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COMMENTS

SOFTENING THE SHORT SHRIFT: REGULATING HOMEOWNERS INSURANCE LIMITS AS CAUSES OF UNDERINSURANCE

When Agnes Everett's home was destroyed by a wildfire, State Farm Insurance, her homeowners insurance provider, agreed that she had suffered a "total loss."¹ When Everett discovered that she had paid premiums for twelve years for "replacement coverage" that left her over \$350,000 underinsured, she brought multiple claims against State Farm—each effectively asserting that State Farm failed to perform as promised.² Everett alleged that when she began her relationship with State Farm, her agent assured her that her policy was sufficient to cover any loss, and that she had "nothing to worry about."³ State Farm responded by stating that six years after its initial assurances, it changed the terms of the policy by instituting limits on the amount it would pay and gave "clearly worded notice" of the change.⁴ State Farm had *also* sent yearly reminders to Everett that the limits on her policy might be "significantly different" than the actual replacement cost of her home, and that it was *Everett's* responsibility to ensure that her coverage was adequate.⁵ The California Court of Appeal, in affirming summary judgment in favor of State Farm, held that while Everett claimed that State Farm's own assurances obligated

1. Appellant's Opening Brief at 6, *Everett v. State Farm Gen. Ins. Co.*, 162 Cal. App. 4th 649 (2008) (No. E041807).

2. *Id.* at 2, 17.

3. *Id.* at 4.

4. Respondent's Brief at 1, *Everett*, 162 Cal. App. 4th 649 (No. E041807). For several years preceding the fire, the annual Renewal Certificate for Everett's policy included a statement that her policy limits reflected an "estimated replacement cost" and that "the actual cost to replace your home may be significantly different." *Id.* at 7. The Certificate also warned that "State Farm does not guarantee that this figure will represent the actual cost to replace your home" and that Everett, the insured, was "responsible for selecting the appropriate amount of coverage" *Id.*

5. *Id.* at 7.

it to keep her “in good hands,” Everett herself bore that burden under the terms of her contract.⁶

Everett’s indignation toward State Farm’s seemingly sudden and convenient abnegation of responsibility is shared by some commentators.⁷ The messages conveyed by insurers, both via advertising and in-person assurances by insurance agents, are sometimes perceived as creating a duty to fulfill the resultant “reasonable expectations” of consumers.⁸ The purpose of this Comment is to explore the legal implications of one possible expectation of consumers—that insurer assessments of “proper” insurance limits actually serve as competent appraisals of property values. State Farm’s written admonishment to Agnes Everett that *she* was responsible to accurately diagnose her own needs may strike many as contrary to insurers’ advertised self-portrayals as competent guardians of consumer interests.⁹ While litigation and research concerning the legal obligations of insurers often focus upon those duties created by the formation of a contract between insurer and insured, insurance limits relate primarily to matters of fact (i.e., the replacement value of a home), the accuracy of which are independent

6. *Everett*, 162 Cal. App. 4th at 661.

7. See Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholders’ Objectively Reasonable Expectations of Insurance Coverage*, 5 CONN. INS. L. J. 335, 380-81 (1998) (asserting that insurers owe a duty to fulfill policyholders’ expectation of protection and that “opportunistic breach” is inconsistent with that duty).

8. *Id.* at 394.

9. See *id.* at 393-94. See also Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1403-05 (1994) (detailing insurer advertisements which promulgate a “story of trust and dependence”). Courts have also recognized the effect of insurer advertising upon consumer perceptions of the duties that insurers undertake. Some have held that such assurances may be considered in determining whether an insurer has committed itself to accepting broad fiduciary duties. See, e.g., *Force v. ITT Hartford Life & Annuity Ins. Co.*, 4 F. Supp. 2d 843, 854 n.11 (D. Minn. 1998); *Dornberger v. Metro. Life Ins. Co.*, 961 F. Supp. 506, 545-47 (S.D.N.Y. 1997). However, in the context of fraud litigation, at least one court has described Allstate’s “you’re in good hands” slogan as an example of “loose general statements made by sellers in commending their wares . . . upon which no reasonable man would rely.” *Smith v. Allstate Ins. Co.*, 160 F. Supp. 2d 1150, 1154 (S.D. Cal. 2001) (quoting W. PAGE KEETON ET AL., PROSSER & KEETON, TORTS § 109, at 756-57 (5th ed. 1984)).

of any contractual obligation on the part of the insurer.

However, where insurance limits are substantially lower than the replacement cost of a home, the processes which were used in setting those limits may come into question. After the 2003 Southern California wildfires, many homeowners found that while their insurance contracts indicated that coverage extended to the replacement cost of their homes, the numerical limits on payment were drastically lower than the cost of rebuilding the homes.¹⁰ Homeowner Pam Mitchell, whose dwelling replacement limit on her State Farm policy was \$358,195, also had an “extended coverage” provision which increased the limit to \$429,834.¹¹ However, the cost of replacing her home was \$782,000.¹² The phenomenon of underinsurance among the victims of the Southern California wildfires brought attention to the software used by insurance agents to assess the appropriate coverage limits for individual homeowners.¹³ The software, designed and manufactured by Marshall & Swift/Boeckh LLC, employed a “Quick Quote” option for assessing residential property value based upon the property’s zip code, square footage, year of construction, and a few other factors.¹⁴ The reliability of this assessment procedure was questioned, and consumer advocates maintained that the “Quick Quote” option resulted in assessments of replacement cost which were forty percent lower than more detailed assessment options offered to insurance agents in the same software.¹⁵

The position of a consumer who procures homeowners insurance from an insurance agent differs from that of other consumers in that the insurance buyer may, like the wildfire victims discussed above, be ignorant of what he or she needs in the first place. One recent study revealed that nearly fifty percent of surveyed homeowners *incorrectly* believed that their insurer or agent bore the responsibility of accurately determining the replacement costs of their dwelling.¹⁶

10. Elliot Spagat, *Insurance Calculator Questioned: Homeowners Discover Coverage was Insufficient*, WASHINGTON POST, July 24, 2004, at G3.

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. J.D. Power, *Homeowners Want Carriers to Offer Identity Theft*, INS. J., Oct. 30, 2006, available at <http://www.insurancejournal.com/news/national/2006/>

Insofar as the consumer relies upon insurer quotes as representative of *what the buyer needs*, the interaction between insurer and the prospective insured would seem to be inconsistent with the sort of arms-length bargaining process usually associated with contract formation.

The legal framework currently applied to purchases of homeowners insurance is inadequate to protect homeowners such as Everett and Mitchell. Both consumer tendencies and the bargaining power and incentives of insurers warrant legal regulation of the “limits assessment” process. Part I of this Comment considers the circumstances surrounding the agreement to purchase homeowners insurance that warrant regulation of the process. Part II.A explores the language of both courts and commentators seeking to justify the legal imposition of a “quasi-fiduciary” duty on insurers based upon the nature of the relationship between insurance agents and consumers. Part II.B addresses the awkwardness of applying such “quasi-fiduciary” obligations, as articulated by those courts and commentators, to the context of initial insurance limits assessments.

Part III.A provides a brief overview of the “reasonable expectations” doctrine and the shortcomings of that doctrine as a means of judicial regulation of insurance contracts, as articulated by recent critics of the doctrine. Part III.B notes the potential remedial effects of a product liability framework to the problem of inadequate value assessment by insurers.

Part IV.A examines the possible role of enterprise liability as a means of achieving the ideal distribution of risk that homeowners insurance would effect if consumers were “perfectly rational” actors. Part IV.B suggests possible regulatory remedies of the practices related to under-assessment, including a blanket prohibition of policy limits in homeowners insurance policies. Such a prohibition could eliminate the acute losses experienced by consumers like Everett, without destroying insurer solvency.

10/30/73688 (discussing J.D. Power & Associates’ 2006 Homeowners Insurance Study). Given the widespread erroneous belief that insurers are obligated to “diagnose” an accurate replacement cost, reports that approximately two-thirds of homes in the United States are underinsured seem unsurprising. *See, e.g.*, Joseph B. Treaster, *Homeowners Come Up Short on Insurance*, N.Y. TIMES, August 31, 2004, at A1 (citing a nationwide estimate by Marshall & Swift/Boeckh, LLC).

I. JUSTIFYING REGULATION

When a consumer seeks either to procure services or to purchase a product via contract, she usually has a fairly good idea of what she wants. The primary reason for acquiring additional information is simply to determine which means will meet the desired end. The consumer, as one who desires the sought-after end, has an incentive to effectively acquire it. When presented with offers of goods or services, she may discriminate between offers based upon their perceived conformity to her desires and their relative expense. She engages prospective sellers in the process of negotiating a bargained-for exchange. Under traditional contract law, in this context, “No person is another’s keeper Each contracting party is free to obtain the best possible deal at the other’s expense.”¹⁷

One of the primary forces moving consumers to buy homeowners insurance is the fact that it is required by mortgage lenders.¹⁸ As such, these consumers may not be “drawn” to the market for insurance because of their desire to be protected from risk, but rather as a procedural prerequisite to the desired end product—a home. As consumer interest in protection decreases in salience, the motivation to acquire information regarding the effectiveness of a particular policy offered also decreases naturally. Accordingly, purchasers of homeowners insurance are often fairly characterized as “uninvolved consumers” who forego the sort of rational deliberation described above.¹⁹

Purchasers of homeowners insurance are also susceptible to what

17. 2 ERIC MILLS HOLMES & MARK S. RHODES, *HOLMES’S APPLEMAN ON INSURANCE* 398 (2d ed. 1996).

18. Jeffrey E. Thomas, *An Interdisciplinary Critique of the Reasonable Expectations Doctrine*, 5 *CONN. INS. L.J.* 295, 314 (1998). Thomas notes that consumer reliance upon information provided by lenders is typical of the “low-involvement consumer.” *Id.*

19. *See id.* at 307. Prospective insureds also rely heavily on word-of-mouth, insurer literature and advertisements, and the assurances of insurance agents themselves. *Id.* at 311-12. At the same time, they seldom “consult sources of neutral and comprehensive information, such as those from consumer organizations and state regulators.” *Id.* at 313. Insurance consumers’ behavior thus bears little resemblance to what Thomas deems “cognitive” consumer behavior, the sort of behavior presumed by the law of contracts. *See id.* at 306-07.

commentators describe as “optimism bias.”²⁰ This term reflects the tendency of consumers to irrationally believe that a low-probability event simply will not happen to them.²¹ The natural effect of this belief is a decrease in concern over whether the insurance limits stated in one’s policy accurately reflect the replacement cost of one’s home. Combined with the tendency of homeowners insurance purchasers to be relatively uninvolved in seeking and deciding upon a policy, this optimism-rooted lack of concern certainly contradicts the traditional paradigm of a “contract”—wherein, as mentioned above, parties with articulable interests wrangle with each other to reach an agreement that conforms to those interests. This sort of consumer behavior may be said to exhibit “bounded rationality” as opposed to “full rationality.” Specifically, prospective purchasers of homeowners insurance may only consider those attributes of the insurance contract that relate to their interests (satisfying lender requirements), while ignoring others (adequacy of “assessed” limits).²² This boundedness can lead not only to agreement upon unfavorable contract terms, but can also result in a lack of awareness of what the purchaser needs at the outset.

Insurance consumers’ decision-making processes may also be affected by factors that behavioral researchers label the “availability heuristic”²³ and “experiential thinking.”²⁴ The availability heuristic reflects individuals’ tendencies to use those concepts and criteria that are “available” (or cognitively accessible) to them at the time the

20. See generally Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 655-66 (1999); Christine Jolls & Cass R. Sustein, *Debiasing Through Law*, 35 J. LEGAL STUD. 199, 204 (2006).

21. See Hanson & Kysar, *supra* note 20, at 656. Hanson and Kysar cite as an illustration of optimism bias one study in which “respondents . . . although correctly estimating that fifty percent of American couples end up in divorce, estimated their own chance of divorce at zero.” *Id.* at 655.

22. See Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1206 (1998) (noting that “market competition actually will force sellers to provide low-quality non-salient attributes in order to save costs that will be passed along to buyers in the form of lower prices.”).

23. Hanson & Kysar, *supra* note 20, at 662. “Heuristic” here simply refers to a “mental rule of thumb.” *Id.*

24. See *id.* at 669.

decision-making process occurs.²⁵ The number of decisional axes that are available will necessarily be limited, and consumers use far fewer criteria than the paradigmatic “rational actor” presumed by contract law—an actor who bears a striking resemblance to the “expected utility maximizer of the economist’s model.”²⁶ One likely reason *why* the availability heuristic is a factor in policy purchasers’ behavior is the simple fact that few have experienced the low-probability losses for which they seek insurance. All individuals tend to act in an intuitive manner, based upon previous encounters with external stimuli.²⁷ The overwhelming majority of consumers have experienced neither a total loss nor the types of resultant battles with insurers that Everett endured.²⁸ One relevant question, explored in Section III.B, is whether informing insurers of the experiences of others can be expected to alter the behavioral effects of both the optimism bias and experiential thinking on the part of consumers.

The bargaining power of individual purchasers relative to their prospective insurers is also exceedingly low.²⁹ Consumers seek (or are required) to protect themselves from disaster. Their means of

25. *See id.* at 662.

26. *See id.* at 669. Hanson and Kysar note that one instantiation of the availability heuristic is that “dramatic stories by people we know about difficulties with a brand of car are likely to be overly influential even if we are familiar, via Consumer Reports, with general statistics of the reliability of different brands.” *Id.* at 663 (quoting Matthew Rabin, *Psychology and Economics*, 36 J. ECON. LIT. 11, 30 (1998)). This phenomenon of reliance upon familiar sources of information, without inquiry into their comprehensiveness or reliability for the purpose of ascertaining one’s *own* vulnerability, is consistent with Thomas’s description of insurance consumers as reliant upon word-of-mouth and neglectful of “neutral” sources, such as consumer studies. *See Thomas, supra* note 18, at 311-13.

27. Hanson & Kysar, *supra* note 20, at 669.

28. Even a major disaster such as the 2003 Southern California wildfires, which covered seven hundred and fifty thousand acres, destroyed only four thousand residential properties—a small fraction of the homeowner population. *See* Howard C. Kunreuther & Erwann O. Michel-Kerjan, *Climate Change, Insurability of Large-Scale Disasters, and the Emerging Liability Challenge*, 155 U. PA. L. REV. 1795, 1825 (2007).

29. *See generally* Anderson & Fournier, *supra* note 7, at 396-98. Here, to say that there is a “disparity in bargaining power” simply means that “one side [the prospective insured] has no meaningful opportunity to influence the terms of the agreement.” Paul F. Kirgis, *The Contractarian Model of Arbitration and its Implication for Judicial Review of Arbitral Awards*, 85 OR. L. REV. 1, 50 (2006).

investigating options and taking relevant information into proper account is often generally short-sighted. Because consumers are relatively unlikely to “shop around” for the better deal,³⁰ the insurer has less incentive to offer a policy containing substantively attractive features to better the competition. The very existence of meaningful competition between insurers is called into question by the fact that insurance contracts, and the obligations that they entail, tend to contain the same provisions as they are based upon standardized forms.³¹

In the context of assessing proper limits for an insured’s home, standardization tends to come in a slightly different form—that of software used by insurers to ascertain limits. The software used in the undervaluation of Pam Mitchell’s home was produced by Marshall & Swift/Boeckh, LLC (MSB).³² In Marshall & Swift’s own words, “As the leading provider of property intelligence, MSB serves nearly every top 100 property insurer in North America.”³³ A competitor described the company as having “a monopoly” on property valuation instruments.³⁴ A consumer intent on finding the company with the best and most accurate means of determining the replacement cost of her property would thus likely be faced with a lack of meaningfully different options.

With limited competition for the business of relatively uninvolved, often arational consumers, insurers have both the incentive and the ability to set low policy limits. The function of lower limits is, simply put, to reduce the potential cost to the insurer and increase the probability that the insured will be forced to bear the sort of losses suffered by Mitchell and Everett. Where an insurer is not limited by rationally vigilant consumer behavior, it may use to its advantage the fact that “[t]he unresponsive consumers will accept the

30. Thomas, *supra* note 18, at 308.

31. See Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389, 1405-06 (2007) (noting that the standardized contracts used by insurers, “virtually all” of which are drafted by the Insurance Services Organization, do not change according to the pressures of competition, but instead resemble “differentiated products offered by a single monopolist”).

32. Spagat, *supra* note 10, at G3.

33. MSB, <http://www.msbinfo.com/Company> (last visited Jan. 29, 2010).

34. Spagat, *supra* note 10, at G3.

exploitive contract without demanding a corresponding decrease in price”³⁵

The consumer inclination to forego “shopping” for insurers, in conjunction with the standardized contracts and methods of property valuation used by insurers, indicates that a bargaining process between insurer and insured is unlikely to take place, and if it does, is unlikely to be effective. For most homeowners, the purchase of insurance seems mischaracterized as a “bargained-for exchange.”

II.A *The Insurer as “Quasi-Fiduciary”*

Both courts and commentators do, from time to time, make reference to the relationship between insurer and insured as a “fiduciary” or “quasi-fiduciary” relationship.³⁶ The term “fiduciary” generally designates a person “required to act for the benefit of another on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence and candor.”³⁷ The appeal of harnessing the “fiduciary” label and its attendant obligations upon the insurer is attributable to the fact that consumers tend to trust that insurers will protect them from the effects

35. See Schwarcz, *supra* note 31, at 1408. Schwarcz, focusing upon the terms and provisions included in the contract, concludes that “if cognitive limitations . . . are widespread, insurers may be able to determine by research and experience which coverage exclusions insureds will ignore or overlook, and then use this information to selectively draft inefficiently one-sided terms.” *Id.* at 1422.

36. See, e.g., *Gibson v. Gov’t Employment Ins. Co.*, 162 Cal. App. 3d 441, 446 (1984) (describing the relationship between an automobile insurer and its insured as a fiduciary relationship); RAFAEL CHODOS, *THE LAW OF FIDUCIARY DUTIES*, 65-66 (2000) (detailing the tendency of the California courts to describe the legal responsibilities of insurers in the language of fiduciary duty); Anderson & Fournier, *supra* note 7, at 385-91 (cataloguing insurer acknowledgments of “the fiduciary duties owed to their policyholders.”); Eileen A. Scallen, *Promises Broken v. Promises Betrayed: Metaphor, Analogy, and the New Fiduciary Principle*, 1993 U. ILL. L. REV. 897, 915-16, 929 (1993) (arguing for the recognition of criteria for a more expansive definition of fiduciary relationships). *But cf.*, e.g., *Metro Renovation, Inc. v. Allied Group, Inc.*, 389 F. Supp. 2d 1131, 1135 (D. Neb. 2005) (holding that Nebraska law does not recognize a generally applicable fiduciary duty owed by the insurer to the insured); Douglas R. Richmond, *Trust Me: Insurers are Not Fiduciaries to Their Insureds*, 88 KY. L.J. 1, 5-6 (1999-2000) (purporting to “demonstrate that insurers are not fiduciaries to their insureds in ordinary circumstances or situations”).

37. BLACK’S LAW DICTIONARY 702 (9th ed. 2009).

of disaster, and insurers cultivate and encourage such trust through advertising and other communications to prospective consumers.³⁸ Another justification of the imposition of a fiduciary duty is that in some situations the difference in the positions of the parties is such “that had the parties in advance negotiated expressly over the issue they would have agreed that the agent owed the principal the high duty that we have described, because otherwise the principal would be placing himself at the agent’s mercy.”³⁹

In the context of limits assessments, the existence of a fiduciary duty—a duty of the insurer to act for the benefit of the insured—would signify the obligation to do everything practicable to ensure that policy limits accurately reflect the cost of replacement in the event of a total loss. It would be a duty to accurately diagnose the insured’s needs. In Everett’s case, as in the case of nearly every insured, the question of a “duty to diagnose” need accurately was, in the court’s view, not in question.⁴⁰ The terms of Everett’s policy explicitly stated that State Farm was *not* responsible for diagnosing Everett’s need.⁴¹ On its face, under standard *contract* law, the terms of the policy indicate that Everett and State farm *did* negotiate expressly and reach an agreement concerning the duty to diagnose.

In describing the duty of the insured, the California Supreme Court has stated that “[w]ith the public trust must go private responsibility consonant with the trust, including qualities of decency and humanity inherent in the responsibilities of a fiduciary.”⁴² When

38. See Anderson & Fournier, *supra* note 7, at 394; Scallen, *supra* note 36, at 933. See also cases cited *supra* note 9.

39. Scott FitzGibbon, *Fiduciary Relationships Are Not Contracts*, 82 MARQ. L. REV. 303, 322 (1999) (quoting *Burdett v. Miller*, 957 F.2d 1375, 1381 (7th Cir. 1992)). FitzGibbon notes that a contracting party’s vulnerability, where extreme, may serve as a factor contributing to a finding of unconscionability. *Id.* at 323-24. However, even where bargaining power is imbalanced in the extreme, invalidation of a contract on the grounds of unconscionability *also* requires that “the terms of the contract are so unfair that enforcement should be withheld.” *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 450 (D.C. Cir. 1965). *But see* Korobkin, *supra* note 22, at 1206 (promoting a view that defines “unconscionability” in terms of “social inefficiency” rather than terms of “unfairness”).

40. *Everett v. State Farm Gen. Ins. Co.*, 162 Cal. App. 4th 649, 660 (2008).

41. *Id.*

42. *Frommoethelydo v. Fire Ins. Exch.*, 42 Cal. 3d 208, 215 (1986); see also CHODOS, *supra* note 35, at 65. The *Frommoethelydo* court specifically designated

such language is employed to impose a duty upon an insurer, several factors justifying regulation discussed in Part I are cited in support.⁴³ Intuitively, it seems fitting to say that companies that benefit by representing themselves to uninformed, vulnerable consumers as being committed to “taking care of” those consumers have also bound themselves to a heightened duty to their policyholders.

Under one proposed standard for determining the existence of a fiduciary duty:

“[A] fiduciary relationship exists when there is (1) dependence or vulnerability by one party on the other, that (2) results in power being conferred on the other (3) such that the entrusting party is not able to protect itself effectively, by “cover” or otherwise, and (4) this entrustment has been solicited or accepted by the party on which the fiduciary obligation is imposed.”⁴⁴

Given the limited bargaining power and lack of either information or meaningful choice on behalf of the prospective insured discussed in Part I, the first of these criteria is easily met. Vulnerability exists the moment the consumer walks into an agent’s office or visits the insurer’s website. The relevant issue under these criteria, however, then becomes the point at which a consumer “confers power” upon the insurer.

The natural response to this question is that power is conferred when the contract is signed.

II.B. “*Quasi-Fiduciary*” Norms as Contractual Obligations

The context in which the language of fiduciary responsibility is applied to insurers strongly indicates that any such purported duty arises from the promises made in the contract between insurer and insured. Limits assessments, construed as extra-contractual

this “private responsibility” as supplemental to an insurer’s contractual duty of good faith and fair dealing. See *Frommoethelydo*, 42 Cal. 3d at 215.

43. Richmond contends that “courts that have cast insurers as fiduciaries have done so to fill the void created by the parties’ disparate bargaining power and insurers’ exclusive control over litigation, settlement, and claim processing.” Richmond, *supra* note 36, at 5. See also Anderson & Fournier, *supra* note 7, at 336.

44. Scallen, *supra* note 36, at 922.

“diagnoses” or approximations of consumer need, take place outside the scope of obligations created by the contract and thus do not fit within the “quasi-fiduciary” obligations often imputed to the insured.

The California Court of Appeal’s explanation of an insurer’s duty to the insured in *State Farm Fire Casualty Co. v. Superior Court*⁴⁵ is illustrative. The court stated that “[t]he relationship between an insurer and an insured is akin to a fiduciary relationship.”⁴⁶ The “kinship” noted by the court lies in the fact that “[t]he insurer is bound to conduct itself with the utmost good faith for the benefit of its insured.”⁴⁷ The court, however, did explain that the insurer’s duty to act in the interests of the insured is not unlimited, but arises from contractual promises and statutory provisions which simply reinforce the contractual duty of good faith.⁴⁸

The concept of a fiduciary duty, even when imputed via the liberal criteria set out by Scallen above, only applies to instances in which the would-be fiduciary has expressed “some indication of acceptance, whether express or implied, of that higher duty.”⁴⁹ Indeed, the sentiment that insurers should be bound by something akin to a fiduciary duty is grounded in the fact that insurers seem to *promise* to do so. However, the obligations arising from a contractual promise are limited to the terms of the agreement. The contractual duty of “good faith” encompasses only those promises. Richard Posner has postulated that:

45. *State Farm Fire & Casualty, Co. v. Superior Court*, 216 Cal. App. 3d 1222 (1989).

46. *Id.* at 1226.

47. *Id.*

48. *Id.* at 374-75; *see also* Cal. Ins. Code §332 (2005) (“Each party to a contract of insurance shall communicate to the other, in good faith, all facts within his knowledge which are or which he believes to be material to the contract and as to which he makes no warranty, and which the other has not the means of ascertaining.”). In Everett’s case, State Farm met this standard simply by notifying Everett of her responsibilities to ascertain her own need. *See Everett, supra* note 4 and accompanying text.

49. Scallen, *supra* note 36, at 971. *See also* Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 BUFF. L. REV. 99, 135 (2008) (“[F]iduciary relationships, like other agency relationships, entail consent by the principal that the fiduciary will act on the principal’s behalf and subject to the principal’s control.”).

The particular confusion to which the vaguely moralistic overtones of 'good faith' give rise is the belief that every contract establishes a fiduciary relationship. A fiduciary is required to treat his principal as if the principal were he In fact the law contemplates that people frequently will take advantage of the ignorance of those with whom they contract⁵⁰

The concept of an insurer's "fiduciary duty" has been effectively limited in application to describe the *contractual* obligations of the insurer.⁵¹ The function of the term has been largely to regulate the duty to execute existing obligations, rather than create new ones.⁵² As in Everett's case, insurer assessment of policy limits occurs "outside" of the scope of the contract and is accompanied by contractual terms expressly relieving insurers of the responsibility to accurately diagnose the need of the insured.⁵³

"Fiduciary duty" is thus ill-suited as a vehicle for the regulation of limits assessments by insurers. Its precedential force extends only so far as the covenant of good faith and fair dealing, which arises under the terms of any contract.

However, the intuition remains that consumers rely upon the self-reported role of the insurer as one who will serve to protect them when calamity arrives, and that insurers benefit from this self-portrayal.

III.A. *Reasonable Expectations and the Insurer's Contractual Duty*

Another means of imposing duty upon the insurer is more explicitly rooted in the contract, rather than solely in the "special qualities" of the relationship between insurer and insured. The doctrine of reasonable expectations has been used by courts to enforce the objectively reasonable expectations of insureds "even though painstaking study of the policy provisions would have negated those

50. FitzGibbon, *supra* note 39, at 324.

51. *See generally* Richmond, *supra* note 36, at 28-29.

52. *See generally id.* When viewed in light of the insurers' contractual obligations, insurer advertisements which seek to induce trust might reasonably be construed as assurances "that [insurers] will act reliably and reasonably, pay valid claims that their policies cover, and defend claims or suits as provided in their policies." *Id.* at 4 n.16.

53. *Everett v. State Farm Gen. Ins. Co.*, 162 Cal. App. 4th 649, 660 (2008).

expectations.”⁵⁴ The reasonable expectations doctrine, so defined, seems to hold promise for those such as Everett. Her attorney argued that, given State Farm’s policy of “extended replacement,” its concomitant imposition of policy limits which ended up being insufficient to replace Everett’s home created an ambiguity in the contract.⁵⁵ Everett’s attorney insisted that such ambiguity in the terms of the policy should be interpreted in favor of Everett when they “would lead an insured to reasonably expect coverage for the claim purportedly excluded.”⁵⁶ The court, however, found that the policy clearly stated that State Farm’s obligation to pay extended only so far as the policy limits.⁵⁷

The reasonable expectations doctrine seeks to protect unsophisticated consumers from complicated, confusing contract language, expounded by insurers who possess superior bargaining power and are thus in a position to extract assent to terms in their favor.⁵⁸ The existence of expectations on the part of consumers, as well as the reasonableness of those expectations, is inferred from the “surrounding circumstances.”⁵⁹ Upon finding a consumer expectation, the court then evaluates actual coverage provided in the policy in relation to that expectation.⁶⁰ Where the party promulgating a standardized adhesion contract “has reason to believe that the adhering party would not have accepted the agreement if he had known the agreement contained the particular term,” that term is not enforceable against the adhering party.⁶¹ Ascertaining the expectations

54. Thomas, *supra* note 18, at 298 (quoting Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970)). Thomas notes that this language endorsing judicial deviation from express contractual terms constitutes the “strongest form” of the doctrine, with the “weakest” being the tendency of courts to use the doctrine “as a rule of construction to resolve ambiguities.” Thomas, *supra* note 18, at 298-99.

55. See Appellant’s Opening Brief, *supra* note 1, at 29.

56. *Id.* at 30 (citation omitted).

57. *Everett*, 162 Cal. App. 4th at 660.

58. See Thomas, *supra* note 18, at 296-97.

59. *Id.* at 299.

60. See HOLMES & RHODES, *supra* note 17, at 417. The doctrine of reasonable expectations is invoked primarily in situations where “one party prepares and proffers a standard form contract to another on a no-bargain take-it-or-leave-it basis . . .” *Id.*

61. *Id.* at 417-18 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 237, cmt.

of consumers via the total surrounding circumstances of the transaction gives the insured an advantage in that extrinsic evidence of the nature of the transaction is sometimes considered despite the general prohibition of parol evidence.⁶²

In a situation such as Everett's, one would be hard pressed to find a single jurisdiction that would use the doctrine of reasonable expectations to impute to State Farm either the duty to include limits which accurately reflect actual replacement costs or refuse to enforce the limits as contrary to reasonable consumer expectations. Even where, to ensure fairness to consumers, courts have used the doctrine to invalidate the implications of contractual language,⁶³ they have relied upon the existence of some contractual language or verbal assurance which effectively put the insurer "on notice" of potential reasonable expectations of coverage.⁶⁴ In the case of inadequate limits, a court is unlikely to find the existence of such notice absent explicit oral or written assurances from the insurer that the policy limits will be sufficient to cover loss.⁶⁵

Absent a specific assurance of adequacy, insurers do not have a general duty to investigate and inform the insured of adequacy of coverage.⁶⁶ A consumer's reasonable expectations have been calibrated by courts according to the existence of such express assurances, and such assurances have been found to supersede written

f (1979)).

62. See David F. Tavella, *Are Insurance Policies Still Contracts?*, 42 CREIGHTON L. REV. 157, 160 (2009). Tavella advocates a "weak" form of the doctrine of reasonable expectations, arguing that extending the scope of the doctrine beyond cases where contractual language is ambiguous and uncertain would undermine "the main goal of contract interpretation [which] generally is to enforce the parties' intent." *Id.* at 158 (quoting *Burkhardt v. Bailey*, 680 N.W.2d 453, 464 (Mich. Ct. App. 2004)).

63. See *Pizzullo v. New Jersey Mfrs. Ins. Co.*, 952 A.2d 1077, 1088-89 (N.J. 2008) (ambiguous language in policy and oral representations by insurers' customer service representative rendered insureds' expectation of "double coverage" reasonable).

64. See ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 189 (3d ed. 2002).

65. See *Free v. Republic Ins. Co.*, 8 Cal. App. 4th 1726, 1730 (1992) (agent's assurances that policy limits were sufficient, upon regular inquiries by principal, gave rise to duty to ensure such sufficiency).

66. See *Jones v. Grewe*, 189 Cal. App. 3d 950, 954 (1987).

terms within the policy.⁶⁷

However, the expectation that an insurer is responsible for correctly assessing the value of a home, and consequently for demarcating adequate limits, usually does not arise from express assurances. Instead, it would seem to arise from the insurer's general representations and activities in determining limits. The insurer or agent asks questions of and receives information from the insured for the purpose of determining limits, using software to assist in the determination.⁶⁸ The consumer, almost always ignorant of reliable processes for determining replacement value, will as a general manner rely upon the determinations made by the insurer.

Furthermore, the policy itself, which contains the specific limits determined by the insurance company, is not presented to the consumer until she receives it in the mail weeks after the purchase transaction.⁶⁹ The insured thus remains uninvolved as a matter of *contractual process* in the determination of specific policy limits. It may be said, then, that consumers develop expectations that the insurer has taken up the responsibility of accurately assessing the replacement costs of the home.

The problem with imputing a *reasonable* expectation to the consumer on this basis is that: 1) limits are represented as *limits* rather than cost assessments in the policy, and 2) the terms of the policy unambiguously label the limit figures as *estimates* rather than accurate appraisals.⁷⁰ Given this unambiguous written language, an insurer may justifiably argue that any expectation of a duty to reliably assess replacement costs is unreasonable, absent some independent assurance (usually in the form of an oral promise) by the insured or agent.

The reasonable expectations doctrine thus resembles the "quasi-fiduciary" duty of good faith and fair dealing in that each hinges on a *contractual manifestation of agreement* that the insurer will undertake

67. See generally Thomas J. Goger, Annotation, *Liability of Insurance Agent or Broker on Ground of Inadequacy of Property Insurance Coverage Procured*, 72 A.L.R. 3d 747 § 11[a] (1976).

68. Spagat, *supra* note 10, at G3.

69. R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother's Keeper: The Inability of an Informed Minority to Correct for Imperfect Information*, 47 HASTINGS L.J. 635, 641 (1996).

70. See *Everett v. State Farm Gen. Ins. Co.*, 162 Cal. App. 4th 649, 661 (2008).

the responsibility of accurate assessment. For Everett or Mitchell to have a contractual cause of action, they would need to point to such a manifestation.

Insurers benefit from both potential confusion regarding their duty to assess and from the bounded consumer rationality discussed in Part I. These factors allow them to limit their own exposure and increase the exposure of their policyholders. The effects of this advantage can sometimes result in a disaster after the disaster when a homeowner suffers a total loss.

III.B. *Insurance Policies as Products: Inadequate Limits and Defective Warnings*

One problem with applying the reasonable expectations doctrine to insurance policies as contracts is that one major factor justifying regulation is that insurance consumers do not exhibit the type of behavior consistent with the development of finely detailed expectations.⁷¹ It assumes the existence of a bargained-for exchange that almost never really takes place.⁷² Optimism bias and other aspects of bounded rationality result in a vulnerable consumer populace, and insurers and their agents may manipulate this vulnerability, especially when the law assumes that the consumer is bargaining under the traditional paradigm.

The reasonable expectations doctrine has also been criticized as a vague and unpredictable means of regulation, which leaves insurers wasting time guessing about consumer expectations that may have no effect on consumer decisions.⁷³ Daniel Schwarcz, after voicing this and other criticisms of the reasonable expectations doctrine, has suggested using a products liability framework for determining whether insurance policies are “defective” such that the insurer is

71. See *supra* Part I.

72. See *supra* Part I.

73. See generally Susan M. Popik & Carol D. Quackenbos, *Reasonable Expectations After Thirty Years: A Failed Doctrine*, 5 CONN. INS. L.J. 425, 433 (1998) (arguing that the doctrine converts “every court into a mini-legislature” engaged in “ad hoc judicial lawmaking”); Schwarcz, *supra* note 31, at 1433-35 (explaining how, under the doctrine of reasonable expectations, “whether the private benefit to the insurer of disclosing-avoiding future liability-is larger, smaller, or equal to the social benefit of disclosure-improving consumer information-will vary on a case-by-case basis”).

legally liable to the consumer for damages.⁷⁴ One duty that would arise under such a framework is the insurer's duty to warn consumers.⁷⁵ Such a duty would impose liability upon insurers "when the foreseeable risks of harm posed by the product could have been reduced or avoided by the provision of reasonable instructions or warnings."⁷⁶ This requirement may have promise in inducing insurers to clarify the risks associated with inadequate insurance limits.

Under the principles of products liability law, a warning that is overloaded with so much information that it becomes difficult to process is ineffective.⁷⁷ An adequate warning would provide prominent, readable, and comprehensible notifications of the risks associated with the policy.⁷⁸ One of the major risks associated with the policy is the risk that policy limits will be insufficient.⁷⁹ The cost of promulgating warnings would be limited to the minimal amount of labor needed to construct them and the relatively limited amount of money needed to print them along with the rest of the policy.⁸⁰ The benefits to consumers could be significant, drawing their attention to the risk of inadequate limits.⁸¹ A duty to warn in clear, prominent language would require insurers to state unequivocally a risk that makes their product look unattractive, a feature of the policy they have a natural incentive to avoid.⁸²

However, there are significant questions as to whether warnings would have the desired effect on consumer behavior. The essence of

74. See Schwarcz, *supra* note 31, at 1436.

75. See *id.* at 1440.

76. *Id.* (quoting RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2(c) (1998)).

77. Compare MARK A. GEISTFELD, PRINCIPLES OF PRODUCT LIABILITY 138 (2006) (stating that "too much" information may lead to confusion or paralysis in consumer choices) with Howard Latin, "Good" Warnings, Bad Products, and Cognitive Limitations, 41 UCLA L. REV. 1193, 1212 (1994) ("[R]esearch suggests that consumers in real settings stop assimilating information long before the point of decision-making paralysis.") and Schwarcz, *supra* note 31, at 1441 ("Multiple warnings tend to crowd one another out, leaving consumers with a diluted set of information that most will either ignore or fail to appreciate.").

78. See Schwarcz, *supra* note 31, at 1441.

79. See *id.* at 1443-44.

80. See GEISTFELD, *supra* note 77, at 134.

81. See Schwarcz, *supra* note 31, at 1444.

82. See GEISTFELD, *supra* note 77, at 136.

optimism bias is that consumers tend to underestimate low-probability events to such a degree that they feel it simply cannot happen to them.⁸³ Some commentators suggest that, by highlighting the negative consequences of underestimated risks, warnings may increase the likelihood that consumers *will* take meaningful steps to avoid such consequences.⁸⁴ The form of such emphasis may be anecdotal.⁸⁵ Telling the stories of those such as Everett or Mitchell who faced significant losses due to underinsurance could raise the likelihood that insurance consumers will more realistically assess their level of susceptibility to “total losses.”

The effectiveness of such an approach is far from clear. The type of warning described above simply relates to consumers the susceptibility of the general population to low-probability events. The basic function of optimism bias is to arationally differentiate between one’s own risks and those of others. Some studies have shown that, despite different attempts to “de-bias” consumers’ cognitive behavior, the optimism bias remains an “indefatigable cognitive feature” that causes “individuals to underestimate the extent to which a threat applies to them even when they can recognize the severity it poses to others.”⁸⁶

Furthermore, warnings that emphasize the high level of loss experienced by Everett and others could function in a way that simply reinforces the optimism bias. Descriptions of individuals who are underinsured by several hundred thousand dollars can serve as an opportunity for prospective consumers to bolster their unrealistic comparisons of themselves to others.⁸⁷ Consumers may simply focus upon the risk-increasing factors of the victims portrayed in the warning (such as the failure to read a policy or understand it, living in a home highly susceptible to fires or other causes of loss), while disregarding the risk-decreasing behaviors of such victims and overestimating the effectiveness of their own risk-decreasing

83. See Hanson & Kysar, *supra* note 20, at 656.

84. Jolls & Sustain, *supra* note 20, at 210-11.

85. *Id.* at 212 (suggesting that “requiring the specific account as opposed to the generalized statement would help to reduce optimism bias” and that “the specific account of harm . . . would change occasionally to avoid the phenomenon of ‘wear-out’ in which consumers learn to tune out messages that are repeated too often”).

86. Hanson & Kysar, *supra* note 20, at 657-58.

87. See *id.* at 729.

behaviors.⁸⁸ A belief that human skill or behavior can control one's risk level at all may facilitate such unrealistic comparison⁸⁹—especially when it comes to natural occurrences such as fire which are often causally independent of victim behavior.

Finally, the fact that many insurance policies are purchased over the internet could further frustrate the effectiveness of promulgated warnings. Most consumers do not actually read the terms of contracts “formed” via internet transactions.⁹⁰ This phenomenon, when taken in conjunction with the legal presumption in a “failure to warn” case that the consumer does actually read the warning provided by the manufacturer,⁹¹ tends to indicate that insurers may be able to rely upon relatively inexpensive yet *ineffective* warnings in shielding themselves from liability.

While prominent warnings targeted to raise awareness of the risks of underinsurance will certainly increase awareness of the phenomenon generally, they may not be sufficient to alter the effects of optimism bias upon consumer behavior. As discussed above, some warnings may even exacerbate consumer optimism bias. In addition, the increasing frequency of online insurance purchases, coupled with consumer tendencies not to read information related to those purchases, make it even more unlikely that “underinsurance warnings” will prove effective in de-biasing consumer behavior.

IV.A. *Enterprise Liability and Inadequate Insurance Policies*

There is reason to believe that consumers’ “bounded rationality”

88. See *id.* at 730 (citing research which indicates that “by giving subjects a ‘worst-case’ list of risk factors or a ‘high-risk’ comparison target, the researchers provided them with further ‘support’ for their biased self-conception.”).

89. See *id.* at 730-31. Insurers themselves might also facilitate such comparisons by promulgating warnings that exploit this consumer tendency. To do so, they need only “provide consumers with lists of risk-decreasing factors or a particularly high-risk consumer as a comparison example so that consumers will process the information in a self-serving manner and thereby exacerbate the optimistic bias.” *Id.* at 730.

90. See Heath H. Bruser, *Form Contracts in an Online World: The Enforceability of Click-Wrap or Browse-Wrap Agreements*, 55 FED. LAW. 14 (Oct. 2008).

91. See, e.g., RESTATEMENT (SECOND) OF TORTS: PRODUCTS LIABILITY § 402A cmt. j (1965).

will be incorrigible and not amenable to even the most carefully crafted warnings. Part of the appeal of requiring warnings as opposed to more aggressive bases for insurer liability is that imposing a duty to warn allows people the freedom to make their own choices.⁹² However, where that freedom is merely nominal, and tort law cannot effect an adjustment in the precautions taken by consumers, some products liability theorists suggest placing “product-accident costs on manufacturers.”⁹³ Hanson and Kysar predict that where the consumer remains “undeterrable,” imposing “enterprise liability” on manufacturers works to provide sufficient incentive for such manufacturers to circulate safer products and pass the cost of this care on to consumers.⁹⁴ The enterprise liability framework provides a promising alternative that would eliminate the qualitatively severe losses of those such as Everett and Mitchell while allowing insurers to compensate for increased costs through product pricing.

Enterprise liability imposes liability on a manufacturer for any harm caused by its product.⁹⁵ An application of this general principle of liability to the context of limits in insurance policies would simply

92. Jolls & Sustain, *supra* note 20, at 202. In addition to this “choice-preserving” function, Jolls and Sustain claim that methods of “de-biasing,” such as consumer warnings, have the added benefit of helping “to address boundedly rational behavior while avoiding the imposition of significant costs on those who do not exhibit bounded rationality.” *Id.* The pivotal assumption of this contention is that “de-biasing” methods will in fact influence consumer behavior in a way that avoids significant social costs.

93. Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: A Response to Market Manipulation*, 6 ROGER WILLIAMS U. L. REV. 259, 269 (2000) [hereinafter Hanson & Kysar, *A Response*].

94. *Id.* at 269-70. In the field of products liability, a major argument against the imposition of enterprise liability is that “consumers would have no incentive to undertake their own precautions if manufacturers were forced to bear all of the cost of the harm that products cause.” *Id.* at 272 (quoting James A. Henderson, Jr. & Jeffrey J. Rachlinski, *Product-Related Risk and Cognitive Biases: The Shortcomings of Enterprise Liability*, 6 ROGER WILLIAMS U. L. REV. 213, 226 (2000)). With respect to homeowners’ incentive to assess the adequacy of their policy limits, the stories of those such as Everett and Mitchell, as well as the prevalence of underinsurance, suggest that policyholders remain boundedly rational *despite* powerful extant incentives to behave otherwise. Indeed, the operation of “bounded rationality” upon decision-making evinces a discontinuity between action and “rational interests.” *See supra* Part I.

95. *Id.* at 263.

require insurers to absorb the cost of “total losses,” in effect abolishing the function performed by replacement coverage limits in homeowners insurance policies.

Ironically, and somewhat instructively, one major argument against the doctrine of enterprise liability in tort law has been that accident victims can “avoid a concentrated loss by insuring.”⁹⁶ Where insurance fails to perform this function, and this failure causes the loss in question, the fact that consumers are far less able to “cover” for the loss than are insurers provides a compelling reason for placing the burden on those insurers.⁹⁷ In fact, the very purpose of insurance is the transfer of risk.⁹⁸ Imposing enterprise liability would facilitate this function, as consumer behavior results in a failure to identify and subsequently discriminate between policies that insure adequately.⁹⁹

Inevitably, the imposition of enterprise liability would lead to insurer externalization of the cost of compensation.¹⁰⁰ This would presumably result in higher premiums. However, given the concurrent incentive for insurers to attract a large number of consumers in order to effectively pool these premiums for the purpose of subsequent investment, they would be forced to keep prices competitive.¹⁰¹ The costs that would result from imposing enterprise liability on inadequate insurance limits would be distributed by

96. VIRGINIA E. NOLAN & EDMUND URSIN, UNDERSTANDING ENTERPRISE LIABILITY: RETHINKING TORT REFORM IN THE TWENTY-FIRST CENTURY 145 (1995) (quoting Richard A. Posner, *Strict Liability: A Comment*, 2 J. LEGAL STUD. 205, 210 n.15 (1973)).

97. See Hanson & Kysar, *A Response*, *supra* note 93, at 274.

98. See JERRY, *supra* note 64, at 15.

99. See Hanson & Kysar, *A Response*, *supra* note 93, at 269.

100. *Id.*

101. Notwithstanding consumers’ tendency to overlook contractual terms, it is “surely a highly realistic assumption” that “the price of a product is a salient product attribute for buyers.” Korobkin, *supra* note 22 at 1234. Consumer surveys support the conclusion that, for most buyers, contractual allocation of the “duty to diagnose” the adequacy of limits is *not* a salient attribute of insurance policies. See J.D. Power, *supra* note 16 and accompanying text. Where insurers may use contractual terms or warnings to avoid the costs of total losses, the natural incentive is to lower premium prices (achieving larger pools of premiums) and increase cost-avoiding terms. However, where insurers bear the costs of total losses, the salience of policy prices to buyers provides an incentive to keep prices low *without* providing an incentive to manipulate buyers into positions of high exposure.

insurers to its policyholders.

Even a relatively significant rise in premiums would be justified to avoid the sort of problems experienced by those such as Everett and Mitchell. It is sensible to distinguish the cost of higher periodic premiums, even when aggregated over a large population of policyholders, from the cost of coping with severe underinsurance, even where the latter is experienced by a relatively small portion of insureds. The two types of losses are *qualitatively* distinct. While higher premiums are certainly not desirable (even when tempered by the incentive to keep premiums low and the pool of consumers large), the devastation that is visited upon those such as Mitchell who are unable through *any* means to “cover” their loss is particularly devastating.¹⁰² The financial *and* emotional toll exacted by such experiences warrants prioritizing the prevention of such losses, even if this results in an aggregate increase in premiums that is higher than the aggregate increase in claim payments during a given year or set of years. To claim otherwise would be to fall into what some label the “impersonal total principle.”¹⁰³ It would be to conclude that a set of individuals each experiencing one mild inconvenience could somehow become large enough to be “worse off” than a single individual suffering from a devastating loss.

Enterprise liability with respect to policy limits would, in a simple manner, eliminate the qualitatively severe experiences suffered by homeowners who find themselves drastically underinsured after a total loss. The natural result of such a liability policy would be to render limits useless as a means of limiting insurer payment on claims resulting from total losses. At the same time, insurers could compensate for higher payouts by distributing these added costs among policyholders. While this may result in higher premiums, it would also alleviate the type of losses caused by underinsurance.

IV.B. *Regulatory Elimination of Total Loss Limits in Homeowners Insurance Policies*

As noted above, the natural effect of imposing enterprise liability

102. See generally Marc Lifsher, *Wildfires Heat Up Debate on Rising Rebuilding Costs: Are Policies Adequate to Help Make Homeowners Whole?*, L.A. TIMES, June 6, 2008, at 1.

103. DEREK PARFIT, REASONS AND PERSONS, 386-87 (1984).

upon insurance policy limits is to strip those limits of the function of reducing insurer risk.¹⁰⁴ However, the exposure of insurers to increased risk can be “covered” via adjustment of premiums.¹⁰⁵ Prohibiting the use of limits by insurers to pay less than the replacement cost of a home, even though the insurance policy otherwise warrants such a replacement, prevents the qualitatively severe losses experienced by those such as Everett and Mitchell.¹⁰⁶ As it would be senseless to allow limits only to prohibit their use in the case of losses which exceed them, the simplest mechanism to achieve the function of enterprise liability as stated above is to statutorily prohibit insurance policies from setting limits.

The effect of such a prohibition would be to require that any homeowner’s insurance policy be a “guaranteed replacement” policy. It would make a conceptual distinction between limits and the rest of the insurance policy (viewed either as a product or a contract), and ban the former as a product too likely to cause severe harm to consumers. Jolls and Susteain acknowledge that “[b]oundedly rational behavior . . . often is . . . taken to justify a strategy of insulation, attempting to protect legal outcomes from people’s bounded rationality.”¹⁰⁷ While they advocate a more careful consideration of “de-biasing” consumers via various legal requirements such as the “policy warnings” described above,¹⁰⁸ there is good behavioral evidence suggesting that such strategies would be largely futile in the context of correcting “optimism bias.”¹⁰⁹

The insulation strategy of barring limits would not affect the law’s treatment of other aspects of the insurance policy itself, such as ambiguous provisions. Schwarcz’s strategy of treating insurance policies as “products” is one example of a framework designed specifically to address the legal implications of defective, or inefficiently drafted and ambiguous policy provisions.¹¹⁰ Policy limits are distinct from policy provisions relating to coverage and exclusion

104. *See supra* Part IV.A.

105. *See supra* Part IV.A.

106. *See supra* Part IV.A.

107. Jolls & Susteain, *supra* note 20, at 200.

108. *Id.* at 202.

109. *See supra* Part III.B.

110. *See* Schwarcz, *supra* note 31, at 1447-48.

in that the process of instituting limits relates not only to determining the obligations of the insurer, but also to determining the needs of the insured. Given the consumer behavior described in Part I, insurance purchasers are especially susceptible to assessment practices which (intentional or not) shift risk exposure from the insurer to the insured via inaccurate “estimates” of consumer need (i.e., reconstruction costs).

Prohibiting the institution of insurance limits would insulate consumers from the effects of confusion regarding *whose* duty it is to assess the needs of the insured. In addition, it would provide insurers *more* of an incentive to accurately predict the cost of replacement for a given dwelling, so that premiums could be accurately calibrated in relation to the potential cost or level of risk imported by an individual consumer.

It is worth mentioning an alternative regulatory measure, and why it would prove inferior to an outright ban on policy limits. Regulation could be enacted which, while not prohibiting policy limits, prohibits *insurers* from calculating those limits. This would sever any insurer motivation to shift risk exposure from the limits assessment process, and require the purchaser to go through the process of calculating replacement costs. Presumably, the demand for services in the area of replacement cost assessment would give rise to service providers bearing the sole interest and obligation of accurately assessing costs. The more demanding process of engaging in a detailed calculation of replacement cost could also counter the low level of consumer involvement mentioned in Part I.

However, the major difference between prohibiting *insurer calculation* of limits and prohibiting policy limits *per se* is that, under the former prohibition, policyholders would *individually* bear the potentially severe cost of inaccurate assessments. This would lead, in some cases, to the type of qualitatively distinct harms suffered by Everett and Mitchell. Under an outright ban of policy limits, the costs related to total losses are distributed amongst premium payments. Individuals will pay higher premiums based upon insurer individual replacement cost projections (which do not serve as limits). In addition, premiums may be raised across the board to account for insurer solvency in the case of a catastrophe requiring a high number of claim payments. The primary advantage to an outright ban on policy limits is that the type of severe losses illustrated by Everett’s

case would be eliminated. As argued in Part IV.A above, the elimination of such devastating losses warrants prioritization.

V. CONCLUSION

Homeowners insurance policyholders are ill-equipped to determine the appropriate limits for their insurance policies.¹¹¹ The current legal framework defining insurers' obligations to their insureds does not effectively account for this reality, in turn providing an incentive for insurers to sustain ambiguity and confusion regarding a duty to accurately assess replacement costs.¹¹² While some suggest that legally required warnings regarding the dangers of underinsurance may correct consumer behavior, the nature of the cognitive biases which largely give rise to consumer vulnerability suggest that such warnings may be ineffective.¹¹³ However, the reasons typically justifying an enterprise liability model of products liability provide a compelling case for banning policy limits altogether.¹¹⁴ Such a ban would be superior to alternative regulatory measures, in that it would work to prevent insurance policy failures that exasperate what is already a devastating experience for homeowners.¹¹⁵

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111. *See supra* Part I.

112. *See supra* Parts I through III.A.

113. *See supra* Part III.B.

114. *See supra* Part IVA through IV.B.

115. *See supra* Part IVA through IV.B.

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