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When Enough Is Not Enough: Correcting Market Inefficiencies In The Purchase And Sale Of Residential Property Insurance

Kenneth S Klein, California Western School of Law

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Abstract

Each year at least hundreds, and often thousands of Americans lose their homes to natural disasters striking populated areas, and tens of thousands lose their homes to single-instance fires, floods, or other catastrophes. A recurring storyline is that the majority of these homeowners are underinsured, meaning they have less insurance than it will cost to rebuild their homes. This Article analyzes whether that is indicative of correctible inefficiencies in the residential property insurance markets. The Article identifies two inefficiencies – (1) Inadequate information, which is impairing informed pricing decisions by purchasers; and (2) Dispute costs (such as litigation) in the instances of loss exceeding coverage. The Article proposes addressing these inefficiencies by adopting a mandatory disclosure, provided at time of purchase or renewal of insurance, based on the EnergyGuide program labeling appliances for energy consumption, and coupling the adoption of that disclosure with a litigation bar on adequacy of coverage.
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WHEN ENOUGH IS NOT ENOUGH: CORRECTING MARKET INEFFICIENCIES IN THE PURCHASE AND SALE OF RESIDENTIAL PROPERTY INSURANCE

by Kenneth S. Klein

I. Introduction

If you own a home, ask yourself, if your home burned down tomorrow, would you have enough insurance to rebuild. One of the recurring stories in the wake of natural disasters is that for a large number of Americans, they think the answer is “yes,” but they learn the answer is “no.” This Article analyzes whether that is indicative of correctable market inefficiencies.

1 Associate Professor of Law, California Western School of Law. This paper was written with the support of a research stipend from California Western School of Law. As always, the Author extends thanks in the writing of this Article to his editor, colleague, and wife, Professor Lisa Black. The Author also appreciates the invaluable assistance and input of the staff of the CWSL Library; his research assistants, Jared Hestetune and Jihan Younis; his professional academic colleagues, Professor Mitch Crusto, Professor Donald Smythe, Professor Theodore Klasterin, and Professor Ed Dauer; his attorney colleagues in the policyholder advocacy community, Amy Bach and Karen Reimus; and his brother who works in the insurance industry, Jonathan Klein.


3 Economics does not use the jargon of a working or failing market, but rather classifies markets as efficient or inefficient. Inefficient markets are ones unnecessarily burdened with external costs or risks, such as a cost or risk that could be eliminated with a solution costing less than the risk or cost itself, or a transactional cost or risk allocated to a party inadequately apprised of the allocation and thus without a reasonable opportunity to account for the risk or cost when negotiating the transaction price. See, e.g., Farlex, The Free Dictionary, Financial Dictionary, http://financial-dictionary.thefreedictionary.com/Inefficient+Market (“A market where prices do not always reflect available information as accurately as possible. Inefficient markets may result from a lag in information transferring to one place to another, deliberate withholding of information by an insider, or other reasons.”); accord, Freeman v. Laventhal & Horwath, 915 F.2d 193, 198 (6th Cir. 1990) (“An inefficient market, by definition, does not incorporate into its price all the available information about the value of a security. Lipton v. Documation, Inc., 734 F.2d 740, 746 (11th Cir.1984), cert. denied, 469 U.S. 1132 (1985); Reingold, supra, 599 F.Supp. at 1264.”).
In the wake of natural disasters in populated areas, insurance companies can incur billions of dollars of exposure on property claims, and homeowners can incur hundreds of millions of dollars of uninsured losses. Hurricane Katrina alone resulted in roughly 18 billion dollars of insured losses. Across the United States in the single year of 2007, 41,000 homeowners lost their homes to disaster. That same year the average home was worth roughly $191,500, and ~40% of those homes were underinsured by an average of ~20%. If all 41,000 homes lost to disaster were insured, then even assuming the cost to rebuild is the same, not more, than the appraised market value of a home (a questionable assumption), this equates to $628,120,000 in uncovered disaster losses to insured homes in a single year. The October and November 2007 Southern California firestorms alone resulted in 1732 total loss residential claims.

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6 June 16, 2009 email from Gary Kerney to Jihan Younis (copy on file with author).


9 PETER M. WELLS, INSURING TO VALUE: MEETING A CRITICAL NEED (2nd ed.) at 46 (2007).

10 California Department of Insurance, Estimate of Summary Loss Data Resulting from the October and November 2007 Southern California Fires, Data as of December 20, 2008. This surely resulted in some homeowners never being able to rebuild. For insurers, the likely consequences are less severe. Insurance Services Office, Managing Catastrophe Risk, May 1996, at 4 (“Large catastrophes are rare; therefore, an insurer that does not have high catastrophe limits is likely to survive.”). Perhaps in recognition of the disparate impact of underinsurance on homeowners and insurers, industry spokesperson may minimize the frequency of underinsurance. David Lazarus, Underinsured wildfire victims feel burned again when coverage comes up short, Los Angeles Times, Nov. 19, 2008, at C1 ( “‘It happens, but it doesn’t happen as often as you might see in the media.’”).
the subset of homeowners who lost their homes to the October 2007 wildfires in San Diego reported the average amount of underinsurance at $240,000.11

Based on data such as this, the media assumes and asserts that the insurance market somehow is “broken,” which apparently is a colloquial, intuitive conclusion that the expected market mechanisms have failed in an unspecified manner.12 But if a rational, adequately informed13 buyer and seller agree to a particular level of insurance coverage at a particular price, in an arm’s-length negotiation, that is an efficient transaction without regard to financial consequences later for one party or the other.14 “Underinsurance” -- instances when the amount of coverage is less than the insurable value of the home -- is not, in and of itself, indicative of market inefficiency; for example, a rational homeowner who has adequate information concerning home value and the cost of insurance and who has a highly remote likelihood of a significant loss might intentionally and correctly purchase less than full insurance.

This Article will step away from the ex post facto accusations and pejorative characterizations surrounding insurance and underinsurance in the wake of mass loss, and analyze the market for actual inefficiencies susceptible of reform.15 The conclusion reached will be that the residential insurance markets are structured to give an incentive to undervalue the cost to rebuild a home,

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11 United Policyholders, http://unitedpolicyholders.org/survey/surveyresults.html. The complete data set is on file with the author. Obviously, the value of these homes was substantially above the national average.


13 The terminology “adequately informed” recognizes that the law may impose a limitation or allocation of risk through contractual disclosures that are not “full” or “perfect.” See generally, MARK GEISTFELD, The Political Economy of Neocontractual Proposals For Products Liability Reform, 72 TEX. L. REV. 803 (1994).

14 See, Burkhardt v. Bailay, 680 N.W.2d 453, 464 (Mich. Ct. App. 2004) (“the bedrock principal of American contract law [is] that parties are free to contract as they see fit, and the courts are to enforce the agreement as written absent some highly unusual circumstance, such as a contract in violation of law or public policy.”).

15 This Article will not address the related topic of how to address intentional or negligent misconduct by agents or brokers.
and that insurance policies mask both the possibility of undervaluation and the allocation between homeowner and insurer of the risk of undervaluation. Simply put, many homeowners do not know how much it would cost to rebuild their homes, do not know that they are underinsuring their homes, and do not know that if they lose their homes, courts may say that their lack of insurance is their own fault. The result is confusion in the pricing of coverage, and litigation in the event of loss. These are, broadly speaking, market inefficiencies resulting from inadequacy of information.

In seeking to address these inefficiencies, this Article builds on the work on Professors Daniel Schwarcz and Jeffrey Stempel, who argue that insurance is more properly thought of as a product, rather than a contract.16 This Article applies that approach to residential property insurance as a means to address the otherwise heretofore seemingly intractable problem of adequate information disclosures in determining the insured value of a home.17

Section II of this Article broadly will describe the market structure of the purchase and sale of residential property insurance, reviewing the theoretical incentives for both buyers and sellers either to fully insure or to underinsure, and identify two inefficiencies in the conveyance of adequate information – both concerning the adequacy of coverage. Section III briefly will survey the historical and extant regulatory and judicial responses to adequacy of coverage disputes. Section IV proposes a regulatory reform of the insurance markets. Section V makes the case for the proposal of Section IV. Section VI addresses anticipated criticisms of the proposal of Section IV.

II. The Prevalence of Residential Underinsurance as a Result of Market Inefficiency

A. THE SIZE OF THE RESIDENTIAL PROPERTY INSURANCE MARKET

As this Section will develop, the residential property insurance market has 50,000,000+ captive customers, each of whom on average must have at least $100,000 of residential property insurance. This is because anyone who has a mortgage must have mortgage insurance at least up to the amount of the outstanding principle of the mortgage. Of course, people also may


17 This Article comes with a caveat. Of necessity, this Article touches upon issues of highly theoretical economics. The Author is not an economist, and is ill-suited to evaluate the highly sophisticated theorems of insurance pricing, behavior, and market structure developed in nuanced economic models. See, e.g., GEORGES DIONNE, HANDBOOK OF INSURANCE (Kluwer 2000). Rather, this Article seeks to provide the platform for sensible legal regulatory reform of the residential property insurance markets, based on observable market behavior. This Article indeed often relies on the words of insurers and homeowners themselves in describing their decisions and perceptions.
voluntarily insure, and may insure for more than their mortgage balance. Measured by annual premiums, it is a multi-billion dollar market.

In 2007 (the most recent year for which nationwide Government data is available), there were 75,647,000 owner-occupied homes in the United States. Of these, 48,742,000 of these homes had a regular and/or home equity mortgage. Indeed, 12,588,000 owner-occupied homes had two or more mortgages. In 2007, 24,631,000 owner-occupied homes included the cost of property insurance as part of their primary mortgage payment (almost certainly, in most if not essentially all of these instances, this occurred because the homeowner had insufficient initial equity and so a condition of the loan was the creation of monthly payment-funded escrows for insurance premiums, taxes, and so-called purchase-money insurance).

Because of the structure of the secondary markets in mortgages, having a mortgage equates to having homeowner’s insurance. The standard covenants for mortgages can be found today on the websites of Fannie Mae and Freddie Mac. Each exemplar includes the requirement that a mortgagee maintain hazard insurance on a home “in the amounts (including deductible levels) and for the periods that Lender requires.”

The consequence is that the insurance industry has a captive market of at least 50,000,000 customers. At least 48,742,000 homes are required to have insurance by the explicit terms of

22 In 1970, Congress created the Federal National Mortgage Association (FNMA, which today is popularly nicknamed Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC, which today is popularly nicknamed Freddie Mac). Emergency Home Finance Act of 1970, 12 U.S.C. §§ 1713, 1717 (1970). The purpose of these entities was to “establish a secondary market for conventional mortgages, primarily single family homes.” RAYMOND A. JENSEN, Mortgage Standardization: History of Interaction of Economics, Consumerism and Governmental Pressure, 7 REAL. PROP. PROP. & TR. J. 397, 399 (1972). “[T]he policy decision was made by the two corporations that the first order of business must be the development of a standard mortgage form.” Id.
mortgage. The duty of a mortgagee to have insurance can exist independently of the explicit terms of the mortgage.\textsuperscript{25} And, of course, a homeowner may opt to purchase home insurance without a legal or contractual requirement to do so.

Most residential insurance has a stated cap, or limit, on the available proceeds to respond to a total loss. Put another way, residential property insurance usually is not a “guaranteed replacement” policy (a policy that pays for the rebuilding of a home regardless of cost).\textsuperscript{26}

If an insurance policy is not “guaranteed replacement,” the amount of coverage may be, but is not necessarily “full,” meaning that the coverage amount will be the entirety of the approximated cost of rebuilding the home. Even in the instances of a mortgaged home with mandated insurance, the insurance purchase transaction will involve some latitude about the percentage of coverage relative to the cost to rebuild the insured home in the instance of total loss. While residential insurance protects the largest asset most consumers ever will own,\textsuperscript{27} a mortgage does not require the homeowner to fully insure, but rather requires the mortgagee to insure up to the outstanding principal of the loan.\textsuperscript{28}

The outstanding principal of the mortgage(s) on a home typically is less than the value of the home. In 2007, the national median value of an owner-occupied home was $191,471.\textsuperscript{29} In 2007,
the median outstanding principal on mortgages of owner-occupied homes was $100,904.30 Even in the heart of the 2009-2010 “sub-prime mortgage crisis,” analysts calculated that roughly 75% of homes had value exceeding the outstanding principal of any loans/mortgages against the property.31 The National Association of Insurance Commissioners calculates that in 2006, “Dwelling Fire and Homeowners Owner-Occupied” insurance policies covered over 60 million homes and accounted for over $48 billion in premiums.32

B. THE THEORETICAL INCENTIVES OF HOMEOWNERS AND INSURERS WHEN DETERMINING THE AMOUNT OF RESIDENTIAL PROPERTY COVERAGE

Many economists theorize that given the flexibility to determine the amount of coverage, the “optimal” choice by a homeowner may be less than full coverage.33 The idea is that the likelihood of a total loss is so remote, that it is of marginal utility to purchase indemnity of this risk.34 This economic work is in harmony with other studies showing that the more remote a risk is, the less likely a consumer will voluntarily insure against it.35


30 U.S. DEP’T OF HOUSING, ibid.


33 See, VERNON L. SMITH, Optimal Insurance Coverage, 76 J. POLITICAL ECONOMY 68 (1968); GEORGE G. SZPIRO, Optimal Insurance Coverage, 52 J. RISK & INS. 704 (1985). But see, CHRISTIAN GOLLIER, Optimal Insurance Design: What Can We Do With and Without Expected Utility?, printed in GEORGES DIONNE, HANDBOOK OF INSURANCE 97-115 (Kluwer 2000) (arguing that if information is adequate and symmetrical, the optimal insurance for a risk adverse purchaser may be full insurance, depending upon various factors, such as the type of deductible). An instructive analysis of the complexity of modeling optimal insurance coverage (even assuming symmetrical information) is found in HARRIS SCHLESINGER, The Theory of Insurance Demand, printed in GEORGES DIONNE, HANDBOOK OF INSURANCE 131-151 (Kluwer 2000).

34 Ibid.

The likelihood in any given year of losing a home to disaster is, in fact, very remote -- the 2007 American Housing Survey data reports that of the 75,647,000 owner-occupied homes in the United States,\(^36\) 41,000 homeowners of owner-occupied units (or roughly one-twentieth of one percent) reported that they moved from their home because of a “Disaster loss (fire, flood, etc.).”\(^37\)

An insurer has at least three incentives to write less than full coverage. The first is the concern of moral hazard. Economists who study insurance posit that in theory, less than full coverage reduces the incidence of loss by exposing the insured to some personal financial risk from a loss.\(^38\) There is little literature to support the conclusion that moral hazard normatively results in behavior that causes the loss of homes (it seems counter-intuitive that a person is more likely to engage in risky behavior – such as smoking in bed – based on an internal calculus that the person has full insurance; indeed, intuitively it seems just as likely that the person willing to take the risk of smoking in bed is also more likely to gamble on having less insurance), but reality does not matter -- insurers perceive moral hazard as a real concern\(^39\) and based on this perception have an incentive to write less than full coverage.

A second concern of insurers is adverse selection. This is the notion that because high-risk insureds never will voluntarily self-identify their risk behaviors to an insurer (and thus between insured and insurer there is asymmetry of information concerning risk), insurers would have to overcharge premium to all customers (to such a level that insurance would fail as a product) unless the insurer has the freedom to broadly categorize customers and price risk based upon the more generic characteristics of the customer.\(^40\) This strategy can run afoul of other legal and societal interests (hence the pejorative characterization of adverse selection as “redlining”), and thus is not unfettered strategy option for insurers.\(^41\) Constricting the right to adverse selection

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\(^{38}\) STEVEN SHAVELL, On Moral Hazard and Insurance, 79 QUARTERLY J. OF ECONOMICS 541 (1979). See also, RALPH A. WINTER, Optimal Insurance under Moral Hazard, printed in GEORGES DIONNE, HANDBOOK OF INSURANCE 155-183 (Kluwer 2000); MARK V. PAULY, Overinsurance and Public Provision of Insurance: The Roles of Moral Hazard and Adverse Selection, 88 QUARTERLY J. ECON. 44, 45 (1975) (“… an optimal solution in this kind of ‘moral hazard situation is for the insured to retain some part of his losses.”). While I will argue at the end of this Article that moral hazard imposes no cost on insurers, what matters for this juncture is that, as these sources confirm, insurers consider moral hazard in analyzing optimal coverage.

\(^{39}\) Ibid.


creates an incentive to adopt an alternative strategy – for all customers, write less than full insurance.

The third incentive is capturing and retaining market share. The customer decision when purchasing new insurance can be a nuanced one.\textsuperscript{42} But the purchase of residential property insurance is materially price elastic.\textsuperscript{43} Residential property insurance largely is a commoditized product.\textsuperscript{44} Sellers (insurers) compete on price. Put another way, while the public may describe that their decision-making is based on other factors,\textsuperscript{45} insurers understand that the buying decision often is made on the basis of premium. This creates an incentive to suppress price (the insurance premium) by selling less than full insurance, if the seller (the insurer) perceives the costs of selling full insurance outweigh the benefits.

The industry perceives the cost consequence of selling full insurance as high. A 1996 whitepaper by the Insurance Services Office – a self-described “leading industry source of information about risk,”\textsuperscript{46} found, “An insurer willing to pay the price of sufficient catastrophe insurance could have trouble competing for business.”\textsuperscript{47}

Conversely, the perceived consequence of selling less than full insurance is very small. Very rarely will a homeowner have a loss that exceeds coverage (and thus potentially results in \textit{ex post facto} customer dissatisfaction) even if the customer has less than full insurance. It is reported

\textsuperscript{42} An extended discussion of how and why customers choose their insurer is found in DANIEL SCHWARCZ, \textit{A Products Liability Theory for the Judicial Regulation of Insurance Policies}, 48 WM & MARY L. REV. 1389, 1404-1422 (2007).

\textsuperscript{43} Economic research describes that residential property insurance is more price elastic than other types of insurance, and catastrophe insurance is even more so. MARTIN F. GRACE, ROBERT W. KLEIN, & PAUL R. KLEINDORFER, \textit{Homeowners Insurance With Bundled Catastrophe Coverage}, 71 J. RISK & INS. 351 (2004).

\textsuperscript{44} One indicia that residential property insurance is a commodity is that there are only six variations of policies, and 80% of all policies are written on an identical form. NAIC, 2006 Dwelling Fire, Homeowners Owner-Occupied, and Homeowners Tenant and Condominium/Cooperative Unit Owner’s Insurance Report at p.34, Table 4, http://www.naic.org/documents/research_stats_homeowners_sample.pdf.

\textsuperscript{45} See, JEFFREY E. THOMAS, \textit{An Interdisciplinary Critique of the Reasonable Expectations Doctrine}, 5 CONN. INS. L.J. 295, 311 (1998-99) (citing data that reputation is the primary driver of consumer choice of homeowner insurer).

\textsuperscript{46} http://www.iso.com/About-ISO/Overview/About-ISO.html

\textsuperscript{47} Insurance Services Office, \textit{Managing Catastrophe Risk}, May 1996, at 4. Accord, PETER M. WELLS, \textit{INSURING TO VALUE: MEETING A CRITICAL NEED} (2\textsuperscript{nd} ed.) at 43 (2007) (“As the industry moved closer to capped policy limits, making certain that the policy limits included all of the costs faced when losses occurred [would charge] … premiums [increased] commensurate with the entire risk assumed.”). Again, it does not matter whether insurers are correct in this evaluation; what matters is that insurers perceive that the insurer cannot afford to write full insurance. This perception is a strong incentive to not write full insurance.
that less than 2% of residential insurance claims are for the total loss of a house (the American Housing Survey data would suggest it is far less than 2%).\textsuperscript{48} If, as calculated above, annually total losses occur to roughly one-twentieth of one percent of homes, then in a single claims year, the likelihood of any insurance claim at all is less than .0004 percent (claims \(\leq .0005 \times .02\)), and 98% of those claims are for less than a total loss (read: likely to be within coverage limits, even if the home is underinsured).\textsuperscript{49} In the end, “gaining greater market share … build[s] an increased capital base for investment.”\textsuperscript{50} And insurers do not perceive that selling less than full insurance in order to capture greater market share puts their business at risk of survival: “Large catastrophes are rare; therefore, an insurer that does not have high catastrophe limits is likely to survive.”\textsuperscript{51}

Of even greater potential importance is the incentives that arise in retaining existing customers. Here, the goal from the perspective of the insurer is for the renewal to be as seamless as possible for the insurer. In the frequently occurring environment of rising rebuilding costs, in order to maintain full coverage (or, for that matter, any percentage level of coverage) requires a revaluation of the property as well as increased premium. This is contrary to the goal of seamless renewal. The insurer incentive is, in the face of rising rebuilding costs, to maintain existing gross coverage of insurance, even if the consequence is a decreasing percentage of coverage. This will cause even initially fully insured homeowners to become underinsured over time. Because this incentive arises in the context of renewals, the possible importance of this incentive may be at the core of predicting insurer behavior; for example, in the early 1990s, one insurer, Allstate, calculated its renewal rate of homeowners insurance at roughly 90%.\textsuperscript{52}

Indeed, an insurer not only has incentive to sell less than full insurance, the insurer’s agent or broker also has incentive to understimate the value\textsuperscript{53} of the home (the base figure against which


\textsuperscript{49} These figures almost certainly explain why residential property insurance is relatively inexpensive.

\textsuperscript{50} \textsc{Peter M. Wells}, \textsc{Insuring To Value: Meeting A Critical Need} (2\textsuperscript{nd} ed.) at 50 (2007).


\textsuperscript{52} http://www.allstatenewsroom.com/media/PDF/H000000001.pdf; accord, \textsc{Justin Syndor}, \textit{Abundant aversion to Moderate Risk: Evidence From Homeowners Insurance} at 14 (August 2006 draft), http://faculty.weatherhead.case.edu/sydnor/deductibles_old.pdf (“... roughly 12% of the sample consisted of customers who were new to the company in the sample year”).

\textsuperscript{53} For purposes of this Article, “value” is the cost to rebuild the home.
percentage of coverage is calculated).\textsuperscript{54} In the period when most insurers wrote guaranteed replacement coverage, “sales and marketing channels within insurance organization[s] would, with regular frequency, downplay the necessity of properly reflecting the replacement cost value needed to properly insure homes.”\textsuperscript{55} Using correct valuation approaches “could create a conflict in goals between the best interests of the carrier or underwriter insuring a property and those of an agent primarily charged with the generation of new business.”\textsuperscript{56}

Capping coverage does not change these incentives. A higher coverage still equates to higher premiums, which exposes an insurer to losing a customer on the basis of price.\textsuperscript{57} The likelihood of a claim exceeding coverage remains \textit{de minimus}. Therefore the rational choice is to understate value. Reinforcing this view is work in law and economics suggesting that when insurance purchasers are biased or ill-informed, insurers are incentivized to exploit that circumstance.\textsuperscript{58}

In summary, in analyzing the structure and incentives in residential insurance markets, one would predict that most customers should not want to insure to full value, most insurers would not want to insure to full value, and most insurance agents and brokers would wish to understate actual value.


\textsuperscript{55} \textsc{Peter M. Wells}, \textit{Insuring to Value: Meeting a Critical Need} (2\textsuperscript{nd} ed.) at 51 (2007).

\textsuperscript{56} \textsc{Peter M. Wells}, \textit{Insuring to Value: Meeting a Critical Need} (2\textsuperscript{nd} ed.) at 51 (2007).


C. REGARDLESS OF ECONOMIC MODELING OF OPTIMAL LEVELS OF INSURANCE, HOMEOWNERS ACTUALLY WANT FULL INSURANCE

The analysis of the residential property insurance market predicts that most customers would not want to insure to full value, and most insurers would not want to insure to full value. Actual market behavior largely bears out these predictions, but also exposes an important divergence – a large and growing segment of consumers (now approaching a majority) will choose to fully ensure, despite the theoretical work demonstrating that this is rarely if ever optimal.

1. The Pervasiveness of Underinsurance.

Marshall & Swift/Boeckh -- the company that manufactures the software insurers commonly use to calculate adequate insurance coverage – is self-interested in promoting the use of accurate tools to measure value; Marshall & Swift/Boeckh reports that for the years it studied, roughly 60% of American homeowners were underinsured by roughly 20-25%:

<table>
<thead>
<tr>
<th>YEAR</th>
<th>PERCENT OF HOMES UNDERINSURED</th>
<th>AVERAGE DEGREE OF UNDERINSURANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>64%</td>
<td>27%</td>
</tr>
<tr>
<td>2004</td>
<td>61%</td>
<td>25%</td>
</tr>
<tr>
<td>2005</td>
<td>59%</td>
<td>22%</td>
</tr>
<tr>
<td>2006</td>
<td>58%</td>
<td>21%</td>
</tr>
</tbody>
</table>

This work is supported by the work of United Policyholders, a leading consumer advocacy group concerned with the frequency and cause of underinsurance, which surveyed homeowners impacted by the 2007 wildfires in San Diego six months, one-year, and two-years after the loss of their homes; these surveys put the frequency of underinsurance at 66% - 75%.

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60 A hyperlink to the entirety of the survey data is found at http://unitedpolicyholders.org/survey/surveyresults.html. The complete data set is on file with the author, who has access to it by virtue of his work with UPH in the wake of the 2007 and 2008 California wildfires. In the years 2003-2008, Southern California has had seriatim wildfires in residential communities. There is no ambiguity that insurance covers losses to wildfire. Therefore, the Southern California wildfires provide a unique data set to study the issues raised in this Article.
The Marshall & Swift/Boeckh data, which is a nationally comprehensive study, describes that even if the “optimal” choice by a homeowner is to underinsure, the percentage of homeowners who fully insure is just over 40%, and is rising. Put another way, a material and increasing percentage of homeowners are sufficiently risk adverse that they will and do purchase full coverage.\textsuperscript{61}

Logically, \(\sim 40\%\) is not the full set of cases where the amount of insurance purchased is not economically “optimal.” It is just a subset of cases where the purchase is less than optimal because the homeowner purchased full insurance. There also will be cases where the purchase both is less than full but still too high, and cases where the purchase is too low.\textsuperscript{62}

In sum, residential property insurance is a market with over 60,000,000 customers, and it appears that a material percentage, perhaps 50\% or more, of these customers are purchasing other than the “optimal” amount of insurance.

2. The Pervasiveness of Unintended Underinsurance.

If, despite homeowners wanting to over-insure, insurers have both an incentive to undervalue and to underinsure, then one would predict that homeowners are actually purchasing less insurance – both in gross dollars and as a percentage of actual value – than the homeowners are seeking to purchase. This would then mean, by extension, that the percentage of homeowners who actually fully insure is less than the percentage of consumers who wish to fully insure. If the percentage of homeowners who actually fully insure currently is just over 40\% and is rising, this suggests that the percentage of consumers who wish to fully insure is at least 50\%. Because of concern with moral hazard and adverse selection, one predicts that an insurer still has an incentive to not offer full value coverage to these consumers. Also, one predicts insurers have an incentive to understate actual full value.

Market behavior bears out these predictions. According to the Insurance Information Network of California, the 2003 Southern California firestorms totally destroyed 3631 homes and the 2007 Southern California firestorms totally destroyed 2180 homes; the two firestorms combined

\textsuperscript{61} The goal of the proposal within this Article is not that insurers are forced to sell, and homeowners are forced to purchase, the “optimal” level of insurance. Rather, the goal of this Article is that there is sufficient comfort that the homeowner was adequately informed of the coverage level, so that in the event of an underinsured loss, there need not be protracted debate of who bear’s responsibility for the rebuild costs in excess of coverage.

\textsuperscript{62} A consumer may unintentionally purchase too little coverage because of the insurer’s incentive to understate the value of the insured structure. Thus, for example, if (1) the optimal level of insurance is 90\% of value, (2) a homeowner intends to insure at 90\% of value, (3) the home has an actual value of $400,000, and (4) the insurer convinces the homeowner that the home value is $300,000, then the homeowner will purchase $270,000 of coverage, which is $90,000 less than optimal coverage.
resulted in over 1000 (roughly 20%) formal “Requests for Assistance” (RFA) to the California Department of Insurance regarding underinsurance (in other words, homeowners asserting they had less insurance than they had expected), with the number of requests increasing in 2007, despite a significantly fewer number of total home losses.  

Other data supports the conclusion that at least roughly 20% of homeowners had less insurance than they had expected. The work of United Policyholders reports that of homeowners of lost or damaged homes in the 2007 Southern California firestorms who had not reached an acceptable settlement with their insurer by six months after the fires, 17% reported filing an RFA with the Department of Insurance by one year after the fires. (Two years after the fires, 28% had filed RFAs.) But of the remaining 83%, roughly one-third explained either a concern that it would make matters worse, or they did not want to anger the insurer, or they did not know how to file an RFA, or they did not think it would do any good. Six months after the fires, 74% of homeowners reported they did not have sufficient coverage to rebuild or repair their homes, and 64% of homeowners reported they amount of funds offered by their insurer was not sufficient to rebuild their homes (this included homeowners with partial losses). Two-years after the fires, 53% of homeowners reported they did ultimately have sufficient coverage to rebuild or repair.

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63 An RFA is not a request for governmental financial assistance. Rather, it is the form that a consumer completes to initiate a formal investigation of an insurer’s practices. See, California Department of Insurance, About Us: An Introduction to CDI Operations (2004), http://www.insurance.ca.gov/0500-about-us/0100-cdi-introduction/.


67 Ibid.

68 See six-month survey results data at http://unitedpolicyholders.org/survey/surveyresults.html. The apparent discrepancy between these two figures results from at least two scenarios – (1) instances when insurers offered settlements in excess of stated policy limits, and (2) instances when homeowners had insufficient coverage to rebuild precisely the home lost, but sufficient funds to rebuild a different home acceptable to them and the lender.
their homes, while 47% reported the insurer agreed to pay them the full amount necessary to rebuild or repair their homes (this included homeowners with partial losses).69

The *ex post facto* record of natural disasters is replete with anecdotal homeowner claims either that they wanted more insurance but could not get it, or that they were assured by their broker or agent that the homeowner had adequate insurance.70 But of course, what homeowners claim, especially after the fact, is hardly dispositive of what homeowners intended at the inception. The insurance industry itself, however, recognizes the pervasiveness of unintended underinsurance. One insurance trade journal reported from a 2010 Zogby/Metlife Auto & Home insurance survey that “Nearly one third (31 percent) of Americans don’t know how much their most valuable assets -- their homes -- are insured for” and that despite “nearly all” insurance companies capping coverage for an

69 See two-year survey results data at http://unitedpolicyholders.org/survey/surveyresults.html. This later figure suggests that only a subset of the full group of underinsureds utilize a formal request for assistance (others in the group will do nothing, or will pursue less formal steps such as simply negotiating directly with the insurer, or will skip to more formal steps such as litigation).

70 Kathy Chu & Elizabeth Weise, *Wildfires spotlight insurance coverage issues*, USA Today, Nov. 1, 2007, at B1; Joseph B. Treaster, *Homeowners Come Up Short On Insurance*, N.Y. Times, Aug 31, 2004, at A1; David Lazarus, *Underinsured wildfire victims feel burned again when coverage comes up short*, Los Angeles Times, Nov. 19, 2008, at C1; *CBS Evening News: Underinsurance With Allstate* (CBS television broadcast July. 14, 2008) (transcript available at http://www.cbsnews.com/stories/2008/07/14/eveningnews/main4261407.shtml (last visited June 22, 2009)); see also, Free v. Republic Ins. Co., 8 Cal.App.4th 1726, 1729 (1992) (“According to the complaint, … [in 1979] and every succeeding year [until 1989] … appellant contacted [the insurance representative] to inquire whether the coverage limits if his policy were adequate to rebuild his home. On each occasion, he was informed they were.”); Cheek v. State Farm Fire & Cas. Co., 110 F.3d 67 (9th Cir. 1997) (“The Cheeks Complaint alleged that State Farm was negligent in failing to provide them with a certain level of earthquake coverage, as they had specifically requested ….”); Appellant’s Opening Brief, Aslan v. State Farm Fire & Cas. Co., 125 F.3d 857 (9th Cir., 1996), 1996 WL 33486909 at p.5 (“Respondent assured Kenneth Asian [sic] that his earthquake policy was sufficient …. “); Desai v. Farmers Ins. Exchange, 47 Cal.App.4th 1110, 1114 (1996) (“Desai informed an insurance vendor, Carol Sacramone Insurance Agency, that he wanted 100 percent coverage …. Sacramone told Desai that Farmers Insurance Group offered the type of insurance Desai wanted, and orally represented that the policy provided ‘100% coverage … ’ “.”); White v. Allstate Ins. Co., 513 F.Supp.2d 674, 677 (E.D. La., 2007) (“Plaintiffs further allege that Tarleton indicated that the hurricane coverage under their homeowner’s policy would cover any and all damages that might be incurred as a result of a hurricane.”); Cameron Parish School Board v. State Farm Fire & Cas. Co., 560 F.Supp.2d 485, 487 (W.D. La. 2008) (“In its Complaint, CPSB alleges that State Farm knew CPSB’s flood insurance was insufficient, that State Farm knew CPSB wanted to maximize its flood insurance, and that State Farm did not tell CPSB additional flood insurance could be purchased outside of the NFIA and with another company.”); Smith v. Kert LeBlanc Ins. Agency, Inc., 2008 WL 2308828, *1 (E.D. La. 2008) (“Plaintiffs contend that they should be paid more than their policy limits because State Farm did not advise them upon renewal of their policy that the amount of their coverage would be insufficient to completely rebuild their home following its destruction. … Plaintiffs argue that they specifically desired and purchased a ‘full replacement policy.’”); Martinonis v. Utica Natl. Ins. Group, 849 N.E.2d 994, 996 (Mass. App., 2006) (“I definitely brought up to him all of this information, and questioned him and asked him and asked him whether it shouldn’t be increased. And he reassured me that that should be adequate.”); Stevens v. Hickey-Finn & Co., Inc., 261 A.D.2d 300, 300-01 (N.Y. App. 1999) (“Plaintiff requested ‘proper and adequate’ coverage … in response, the agent, as she had in prior years, utilized a “Home Aestimator” computer program to check …. In the aftermath of a fire at the insured premises, plaintiff discovered that, in fact, he had been seriously underinsured ….”).
insured loss of a home, “More than two thirds (71 percent) of those surveyed believe insurance pays for the full cost to rebuild their property in the event of a major loss, such as a fire or other natural disaster.”71 Simply put, most Americans think they have more insurance than they actually have.

D. THE PERVASIVENESS OF AMBIGUITY CONCERNING WHETHER IT IS THE INSURER OR THE HOMEOWNER WHO BEARS THE RISK OF UNDEREVALUATION RESULTING IN UNDERINSURANCE

So how does this happen? How is it that half of America has less insurance coverage than it thinks it has? As described above, insurers have an incentive to understate the actual value of homes, and that incentive plays out in a variety of ways in actual market transactions.72 If insurers act in accordance with this incentive, then homes are underinsured to value even if the homeowner selects the optimal percentage of insured value. The insurance industry has a several decade history of understating value.

Following World War II, the market for homes exploded, thus creating both mortgage lenders insisting on homeowner’s insurance and the homeowner’s insurance market.73 “Since homeowners were not prepared to [evaluate cost of replacing a lost home], the insurance industry began to take an active and scientific role in establishing total replacement cost before losses actually occurred.”74 But insurers were slow to react as market changes meant the formulas had to be revisited, and thus underinsurance resulted.75

Before 1994, when most residential insurance policies were “guaranteed replacement policies,” insurers explicitly bore the responsibility for accurate valuation. “The history of homeowners’ insurance business after World War II … eventually taught property writers that the financial viability of their business is directly linked to establishing accurate defendable insurable values


73 PETER M. WELLS, INSURING TO VALUE: MEETING A CRITICAL NEED (2nd ed.) at 7-12 (2007).

74 PETER M. WELLS, INSURING TO VALUE: MEETING A CRITICAL NEED (2nd ed.) at 11 (2007).

75 PETER M. WELLS, INSURING TO VALUE: MEETING A CRITICAL NEED (2nd ed.) at 7-20 (2007).
for each risk insured.” In other words, in the context of guaranteed replacement, or *de facto* full insurance policies, the party bearing the responsibility for valuation also bore the cost from error in the calculation.

Since 1994, in response to the perceived cost of providing no-limit insurance for a total loss, almost all insurers did away with “guaranteed replacement” policies. When guaranteed replacement coverage ceased to be the industry norm, this created both an increased incentive to undervalue a home, and ambiguity whether the insurer or the homeowner bore the risk of undervaluation.

Capped insurance coverage created, in the first instance, the possibility of underinsurance. By doing so, capped insurance increased the incentive to an insurer to understate property value. This is because capped coverage reduces the risk of valuation error to the insurer.

Under guaranteed replacement policies, in the event of total loss the carrier paid claims in excess of the base values upon which premium was calculated. The insurer bore the full cost of valuation error. Under capped policies, an insurer only bore this cost of error if, in the terminology of insurance law, in the wake of loss the policy was “reformed” (typically as a result of litigation) to provide coverage as if the value had been correctly stated.

Another consequence of the elimination of guaranteed replacement coverage was the creation of ambiguity about whether insurers or homeowners bore ultimate responsibility for error in valuation. This ambiguity can be seen in the contrasting post-loss positions of homeowners and insurers. Homeowners perceive their brokers or agents as the experts on how much insurance is adequate. But brokers and agents contend their expertise is not risk valuation, but rather the

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76 PETER M. WELLS, INSURING TO VALUE: MEETING A CRITICAL NEED (2nd ed.) at 21 (2007).


nuances of policies and forms, and the resulting differences between various insurance policies. As a spokesman for Insurance Information Network of California said in the wake of the 2003 California wildfires, “It’s ultimately up to the homeowners to try to ascertain if [the coverage] is enough.” The American Insurance Association argues that “it really is the homeowner who is in the best position” to know what coverage is needed. Identical arguments are made by the Association of California Insurance Companies and the Personal Insurance Federation of California.

E. ONE APPROACH TO ELIMINATING INSURER RESPONSIBILITY FOR UNDERVALUATION

One would predict that a rational insurer would, if it could, eliminate any potential insurer responsibility for undervaluation, and do so in a way that would not cause the customer to choose a different insurer. That prediction is borne out by a clause now found in some insurance policies.

The clause and its mechanism is illustrated by the case of Everett v. State Farm General Ins. Co. From 1991 to 1997 Agnes Everett’s home was insured by State Farm with guaranteed replacement cost coverage. In 1997, State Farm provided written notification to Ms. Everett that her policy was being changed to have a limit to replacement coverage. That renewal provided a specific amount of “replacement cost” coverage should Ms. Everett suffer a total loss.

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81 Elliot Spagat, Homeowners haunted by underinsurance, Contra Costa Times, July 11, 2004, at __; see also Joseph B. Treaster, Homeowners Come Up Short On Insurance, N.Y. Times, Aug 31, 2004, at A1 (quoting a representative of the Insurance Information Institute saying, “It’s the homeowner’s responsibility to see that his home is properly insured.”); Liz Pulliam, Flirting With Disaster: Millions of people are now exposed to the possibility of a devastating loss, Los Angeles Times, Aug 2, 1998, at D1 (quoting a spokesperson for Framers Insurance, “The consumer has the responsibility to determine what their coverage should be.”); see also, Smith v. Kert LeBlanc Ins. Agency Inc., 2008 WL 2308828, *2 (E.D. La. 2008) (“according to State Farm, … [it is the homeowner] upon whom the duty rested to advise their insurer of any necessary increase in coverage.”).

82 American Insurance Association’s July 7, 2008 Opposition to Request For De-publication, filed with the Supreme Court of California.

83 ACIC’s and PIFC’s June 25, 2008 and July 2, 2008 Opposition to Request For Depublication, filed with the Supreme Court of California. For the perspective of the policyholder on Everett, see LEE HARRIS, Does Everett v. State Farm Shut the Door on Underinsured Homeowners?, 38:6 FORUM 17 (November/December 2008).


85 162 Cal.App.4th at 652.

of her home. For the next six years, each annual renewal statement from State Farm to Ms. Everett stated:

The State Farm replacement cost is an estimated replacement cost based on general information about your home. It is developed from models that use cost of construction materials and labor rates for like homes in the area. The actual cost to replace your home may be significantly different. State Farm does not guarantee that this figure will represent the actual cost to replace your home. You are responsible for selecting the appropriate amount of coverage and you may obtain an appraisal or contractor estimate which State Farm will consider and accept, if reasonable. Higher coverage amounts may be selected and will result in higher premiums.

In October of 2003, Ms. Everett lost her home to wildfire.

The resulting litigation reflects that the clause had the effect, at least in the one litigated instance, of eliminating risk to State Farm of undervaluation, without creating risk to State Farm of losing a customer. At trial, State Farm pointed to and relied upon (successfully) the policy language, “You are responsible for selecting the appropriate amount of coverage.” Yet State Farm almost certainly never was at risk from losing Ms. Everett as a customer, since if Ms. Everett ever even read the language, then she would have understood State Farm to be encouraging her to not question the adequacy of her coverage; after all, State Farm told her that State Farm had calculated the cost of rebuilding her home, that if she wanted to ask State Farm for more insurance then she would have to spend money and hire professionals to support why she wanted more insurance, that even then State Farm might not agree to give her more insurance, and if State Farm did agree then that would cost her yet more money. Even in the face of the State Farm clause, Ms. Everett believed she was entitled to full replacement coverage, without regard to policy limits.

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87 162 Cal.App.4th at 653-54.

88 Although it is not clear from the published Opinion, almost certainly the “model” used was the Marshall & Swift “quick quote” function, which calculates cost using only zip code, square footage, and year of construction.

89 162 Cal.App.4th at 653 (footnote added).

90 162 Cal.App.4th at 653-54.

91 162 Cal.App.4th at 654.

92 162 Cal.App.4th at 654.
F. THE INCENTIVES TO UNDERINSURE HAVE CREATED MARKET INEFFICIENCIES

Summarizing the preceding sections, we see that while a large and increasing percentage of homeowners wish to fully insure, insurers perceive that “An insurer willing to pay the price of sufficient catastrophe insurance could have trouble competing for business.”93 This frames something akin to a prisoner’s dilemma for insurers. Insurers are competing against each other for a fixed number of customers in a largely mature market (most potential customers already are actual customers). Insurers see the market largely as commoditized. Using sound actuarial principles to calculate premium should yield roughly the same premium for all insurers. While an insurer may have an economic incentive to use less sound, more aggressive actuarial principles, insurance is a regulated product requiring state approval of the actuarial soundness of an insurance product. The other variable in setting price is the “valuation” of the home. And here is the “prisoner’s dilemma.” If an insurer could depend upon competitors to do accurate valuation, then the insurer is not at risk of losing market share on the basis of valuation approach. Otherwise, the insurer has an incentive to adopt two strategies: (1) devise “valuation” formulas that support lower valuation than those of one’s competitors without putting the actuarial soundness of the business at risk, and (2) shift the risk of underinsurance due to undervaluation to the homeowner in a manner that does not change price.

The premise of the products of Marshall & Swift/Boeckh (the producer of the predominant valuation tools) is that while there are many ways to calculate valuation, there is only one, objectively accurate valuation.94 Insurance brokers and agents certainly would debate this assertion, viewing valuation as much more art than science, and potentially prohibitively time-consuming art at that. In other words, in writing new business, with enough time and attention agents and brokers could value a home into a relatively tight range, but the time dedicated to each home would be inconsistent with a successful business model, even assuming customers would stand for it. The problem would be even worse in the instance of renewed basis, as it would be inconsistent with the idea of a seamless renewal process.

If an insurer has to choose between likely undervaluation and likely overvaluation, the rational strategy is either to intentionally promote or to passively allow an undervaluation. Property insurance is highly price elastic, and so overvaluation cost the insurer most business. By contrast, if most homes do not have an insured loss at all in a coverage year, and less than two

93 Insurance Services Office, Managing Catastrophe Risk, May 1996, at 4. “As the industry moved closer to capped policy limits, making certain that the policy limits included all of the costs faced when losses occurred [would charge] …. premiums commensurate with the entire risk assumed.” PETER M. WELLS, INSURING TO VALUE: MEETING A CRITICAL NEED (2nd ed.) at 43 (2007).

94 PETER M. WELLS, INSURING TO VALUE: MEETING A CRITICAL NEED (2nd ed.) (2007).
percent of claims are total loss claims, then a home fully insured to stated value -- but actually undervalued -- is unlikely to experience a loss in excess of coverage. The only real risk to an insurer is that a loss in excess of coverage will occur, and that the insurer will be held responsible for the shortfall.\textsuperscript{95} That risk is self-perceived as low, even in the face of mass loss such as to natural disaster: “Large catastrophes are rare; therefore, an insurer that does not have high catastrophe limits is likely to survive.”\textsuperscript{96}

But the benefit of this approach can be enhanced if the insurer can shift the risk of underinsurance due to undervaluation to the homeowner, and do so in a manner that does not raise price. The challenge is that in a commoditized marketplace, even a homeowner who wants “full” insurance will select their insurer by picking the cheapest insurance. If the insurer discloses to the homeowner that what really is being offered is “full” insurance of only 80\% of the house, then the insurer may well lose that customer.\textsuperscript{97} The consequence is an incentive to have a home that is undervalued, and a homeowner who in making the purchase decision is not accounting for the risk of undervaluation. In essence, the Everett clause.

The result will be two inefficiencies:

1. Inadequate information impairing informed pricing decisions by purchasers.
2. Dispute costs (such as litigation) in the instances of loss exceeding coverage.

There is some, but limited data available to quantify the cost of inadequate information impairing informed pricing decisions by purchasers. This inaccessibility of contract language to consumers is an understood dynamic in lengthy insurance contracts. The length of insurance policies, and the lack of prominence of the disclosure, can utterly defeat any effectiveness it otherwise might have.\textsuperscript{98} Homeowners are not fully aware of how their coverage is calculated, or what their policy

\textsuperscript{95} One might quarrel with the morality of such a strategy, but at this juncture this Article simply is laying out the rationality of such a strategy.

\textsuperscript{96} Insurance Services Office, Managing Catastrophe Risk, May 1996, at 4.

\textsuperscript{97} There is a joke about a hungry traveler who, upon stopping at a roadside restaurant that has a huge sign advertising it is “Open 24 Hours,” encounters the restaurant owner locking the doors and closing for the evening. When the now distraught traveler asks about the sign, the owner responds, “The sign doesn’t say which 24 hours!”

Compounding the inefficiency of the clarity of the policy, the homeowner typically does not even get their full insurance policy until long after the policy is purchased. Each year there are hundreds of millions of dollars of uninsured losses resulting from unintended underinsurance. The California Department of Insurance reports there were 5,817 residential insurance claims resulting from the November 2008 firestorms in Central California. The 5817 claims resulted in over $610,000,000 in direct incurred loss; only roughly 75% of which was paid. This means that roughly $150,000,000 in incurred losses (meaning losses which the insurer felt were sufficiently credibly covered claims that the insurer reserved against them) were losses where the homeowner claimed coverage, and the insurer denied it.

The same firestorms resulted in 733 total loss claims. We can assume that the vast bulk of the $150,000,000 arose in those cases.

As many as 50% of insured homes think they have “full” insurance. The one-year survey of United Policyholders found that 51% of homeowners reported, after loss, that they either were “very unsatisfied” or “unsatisfied” with the adequacy of their insurance coverage in the wake of

99 See, ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 32[b] (2d ed. 1996) (“an insured relies not upon the text of the policies but upon the general descriptions of the coverage provided by the insurer and its agents); Todd D. Rakoff, Contracts of Adhesion: An Essay in Reconstruction, 96 HARV. L. REV. 1173, 1179 (1983). See also, PETER M. WELLS, INSURING TO VALUE: MEETING A CRITICAL NEED (2nd ed.) at 53 (2007)(it is believed in the industry that consumers have “no real understanding of the value of their structures or the pricing variables that determine[] their rates.”).

100 See, e.g., ROBERT E. KEETON, INSURANCE LAW RIGHTS AT VARIANCE WITH POLICY PROVISIONS, 83 HARV. L. REV. 961, 968 (1970) (“the normal processes for marketing most kinds of insurance do not ordinarily place the detailed policy terms in the hands of the policyholder until the contract has already been made. In life insurance marketing, for example, the policyholder does not ordinarily see the policy terms until he has signed the application (his offer to contract with the company) and has paid a premium, and the company has approved the application and has executed and issued the policy. This often means a delay of weeks, and occasionally even longer, between making an application and having possession of the policy — a factor enhancing the policyholder's disinclination to read his policy carefully or even to read it at all.”); MICHELLE E. BOARDROOM, CONTRA PROFERENTEM: THE ALLURE OF AMBIGUOUS BOILERPLATE, 104 MICH. L. REV. 1105, 1106 (2006) (“… insurance contracts typify the modern consumer contract--boilerplate clauses, little negotiation, written in legalese, and received by the consumer only after the contract has begun.”). Insurers also have asserted that policy language can equate to a counter-offer, which the insured then accepts by retaining the policy and paying the premiums. Appellee’s Brief, Cheek v. State Farm Fire & Cas. Co., 110 F.3d 67 (1996), 1996 WL 33486441, *6.

101 California Department of Insurance, Estimate of Summary Loss Data Resulting from the November 2008 Southern California Fires, Data as of May 10, 2009.

102 California Department of Insurance, Estimate of Summary Loss Data Resulting from the November 2008 Southern California Fires, Data as of May 10, 2009.

103 California Department of Insurance, Estimate of Summary Loss Data Resulting from the November 2008 Southern California Fires, Data as of May 10, 2009.
loss. In other words, undervaluation, even very conservatively calculated, caused an unexpected, uninsured loss due to underinsurance of tens of millions of dollars in just 733 homes. In an average year, across the Nation, there are in excess of 30,000 homes that are totally lost to disaster.

The United Policyholders survey of survivors of the 2007 Southern California firestorms reported the average amount of underinsurance to be $240,000.

The cost of dispute resolution is harder to quantify. The cost can arise in at least three ways: (1) extended and contentious claims resolution that does not result in external dispute resolution mechanisms; (2) complaints and requests for intervention to external entities (such as a state Department of Insurance) that do not result in litigation; and (3) litigation. A survey from United Policyholders calculates the frequency of unsuccessful claims negotiations as 64%. As discussed above, ~20% of these instances resulted in complaints to the Department of Insurance. Even a cursory survey of reported legal decisions reveals a lot of litigation disputes over the causes of and responsibility for underinsurance. It is hard to know with precision, however,

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107 For a broader discussion of the cost of litigation as a tool of insurance regulation, see KENNETH S. ABRAHAM, The Insurance Effects of Regulation by Litigation, printed as Chapter 7, pp. 212-243 within W. KIP VISCUSI, REGULATION THROUGH LITIGATION (AEI-Brookings Joint Center for Regulatory Studies 2002).


109 See, e.g., Free v. Republic Ins. Co., 8 Cal.App.4th 1726, 1729 (1992) (“According to the complaint, … [in 1979] and every succeeding year [until 1989] … appellant contacted [the insurance representative] to inquire whether the coverage limits if his policy were adequate to rebuild his home. On each occasion, he was informed they were.”); Cheek v. State Farm Fire & Cas. Co., 110 F.3d 67 (9th Cir. 1997) (“The Cheeks Complaint alleged that State Farm was negligent in failing to provide them with a certain level of earthquake coverage, as they had specifically requested …”); Appellant’s Opening Brief, Aslan v. State Farm Fire & Cas. Co., 125 F.3d 857 (9th Cir., 1996), 1996 WL 33486909 at p.5 (“Respondent assured Kenneth Asian [sic] that his earthquake policy was sufficient ….”); Desai v. Farmers Ins. Exchange, 47 Cal.App.4th 1110, 1114 (1996) (“Desai informed an insurance vendor, Carol Sacramone Insurance Agency, that he wanted 100 percent coverage …. Sacramone told Desai that Farmers Insurance Group offered the type of insurance Desai wanted, and orally represented that the policy provided ‘100% coverage …’”); White v. Allstate Ins. Co., 513 F.Supp.2d 674, 677 (E.D. La., 2007) (“Plaintiffs further allege that Tarleton indicated that the hurricane coverage under their homeowner’s policy would cover any and all damages that might be incurred as a result of a hurricane.”); Cameron Parish School Board v. State Farm Fire & Cas. Co., 560 F.Supp.2d 485, 487 (W.D. La. 2008) (“In its Complaint, CPSB alleges that State Farm knew CPSB’s
just how large the burden of dispute resolution is. Many claims do not go to litigation, and many litigation claims do not go to trial and reported appellate decision.

III. A History of Legislative and Judicial Responses to Information Inefficiencies in Insurance Transactions

Both of the inefficiencies identified above result from imperfect information. Homeowners have less insurance than they expect when they have imperfect information about valuation. Disputes arise when there is lack of clarity on the distribution of the risk of inaccurate valuation.

Expressed another way, when a homeowner purchases residential property insurance, the determination of coverage, valuation, and apportionment of risk (of either underinsurance or undervaluation), will result in one of five scenarios:

(1) Homes with guaranteed replacement coverage.
(2) Homes with capped coverage that are correctly valued and have full insurance.
(3) Homes with capped coverage that are correctly valued, are insured for less than full value, and both insurer and homeowner are adequately informed both (A) that in the event of loss the coverage may be less than the cost to rebuild, and (B) the apportionment, between insurer and homeowner, of responsibility for any shortfall of coverage to fund the rebuild of the home.
(4) Homes with capped coverage that are correctly valued, are insured for less than full value, and the homeowner (and perhaps the insurer) is inadequately informed of either (A) that in the event of loss the coverage may be less than the cost to rebuild, and (B) the apportionment, between insurer and homeowner, of responsibility for any shortfall of coverage to fund the rebuild of the home.

flood insurance was insufficient, that State Farm knew CPSB wanted to maximize its flood insurance, and that State Farm did not tell CPSB additional flood insurance could be purchased outside of the NFIA and with another company.”); Smith v. Kent LeBlanc Ins. Agency, Inc., 2008 WL 2308828, *1 (E.D. La. 2008) (“Plaintiffs contend that they should be paid more than their policy limits because State Farm did not advise them upon renewal of their policy that the amount of their coverage would be insufficient to completely rebuild their home following its destruction. … Plaintiffs argue that they specifically desired and purchased a ‘full replacement policy.’”); Martinonis v. Utica Natl. Ins. Group, 849 N.E.2d 994, 996 (Mass. App., 2006) (“I definitely brought up to him all of this information, and questioned him and asked him and asked him whether it shouldn’t be increased. And he reassured me that that should be adequate.’”); Stevens v. Hickey-Finn & Co., Inc., 261 A.D.2d 300, 300-01 (N.Y. App. 1999) (“Plaintiff requested ‘proper and adequate’ coverage … in response, the agent, as she had in prior years, utilized a ‘Home Aestimator’ computer program to check …. In the aftermath of a fire at the insured premises, plaintiff discovered that, in fact, he had been seriously underinsured ….’”); Everett v. State Farm General Ins. Co., 162 Cal.App.4th 649, 656-58 (2008).

(5) Homes with capped coverage that are undervalued and the homeowner (and perhaps the insurer) is inadequately informed of either (A) that in the event of loss the coverage may be less than the cost to rebuild, and (B) the apportionment, between insurer and homeowner, of responsibility for any shortfall of coverage to fund the rebuild of the home.

Scenarios (1) and (2) do not lead to either of the inefficiencies identified in this Article. Because Scenario (3) only requires objectively, not subjectively, adequate information, there may still be some instances of either of the described inefficiencies, but the frequency and cost will be greatly reduced. The targets of this Article are Scenarios (4) and (5).

The problem of clearly conveying information in insurance contracts is not news. Legislatures and courts are no strangers to the problems that flow from the difficulty consumers have in understanding their insurance policies. Both institutions have tried to address the problem of inadequate information through the jurisprudence of contracts.

Legislatures have adopted a variety of approaches to impose clarity and disclosure on the purchase and sale of various insurance products. For homeowners’ insurance, the predominant tool of choice is the Flesch Readability Index.

In 1948, Rudolph Flesch published a methodology to measure the ease of understanding a statement written in English. It is used by numerous government agencies including the United States Department of Defense. In other words, the Flesch Readability Index, properly applied, is a recognized metric of language clarity.

While in principle the States’ adoption of the Flesch readability metric is a rational response to the lack of clarity in insurance transactions, in practice the adoption falls short. Twenty-five States, as well as the District of Columbia, require that at least some types of insurance policies (most often, but not always, homeowners’ policies) have a minimum “Flesch readability score,”


113 RUDOLF FLESCH, A New Readability Yardstick, 32 J. APPL. PSYCH. 221 (1948).

the required minimum score either is 40 or 45. The Flesch formula divides the ease of readability of language into the categories of: Very Easy, Easy, Fairly Easy, Standard, Fairly Difficult, Difficult, Very Confusing. Language is in the second lowest category – Difficult – if it has a score between 30 and 49. In other words, rather than utilize the Flesch metric to mandate readable insurance policies, the State legislatures have adopted a metric that a policy is satisfactorily clear if the policy is at least “difficult” to understand, or put another way, simply not “very confusing.”

The judicial response to insurance coverage disputes also approaches the question from the premise that insurance policies are contracts, and thus subject to traditional contract doctrines and tools to refine clarity. Cases such as Everett illustrate the resulting problem of a traditional contract analysis. State Farm asserted successfully that it had clearly and effectively shifted risk. Yet Ms. Everett plainly had not gotten that message. And this is not simply because either she did not read her policy or was too unsophisticated to understand it. Ms. Everett’s circumstances, and how State Farm dealt with them, resulted in a sufficiently problematic legal outcome that the California Insurance Commissioner supported depublication of the Everett appellate decision. Traditional contract doctrines left sufficient ambiguity, even confronted with State Farm’s clause, for credible and costly litigation to ensue.


117 RUDOLF FLESCH, A New Readability Yardstick, 32 J. APPL. PSYCH. 221, 230 (1948).

118 RUDOLF FLESCH, A New Readability Yardstick, 32 J. APPL. PSYCH. 221, 230 (1948).

119 See, e.g., Pardee Construction Co. v. Insurance Co. of the West, 77 Cal.App.4th 1340, 1352 (“While insurance contracts have special features, they are still contracts to which the ordinary rules of contract interpretation apply.”).

120 162 Cal.App.4th at 654-63.

Special contract doctrines crafted to address insurance contracts in particular have fared no better. In 1970, the legendary Robert Keeton proposed biasing the interpretation of contracts to favor the reasonable expectations of the insured. Under the doctrine, insureds get the coverage they reasonably expect without regard to the verbiage of the policy. Keeton saw it as a way to avoid precisely the kind of problem this Article is addressing – after-the-fact surprises about the sufficiency of coverage. The doctrine grew out of the common-sense but probably inaccurate notion that because insurance contracts could be thought of as contracts of adhesion, normal market mechanisms to encourage efficient contracting failed. As a matter of jurisprudence and economics, the advisability of this approach has been debated.

Most states, however, have used the doctrine in a far less aggressive ways than this, such as using it as a proxy for ordinary contract principles. In any event, the doctrine suffered from a host of problems in application. Today, few states follow the rule, and the case law describing it is convoluted.
A second approach in the courts has been the special duty doctrine. This approach starts from the premise that insurance is a contract just like any other contract.\textsuperscript{131} Thus, because policy coverage limits are explicitly set forth in the contract, the insurer and its representatives have no general duty to make sure that the limits are adequate unless their actions create a special relationship and duty to do so.\textsuperscript{132} Yet in the end this approach too was unsuccessful. As one writer has summarized the point, “the courts’ fixation on the concepts of ‘contract of adhesion’ and ‘bargaining disparity’ has caused the judiciary to misidentify the problem,” which actually “is with information imbalance.”\textsuperscript{133}

IV. Legislative proposal

Courts and legislatures have explored, without success, various contract doctrines in order to address inadequate information in insurance transactions.\textsuperscript{134} The challenge is to identify a mechanism that discloses information more effectively without unnecessarily impairing the ability of competitors to compete. It would seem that to address inadequacy of information in insurance transactions, one needs to broaden their scope beyond insurance contract jurisprudence.

A. METHODS OF CURING INFORMATION INADEQUACY

A variety of non-insurance consumer contracts mandate language, font, and prominence of information within a contract, such as the detailed disclosures and consents sometimes mandated in real estate sales contracts.\textsuperscript{135} But as discussed above, there is little history of these approaches

\textsuperscript{131} See, e.g., Bank of the West v. Superior Court, 2 Cal.4th 1254, 1264 (1992) (“While insurance contracts have special features, they are still contracts to which the ordinary rules of contractual interpretation apply.”).


\textsuperscript{135} See Appendix D to this Article for an example of various clauses of real estate contracts mandated under California law. For examples of such an approach in other consumer contracts, see California regulations addressing disclosure and risk arises in product tanning (Cal. Bus. & Prof. C. §22701 et seq.), dating ad weight loss

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working in insurance contracts. Just three of the problems are the length of the contracts, the turgid language used, and the timing of delivery of the policy after the policy issues.

An alternative approach is suggested by recent scholarship arguing for the abandonment entirely of the predicate of insurance as contract. One very familiar example of an extra-contractual approach to information inadequacy is the product warning label on cigarettes.

But, of course, the cigarette label itself demonstrates that not all product disclosure labels meet the goal of effectively and clearly disclosing critical information without unnecessarily impairing the ability of competitors to compete. Cigarette warnings labels, at least as configured in the United States, do not clearly and effectively convey information to consumers. While the Supreme Court has recognized that the labels do provide some limited tort liability immunity, the failure of the labels has been argued to promote more litigation as a means of curbing smoking. Put another way, cigarette warning labels seem to neither have achieved a cessation of litigation nor clearly disclosing critical information.


The relationship of cigarette warning labels to consumer behavior is a highly nuanced and complex problem, and can be interpreted in a variety of ways. The point simply is, not all product warning labels are of equal dignity, or easily measured efficacy.

The approach this Article adapts is one demonstrated as effective\textsuperscript{142} -- the EnergyGuide program promoting energy efficiency in home appliances.\textsuperscript{143} The EnergyGuide program mandates the now ubiquitous yellow label “to maintain uniformity for immediate consumer recognition and readability.”\textsuperscript{144}

B. A PROPOSAL TO CURE INFORMATION INADEQUACY IN HOMEOWNER’S INSURANCE

The essential qualities of the EnergyGuide label are its clarity, simplicity, and focus. Through simple text and reinforcing, intuitive graphics, the EnergyGuide label conveys at a glance the relative energy efficiency of an appliance within the group of similar appliances.\textsuperscript{145} At the same time, the label in no way mandates how a manufacturer may compete.

The exact same approach can be used for addressing the adequacy of homeowners insurance to cover a total loss (for purposes of clarity of reference, the proposal of this Article will be referred to as the “CoverageGuide” program.) Here are the features of the proposal, all of which would need to be incorporated into a regulatory scheme:

1. The first feature of the CoverageGuide program would be a single page (8.5” x 11”) yellow label that through simple text, and an intuitive graphic, conveys to the consumer the relative (1) amount of offered coverage under the proposed policy, compared to (2) the likely amount of coverage necessary in the event of a total loss. In contrast to the EnergyGuide label, this approach would add one additional, minor level of complexity – the amount of money the


\textsuperscript{143} See 16 C.F.R. pt. 305, promulgated pursuant to 42 U.S.C. § 6201 \textit{et seq.}

\textsuperscript{144} 16 C.F.R. § 305.11(a)(1).

\textsuperscript{145} 16 C.F.R. § 305.11(a)(5)(ii)(C).
The consumer would have to pay for the insurance at various levels. The text, of course, would be mandated, both in terms of content, font, emphasis, and placement. The label would look as follows:

![Insurance Guide Label](image)

For an example of how this is achieved in a regulation, see 16 C.F.R. § 305.11(a), which does precisely this for the EnergyGuide label.
This label is intentionally designed to look just like the EnergyGuide label. One of the key elements of this proposed label is that there is a shared responsibility between insurer and insured. The homeowner bears responsibility/risk in three ways. First, the homeowner is informed that the amount of insurance the homeowner actually needs to rebuild in the event of total loss is calculated “based on information you’ve provided.” Second, the homeowner is informed: “ATTENTION: If you suffer a Total Loss of your home and the amount of Your Insurance is less than the Amount needed to Rebuild, you would be responsible for the difference in cost.” Finally, the homeowner receives notice that if the coverages and deductibles actually purchased change, then the cost of the insurance may change.

2. The notice to the homeowner regarding the cost being dependent upon the coverages and deductibles highlights a second important feature of the proposed CoverageGuide program – timing. One of the dilemmas of the purchase of insurance is that the policyholder may not get the full copy of the policy (where, for example, the clause stating that the amount of insurance is the homeowner’s responsibility may reside) until after the insurance is purchased, and the initial premium paid. The proposed CoverageGuide program would require that the yellow page “label” be the cover page of any quote for the purchase or renewal of homeowners’ insurance. This requirement eliminates any discussion of whether the homeowner was adequately and timely informed of the level of coverage.

3. The third feature the proposed CoverageGuide program is an approach to make sure the methodology for the critical calculations – the cost of rebuilding the home – provides the consumer with clear and adequate information while preserving the ability of insurers to freely and vigorously compete for customers. A homeowner’s protection from loss is no better than the accuracy of the calculation of the cost to rebuild the home. Yet an insurer either may not wish to incur the cost of a comprehensive evaluation of rebuild costs, or may have a preferred method of calculation that the insurer considers to give it a competitive advantage. As Marshall & Swift/Boeckh has comprehensively reported, however, there is not unanimity in the methodology for calculating adequacy of coverage.147

This then leads to the third feature of the proposed CoverageGuide program – the insurer can use any methodology the insurer chooses; however, if there is a total loss, and if under the insurer’s own methodology that results in inadequate insurance, then the policy shall be deemed as a matter of law to be guaranteed replacement insurance. This leaves the insurer to compete as the insurer chooses, but simultaneously protects the homeowner against the insurer getting it wrong.

147 PETER M. WELLS, INSURING TO VALUE: MEETING A CRITICAL NEED (2nd ed.) at 18-59 (2007).
4. The fourth feature of the program is a simple one – the insurer must provide at least one coverage option that provides full coverage in the amount calculated by the insurer as the actual cost to rebuild the home after a total loss. The homeowner may not want this level of coverage, but by providing the option the insurer is insulated from the after-the-fact assertion that the homeowner had no opportunity to fully insure the home for a total loss.

5. The fifth feature of the program is intended to insulate the homeowner from clauses in the full insurance policy that undercut the CoverageGuide “label.” The problem with the clause in the insurance policy in Everett is that the clause simultaneously put the risk of inadequate insurance on the homeowner and gave the homeowner incentive to not focus on the adequacy of coverage. Similar mischief can be avoided under the CoverageGuide program by providing that the first four features of the program – most importantly the fourth feature outlined immediately above – are binding and cannot be altered by the content of the insurance policy.

6. The final feature of the program would be the homeowner would be barred from suing asserting that the coverage was inadequate in amount. This is the converse of deeming the insurer as providing full replacement coverage (feature 3, above) – here, if the insurer fully and completely complies with all of the first five features of the program, then the homeowner shall be deemed, as a matter of law, to have been adequately informed of the amount of coverage.

V. The Case For The Proposal

On its face, this program seeks to eliminate or at least reduce the frequency of both identified inefficiencies. Dispute costs will be reduced since litigation will be explicitly banned. Information inadequacy will be reduced because of the clarity of the disclosures.

Additionally, the program is designed to preserve competition. An insurer essentially can do anything it wishes in setting price. Thus, the program satisfies the goal of disclosing information more effectively without unnecessarily impairing the ability of competitors to compete.

An EnergyGuide-like label for insurance has a variety of advantages. First, unlike most approaches to remedying information imbalances in consumer commercial information, here there is data demonstrating that this approach works. While legislatures and courts have explored any number of other approaches – ranging from strict liability law to product labeling to the doctrine of caveat emptor – there is virtually no data supporting any other approach as effective.

By mimicking the visual look of the EnergyGuide label, consumers see a familiar form, which consumers immediately understand is providing important information in a comparative
format. The EnergyGuide label is ubiquitous. At a glance the consumer recognizes the yellow label as something conveying important information comparing potential product choices. Utilizing this same aesthetic approach in insurance transactions provides sufficient assurance that the purchaser either knew or should have known about the adequacy of the insurance, and so a bar to litigation would be appropriate.

In turn, insurers are given something of immediate value – an approach that insulates them from litigation. Put another way, a legislator or regulator in the arena of insurance would recognize two public policy gains – (1) the policy maker could have comfort in concluding that, in the event of inadequate insurance to rebuild, the homeowner was in a bed of their own making; and (2) at least in the particular context of the cost of adequate homeowner’s insurance, the policy maker would be insulated from the argument of insurers, when seeking to raise rates, that the cost of frivolous litigation was the primary driver.

The concern of insurance companies – ability to compete on the basis of price – also survives this regulatory approach. Insurance companies can price insurance, and even can calculate rebuilding costs, however a company wishes. If a company wishes to bear some back end risk in order to garner immediate market share, then that is completely acceptable.

The combination of three factors – some risk shifting to the insured, the bar on some kinds of litigation, and the protection of the insurer to compete/price/rate how the insurer chooses – should lessen industry resistance to the proposal.

Finally, the proposed CoverageGuide “label” scores “fairly easy” to understand under the Flesch Readability index.

VI. The Case Against The Proposal (And a Response To It)

A prominent criticism of this proposal certainly will come from insurers, who will assert that it fails to understand the nature of their business. This criticism will take several forms, including that the proposal does not recognize how an insurer needs to seamlessly renew policies (in other words, not spend insurer time and customer time annually re-evaluating value and coverage); and the proposal does not recognize how hard, nuanced, uncertain, and expensive it can be for an insurer to properly value a home. But these factors are, in fact, accounted for in this proposal. The proposal first reflects a choice between two approaches – leaving the


149 Given that residential property insurance is placed as part of the purchase of a house, and the premium frequently is built into the monthly mortgage payment, one would expect a material part of the business of a residential property insurance would be achieving high renewal persistency.
valuation methodology up to the insurer, or imposing a methodology on all insurers by regulatory fiat. The proposal opts to reject the fiat for two reasons – (1) a fiat strips insurers of one way in which insurers can differentiate and compete with each other; and (2) a fiat imposes an untested model that might or might not be accurate. What the proposal finds unacceptable is giving the insurer leeway to invest as much or as little attention into valuation as the insurer wishes, but then to allow the insurer to shift the risk of undervaluation to the homeowner. The insurer, in order to remain in business, has to engage in some evaluation of the risk it writes or indemnifies. The insurer should not be allowed to internally undertake that evaluation, and nonetheless externally shift the risk of error to its customer.\(^{150}\) Thus, the proposal seeks to balance matters between the insurer and insured by giving the insurer both the freedom to write and value risk as it wishes and a litigation shield from insureds who purchase less coverage than turned out to be needed, but by giving insureds protection through policy reformation should the disclosed valuation be, in retrospect, inaccurate.\(^{151}\) Further, the insurer’s responsibility for undervaluation is tempered by the valuation being based on information provided by the homeowner.

Unspoken but inherent in industry criticism of the proposal will be another concern – the CoverageGuide label sets a price or floor in claims adjusting negotiations. Put another way, the data on the level cuts the legs out of a potential profit strategy of the insurer, which is successfully adjusting claims at below actual per square foot price of rebuilding.\(^{152}\) This is undoubtedly true. It is a strength of the proposal, not a weakness.

A related criticism will be that this proposal fails to understand the nature of homeowners purchasing insurance. This may take the form of saying that homeowners will no more pay attention to this disclosure than any other, and that insurance is moving away from paper transactions. As to the later concern, the disclosure can just as easily be the first screen\(^ {153}\) of an

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\(^{150}\) Insurers sometimes assert that the homeowner is best positioned to know the value of the home. This may be an oblique reference to asymmetry of information concerns that animate adverse selection. But insurers already have to underwrite risk in the face of this asymmetry, and most profitably do so without having an *Everett*-like firewall clause.

\(^{151}\) A potential problem arises in instances of mass loss, because scarcity can distort per square foot construction costs. This can be dealt with, however, with the sorts of riders now written, which give a percentage increase in coverage – typically 25\% or 50\% if actual rebuild costs exceed caps. This “extended” coverage, as it is called, is designed to address precisely these kinds of scenarios. The “reformation” prong of the proposal is intended to calculate rebuild costs in a non-scarcity market.

\(^{152}\) For an extended, albeit non-neutral, discussion of the various incentives insurers have to use the claims adjusting process as a profit opportunity, see *Jay M. Feinman, Delay Deny Defend: Why Insurance Companies Don’t Pay Claims and What You Can Do About It* (Portfolio 2010).

\(^{153}\) In light of the proliferation of, and variation in, ecommerce, a good regulation will need to pay special attention to defining what is the “first screen.”
ecommerce transaction as it can be the first page of a paper transaction. As to the former concern, it simply is unacceptable to place insurers in the box that no matter how plain the disclosure, the homeowner never has to take personal responsibility for the homeowner’s choices.

One potential criticism of this proposal is that it is too specific. Put another way, it is impossible to write the perfect contract and fixing one informational inadequacy in a complex contract transaction is at best an incremental gain. But the rebuilding of a home is, for most individuals, the single largest and most complex financial transaction of their lives, and as discussed above total loss claims account for a disproportionate share of any actual losses from underinsurance. If there is any single aspect of consumer insurance that merits attention in isolation, then one could make a good case for it being the total loss coverage provided in homeowners insurance.

To residents of areas that suffer a type of total loss that insurance may or may not respond to (such as happened in New Orleans if one lost their home to Hurricane Katrina), this proposal is incomplete, as the disclosure form does not clarify the precise boundaries of coverage. To these critics, all I can say is that the more one tries to put on the form, the less effective it will be in conveying anything at all. Further, if one tried to use the “Yellow label” approach to all aspects of consumer insurance, the repetition of the solution would swallow up its efficacy. While it can be argued that consumers understand the most important terms in standard contracts, that demonstrably is not the case in residential casualty insurance contracts.

While it is cogent to argue that mandatory rules regulating risk in consumer contracts only are necessary when sellers’ “incentives are flawed by some market failure,” here that is the case.

A concern with a proposal, such as this one, highlighting a particular risk, is that it minimizes the importance of all other risks. But this is the single largest, and most consequential risk. Put another way, the cost of not addressing this risk – leaving matters as they are – is too great. The

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154 The only transaction which might rival it would be the original purchase of the same home. Because real estate, as a general matter (and over any time line of length) appreciates, and because new construction is both more expensive and more complex than the purchase of an existing home, the purchase of a home still is a smaller and materially less complex transaction.


cost of highlighting multiple risks is to mimic the way insurance works right now – attempting to convey so much that nothing is actually conveyed.

It might be argued that this proposal is politically impossible to achieve. Insurers are famously resistant to even rational change. Campaign contributions do matter to elections, and insurers are legendary campaign contributors. Consumer advocates undoubtedly will argue that the insurance industry cannot be trusted to not carve up or co-opt this proposal in the lawmaking process, thus changing it from one of balance to one that hurts consumers. Free-floating fear of making a bad situation worse, however, is not a basis to not try to make a bad situation better. Offering insurers a litigation shield without impairing an insurer’s ability to compete should ameliorate much potential opposition.

One might argue that there is a simpler solution – a single regulation straightforwardly mandating that all coverage be “guaranteed replacement coverage.” That most assuredly would work. But equally assuredly, the industry would resist it fiercely, and likely ultimately defeat it. After all, that is the market as it existed before 1994, and which the industry now has almost wholly abandoned as a business model.

Similarly, simply tightening current regulations to require insurance contracts in their entirety to score “easy” on the Flesch readability index would not work. A document of that length and complexity is incapable of getting such a score on Flesch – indeed, that is precisely the problem.

Finally, and to an economist most damning, is the possibility that requiring full insurance to be offered will increase the incidence of home losses as a result of moral hazard. While this is a theoretical concern, it demonstrably is a de minimus one. Here is why: According to census data, in an average year there are 30,000 total loss homes. Many of these are lost in mass disasters, which obviously cannot be a loss due to moral hazard, and many others are lost to non-insurable causes, such as flood. So there are perhaps 20,000 total lost homes a year which might even theoretically be homes that were lost because of moral hazard. Moral hazard only arises to insured homes. Only 80% of homes are insured at all, so that gets the set down to 16,000. Moral hazard concerns primarily arise if homes are fully insured. Only roughly half of insured homes are fully insured. That gets the set down to 8000 homes that could be a moral hazard loss. As discussed earlier, there are reasons to question whether moral hazard really accounts for any lost

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homes at all. But assuming it does, certainly that frequency could not be more than 10%. So assume that 10% of those 8000 homes would not have been lost but for risks taken due to moral hazard. Our most recent data year is 2007, when the average value of homes was $191,500. So if moral hazard causes the annual loss of 800 homes of an average value of roughly $200,000, and which absent moral hazard would not have been lost, then moral hazard causes insurers to experience an incurred loss annually of $160,000,000. But, of course, insurers are in the actuary business, and so they do not incur this loss, but rather pass it through in premium. So what is the “cost” of moral hazard, assuming it actually occurs in residential insurance markets? In 2006, the National Association of Insurance Commissioners calculated the average residential property insurance premium as $801, across sixty million policies. If $160,000,000 is spread across 60,000,000 policies costing an average premium of $801 each per year, moral hazard apparently would increase this premium by about $2.67 per policy per year, or put another way, a premium increase of roughly one-third of one percent.

VII. Conclusion

While it may seem an initially odd idea to treat the purchase of home insurance the same as buying a washer dryer, it is an acceptable solution to address information inadequacy in the insurance markets. The current market structure promotes inefficiencies that are entirely avoidable, and are morally dubious. Put another way, the current market place is not structured in a way where we would expect consensus saying that underinsured homeowners like Ms. Everett brought financial ruin on themselves. An approach that eliminated inefficiencies, preserved free competition, and gave confidence that homeowners knew what they were buying, should be embraced.

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APPENDIX A

California:

5. Property Insurance. Borrower shall keep the improvements now existing or hereafter erected on the Property insured against loss by fire, hazards included within the term “extended coverage,” and any other hazards including, but not limited to, earthquakes and floods, for which Lender requires insurance. This insurance shall be maintained in the amounts (including deductible levels) and for the periods that Lender requires. What Lender requires pursuant to the preceding sentences can change during the term of the Loan. The insurance carrier providing the insurance shall be chosen by Borrower subject to Lender’s right to disapprove Borrower’s choice, which right shall not be exercised unreasonably. Lender may require Borrower to pay, in connection with this Loan, either: (a) a one-time charge for flood zone determination, certification and tracking services; or (b) a one-time charge for flood zone determination and certification services and subsequent charges each time remappings or similar changes occur which reasonably might affect such determination or certification. Borrower shall also be responsible for the payment of any fees imposed by the Federal Emergency Management Agency in connection with the review of any flood zone determination resulting from an objection by Borrower.

If Borrower fails to maintain any of the coverages described above, Lender may obtain insurance coverage, at Lender’s option and Borrower’s expense. Lender is under no obligation to purchase any particular type or amount of coverage. Therefore, such coverage shall cover Lender, but might or might not protect Borrower, Borrower’s equity in the Property, or the contents of the Property, against any risk, hazard or liability and might provide greater or lesser coverage than was previously in effect. Borrower acknowledges that the cost of the insurance coverage so obtained might significantly exceed the cost of insurance that Borrower could have obtained. Any amounts disbursed by Lender under this Section 5 shall become additional debt of Borrower secured by this Security Instrument. These amounts shall bear interest at the Note rate from the date of disbursement and shall be payable, with such interest, upon notice from Lender to Borrower requesting payment.

All insurance policies required by Lender and renewals of such policies shall be subject to Lender’s right to disapprove such policies, shall include a standard mortgage clause, and shall name Lender as mortgagee and/or as an additional loss payee and Borrower further agrees to generally assign rights to insurance proceeds to the holder of the Note up to the amount of the outstanding loan balance. Lender shall have the right to hold the policies and renewal certificates. If Lender requires, Borrower
shall promptly give to Lender all receipts of paid premiums and renewal notices. If Borrower obtains any form of insurance coverage, not otherwise required by Lender, for damage to, or destruction of, the Property, such policy shall include a standard mortgage clause and shall name Lender as mortgagee and/or as an additional loss payee and Borrower further agrees to generally assign rights to insurance proceeds to the holder of the Note up to the amount of the outstanding loan balance.

In the event of loss, Borrower shall give prompt notice to the insurance carrier and Lender. Lender may make proof of loss if not made promptly by Borrower. Unless Lender and Borrower otherwise agree in writing, any insurance proceeds, whether or not the underlying insurance was required by Lender, shall be applied to restoration or repair of the Property, if the restoration or repair is economically feasible and Lender’s security is not lessened. During such repair and restoration period, Lender shall have the right to hold such insurance proceeds until Lender has had an opportunity to inspect such Property to ensure the work has been completed to Lender’s satisfaction, provided that such inspection shall be undertaken promptly. Lender may disburse proceeds for the repairs and restoration in a single payment or in a series of progress payments as the work is completed. Unless an agreement is made in writing or Applicable Law requires interest to be paid on such insurance proceeds, Lender shall not be required to pay Borrower any interest or earnings on such proceeds. Fees for public adjusters, or other third parties, retained by Borrower shall not be paid out of the insurance proceeds and shall be the sole obligation of Borrower. If the restoration or repair is not economically feasible or Lender’s security would be lessened, the insurance proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower. Such insurance proceeds shall be applied in the order provided for in Section 2.

If Borrower abandons the Property, Lender may file, negotiate and settle any available insurance claim and related matters. If Borrower does not respond within 30 days to a notice from Lender that the insurance carrier has offered to settle a claim, then Lender may negotiate and settle the claim. The 30-day period will begin when the notice is given. In either event, or if Lender acquires the Property under Section 22 or otherwise, Borrower hereby assigns to Lender (a) Borrower’s rights to any insurance proceeds in an amount not to exceed the amounts unpaid under the Note or this Security Instrument, and (b) any other of Borrower’s rights (other than the right to any refund of unearned premiums paid by Borrower) under all insurance policies covering the Property, insofar as such rights are applicable to the coverage of the Property. Lender may use the insurance proceeds either to repair or restore the Property or to pay amounts unpaid under the Note or this Security Instrument, whether or not then due.
5. **Borrower’s Obligation to Maintain Hazard Insurance or Property Insurance.** I will obtain hazard or property insurance to cover all buildings and other improvements that now are, or in the future will be, located on the Property. The insurance will cover loss or damage caused by fire, hazards normally covered by “Extended Coverage” hazard insurance policies, and any other hazards for which Lender requires coverage, including, but not limited to earthquakes and floods. The insurance will be in the amounts (including, but not limited to, deductible levels) and for the periods of time required by Lender. What Lender requires under the last sentence can change during the term of the Loan. I may choose the insurance company, but my choice is subject to Lender’s right to disapprove. Lender may not disapprove my choice unless the disapproval is reasonable. Lender may require me to pay either (a) a one-time charge for flood zone determination, certification and tracking services, or (b) a one-time charge for flood zone determination and certification services and subsequent charges each time remappings or similar changes occur which reasonably might affect the flood zone determination or certification. If I disagree with the flood zone determination, I may request the Federal Emergency Management Agency to review the flood zone determination and I promise to pay any fees charged by the Federal Emergency Management Agency for its review.

If I fail to maintain any of the insurance coverages described above, Lender may obtain insurance coverage, at Lender’s option and my expense. Lender is under no obligation to purchase any particular type or amount of coverage. Therefore, such coverage will cover Lender, but might or might not protect me, my equity in the Property, or the contents of the Property, against any risk, hazard or liability and might provide greater or lesser coverage than was previously in effect. I acknowledge that the cost of the insurance coverage so obtained might significantly exceed the cost of insurance that I could have obtained. Any amounts disbursed by Lender under this Section 5 will become my additional debt secured by this Security Instrument. These amounts will bear interest at the interest rate set forth in the Note from the date of disbursement and will be payable with such interest, upon notice from Lender to me requesting payment.

All of the insurance policies and renewals of those policies will include what is known as a “Standard Mortgage Clause” to protect Lender and will name Lender as mortgagee and/or as an additional loss payee. The form of all policies and renewals will be acceptable to Lender. Lender will have the right to hold the policies and renewal certificates. If Lender requires, I will promptly give Lender all receipts of paid premiums and renewal notices that I receive.
If I obtain any form of insurance coverage, not otherwise required by Lender, for damage to, or destruction of, the Property, such policy will include a Standard Mortgage Clause and will name Lender as mortgagee and/or as an additional loss payee.

If there is a loss or damage to the Property, I will promptly notify the insurance company and Lender. If I do not promptly prove to the insurance company that the loss or damage occurred, then Lender may do so.
The amount paid by the insurance company for loss or damage to the Property is called “Insurance Proceeds.” Unless Lender and I otherwise agree in writing, any Insurance Proceeds, whether or not the underlying insurance was required by Lender, will be used to repair or to restore the damaged Property unless: (a) it is not economically feasible to make the repairs or restoration; (b) the use of the Insurance Proceeds for that purpose would lessen the protection given to Lender by this Security Instrument; or (c) Lender and I have agreed in writing not to use the Insurance Proceeds for that purpose. During the period that any repairs or restorations are being made, Lender may hold any Insurance Proceeds until it has had an opportunity to inspect the Property to verify that the repair work has been completed to Lender’s satisfaction. However, this inspection will be done promptly. Lender may make payments for the repairs and restorations in a single payment or in a series of progress payments as the work is completed. Unless Lender and I agree otherwise in writing or unless Applicable Law requires otherwise, Lender is not required to pay me any interest or earnings on the Insurance Proceeds. I will pay for any public adjusters or other third parties that I hire, and their fees will not be paid out of the Insurance Proceeds. If the repair or restoration is not economically feasible or if it would lessen Lender’s protection under this Security Instrument, then the Insurance Proceeds will be used to reduce the amount that I owe to Lender under this Security Instrument. Such Insurance Proceeds will be applied in the order provided for in Section 2. If any of the Insurance Proceeds remain after the amount that I owe to Lender has been paid in full, the remaining Insurance Proceeds will be paid to me.

If I abandon the Property, Lender may file, negotiate and settle any available insurance claim and related matters. If I do not answer, within 30 days, a notice from Lender stating that the insurance company has offered to settle a claim, Lender may negotiate and settle the claim. The 30-day period will begin when the notice is given. In either event, or if Lender acquires the Property under Section 22 of this Security Instrument or otherwise, I give Lender my rights to any Insurance Proceeds in an amount not greater than the amounts unpaid under the Note and this Security Instrument. I also give Lender any other of my rights (other than the right to any refund of unearned premiums that I paid) under all insurance policies covering the Property, if the rights are applicable to the coverage of the Property. Lender may use the Insurance Proceeds either to repair or restore the Property or to pay amounts unpaid under the Note or this Security Instrument, whether or not then due.
## APPENDIX B

**Southern California Firestorms of 2003 & 2007 Compared**

<table>
<thead>
<tr>
<th>Year</th>
<th>Acres Burned</th>
<th>Total Structures Destroyed</th>
<th>Total Homes Destroyed</th>
<th>Insured Losses</th>
<th>Total Claims</th>
<th>Total Request for Assistance</th>
<th>Request for Assistance for Interinsurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>733,697</td>
<td>4,956</td>
<td>3,681</td>
<td>$2.2 billion*</td>
<td>16,100</td>
<td>676</td>
<td>376</td>
</tr>
<tr>
<td>2007</td>
<td>618,021</td>
<td>3,187</td>
<td>2,190</td>
<td>up to $2.32 billion**</td>
<td>39,000**</td>
<td>4351</td>
<td>781</td>
</tr>
</tbody>
</table>

* Adjusted for inflation
** 2007 CDF Annual Report, Projected
† California Department of Insurance, July 2006
\[Summary: CDF, 2007\]
APPENDIX C

Tobacco Warning Labels

Canada & UK

United States
Smoking kills

Caution: Cigarette Smoking May Be Hazardous To Your Health

Smokers die younger
18) **LIQUIDATED DAMAGES:** By placing their initials immediately below, Buyer and Seller agree that it would be impracticable or extremely difficult to fix actual damages in the event of a default by Buyer, that the amount of Buyer’s Deposit hereunder (as same may be increased by the terms hereof) is the parties’ reasonable estimate of Seller’s damages in the event of Buyer’s default, and that upon Buyer’s default in its purchase obligations under this agreement, not caused by any breach by Seller, Seller shall be released from its obligations to sell the Property and shall retain Buyer’s Deposit (as same may be increased by the terms hereof) as liquidated damages, which shall be Seller’s sole and exclusive remedy in law or at equity for Buyer’s default.

Buyer's Initials ___________ Seller's Initials ___________

31) **ARBITRATION OF DISPUTES:** If a controversy arises with respect to the subject matter of this Purchase Agreement or the transaction contemplated herein (including but not limited to the parties’ rights to the Deposit or the payment of commissions as provided herein), Buyer, Seller and Agent agree that such controversy shall be settled by final, binding arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, and judgment upon the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof.

**NOTICE:** By initialing in the space below you are agreeing to have any dispute arising out of the matters included in the “Arbitration of Disputes” provision decided by neutral arbitration as provided by California law and you are giving up any rights you might possess to have the dispute litigated in court or jury trial. By initialing in the space below you are giving up your judicial rights to discovery and appeal, unless such rights are specifically included in the “Arbitration of Disputes” provision. If you refuse to submit to arbitration after agreeing to this provision, you may be compelled to arbitrate under the authority of the California Code of Civil Procedure. Your agreement to this arbitration provision is voluntary.

We have read and understand the foregoing and agree to submit disputes arising out of the matters included in the “Arbitration of Disputes” provision to neutral arbitration.

Buyer’s Initials ___________ Seller’s Initials ___________

Buyer’s Agent’s Initials ___________ Seller’s Agent’s Initials ___________