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A Products Liability Theory for the Judicial Regulation of Insurance Policies

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A PRODUCTS LIABILITY THEORY FOR THE JUDICIAL REGULATION OF INSURANCE POLICIES

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ABSTRACT

Many insurance law commentators believe that judges should regulate the substance of insurance policies by refusing to enforce insurance policy terms that are exploitive or otherwise unfair. The most common guide for the judicial regulation of insurance policies is the "reasonable expectations doctrine," which requires courts to disregard coverage restrictions that are beyond insureds' reasonable expectations unless the insurer specifically informed the insured about the restriction at the time of purchase. This Article argues that although the judiciary has a potential role to play in policing insurance policy terms, that role should not be defined by reference to consumers' reasonable expectations. Instead, by drawing on the parallels between insurance policies and ordinary consumer products, this Article advances a products liability framework for understanding how and why courts should regulate insurance policies. It proposes that, just as firms that make defective products must pay for the resulting injuries, insurers that issue "defective" insurance policies should have to provide coverage to insureds. The Article argues that the usefulness of the analogy to products liability law goes well beyond understanding the normative basis for the judicial regulation of insurance policies. Products liability law offers

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important insights into how courts can efficiently correct failures in insurance markets by encouraging effective disclosure to consumers and appropriately setting penalties so that insurers take an optimal amount of care in drafting policy terms.

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INTRODUCTION

In the wake of Hurricanes Katrina, Rita, and Wilma, insurers feared no one more than Trent Lott. Not only did the Mississippi senator have an obvious political incentive to insist that insurers pay for as much of the unprecedented hurricane damage as possible, he had a strong personal incentive as well: his house lay in ruins, and his insurer insisted that it was not liable for the damage as Lott's policy excluded coverage for all losses caused by flooding.[1] Lott—like thousands of other hurricane victims along the Gulf Coast facing similar resistance from their insurers[2]—quickly filed suit, claiming that his insurer's reliance on the flood exclusion violated his "reasonable expectation" of coverage.[3] Lott had purchased a "Hurricane Deductible Endorsement" precisely so that he would be covered for hurricane damage.[4] He argued that the insurer, by offering this endorsement, had fostered an expectation that he "would have full and comprehensive coverage for any and all hurricane damage."[5] It was that expectation that mattered, Lott claimed, and not the technical wording of the insurance policy.[6]

Lott's basic argument, which is echoed in the lawsuits of thousands of other hurricane victims,[7] is founded in a controversial rule of insurance law known as the "reasonable expectations doctrine." Under the doctrine, insureds are entitled to the insurance coverage they reasonably expect *even though* the applicable policy terms

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1. *See* Complaint ¶ 17, Lott v. State Farm Fire & Cas. Co., No. 1:05-cv-00671-LTS-RHW (S.D. Miss. Dec. 15, 2005).

2. *See* Jim Hood, Op-Ed., *A Policy of Deceit*, N.Y. TIMES, Nov. 19, 2005, at A15 (explaining the broad-ranging lawsuit the Mississippi Attorney General's office brought against insurers to force them to cover all water damage that policyholders suffered as a result of hurricanes).

3. Complaint, *supra* note 1, ¶ 14.

4. *Id.* ¶ 3 (internal quotation marks omitted).

5. *See id.* ¶ 11.

6. *See id.* ¶ 14.

7. *See* Jeremy Alford & Joseph B. Treaster, *Was It Wind or Water? Gulf Coast Lawyer Is Taking On Insurers*, N.Y. TIMES, Sept. 21, 2005, at C1; Jennifer Bayot, *Mississippi Sues Insurers over Damage from Storm*, N.Y. TIMES, Sept. 16, 2005, at C4; Joseph B. Treaster & Cornelia Dean, *Yet Another Victim of Katrina: Federal Flood Insurance Program Is Itself Under Water*, N.Y. TIMES, Jan. 6, 2006, at C1.

unambiguously exclude such coverage.[8] Insureds, therefore, can overcome unambiguously applicable exclusions in their policies if an *objectively reasonable* insured would expect coverage on the basis of factors such as policy language and structure, the insurer's marketing practices, underwriting theory, and generalized beliefs among consumers about the scope of different types of insurance.[9] Lott's complaint advanced each of these arguments: It claimed that the policy's language—in particular, its "Hurricane Deductible Endorsement"—created an expectation of complete hurricane coverage, and that Lott's insurance agent implicitly fostered this expectation.[10] It also suggested that the insurer's advertising campaign, which held the insurer out as a "[g]ood [n]eighbor," reinforced this expectation.[11] Finally, it argued that most ordinary consumers would reasonably expect that hurricane insurance coverage would cover losses due to flooding associated with a hurricane.[12]

Seizing on the breadth of the arguments available to those invoking the reasonable expectations doctrine, some have suggested that it inappropriately legitimizes "judge-made insurance."[13] But most insurance law commentators view the doctrine as a sensible response to the argument that insurance policies are contracts of adhesion, which sophisticated insurers unilaterally draft and offer to uninformed consumers on a take-it-or-leave-it basis.[14] Commentators have argued that, without the threat of the

8. *See* Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970). Keeton initially suggested that courts should enforce "[t]he objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts ... even though painstaking study of the policy provisions would have negated those expectations." *Id.*

9. *See* Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 371 (1986). Keeton himself did not elaborate on exactly how courts would discern insureds' reasonable expectations, but clearly did envision that sources other than the policy's text could inform the determination. *See* Keeton, *supra* note 8, at 967.

10. Complaint, *supra* note 1, ¶¶ 13-14.

11. *Id.* ¶ 63 (internal quotation marks omitted).

12. *See id.* ¶ 14.

13. *See, e.g.*, Kenneth S. Abraham, *Judge-made Law and Judge-made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151, 1152 (1981) (arguing that the doctrine is "an unprincipled judicial preference for the insured" that must be limited).

14. *See generally* Symposium, *The Insurance Law Doctrine of Reasonable Expectations*

"judicial regulation of insurance"—the ex post alteration of an insurance policy's provisions by courts[15]—insurers would exploit unwary consumers by inserting unfair coverage exclusions into insurance policies.[16] Not only does a reasonable expectations rule protect consumers from such exploitation, according to this view, but it also encourages insurers to inform consumers about potentially surprising terms because insurers can avoid liability under the doctrine by adjusting inaccurate consumer expectations before the policy is purchased.[17]

Despite this relatively widespread support from insurance law commentators, the reasonable expectations doctrine suffers from serious practical and theoretical failures.[18] Only a handful of state courts follow the rule, and the case law endorsing it is confused and inconsistent.[19] Moreover, contract law scholars have largely debunked the contracts-of-adhesion argument on which the reasonable expectations doctrine was originally justified. They have established that neither consumer assent nor government regulation is necessary to lead firms to design efficient standard forms when market forces work sufficiently well.[20] Given the doctrine's

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After Three Decades, 5 CONN. INS. L.J. 1 (1998).

15. *See* Kenneth S. Abraham, *The Insurance Effects of Regulation by Litigation*, *in* REGULATION THROUGH LITIGATION 212-33 (W. Kip Viscusi ed., 2002). Abraham notes a number of plausible ways to define insurance regulation through litigation. *See id.* at 231-33.

16. *See* Keeton, *supra* note 8, at 968; *see also* JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS: LAW AND STRATEGY FOR INSURERS AND POLICYHOLDERS 311-19 (1994) (noting that traditional contract principles do not always fit well with insurance law); James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. ST. L.J. 995, 1055 (1992) (noting that insureds are uninformed about their insurance needs); Rahdert, *supra* note 9, at 371 (arguing that "[r]ecurring questions such as the enforceability of business risk exclusions" lead to uncertainty in the law); Bob Works, *Excusing Nonoccurrence of Insurance Policy Conditions In Order To Avoid Disproportionate Forfeiture: Claims-Made Formats as Test Case*, 5 CONN. INS. L.J. 505, 553-57 (1998-99) (suggesting that "the vulnerability that results from sequential performance of aleatory contracts" can be addressed through the use of "contract law as an ex post governance mechanism[] for controlling opportunism").

17. Keeton, *supra* note 8, at 968.

18. *See* Jeffrey Stempel, *Unmet Expectations: Undue Restriction of the Reasonable Expectations Approach and the Misleading Mythology of Judicial Role*, 5 CONN. INS. L.J. 181, 182 (1998-99) (describing the reasonable expectation doctrine's "attraction to academics but resistance from elements of bench and bar").

19. *See infra* Part II.A.

20. *See generally* Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361, 363 (1991) (arguing that

stunted evolution in the courts and the academic undermining of its core rationale, it is hardly surprising that some view it to be both antiquated and largely irrelevant.[21] Because the reasonable expectations doctrine has served as the primary theoretical and doctrinal construct for the judicial regulation of insurance over the past forty years, the demise of the reasonable expectations doctrine has corresponded with the demise of judicial intervention in the content of insurance policies.

This Article seeks to reinvigorate the idea that *limited* judicial regulation of insurance may be in the best interests of insurance consumers.[22] Focusing on consumer-oriented markets for property/casualty insurance,[23] it claims that the market mechanisms that ordinarily lead firms to draft efficient standard-form contracts may fail to produce socially optimal results in many insurance

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selecting a mandatory rule is necessary only when sellers' "incentives are flawed by some market failure"); George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1313 (1981) (arguing that the market will lead manufacturers to provide consumers with the optimal warranty coverage); Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1389 (1983) (maintaining that consumers understand the most important terms in standard contracts).

21. *See, e.g.*, Kenneth S. Abraham, *The Expectations Principle as a Regulative Ideal*, 5 CONN. INS. L.J. 59, 61-62 (1998-99) (arguing that "courts rarely invoke the [reasonable expectations] doctrine in practice" and its analytical framework has been largely irrelevant to many of the most significant developments in insurance law in the last thirty years).

22. This Article thus relies on a welfare-economics framework to identify normatively preferable outcomes. On the overlap, and relationship between, fairness considerations and welfare economics, see generally LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002).

23. Property/casualty insurance covers legal liabilities and losses to property and income-producing assets. *See* ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 13A (2d ed. 1996). It is typically contrasted with personal lines of insurance, such as health, life, or disability. This Article's focus on property/casualty insurance is motivated by the significant differences between property/casualty insurance markets and insurance markets for personal lines of insurance. Most notably, many personal lines of insurance, particularly health and disability, are sold as group policies through employers. *See id.* § 13C; *see also* Jeffrey R. Brown & Austan Goolsbee, *Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry* 3 (John F. Kennedy Sch. of Gov't, Harvard Univ., KSG Working Paper No. 00-007, 2000), *available at* http://ssrn.com/abstract=253795 (noting that, in 1998, only 22% of all life insurance policies were purchased by individuals). Moreover, although the reasonable expectations rule applies to all variations of insurance coverage, *see* STEMPEL, *supra* note 16, at 323-24, most reasonable expectations cases involve property/casualty insurance. In part this is because insurance sold through group plans is often subject to the procedural limitations of ERISA. *See id.*

markets. In part this is because various unique features of the property/casualty insurance industry, such as policy standardization, the use of endorsements, and price regulation, limit the effectiveness of market mechanisms.[24] But it is also because consumer behavior in many of these insurance markets departs from the assumptions of the standard economic model: consumers in property/casualty insurance markets tend to be ill-informed about policy details and to ignore nonsalient policy terms.[25] In the absence of government intervention, insurers may have an incentive to exploit these consumer limitations by drafting inefficient terms.[26] Because state administrative regulation of substantive policy terms is both inherently and practically limited, targeted judicial intervention to prevent such insurer overreaching is potentially appropriate.[27]

Given the failures of the reasonable expectations doctrine in defining the appropriate contours of such judicial intervention, this Article advances a products liability model for the judicial regulation of insurance. Although several commentators have previously explored the implications of products liability law for contract law, none have done so in the context of insurance policies.[28] The model

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24. *See infra* Part I.A.

25. *See infra* Part I.B.

26. *See infra* Part I.C.

27. *See infra* Part I.C.

28. Richard Craswell has suggested that the basic rule in products liability, that plaintiffs should be required to show a reasonable alternative design, should be applied to contract law. *See* Richard Craswell, *Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere*, 92 VA. L. REV. 565, 624 (2006) [hereinafter Craswell, *Taking Information Seriously*] (noting that the proposal that plaintiffs be required to suggest alternative disclosure "would bring misrepresentation and nondisclosure closer to design defect cases in torts, in which the plaintiff generally must identify some alternative to the manufacturer's design"). He has also explored products liability law in the context of deceptive advertising. *See* Richard Craswell, *Interpreting Deceptive Advertising*, 65 B.U. L. REV. 657, 681 (1985). Robert Hillman and Jeffrey Rachlinski have also noted some parallels between products liability law and the judicial interpretation of standard-form contracts. *See* Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-form Contracting in the Electronic Age*, 77 N.Y.U. L. REV. 429, 444 (2002). In the insurance law literature, several commentators have recognized the similarities of products liability law and the reasonable expectations doctrine, but none have elaborated on them. *See* Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholders' Objectively Reasonable Expectations of Insurance Coverage*, 5 CONN. INS. L.J. 335, 422-23 (1998-99) (suggesting that insurance in general is a defective product because of the discrepancy between what insurers suggest they sell in advertising and what they actually sell); James M. Fischer, *The Doctrine of Reasonable Expectations Is*

provides analytical clarity as to why courts should potentially regulate the content of insurance policies: these policies are consumer products,[29] and, in certain cases, they may be "defectively" designed. By requiring that firms pay damages to consumers who are "injured" by these defective insurance products, the judicial regulation of insurance can induce insurers to design their products optimally despite consumer ignorance and bounded rationality. Just as products liability law attempts to promote social efficiency by placing obligations on firms beyond what they "agreed" to give to the consumer,[30] appropriately tailored "judge-made insurance" has the potential to help promote the efficient drafting of insurance policies.[31]

Products liability law not only clarifies the normative case for why courts should occasionally deviate from insurance policy terms, but also provides a practical and theoretically sound doctrinal structure for implementing this principle.[32] First, products liability law suggests that informing consumers about product information

Indispensable, if We Only Knew What For?, 5 CONN. INS. L.J. 151, 158 (1998-99) (noting that "judicial expectations regarding the proper contours of insurance law forces carriers to provide a consumer-safe and consumer-friendly package of coverage, much like product liability law encourages manufacturers to build and equip a reasonably safe vehicle consistent with so called 'consumer expectations'").

29. *See* Anderson & Fournier, *supra* note 28, at 423 ("In the past, insurance policies were treated as contracts. Today, more and more they are treated like products."); Ian R. Macneil, *Bureaucracy and Contracts of Adhesion*, 22 OSGOODE HALL L.J. 5, 18-19 (1984) (using term "bureaucratic good" to describe contracts of adhesion such as insurance policies); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 546 (1971) (describing the sale of insurance as the "sales of promises"); *see also* TOM BAKER, INSURANCE LAW AND POLICY: CASES, MATERIALS, AND PROBLEMS 46 (2003) (discussing the practice within the insurance industry of referring to insurance policies as "products").

30. *See* WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 280-81 (1987); STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 258-59 (2004); W. KIP VISCUSI, REFORMING PRODUCTS LIABILITY 64-66 (1991) ("[The] rationale for liability is that it replaces incentives that are missing when the market is not functioning perfectly."); Victor P. Goldberg, *The Economics of Product Safety and Imperfect Information*, 5 BELL J. ECON. & MGMT. SCI. 683, 683 (1974); Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353, 380 (1988).

31. *See infra* Part I.C.

32. Comparing insurance law to products liability law is thus a worthwhile endeavor. *See* Cass R. Sunstein, Commentary, *On Analogical Reasoning*, 106 HARV. L. REV. 741, 744 (1993) ("For analogical reasoning to work well, we have to say that the relevant, known similarities give us good reason to believe that there are further similarities and thus help to answer an open question.").

is not as easy as the reasonable expectations doctrine supposes. Because consumers can only digest a limited amount of information, requiring firms to perfect consumer information is not sensible. Instead, products liability law requires firms to inform consumers about particularly important safety risks and to provide instructions in an easy-to-read and obviously visible manner.[33] A doctrine for the judicial regulation of insurance should similarly recognize consumers' bounded rationality and focus insurers' disclosure obligations on a limited number of particularly important terms, instead of all terms that a consumer might not reasonably expect. Adopting a more limited and narrowly tailored disclosure requirement could both enhance insurers' compliance with legal standards and promote the effective operation of consumer insurance markets.

Second, products liability law suggests that any regime for the judicial regulation of insurance must be limited in scope and should incorporate a cost/benefit analysis to determine when insurers should be required to cover losses that their policies unambiguously exclude. Several decades ago, the dominant standard in products liability law for defining a product design defect turned on whether the product was inconsistent with ordinary consumers' safety expectations.[34] However, in intervening years, most courts and scholars have abandoned this consumer-expectations approach to defining product design defects, in favor of a "risk-utility test."[35] Under this test, products are defectively designed when the foreseeable risks of harm posed by a product could have been reduced by the adoption of a reasonable alternative design.[36] Although imperfect, the test does a better job than the antiquated consumer-expectations test of identifying unsafe product features that are the result of a manufacturer's inefficient attention to product safety. The efficiency of consumer insurance markets could be enhanced if insurance law moved in the same direction, abandoning a rule based on consumer expectations in favor of one that tested whether an insurer could have drafted a policy differently, ex ante, to allocate risks more efficiently.

33. *See infra* text accompanying notes 219-21.
34. *See infra* notes 280-81 and accompanying text.
35. *See infra* notes 277-79 and accompanying text.
36. *See infra* note 278 and accompanying text.

Relying on these structural lessons from products liability law, this Article constructs and evaluates a model in which judges impose insurance coverage in the case of either a "defective insurance warning" or an "insurance policy design defect." A "defective insurance warning" would occur when insurers fail to adequately warn insureds about a limited number of coverage limitations that are most likely to enhance the overall efficiency of coverage. This Article tentatively proposes that these warnings should disclose any substantial deviations from industry norms in policy language and inform insureds that they may not be covered for losses that they easily could have prevented. It also suggests that insurance warnings could inform consumers about state-underwritten supplemental insurance options and perhaps even "debias" consumers by focusing their attention on certain salient limits of insurance. The "policy design defect," by contrast, would discourage insurers' use of exploitive terms ex ante and correct for those terms ex post. When a policy exclusion applied in a way that might be inconsistent with its underwriting purpose, an insured would be deemed to have been "harmed" by his policy. In such cases, insurers would have to compensate the victims of such insurance harms if the insured could demonstrate a foreseeable and reasonable alternative policy design that would have avoided the insurance harm.

Ultimately, this Article stops short of affirmatively recommending that courts immediately adopt the proposed products liability model. The desirability of the model depends on how poorly insurance markets operate, how well judges can perform the inquiries required of them by the proposed doctrinal structure, and the impact the proposal would have on insurance litigation. Although this Article suggests that the initial analysis favors the products liability model on these fronts, significant counterarguments exist that ought not to be dismissed without further research and debate. What is clear, however, is that products liability law, and not the reasonable expectations doctrine, provides the best touchstone for assessing the costs and benefits of an interventionist judicial approach to insurance disputes.

Part I of this Article provides an updated justification for the judicial regulation of insurance policies. It concludes that certain structural elements of the insurance industry exacerbate the consequences of imperfect consumer information and bounded rationality in many insurance markets. Part II argues that the reasonable expectations doctrine's shaky practical and theoretical foundations render it unsuitable for defining the role of judges in regulating insurance. Finally, Part III develops and evaluates the central proposal of this Article: products liability law can potentially serve as an effective template for guiding the judicial regulation of insurance policies.

I. THE NEED FOR JUDICIAL REGULATION OF PROPERTY/CASUALTY INSURANCE

Prior to the middle of the twentieth century, courts routinely treated insurance policies as ordinary contracts that should generally be enforced as written.[37] Starting in the 1950s and 1960s, though, a new generation of scholars began to challenge this approach, arguing that contracts of adhesion, such as insurance policies, create unique risks of consumer exploitation.[38] These scholars suggested that courts should take a correspondingly interventionist approach to construing such standard-form contracts in order to protect consumers from unanticipated exploitive terms.[39] In no field of law were these arguments more successful than in insurance. Finding state regulation of insurance policies inadequate, insurance law commentators quickly embraced a novel

37. *See* SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 900 (Walter H.E. Jaeger ed., 3d ed. 1963); *see also* Peter Nash Swisher, *Symposium Introduction*, 5 CONN. INS. L.J. 1, 3-6 (1998-99) (discussing Williston's "contractually based interpretation of insurance contracts"). The doctrines of estoppel and waiver supplied only limited exceptions to this principle, applicable when the insurer or agent affirmatively misled an insured who relied on those misrepresentations, or voluntarily relinquished a right created in the insurance policy. *See* STEMPEL, *supra* note 16, §§ 3.1-.5. *See generally* Clarence Morris, *Waiver and Estoppel in Insurance Policy Litigation*, 105 U. PA. L. REV. 925, 928-29 (1957). Whether an insured party understood the terms of an insurance policy, or may have expected terms different from those contained in the policy, was immaterial as the insured had a duty to read these terms. *See* STEMPEL, *supra* note 16, § 3.4.

38. *See, e.g.*, Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 629 (1943); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1226 (1983); Slawson, *supra* note 29, at 546.

39. *See* Rakoff, *supra* note 38, at 1175 (observing that "there is a quite general perception that different law must be applied to contracts of adhesion").

"reasonable expectations" doctrine to combat the perceived risks associated with contracts of adhesion.[40] This doctrine, moreover, was not the only newly emerging vehicle for the ex post judicial regulation of insurance policy content: courts routinely found insurance policies unconscionable,[41] and in one notable case concluded that policy terms violated an insurer's implied warranty of fitness.[42]

Since commentators and courts first embraced the judicial regulation of insurance, modern contract law theorists have largely debunked the claim that contracts of adhesion present unique risks for consumer exploitation. Although consumer assent to standard-form contracts is limited, such contracts are subject to market forces that can encourage firms to draft efficient, rather than exploitive, terms.[43] In fact, firms will generally have an incentive to draft efficient form contracts so long as a sufficient percentage of consumers (1) are informed about the content of those terms,[44] and (2) act rationally to maximize their utility on the basis

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40. *See generally* Symposium, *supra* note 14 (discussing the reasonable expectations doctrine in insurance law); *see also* Keeton, *supra* note 8, at 967 (same).

41. *See generally* STEMPEL, *supra* note 16, § 7.

42. *See* C & J Fertilizer, Inc. v. Allied Mut. Ins., 227 N.W.2d 169, 178 (Iowa 1975). An implied warranty of fitness for insurance has never garnered significant support. *See* Rahdert, *supra* note 9, at 339 & n.54.

43. *See* Craswell, *supra* note 20, at 363; Schwartz & Wilde, *supra* note 20, at 1389. *See generally* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 4.8 (6th ed. 2003). Empirical evidence lends some support to the basic model of standard-form contracts in some markets. *See* Priest, *supra* note 20, at 1313 (reviewing warranty provisions and finding that they were both generally efficient and unaffected by market structure); Florencia Marotta-Wurgler, *Competition and the Quality of Standard Form Contracts: An Empirical Analysis of Software License Agreements* (N.Y. Univ. Sch. of Law, Law & Econ. Research Paper Series, Working Paper No. 05-11, 2005), *available at* http://ssrn.com/abstract=799274 (confirming Priest's conclusion that market share does not affect the quality of standard-form terms). Even under ideal market conditions, firms may find including one-sided terms in their form contracts efficient when courts are imperfectly informed. *See* Lucian A. Bebchuk & Richard A. Posner, *One-sided Contracts in Competitive Consumer Markets*, 104 MICH. L. REV. 827, 827 (2006). However, this potential is immaterial here because firms only rely on inefficient terms in these circumstances to defend against opportunistic customers. *See id.*

44. Schwartz & Wilde, *supra* note 20, at 1398-99; Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 630 (1979). Although consumers must be informed about both contract terms and the facts of the world that the contract regulates, most tend to focus their attention on the former. This limitation is particularly appropriate in the insurance context, in which information asymmetries regarding the underlying risks are generally thought to favor consumers, leading to problems in the supply of insurance rather than the demand. *See generally* Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance*

of that information.[45] In light of this modern understanding, it is now clear that the real issue for evaluating the efficiency of insurance policies, and the concomitant need for legal intervention —whether via the judiciary or state regulators—is whether, and in what ways, existing market mechanisms fail to ensure efficient insurance policy terms.[46] If consumers are systematically uninformed about standard contract terms, or biased with regard to processing information about those terms, then insurance policies may indeed be exploitive in the absence of government intervention.[47]

This Part argues that the significant risks of such market failure may warrant judicial regulation of insurance policies.[48] Part I.A begins the argument by contending that structural elements of many consumer-oriented property/casualty insurance markets—

Markets: An Essay on the Economics of Imperfect Information, 90 Q.J. ECON. 629, 629 (1976).

45. *See* Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1217-18 (2003).

46. *See* Fischer, *supra* note 16, at 1047 ("[T]he 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."); Rahdert, *supra* note 9, at 374 ("Those courts that have addressed the policy considerations behind the reasonable expectations doctrine have overemphasized adhesion and unconscionability.").

47. Firms facing systematically uninformed or irrational consumers may have an incentive to save costs by drafting exploitive terms. *See* Victor P. Goldberg, *Institutional Change and the Quasi-invisible Hand*, 17 J.L. & ECON. 461, 485 (1974); Michael I. Meyerson, *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583, 595 (1990). This outcome is especially likely in a price competitive industry, where competition may force firms to use inefficiently exploitive terms in order to support low prices. *See* Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1376 (2004). *See generally* Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630 (1999) [hereinafter Hanson & Kysar, *The Problem*] (stating that economic incentives cause "manufacturers to engage in practices that ... utilize non-rational consumer tendencies to influence consumer preferences and perceptions for gain"); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420 (1999) [hereinafter Hanson & Kysar, *Some Evidence*] (presenting "empirical evidence of market manipulation").

48. The analysis is thus limited to consumer-oriented insurance markets, rather than insurance markets in which purchasers are sophisticated business enterprises. One objection to this dichotomy is that policy terms in consumer-oriented insurance markets are often quite similar, if not identical, to policy terms in more business-oriented insurance markets. For this reason, one might plausibly claim that, to the extent there are inefficiencies in insurance markets, they must not be limited to consumer insurance markets. This Article is not opposed to the concept that business-oriented insurance markets may indeed be quite inefficient, but neither is it committed to that concept. Policy terms that may be inefficient in consumer-oriented markets may be quite efficient in business-oriented markets.

including policy standardization, the widespread use of endorsements, and price regulation—mean that comparatively small levels of consumer misinformation or bounded rationality may result in exploitive insurance policies. Part I.B, in turn, claims that available empirical evidence suggests that consumer information and rationality in these insurance markets is limited because of the complexity of insurance, the small number of consumers that experience the most important features of insurance policies, the profit motives of agents and brokers, and the cognitive limitations of consumers. Finally, Part I.C claims that these market limitations create a potential need for the judicial regulation of property/casualty insurance: not only are the efficiency consequences of such market failures significant, but the primary alternative of state administrative regulation is both inherently and practically limited.

A. Insurance Policies and the Efficiency of Standard-form Contracts

The standard-form contracts that insurers use are unique. Unlike any other standardized contract, insurance policies are collectively drafted by competing firms and, as a practical matter, must be used by all but the largest market participants. The insurance policies themselves are comprised of simple base policies that can be supplemented with numerous "endorsements."[49] Prices for these insurance policies, although not collectively set, are frequently subject to heavy state regulation.[50] Moreover, these contracts describe an immense set of potential future circumstances, classifying unknown and unknowable events into different categories.[51] Finally, the costs to insurers of changing policy terms are particularly significant.[52] Standing alone, each of these unique characteristics of insurance policy drafting might have only a small effect on the capacity of market mechanisms to ensure efficient standardized terms. Nevertheless, when taken together they create significant

49. *See infra* notes 61-71 and accompanying text.
50. *See infra* notes 72-79 and accompanying text.
51. *See infra* notes 80-82 and accompanying text.
52. *See infra* notes 83-86 and accompanying text.

reason to believe that comparatively small levels of imperfect consumer behavior can lead to inefficient policy terms.

First, the collective process through which many insurance policies are initially drafted can stunt the competitive forces that promote efficient contract terms in other markets involving standard-form contracts. In most consumer-oriented property/casualty insurance markets, virtually all insurers offer policies that are drafted by the Insurance Services Organization (ISO).[53] Each year the ISO drafts a small handful of "base policies" for each insurance line, as well as hundreds of endorsements that can be added to the base policies in order to customize coverage.[54] Use of these standardized forms is practically a necessity for most insurers because they result in substantial savings on drafting costs, regulatory compliance, and the collection and analysis of actuarial data. Finding property/casualty insurers who offer policies that substantially deviate from ISO forms is therefore often difficult, if not impossible.[55]

This noncompetitive, collective drafting process means that comparatively small deviations from ideal market conditions may lead to inefficient policy terms. Although insurers can choose among various ISO forms and endorsements to offer to consumers, none of this variation in contract language is the result of competitive processes.[56] Rather, the various base forms and endorsements are

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53. *See* INS. SERVS. OFFICE, INC., ISO: ENHANCING COMPETITION IN THE WORLD'S INSURANCE MARKETS (1997), *reprinted in* KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION: CASES AND MATERIALS 33-34 (3d ed. 2000). Because insurers are substantially exempt from federal antitrust laws, they are allowed to collaborate with each other to draft standard coverage language. *See* McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1013 (2000).

54. For instance, in 1998 the ISO maintained 5 basic homeowner's policies, with 73 country-wide endorsements and 118 state-specific endorsements. It also maintained 11 basic Commercial General Liability (CGL) policies, with 147 country-wide endorsements. INS. SERVS. OFFICE, INC., *supra* note 53, at 34; *see also* Hartford Fire Ins. Co. v. California, 509 U.S. 764, 772 (1993) (describing role of ISO in drafting standard Commercial General Liability insurance policies).

55. *See* INS. SERVS. OFFICE, INC., *supra* note 53, at 33 ("A very substantial percentage of the standard-form policies that the [property/casualty] industry uses are prepared by the Insurance Services Office.").

56. Much literature in economics and business journals discusses the competitiveness of property/casualty insurance markets. *See, e.g.*, J. David Cummins, *Property-Liability Insurance Price Deregulation: The Last Bastion?*, *in* DEREGULATING PROPERTY-LIABILITY INSURANCE: RESTORING COMPETITION AND INCREASING MARKET EFFICIENCY 1, 2-4 (J. David Cummins ed., 2002) (explaining that deregulation of property/casualty insurance could benefit

analogous to differentiated products offered by a single monopolist. If consumers are perfectly informed and rational, then this monopoly-like drafting of insurance policy terms should not impact the efficiency of those terms: even a monopolist will find it profitable to offer efficient contract terms and extract consumer surplus through monopoly pricing.[57] But, when some nontrivial percentage of consumers is not perfectly responsive to insurance policy terms, collectivized policy drafting exacerbates the risk of inefficient terms.[58] In these circumstances, informed and rational consumers faced with inefficient coverage provisions may not have the option of going to a competing insurer to find different and better coverage. Consequently, the only way these consumers can "punish" insurers for using inefficient terms is to drop out of the market for insurance altogether. This result stands in stark contrast to a competitive drafting market: when competitors can easily offer different standard forms, a firm that uses inefficient standard contracts risks losing all of the business of informed and rational consumers to a competitor that offers more efficient terms.[59]

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consumers because "the insurance industry is competitive"); Paul L. Joskow, *Cartels, Competition, and Regulation in the Property-Liability Insurance Industry*, 4 BELL J. ECON. & MGMT. SCI. 375, 375 (1973). This literature, however, suggests only that there is significant competition in the industry on price, not on policy language. *See* Michelle E. Boardman, Contra Proferentem*: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105, 1113-14, 1117 (2006). Indeed, the insurance industry itself acknowledges that essentially no competition exists within the industry on contract terms, contending that this lack of competition as to policy language is actually what facilitates price competition in the first place. *See* INS. SERVS. OFFICE, INC., *supra* note 53, at 33 ("With most insurers offering policies based on standard ISO language, insurance consumers can readily compare their options, based on price, coverage, service. By contrast, if standardized coverages did not exist, consumers would face an unintelligible array of different insurance forms.").

57. *See* Alan Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 VA. L. REV. 1053, 1071 (1977); A. Michael Spence, *Monopoly, Quality, and Regulation*, 6 BELL J. ECON. & MGMT. SCI. 417, 417 (1975). That insurers would ultimately compete on price does not alter this conclusion, because insurers will profit most from offering efficiently designed products when consumers are fully responsive, even with price competition. *Cf.* Fischer, *supra* note 16, at 1054-56 (arguing that the sharing of actuarial data among insurers retards competition and leads insurers to provide less coverage than if each insurer had to compete separately for information).

58. Recent empirical research does suggest that, in the context of software license agreements, the quality of standard-form terms is generally independent of market structure. *See* Marotta-Wurgler, *supra* note 43, at 5. However, the research does not directly test whether this result applies in the case of monopoly markets.

59. *See* Schwartz & Wilde, *supra* note 20, at 1398-99. The percentage of consumers that

Indeed, the risks posed by monopoly standard-form drafting may be particularly severe in many insurance markets. Even in monopolistic drafting environments, the risk that informed and rational consumers will choose to entirely forego purchasing a good that is associated with an unfair standardized contract can effectively dissuade the use of inefficient contract terms. But in the case of many consumer insurance policies, most informed and rational consumers are likely to find the prospect of going entirely without insurance to be virtually impossible. Indeed, one cannot generally drive a car or acquire a mortgage without insurance.[60] Moreover, unlike large corporations, most consumers do not have the capacity to substitute from traditional insurance to alternative risk transfer devices, such as catastrophe bonds or self-insurance. As such, when insurance policies are exploitive the only practical option available to such responsive consumers will be to purchase policies with higher deductibles or to not purchase optional coverage such as collision insurance. These consumers, in general, will not choose to entirely forego purchasing insurance, as they might in a market with standard forms that are genuinely optional.

A second unique feature of insurance that may create a particularly significant risk of inefficient terms is insurers' use of policy endorsements.[61] Regardless of the level of drafting competition, informed and rational insurance consumers can deter a firm's use of exploitive terms only when firms are unable to identify these consumers ex ante and offer them different contract terms.[62] When firms can identify responsive consumers in this way, their profit-maximizing strategy will be to offer these consumers efficient

must be responsive in order for manufacturers to offer efficient contract terms depends on various market specifics, including (1) the cost savings to the firm of the inefficient term, and (2) the amount of profit that firms make on informed consumers given efficient terms. *See* 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, 675 (1996). Depending on these variables, Cruz and Hinck have suggested that the percentage could range from one to ninety percent. *Id.*

60. *See* JERRY, *supra* note 23, §§ 53A, 133.

61. *But see* Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171, 242 n.194 (1995) (arguing that insurers have a particularly difficult time distinguishing between informed and uninformed consumers because of the uniform standard-form contract).

62. *See* Cruz & Hinck, *supra* note 59, at 674-75.

contract terms, but to offer unresponsive consumers inefficient, exploitive contract terms.[63] The unresponsive consumers will accept the exploitive contract without demanding a corresponding decrease in price, whereas responsive consumers will not go to competitors or forego purchasing the associated good because efficient terms are available to them.[64]

Insurers may be able to segment their consumers in this way through the common practice of offering a small number of base policies with a wide array of supplementary endorsement options.[65] Because responsive consumers are by assumption knowledgeable about policy terms, they will choose endorsements that eliminate inefficiently one-sided exclusions. By offering exploitive coverage in the standard base policy, but then providing efficient coverage in alternative base policies or endorsements, insurers can conceivably discriminate between responsive and unresponsive consumers. For one potential example of this phenomenon, consider the prominent case *Atwood v. Hartford Accident & Indemnity Co.*[66] In *Atwood*, a self-employed electrician was sued after failing to repair a thermostat, which caused a child to die of heat exposure.[67] The electrician's insurance policy unambiguously excluded coverage for liabilities resulting from "completed operations," and the child's death clearly occurred after the electrician had finished working on the thermostat.[68] Nonetheless, the *Atwood* court held that the electrician's liability insurer was obligated to cover the loss.[69] One explanation for this seemingly puzzling result is that the exclusion limited coverage in a way that the market did not check, because informed consumers could simply purchase supplemental coverage that filled

63. *Cf.* Rappaport, *supra* note 61, at 242 (noting that "[s]ellers that use harsh terms lose more to comparison shoppers who purchase elsewhere than they benefit from the uninformed customers who buy contracts with harsh terms" because of the seller's inability to differentiate between responsive and unresponsive consumers).

64. *Id.*

65. Even if endorsements do create the risk of discrimination between informed and uninformed consumers, they are nonetheless justified because they facilitate the provision of coverage that matches individuals' risk preferences.

66. 365 A.2d 744 (N.H. 1976).

67. *Id.* at 745.

68. *See id.* at 745-46.

69. The court held that the exclusion was not applicable because it was buried in the policy's fine print and not within the insured's reasonable expectations. *Id.* at 746-47.

this gap. Indeed, although the standard commercial liability policies of the time included the "completed operations clause," knowledgeable consumers could easily bypass the exclusion by purchasing a widely available endorsement.[70] Many informed insureds purchased this coverage, which protected them from the most significant emerging risks they faced as professionals.[71]

A third unique element of insurance markets that may exacerbate the risk of inefficient policy terms is the prevalence of price regulation in many consumer insurance markets. Although states have increasingly allowed free market forces to set insurance prices, a large number of states regulate the prices of automobile and homeowners insurance.[72] Historically, this rate regulation was primarily intended to ensure that insurance rates were adequate and insurers remained solvent.[73] Today, however, rate regulation is also intended to prevent insurers in noncompetitive markets from charging supracompetitive prices for their policies.[74] One unintended consequence of this regulation, though, is that insurers in noncompetitive markets may favor nonprice methods, such as unfairly using one-sided policies, to extract consumer surplus.[75] Although insurers will generally prefer to exploit their market power through the use of monopoly pricing,[76] the existence of price regulation may cause insurers to resort to the second-best solution of offering one-sided terms in order to extract supra-competitive profits.

Price regulation may also lead to inefficient insurance policies even in naturally competitive markets if state regulators cause

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70. *See* Roger C. Henderson, *Insurance Protection for Products Liability and Completed Operations—What Every Lawyer Should Know*, 50 NEB. L. REV. 415, 418 (1971).

71. *Id.* at 416-18.

72. *See* BAKER, *supra* note 29, at 125. Almost all states regulate the price of automobile insurance, and many regulate the prices of homeowners insurance and workers' compensation insurance. *See id.* Most state insurance regulators must either approve rates before they are charged (in prior-approval states) or shortly after they are used in the market (in prior-use states). *See* Cummins, *supra* note 56, at 3.

73. *See* BAKER, *supra* note 29, at 125.

74. *Id.*

75. The strength of this objection is tempered by the fact that most lines of property/casualty insurance tend to be sold in markets that are naturally competitive on price. *See supra note* 56.

76. *See* Spence, *supra* note 57, at 417.

insurers to charge subcompetitive rates for their policies.[77] Insurers have often complained that state regulators artificially cap policy prices below the rate that is justified by unrealized risks.[78] Because the price of insurance is uniquely visible, there is reason to believe that state regulators face political incentives to keep insurance policy rates lower than they ought to be. Indeed, many public insurance programs, such as Federal Flood Insurance and residual hurricane coverage in Florida, have chronically charged insufficient premiums, leading to massive shortfalls in revenues.[79]

A fourth reason that insurance contracts may tend to be inefficient is that more opportunities for inefficiencies are present in the insurance context than in most contractual settings. Unlike most contracts, which typically concern a discrete set of issues surrounding a particular transaction or event, insurance policies categorize and assign results to the entire universe of potential risks that insureds of all different types face. To do so, insurance policies must frequently rely on abstract and generalizable language, such as "occurrences," "related acts," "wear and tear," and the like.[80] Not only do these terms create a unique potential for ambiguity,[81] but they also create the unique potential for ostensibly unambiguous but inefficient results. Courts often find that the sheer breadth of an insurance policy term makes its application to a particular set of facts unambiguous from a linguistic standpoint, even when that result was clearly never contemplated by the drafters and may not, therefore, make economic sense.[82] Although this type of gap between

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77. If the reason that insurers offer inefficient terms is overly aggressive price regulation, then the wisdom of forcing insurers to offer efficient terms may be unclear.

78. *See, e.g.*, *State Farm Makes Legal Challenges to Texas' Rejection of Rate Increase*, BESTWIRE, Aug. 1, 2006, http://www.ambest.com (describing frequent conflicts between state regulators and homeowners insurers who are denied requested rate increases).

79. *See, e.g.*, Christopher Drew & Joseph B. Treaster, *Politics Stalls Plan To Bolster Flood Coverage*, N.Y. TIMES, May 15, 2006, at A1.

80. *See generally* ABRAHAM, *supra* note 53, at 165-86 (sample homeowners policy).

81. *See* SHAVELL, *supra* note 30, at 299-301; Alan Schwartz, *Incomplete Contracts*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 277, 279-83 (Peter Newman ed., 1998). For an excellent review of this issue, see Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 547-50 (1996).

82. For a good example of this phenomenon, consider the "related acts" provisions that are commonly found in liability insurance policies, and that treat as a single claim all claims that arise out of "related acts" or a "series of related acts." In deciding what this clause means, some courts have defined the word "related" according to its "ordinary" or "common" meaning.

linguistic meaning and intent may occur in any contract, the peculiar extent to which insurance policies must use vague and general terms means that it is significantly more likely to occur in insurance policies.

Finally, insurers may tend to rely on inefficient policy terms because they directly bear the costs of redrafting policy language, which are often quite large. One of the significant benefits to insurers of uniform and consistent policy language is that it is repeatedly interpreted by courts, leading to each term having a rich meaning that, like a statute, begins with the language of the contract but extends into the case law.[83] This effect is enhanced in insurance markets, as repeated judicial interpretation of boilerplate allows insurers to learn not only about the meaning of those terms, but also about the actuarial ramifications of these meanings.[84] Moreover, such predictability is particularly important for insurers because it allows them to reduce the amount of capital they must keep accessible to pay for losses during a particularly high period of insured losses.[85] These benefits of static policy language may counsel in favor of retaining otherwise inefficient policy terms, at least for some period of time. But insurers may tend to cling to historical terms beyond that point: whereas the social costs of outdated policy language are at least partially borne by consumers, the benefits of such language flow directly to insurers. Indeed,

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The question of ambiguity under this approach is then determined by asking whether, in the specific case at hand, it is ambiguous if the acts in question are "related." *See, e.g.*, Cont'l Cas. Co. v. Wendt, 205 F.3d 1258 app. at 1262-63 (11th Cir. 2000) (per curiam) (indicating that the "Court can see no ambiguity when applying the language of the policy to the facts of this case"); Gregory v. Home Ins. Co., 876 F.2d 602, 605-06 (7th Cir. 1989) (allowing a broad definition of "related"); Cont'l Cas. Co. v. Brooks, 698 So.2d 763, 764-65 (Ala. 1997) (per curiam). This approach can potentially lead courts to find that two events are unambiguously "related" under the meaning of the policy, even when this result is contrary to the clause's purpose.

83. *See* Boardman, *supra* note 56, at 1110-11; Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 718 (1997).

84. Boardman, *supra* note 56, at 1114.

85. *See* ABRAHAM, *supra* note 53, at 2; *see also* Michelle E. Boardman, *Known Unknowns: The Illusion of Terrorism Insurance*, 93 GEO. L.J. 783, 784 (2005). Insurers must incur significant accounting and tax costs in order to keep large amounts of capital liquid. *See* Dwight M. Jaffee & Thomas Russell, *Catastrophe Insurance, Capital Markets, and Uninsurable Risks*, 64 J. RISK & INS. 205, 208 (1997).

commentators have frequently noted that "[i]nsurers will cling for decades to language that courts continually declare ambiguous."[86]

B. Consumer Information and Rationality in Property/Casualty Insurance Markets

The arguments developed in Part I.A suggest that there are unique risks in many insurance markets that relatively small levels of consumer ignorance or irrationality can lead to inefficient policy terms. To the extent that insurance consumers are perfectly informed and rational, however, these arguments are unavailing.[87] But the available evidence suggests that insureds' information and rationality are very limited in many consumer-oriented property/casualty insurance markets.

1. The Assumption of Consumer Knowledge

The actual market mechanisms by which property/casualty insurance consumers become "informed" about policy terms have virtually nothing to do with insureds reading policy terms.[88] Instead, the empirical evidence suggests that consumers learn about policy terms through (a) reputation effects, (b) insurance information intermediaries, and (c) secondary literature. Each of these sources filters information about policy terms, condensing and repackaging it into a form that consumers can easily understand. At

86. Boardman, *supra* note 56, at 1106.

87. For this reason, even though many of the structural limits described above apply to insurance markets that are geared towards sophisticated commercial purchasers, these markets may not suffer from significant inefficiencies in policy language. *See supra* note 48.

88. *See* JERRY, *supra* note 23, § 32[b] ("In forming a contract, an insured relies not upon the text of the policies but on the general descriptions of the coverage provided by the insurer and its agents during the time the insured was considering whether to submit an application."); Rakoff, *supra* note 38, at 1179 ("[T]he adhering party is in practice unlikely to have read the standard terms before signing the document and is unlikely to have understood them if he has read them."). Even if insureds wanted to learn directly about the scope of potential coverage, they might find doing so a difficult task: insureds generally do not receive the policy itself until after they have agreed to purchase their insurance. *See* JERRY, *supra* note 23, § 32[b]. Some lines of insurance allow the insured to cancel coverage shortly after receiving the contract. *See* MURIEL L. CRAWFORD, LAW AND THE LIFE INSURANCE CONTRACT 174 (7th ed. 1994).

the same time, these informational sources are limited in their capacity to convey nuanced policy information to consumers.

a. Reputation

Insurance consumers rely heavily on the reputation of insurers when deciding whether, and from whom, to purchase insurance.[89] Discussions with family and friends are the leading source of such information. One 1995 study found that 51% of homeowner insureds and 54% of auto insureds relied on word of mouth to learn about insurance, eclipsing all other sources of information.[90] A more recent 2001 study found that 56% of recent consumers relied on information from someone they knew when buying auto insurance and 98% of those consumers considered this information somewhat or very valuable.[91] Again, no other source of information was as frequently cited by insureds as a basis upon which they made their insurance-purchasing decision.[92] Other popular sources for learning about insurance are closely tied to insurers' reputations: insurance shoppers look to (1) insurance company advertisements (23% among recent automobile insurance purchasers), (2) television (10%), and (3) the yellow pages (14%).[93] Reputation affects repeat purchasers' decision making as well: ignoring price shifts, people tend to stay with an insurer when they are happy with the coverage they have received.[94]

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89. For a general discussion of the role of reputation in disciplining sellers' contracting behavior, see Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981). On the limits of reputation, see Oliver E. Williamson, *Economic Institutions: Spontaneous and Intentional Governance*, 7 J.L. ECON. & ORG. 159, 166-72 (1991).

90. *See* Jeffrey E. Thomas, *An Interdisciplinary Critique of the Reasonable Expectations Doctrine*, 5 CONN. INS. L.J. 295, 311 (1998-99) (citing INS. RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 15 fig.2-7, 31 fig.2-27 (1995) [hereinafter PAM 1995]).

91. INS. RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 2001, ISSUE 2, at 6 fig.2-5 [hereinafter PAM 2001].

92. *See id.*

93. *See id.* Insurers' costly investments in advertising can be understood to enhance reputation by signaling to consumers their confidence in their products. *See* Paul Milgrom & John Roberts, *Price and Advertising Signals of Product Quality*, 94 J. POL. ECON. 796 (1986); Phillip Nelson, *Advertising as Information*, 82 J. POL. ECON. 729, 732 (1974).

94. *See* INS. RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 2000, ISSUE 2, at 5 fig.2-3 (reporting that only 7% of homeowners or renters changed insurers in the last 5 years, but

Reputation, however, has limitations as a mechanism for transmitting information about insurance coverage to consumers. Reputation is largely a function of consumer satisfaction, which studies suggest is based primarily on consumers' perceptions of insurers' reliability.[95] Unlike virtually any other product, the most important element of insurance policies—the protection they provide against low-probability, high-cost losses[96]—is also an element that only a few insureds actually use or experience.[97] Consequently, most insureds can *personally* judge their insurer's reliability only when it comes to relatively small claims, such as a broken windshield or a fallen tree. Consumers who assess insurers' reputations based on the advice of friends and family, or on their own past insurance experiences, may therefore get a skewed perspective on the scope of their insurance coverage that unduly takes into account insurers' responsiveness to relatively unimportant, inexpensive claims.[98]

The initial evidence suggests that reputation in insurance markets may be limited in this way. First, as noted above, consumers do indeed tend to rely on the experiences of friends and family in assessing insurers' reputations.[99] By contrast, the evidence suggests that only a small percentage of consumers consult either consumer-oriented magazines or state government websites that post complaints of aggrieved insurance consumers.[100] Even more notably, consumers that did consult these sources found them less useful than advice from friends and family.[101] Second, the prospect

23% of auto insureds did). When consumers do change insurers, they overwhelmingly cite price as the reason. *See id.* at 6 fig.2-4.

95. *See* Marla Royne Stafford et al., *Determinants of Service Quality and Satisfaction in the Auto Casualty Claims Process*, 12 J. SERVS. MKTG. 426, 434 (1998).

96. *See infra* note 135 and accompanying text.

97. Colin F. Camerer & Howard Kunreuther, *Decision Processes for Low Probability Events: Policy Implications*, 8 J. POL'Y ANALYSIS & MGMT. 565, 566 (1989).

98. *See* Rappaport, *supra* note 61, at 242 & n.196.

99. *See* Thomas, *supra* note 90, at 311.

100. Only 6% of recent insureds report learning about insurance through the state government, and only 10% report consulting a consumer organization magazine. *See* PAM 2001, *supra* note 91, at 6 fig.2-5.

101. Eighty-three percent of consumers found public information helpful, which was substantially lower than the percent that found consulting with friends and family to be helpful. *See id.* Although the percentage finding consumer magazines helpful was higher, at 92%, it did not approach the 98% level of information from friends and family. *Id.*

that insurers' reputations disproportionately track coverage for small losses helps to explain the otherwise puzzling fact that insurance policies often cover small losses, such as broken car windshields or storm damage to trees, shrubs, and plants. Rational consumers, one would expect, would not demand such coverage given the trivial risks these losses present and the comparative size of the administrative costs insurers incur when paying for these losses. But if consumers disproportionately rely on insurers' coverage of common losses to assess reputation, then insurers can improve their general reputation by providing this relatively cheap coverage.

Finally, the potential that insurers' reputations unduly track coverage for high-probability, low-cost losses also helps to explain the "big claims" exclusion in insurance law.[102] In a number of different business insurance lines, commentators have observed that insurers tend disproportionately to fight large claims.[103] In the cases of liability from pollution and asbestos, for instance, the administrative costs of disputes have often outweighed the total amount that insurers paid in compensation.[104] Although commentators have focused on business insurance contexts when discussing this "big-claim" exclusion,[105] anecdotal evidence suggests that consumer-oriented property/casualty insurers also disproportionately fight big claims.[106] To the extent this evidence is correct, it is consistent with a perception among insurers that their reputations insufficiently reflect their willingness to pay big claims.

b. Insurance Information Intermediaries

A second common source of information for consumers in the property/casualty industry is information intermediaries, such as insurance agents or brokers.[107] Other than family and friends, such

102. Abraham, *supra* note 15, at 213.

103. *See id.*; Richard E. Stewart & Barbara D. Stewart, *The Loss of the Certainty Effect*, 4 RISK MGMT. & INS. REV. 29, 33 (2001) ("From an insurer's point of view, resisting large claims has become an effective, perhaps even necessary, competitive strategy.").

104. Stewart & Stewart, *supra* note 103, at 33.

105. Abraham, *supra* note 15, at 213.

106. Stewart & Stewart, *supra* note 103, at 40-42.

107. The average consumer "depends on an insurance agent and insurance company to sell

intermediaries are most commonly mentioned as a source from which consumers initially learned about insurance; in 1995, for example, 45% of insured homeowners and 42% of insured drivers relied on information from an insurance agent or broker.[108] In 2001, 40% of consumers relied on insurance agents to learn about automobile insurance.[109]

Insurance information intermediaries are likely to do a good, though imperfect, job of informing consumers about basic coverage exclusions and available potential endorsements. The unique advantage of these information sources is that they help assess a consumer's individual need for insurance and explain coverage options appropriate to that individual.[110] In doing so, they filter out the most relevant information about different policy options and answer consumers' basic questions. For these reasons, most insurance consumers report being satisfied with the information they learn from these sources: more than 90% of insurance consumers rated the information they learned from insurance agents or brokers as somewhat or very helpful.[111]

Although insurance information intermediaries greatly improve consumer information, they do not eliminate all deficiencies in consumer knowledge. First, information intermediaries generally tend to focus on basic coverage terms and avoid coverage nuances that cannot be altered with supplemental coverage: insurance agents and brokers are only trained to know about basic coverage information and matters that potentially require consumer decision making.[112] Second, both insurance agents and insurance brokers

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him a policy that 'works' for its intended purpose in much the same way that he depends on a television salesman and television manufacturer." Slawson, *supra* note 29, at 547. Insurance information intermediaries also include banks. Although only 8% of respondents relied on banks to learn about insurance in 2001, PAM 2001, *supra* note 91, at 6 fig.2-5, their importance has likely increased significantly in recent years as the Gramm-Leach-Bliley Act, which allows banks to sell insurance, was passed only in 1999. Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12 U.S.C. and 15 U.S.C.).

108. *See* Thomas, *supra* note 90, at 311-12 (citing PAM 1995, at 15 fig.2-7, 31, fig.2-27).

109. *See* PAM 2001, *supra* note 91, at 6 fig.2-5.

110. *See* ABRAHAM, *supra* note 53, at 56.

111. *See* Thomas, *supra* note 90, at 312 (citing PAM 1995, at 15 fig.2-7, 31, fig.2-27).

112. *See* R.D. Blanchard, *An Insurance Agent's Legal Duties to Customers*, 21 HAMLINE L. REV. 9, 9-10 (1997). Understanding more detailed nuances of coverage will often require legal expertise.

have a strong incentive to sell insurance to consumers.[113] They therefore have a tendency to focus on the positive elements of coverage, telling "stories" that, while technically accurate, gloss over many of the less salient ways in which a policy limits coverage.[114]

Insurance information intermediaries will also fail to protect the interests of consumers that purchase insurance from direct underwriters, who sell policies directly to consumers.[115] Consumers who bypass information intermediaries almost universally purchase their policies through particularly large insurers, such as Allstate, Nationwide, State Farm, and GEICO.[116] These megainsurers are also the insurers most likely to deviate from standard ISO policy language: because these large insurers have enough policyholders to generate accurate actuarial predictions using only their own loss experiences, they do not need to rely on the aggregate industry data maintained by the ISO.[117] For this reason, they also do not need to

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113. Insurance agents owe their primary allegiance to the insurer. *See* Robert H. Jerry, II & Reginald L. Robinson, *Statutory Prohibitions on the Negotiation of Insurance Agent Commissions: Substantive Due Process Review Under State Constitutions*, 51 OHIO ST. L.J. 773, 773 (1990). Insurance brokers, at least ostensibly, solely represent the consumer. But as a recent Eliot Spitzer lawsuit revealed, in practice most brokers nonetheless have significant loyalties to insurers as well. *See generally* Daniel Schwarcz, *Beyond Disclosure: The Case for Banning Contingent Commissions and other Insurer-Paid Bonuses for Independent Intermediaries*, 25 YALE L. & POL. REV. (forthcoming 2007) (arguing that contingent commissions, which are essentially bonuses that insurers pay to brokers and independent agents for bringing the insurer a particularly large volume of profitable customers, have the potential to distort the advice that ostensibly independent insurance intermediaries give to their customers).

114. *See* Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1400-16 (1994).

115. Direct underwriters should be contrasted with insurers who use exclusive agents. Some agents are independent and sell policies from multiple different insurers, whereas others are exclusive and sell only one insurer's policies. *See* Laureen Regan & Sharon Tennyson, *Agent Discretion and the Choice of Insurance Marketing System*, 39 J.L. & ECON. 637 (1996). In either case, the insured receives expert advice about the scope of coverage. *But see* Dana A. Kerr, *Understanding Basis Risk in Insurance Contracts*, 9 RISK MGMT. & INS. REV. 37, 50 (2006) (raising the question whether consumer coverage expectations may be more accurate when they purchase from independent agents rather than direct agents); Schwarcz, *supra* note 113. In the case of direct underwriters, by contrast, there is *no* insurance agent; the consumer merely purchases the insurance online or over the phone.

116. *See* ABRAHAM, *supra* note 53, at 56.

117. *See* BAKER, *supra* note 29, at 47. One example of this phenomenon is State Farm's unique "lead in" clause in homeowner's policies, which excludes coverage whenever an excluded risk contributes in any way to a loss. *See* Murray v. State Farm Fire & Cas. Co., 509 S.E.2d 1, 13 (W. Va. 1998). Under this exclusion, which reverses the traditional efficient-

use the standard-form language from which the aggregate data is derived. Consumers who purchase insurance from direct underwriters therefore potentially purchase a substantively different policy from that which is offered by most insurers and forego the advice of an information intermediary about these differences. For these reasons, their interests may not be protected at all by informed consumers who rely on an information intermediary to purchase insurance.[118]

Insurance information intermediaries that also lend to clients on a secured basis—such as banks or other mortgage providers that require homeowners insurance[119]—may provide an additional measure of protection to consumers who rely on them.[120] Unlike other information intermediates, these lenders have a direct stake in the substantive scope of policy language because it protects their collateral. But even these intermediaries will imperfectly steer consumers to efficient coverage. First, the interests of lenders and consumers may not be perfectly aligned: lenders care about protecting collateral only to the extent that the collateral secures a loan. Because the value of an insured asset typically exceeds the loan amount, lenders will tend to care about a narrower band of coverage issues than insureds. Second, lenders may protect their interests primarily by negotiating ex post resolutions of coverage disputes that are favorable to them, but not necessarily the consumer.[121] Unlike consumers, banks and other lenders are repeat players that have established relationships with insurance adjustors, facilitating this type of ex post negotiation.[122] To the extent

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proximate-cause rule, State Farm has consistently argued that it has no obligation to cover any losses that are in any way caused by "earth movement," a traditionally excluded risk. *See id.*

118. This concern may be offset by the fact that the standard policy argument made in *supra* text accompanying notes 52-59 is not applicable in this case, as informed consumers can receive the coverage they desire.

119. *See supra* note 60 and accompanying text.

120. At least in 2001, surprisingly few consumers relied on lending institutions to help advise them about the purchase of insurance. *See supra* note 107 (only 8% of survey respondents relied upon banks to learn about insurance in 2001).

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

122. *See id.* at 881-84 (explaining that a firm's willingness to award discretionary ex-post

that lenders can protect their interests through this ex post strategy, they will have insufficient incentives to steer insureds to efficient coverage ex ante.

c. Secondary Literature

A final source on which insurance consumers heavily rely is secondary materials written either by the insurance industry or by consumer advocacy groups.[123] In 2001, 21% of recent insurance shoppers relied on insurance company literature and 10% relied on consumer information magazines.[124] Insurance regulators also provide consumers with educational publications and services such as a consumer hotline and on-site seminars.[125]

Although these information sources are reportedly helpful to consumers,[126] they are also limited. Unlike insurance information intermediaries, they do not provide individualized information to insurance consumers. Because written literature must be accessible and relevant to a wide range of readers, it can explain only the most basic coverage exclusions and endorsement options. And, of course, insurers, like agents and brokers, ultimately profit from selling more insurance. At the margins, therefore, they have an incentive either to not disclose coverage limitations in secondary literature or to do so in the way that makes the limitations most palatable to consumers.[127]

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benefits to a customer will depend on the extent to which that customer is a repeat player).

123. *See* Rappaport, *supra* note 61, at 240 n.187 (noting that "[b]rochures and summaries have been neglected as a means of informing consumers about the terms of their form contracts").

124. *See* PAM 2001, *supra* note 91, at 6 fig.2-5.

125. Brenda P. Wells & Marla Royne Stafford, *Insurance Education Efforts and Insurer Service Quality*, 15 J. INS. REG. 540, 540-41 (1997).

126. PAM 2001, *supra* note 91, at 6 fig.2-5 (finding that 92% of consumers rate insurance company literature to be somewhat or very helpful and 97% rate consumer organization magazines to be somewhat or very helpful).

127. *See* Rappaport, *supra* note 61, at 240 n.187 ("One significant problem with brochures and sales materials ... [is] that they may be misleading.").

2. *The Assumption of Consumer Rationality*

Even when insurance consumers do learn about a policy term, they may irrationally discount it when deciding whether to purchase insurance. A growing body of research suggests that consumers irrationally tend to disregard nonsalient terms in ordinary standard-form contracts, even if they are informed about those terms.[128] The reason is that consumers are boundedly rational; in this case, they are only capable of incorporating a limited number of considerations into their purchasing decisions.[129] Whether consumers will tend to consider a contract term in their decision making is often determined by basic heuristics that do not necessarily identify the most important terms.[130] Consumers, for instance, may focus on a term involving an issue that has recently been discussed in the news, even if the term is relatively unimportant.[131] Firms that can identify nonsalient terms will have an incentive to draft them so that they are inefficiently one-sided.[132]

In the insurance context, contract terms that govern low probability risks may be particularly likely to be nonsalient for many consumers. All else being equal, insurance consumers tend to "refuse to attend to or worry about events whose probability is below some threshold," no matter how high the expected cost of such an

128. *See, e.g.*, Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 240-44 (1995); Robert A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, 85 CORNELL L. REV. 717, 721 (2000); Hillman & Rachlinski, *supra* note 28, at 451; Korobkin, *supra* note 45, at 1217-18; Russell Korobkin, *The Efficiency of Managed Care "Patient Protection" Laws: Incomplete Contracts, Bounded Rationality, and Market Failure*, 85 CORNELL L. REV. 1, 8-9 (1999).

129. David M. Grether et al., *The Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 S. CAL. L. REV. 277, 300 (1986) (finding that psychological literature suggests "the number of salient or determinate product attributes ... does not exceed five, and often is less"); Hillman & Rachlinski, *supra* note 28, at 451 ("[Consumers] rely on casually acquired, partial information, sufficient to make them comfortable with their choice .... [and] are therefore unlikely even to consider whether the assessment of the remote risks described in boilerplate terms is important to their decision to enter into a contract.").

130. *See* Korobkin, *supra* note 45, at 1223.

131. *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1518-22 (1998) (discussing the potential importance of availability in determining what issues consumers focus on in decision-making processes).

132. *See* Hanson & Kysar, *The Problem*, *supra* note 47, at 745-49 (arguing that manufacturers have a natural incentive to exploit consumers' cognitive biases).

accident.[133] Thus, various laboratory investigations have found that individuals consistently prefer to insure against high-probability, low-cost events.[134] This observed behavior contrasts sharply with the expected utility model of insurance, which predicts that insureds will generally prefer to insure against low-probability, high-cost events over high-probability, low-cost events, if the expected loss and premium are kept constant.[135] Field evidence similarly suggests that people tend simply to ignore seemingly improbable risks. In one classic study of insurance, for instance, interviewers surveyed people living in hazard-prone areas in California about their attitudes towards insurance.[136] The study revealed that, though many homeowners living in these areas were aware that they faced potentially large liabilities in the event of a flood or an earthquake, remarkably few of them had invested even minimal effort in learning about available insurance options.[137] Even those who were aware of the likelihood of these risks tended not to insure against them, despite having purchased ordinary homeowners insurance.[138]

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133. HOWARD KUNREUTHER, DISASTER INSURANCE PROTECTION: PUBLIC POLICY LESSONS 236 (1978); *see also* RISA PALM, EARTHQUAKE INSURANCE: A LONGITUDINAL STUDY OF CALIFORNIA HOMEOWNERS 5-6 (1995); Jolls et al., *supra* note 131, at 1518-19; Paul Slovic et al., *Preference for Insuring Against Probable Small Losses: Insurance Implications*, *in* THE PERCEPTION OF RISK 51, 67-68 (Paul Slovic ed., 2000); Mark J. Machina, *Choice Under Uncertainty: Problems Solved and Unsolved*, 1 J. ECON. PERSP. 121 (1987). Countervailing factors may lead insurance consumers to focus too much on low-probability risks. For instance, a risk may be exaggerated if it has recently occurred (availability heuristic), or figured prominently in media coverage (social amplification of risk). *See* PALM, *supra*.

134. One well-known study simulated an insurance decision by having subjects choose a red or blue ball from an urn. *See* Slovic et al., *supra* note 133, at 54-57. The blue ball represented a hazard against which study participants could insure; by varying the ratio of colored balls, experimenters could manipulate the probability of loss. *Id.* Contrary to expected utility theory, "a strong preference was found for insuring against high-probability, low-cost events." *Id.* at 56. This result was consistent among different populations and was replicated in a number of different experimental designs. *Id.* at 62-67.

135. *See* Slovic et al., *supra* note 133, at 52-53. *See generally* JOHN VON NEUMANN & OSKAR MORGENSTERN, THEORY OF GAMES AND ECONOMIC BEHAVIOR (1944).

136. KUNREUTHER, *supra* note 133, at 236.

137. *Id.* at 236-43. People's expectations of federal aid in the event of a natural disaster did not explain these findings, as most reported that they did not anticipate relying on such aid. *Id.* at 237-38.

138. Evidence from a 1993 study in California supports these results: objective factors, such as proximity to a fault line, had little to do with whether a homeowner purchased earthquake insurance. PALM, *supra* note 133, at 75-78.

Observation therefore suggests that insurance decision making is typically a sequential process: most insurance consumers first decide whether a potential loss is a "problem"; then, if and only if it is, do they consider insurance.[139] As such, insurers may face insufficient market pressure to draft efficient terms when those terms govern sufficiently low probability events. Yet this is precisely when adequate insurance coverage is most valuable. More generally, if cognitive limitations such as consumers' sequential approach to insurance 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.[140]

C. A Role for Judicial Intervention

The evidence and analysis discussed above suggests that imperfections in many consumer-oriented property/casualty insurance markets may lead to inefficient policies. Of course, the mere existence of market problems does not necessarily warrant government intervention, which is itself both costly and imperfect. But the social welfare consequences of failures in insurance markets are sufficiently large that such intervention may be optimal.[141] And while state insurance regulators can and do review the substance of policy terms,[142] effective regulation of insurance policies also requires the ex post examination of policy terms in light of their specific applications to insureds' losses. The judiciary has an obvious comparative advantage to regulators in performing this function, especially given the particular risks of agency capture in the insurance context.[143]

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139. *See* KUNREUTHER, *supra* note 133, at 241; *see also* Slovic et al., *supra* note 133, at 56-57 (endorsing sequential model of insurance decision making).

140. *See* Hanson & Kysar, *The Problem*, *supra* note 47, at 747-49.

141. Whether this is true, of course, depends on the costs and reliability of judicial intervention. *See infra* Part III.C.

142. *See infra* notes 151-55 and accompanying text.

143. *See infra* notes 156-59 and accompanying text.

1. *The Social Welfare Consequences of Inefficient Coverage*

When insurers do use exploitive terms or insufficient care in drafting, the negative effects on social welfare are often significantly larger than in the case of other types of inefficiently drafted standard-form contracts. In part, this is because insurers are much more efficient bearers of the risk of inefficient insurance policy terms than insureds.[144] Insureds who are denied coverage will have suffered a significant loss and, consequently, be particularly likely to value coverage.[145] By contrast, because the payment of coverage by an insurer in any individual case will typically be a small loss relative to the insurer's net assets, the insurer is not particularly harmed by bearing that risk.[146]

A second and related reason why suboptimal insurance coverage can be particularly inefficient is that wronged "insured[s] ha[ve] no ability to 'cover'" for the inefficient denial of coverage.[147] Insurance contracts are distinctive in part because they involve sequential and contingent performance: the insured performs routinely by paying premiums, whereas the insurer's performance—paying claims—is contingent on an event that may not happen.[148] Even among such aleatory contracts, though, insurance policies are unique because the insured cannot contract with anyone else for substitute performance if the insurer refuses to perform.[149] Once the insurer denies an insured's claim, "the policyholder has nowhere else to go."[150] For this reason, the insured's misguided reliance on insurance coverage can be particularly damaging.

144. The application of an unexpected exclusion is analogous to a risk from the consumers' perspective. *See* Kerr, *supra* note 115, at 41-43.

145. *See* SHAVELL, *supra* note 30, at 258 ("Risk aversion is most relevant in situations in which losses would be large in relation to a person's assets and thus would impinge substantially on his utility.").

146. *Id.* at 258-59.

147. Works, *supra* note 16, at 583 n.185 (quoting E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 447 (Del. 1996)).

148. *Id.* at 578-88; BAKER, *supra* note 29, at 89.

149. *See* BAKER, *supra* note 29, at 89; Works, *supra* note 16, at 584 n.186.

150. *See* BAKER, *supra* note 29, at 89.

2. *The Limitations of State Administrative Regulation*

Although the content of insurance policies is generally subject to state regulatory review, many insurance law commentators assume that this regulation is perfunctory and ineffective.[151] Despite this widespread sentiment, to date there has been no systematic study of such regulation.[152] Moreover, state regulators' scrutiny of insurance policies can occasionally be quite substantive. For instance, Texas insurance regulators engaged in a prolonged debate with insurers about their proposal to exclude losses from mold in standard homeowners policies,[153] and New York regulators refused to allow many insurers to switch from "occurrence" policies to "claims-made" policies.[154] Additionally, the lessons that one state regulator learns in the process of substantively reviewing policies can often be shared with regulators from other states through the National Association of Insurance Commissioners (NAIC).[155]

Nonetheless, at this point there is not enough evidence to overcome the presumption that state regulatory review cannot be relied on to police the substantive content of insurance policies absent support from the judiciary. State insurance regulators typically come from within the insurance industry, leading to potentially significant regulatory capture.[156] This is particularly

151. *See id.* at 47 (noting that while "[t]here has been no systematic, scholarly study of the effectiveness of state regulation of insurance forms," most commentators assume that such regulation is inadequate); Keeton, *supra* note 8, at 967 ("Regulation is relatively weak in most instances, and even the provisions prescribed or approved by legislative or administrative action ordinarily are in essence adoptions, outright or slightly modified, of proposals made by insurers' draftsmen.").

152. *See* BAKER, *supra* note 29, at 47.

153. *See* Terrence Stutz, *Lift Freeze on Policies, Insurers Told; State Regulator Seeks Solution To Rise in Home Mold Claims*, DALLAS MORNING NEWS, Aug. 31, 2001, at 1A; Mike W. Thomas, *Regulators, Insurers Engaged in Homeowners-policy Showdown*, SAN ANTONIO BUS. J., Nov. 16, 2001, at 1.

154. STEMPEL, *supra* note 16, at 601.

155. *See* Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 667-70 (1999) (discussing the ways in which the National Association of Insurance Commissioners allows different states' insurance regulators to impact one another); *see also* Spencer L. Kimball, *The Case for State Regulation of Insurance*, *in* INSURANCE, GOVERNMENT, AND SOCIAL POLICY 420 (Spencer L. Kimball & Herbert S. Denenberg eds., 1969) (noting that the NAIC promotes uniformity).

156. *See* Randall, *supra* note 155, at 639-41 (arguing that "the problem of capture as it

problematic given that insurers generally do not individually submit policies for review by regulators; rather, the ISO itself "actively pursue[s] approvals" of its own standard forms.[157] Moreover, state insurance regulators generally view their primary duty to be assuring insurer solvency.[158] For this reason, their substantive review of policy terms is not typically a priority.

Even if these practical concerns could be overcome, any regulatory regime capable of combating inefficient policy terms would need to rely heavily on ex post, as well as ex ante, review. Inefficiencies in policy terms will frequently be hard to assess ex ante given their breadth and their potential to apply in a way that regulators may not be able to anticipate. Moreover, some anecdotal evidence suggests that regulators may be willing to accept false assurances from insurers that particularly broad clauses will be enforced only in limited circumstances.[159] Although there is no theoretical problem with state administrators reviewing insurance policy content ex post, the judiciary will typically enjoy a comparative advantage in this task.

Ultimately, then, state administrative review is not a sufficient check on the content of insurance policies and must be supplemented with limited judicial oversight if it is to be effective. At the same time, state regulation ought not to be irrelevant to the judicial process, especially when regulators have considered ex ante the precise issues that litigation raises ex post. In fact, a doctrinal recognition of state insurance regulation may lead regulators to take a more active role in reviewing policy provisions and encourage further cooperation among insurers of different states through the NAIC.

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exists in other regulatory contexts is minimal when compared to the problem in the insurance industry" for various reasons, including that "[t]he industry directly funds the NAIC").

157. Insurance Services Organization, About ISO—Helping Insurers Comply with Legal and Regulatory Requirements, http://www.iso.com/about_iso/about08.html (last visited Jan. 25, 2007).

158. *See* Neil A. Doherty & Harris Schlesinger, *Rational Insurance Purchasing: Consideration of Contract Nonperformance*, 105 Q.J. ECON. 243, 243 (1990).

159. For example, according to one oft-quoted insurance industry representative, who was testifying before the Texas Insurance Department, "the language of the [absolute pollution] exclusion was drafted with unrealistic breadth to ensure its effectiveness," but "it would not be literally enforced against insured[s] in cases where doing so would be inconsistent with basic understanding about the policy." Stempel, *supra* note 18, at 235-36.

II. Reasonable Expectations as a Flawed Doctrine for the Judicial Regulation of Insurance

Professor (now Judge) Robert Keeton initially proposed the reasonable expectations rule as a guide for the "judicial regulation of" insurance policies.[160] Keeton's rule requires insurers to provide the coverage that consumers reasonably expect, at least when the insurer does not "[call a coverage limitation] to the attention of a policyholder at the time of contracting, thereby negating surprise to him."[161] It thus attempts to correct for consumers' lack of meaningful assent to an adhesive insurance policy by requiring either explicit consumer assent to a policy term (when the insurer specifically informs the consumer of a term) or implicit assent to the term (when the term is within consumers' reasonable expectations).[162]

As Part I argues, Keeton's intuition that insurance policies can include exploitive terms was, and is, very real.[163] At the same time, though, Keeton's reasonable expectations solution largely ignores the key analytical issue of whether market forces effectively constrain the content of insurance policy terms. This Part argues that this misdiagnosis necessitates jettisoning the reasonable expectations doctrine as a basis for defining the proper scope of the judicial regulation of insurance policies. Part II.A explains the practical failure of the reasonable expectations doctrine to evolve into an analytically coherent basis for the judicial regulation of

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160. Keeton, *supra* note 8, at 967.

161. *Id.* at 967-68.

162. *Id.*

163. This is not surprising, given that Keeton's proposed reasonable expectations rule was reflected in existing case law. Perhaps the best example involved an insurer that positioned an automated vending machine for flight insurance in front of a charter airline company's ticket gate. Lachs v. Fidelity & Cas. Co., 306 N.Y. 357, 358 (N.Y. 1954). Despite the placement of the machine, the policy purported to deny coverage for privately chartered flights. *Id.* at 367. The court nonetheless held that the policy covered an insured who was killed in a charter flight because the vending machine's placement created a reasonable expectation of coverage. *Id.*; *see also* Kievit v. Loyal Protective Life Ins. Co., 170 A.2d 22, 30-31 (N.J. 1961) (finding that an "accident insurance policy" created a reasonable expectation of coverage when the insured was accidentally struck in the head, triggering a preexisting Parkinson's condition, despite a clause excluding coverage for loss due to disability caused by disease).

insurance. Part II.B argues that, as a matter of theory, the doctrine is a poor tool for correcting the market failures that drive the need for judicial regulation of insurance policies.

A. *The Stunted Evolution of the Reasonable Expectations Doctrine*

The reasonable expectations doctrine has figured prominently in thousands of insurance coverage disputes.[164] But it has failed to emerge as either a popular or an analytically sound basis for guiding the judicial regulation of insurance.[165] Instead, most of the cases using reasonable expectations language do not apply the doctrine as a vehicle for the judicial regulation of insurance policies at all.

The majority of cases invoking reasonable expectations language use the doctrine as a proxy for a variety of traditional and uncontroversial contract law principles.[166] The most common example is when courts use the doctrine to fill gaps or ambiguities in policy language.[167] In these cases, courts hold that an insured is entitled

164. According to one recent state survey conducted by a plaintiff, twenty-four states have adopted some form of reasonable expectations analysis for determining whether a contract is ambiguous, and thirty-nine allow reasonable expectations analysis to guide the court's construction of ambiguous language. *See* Steinberg v. Nationwide Mut. Ins. Co., 224 F.R.D. 67, 77-78 (E.D.N.Y. 2004). *See generally* STEMPEL, *supra* note 16, § 11.1 ("Prior to the express recognition of the [reasonable expectations] doctrine, courts had been silently following some variant of this construct for years.").

165. *See* Fischer, *supra* note 28, at 180 (concluding that the reasonable expectations "inquiry has advanced very little beyond Keeton's initial paper"). Some, such as Kenneth Abraham, argue that courts should eschew the role of regulator, using reasonable expectations analysis only as a proxy for traditional contract law principles or as an expanded basis for preventing insurers' affirmative misrepresentations to consumers. Abraham, *supra* note 81, at 547-50 (arguing that the strong form of the reasonable expectations doctrine serves the useful, if limited, role of allowing courts to alter their interpretive frameworks where doing so is efficient but would contravene earlier precedents); Abraham, *supra* note 13, at 1155 (arguing against the reasonable expectations doctrine when the insurer or agent has not affirmatively misled the insured); Abraham, *supra* note 21, at 61-62 (arguing that the reasonable expectations doctrine can best be used as a guiding principal for state regulators rather than as a method for allowing judges to overturn unambiguous policy language).

166. *See* Rahdert, *supra* note 9, at 345-54.

167. ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES § 6.3(a)(2), at 628 n.4 (student ed. 1988) (noting that "[i]t seems likely that there has always been an implicit understanding that ambiguities, which in most cases might be resolved in more than just one or the other of two ways, would be resolved favorably to the insured's claim only if a reasonable person in

to the coverage he or she would reasonably expect only after finding that the policy's language is ambiguous.[168] Other courts use the reasonable expectations principle as an aid to determine whether there exists a contractual gap at all.[169] In this variation, the reasonable expectations doctrine sets the underlying interpretive framework for determining the policy's content.[170] In yet a third variety of reasonable expectations cases, courts invoke the doctrine to provide coverage when "the insurer's words, conduct, or a situation for which the insurer is responsible have created [an incorrect] expectation."[171] Although these so-called "misleading impression" cases expand on the doctrine of estoppel, they still fit comfortably within traditional contract law principles: that a contracting party misrepresenting pertinent facts may be bound by those misrepresentations is hardly a radical notion.[172]

Only a small minority of states, estimated as falling somewhere between six and ten, explicitly use a reasonable expectations rule that resembles judicial regulation of insurance policies.[173] These

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the insured's position would have expected coverage").

168. *See id.* This gap-filling rule tracks the traditional rule in contract law that, when the parties have not explicitly resolved an issue in their contract, the court should impose the terms they would have agreed to had they reached the issue themselves. *See* Abraham, *supra* note 81, at 547.

169. For instance, one recent case concluded that an exclusion in a homeowners policy for losses caused by settling did not apply when an insured's water pump broke, which led to water seeping under the insured's house and causing the entire house to twist out of shape. *See* West v. Umialik Ins. Co., 8 P.3d 1135, 1136 (Alaska 2000). The court reasoned that the exclusion was accompanied by other water damage exclusions dealing with "water from external sources." *Id.* at 1142. As such, the court found that an ordinary insured would understand the "settling" exclusion to refer to natural settling that occurs over time, not sudden settling caused by a burst water pipe. *Id.* at 1143-44.

170. *See* Mark C. Rahdert, *Reasonable Expectations Revisited*, 5 CONN. INS. L.J. 107, 112 (1998-99) (explaining that courts often use the reasonable expectations doctrine to ascertain the meaning of a policy).

171. Abraham, *supra* note 13, at 1155. The flight-insurance vending machine scenario is one example of this type of case. *See supra* note 163.

172. *See* 7 CORBIN ON CONTRACTS § 28.13 (Joseph M. Perillo ed., rev. ed. 2002).

173. *Compare* Stempel, *supra* note 18, at 193-94 (describing the number of states who have adopted Keeton's version of the reasonable expectations doctrine as "relatively small, numbering approximately a half-dozen"), *with* Roger C. Henderson, *The Formulation of the Doctrine of Reasonable Expectations and the Influence of Forces Outside Insurance Law*, 5 CONN. INS. L.J. 69, 72-73 (1998-99) (noting that the reasonable expectations doctrine "has been embraced by at least ten jurisdictions"). "[D]etermining the exact status of the reasonable expectations school is difficult" because many state courts are not clear about how they use the doctrine. STEMPEL, *supra* note 16, § 11.1, at 313 (footnote omitted).

cases grant coverage to insureds despite clearly applicable exclusionary language in the policy and the absence of affirmatively misleading representations by the insurer.[174] Aside from this unifying theme, though, the cases differ widely in their methodology.[175] In some cases, courts argue that an insurance policy's language and structure, although perhaps unambiguous from a technical perspective, are sufficiently confusing to cause an average person to have an expectation of coverage.[176] In other cases, courts conclude that insureds have a reasonable expectation of coverage based on factors beyond the policy's language and structure, such as the insurer's advertising practices, underwriting theory, or generalized beliefs among consumers.[177]

According to a number of insurance law scholars, this variability in the case law is emblematic of the reasonable expectations doctrine's inherent vagueness and lack of predictability.[178] In most

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174. Courts do tend to reserve this more substantive version of the reasonable expectations doctrine for instances in which the insured is a consumer or small business. STEMPEL, *supra* note 16, § 11.4.1, at 325; *see also* Jeffrey W. Stempel, *Reassessing the "Sophisticated" Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807, 809 (1993) (arguing that sophisticated policyholders are also entitled to protection from courts, but focusing on ambiguity rule).

175. *See* Rahdert, *supra* note 170, at 112. Rahdert categorizes these cases into those in which the court (1) finds the policy terms unconscionable, (2) determines that departing from policy language is necessary to safeguard the essential objectives of the policy, or (3) enforces public policy in favor of assured compensation to injured parties. *See id.* at 112-14.

176. For example, many courts have required insurers to cover liabilities stemming from insureds' release of toxic fumes despite a provision that excludes coverage for liabilities caused by the "discharge" or "dispersal" of a "pollutant." A "pollutant" is typically defined as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste." Bituminous Cas. Corp. v. Sand Livestock Sys., Inc., No. C04-4028-PAZ, 2005 U.S. Dist. LEXIS 12276, at *6 (D. Iowa June 22, 2005) (internal quotation marks omitted). Although most agree that this language unambiguously excludes liabilities from toxic fumes, many courts hold that a reasonable policyholder would not understand this point. *See id.* at **17-24 (reviewing case law).

177. *See* Rahdert, *supra* note 9, at 371. For one canonical example, see *supra* text accompanying notes 66-69 for a discussion of *Atwood v. Hartford Accident & Indemnity Co.*, 365 A.2d 744, 746-47 (N.H. 1976). Another illustrative case, *Tower Insurance Co. v. Judge*, 840 F. Supp. 679, 693 (D. Minn. 1993), held that a coverage exclusion for liabilities arising out of criminal acts did not apply when an insured purposely electrocuted his friend as a prank. The court reasoned that the exclusion violated the insured's reasonable expectations because his act "was not inherently criminal but rather was criminal only because of the tragic result." *Id.*

178. *See* Fischer, *supra* note 28, at 154 (concluding that the doctrine of reasonable expectations is "little more than judicial expectations masquerading as policyholder

cases, these commentators observe, "it is unrealistic to suppose that the insured would actually or reasonably expect the coverage in question."[179] Recent empirical data has confirmed this intuition, revealing that when most consumers purchase insurance, they have few specific expectations about whether they will be insured in particular factual scenarios.[180] For these reasons, many have argued "that the reasonable expectations doctrine rests on dubious assumptions"[181] and "is difficult to implement in a systematic and principled fashion."[182]

B. Reasonable Expectations as a Corrective for Market Failure?

Even assuming that the practical failures of the reasonable expectations doctrine could be overcome, its theoretical basis as a method for the judicial regulation of insurance is highly suspect. Because the doctrine incorrectly targets consumers' lack of assent to insurance policies, it fails to respond to the market problems that exist in consumer and small business property/casualty markets. In fact, it actually exacerbates many of these problems, creating inefficient coverage and encouraging both the under- and over-provision of information to consumers.

1. Reasonable Expectations and Inefficient Coverage Exclusions

One of the most common justifications for the reasonable expectations rule is that it protects consumers from unfair and surprising coverage exclusions.[183] At first glance, this justification may seem correct; the rule seems to apply when market failure is

expectations"); Frank E. Gardner, *Reasonable Expectations: Evolution Completed or Revolution Begun?*, 669 INS. L.J. 573, 577-78 (1978); William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267, 268-72 (1986).

179. Abraham, *supra* note 13, at 1162; *see also* Works, *supra* note 16, at 558 ("The reality, of course, is that real insureds simply do not have expectations of any kind about most of the subjects treated by the provisions that lurk unread in their policies ....").

180. *See* Thomas, *supra* note 90, at 333 (concluding "that insureds do not rationally evaluate insurance information or arrive at specific expectations of coverage").

181. *Id.*

182. Rahdert, *supra* note 170, at 133.

183. *See* Fischer, *supra* note 28, at 180; Keeton, *supra* note 8, at 966-67; Rahdert, *supra* note 9, at 374-92; Stempel, *supra* note 18, at 186-87.

most likely because insureds have incorrect information about the scope of their coverage. In fact, though, the doctrine does a remarkably poor job of identifying market failure: that some or even many insureds do not reasonably expect a policy term does not mean that market mechanisms have not effectively influenced the insurer's drafting of that term.[184] Precisely because most consumers recognize how complicated insurance is, they rely on informational sources that reflect and incorporate the substantive scope of their policies. Thus, reputation, information intermediaries, and secondary literature each inform consumers about coverage in a nontechnical manner that, although imperfect, reflects the underlying policy's actual scope of coverage.[185] And because market conditions need not be ideal for insurers to prefer efficient policies, these sources may deter patently inefficient drafting by insurers.[186]

Even when the doctrine does correctly identify market failure, it does not solve it. Consumers may expect coverage that they would not be willing to pay for if they knew the cost, or, conversely, may fail to expect coverage for which they would be willing to pay. Consider one particularly egregious example, *Philadelphia Indemnity Insurance Co. v. Barerra*, in which the insured purchased supplemental liability insurance beyond the statutory minimum when he rented a car.[187] The policy excluded coverage for accidents resulting from driving under the influence of alcohol.[188] When the insured, driving intoxicated, was involved in a serious car crash, the

184. *See supra* note 20 and accompanying text.

185. *See supra* Part I.B.1.

186. *See supra* note 59. The reasonable expectations rule may also lead courts to ignore already existing inefficient coverage if courts conclude that broad policy language should negate consumer expectations of coverage. For example, a series of cases have concluded that insurers can exclude coverage for liabilities arising from acts of self-defense because the breadth and clarity of the "intentional acts" exclusion negates whatever expectations of coverage the insured may have had. *See* Hewitt v. Allstate Ins. Co., 726 So. 2d 1120, 1123 (La. Ct. App. 1999); Allstate Ins. Co. v. Bauer, 977 P.2d 617, 620 (Wash. Ct. App. 1999). That a clause is broad and clear, though, does not mean that it is efficient. Indeed, in the above cases, causing injury to someone in the course of acting in self-defense does not present any moral hazard concerns and may involve low administrative costs in the event of a criminal determination. *See* Allstate Ins. Co. v. Takeda, 243 F. Supp. 2d 1100, 1107 (D. Haw. 2003); Farmers & Mechs. Mut. Ins. Co. of W. Va. v. Cook, 557 S.E.2d 801, 810 (W. Va. 2001).

187. 21 P.3d 395, 397 (Ariz. 2001).

188. *Id.* at 397-98.

supplemental insurer denied liability coverage.[189] The court held that this denial of coverage violated the insured's reasonable expectations because the exclusion was buried in fine print.[190] Regardless of the court's motivations, its embrace of the reasonable expectations doctrine effectively mandated that supplemental automobile coverage in Arizona cover accidents caused by drunk driving, unless the insurer and insured have a meeting of the minds to the contrary.[191] This result increases the cost of supplemental liability coverage for those who do not drink and drive, and potentially increases the overall incidence of drunk driving by allowing individuals to insure against this risk though it is within their control.[192]

2. *Reasonable Expectations and Informing Consumers*

Despite the reasonable expectations rule's limits at correcting for inefficient coverage, it might nonetheless be a sensible rule if it led insurers to convey an efficient amount of information to consumers. Indeed, many have emphasized that the doctrine encourages insurers to disclose potentially surprising exclusions to consumers in order to avoid the prospect of liability.[193]

The incentives for disclosure that the rule creates, however, are far from socially ideal. Insurers will find disclosure to be worthwhile under the rule only if "the risk of increased liability outweighs ... the cost of anticipating the insured's expectation of coverage and the

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189. *Id.* at 398.

190. *See id.* at 400-03. The risk of market failure was slight; regardless of what the insured knew, this type of exclusion should be unsurprising to anyone knowledgeable about insurance.

191. *See id.* at 403.

192. In many cases the prospect of losing one's assets may be a more significant deterrent to drunk driving than the risk of jail time. *See* Frank A. Sloan et al., *Effects of Tort Liability and Insurance on Heavy Drinking and Drinking and Driving*, 38 J.L. & ECON. 49, 73 (1995).

193. *See, e.g.*, BAKER, *supra* note 29, at 45 (describing the rule as an information-forcing mechanism); Fischer, *supra* note 16, at 1064 (arguing that the reasonable expectations rule "is justified as 'best suited to inducing one party to share important information with the other'" (quoting Robert Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 608-09 (1990))); Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 853 (1990) (concluding that the reasonable expectation doctrine "eliminate[s] [the] barriers to intelligent participation").

cost of dispelling it."[194] This incentive structure is badly misaligned with the socially efficient result. First, the increased liability to the insurer from not disclosing an unexpected term is unrelated to the social benefits of such disclosure. An insurer's avoidance of a payment is not a social benefit, and may well decrease social welfare if the insured values the money more than the insurer. Instead, the potential increase in social welfare from disclosure stems from improving consumer information, which may lead consumers to make more appropriate coverage decisions.[195] 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.

Second, and less intuitively, the private cost of disclosure to the insurer may be substantially less than the total social costs. An insurer's efforts to anticipate and disclose unexpected terms are both private and social costs. But disclosure also creates a social cost that the insurer need only partially bear: the cost to the consumer of learning about otherwise unexpected policy terms. This social cost does not consist merely of the additional effort and time consumers take to learn more information. Conveying information to consumers also carries the cost of potentially crowding out consideration of other, more important, issues.[196] The potential for such crowding out is particularly strong in the case of insurance consumers because of their limited capacity to conceptualize risk: informing people about risks can lead them to overestimate the likelihood of those risks[197]

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194. Abraham, *supra* note 13, at 1172. Disclosure will be particularly unlikely when an exclusion "involve[s] minor or highly technical components of coverage," but may occur when the insurer affirmatively creates the insured's misimpression. *See id.* at 1174.

195. *See supra* Part I.B.

196. *See* Craswell, *Taking Information Seriously*, *supra* note 28, at 583-84. *See generally* Jolls et al., *supra* note 131, at 1534 (describing how the presentation of information about risk affects people's ultimate perception of risk). For example, the Food and Drug Administration recently shifted the disclosure rules for prescription drug labels, requiring simpler and less comprehensive information to be disclosed. *See* Gardiner Harris, *New Drug Label Rule Is Intended To Reduce Medical Errors*, N.Y. TIMES, Jan. 19, 2006, at A20. The earlier requirement of intensely detailed and comprehensive information sheets led to fewer than one in ten physicians routinely reading drug labels, and caused doctors who did read these labels to learn little. *Id.*

197. *See* Paul Slovic, *Informing and Educating the Public About Risk*, 6 RISK ANALYSIS 403 (1986), *reprinted in* THE PERCEPTION OF RISK 182, 184 (Paul Slovic ed., 2000). One study, for instance, found that people tended to adjust their risk estimates upward when given new

or ignore other more important risk information.[198] An insurer that highlights an exclusion may therefore cause consumers to overestimate the likelihood of the associated risk, or to ignore other, more important, risks. This social cost is borne by both the insurer and the consumer; as such, the private cost to the insurer of biasing consumer information will be less than the social cost.

This analysis can be summarized as follows:

	Cost of disclosure to insurer = Social cost	Cost of disclosure to insurer < Social cost
Benefit of disclosure to insurer > Social benefit	*Cell A* Overencourages Disclosure	*Cell D* Overencourages Disclosure
Benefit of disclosure to insurer < Social benefit	*Cell B* Underencourages Disclosure	*Cell E* Ambiguous Result
Benefit of disclosure to insurer = Social benefit	*Cell C* Correct Amount of Disclosure	*Cell F* Overencourages Disclosure

As this matrix suggests, in most instances the reasonable expectations rule will not efficiently encourage the disclosure of potentially surprising coverage restrictions. If the benefit of disclosure to the insurer is larger than the social benefit—perhaps because disclosure will substantially decrease the likelihood of a court invoking the reasonable expectations doctrine, but will not impact the purchasing

information about why certain risks were *unlikely* to occur. *See* M. Granger Morgan et al., *Powerline Frequency Electric and Magnetic Fields: A Pilot Study of Risk Perception*, 5 RISK ANALYSIS 139 (1985).

198. *See* W. Kip Viscusi, *Individual Rationality, Hazard Warnings, and the Foundations of Tort Law*, 48 RUTGERS L. REV. 625, 650 (1996). *See generally* Robert S. Adler & R. David Pittle, *Cajolery or Command: Are Education Campaigns an Adequate Substitute for Regulation?*, 1 YALE J. ON REG. 159 (1984) (challenging the efficacy of consumer information programs).

decisions of many consumers—then the rule results in overdisclosure, as suggested in Cells A and D. Overdisclosure also occurs if the insurer does not bear all of the social costs of disclosure, as Cell F indicates. If, by contrast, the social benefit of disclosure is larger than the private benefit to the insurer—consider a very surprising term in the fine print of a policy that does not result in litigation—then underdisclosure is likely, as depicted in Cell B.[199]

III. PRODUCTS LIABILITY LAW AND THE JUDICIAL REGULATION OF INSURANCE POLICIES

The failures of the reasonable expectations doctrine call for an updated doctrinal approach to potentially inefficient, one-sided terms in the property/casualty insurance industry. To date, commentators have made a number of attempts to craft such a framework.[200] Virtually all of these proposals have been based on doctrines of contract law.[201] This fact is hardly surprising, given that Keeton's article originally framed the issue as one of consumers' lack of assent to insurance policy terms.[202] But premising the judicial regulation of insurance on contract law is an odd strategy:

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199. The potential that disclosure will create social costs that the insurer need not bear, in the form of crowding out consumer information, creates some ambiguity about this result, as suggested in Cell E. But it also suggests that, even when the private benefit to the insurer of disclosure is equal to the social benefit of disclosure, insurers may disclose too much under the reasonable expectations rule because they will ignore some segment of the social costs associated with crowding out consumer risk information.

200. Mark Rahdert, for instance, has argued that courts should defer generally to policy language, and only overturn provisions in which insurers impose their "naked preferences" on insureds. Rahdert, *supra* note 9, at 374-92. Similarly, Jeffrey Stempel has argued that courts should use "strong" reasonable expectations analysis to counter "absurd hyperliteral interpretations of policy text." Stempel, *supra* note 18, at 183-84. Another suggestion, advanced by Bob Works, is that courts should embrace the disproportionate forfeiture rule of contract law to prevent insurers from relying on comparatively insignificant coverage conditions to completely deny coverage to insureds. Works, *supra* note 16, at 588-89.

201. One exception is the proposal, advanced by at least one court, that the implied warranty of fitness—a doctrine from the law of sales—may be applicable to insurance law. *See supra* note 42.

202. Scholars have frequently defended the reasonable expectations doctrine as an ordinary principle of contract law, noting that "it is surprising that it has been such a controversial doctrine" given "how close the doctrine of reasonable expectations hews to the contract law ideal, of consent." BAKER, *supra* note 29, at 45; *see* Stempel, *supra* note 18, at 273.

a basic principle of contract law is that courts should not "rewrite the parties' agreement."[203]

This Part offers an alternative approach to the judicial regulation of insurance, based on products liability law. As Part III.A explains, products liability law offers an attractive template for the judicial regulation of insurance because its core purpose is to respond to failures in consumer product markets caused by consumer misinformation or bounded rationality. Equally important, the basic structure of products liability law mirrors the judicial regulation of insurance: in both cases, the law requires the seller of a product to compensate the buyer for injury despite the original sale not including any such right to compensation. Part III.B develops the specific contours of a products liability approach for the judicial regulation of insurance. It argues that the doctrine of defective warnings in products liability law provides a good method for encouraging efficient disclosure to insurance consumers about the terms of their policies. It also suggests that the doctrines governing design defects in products liability law can provide a good method for inducing insurers to draft efficient policy provisions. As in products liability law, the potential benefits of these forms of judicial intervention must be weighed against the costs of such intervention, which include a potential increase in insurance litigation and judicial workload. Part III.C discusses the costs and benefits of a products liability model, and suggests that although the benefits of limited judicial intervention are likely to outweigh the costs, further study is needed before the wisdom of intervention can be confidently embraced.

A. *Justifying a Products Liability Model*

The parallels between products liability law and the judicial regulation of insurance are striking. Perhaps most significantly, the core purpose of each judicial doctrine is the same—to correct for the market failures that result from ordinary consumers' misinforma-

203. *See* CORBIN ON CONTRACTS § 24.19, at 184 (Joseph M. Perillo ed., rev. ed. 1998) ("In judicial opinions it is often stated that 'the courts do not make a contract for the parties' and that the parties must be content to perform and to receive performance in accordance with whatever agreement they themselves chose to form.").

tion and cognitive limitations. As in insurance markets,[204] fully informed and rational consumers would obviate the need for products liability law because manufacturers would take an optimal amount of care in designing and manufacturing their products.[205] Most consumers, however, are not fully informed and rational about product safety. Although they may be informed about the safety risks associated with generic product types, learning about the relative safety of different manufacturers' products will frequently be expensive for consumers.[206] Additionally, consumers are subject to a variety of cognitive biases that, on balance, may lead them to underappreciate products' safety risks.[207] And even when the impact of these biases on consumer perceptions might otherwise be ambiguous, firms have a natural competitive incentive to manipulate these biases through advertising and other marketing techniques that cause consumers to underestimate product risks.[208] For these reasons, even legal thinkers who generally prefer not to tamper with markets acknowledge the potential need for products liability law to restore manufacturers' proper safety incentives.[209]

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204. *See supra* text accompanying notes 43-45.

205. These consumers would base their purchasing decisions on a product's true price, which is the sum of the product's sticker price and the expected accident costs of the product. *See* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 51-53 (1987). Consequently, firms would profit from taking any safety precautions that cost less than the associated decrease in expected accident costs: the firm could thereby increase the sticker price of the product by the cost of taking the safety precaution, while reducing the true price of the product. The quantity demanded would thus increase, resulting in additional sales and profits.

206. SHAVELL, *supra* note 30, at 215-17.

207. *Compare* Howard Latin, *"Good" Warnings, Bad Products, and Cognitive Limitations*, 41 UCLA L. REV. 1193, 1240-41 (1994) (arguing that products liability law should correct for consumers' systematic underappreciation of risk), *with* Schwartz, *supra* note 30, at 380 (concluding that "it seems premature to make this experimental data the factual premise of important legal rules").

208. Hanson & Kysar, *Some Evidence*, *supra* note 47, at 1554-58 (arguing that products liability law should respond to manufacturers' natural incentive to exploit consumers' cognitive biases).

209. *See, e.g.*, LANDES & POSNER, *supra* note 30, at 280-81 (arguing that products liability law addresses the fact that consumers inaccurately estimate risk); SHAVELL, *supra* note 30, at 214-15 (arguing that when consumers are uninformed about product safety "firms will not take care in the absence of liability"); VISCUSI, *supra* note 30, at 64-66 (arguing that the purpose of products liability law is to remedy "the chief inadequacy of the market," which "is inadequate risk information"); Goldberg, *supra* note 30, at 687 (showing that legal intervention is justified only if consumers are imperfectly informed); Schwartz, *supra* note 30,

This perceived inability of the market to produce optimally safe products parallels the market failures, described in Part I, which may impact the efficiency of form contracts in many property/casualty insurance markets. Just as the manufacturer of a tangible good may face insufficient incentives to design a product to be optimally safe because consumers will not know about those efforts, insurers may face insufficient incentives to exert an optimal amount of effort in precisely delineating risks that can be efficiently covered. And just as a product manufacturer may affirmatively decide on a product design that is cheap but unsafe, so too may an insurer decide on an overly broad coverage restriction that causes insureds not to receive coverage that can be efficiently provided.

Not only are the purposes of products liability law and the judicial regulation of insurance identical, but so is the fundamental structure of each doctrine. First, in both cases the law regulates a firm's sale of a product to an end consumer: insurance policies are distinctive among most standard-form contracts because they are not simply peripheral "product features," but largely constitute the product that consumers purchase.[210] Second, both products liability law and the judicial regulation of insurance are structured around a similar remedial principle: they potentially require that a firm give its customer compensation when he or she is harmed, despite the fact that the original sale to the customer did not include any such right to compensation.[211]

The analogy, of course, is imperfect. An insurance policy compensates insureds for harm that is caused by something or someone else. Products liability law, by contrast, requires only firms whose defective products cause an injury to pay compensation.[212] For this reason, one might reasonably distinguish these two areas of law based on the fact that the judicial regulation of insurance does not affect injurers' behavior, whereas the primary purpose of products

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at 378 (noting that products liability law should be responsive to information asymmetries and consumer biases, and that strict liability may be justified if consumers underestimate risk).

210. *See supra* note 29 and accompanying text.

211. *See* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 1 (1998); *supra* notes 173-77 and accompanying text.

212. *See* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 1.

liability law is to impact potential injurers' actions.[213] But inefficient, one-sided insurance policies harm insureds in much the same way that a product harms a consumer when it fails to include a cost-efficient safety device. In both cases, the product fails to protect the consumer against a risk even though the firm that designed the product could have efficiently provided such protection. Consider, for instance, the harm that a safety net causes to a circus performer who falls from a high-rope and then crashes through the net's webbing. In one sense, the circus performer's fall is the cause of his harm. But in another sense, the safety net itself caused the performer's injury because it did not serve its intended purpose of protecting the performer from an anticipated risk. An insurance policy that omits efficient coverage can be understood to harm the insured in the same way.

B. Constructing a Products Liability Model

Products liability law attempts to correct for consumer ignorance and irrationality through the use of two basic doctrines: defective warnings and defective designs.[214] The doctrine of defective product warnings encourages firms to disclose safety information to consumers, attempting to correct for market failures directly by improving consumer information.[215] In many ways, then, it parallels the information-forcing rationale of the reasonable expectations doctrine.[216] The doctrine of defective product designs corrects for market failures less directly: by forcing firms to internalize the costs of their inefficient safety designs, it induces them to take an efficient level of care.[217] It thus parallels the ostensible capacity of

213. *See supra* note 209 and accompanying text.

214. Product defects are typically split into three, rather than two, groupings: in addition to design defects, and defective warnings, products liability law includes a doctrine of manufacturing defects. *See* DAVID G. OWEN, PRODUCTS LIABILITY LAW 334-35 (2005); JANE STAPLETON, PRODUCT LIABILITY 250-58 (1994). Manufacturing defects involve products that have unintended irregularities such as a missing screw or a cracked metal piece. *See* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2. The analogue to a manufacturing defect in insurance law would be a misprinted insurance policy. Obviously this is not a significant concern.

215. *See* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2.

216. *See supra* note 193 and accompanying text.

217. *See* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2, cmt. a.

the reasonable expectations doctrine to deter consumer exploitation.[218]

1. Defective Warnings

The doctrine of defective warnings in products liability law offers important insights about how insurance law can potentially induce efficient disclosure to consumers about the content of insurance policies. Under the basic Restatement test, firms are strictly liable for providing an "inadequate" warning or instruction to consumers "when the foreseeable risks of harm posed by the product could have been reduced or avoided by the provision of reasonable instructions or warnings."[219] By merely requiring that the warning or instruction be adequate, the test induces firms to convey a limited amount of particularly important information to the consumer. This limited scope of the defective warning doctrine is motivated by the widespread recognition that only a small amount of information can practically be communicated to most consumers.[220] Communicating warning information imposes costs on both the recipient and the transmitter of information. 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.[221] By selectively

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218. *See supra* note 183 and accompanying text.

219. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2(c). Early in products liability law, courts and scholars adopted a unitary definition of a product defect. *See* OWEN, *supra* note 214, at 334. Gradually, though, they began to realize that the issue of how firms should communicate to consumers is independent from encouraging firms to adopt optimal product designs. *See id.* at 334-36. The reasonable expectations doctrine, by contrast, attempts a unitary solution for the dual concerns of inducing effective communication to consumers and encouraging efficient product design. *See supra* Part II.B.1-2.

220. *See* Latin, *supra* note 207, at 1195, 1198 ("Product warnings and other disclosure mechanisms can be effective only when intended recipients are able to receive, comprehend, and act upon the information imparted," but there are "numerous reasons why consumers do not read, understand, remember, or follow 'good' warnings."); A.D. Twerski et al., *The Use and Abuse of Warnings in Products Liability—Design Defect Litigation Comes of Age*, 61 CORNELL L. REV. 495, 511-16 (1976) ("Warnings, in order to be effective, must be selective.... The warning process, in order to have an impact, will have to select carefully the items which are to become part of the consumer's mental apparatus while using the product."); Viscusi, *supra* note 198, at 627 ("Because people have limited information processing capabilities, it is not feasible to provide them with unlimited warning information.").

221. *See* OWEN, *supra* note 214, at 589-92; Craswell, *Taking Information Seriously*, *supra* note 28, at 583-84; *supra* notes 195-98 and accompanying text.

targeting the information that is particularly likely to decrease inefficient accidents in ways that other rules cannot, the defective warning is responsive to both the costs and the benefits of conveying information to consumers.

Instead of unrealistically encouraging undifferentiated disclosure to consumers, insurance law could mimic products liability law and impose insurance coverage for risks that insurers do not "adequately disclose" to insureds. Either on the declarations page, or in another appropriately highlighted document, insurers could cheaply and effectively inform consumers about a limited number of coverage exclusions and their potential implications. If written in bold, large print, and placed below a heading with large, capitalized letters reading "WARNING," many, if not most, consumers would read an appropriately limited disclosure. These disclosures would not be intended as communications to the court, and would not, therefore, govern the adjudication of coverage disputes.[222] Instead, they would simply provide a basic explanation of particularly important types of coverage exclusions and would merely need to be found "adequate."[223] Many insurers and agents already provide such a warning; recognizing the importance of this warning and subjecting it to limited judicial scrutiny would be a big step toward improving insurance consumers' information about their policies.

Of course, this suggestion of limited and targeted disclosure of policy terms begs the question of precisely which terms should be highlighted. Although the details of a disclosure regime would need to be worked out over time, several basic suggestions can be made. First, insurers could be required to disclose the basic ways in which their policies substantially deviate from any existing industry norms.[224] As discussed in Part I, consumers are particularly unlikely

222. Indeed, insurance policy language is meant to communicate to courts, not consumers. *See* Boardman, *supra* note 56, at 1107; Rappaport, *supra* note 61, at 240 n.187. In order to improve consumer information, judicial regulation must address itself to the methods by which insurers do communicate with insureds, such as declarations pages, brochures, and Internet websites.

223. They would thus be quite similar in basic design to the disclosures that the Truth in Lending Act, 15 U.S.C. §§ 1601-1615 (2000), requires credit card companies to make to consumers. *See* Bar-Gill, *supra* note 47, at 1417-20.

224. Requiring State Farm, for instance, to disclose on a "Warnings" page, in easily understandable language, that its earth-movement exclusion is broader than the industry standard, would help to correct the market failure discussed in note 117, *supra*. If the clause

to be aware of such deviations in their policies because the companies that are most capable of deviating from standardized language are also the most likely to sell insurance to them directly, bypassing informed intermediaries.[225] Moreover, the cost of this consumer ignorance may be significant. If large insurers can exploit their size to incorporate inefficient, one-sided terms into their policies, they may stymie the sustainability of smaller insurers that help to promote competition. This proposal is not unprecedented: in the market for sovereign bond contracts, for instance, the U.S. Securities and Exchange Commission has opined that sovereigns must disclose in their prospectus any deviations from the standard boilerplate language typically used in such contracts.[226]

Second, and more generally, insurance law could require a basic disclosure to consumers that they are less likely to receive coverage if they act in a manner that clearly and obviously increases their risk of loss. This disclosure requirement parallels the doctrine in products liability law that firms must provide adequate instructions to consumers about how to use their products safely.[227] Instructions on safe product use enhance efficiency by allowing consumers, rather than manufacturers, to take an efficient amount of care when using a product.[228] Although insureds obviously do not "use" their insurance as they use other products, insureds who are generally knowledgeable about their insurance coverage will derive more value from their insurance as a result. Additionally, informing insureds about the basic principle of moral hazard, and providing a

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is efficient, disclosure will not discourage consumers' purchases. If it is not efficient, consumers will shop elsewhere unless State Farm either removes the exclusion or offers it as an option with an associated price decrease.

225. *See supra* Part I.B.1.b. A similar phenomenon is well known in products liability law. Consumers often are knowledgeable only about the general risks that a product type carries, but are not responsive to how safe specific brands of a given product are compared to one another. *See supra* note 206 and accompanying text. But because product differentiation along the dimension of safety is so complicated and difficult to identify, there are no practical ways to inform consumers directly about this differential. *Id.* By contrast, the standardization of policy language in the property/casualty insurance industry allows both courts and insurance companies to identify the limited ways in which a given policy departs from the ISO standard form. *See supra* notes 53-55 and accompanying text.

226. *See* Stephen J. Choi & G. Mitu Gulati, *An Empirical Study of Securities Disclosure Practices*, 80 TUL. L. REV. 1023, 1038-40 (2006).

227. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2 (1998).

228. *See* OWEN, *supra* note 214, at 565.

few simple illustrations, has the side benefit of improving insureds' own levels of care and activity.[229]

One recurrent issue in California insurance law helps illustrate the value of a general moral hazard disclosure. Several automobile insurers in California limit liability insurance for permissive users of an automobile to the statutory minimum even when the named insured purchased coverage beyond the statutory minimum.[230] This coverage limitation is sensible from a moral hazard perspective, because a permissive user may be less skilled at driving than the insured, as well as less familiar than the insured with the particular vehicle. California courts, however, have repeatedly invalidated these exclusions because they were not conveyed clearly enough to the insured.[231] Although the disclosure that the California courts envision may be unrealistic, the animating concern in their decisions that insureds are surprised by this coverage limitation is plausible. A general warning, provided to all consumers, that their policy is not likely to cover losses stemming from relatively risky behavior would help counteract this concern. It would prompt many insureds to think twice before lending their car out to friends or relatives, and perhaps even to call their insurer or agent to inquire about their coverage in such situations.

A third potential insurance warning might seek to mitigate consumers' cognitive biases when it comes to assessing insurance policy coverage. Rather than assuming the persistence of consumers' bounded ability to assess the limitations of insurance,[232] this approach would attempt to help consumers overcome this limitation through the use of insurance warnings.[233] A similar strategy has

229. *See* Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORNELL L. REV. 129, 181 (1990).

230. Mid-Century Ins. Co. v. Haynes, 218 Cal. App. 3d 737, 738-39 (Cal. Ct. App. 1990).

231. In one case, the exclusion merely appeared on the last page of the policy. *See* Thompson v. Mercury Cas. Co., 100 Cal. Rptr. 2d 596, 598 (Cal. Ct. App. 2000). In a more recent case, the exclusion was referenced by number on the declarations page and contained a heading "PERMISSIVE USER LIMITATION." Haynes v. Farmers Ins. Exch., 13 Cal. Rptr. 3d 68, 71 (Cal. 2004).

232. *See supra* Part I.B.2.

233. *See generally* Christine Jolls & Cass R. Sunstein, *Debiasing Through The Law*, 35 J. LEGAL STUD. 199, 200 (2006) (describing various ways in which law might "debias" consumers in a way that "operat[es] directly on the boundedly rational behavior and attempt[s] to reduce or eliminate it").

recently been proposed in the consumer safety context: two prominent commentators have suggested that law can address consumers' tendency to under-appreciate the risks associated with the products they use by triggering countervailing biases, such as the availability heuristic or framing effects.[234] Insurance warnings might similarly attempt to counteract consumers' tendency to under-appreciate insurance exclusions for low-probability risks by employing availability or framing effects. An insurance warning could, for instance, remind people of the percentage of Hurricane Katrina related claims that were turned down by insurers and subsequently litigated.[235] A different approach might use insurance warnings to lengthen consumers' time horizons so certain underappreciated risks seem more sizeable: evidence suggests that people respond more rationally to risks that are estimated over a significant period of time.[236] A warning indicating the likelihood of being denied coverage for a large claim over the course of a lifetime could potentially counteract consumers' inattention to the limits of insurance when it comes to significant losses.

Yet a fourth warning strategy could inform consumers about specific limitations in their insurance coverage that could be addressed by purchasing state-underwritten supplemental coverage. State-underwritten insurance schemes often rely on private insurers to inform consumers about the availability of this supplemental coverage. For instance, private insurance companies sell federally-underwritten flood insurance.[237] Similarly, the California Earthquake Authority relies on participating insurers to sell its policies.[238] However, private insurers are likely to have inadequate incentives to market these policies to their customers: "[a]lthough private insurance companies receive expense allowances and reimbursements from the government for selling [these types of] insurance,

234. *See id.* at 209-12.

235. The effectiveness of this strategy would obviously need to be tested. Some evidence suggests, for instance, that even informing people about risks with lurid details will do little to convince them to insure against risks that are perceived to be too unlikely to worry about. *See* Slovic et al., *supra* note 133, at 76.

236. *Id.* at 77.

237. *See* The National Flood Insurance Program, http://www.fema.gov/plan/prevent/floodplain/about_the_nfip.shtm (last visited Jan. 25, 2007).

238. *See* California Earthquake Authority, General Information, http://www.earthquakeauthority.com/CEAGeneralInformation.htm (last visited Jan. 25, 2007).

they do not earn any investment income from insureds' premium dollars, a primary source of income for ordinary insurance policies."[239] It is therefore hardly surprising that one study found that homeowner "insureds are more likely than not to incorrectly assume damages due to floods were covered, and nearly as likely to incorrectly assume that damages due to earthquakes were covered" by their homeowner policies.[240] Requiring insurers to warn their customers about these limitations in ordinary insurance policies could enhance consumer information about the limits of ordinary insurance and encourage consumers to consider purchasing this supplemental coverage.

Ultimately, one of the virtues of an adequate disclosure requirement is that it could gradually develop, in light of issues faced in real cases, to reflect a sensible set of disclosure rules. The suggestions offered here may need to be supplemented or decreased in breadth. Either way, the general approach of current insurance law doctrines has much to learn about informing consumers from the limited and targeted approach of products liability law.

2. Insurance Harms and Design Defects

The doctrines of products liability law also suggest a method for implementing the judicial regulation of insurance in a way that can help improve insurers' incentives to draft efficient policies. Following products liability law, courts could improve the drafting incentives of insurers by imposing insurance coverage, despite clear policy language to the contrary, when the coverage dispute involves (a) a provision that is particularly likely to be the result of inefficient drafting by insurers due to market failure ("insurance harms"), *and* (b) policy language that fails a cost-benefit, reasonable-alternative-design test that assesses whether the insurer acted inefficiently in choosing to draft or adopt policy language ("insurance design defects").[241] When there is both an insurance harm and an insurance design defect, (c) insurers could be required to pay

239. *See* Daniel Schwarcz, *Keep On Giving to Katrina Relief*, DENVER POST, Sept. 17, 2005, at E-05 (on file with author).

240. *See* Thomas, *supra* note 90, at 322.

241. *See infra* notes 243-88 and accompanying text.

coverage that causes them to internalize the costs of their failure to act efficiently ("damages").[242]

a. Deviations for a Clause's Purpose as an Insurance Harm

Many coverage exclusions present only slight risks of market failure or can be easily checked via conventional ex ante state insurance regulation.[243] Testing such provisions for efficiency can result in large costs that are offset by insignificant benefits.[244] First, any uniform application of an imprecise test over a large number of samples creates the significant risk of false positives—in this scenario, cases in which courts err and refuse to enforce efficient coverage exclusions. Such false positives are particularly problematic in the insurance context because risks that cannot be predicted ex ante, or eliminated by pooling, create especially large costs for insurers.[245] Second, even if the legal test was particularly accurate, indiscriminately applying it to clauses that present only a slight risk of market failure would result in significant administrative costs. Courts would need to confirm that each clause was efficient even when that result seemed relatively certain without in-depth examination.

These concerns are minimized in products liability law because that set of doctrines applies only when the consumer-plaintiff has been harmed by the firm's product. From a traditional perspective, of course, this requirement of harm follows from the purpose of

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242. *See infra* notes 289-301 and accompanying text. In the case of an affirmative misrepresentation, the insurer should be liable under principles articulated by Abraham. *See* Abraham, *supra* note 13, at 1155; *see also supra* note 171 and accompanying text. Although the misleading impression cases fit within traditional contract law concepts, *see supra* note 172 and accompanying text, they are also analogous to misrepresentation in product law. Because misrepresentation about product features is not within the realm of products liability law, *see* OWEN, *supra* note 214, at 335, Abraham's proposal is not incorporated into the products liability model developed herein.

243. *See supra* Part I.C.2.

244. This result points to yet another limitation of the reasonable expectations doctrine: it attempts to correct unfair, oppressive, or inefficient terms ex post by applying a single test to all challenged coverage exclusions. *See supra* Part II.B.1.

245. *See* Abraham, *supra* note 15, at 222-23. As Abraham explains, uncertainty about the scope of coverage at the time of sale creates an "uncertainty tax" on the purchase of insurance. *Id.*

products liability law: to compensate those who are injured.[246] But from an economic perspective such compensation is not necessary: first-party insurance, many economists argue, would be a more efficient vehicle than tort law for compensating accident victims.[247] Instead, the economic view is that products liability law compensates accident victims due both to the particularly large risk that manufacturers will take insufficient safety precautions, and to the large social welfare consequences of this type of market failure.[248]

Any rule for the judicial regulation of insurance should embrace a similar dichotomy between product features that are likely to involve market failure and those that are not. Plaintiffs should not be able to argue for "judge-made insurance" in any coverage dispute, regardless of the risk of market failure or the consequences of such market failure. Instead, as in products liability law, the judicial regulation of policy terms should be available to plaintiffs only when there is a particularly strong reason to believe that market failure has allowed insurers to act inefficiently in drafting their policy, and when the harms of such market failure are particularly large. There is consequently a need to define an insurance harm—a category of uninsured losses in which the applicable coverage exclusion is particularly likely to be the result of inefficient behavior by the insurer due to market failure.[249]

This Article proposes defining an "insurance harm" as *the denial of insurance coverage when any ambiguity exists, from an ex post*

246. *See* PROSSER AND KEETON ON THE LAW OF TORTS 5-6 (W. Page Keeton et al. eds., 5th ed. 1984).

247. *See* SHAVELL, *supra* note 30, at 267-68; George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1524-26 (1987).

248. *See supra* notes 204-09 and accompanying text. Products liability law could theoretically compensate consumers who purchased products that merely disappointed them, such as a radio or television that failed to work well. From a law and economic perspective, judicial intervention is not warranted in these instances only because the market is presumed to work well, and the costs when it does not work well are not substantial. *See* OWEN, *supra* note 214, at 332-33.

249. In products liability law, inefficient manufacturer actions are particularly likely when a consumer has been injured. But the same test cannot be employed in insurance law, because a core feature of insurance is that it protects against only a limited number of risks. Allowing insureds to argue for "judge-made insurance" whenever they have been denied coverage would thus be analogous to allowing consumers to argue for compensation when they have received a cell phone that does not have a loud enough ring tone, or a television whose picture is not sufficiently crisp.

perspective, about whether the underwriting purposes of the applicable policy exclusion warrant not covering the loss at issue. Under this test, a court would ask whether the insurer has any legitimate *underwriting purpose* for not insuring against the *specific loss* that befell the insured. Most textbook accounts of insurance list the following five basic underwriting purposes in order for a loss to be insurable: the loss must be (1) measurable and (2) observable, and must involve (3) low correlation, (4) low risk of moral hazard, and (5) low risk of adverse selection.[250] A sixth underwriting purpose—that the risk be anticipated—obviously does not apply when analyzing whether a risk is ex post insurable.[251] Finally, a crucial underwriting purpose often ignored in traditional insurance textbooks is the reduction of "juridical hazard."[252] This term encompasses the transaction costs to insurers of deciding whether to pay a claim, which include the costs of fact gathering and legal fees.[253] Often, insurance policies are written using bright-line rules that imperfectly facilitate legitimate underwriting purposes while minimizing juridical hazard, because they are easy to apply after an insured has incurred a loss.[254] Application of these clauses should not be considered an insurance harm, because they serve a legitimate and important underwriting function that often enhances the overall efficiency of the insurance arrangement.

To see how this definition of an insurance harm would operate, consider a few examples. One good example of an insurance harm comes from *Coblentz v. Oklahoma Farm Bureau Mutual Insurance Co.*, in which the insured purchased a homeowners policy with an endorsement that required the insurer to pay for the replacement

250. Neil A. Doherty & Alexander Muermann, *Insuring the Uninsurable: Brokers and Incomplete Insurance Contracts* 4 tbl.1 (The Wharton Sch., Univ. of Pa., CFS Working Paper, No. 2005/24, 2005), *available at* http://irm.wharton.upenn.edu/muermann/dohertymuermann 101905.pdf; *see also* BARUCH BERLINER, LIMITS OF INSURABILITY OF RISKS 3-4 (1982) (analyzing the criteria of insurability).

251. Doherty & Muermann, *supra* note 250, at 4 tbl.1.

252. *See* EDWIN W. PATTERSON, ESSENTIALS OF INSURANCE LAW § 68 (1935); Works, *supra* note 16, at 610-11 ("Though introductory insurance texts ... do not give 'juridical hazard' the same prominence as [other underwriting concerns], the real-world importance of 'juridical hazard' clearly is reflected in a variety of insurance practices and institutions ....").

253. *See* PATTERSON, *supra* note 252, § 68.

254. *See* Works, *supra* note 16, at 610-11.

cost of any lost or damaged goods.[255] The endorsement required the insured to complete repairs before he received any insurance money beyond the market value of the property at the time of the loss.[256] Its purpose was to prevent insurance fraud: because replacement value is generally greater than market value,[257] insureds looking to move could potentially profit by destroying their home and collecting insurance rather than selling the house. When Coblentz's house was destroyed by a tornado, the insurer paid about $16,000, the market value of the home, but withheld the additional $20,000 needed to replace the home until construction was complete.[258] Unfortunately, without this $20,000 Coblentz did not have enough capital to pay for replacing the home.[259] This exclusion of coverage would be an insurance harm. From an ex post perspective, it is relatively clear that the applicable clause's underwriting purpose did not apply: Coblentz's home was destroyed by a tornado,[260] which is impossible to fake. Importantly, the reason the excessively broad clause did not take into account situations such as Coblentz's had nothing to do with reducing juridical hazard: the very nature of Coblentz's loss made clear that the underwriting purpose did not apply.[261]

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255. 915 P.2d 938, 939 (Okla. Civ. App. 1995), *overruled by* Bratcher v. State Farm Fire & Cas. Co., 961 P.2d 828, 831 (Okla. 1998).

256. *Id.*

257. *See, e.g., id.* (finding that the cash (market) value of plaintiffs' home was approximately $20,000 less than the claimed replacement value).

258. *Id.*

259. *Id.*

260. *Id.*

261. For another example of an insurance harm, consider a popular exclusion in aircraft insurance policies for loss caused by wear and tear to the airplane. This exclusion provides that any "damage caused by heat which results from the operation, attempted operation or shutdown of the engine" constitutes "wear and tear." Meridian Leasing, Inc. v. Associated Aviation Underwriters, Inc., 409 F.3d 342, 348 (6th Cir. 2005) (internal quotation marks omitted); *see also* Arawak Aviation, Inc. v. Indem. Ins. Co. of N. Am., 285 F.3d 954, 955 (11th Cir. 2002) (containing nearly identical exclusion language). The purpose of the "wear-and-tear" exclusion is to exclude nonfortuitous losses that predictably result from continued use of an airplane. Nonetheless, airplane insurers have occasionally invoked the clause to deny coverage in situations that seemingly depart from this purpose. In *Meridian*, for instance, an insurer relied on the wear-and-tear exclusion to deny coverage when an airplane, purchased several months earlier, exploded and burned as the pilot attempted to start the engine. 409 F.3d at 344-45. In *Arawak*, the insurer relied on the clause to deny coverage when the pilot did not properly secure the oil cap on the engine, leading to excessive heat during flight. 285 F.3d at 955. Both cases present examples of insurance harms because the insurer was relying on a coverage exclusion when the underwriting purpose of that exclusion did not clearly

For a second, more prominent example of an insurance harm, consider the "absolute pollution exclusion," which broadly prohibits coverage for all liabilities "arising out of the .... discharge, dispersal, seepage, migration, release, or escape of .... any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals, and waste."[262] The underwriting purposes of this clause are to limit the risks of adverse selection and moral hazard inherent to gradual pollution that suddenly became significant after the passage of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).[263] But the clause's sheer breadth means that insurers often invoke it to deny coverage, even when the nature of the loss makes clear that doing so does not advance these underwriting purposes.[264] In one case, for example, an insured's employees accidentally spilled ammonia from a blueprint machine in the course of moving equipment.[265] In another case, a construction worker applied a sealant to a warehouse floor that immediately contaminated the food stored in the building.[266] In each of these instances, an insurer's reliance on the absolute pollution exclusion to deny coverage would be considered an insurance harm because, from an ex post perspective, it is self-evident from the nature of the loss that the clause's purpose would not warrant the denial of coverage; both cases involve *sudden* accidents that do not implicate the adverse selection or moral hazard problems of gradual pollution. Nor can the absolute pollution clause be justified in these cases on grounds that it

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encompass avoiding the losses at issue.

262. Jeffrey W. Stempel, *Reason and Pollution: Correctly Construing the "Absolute" Exclusion in Context and in Accord with Its Purpose and Party Expectations*, 34 TORT & INS. L.J. 1, 2 (1998) (quoting Ins. Servs. Office, Inc. CGL Form CG 00 02 11 88 (1988)); *see* Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942, 952-54 (1988) (discussing the pollution exclusion).

263. Abraham, *supra* note 262, at 952-54.

264. *See* Stempel, *supra* note 262, at 3-5 (noting that "[i]nsurer attorneys have ... argued vigorously that the exclusion is clear and was intended to bar coverage for any claim in which a 'pollutant' contributed to the injury"); *see also* Pipefitters Welfare Educ. Fund v. Westchester Fire Ins. Co., 976 F.2d 1037, 1043 (7th Cir. 1992) ("Without some limiting principle, the pollution exclusion clause would extend far beyond its intended scope, and lead to some absurd results.").

265. Deni Assocs. of Fla. v. State Farm Fire & Cas. Ins. Co., 711 So. 2d 1135, 1136 (Fla. 1998).

266. Cincinnati Ins. Co. v. Becker Warehouse, Inc., 635 N.W.2d 112, 114-15 (Neb. 2001).

reduced juridical hazard: the very character of the losses described above indicated that the core underwriting purposes of reduced moral hazard and adverse selection did not apply.

Contrast these examples of insurance harms with two different cases. First, consider a straight forward example: the Katrina-related litigation discussed at the outset of this Article. Recall that in this litigation, victims of Hurricanes Katrina, Rita, and Wilma have sought to compel their private insurers to cover flood damage to their homes even though flood damage is specifically excluded from all homeowners insurance policies.[267] The exclusion of these losses would not be an insurance harm. The reason why private insurers do not cover flood damage—to avoid highly correlated risks[268]—is precisely applicable to the recent hurricanes: when floods occur, many insureds with the same risk profiles suffer extensive damage.

Now consider a second, more difficult example from the classic insurance case *Atwater Creamery Co. v. Western National Mutual Insurance Co.*[269] *Atwater* featured a common clause in commercial burglary policies that excluded coverage for burglaries when there were no visible marks of forced entry on any external doors or windows.[270] The clause encouraged employers to hire trustworthy employees, because it tended not to cover "inside jobs," where external marks of entry would be less likely to exist.[271] It also encouraged insureds to properly lock all windows and doors. Based on these underwriting purposes, the *Atwater* court concluded that the clause should not apply in the case before it because the evidence strongly suggested that the specific insured's loss was attributable neither to an inside job nor to insufficient care.[272] Although intuitively attractive, this reasoning would not support the finding of an insurance harm. The visible marks clause served

267. *See* Schwarcz, *supra* note 239.

268. Insurers pool risks by grouping together a large number of policyholders who face similar but independent risks, so that they are able to take advantage of the law of large numbers. When risks cannot be made predictable in this way, insurers must hold large amounts of liquid capital so that they are able to remain solvent in the event of large losses. For an explanation of why this strategy is so costly, see *supra* note 85.

269. 366 N.W.2d 271 (Minn. 1985) (en banc).

270. *Id.* at 275.

271. *Id.* at 276 (internal quotation marks omitted).

272. *See id.* at 278-79.

a legitimate underwriting purpose in *Atwater* because it reduced juridical hazard. Unlike both *Coblentz* and the Pollution Exclusion cases, *the nature of the loss in Atwater did not make clear that the underwriting purpose did not apply*. This was only clear to the court after it examined all of the evidence at hand, and concluded that the burglary was not an inside job and that Atwater had taken an adequate amount of care. But such ex post factual investigation is costly, and, for that reason, providing coverage that would require it may well be inefficient.

Defining an insurance harm in this way has a number of advantages consistent with the requirement in products liability law that plaintiffs be the victims of harm caused by a firm's product. First, and most important, most coverage exclusions will clearly not constitute insurance harms, because losses will typically either fall squarely within the underwriting purpose of a coverage exclusion or be clearly covered by the policy. Consequently, the rule would avoid the problems of false positives, lack of predictability, and high administrative costs that plague application of the reasonable expectations doctrine.[273] Second, potential deviations from a clause's underwriting purposes should be relatively easy for courts to identify ex post in the context of specific cases. Indeed, some courts at present opine on deviations from underwriting purposes in the course of interpreting ambiguous coverage provisions.[274]

273. To be sure, there still might be an uncertainty tax, to use Abraham's phraseology. *See supra* note 245.

274. *See, e.g.*, Herald Square Loft Corp. v. Merrimack Mut. Fire Ins. Co., 344 F. Supp. 2d 915, 921-22 (S.D.N.Y. 2004) (finding that a pollution exclusion was ambiguous about whether liabilities arising from lead paint were excluded because the general purpose of the pollution exclusion is "to shield insurers from the costs of environmental cleanups" (quoting Belt Painting Corp. v. TIG Ins. Co., 100 N.Y.2d 377, 386 (2003))). For this reason, one potential objection to the proposed definition of an insurance harm is that it does not move significantly beyond the ambiguity rule. This potential overlap between the ambiguity rule and the proposed insurance harm concept, though, is a potential pitfall of any conceivable regime for the judicial regulation of insurance. The ambiguity rule "provides no guidance as to the criteria to be used in determining when a policy provision is or is not reasonably subject to two interpretations." Abraham, *supra* note 81, at 538; *supra* text accompanying notes 166-70 (discussing how some courts use the reasonable expectations test when in truth they are interpreting ambiguities). It is therefore inevitable that some courts will imbue the ambiguity rule with meaning that potentially overlaps with a proposal for the judicial regulation of insurance. In any event, most courts do indeed refuse to look at the underwriting purpose of clauses they view to be linguistically unambiguous. *See, e.g.*, Nat'l Elec. Mfrs. Ass'n v. Gulf Underwriters Ins. Co., 162 F.3d 821, 825-26 (4th Cir. 1998); Technical Coating Applicators,

Third, the proposed insurance harm definition does a reasonably good job of segregating out coverage exclusions that are most likely to be inefficiently designed in a way that the judiciary can plausibly address. It does so by attempting to isolate clauses that fail to anticipate specific loss scenarios, and are thus too broad relative to their underwriting justification. Although the denial of coverage may be inefficient even when there is a legitimate underwriting purpose for not covering the loss, there is at least some reason to believe that such exclusions are sensible, and resolving the issue is likely to be difficult. Moreover, fewer reasons exist to be skeptical about how well the insurance market works when it comes to such cases, which will tend to involve losses that the applicable exclusion clearly contemplated. Insurance markets should work better in checking the efficiency of these clauses, because insurance information intermediaries will tend to be knowledgeable about the paradigmatic applications of different exclusions.[275] Additionally, traditional ex ante review of policy terms by state regulators should provide a sufficient check against obviously intended overreaching by insurers. Although regulators may frequently fail to grasp the breadth of policy language, they generally anticipate the types of losses the clause is intended to exclude and evaluate the appropriateness of those provisions.[276]

b. Defective Insurance Designs

Simply because a product harms a consumer does not mean that a firm has acted inefficiently and sold a defective product. As such, the products liability rule in virtually every jurisdiction is that a

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Inc. v. U.S. Fid. & Guar. Co., 157 F.3d 843, 846 (11th Cir. 1998); Owners Ins. Co. v. Farmer, 173 F. Supp. 2d 1330, 1333-34 (N.D. Ga. 2001); Cincinnati Ins. Co. v. Becker Warehouse, Inc., 635 N.W.2d 112, 118-21 (Neb. 2001); Nat'l Union Fire Ins. Co. v. CBI Indus., Inc., 907 S.W.2d 517, 521-22 (Tex. 1995).

275. *See supra* Part I.B.1.b. Consumers would also be more likely to find out about the straightforward application of policy terms via secondary literature. *See supra* Part I.B.1.c.

276. *See supra* Part I.C.2. Indeed, this is precisely why regulatory approval relating to a product's safety is relevant in a product liability suit only "with respect to the risks sought to be reduced by the statute or regulation." RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 4(b) (1998). *See generally* Symposium, *Regulatory Compliance as a Defense to Products Liability*, 88 GEO. L.J. 2049 (2000) (considering "the appropriate weight to be assigned to regulatory compliance").

product must have been defectively designed for a plaintiff to be entitled to recovery.[277] This requires that "the foreseeable risks of harm posed by the product could have been reduced or avoided by the adoption of a reasonable alternative design ... and the omission of the alternative design renders the product not reasonably safe."[278] Known as the "risk-utility test," this definition of a design defect has been widely embraced by scholars, and by a significant number of courts.[279] Defining design defects in this way helps correct market failures that lead to inefficiently unsafe products by identifying when the market has failed to induce the manufacturer to take an optimal level of care in designing a product.

Interestingly, the old and widely criticized[280] test in products liability law for defining a design defect was almost precisely the same as the reasonable expectations test in insurance law. The "consumer expectations" approach to defining design defects asked whether the product was "dangerous to an extent beyond that which would be contemplated by the ordinary consumer who purchases it, with the ordinary knowledge common to the community as to its characteristics."[281] The reasons that products liability scholars typically reject this consumer expectations test largely parallel the reasons that the reasonable expectations doctrine is not a good method for identifying inefficient coverage exclusions. First, like the reasonable expectations test, both courts and scholars have found the test to be unavoidably vague.[282] Second, it is both under- and over-inclusive in identifying inefficient product designs.[283]

Insurance law could follow products liability law and jettison its consumer expectations approach in favor of a defective design test

277. *See* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2.

278. *Id.* § 2(b).

279. James A. Henderson, Jr. & Aaron D. Twerski, *Achieving Consensus on Defective Product Design*, 83 CORNELL L. REV. 867, 882-89 (1998). *See generally* Douglas A. Kysar, *The Expectations of Consumers*, 103 COLUM. L. REV. 1700 (2003) (reviewing the scholarly embrace of the risk utility test over the consumer expectations test, but noting less enthusiasm from courts for this shift).

280. Henderson & Twerski, *supra* note 279, at 876-83.

281. RESTATEMENT (SECOND) OF TORTS § 402A cmt. I (1965); *see* Kysar, *supra* note 279, at 1701-02.

282. *Compare* STAPLETON, *supra* note 214, at 236, *and* Kysar, *supra* note 279, at 1715-16, *with* Part II.A.

283. *Compare* Kysar, *supra* note 279, at 1716-18, *with* Part II.B.1.

that evaluates whether an insurance harm was the result of inefficient insurer behavior, by applying a marginal cost-benefit test premised on reasonable alternative designs. As in products liability law, the mere existence of an insurance harm does not necessarily mean that an insurer has acted inefficiently in drafting a policy, and should not, therefore, be sufficient for an insured to prevail in a coverage suit. Such a system would not only penalize insurers even when they may well have acted efficiently, but would encourage excessive litigation.[284] If, however, a plaintiff can show that (1) the insurance harm was foreseeable ex ante, and (2) could have been avoided by reasonable alternative language, the inefficiency of the insurer's drafting will be clear.[285]

To see how this proposal would work, reconsider two of the examples discussed in the insurance harms section. In *Coblentz*, the plaintiff suffered an insurance harm when his insurer would not pay him the replacement cost of his house until after construction was complete, yet he could not complete construction without his insurance proceeds.[286] Before the plaintiff could establish liability, he would need to show that the risk of this result was foreseeable ex ante and could be resolved by reasonable alternative language. This would likely not be difficult in *Coblentz* because the overbreadth of the policy's replacement clause relative to its underwriting purpose was fairly obvious, and it could have been reasonably resolved ex ante through myriad drafting techniques.[287]

284. Insurance law could conceivably embrace the enterprise liability standard that has been rejected in products liability law. *See* Hanson & Logue, *supra* note 229, at 168-73. Under the enterprise liability standard, a plaintiff would be entitled to coverage so long as he were able to show an insurance harm. This approach could conceivably reduce the costs of litigating what the insurer should have foreseen from an ex ante perspective. Moreover, to the extent that these losses cannot be efficiently avoided, the insurer is clearly the more efficient risk bearer than the insured. As noted above, though, such a system would be likely to produce excessive litigation. Moreover, in products liability law, the core benefit of an enterprise liability regime is that it optimizes consumers' activity levels even if consumers are insured. *See id.* There is no analogous benefit to enterprise liability in the insurance context.

285. For a discussion of the capacity of courts to employ this test in practice, see *infra* text accompanying notes 311-12.

286. *See supra* notes 255-59 and accompanying text.

287. For instance, the clause could have provided that insurance money in excess of the market value of the home will be paid directly to contractors or builders who are replacing the home.

Now consider the absolute pollution exclusion,[288] which presents a less straightforward case: although clearly overbroad, resulting in the potential for insurance harms, the clause may well be the result of efficient behavior by insurers. There may simply be no feasible linguistic way to better carve out the types of losses against which the pollution exclusion is meant to protect than the absolute pollution exclusion. If so, then insureds should not be allowed to receive coverage by bringing suit: the prospect of resolving all coverage disputes involving insurance harms ex post through litigation is likely to be the least efficient solution of all.

c. Damages

Once plaintiffs show both an insurance harm and a defective policy design, they would be entitled to "damages." Products liability law discourages defective product designs by requiring firms to pay for the social costs caused by those product defects. Assuming that a firm's design is indeed inefficient, this penalty should encourage manufacturers to take an efficient amount of care.[289] To correct for the legal system's inability to compensate for some harm that defective products cause, tort law also occasionally imposes punitive damages.[290] If punitive damages roughly correspond to the likelihood that a firm's behavior will not be challenged in court, firms will internalize the costs of their defective products even when those product defects are unlikely to be prosecuted.[291]

Requiring insurers to provide coverage in the event of an insurance harm caused by a defective policy design limits insurers' affirmative incentive to draft overbroad, careless, or exploitive exclusions. Unlike products liability law, however, it does not necessarily provide insurers with an incentive to use an optimal amount of care in drafting their policies: instead of incurring the ex ante cost of drafting a more efficient insurance policy, an insurer could simply use inefficient policy language and pay the costs of

288. *See supra* notes 262-66 and accompanying text.

289. *See* SHAVELL, *supra* note 30, at 219-20.

290. *See* A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 872 (1998) (discussing "the merits of punitive damages").

291. *See id.* at 873-74.

coverage if, and when, the insured challenges the clause.[292] The insurer would find this course attractive because the most the insured could win as a result of that challenge would simply be what he or she would be entitled to had the clause been redrafted in the first place.

Consider one prominent example of this phenomenon. Many liability insurance policies explicitly provide that the insurer has complete control over litigation expenditures and the decision whether to settle. Although generally a sensible method for reducing moral hazard in litigation spending, the clause can result in an insurance harm in some cases. When potential liability in a suit exceeds the total amount of liability coverage under the policy, the purpose of the clause—to eliminate moral hazard by allowing the financially interested party to make litigation decisions—is no longer applicable.[293] Instead, the insurer and insured may have conflicting incentives about when to settle and how much to spend in litigation costs.[294] Since the landmark case *Crisci v. Security Insurance Co.*,[295] courts have recognized this problem and developed solutions to it. Today, a wide body of case law carefully defines when an insurer has a duty to settle, and applies regardless of an insurance policy's statement to the contrary.[296] This case law would likely allow a plaintiff to overcome the second hurdle of the design defect proposal: it essentially defines the reasonable alternative

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292. *See* Korobkin, *supra* note 45, at 1286-90.

293. *See* Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1136-37 (1954); Kent D. Syverud, *The Duty To Settle*, 76 VA. L. REV. 1113, 1116 (1990). *But see* Alan O. Sykes, *Judicial Limitations on the Discretion of Liability Insurers to Settle or Litigate: An Economic Critique*, 72 TEX. L. REV. 1345, 1348, 1361-65 (1994) (arguing that policies granting unfettered discretion to insurers are not likely to be the result of market failure, but instead may reflect an attempt to limit the judgment-proof problem). *See* Kyle D. Logue, *Solving the Judgment-Proof Problem*, 72 TEX. L. REV. 1375, 1380-83 (1994) (reviewing Sykes's argument, and finding that, at least with regard to policies geared toward unsophisticated consumers, clauses that grant insurers unfettered right to make settlement decisions are likely the result of market failure).

294. Syverud, *supra* note 293, at 1116.

295. 426 P.2d 173 (Cal. 1967).

296. *See, e.g.*, Westchester Fire Ins. Co. v. Gen. Star Indem. Co., 183 F.3d 578, 582-83 (7th Cir. 1999) (holding an insurer liable when it failed to settle within the primary policy limits when it had a chance to do so); Pavia v. State Farm Mut. Auto. Ins. Co., 626 N.E.2d 24, 26-27 (N.Y. 1993) (noting that "[t]he duty of 'good faith' settlement is an implied obligation derived from the insurance contract").

design that an insurance policy could use to eliminate the insurance harm.[297] Even if the case law could not be easily condensed into policy language, the policy could simply acknowledge the principles developed in the case law. Nonetheless, insurers continue to draft most liability insurance policies to stubbornly proclaim that the insurer always controls the costs of litigation and the decision whether to settle.[298] The reason that insurance policies ignore this judicially crafted exception is because insurers have nothing to lose from doing so:[299] if an insured invokes the case law, the insurer is in the same position it would be in had it included the exception in the policy itself. But, if an insured does not invoke the case law or cannot credibly commit to litigating the issue, the insurer can avoid the judicially mandated rule.

Allowing insurers to retain inefficient language that can be judicially corrected ex post can lead to two types of social costs. First, this approach only provides optimal insurance to consumers who litigate or are savvy enough to know that they could litigate the issue. Even then, these insureds may only receive this insurance after a significant period of time has elapsed in litigation. Second, this approach results in significant judicial costs that could be avoided by the insurer providing the coverage through redrafted language.[300]

To eliminate insurers' incentive to use this strategy and instead encourage them to draft efficient policy terms ex ante, they could be required to pay a premium above the coverage amount that the

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297. Allowing insurers to completely control settlement also has negotiation advantages, as they are sophisticated parties that are generally risk-neutral with respect to litigation losses and can credibly limit settlement offers due to their internal corporate structure. *See* Syverud, *supra* note 293, at 1137-38. The case law that defines an insurer's duty to settle does a good job of providing a reasonable alternative design because it is responsive to this benefit while limiting the insurance harm that results from potential liabilities that exceed policy limits.

298. *Id.* at 1118. The typical language of this provision is that the insurer "may make such investigation and settlement of any claim or suit as [the insurer] deems expedient." *Id.* (quoting INS. SERVS. OFFICE, INC., COMPREHENSIVE PERSONAL LIABILITY ENDORSEMENT 2 (1973)). Certain insurance policies—in particular, professional liability policies—do explicitly give settlement authority to the insured. *See id.* at 1173-76. In these cases, even a settlement below the policy limit may not be desirable for the insured, because the nonmonetary reputation costs of a settlement can be quite high.

299. *Id.* at 1164.

300. *Id.* at 1165.

insured would ordinarily be due if a plaintiff can successfully establish an insurance harm caused by a defective policy. The premium would need to offset several costs that insurers could otherwise externalize. First, like punitive damages in tort law, it must eliminate the cost savings to the insurer that, in the event of an inefficient policy, would result from insureds who do not litigate. Second, it should make the insurer internalize the administrative costs of litigating defective policy provisions. Interestingly, at least some jurisdictions seem to endorse a variant of this approach when it comes to the duty to settle: in some states, plaintiffs can recover attorneys' fees or emotional distress damages when the insurer is found to have violated its judicially constructed duty to settle.[301]

3. *The Interaction of Design Defects and Defective Warnings*

Following the lead of products liability law, the two types of insurance claims described above should be mutually exclusive from one another, so that insureds can assert defective design claims against insurers regardless of the adequacy of the warnings that the insurer provides, and vice versa. Products liability adheres to this rule because of the inherent limitations of warnings. Although the effectiveness of warnings varies, "[p]sychological and consumer behavior studies indicate that inattention to warnings is an inevitable result of limited cognitive capacity, memory, attention span, and time."[302] Most jurisdictions and commentators now agree that, for this reason, a defectively designed product cannot be made safe with a good warning.[303]

As in products liability law, even the most laudable attempts at communicating information to a consumer will often not result in the consumer fully incorporating that information into his decision-

301. *See id.* at 1120-21 & nn.16-18 (reviewing case law of states with each doctrine).

302. Latin, *supra* note 207, at 1198. "Product warnings and other disclosure mechanisms can be effective only when intended recipients are able to receive, comprehend, and act upon the information imparted," but there are "numerous reasons why consumers do not read, understand, remember, or follow 'good' warnings." *Id.* at 1195, 1198.

303. Owing to a comment in the Restatement Second of Torts, some courts and scholars in early years of tort law originally suggested that a sufficiently good warning could serve as a defense. *See* OWEN, *supra* note 214, at 335-47. The prevailing view now rejects this position. *See id.* at 348-50.

making process. Because of the significant evidence that insureds tend to be subject to an array of cognitive biases,[304] a rule allowing insurers to design any coverage scheme they want if they inform consumers might allow insurers to exploit consumers' cognitive limitations. Allowing insureds to argue that a clause highlighted in a warning resulted in an insurance harm and was defective would help to address this concern. This result stands in stark contrast to the dominant interpretation of the reasonable expectations doctrine, which allows an insurer to exclude coverage for any loss so long as the exclusion is adequately communicated to the insured.[305]

C. The Costs of a Products Liability Model

This Article stops short of arguing that courts should unequivocally adopt the proposed products liability model for the judicial regulation of insurance. Just as with products liability law, the proposals sketched out above would undoubtedly have significant costs. A potentially significant segment of insureds, armed with new doctrinal vehicles to attack unfavorable insurance outcomes, might choose to sue when they otherwise would not. Faced with increased litigation costs, insurers would raise the price of policies and courts would adjudicate additional disputes.[306]

The size of these costs largely depends on the extent to which the proposal would increase insurance-related litigation, which is hard to predict. The increase in insurance litigation stemming from the defective warning proposal would likely be marginal, as the requirement of an adequate warning is a relatively low bar for insurers to meet and the content of such warnings could be easily developed in initial litigation given the uniformity of most insurance

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304. *See supra* Part I.B.2.

305. *See* ABRAHAM, *supra* note 53, at 48-49.

306. For a prominent critique of products liability law that raises these concerns, see PETER W. HUBER, LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES 3-11 (1988). The increase in insurance premiums would parallel the increased price of consumer goods attributable to products liability law, which Huber terms the "tort tax." *See id.* at 3-5. Similarly, the potential administrative costs of the proposal parallel the criticisms of the "reasonable alternative design" approach in products liability law as imposing a tremendous burden on courts. *See* Ellen Wertheimer, *The Biter Bit: Unknowable Dangers, the Third Restatement, and the Reinstatement of Liability Without Fault*, 70 BROOK. L. REV. 889, 931-32 (2005).

language.[307] Moreover, state regulators could easily become involved in helping to develop basic warnings that insurers could use with little fear of liability. But the potential litigation effects of the design defect proposal are more difficult to anticipate. First, the amount that this proposal would increase litigation obviously depends on whether the baseline jurisdiction's legal regime is assumed to embrace a strong form of the reasonable expectations doctrine.[308] Second, the way in which courts apply the insurance harm screening mechanism would critically affect the resulting increase in litigation. The insurance harm requirement is the key way in which the design defect proposal attempts to limit litigation.[309] If courts interpreted this requirement too narrowly, the proposal might well substantially increase the ultimate cost of insurance.[310]

Not only does the products liability framework create potentially significant costs, but its promised benefits—the improved efficiency of insurance markets and protection of insurance consumers—depend on an admittedly optimistic view of courts' abilities. The proposed framework requires courts to identify underwriting purposes, alternative drafting options, and the foreseeability of insurance harms. If courts do a poor job with these tasks, insurers might be penalized for efficient drafting practices, such as retaining partially outdated language because the costs of moving to new language would be much larger. Both of these objections are significant and point to the need for further research and debate. The proposal, of course, is designed to take into account these objections and to erect a system that both is administrable and

307. *See supra* notes 53-55 and accompanying text.

308. If so, litigation costs may well decrease as the insurance harm requirement screens out a significant number of cases that the reasonable expectations doctrine does not. *See supra* notes 273-76 and accompanying text.

309. *See id.*

310. It is not obvious whether the proposed doctrinal structure would increase the number of lawsuits or merely the complexity of those lawsuits. One plausible hypothesis is that a defective design regime would not increase the number of lawsuits because plaintiffs with a viable defective design claim also have a viable interpretive claim that they would advance regardless of other doctrinal details. To the extent that a clause is applied in a manner inconsistent with its underwriting purpose—and thus an insurance harm exists—a plaintiff likely has a decent argument that the clause itself is ambiguous and should be interpreted against the drafter. *See supra* note 274.

minimizes the resulting increase in litigation.[311] Indeed, one of the core benefits of the proposal is that it is fashioned from already existing doctrines that, arguably, work reasonably well at improving consumer safety markets without unduly increasing product prices or burdening courts. In fact, judges in many respects are likely more capable at applying the proposed doctrinal structure than they are at applying products liability in tort law: judges' capacity to assess the design of an insurance policy will be much more within their core competence than their capacity to assess consumer products such as lawnmowers and ladders. And, as noted earlier, the insurance harm concept parallels the interpretive methods that some courts occasionally employ to determine the meaning of an insurance clause.[312] In the end, though, the specific proposals developed above should serve as the starting point for further discussion, rather than the end point for a new doctrine of insurance law.

CONCLUSION

For over four decades, the critical wisdom in insurance law has been that courts should regulate insurance policy terms to prevent consumer exploitation and facilitate disclosure to insurance consumers. For equally as long, the reasonable expectations doctrine has served as the core basis for defining the appropriate scope of such regulation. Yet both the practical and theoretical foundations of this doctrine have been substantially undermined during this time. Most courts have contorted the doctrine such that it has virtually no practical effect, and those that have attempted to develop a more capacious doctrine have seen their efforts uniformly criticized by close studies of the case law. Moreover, contract law scholars have developed an analytically rigorous explanation as to why standard-form contracts do not necessarily present unique risks for consumer exploitation.

This Article proposes a new doctrine for the judicial regulation of insurance policies that parallels products liability law. Unlike the reasonable expectations doctrine, which responds to the failure of

311. *See supra* notes 273-76 and accompanying text.
312. *See supra* note 274 and accompanying text.

consumers to assent to insurance purchases, a products liability approach responds to the market failures that plague many consumer insurance markets. Because the structure of products liability law parallels the structure of the judicial regulation of insurance, it potentially holds the key to developing an administrable and analytically coherent basis for judicial intervention in private insurance arrangements. At the very least, the products liability model offers a new approach to improving private insurance markets that is clearly tethered to the sources of such market failure.

At the same time, the products liability proposal sanctions only a limited role for the judiciary in regulating insurance. That role is shaped by the core institutional advantage of courts—their ex post perspective on insurance policy language.[313] In many cases—including Trent Lott's Hurricane Katrina claim—the relative efficiencies of different coverage schemes will be beyond the competence of courts to assess.[314] As the fate of the reasonable expectations doctrine suggests, sanctioning judicial intervention in insurance policy language is not a viable option in these situations. Instead, expert regulators, with the time and resources to investigate competing empirical considerations, must take the lead.

313. *See supra* text accompanying notes 158-59; text accompanying notes 275-76.
314. *See* text accompanying notes 267-68.