
WHOSE CONCEPTION OF INSURANCE?

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In response to Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653 (2013).

INTRODUCTION

Professor Abraham's new Article, *Four Conceptions of Insurance*,¹ offers an invaluable overview and critique of four modern conceptions of insurance. He cautions that "the particular lens through which we view insurance law cannot tell us what principles should govern or what policy choices to make."² But who is the "we" in that statement? This Response focuses on three overlooked groups with an important interest in such governing principles and policy choices. First, Abraham mentions insurance brokers only briefly, describing how large insurance brokers can negotiate policy terms.³ But brokers, large and small, play an important role in deciding which available insurance a policyholder purchases. Second, any discussion of homeowners insurance should include mortgage holders, who require mortgagors to purchase insurance and whose interest in the scope of coverage is equal to or greater than the homeowner's. Third, within the construction industry, general contractors seek to transfer risk to their subcontractors, who must purchase liability policies naming general contractors

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¹ Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653 (2013).

² *Id.* at 698.

³ *Id.* at 660.

as “additional insureds.” The contract model, which looks to the intent of the insurer and the subcontractor, as expressed in the policy language, preserves the expectations of the parties to the contract. In examining each of these three overlooked groups’ interests in an insurance transaction, we may discover that the contract model, so frequently maligned in the academic literature,⁴ is not so bad after all.

I. INSURANCE BROKERS

An insurance broker is an independent middleman who acts as the policyholder’s agent in placing insurance coverage.⁵ The broker, whose compensation comes from commissions on policy premiums, often is identified on the policy’s declarations page.⁶ A broker’s role and interest in an insurance transaction should influence our view of insurance.

Abraham, in his discussion of the contractual conception, notes that “[f]or sizable businesses and other institutions, contractual intent and understanding are potentially more plausible and meaningful notions. These entities have access to attorneys and insurance brokers to advise them.”⁷ Nevertheless, Abraham opines that the “notion of contractual intent is often problematic,” observing that, in his experience, “commercial policyholders’ own ‘experts’ frequently are not conversant with many of the terms of the numerous insurance policies that their . . . clients purchase.”⁸

From my own anecdotal experience, that observation, although sometimes true, is overbroad. It rarely applies to industry-specific brokers. For most any construction trade in a particular region, there are insurance brokers who know their clients’ businesses and insurance needs. An insurer looking to enter that market must do so through those brokers, who can wield enormous influence. They can advocate particular endorsements to broaden coverage beyond the standard commercial general liability (CGL) policy, and they can resist endorsements designed to narrow coverage.

Just as Abraham necessarily relied on his personal experience, I have no citations to support my observations. It is important for lawyers to remember, though, that they rarely receive a call when the policyholder has clearly purchased the correct coverage for its loss. And there are some objective

⁴ See, e.g., *id.* at 667-68.

⁵ Douglas R. Richmond, *Insurance Agent and Broker Liability*, 40 TORT TRIAL & INS. PRAC. L.J. 1, 5 (2004); Colin Sammon, Comment, *Insurance Agent and Broker Liability: Crossing the Two Way Street*, 29 OHIO N.U. L. REV. 237, 240 (2002).

⁶ Richmond, *supra* note 5, at 6-7.

⁷ Abraham, *supra* note 1, at 660.

⁸ *Id.* at 660-61.

markers of brokers' sophistication and leverage in insurance transactions. On the 2012 Fortune 500 list, the nation's two largest insurance brokers, Marsh & McLennan Companies and Aon, ranked 231⁹ and 235,¹⁰ respectively—higher than all but a handful of casualty insurers.

Broker expertise does not just aid large corporate policyholders. Objective evidence indicates that small brokers' expertise collectively gives individual consumers leverage in the scope of coverage under homeowners policies. Professor Daniel Schwarcz, one of the few academics studying the role of brokers in the insurance marketplace, has concluded that broker commission systems do not do enough to steer clients toward cost-efficient coverage.¹¹ But his research indicates that brokers do aid homeowners in selecting broader coverage, even if he believes that brokers do not do enough. In a recent article, Schwarcz demonstrates that, contrary to conventional wisdom, the terms of homeowners policies differ considerably from one insurer to the next.¹² The breadth of coverage often turns on who places the coverage: captive insurance agents, who are authorized to sell only one insurer's policies, or independent brokers. Specifically, Schwarcz found that "the carriers who employ the least generous policy forms disproportionately use captive agents to distribute their policies, whereas the companies with unusually generous policies tend to rely on independent agents."¹³ This research indicates that independent brokers, working on behalf of policyholders, collectively can broaden the scope of coverage under homeowners policies, or at least resist the narrowing of coverage.

The value of broker expertise is not measured merely by the ability to negotiate the scope of coverage under a particular policy. Rather, brokers who understand their clients' needs can aid them in purchasing all of the

⁹ See *Fortune 500: 231. Marsh & McLennan*, CNNMONEY (May 21, 2012), <http://money.cnn.com/magazines/fortune/fortune500/2012/snapshots/2402.html>.

¹⁰ See *Fortune 500: 235. Aon*, CNNMONEY (May 21, 2012), <http://money.cnn.com/magazines/fortune/fortune500/2012/snapshots/2430.html>.

¹¹ See Daniel Schwarcz, *Differential Compensation and the "Race to the Bottom" in Consumer Insurance Markets*, 15 CONN. INS. L.J. 723, 726 (2009) ("[I]nsurers who rely on independent agents to sell consumer lines of insurance should be prohibited from paying different rates of compensation to different agents for the sale of the same line of insurance."); Daniel Schwarcz, *Beyond Disclosure: The Case for Banning Contingent Commissions*, 25 YALE L. & POL'Y REV. 289, 293-94 (2007) ("[A] disclosure requirement in consumer insurance markets is unlikely to address meaningfully the core risk of contingent commissions—the potential for inefficient steering.").

¹² Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263, 1266 (2011).

¹³ *Id.* at 1277.

appropriate policies or coverages. Most standard CGL exclusions correspond to other coverages available for purchase by the insured. Exclusions for injuries “arising out of the rendering of or the failure to render professional services” reflect that “professionals customarily have or are supposed to have professional liability insurance, so that their services should not also be covered by their general liability carrier.”¹⁴ Similarly, the CGL exclusion for property damage to personal property in the care, custody, or control of the insured corresponds to first-party inland marine coverage for insureds who handle third parties’ chattel.¹⁵

These coverages generally are not intended to overlap. If the broker purchases multiple primary-layer policies applying to the same risk, then it is not doing right by its policyholder. Primary-layer insurance carries higher premiums than higher-layer excess or umbrella insurance.¹⁶ If an insured wants additional coverage for a particular risk, it is far more economical to purchase an excess or umbrella policy.

Just as a good broker can bring great value to policyholders, there are legal remedies for a broker’s deficient performance. When a policy fails to provide the coverage that the policyholder thought it purchased, the policyholder frequently will look to the broker to address that shortfall.¹⁷ And, although the default rule is that brokers have no duty to advise their clients regarding their insurance needs, brokers in some circumstances may assume (expressly or impliedly) such a duty.¹⁸ The policyholder may fare better in court against the broker than against the insurer if reading the policy would have disclosed a gap in coverage. In many jurisdictions, the failure to read a policy is not a defense in a failure-to-procure action against the broker, if the policyholder can establish reasonable reliance on the broker’s

¹⁴ Harbor Ins. Co. v. Omni Constr., Inc., 912 F.2d 1520, 1521, 1524 (D.C. Cir. 1990).

¹⁵ See Customized Distribution Servs. v. Zurich Ins. Co., 862 A.2d 560, 561-63 (N.J. Super. Ct. App. Div. 2004) (noting that the insured “obtained the [warehouseman’s liability] coverage to fill the gap created by the ‘care, custody, and control exclusion’ contained in the CGL policy”).

¹⁶ See Scott M. Seaman & Charlene Kittredge, *Excess Liability Insurance: Law and Litigation*, 32 TORT & INS. L.J. 653, 657 (1997) (“The premium paid by the insured for each successive layer of coverage is usually proportionately less expensive than for the immediately underlying layer.”).

¹⁷ See generally 1 ALLAN D. WINDT, *INSURANCE CLAIMS AND DISPUTES: REPRESENTATION OF INSURANCE COMPANIES AND INSURED* § 6:44, at 494 (3d ed. 1995) (“[I]f a policy does not provide the coverage that the insured hired the broker to obtain, and the broker does not apprise the insured of that fact, the insured may have a remedy against the broker for the equivalent of the missing policy benefit in the event of a later occurrence that was supposed to have been, but was not, covered.”).

¹⁸ Richmond, *supra* note 5, at 26 & nn.194-96, 27 & n.197.

expert review of the policy.¹⁹ There is insurance available for the breach of a broker's duties—a broker's own errors-and-omissions liability insurance.²⁰

To me, then, two propositions seem clear. First, brokers have the obligation to know the coverage they place. Second, when brokers meet that obligation, they can exercise great influence over whether their clients have coverage for losses when they arise. Critics of the contract model protest that brokers regularly fail to meet this threshold obligation. Whether or not that perception is accurate, a broker's undereducation does not mean that his client lacks bargaining power. Rather, it indicates that the broker has failed to exercise his client's bargaining power. It seems quite a leap, then, to require an insurer to provide coverage where a careful review of the policy would have shown no coverage.²¹ A reasonable observer could conclude instead that policyholders and state regulators should take a greater interest in brokers' "trustworthiness and competence."²²

II. MORTGAGE HOLDERS

Abraham addresses homeowners policies in some detail, but he only briefly mentions mortgage holders.²³ Mortgagees have just as much economic interest as do homeowners in the scope of coverage for property losses. The Federal Reserve Board estimates that, as of the first quarter of 2013, owners hold approximately 49.2% equity in their household real

¹⁹ See *id.* at 43-45 (surveying the law regarding policyholders' duty to read their policies).

²⁰ See generally Licia A. Esposito Eaton, Annotation, *Insurance Agents' and Brokers' Professional Liability Insurance*, 55 A.L.R.5th 681 (1998) (providing an overview of coverage issues under such professional liability policies).

²¹ Compare Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970) ("The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."), with *Wilkie v. Auto-Owners Ins. Co.*, 664 N.W.2d 776, 783 (Mich. 2003) ("Whether Professor Keeton intended this analysis to spawn a frontal assault on the ability of our citizens to manage, by contract, their own affairs, it had that effect because numerous courts, to one degree or another, adopted some form of the rule.").

²² See *Robertson v. California*, 328 U.S. 440, 450 (1946) (endorsing the requirement that a surplus line broker's license issue only after a finding of "trustworthiness and competence" by the state insurance commissioner as "an appropriate means of safeguarding the public against the obvious evils arising from the lack of those qualifications").

²³ Compare Abraham, *supra* note 1, at 663, 676-78 (discussing first-party homeowners coverage), with *id.* at 677 (briefly mentioning the relationship between mortgages and construction loans).

estate,²⁴ meaning that mortgagees hold a slight majority of equity. No one would contend that Fannie Mae, Freddie Mac, or the nation's large banks lack bargaining power. Any conceptual model for property insurance should account for the prominent interest that mortgagees hold in the scope of coverage.

The prevalence of homeowners insurance is owed to the fact that mortgage holders require homeowners to carry such insurance.²⁵ The Federal Housing Finance Agency (FHFA), in setting Fannie Mae and Freddie Mac guidelines for purchasing mortgages on the secondary market, heavily influences the terms of homeowner mortgages,²⁶ including requirements for homeowners insurance.²⁷ FHFA requires insurance “against loss or damage from fire and other hazards”—such as “wind, civil commotion (including riots), smoke, hail, and damages caused by aircraft, vehicle, or explosion”—“covered by the standard extended coverage endorsement.”²⁸

Since before Fannie Mae's creation in 1938,²⁹ property insurance policies have contained standard clauses giving mortgagees certain rights.³⁰ As these clauses have developed, a mortgagee is not within the definition of “the

²⁴ BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS 109 tbl.B.100 (2013), available at <http://www.federalreserve.gov/releases/z1/current/z1.pdf>.

²⁵ See Kenneth S. Klein, *When Enough Is Not Enough: Correcting Market Inefficiencies in the Purchase and Sale of Residential Property Insurance*, 18 VA. J. SOC. POL'Y & L. 345, 351 (2011) (noting that “having a mortgage equates to having homeowner's insurance”). For a standard insurance clause in a California mortgage, see *id.* at 388, which states, “All insurance policies required by Lender and renewals of such policies shall be subject to Lender's right to disapprove such policies, shall include a standard mortgage clause, and shall name Lender as mortgagee and/or as an additional loss payee” (citation omitted). For a sample clause in a commercial mortgage, see Gary A. Goodman & Bella Shirin, *Understanding Insurance Vocabulary in Loan Transactions*, 129 BANKING L.J. 22, 48 (2012):

All insurance policies shall be endorsed in form and substance acceptable to Agent to name Agent on behalf of the Banks as an additional insured, loss payee or mortgagee thereunder, as its interest may appear, with loss payable to Agent on behalf of the Banks, without contribution, under a standard New York (or local equivalent) mortgage clause.

²⁶ See Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143, 196 (2009) (discussing how government-sponsored entities like Fannie Mae and Freddie Mac, prodded by congressional Democrats, were able to eliminate binding mandatory arbitration provisions from mortgages).

²⁷ Schwarcz, *supra* note 12, at 1316.

²⁸ *Id.* at 1317 (quoting FANNIE MAE, SELLING GUIDE: FANNIE MAE SINGLE FAMILY 863 (Jan. 27, 2011), available at <https://www.fanniemae.com/content/guide/selo12711.pdf>).

²⁹ See, e.g., Raymond C. Niles, *Eighty Years in the Making: How Housing Subsidies Caused the Financial Meltdown*, 6 J.L. ECON. & POL'Y 165, 168 (2010) (“In 1938, the [National Housing] Act created the Federal National Mortgage Association, now known as Fannie Mae, to purchase mortgage loans from banks and securitize them.”).

³⁰ See *Syndicate Ins. Co. v. Bohn*, 65 F. 165, 167 (8th Cir. 1894) (quoting the full text of a “union mortgage clause”).

insured,” but rather has rights as a payee.³¹ Under a standard mortgage clause, an insurer will pay an innocent mortgagee’s otherwise covered claim even if the policyholder breaches a condition of coverage.³²

In a well-functioning market, therefore, mortgagees’ interest in the scope of coverage should cause them to demand insurance policies that provide an economically optimal scope of coverage. As we know all too well from the financial meltdown of 2008, however, mortgage holders generally are more concerned with quickly selling mortgages on the secondary market than with holding on to stable income-creating mortgages. Thus, in his study of how certain insurers issue narrower-than-standard homeowners coverage, Schwarcz argues against the notion that mortgage holders “police against inefficient coverage restrictions.”³³ Professor Kenneth Klein, in examining why so many homeowners policies carry insufficient policy limits, has described how incentives to underinsure create market inefficiencies.³⁴

Neither of these observations, however, applies to the scope of covered loss under a standard “all-risk” homeowners policy special form 3 (HO₃).³⁵ Klein addresses the amount of money available to pay a covered loss, not the scope of coverage under the policy language. Schwarcz’s objection is that mortgage holders and government regulators have failed to prevent certain large national carriers from issuing policies that “are substantially worse than the presumptive industry default of the 1999 [Insurance Services Office] HO₃ form.”³⁶

Where a policy does in fact incorporate a standard HO₃ form, there is reason to believe that the scope of coverage under the policy language is the product of a reasonably well-functioning market. Standard “all-risk” homeowners forms have been evolving over a long period of time, and a 1960s homeowners policy (while less detailed) is recognizable when compared to a

³¹ See *Rent-A-Car Co. v. Globe & Rutgers Fire Ins. Co.*, 148 A. 252, 254-55 (Md. 1930) (contrasting decisions under homeowners policies with auto insurance contract that defined “assured” to include lender).

³² LEE R. RUSS & THOMAS F. SEGALLA, *COUCH ON INSURANCE* 3D §§ 65:48-65:49 (2011); John W. Steinmetz et al., *The Standard Mortgage Clause in Property Insurance Policies*, 33 *TORT & INS. L.J.* 81, 83 & n.11 (1997).

³³ Schwarcz, *supra* note 12, at 1316.

³⁴ See Klein, *supra* note 25, at 367-72.

³⁵ For standalone homes, the most prevalent form is the 1999 version of the HO₃ form promulgated by the Insurance Services Office. See Schwarcz, *supra* note 12, at 1273, 1277.

³⁶ *Id.* at 1277, 1314-17.

modern policy.³⁷ It seems unlikely that standard forms would deviate significantly from what mortgage holders, when paying attention, think to be essential terms of coverage. Viewed through that lens, the standard homeowners policy does not appear to be the product of unequal bargaining power between individual homeowners and insurers, but rather a reflection of the scope of coverage that mortgage holders find economically justified.

III. GENERAL CONTRACTORS

In the construction industry, a general contractor typically will require that its subcontractors' CGL insurance policies name the general contractor as an "additional insured" with respect to the subcontractor's work.³⁸ When the general contractor is sued for defective construction or for on-site bodily injury, it typically will demand that each of its subcontractors' insurers defend and indemnify it as an additional insured.

But the subcontractor may not want its insurer to pay where coverage is questionable, or to pay a disproportionate share of the general contractor's defense or indemnity. As one commentator has noted, "Every time his insurance becomes involved to defend or pay a judgment, the subcontractor must pay his deductible and further faces the possibility of escalating premiums and diluting policy limits to pay his own costs and judgments."³⁹

The question of the scope of coverage for the general contractor's claim goes to the very heart of insurance. The essence of an insurance contract is that the insured pays a premium in exchange for the insurer assuming a specified risk.⁴⁰ While in the ordinary insurance relationship, the risk of increased premiums deters the insured from engaging in risky activity, "the additional insured is insulated against this prospect by the fact that it is not responsible for premium payments to the insurer and is unaffected by the raising of premiums."⁴¹

³⁷ Compare *Samuel v. Sewerage & Water Bd. of New Orleans*, 181 So. 2d 243, 245 (La. Ct. App. 1965) (quoting from standard form), with *Homeowners Composite Form: Section I – Perils Insured Against* (presenting a modern composite HO3 form), in SUSAN J. MILLER, MILLER'S STANDARD INSURANCE POLICIES ANNOTATED (6th ed. 2011).

³⁸ See generally PHILIP L. BRUNER & PATRICK J. O'CONNOR, JR., BRUNER AND O'CONNOR ON CONSTRUCTION LAW § 11:151 (2013).

³⁹ Trisha Strode, Note, *From the Bottom of the Food Chain Looking Up: Subcontractors Are Finding that Additional Insured Endorsements Are Giving Them Much More than They Bargained for*, 23 ST. LOUIS U. PUB. L. REV. 697, 698 (2004).

⁴⁰ *In re Tex. Ass'n of Sch. Bds., Inc.*, 169 S.W.3d 653, 658 (Tex. 2005) ("The payment of the premium by the insured and the assumption of a specified risk by the insurer are the essential elements of the contract of insurance." (citation and internal quotation marks omitted)).

⁴¹ Samir B. Mehta, Comment, *Additional Insured Status in Construction Contracts and Moral Hazard*, 3 CONN. INS. L.J. 169, 186-87 (1996).

Thus, when a dispute turns on the existence or scope of “additional insured” coverage, contract law looks to the intentions of the policyholder (who paid the premium) and of the insurer, as expressed in the language of the policy, not to the expectations of the putative additional insured.⁴² The contractual model of insurance thereby operates to protect the interests of the policyholder.

The Supreme Court of Minnesota’s recent decision in *Engineering & Construction Innovations, Inc. v. L.H. Bolduc Co.*,⁴³ reflects this dynamic. The general contractor for a sewer pipeline sued its subcontractor and the subcontractor’s CGL insurer for repairs that the general contractor had to make after one of the subcontractor’s metal sheets damaged the pipe.⁴⁴ A jury determined that the subcontractor was not negligent,⁴⁵ but the general contractor asserted that the subcontractor was still liable under the indemnity provisions of its subcontract, and that the subcontractor’s insurer was liable under the policy’s “additional insured” endorsement.⁴⁶ The case drew a number of amicus curiae briefs,⁴⁷ including one submitted by state and national subcontractors’ associations.⁴⁸ That brief did not merely argue for the subcontractors’ position on contractual indemnity, but claimed more

⁴² See *Leamington Co. v. Nonprofits’ Ins. Ass’n*, 615 N.W.2d 349, 354-55 (Minn. 2000) (explaining that a reformation claim by a third party asserting “additional insured” status turns on the intentions of the insurer and named insured); *Christenberry v. Tipton*, 160 S.W.3d 487, 494 (Tenn. 2005) (commenting that “when interpreting an insurance policy, . . . a cardinal rule is that a court must attempt to ascertain and give effect to the intent of the parties”); see also *One Beacon Ins. Co. v. Crowley Marine Servs., Inc.*, 648 F.3d 258, 272 (5th Cir. 2011) (parsing the language of the insurance policy and concluding that an unnamed third party was not an additional insured); WINDT, *supra* note 17, § 4:05, at 181 (noting that, notwithstanding the ordinary rule that the allegations of the underlying tort complaint control whether the liability insurer has a defense obligation, “[s]everal courts . . . have held that the insurer is not obligated to provide a defense for a stranger merely because the plaintiff alleges facts that, if true, would make the stranger an additional insured as defined in the policy”).

⁴³ 825 N.W.2d 695 (Minn. 2013).

⁴⁴ *Id.* at 698-701.

⁴⁵ *Id.* at 701.

⁴⁶ *Id.* at 702.

⁴⁷ See *Minnesota Appellate Court Issues in Briefs*, MINN. ST. L. LIBR., <http://mn.gov/lawlib/briefs/a110159sc.html> (last visited Nov. 5, 2013) (listing the amicus briefs filed in the case). By way of disclosure, I authored an amicus brief for the American Insurance Association. See Brief of Amicus Curiae The American Insurance Ass’n, *Eng’g & Constr.*, 825 N.W.2d 695 (No. A11-0159), 2012 WL 7160265.

⁴⁸ See Brief of Amicus Curiae The American Subcontractors Ass’n of Minnesota & The American Subcontractors Ass’n, *Eng’g & Constr.*, 825 N.W.2d 695 (No. A11-0159), 2012 WL 7160266.

broadly that the insurer's "additional insured" endorsement should be construed narrowly.⁴⁹ The court ruled for both the subcontractor and the insurer.⁵⁰

Insurance coverage disputes do not always fit a policyholder-versus-insurer narrative. Different insureds (or putative insureds) may ask a court to adopt competing interpretations of an insurance policy. A contract approach, which gives the words in a policy their objectively reasonable meaning, therefore provides the most workable means of resolving such disputes.

CONCLUSION

The literature regarding alternative conceptions of insurance focuses on the perceived shortcomings of the contractual model.⁵¹ Examining the roles of brokers, mortgage holders, and general contractors, however, puts those critiques in a different light. Brokers have a duty to know the coverage they place, and they have every incentive to ensure that their clients purchase the appropriate range of available coverages. Given mortgage holders' longstanding interest in the scope of coverage under homeowners policies, standard policies may be fairly close to the ideal economic balance. Disagreements between general contractors and subcontractors regarding the scope of coverage under "additional insured" endorsements demonstrate the value of measuring coverage by the language of the contract. Abraham's article invites a dialogue about what we want from insurance, and I hope that the dialogue will appreciate the value of understanding who "we" are.

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⁴⁹ *Id.* at 15-16.

⁵⁰ *Eng'g & Constr.*, 825 N.W.2d at 710, 714.

⁵¹ See, e.g., Abraham, *supra* note 1, at 667-68.