assumption of another’s liability, so long as

¹³⁷ 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).

¹³⁸ See generally *Baker*, *supra* note 42.

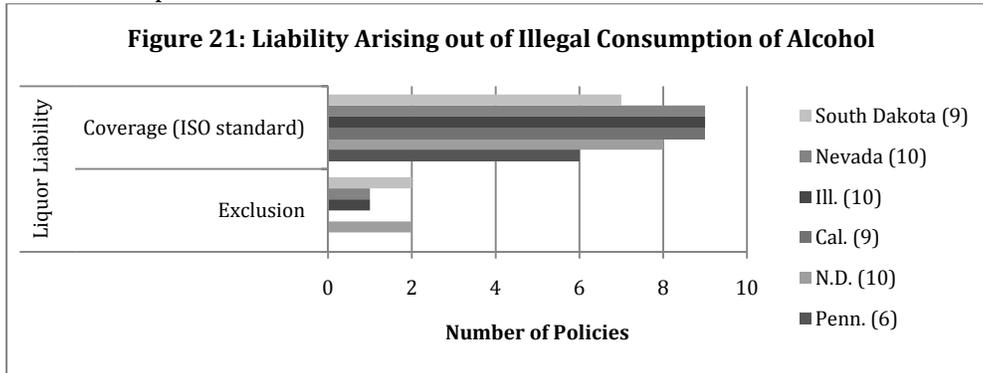
¹³⁹ See, e.g., *Martin v. Thrifty Rent a Car*, 145 F.3d 1332 (6th Cir. 1998) (Thrifty’s standard rental agreement required renter to indemnify Thrifty); *Hertz Corp. v. Zurich Am. Ins. Co.*, 296 F. Supp. 2d 668, 671–72 (E.D. Va. 2007) (Hertz’s equipment rental contract required renter to indemnify rental 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).

this occurs prior to the liability-generating occurrence.¹⁴⁰ As reported in Figure 20, however, this is not true of many homeowners policies.



f. Liability Stemming from Illegal Consumption of Alcohol

Liability related to the illegal consumption of alcohol poses an obvious risk for households that include teenagers. Perhaps for this reason, the HO3 policy does not exclude this liability. Nor, as Figure 21 shows, do most other insurers. Surprisingly, though, several insurers do indeed exclude this liability risk in their policies.¹⁴¹



g. Lead, Pollution, and Mold Liability

As noted above, one of the major modern coverage issues involved the degree to which commercial liability insurance policies cover pollution-related liability.¹⁴² Presently, most general commercial liability policies contain an “absolute pollution exclusion.”¹⁴³ 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 or pollutants. Even more importantly, unlike commercial businesses, homeowners are generally exempt from federal liability for contamination that occurred prior to their ownership of property.¹⁴⁴

¹⁴⁰ HO3, *supra* note 36, at 18; *See* STEMPER, *supra* note 2, § 14.14 (noting that this coverage does not violate the principle of fortuity).

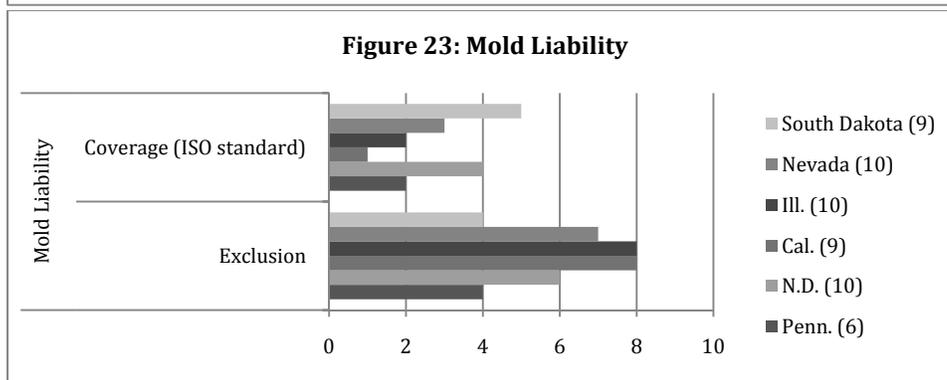
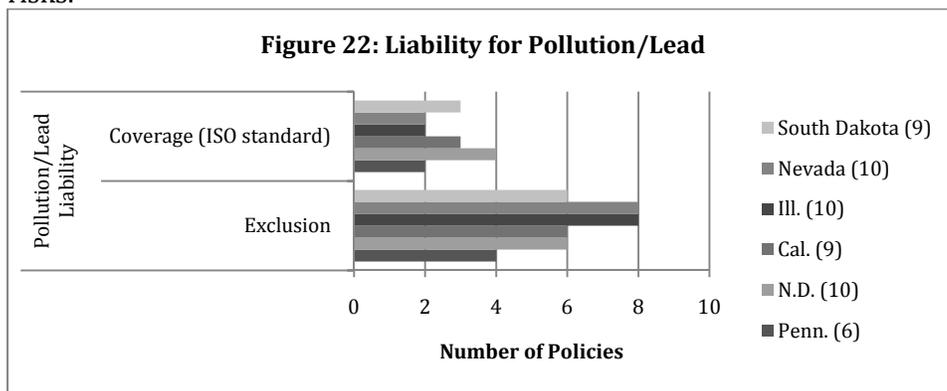
¹⁴¹ One insurance group accounts for the data points in four of the states, with a second insurance group accounting for the additional data points in North and South Dakota.

¹⁴² *See* Note 102, *supra*.

¹⁴³ *See* Stempel, *supra* note 103.

¹⁴⁴ *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*

The ISO policy does not contain any exclusions for liability involving lead, pollution, or mold. However, the ISO does maintain various endorsements that can be added to the HO3 policy to exclude or limit these sources of liability.¹⁴⁵ 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 some insurers continue to cover these liability risks.



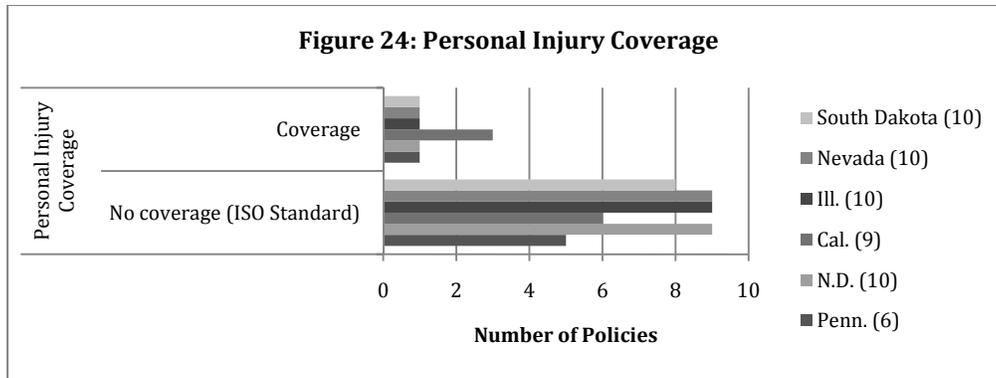
h. Liability for Personal Injury

As suggested at the outset of this Section, standard homeowners policies cover only liability involving bodily injury or property damage.¹⁴⁶ By contrast, most policies do not cover liability stemming from harms such as mental anguish, false imprisonment, or humiliation. 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.

Builders, LLC, 655 F. Supp. 2d 473, 498–99 (D.N.J. 2009) (dismissing CERCLA claims against homeowners under innocent owner defense).

¹⁴⁵ See ISO, endorsement.

¹⁴⁶ See TAN, supra notes 125-126.



4. Interpretation, Limitations and Qualifications

a. Insurance Policy Variability

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 complete account of how homeowners policies differ. As described above, the specific terms identified for study were not a random sample, but were chosen because they are commonly litigated, particularly important, or reflective of initially-observed variability.¹⁴⁷ Numerous terms in the sample policies varied even though they were not isolated for study.¹⁴⁸ 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 exclusions.¹⁴⁹

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 and able to issue data calls.¹⁵⁰ The sampled states may have more extensive regulatory resources or more pro-consumer dispositions, which could in turn impact the degree of variability in policy terms. However, one would presumably expect this to reduce, rather than to enhance, policy variability. Moreover, the similarity in results across the sampled states provides reason to suspect that they are indicative of a national trend. This is particularly true given that policies from the top thirteen insurance groups nationally were included in the sample, and affiliated companies operating in different states usually used very similar, or identical, forms with minimal state-specific amendments.¹⁵¹

A third qualification applies to those policy terms isolated for study that can be changed by endorsement: law and ordinance exclusions, personal injury liability coverage, and – to some degree – internal limits.¹⁵² The variability

¹⁴⁷ See Part II.A.1.

¹⁴⁸ 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; liability coverage of prejudgment interest; liability coverage of punitive damages, and articulations of the duty to defend.

¹⁴⁹ For instance, all observed policies included all of the named perils for personal property and property exclusions from the HO3 form.

¹⁵⁰ See Part II.A.1, *infra*.

¹⁵¹ See TAN 63-64.

¹⁵² See Part II.A.1.i.j & 2.h.

reflected in these categories simply involves the setting of a default by the insurer. Carriers that do not include these coverages in their base policy may simply be offering consumers enhanced choice or improving their own risk classification by allowing consumers to self-select into different groups.¹⁵³ Interpretation of these forms of variability is thus quite complicated, turning on issues such as how well agents inform consumers about potential endorsements and whether comparison shoppers take into account different defaults when comparing different companies.

A final qualification is that differences in policy terms are only imperfectly indicative of differences in coverage. It is well known that companies occasionally give agents discretion to waive contractual violations.¹⁵⁴ This could be particularly true in the insurance context, where trained adjusters routinely apply policy language.¹⁵⁵ Similarly, several terms identified for study – including concurrent causation and increase in hazard terms – appear to vary outside of permissible bounds set either by statute or courts. With respect to these terms, variability in contract language may not reflect variability in coverage if claims handling processes ensure that judicial or statutory requirements trump contrary language in policies. Unfortunately, it is impossible to assess the actual degree to which differences in policy language translate into predictable differences in claims determinations. The reason, though, is that insurers have systematically fought to hide from public scrutiny any insurer-specific data on claims handling, notwithstanding the fact that regulators collect and analyze vast amounts of such data.¹⁵⁶

However, the terms of insurance policies are obviously important to consumers even if they do not perfectly define the scope of coverage. Insurance contracts are valuable to consumers not only because they define the scope of coverage, but also because they cabin the discretion of adjusters and their claims handling superiors to deny claims. As such, variability in policy language is relevant even if it is not presently generating differences in claims handling approaches, as it impacts insurers' discretion to approach claims handling differently in the future. Were this not the case, insurance contracts could be replaced by an insurer's promise to use its best judgment in paying claims.

b. Insurance Policy Efficiency

A much 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. A substantial majority of the deviant policy terms are downward deviations from the presumptive HO3 baseline. Although reductions in coverage certainly can reflect efficient efforts

¹⁵³ See Daniel Schwarcz & Amy Monahan, *Will Employers Undermine Health Care Reform by Dumping Sick Employees*, 96 VA. L. REV. 125 (2011) (describing indirect risk classification).

¹⁵⁴ See 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 situations in which firms grant agents authority to depart from standard-form contracts ex post).

¹⁵⁵ Jeffrey W. Stempel, *The Other Intermediary*, 15 CONN. INS. L. J. 599, 618-19 (2009).

¹⁵⁶ See generally Schwarcz, *Regulating Insurance Sales or Selling Insurance Regulation*, *supra* note 46, at 1761.

by insurers to manage problems such as adverse selection and moral hazard, the specific content of some of these deviations raise various efficiency-related concerns.¹⁵⁷

First, several reductions in coverage – particularly the “increase in hazard” clauses and global requirements that covered losses be “sudden and accidental” – arguably grant insurers excessive discretion in making claims decisions.¹⁵⁸ Such discretion is troubling, as the sequential, contingent structure of insurance can create incentives for insurers to over-reach in claims handling.¹⁵⁹ Of course, courts can, and do, police against such over-reaching; recall that courts impose various restrictions on the literal meaning of increase-in-hazard clauses,¹⁶⁰ and they might well do the same if insurers uses the global requirement that a loss be “sudden and accidental” to dramatically limit coverage.¹⁶¹ But, as I have discussed at length elsewhere, the capacity of courts to police the abuse of claims handling discretion in personal lines of insurance is quite limited: coverage litigation is slow, inaccessible and unpredictable and many policyholders never seriously consider the possibility that they could sue their carrier for a claims denial.¹⁶² Although extra-contractual remedies can mitigate this problem, they do so imperfectly and their availability is limited in many states.¹⁶³

Second, a disturbing trend in the data is the reemergence of policy terms that courts have repeatedly rejected in the past. This is most apparent with respect to terms that exclude coverage for theft resulting from swindle or trick or involving mysterious disappearance.¹⁶⁴ These terms strongly resemble the infamous “visible marks” clauses that many courts rejected decades ago.¹⁶⁵

¹⁵⁷ Of course, many deviations – such as those purporting to preserve the insurers’ right to first dollar subrogation – raise difficult issues regarding optimal coverage design. See Sykes, *supra* note 122.

¹⁵⁸ *But, cf.* Jerry & Richmond, *supra* note 92, at 423 (arguing in favor of insurers maintaining substantial discretion to deny claims via an increase of hazard clause, as it operates as a “modern day warranty” that policyholder will not increase risk).

¹⁵⁹ 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).

¹⁶⁰ See Part II.A.2, *supra*.

¹⁶¹ It is precisely because of the importance that courts play in policing insurer abuse that discretionary clauses in insurance policies – which purport to give insurers discretion to deny claims with only limited judicial review – are so troubling. See John Langbein, *Trust Law as Regulatory Law: The Unum/Provident Scandal and Judicial Review of Benefits Denials Under ERISA*, 101 NW. U.L. REV. 1315, 1340-42 (2007) (discussing the problems created by discretionary clauses).

¹⁶² *Id.* at 746-50. By contrast, these barriers to courts are much less of a problem in commercial insurance lines, where increases in hazard clauses, for instance, are not uncommon.

¹⁶³ *Id.* at 746; see also Schwarcz, *Products Liability Theory*, *supra* note 4, at 1456-59 (explaining how judicial regulation of insurance can only be effective for non-litigants if extra-contractual damages reflect the likelihood that an insurers’ behavior will not be challenged in court).

¹⁶⁴ See Part II.A.2.f, *supra*. Another example of this is, once again, the increase in hazard clause, which resembles the historic barratry defense in insurance law that courts generally abandoned because of its indeterminacy. See KENNETH S. ABRAHAM, *THE LIABILITY CENTURY: INSURANCE AND TORT LAW FROM THE PROGRESSIVE ERA TO 9/11*, at 21-16 (2008).

¹⁶⁵ See Part II.A.2, *supra*.

They effectively require policyholders to bear the risk that their property will be stolen without clear evidence of theft in order to reduce the risk of moral hazard. But while the underlying risk (theft without clear evidence) is substantial, the potential moral hazard benefits of the exclusion seem minimal: it is not easy to guard against swindle or trick, and, to the extent that insurers have plausible evidence that a mysterious disappearance involves fraud, they can easily deny the claim on that basis. Although bright-line exclusions certainly reduce insurer costs of investigation,¹⁶⁶ insurers generally have a strong reason to investigate potential fraud irrespective of coverage issues: insurers will not want to renew coverage of policyholders whom they suspect of fraud.

Third, at least some of the exclusions found in deviant policies do not seem to further any plausible insurance purpose, such as reducing moral hazard or adverse selection.¹⁶⁷ Consider here, for instance, the aggregate limit of \$1,000 that one carrier places on all loss resulting from artificial changes in electrical currents.¹⁶⁸ An artificial change in electrical currents is obviously likely to simultaneously damage multiple pieces of property. An aggregate limit on coverage, therefore, places substantial risk on policyholders stemming from the prospect that they will have numerous items plugged into the wall during an electrical surge. By contrast, both a per-property limit or limit on certain types of property avoid placing this risk on policyholder while more directly reducing moral hazard by encouraging them to employ devices such as surge-protectors for their big-ticket items.

Finally, several of the terms in deviant policies appear to have been imported from the commercial liability sphere despite important differences in the liability risks facing homeowners and commercial enterprises. The best example of this involves liability coverage restrictions for pollution, mold, and lead. As discussed earlier, the liability regime that motivated insurers to exclude these risks in their commercial policies does not apply to homeowners, who are specifically exempt from liability under CERCLA.¹⁶⁹

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.

1. Data and Methodology

As revealed more fully below, the coding required for this Section was quite resource intensive. For this reason, the sample in this Section was limited

¹⁶⁶ Schwarcz, *Products Liability Theory*, *supra* note 4, at 1451-52.

¹⁶⁷ See Marotta Wurgler, *Standard Form Contract Quality*, *supra* note 173, at 475 (noting the difficulty involved in assessing the efficiency of contract terms). *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 efficiently allocate responsibility between manufacturer and consumer so as to maximize life of products and insure against loss).

¹⁶⁸ See Part II.A.2.h, *supra*.

¹⁶⁹ Part II.A.3.g, *supra*.

to the policies collected from North Dakota and Pennsylvania.¹⁷⁰ These states were selected for several reasons. First, both states have limited product requirements for homeowners insurance policies.¹⁷¹ As a result, they provide a good set of test cases for policy variability in the absence of legal intervention. Second, homeowners in these states are exposed to a similar set of perils. Third, these states have only a single overlapping carrier among the policies collected, resulting in a set of policies from sixteen distinct insurance groups. Finally, North Dakota includes several relatively small regional insurers,¹⁷² which produces a more varied set of carriers.

With this set of sixteen insurance policies in place, each policy was assigned a score reflecting its generosity. To do so, approximately 200 individual terms in the HO3 policy were compared with the corresponding terms in each of the sampled policies. When a term in a sample policy was unambiguously more generous than the corresponding term in the HO3 policy, it was assigned a value of 1. When a sample policy's term was unambiguously less generous, it was assigned a value of -1. And if the terms were substantially identical, or it could not be determined which was more generous, it was assigned a value of 0. This approach produces an aggregate score of between -200 and 200 for each of the sampled policies ("Measure One").

This approach largely mirrors the methodology of the leading empirical studies of consumer contracts.¹⁷³ 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

¹⁷⁰ As reflected in the data in Part II, one Pennsylvania carrier did not provide either (i) its enumerated perils property coverage, or (ii) its liability coverage in response to the data call. Rather than eliminate this carrier, I supplemented these missing pieces of its policy with the corresponding pieces from the carrier's Illinois policy. Although Illinois has more extensive content regulation than Pennsylvania, such regulation did not appear to influence these portions of the policy.

¹⁷¹ For a list of their product requirements in homeowners insurance, see NAIC Product Requirements tool, *supra* note 50. Apart from regulations governing cancellation, declination and non-renewal, North Dakota has a valued-policy law, Section 26.1-39-05, and requires coverage for innocent co-insureds who are the victims of domestic abuse Section 26.1-39-24. The North Dakota Insurance Department also prohibits absolute pollution exclusions and requires that prejudgment interest 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-insureds who are the victims of domestic abuse, Pennsylvania Protection From Abuse Act. Because these coverages were required by state law, they were not included in the scoring of policies.

¹⁷² See 2009 MARKET SHARE REPORT, *supra* note 44.

¹⁷³ 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 software license contracts. From these contracts, she selects 24 important terms and codes them according to whether each term was the same, more, or less favorable than the UCC default. These resulting consumer-friendliness scores figure prominently in much of her work. Marotta-Wurgler's approach for selecting terms mirrors my approach in Part A. In this Section, by contrast, I rely on the contract's internal structure to define each term and attempt to capture virtually all meaningful terms in the contract.

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.¹⁷⁴ Nor is determining how a sample policy term compares to the corresponding ISO term.¹⁷⁵ These limitations were managed by adhering to specific criteria in defining terms¹⁷⁶ and by the author doing all the coding, using a Research Assistant only to perform spot checks on consistency over time. Additionally, the fact that all policies evolved from a common 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 policy terms deviate from the corresponding HO3 policy term. For instance, a policy that contains a term that is slightly less generous than the corresponding HO3 term is coded the same way as a policy with a much less generous term. Second, this approach ignores differences in the relative importance of policy terms.

To address these limitations, several additional coding approaches were employed. First, in addition to assigning each term a “difference value” of 1, 0, or -1, each term was also assigned a “departure value” ranging from -3 to +3, reflecting the author’s subjective assessment of the degree to which the sample policy term differs from the corresponding HO3 term.¹⁷⁷ Thus, small deviations from the HO3 form were assigned a 1/-1, moderate deviations a 2/-2, and large deviations a 3/-3. Second, terms were assigned an “importance value” from 1 to 10 depending on the author’s subjective judgment of its importance to coverage.¹⁷⁸

This approach produces three metrics of contract quality in addition to measure one, which simply aggregates difference measures. Measure two

¹⁷⁴ 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 policies exclude coverage of emotional distress liability in the definition of “bodily harm” whereas others exclude such coverage in the grant of liability coverage. In other cases, a term in the HO3 policy is split among several places in the sample policy. For instance, the ISO policy contains a single term exempting from several exclusions liability owed to a residence employee, while other policies place this exemption in each of the exclusions.

¹⁷⁵ This is particularly true when policy language 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.

¹⁷⁶ Terms were defined using the following principles: (i) 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, (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, and (vi) approximately twenty terms are included that are found in non-ISO policies and not otherwise captured.

¹⁷⁷ Armed with more data, it might be possible to quantify the expected value of deviant policy terms.

¹⁷⁸ The importance values of all of the terms in the contract are available from the author and the Law Review.

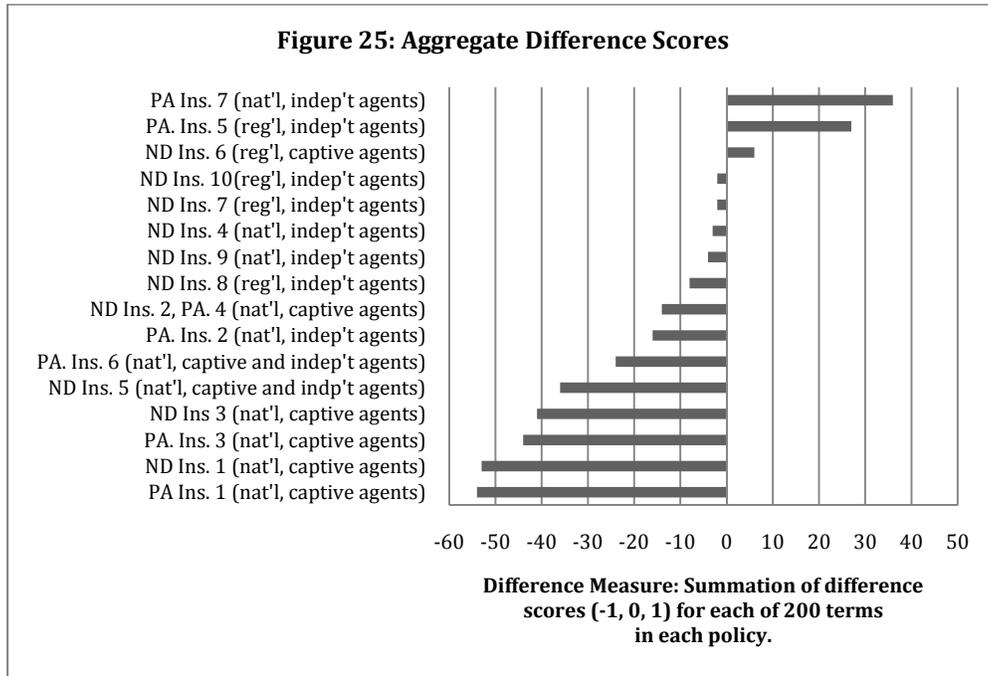
aggregates “departure values,” thus producing aggregate scores for sample policy that can range between -600 and 600. This measure introduces additional subjectivity, but captures the degree of deviation in each term. Two additional measures of contract quality are generated by multiplying the difference values by the “importance values” of each term (“Measure three”) by multiplying the departure values by the “importance values” of each term (“Measure four”). These measures of contract quality are summarized below.

	Calculation Method	Benefits	Drawbacks
Measure 1	Summation of Difference Score (0, 1, -1)	Most objective, follows literature	Does not capture either importance of terms or extent of deviation
Measure 2	Summation of Departure Scores (-3 to +3)	Captures extent of difference between H03 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)	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)	Captures both extent of difference between terms and degree of importance	Introduces the most subjectivity

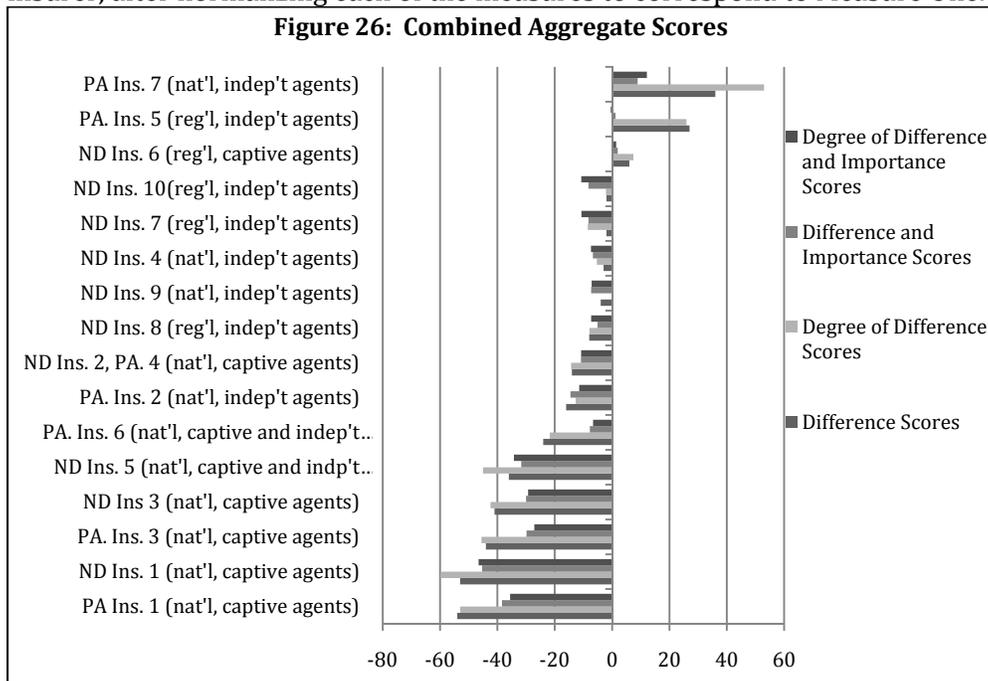
Ultimately, of course, each of these measures is as an inherently crude measure of a sample policy’s generosity. At the same time, large deviations in scores clearly reflect something about the generosity of different policies.

2. Results

Figure 25 reports Measure One for each of the sixteen insurers in the data set. Scores above zero indicate that the sample policy is more generous than the H03 policy and scores below zero indicate the opposite. Although individual insurers are not named, both their distribution system and their geographic reach are identified. The figure suggests that several carriers’ policies are more generous than the H03 policy. Consistent with Section A, though, many more insurers have policies that are substantially worse than the H03 policy. Finally, many insurers’ policies are close to the H03 policy in overall generosity.



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 normalizing each of the measures to correspond to Measure One.



3. Implications, Limitations, and Qualifications

Irrespective of the approach used to measure contract generosity, there are substantial deviations among carriers in the generosity of their policies. These deviations suggest that five carriers among the sixteen studied employ policies that are substantially less generous than the HO3 policy. 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 and the HO3 policy.

Standing alone, these data do not necessarily reflect differences among carriers in contract efficiency. 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. In other words, heterogeneity in policy terms may simply reflect heterogeneity in consumer preferences and characteristics.¹⁷⁹ At the same time, heterogeneity in policy terms is also consistent with market scenarios in which some firms “specialize” in exploitation via non-salient contract terms.¹⁸⁰ Alternatively, heterogeneity in the generosity of insurance policies may reflect the fact that some insurers are effectively locked in to offering the old, standard policy, and thus are unable to profit from consumer ignorance by decreasing non-salient elements of coverage.

Nonetheless, the data presented in this Section, when considered in combination with some of the more troubling individual terms discussed in Part A,¹⁸¹ do raise the *concern* that individual carriers are exploiting consumer ignorance to ratchet back coverage. This interpretation seems to better explain the data for several reasons. First, the traditional 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.¹⁸² If insurers were really attempting to appeal to different types of consumers, then, at the very least, one would not expect for them to refuse to inform consumers about the particularities of their product at the point of sale.

Second, 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

¹⁷⁹ 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).

¹⁸⁰ 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”); 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”).

¹⁸¹ See Part II.A.

¹⁸² See Part III, *infra*.

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.¹⁸³ 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. Admittedly, there are various alternative explanations for this correlation. Most notably, large insurers are both more likely to utilize captive distribution systems¹⁸⁴ and more likely to find deviating from standard forms to be economically feasible.¹⁸⁵

Finally, the exploitation hypothesis is also more consistent with the apparent practice of some companies who recently developed new, less generous forms, of keeping existing policyholders on older versions of their policy forms. Several of the insurers utilizing the least generous policy forms continue to issue older, more generous, versions of their policies to their long-time policyholders, at least in some states. To the extent that their new, less generous, policies were truly more efficient, one would expect them to encourage those policyholders to switch to these new forms. By contrast, to the extent that the new forms were exploitative, one would expect insurers to be hesitant to move existing business to the new forms, as such policyholders would be well situated to inquire about, and determine, the differences in the two forms. In fact, one agent revealed in an interview that he was specifically instructed by his carrier not to switch old policyholders on to the new form, as doing so could generate “legal problems.”¹⁸⁶

One important objection to the exploitation theory is that mortgage holders, who require mortgagors to purchase homeowners insurance, would police against any exploitation. Ultimately, though, this objection is not compelling. The insurance requirements that lenders place on homeowners stem from the rules that secondary purchasers of mortgages – particularly Fannie Mae and Freddie Mac – have in place for the mortgages they will purchase on the secondary market.¹⁸⁷ Yet these rules apparently themselves operate on the assumption that homeowners policies are completely uniform and, in any event, place no requirements on any coverage details. They require that insurance “must protect against loss or damage from fire and other hazards covered by the standard extended coverage endorsement.”¹⁸⁸ The

¹⁸³ 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*.

¹⁸⁴ 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).

¹⁸⁵ See Part I, *supra*.

¹⁸⁶ Interview with Agent 2 (MN).

¹⁸⁷ See Adam Levitan, *Hydraulic Regulation*, 26 YALE J. REG. 143, 196-97 (2009) (explaining the role of secondary market purchasers of mortgages in shaping the rules that apply in the underlying mortgage transaction).

¹⁸⁸ Fannie Mae Selling Guide, Coverage Requirements, B7-3-03, General Hazard Insurance Coverage, at 862, available at: <https://www.efanniemae.com/sf/guides/ssg/>

“extended coverage endorsement” is a reference to the extension of fire insurance to cover other perils, such as “wind, civil commotion (including riots), smoke, hail, and damages caused by aircraft, vehicle, or explosion.”¹⁸⁹ Thus, lenders require only that policyholders have coverage against the standard perils (which all policies observed do), but say nothing about the details or scope of that coverage.¹⁹⁰

Ultimately, the data does not clearly demonstrate consumer exploitation. But it does raise the prospect of such exploitation and it suggests that further research of this issue is warranted. Future work could provide further insight on these questions by assessing whether carriers with less generous policies offer lower premiums.¹⁹¹ 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.¹⁹²

At the same time, the data show that many insurers do largely match the coverage found in the HO3 policy, and some companies offer substantially more generous policies. All this suggests that, even if some carriers are exploiting uninformed consumers, most are not. Some carriers may have shied away from cutting coverage because of the fear of reputational consequences, others may have been deterred by the prospect of regulatory or judicial backlash, and still others may not have the option to cut coverage because of their dependence on the standard form. But whether the majority of insurers will continue to refrain from decreasing the generosity of their coverage in the future is less clear.

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.”¹⁹³ Another warns in a series of amusing commercials featuring various personified perils that “cut-rate insurance” may not cover certain losses.¹⁹⁴ Yet a third notes that “[y]ou need the best homeowners insurance coverage available – at a reasonable price.”¹⁹⁵ Given these insurer exhortations 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.

¹⁸⁹ *Id.*

¹⁹⁰ Lenders do impose substantial requirements with respect to the financial strength of insurers. *See id.* They also do require that loss settlement of the home be on a replacement cost basis. *See id.*

¹⁹¹ 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.

¹⁹² Price differences, even in the aggregate, may therefore represent either differences in the policyholder pool or differences in the underwriting approaches of different carriers.

¹⁹³ *See* State Farm Advertisement (on file with author).

¹⁹⁴ *See* Allstate Advertisements (on file with author).

¹⁹⁵ *See* Farmers Advertisements (on file with author).

As this Part details, nothing could be further from the truth.¹⁹⁶ 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.¹⁹⁷ As Part A describes, consumers simply cannot access insurance policy forms on a pre-purchase basis, and the policies they receive after purchase are virtually indecipherable. Part B demonstrates that alternative sources of information— including insurance agents, marketing materials, and reputation — are insufficient to allow consumers to select among carriers on the basis of their policy forms. 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.¹⁹⁸ Traditionally, most assumed that informed minorities that policed the content of standard form contracts would do so through pre-purchase, comparison shopping.¹⁹⁹ Starting with *ProCD v. Zeidenberg*,²⁰⁰ however, scholars suggested that an informed minority could protect the interests of consumers even if contracts were not made available to consumers until after purchase of the underlying good.²⁰¹ Others, not surprisingly, questioned the effectiveness of market mechanisms in this context, arguing that such rolling contracts present special risks of consumer exploitation.²⁰²

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

¹⁹⁶ See generally Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395 (1994) (arguing that insurers tell radically different “sales stories” and “claims stories”).

¹⁹⁷ Consumers would also find it impossible to comparison shop on the basis of different insurers' claims-handling practices, as regulators have refused to make insurer-specific data on this — which they collect to facilitate market conduct regulation — publicly available. See Schwarcz, *Regulating Insurance Sales*, *supra* note 46, at 1761.

¹⁹⁸ 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).

¹⁹⁹ See *id.*

²⁰⁰ 86 F.3d 1447.

²⁰¹ See Marotta-Wurgler, *Pay Now, Terms Later Contracts*, *supra* note 173 (reviewing literature); Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WISC. L. REV. 679 (reviewing literature).

²⁰² See Korobkin, *supra* note 180, at 1265; Robert Hillman, *Rolling Contracts*, 71 FORDHAM L. REV. 743 (2002).

availability of policy terms is important to promote consumer choice. Efficiency is not a monolithic concept – different contracts can be efficient for different consumers depending on their preferences and circumstances.²⁰³ This may be particularly true in the insurance context, as consumers exhibit varied degrees of risk aversion and insurance needs vary greatly. Moreover, research suggests that the value of insurance can be quite particular and idiosyncratic.²⁰⁴ Finally, the fact that the insurance policy is the sole “product” that a consumer purchases elevates the presumed importance of individual terms to consumers.²⁰⁵ For these reasons, even if all existing insurance policies were efficient for some consumers, their lack of availability on a pre-purchase basis would nonetheless produce inefficient matching of consumers with policies. Some consumers would purchase coverage more generous than they desire (given the price) and, more importantly, other consumers would purchase coverage less generous than they truly desire.

Second, whereas ordinary rolling contracts are normally accessible on a pre-purchase basis to motivated comparison shoppers, different carriers’ policies are not. In the ordinary rolling contract scenario consumers *could* acquire the contract on a pre-purchase basis if they were so motivated.²⁰⁶ Indeed, in the leading empirical study of rolling contracts, the author was able to collect most of the contracts studied directly from the firms with a simple request.²⁰⁷ This is not surprising: usually, the only reason consumers do not receive the contract on a pre-purchase basis is that something about the purchasing context makes this practically difficult, as in the case of an over-the-phone purchase.²⁰⁸ By contrast, as detailed below, it is essentially impossible even for highly informed and motivated consumers to acquire carriers’ policies on a pre-purchase basis. This distinction is important – one of the key arguments for why rolling contracts do not present distinctive efficiency concerns is that consumers could comparison shop on the basis of differences in terms if they were so inclined.²⁰⁹

Third, the insurance context is distinctive because consumers would face non-trivial costs if they canceled coverage when they received their contract after purchase. Policyholders are usually practically required to maintain homeowners insurance as a condition of their mortgage.²¹⁰ A

²⁰³ In other words, there is no reason to suspect homogeneity in the preferences of consumers generally, much less readers and non-readers. See Gillette, *supra* note 201, at 691.

²⁰⁴ See Daniel Schwarcz, *Regulating Consumer Demand in Insurance Markets*, 3 ERAS. L. REV. 23 (2010) (exploring various influences on consumer demand in insurance markets); 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).

²⁰⁵ See Schwarcz, *Products Liability*, *supra* note 4.

²⁰⁶ See Marotta-Wurgler, *Pay Now, Terms Later Contracts*, *supra* note 167, at 315; Gillette, *supra* note 201, at 691.

²⁰⁷ See Marotta-Wurgler, *Pay Now, Terms Later Contracts*, *supra* note 167, at 315.

²⁰⁸ 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 contract terms).

²⁰⁹ See, e.g., Gillette, *supra* note 201, at 691; Robert Hillman, *Online Boilerplate: Would Mandatory Website Disclosure of E-Standard Terms Backfire?*, 104 MICH. L. REV. 837, 843-45 (2006).

²¹⁰ See Jeffrey E. Thomas, *An Interdisciplinary Critique of the Reasonable Expectations Doctrine*, 5 CONN. INS. L.J. 295, 314 (1998).

consumer who was dissatisfied with a policy she received in the mail could not, therefore, simply cancel coverage. Rather, she would first have to purchase coverage elsewhere. Yet such a consumer would have no basis for determining the relative generosity of alternative insurers' policies. Moreover, purchasing coverage from a new carrier is hardly trivial. The policyholder may already have invested resources in finding an agent and supplying all necessary underwriting information. Unless the initial agent was independent, switching carriers would include the costs of switching agents as well.²¹¹ Once again, this distinctive feature of insurance contracts 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.²¹²

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 heterogeneous. This is true irrespective of whether rolling contracts present unique efficiency risks. At the same time, the lack of pre-purchase availability of policy forms described below raises 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 insurers' policy forms on a pre-purchase basis: through insurers, insurance agents, or state insurance regulators. Each of these is examined in turn.

i. Accessibility of Policy forms through Insurers

An information-seeking consumer might first look to insurers' websites to access copies of policy forms. A thorough review of these websites reveals that such an effort would be fruitless: not a single one of the top twenty homeowners insurers in the nation makes their homeowners policies available online.²¹³ This fact help explain the business model of a website, run by an independent third party, that actually *sells* copies of 91 different policy forms to the public.²¹⁴ To download a single policy, the user must pay \$9.95.²¹⁵

ii. Accessibility of Policy forms through Insurance Agents

Insurance agents are a second potential source of insurance policies. In order to assess whether agents would provide unfamiliar²¹⁶ consumers with policy forms on a pre-purchase basis, twenty randomly selected agents in two states (Minnesota and Pennsylvania) were contacted. Posing as a consumer,

²¹¹ A substantial majority of personal lines insurance products are sold through captive agents. See Schwarcz, *Differential Compensation*, *supra* note 183.

²¹² See, e.g., Gilette, *supra* note 201, at 691; Marotta-Wurgler, *Pay Now, Terms Later Contracts*, *supra* note 167, at 315; Gateway, 105 F.3d at 1149.

²¹³ A Research Assistant exhaustively searched each of these websites, 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.

²¹⁴ See <http://www.uclaim.com/products.asp> (last visited January 4, 2011).

²¹⁵ See *id.*

²¹⁶ Although one might well be able to acquire an insurance policy through one's long time agent, the key question for assessing the possibility of comparison shopping is whether a shopper could acquire copies of policy forms from unfamiliar agents with whom he or she does not have a preexisting relationship.

the caller asked the agents for copies of their homeowners insurance policy form.²¹⁷

These calls suggest that it is very difficult, but not impossible, for an ordinary consumer to acquire homeowners policies from insurance agents. In total, two agents – one from Pennsylvania and one from Minnesota – provided blank homeowners forms.²¹⁸ The other eighteen either explicitly refused to provide 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 the caller’s attempt to compare insurers on the basis of policy forms was misguided, and emphasized that purchasing decisions should be based 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.²¹⁹ Moreover, the vast majority of states require that these filings be made available to the public upon request.²²⁰ 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 state insurance regulators is that regulators often do not have these policies in their records. An assessment by North Dakota’s own personnel determined that its records contained the policies of only two of the top ten homeowners insurers in the state.²²¹ South Dakota’s personnel similarly reported that many of the policy forms of the top ten insurers were

²¹⁷ A research assistant contacted the Minnesota agents whereas the author contacted the Pennsylvania agents. 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 asked if he could obtain a copy of their most popular homeowners form. If asked, he would explain he was a first-time homebuyer, t was not a current customer, and did not have a closing date, purchase agreement, or preapproved mortgage loan.

²¹⁸ The Minnesota agent mailed a copy of a blank form, which did not include the Minnesota mandatory endorsement. The Pennsylvania agent e-mailed a copy of the blank policy form.

²¹⁹ See HOLMES’ APPLEMAN ON INSURANCE § 2.10, *Regulation of Policy Forms* (2d ed. 1996).

²²⁰ In a recent survey of state insurance departments, 89% of respondents reported such a requirement. See Survey, Filing Access Working Group, SERFF (June 30, 2010) (on file with author).

²²¹ See Letter from Larry Musklowski, North Dakota Department of Insurance, to Daniel Schwarcz (May 3, 2010) (on file with author).

not available in their records.²²² 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.²²³ Ohio's records contained policies from only approximately half of the top ten carriers in their state, many of which may not have included mandatory endorsements.²²⁴ Illinois was able to secure partial copies of the policy forms of seven of the top ten carriers in the state, but required a data call to determine which policies were presently in use and to identify mandatory endorsements.²²⁵ A *ten-hour* search at the Minnesota Department of Commerce did not turn up a single "base" insurance policy for any of the top five homeowners insurers in the state. Author correspondences with regulatory officials in Pennsylvania,²²⁶ California,²²⁷ Wisconsin,²²⁸ and Nevada²²⁹ similarly suggested that these states had, at best, quite incomplete copies of insurers' homeowners policy forms on record.

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' form filings, only for a specific period of time – often five years, at which point they are often destroyed. Yet insurers only submit filings to regulators when they change their policy forms. Even more importantly, when insurers change their policy forms, they typically only submit for review the specific language they are altering in their forms, without providing a new copy of the policy form as a whole. 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 insurance departments apparently do not require insurers to note whether filed endorsements are optional or mandatory. As a result, regulators often cannot determine either whether specific amendments are mandatory or whether all of the mandatory endorsements can be accounted for. Many insurers maintain numerous mandatory endorsements that substantially change the terms of their policies.

²²² See Email from Randy Moses, South Dakota Department of Insurance, to Daniel Schwarcz, (May 6, 2010) (on file with author).

²²³ See Email from Curt Wallace, Michigan Department of Insurance, to Daniel Schwarcz, (June 4, 2010) (on file with author). 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.

²²⁴ 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).

²²⁵ See Emails from Kathi Armstrong, Illinois Department of Insurance, to Daniel Schwarcz (May 11, 12; Oct. 13).

²²⁶ See Emails from Carolyn Morris, Pennsylvania Department of Insurance, to Daniel Schwarcz (June 18-23) (on file with author).

²²⁷ See Telephone Interview with Joel Laucher, California Department of Insurance (May 13, 2010).

²²⁸ See Emails from Roger Frings, Wisconsin Department of Insurance, to Daniel Schwarcz (April 21, 2010) (on file with author).

²²⁹ See Emails from Gennady Stolyarov, Nevada Division of Insurance, to Daniel Schwarcz (August 20, 2010) (in file with author).

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.²³⁰ Outside of these four states, filings can be accessed in one of two ways. Often, one must either physically visit the insurance department or hire a private company to do so.²³¹ Alternatively, in some states, a consumer can obtain copies of policies by submitting a request for records directly to regulators.²³² Departments typically charge a per-page copying fee, an hourly fee, or both to fulfill such requests.²³³

However a regulator's records are accessed, they are incredibly difficult to search. Insurers' filings are almost universally contained in an electronic filing system known as SERFF.²³⁴ This system is very poorly designed from the standpoint of retrieving specific filings.²³⁵ 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, or base forms. In order to determine the content of a filing, the searcher must therefore click on the document link. Similarly, while searches can be limited to a specific company, a single insurance group typically has numerous insurance companies licensed to do business in a state.²³⁶ Consumers often do not know which of these companies is providing their insurance. Although departmental employees and private companies may be familiar with SERFF, pulling up desired forms can still take a significant amount of time (and 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. None of this is surprising: SERFF was designed only to facilitate the electronic submission of filings, not public records searches.²³⁷

²³⁰ SERFF Survey, *supra* note 220.

²³¹ 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).

²³² For instance, this was true in Illinois, Michigan, and Ohio.

²³³ For instance, in Michigan labor costs were \$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) (on file with author); N.D.C.C. § 44-04-18.10.

²³⁴ See <http://www.serff.com>.

²³⁵ 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.").

²³⁶ Only a subset of these companies may be licensed to provide homeowners insurance. Similarly, only some of these companies may be issuing new policies.

²³⁷ See *Information from Filings*, *supra* note 235.

2. Consumer Comprehension of Policy Forms

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,²³⁸ 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 a policy containing unusually broad exclusions might well cancel coverage or inform neighbors or friends of his dissatisfaction with the company. This, in turn, could exert a disciplining force on insurers and limit large mismatches between a consumer's preferences and the insurance they actually purchase.

Yet every facet of the post-purchase delivery of policy forms inhibits consumer comprehension of the coverage that is purchased. First, insurers typically mail the entire policy to consumers shortly after purchase, sending only a copy of the declarations pages at renewal.²³⁹ Consequently, the sole instance when consumers usually receive their policies is several weeks after purchase. This is likely to be a stressful and busy time for many consumers, when they are purchasing a new home and/or moving to a new geographic region.²⁴⁰ Under such circumstances, few consumers will devote substantial attention to reading the fine print of their insurance policies.²⁴¹

Second, even motivated consumers are ill-equipped to comprehend the meaning of typical homeowners policies, which are, in many ways, uniquely impenetrable.²⁴² Consider the basic structure of the property coverage provided by a typical homeowners policy.²⁴³ 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,²⁴⁴ 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; (ii) the peril that damaged the property must be described in the "Perils Insured Against" section; (iii) no provision from the

²³⁸ See Part III.A. *supra*.

²³⁹ Some insurers, such as Allstate, allow policyholders to access copies of their own policies online.

²⁴⁰ See Schwarcz, *Consumer Dispute Resolution*, *supra* note 159, at 744.

²⁴¹ See Korobkin, *supra* note 180, at 1226.

²⁴² Although many consumer contracts are hard to understand, insurance policies are often singled out as being uniquely indecipherable. See generally Boardman, *Allure of Ambiguous Boilerplate*, *supra* note 32, 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").

²⁴³ See Professor Daniel Schwarcz, Testimony to NAIC Readability Committee (March 2010); Professor Brenda Cude, Testimony to NAIC Readability Committee (March 2010); Amy Bach, Executive Director of United Policyholders, Testimony to NAIC Readability Committee (March 2010); *available at* http://www.naic.org/documents/committees_d_ccwg_100328_testimony_consumer.pdf.

²⁴⁴ Most policies have these terms under headings such as "Section I – Property Covered," "Section I – Perils Insured Against," etc. These policies would be much clearer if the headings read: "Section I.A. Property Covered," "Section I.B Perils Insured Against" etc. While a small example, this illustrates a much larger point.

“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 property damage, the policyholder must understand the relationship among six different portions of the contract.²⁴⁵

Insurance policies are also indecipherable because they rely on verbose and confusing grammatical structures and word choices.²⁴⁶ To be sure, many states require insurance policies to meet minimum “readability” scores, which are based on objective, quantitative metrics.²⁴⁷ The typical requirement is that insurance contracts score 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 eighth-grade level and college graduates typically read at the tenth grade level.²⁴⁸ 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.²⁴⁹ 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 identify questionable coverage decisions.

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

Various forms of information can proxy for the generosity of an insurer’s coverage. For instance, an insurer that never paid claims would presumably soon find a corresponding number of customers. This Section explores various potential informational proxies for the relative generosity of carriers’ policy terms. It provides preliminary evidence that various informational proxies, including insurance agents, marketing materials, and

²⁴⁵ For further elaboration of this point, see Daniel Schwarcz, Testimony to NAIC Readability Committee (March 2010) (noting, among other things, that the conditions sub-section of policies contains various provisions that are not conditions, various exclusions are contained outside of the exclusions section, and the logical structure of the contract is inconsistent).

²⁴⁶ See generally Boardman, *Allure of Ambiguous Boilerplate*, *supra* note 32, at 1107.

²⁴⁷ See Cude Testimony, *supra* note 243; 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.”).

²⁴⁸ CECILIA CONRATH DOAK, LEONARD G. DOAK, & JANE H. ROOT, *TEACHING PATIENTS WITH LOW LITERACY SKILLS* (2d ed. 1996).

²⁴⁹ Boardman, *Allure of Ambiguous Boilerplate*, *supra* note 32, at 1107 (“[T]he insurers' audience from start to finish is the courts, a practice that leaves policyholders by the wayside, and one that courts unwittingly encourage.”).

general reputation do a poor or limited job of informing consumers of potential differences in policy form generosity.

1. Information from Agents

The most important informational proxy that consumers have for the content of their policies is their insurance agent.²⁵⁰ 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.²⁵¹ 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.”²⁵²

In order to gather some preliminary empirical evidence about the accuracy of this claim, eleven insurance agents in four different states were interviewed. Five interviews were conducted in person with Minnesota insurance agents, with the remaining six interviews conducted over the phone with non-Minnesota agents.²⁵³ 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.²⁵⁴ Many agents initially agreed to be interviewed, but later declined after receiving an IRB disclosure form. In several cases, agents explained that they were explicitly instructed by their affiliated insurer not to be interviewed.

Interviews were semi-structured, centering around two ways that agents might promote consumer knowledge about differentials in coverage generosity. First, agents might directly inform consumers of the importance of comparison-shopping based on differences in policy generosity. To assess this, agents were questioned about whether they believed that carriers’ policy forms differed in their generosity. 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, agents were asked various questions regarding the coverage provided by the policy forms they sold, with a focus on coverage issues described in Part II.A. With respect to both issues, agents were

²⁵⁰ See Schwarcz, *Products Liability Theory*, *supra* note 4, at 1415-16.

²⁵¹ See Schwarcz, *Differential Compensation*, *supra* note 183, at 727-29.

²⁵² Schwarcz, *Products Liability Theory*, *supra* note 4, at 1416; *see also* Abraham, *supra* note 3, at 56.

²⁵³ Most of the non-Minnesota agents were located in Illinois. However, I also interviewed a Nevada agent and a Pennsylvania agent.

²⁵⁴ 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. For this reason, the agents interviewed were likely not representative. But selection effects likely resulted in agents who were more confident in their knowledge base, thus only enhancing the findings described above.

asked how often these issues came up in discussions with consumers shopping for coverage.

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 HO3 policy.²⁵⁵ Among these, several did suggest that an individual carrier could add “bells and whistles” onto the standard HO3 policy, such as identity theft. Two of the remaining captive agents indicated uncertainty about whether carriers’ policies differed.²⁵⁶ These agents both explained that they were only familiar with their own carriers’ coverage and that they had not examined other carriers’ policies. Finally, the remaining two captive agents indicated that there were indeed differences in carriers’ policy language, but that they did not know what those differences were.²⁵⁷

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 decision-making among different carriers.²⁵⁸ 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.”²⁵⁹

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 detailed questions about policy language involved claims issues rather than sales issues.²⁶⁰ One such agent explained “I know just enough to be dangerous, but that’s all the insurance company wants me to be.”²⁶¹ 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.”²⁶²

²⁵⁵ 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).

²⁵⁶ Interview with Agent 5 (MN); Interview with Agent 7 (IL).

²⁵⁷ Interview with Agent 8 (IL); Interview with Agent 9 (IL).

²⁵⁸ Interview with Agent 5 (MN); Interview with Agent 7 (IL).

²⁵⁹ Interview with Agent 7 (IL).

²⁶⁰ See Baker, *Claims Stories*, *supra* note 196.

²⁶¹ Interview with Agent 6 (IL).

²⁶² Interview with Agent 9 (IL).

The three independent agents I interviewed varied substantially in their knowledge of different carriers' policy forms. On one end of the spectrum, one independent agent was quite knowledgeable about policy language variation in the homeowners market.²⁶³ This agent, whose clientele were wealthy individuals typically referred by financial advisors, explained that the policy forms of "high end" companies are usually systematically better than the standard HO3 forms. Indeed, he said 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 carriers provided. This agent indicated familiarity with a broad range of issues, including concurrent causation and mold coverage. He stated that the high-end companies tend to match one another in terms of coverage terms.

The second independent agent similarly explained that carriers' forms differ in important ways with respect to their basic design.²⁶⁴ 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 policies that he sold differed in specific policy language and 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 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 policy language. This agent indicated lack of familiarity with many of the issues canvassed in Part II, repeating the explanation that these involved claims issues rather than sales issues.

Of course, these interviews are only suggestive given the limited number conducted and the semi-structured, qualitative methodology employed. At the very least, though, they provide strong reason to suspect that the information available from many insurance agents is not sufficient to allow consumers to comparison shop on the basis of differences in policy language.²⁶⁵ An exception appears to be that independent agents serving high end clients may specifically emphasize the generosity of certain insurers' policies in steering their customers.²⁶⁶

²⁶³ Interview with Agent 1 (MN).

²⁶⁴ Interview with Agent 4 (MN).

²⁶⁵ See also Boardman, *Insuring Understanding*, *supra* note 4, at 1093-98; Baker, *Claims Stories*, *supra* note 196.

²⁶⁶ This is consistent with the finding that carriers with the worst forms employ a captive distribution system whereas carriers with better forms tend to employ an independent distribution system. See Part II.B, *supra*.

As I have explored at length in earlier work, however, even independent insurance agents who are informed about differences in carriers' policies are not properly incentivized to fully inform consumers about these differences.²⁶⁷ Such agents typically receive different amounts of compensation based on the insurers to which they refer policyholders. 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. Nuanced differences in policy language among different carriers are precisely such an issue.

2. Information from Insurers

Not surprisingly, insurers' marketing materials reflect the same basic information that agents provided.²⁶⁸ A comprehensive review of these materials is beyond the scope of this article.²⁶⁹ But to get a preliminary sense of these insurers' marketing materials, the websites of the top twenty homeowners insurers nationally were reviewed for explanatory materials regarding the coverage details of homeowners insurance.

Although the sampled websites differed substantially with respect to the specificity of information available about the content of homeowners coverage, none of them explained coverage with sufficient specificity to allow for cross-company comparison.²⁷⁰ The best websites provided a good amount of basic information about homeowners policies generally, such as 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.²⁷¹ Some websites

²⁶⁷ See Schwarcz, *Differential Compensation*, *supra* note 183; Daniel Schwarcz, *Beyond Disclosure Beyond Disclosure: The Case for Banning Contingent Commissions*, 25 YALE L. & POL'Y REV. 289 (2007).

²⁶⁸ Schwarcz, *Products Liability Theory*, *supra* note 4, at 1419 (describing role and importance of marketing information).

²⁶⁹ For a good, recent review of insurers' marketing, 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").

²⁷⁰ 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 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).

²⁷¹ 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

explain whether a specific loss would or would not be covered.²⁷² 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.²⁷³

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."²⁷⁴ Along these lines, another insurer promises simply that it provides "Broad, flexible protection for your home, possessions and YOU!"²⁷⁵ These websites often make generalizable statements such as "[w]e protect the roof over your head 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."²⁷⁶

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 contains "50 Xtra features" and lists seven of them.²⁷⁷ 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.²⁷⁸ A quick Google search for this company pulled up marketing material that describe in more detail the various ways in which the company's policy is more generous than the standard HO3 form.²⁷⁹ In sum, insurers' marketing materials largely matched the limited information that was available from insurance agents.

coverage "may" protect the insured against, including "[l]iability to others such as sports activities" and "[a]cts of pets." See 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.

²⁷² See, e.g., www.metlife.com; www.libertymutual.com. The FAQ in the Liberty Mutual website includes a lot more details as to what the policy covers (the questions detail coverage for bursting pipes, freezing pipes, vandalism, living expenses, damaged trees, debris removal, and items not covered by the personal property coverage). See *id.*

²⁷³ See, e.g., www.travelers.com.

²⁷⁴ See, e.g., www.farmers.com.

²⁷⁵ See, e.g., www.auto-owners.com.

²⁷⁶ See, e.g., www.statefarm.com.

²⁷⁷ See 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.*

²⁷⁸ See www.chubb.com.

²⁷⁹ See Chubb Marketing Material, available at

<http://www.mullerinsurance.com/resources/ChubbHomeownerComparison.pdf>

accessed 1/18/11).

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3. Information from Regulators

Only one state provides its consumers with any information at all regarding the relative generosity of different carriers' policy forms. The Texas Office of Public Insurance Council ("OPIC) – an independent agency charged with representing Texas consumers as a class regarding insurance-related issues²⁸⁰ – maintains an excellent website that allows consumers to compare the coverage that different insurers provide along twenty-one pre-specified dimensions.²⁸¹ Unfortunately, even this website only partially and imperfectly captures differences in carriers' policies, and it does not provide consumers with the capacity to actually acquire different companies' forms on a pre-purchase basis.

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, whose sole mission is to protect insurance consumers' interests.²⁸² 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.²⁸³ In response to a perceived mold crisis, the state overhauled its system for regulating insurers, allowing them to complete freedom to customize their policy forms. In response to this sudden and publicly visible change in the regulation of homeowners policy forms OPIC established its website for the comparison of policy forms.²⁸⁴

Most insurance regulators do provide consumers with company-specific consumer *complaint* information. Although this information continues to be inconsistent and difficult to interpret, ongoing reforms may make this information more accurate and reliable.²⁸⁵ But even so, complaint data is a 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.²⁸⁶ And while a company's deficiencies in claims handling may correlate to the generosity of its coverage, it will also capture many other variables as well.

4. Reputation and Price 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

²⁸⁰ 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. OPIC was created by Tex. Ins. Code Ann. § 501, et seq. For discussion of the value that institutions such as OPIC can provide in the regulatory Process, see McDonnell & Schwarcz, *Regulatory Contrarians*, *supra* note 12.

²⁸¹ See <http://www.opic.state.tx.us/hoic.php>.

²⁸² See McDonnell & Schwarcz, *Regulatory Contrarians*, *supra* note 12.

²⁸³ 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>.

²⁸⁴ See *id.*

²⁸⁵ See Schwarcz, *Redesigning Dispute Resolution*, *supra* note 159, at 756.

²⁸⁶ See *id.*

of coverage.²⁸⁷ But carriers' reputations are an imperfect proxy for the quality of their coverage, as insurance is a classic "credence good," meaning that most consumers cannot evaluate its quality even after purchase.²⁸⁸ This is for two reasons: most insureds do not experience a large claim at all (protection against which is the most important feature of insurance) and, even when they do, they are ill equipped to evaluate the "quality" of an insurers' response.²⁸⁹ It is perhaps for these reasons that insurers spend so much on establishing their reputation through advertising.²⁹⁰ An additional limitation of reputation is that it is unlikely to discourage insurers from employing terms that afford them substantial *discretion* to deny claims.²⁹¹ 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 an insurance contract 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 is price, as consumers can often reasonably assume that products that cost more are also higher quality.²⁹² Not so insurance markets.²⁹³ Insurance is unique in that its price 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 may be more reflective of differences in those companies' underwriting methodologies than differences in the quality of the underlying products that consumers purchase.

IV. Implications and Recommendations

The practical and theoretical implications of Parts II and III of this Article are wide ranging. This Part considers several of the most significant of these implications. First, and perhaps most obviously, insurance regulators must act quickly to substantially improve the transparency of insurance policy terms in personal lines markets. In fact, there is a strong argument that lawmakers should respond to present market conditions by mandating standardized policy forms to reduce information costs to consumers. These issues are discussed in Part A. Part B then considers the implications of this

²⁸⁷ Path dependence and the prospect of regulatory scrutiny are also important potential explanations.

²⁸⁸ See generally Richard Craswell, *Interpreting Deceptive Advertising*, 65 B.U.L. Rev. 657, 720-25 (1986) (providing overview of credence goods). 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 159, 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).

²⁸⁹ See Korobkin, *supra* note 180, 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.").

²⁹⁰ See Boardman, *Insuring Understanding*, *supra* note 4, at 1093-98.

²⁹¹ As argued earlier, such discretion is particularly troubling in insurance, yet is increasingly found in deviate policies. See Part II.A, *supra*.

²⁹² See CASS SUNSTEIN & RICHARD THALER, *NUDGE* 78 (2008) ("Most of the time, Competition ensures that price serves as a good signal of quality").

²⁹³ *But cf. id.* (suggesting that price may be a reasonable proxy of quality in some insurance markets).

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.²⁹⁴ 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.²⁹⁵ 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. Finally, transparency helps to deter overreaching by firms because it increases the chance of being exposed in the future.

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.²⁹⁶ If this Working Group is to successfully modernize insurance regulation to reflect current market conditions, it must avoid easy, but ineffective, solutions. For instance, evidence suggests that simple disclosure mandates are typically not effective in remedying market problems.²⁹⁷ While disclosure may nonetheless be desirable for non-consequentialist reasons, a mere disclosure mandate 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.²⁹⁸ There is recent precedent for such an approach, as the Credit Card Act of 2009 required credit card issuers to publish

²⁹⁴ See Part II.B., *supra*.

²⁹⁵ See Schwartz & Wilde, *supra* note 198.

²⁹⁶ See Introduction, *supra*.

²⁹⁷ 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).

²⁹⁸ Cf. Hillman, *supra* note 209. 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*.

on the internet their cardholder contracts.²⁹⁹ 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.³⁰⁰ 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 might consider requiring 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 HO3 baseline.³⁰¹ They should be tested for effectiveness and agents 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.³⁰² 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.³⁰³

²⁹⁹ Credit Card Act of 2009, Pub. L. No. 111-24, § 204, 123 Stat. 1734, 1736 (2009). The Act also requires card companies to submit their contracts to the Board of Governors of the Federal Reserve System which much then be made available via a public website. *Id.*

³⁰⁰ *See* Part III.B, *supra*.

³⁰¹ *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.")

³⁰² *See* Boardman, *Allure of Ambiguous Boilerplate*, *supra* note 32, at 1107

³⁰³ *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.").

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.”³⁰⁴ 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.”³⁰⁵ 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.³⁰⁶

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 sensible for regulators to impose mandatory floors on homeowners policies in much the same way they historically did with fire insurance policies.³⁰⁷ 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.³⁰⁸ The lack of a coverage floor in these states is therefore attributable to 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 reforms can allow consumers to make fully informed comparisons regarding the quality of different carriers’ policies. To the extent that industry impedes genuine transparency, regulators shy away from comprehensive reform, or informed consumer decision-making proves impossible given cognitive limitations and the complexity of the underlying contractual documents, then mandatory minimum floors may be an effective second-best solution.³⁰⁹ 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, while the findings in this article provide reason to suspect such inefficiencies in the current marketplace, further research and evaluation is needed before conclusions on this issue can be reached.³¹⁰

³⁰⁴ 29 USCS § 1024 (b)(1).

³⁰⁵ 29 U.S.C. § 1022(a).

³⁰⁶ *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.”).

³⁰⁷ *See* Part I, *supra*.

³⁰⁸ *See, e.g., Watson v. USAA*, 566 N.W.2d 683 (1997) (reprinted in BAKER, *supra* note 15, at 322-327).

³⁰⁹ *See* Abraham L. Wickelgren, *Standardization as a Solution to the Reading Costs of Form Contracts* (draft on file with author).

³¹⁰ *See* Part II, *supra*.

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.³¹¹ Insurers would then be free to offer consumers a company-specific package of amendments to this policy in exchange for an increase or decrease in premiums.³¹² Empirical studies have repeatedly shown that individuals generally tend to stick with defaults.³¹³ 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.³¹⁴ By requiring that insurers only offer company-specific provisions in the form of optional 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.³¹⁵ 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

³¹¹ See generally SUNSTEIN & THALER, *supra* note 292, at 103-116 (exploring the importance of defaults generally); Schwarcz, *Regulating Consumer Demand*, *supra* note 204, at 38-45 (exploring a range of libertarian paternalistic interventions in insurance markets, including setting defaults consistent with the prescriptions of Expected Utility Theory).

³¹² Cf. Sharon Tennyson, *Rethinking Consumer Protection Regulation in Insurance Markets*, Networks Financial Institute Policy Brief 10-11 (Sept. 2010) (suggesting that regulators restrict product approval to a narrow range of “plain vanilla” products, require insurers to offer these products, but also allow insurers to offer additional products not subject to regulatory review, subject to clear disclosure).

³¹³ See Schwarcz, *Regulating Consumer Demand*, *supra* note 204, at 44-45.

³¹⁴ See *id.*

³¹⁵ 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).

develop a products liability framework for understanding how and why courts should depart from the unambiguous language of insurance policies.³¹⁶ 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.”³¹⁷ 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.³¹⁸ Although the indeterminacy of this doctrine has been criticized by numerous scholars,³¹⁹ one effective way to operationalize it in practice would be to 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.³²⁰

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.³²¹ 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 substantive unconscionability can be offset by large degrees of procedural unconscionability.³²²

³¹⁶ 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).

³¹⁷ Schwarcz, *Products Liability Theory*, *supra* note 4, at 1441.

³¹⁸ See Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 *Harv. L. Rev.* 961 (1970);

³¹⁹ 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 210; Schwarcz, *Products Liability Theory*, *supra* note 4, at 1426-35.

³²⁰ 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”).

³²¹ 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).

³²² See Hillman, *supra* note 209, at 854.

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.³²³ 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.³²⁴ 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.³²⁵ Less cynically, it may be that consumer ignorance means that regulators are not particularly likely to learn about this issue, as regulators often rely on consumer complaints to identify market problems.³²⁶

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 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.³²⁷

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. Most importantly, it provides some empirical evidence of potentially

³²³ See Jackson, *supra* note 297.

³²⁴ See Hamilton, *supra* note 303 (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).

³²⁵ See McDonnell & Schwarcz, *Regulatory Contrarians*, *supra* note 12.

³²⁶ See Schwarcz, *Consumer Dispute Resolution*, *supra* note 159, at 753.

³²⁷ See McDonnell & Schwarcz, *Regulatory Contrarians*, *supra* note 12 (discussing the various reasons why financial regulators have difficulty evolving along with the markets they regulate).

inefficient terms in standard form contracts. Of course, as emphasized in Part II, the evidence collected is both indeterminate and contestable, requiring further study and debate before conclusions regarding the efficiency of deviant contracts can confidently be assessed. Nonetheless, even the preliminary and tentative evidence of contract inefficiencies presented herein is significant, given the dearth of empirical evidence on standard form contracts in the literature.

The Article may also have some implications for the theoretical literature on standard form contracts. First, it suggests that this literature may have under-appreciated the extent to which mass segmentation of consumers among different firms can undermine the efficiency of standard form contracts.³²⁸ 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.³²⁹

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.³³⁰ One striking feature of the results reviewed in Part II is that insurers' downward deviations in coverage are typically complicated and difficult to explain, in many cases requiring deep familiarity with insurance law.³³¹ By contrast, the marketplace seems to continue to embrace uniformity with 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 may be that these terms are easy to understand – if one policy covered loss due to lightning or theft, but another did not, consumers would eventually learn about this fact.³³² Indeed, many of the insurer websites samples above specifically listed each of the covered perils for personal property.³³³

A final implication of this study is that, with respect to standard form contracts, context matters.³³⁴ Some markets may work well in protecting

³²⁸ See Schwartz & Wilde, *supra* note 198, 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*.

³²⁹ See Part II, *supra*.

³³⁰ See Korobkin, *supra* note 180, 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.

³³¹ See Part II.A, *supra*.

³³² See Korobkin, *supra* note 180, 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.”).

³³³ See Part III, *supra*.

³³⁴ See Bar-Gill, *supra* note 180.

consumers from exploitation through standard form contracts.³³⁵ 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.³³⁶ 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 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.

³³⁵ See Richard Epstein, *The Neoclassical Economics of Consumer Contracts*, 92 MINN. L. REV. 803 (2008).

³³⁶ See, e.g., Marotta Wurgler, *Standard Form Contract Quality*, *supra* note 173; 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).