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The Role of Courts in the Evolution of Standard Form Contracts: An Insurance Case Study

Daniel Schwarcz*

Standard form contracts are a pervasive feature of modern commercial life – for ordinary consumers and big businesses alike. Yet remarkably little is currently known about how and when these contracts evolve in response to judicial decisions that interpret and apply them in individual disputes. Homeowners insurance policies offer a particularly fertile ground for studying this issue due to both the prominence of the insurance law doctrine that ambiguities are interpreted against the drafter and the historic standardization of insurance policies across different insurers. Utilizing a unique hand-collected dataset, this Article empirically investigates the links between innovation in the dominant “ISO HO3” homeowners policy and published caselaw interpreting that contract. The results demonstrate that judicial caselaw has indeed played a vital role in the evolution of homeowners insurance policies over the last fifty years, forcing insurers to spell out their obligations more precisely and clearly. Notably, judicially prompted changes to policy language have often expanded coverage, suggesting that judicial scrutiny can empower regulators and market intermediaries to secure drafting concessions in revisions to homeowners policies. Normatively, these results provide strong support for insurance law’s central doctrine that ambiguities are interpreted against the drafter. When considered in light of prior research demonstrating that some homeowners insurers have recently begun departing from

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the ISO HO3 policy in ways that systematically restrict coverage, this Article's results also suggest that states should strongly consider requiring homeowners policies to provide coverage that is no less generous than the ISO HO3 policy. With respect to contract law more generally, the Article's findings suggest that contractual innovation, particularly when prompted by caselaw, operates quite differently in different market and regulatory settings.

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INTRODUCTION

Standard form contracts are a pervasive feature of modern commercial life—for ordinary consumers and big businesses alike.¹ Yet remarkably little is currently known about how and when standard form contracts evolve in response to cases that interpret and apply them in individual disputes.² To date, this relationship between caselaw and the evolution of standard form contracts has principally been studied in two narrow domains: sovereign bond contracts³ and end user license agreements (EULAs).⁴ With respect to a number of key issues—such as how and when contract terms change in response to judicial pressures—these studies have yielded contrasting results.⁵ Just as importantly, these studies have left unanswered a range of key issues regarding the role of courts in prompting contractual innovation, such as the extent to which judicially triggered revisions to standard form contracts systematically favor drafters or contract adherents.

This Article aims to make progress in answering these pivotal questions for contract law by examining the issue in a new setting: insurance. Insurance contracts offer a particularly fertile ground for studying the interplay between contractual innovation and

1. See Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1226 (1983); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 546 (1971); MARGARET JANE RADIN, *BOILERPLATE: THE FINE PRINT, VANISHING RIGHTS, AND THE RULE OF LAW* 33–53, 123–42 (2013).

2. Some studies have found that even terms that courts have found unenforceable are nonetheless included in many consumer contracts. See Meirav Furth-Matzkin, *On the Unexpected Use of Unenforceable Contract Terms: Evidence from the Residential Rental Market*, 9 J. LEGAL ANALYSIS 1, 3 (2017); Meirav Furth-Matzkin, *The Harmful Effects of Unenforceable Contract Terms: Experimental Evidence*, 70 ALA. L. REV. 1031, 1035 (2019).

3. See also Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 VA. L. REV. 713, 725 (1997) (examining contractual innovation in the context of bond covenants). See generally Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929 (2004) (studying innovation in sovereign bonds); Stephen J. Choi, Mitu Gulati & Eric A. Posner, *The Dynamics of Contract Evolution*, 88 N.Y.U. L. REV. 1 (2013) (same).

4. See generally Florencia Marotta-Wurgler & Robert Taylor, *Set in Stone? Change and Innovation in Consumer Standard-Form Contracts*, 88 N.Y.U. L. REV. 240 (2013) (studying changes to end user license agreements over time); Giuseppe Dari-Mattiacci & Florencia Marotta-Wurgler, *Learning in Standard Form Contracts: Theory and Evidence* (N.Y.U. Ctr. for L., Econ. & Org., Working Paper No. 18-11, 2018) (same).

5. See *infra* Part I.

caselaw, for two central reasons.⁶ First, insurance policies have traditionally been drafted by a private entity known as the Insurance Services Office (ISO), resulting in the rough standardization of insurance policies across different insurance companies.⁷ Although some insurers have recently begun utilizing their own proprietary policies, most insurers continue to rely on forms that hew closely to the ISO model.⁸ Second, the central doctrine of insurance law – that ambiguities are interpreted against the drafter – potentially creates strong incentives for insurers to re-draft their policy terms in response to caselaw.⁹

In studying how and when insurance policies evolve in response to judicial pressures, this Article focuses on one of the most important types of ISO policies: the HO3 homeowners insurance policy. This homeowners policy provides “open peril” property insurance against risk to an insured’s home, “named peril” coverage of the insured’s personal property, and liability insurance against suits alleging certain types of bodily injury or

6. To be sure, like any contractual setting, insurance contracts also raise their own unique complications. Perhaps most importantly, state insurance regulation constrains the terms of homeowners insurance policies in various significant ways. See generally KENNETH S. ABRAHAM & DANIEL SCHWARCZ, *INSURANCE LAW AND REGULATION* 150–54 (7th ed. 2020). Policy form regulation typically occurs through a prior approval process, whereby insurers and ISO file proposed base policies and endorsements with the insurance department, which must approve them before they may be used. Robert L. Tucker, *Disappearing Ink: The Emerging Duty to Remove Invalid Policy Provisions*, 42 AKRON L. REV. 519, 577 (2009). During this review process, state regulators ostensibly review the forms to determine whether they are “unfair,” “ambiguous,” “unreasonable,” “contrary to public policy,” or some combination of these broad standards. See, e.g., ALA. CODE § 27-14-9 (LexisNexis 2014); GA. CODE ANN. § 33-24-10 (2013); NEB. REV. STAT. § 44-7513 (2010). The actual extent of this type of review varies significantly by state and type of filing. For instance, ISO submissions get substantially more attention because of how many carriers use all or some of ISO Forms. Additionally, regulators review filed policy forms to ensure that they comply with various state-specific rules. This type of “check-the-box” regulatory review is more commonly enforced, though even here state insurance regulation is quite uneven. Section IV.A, *infra*, discusses how rate regulatory review and ISO’s participation in this process impacts the implications of the Paper’s findings. As is relevant here, regulatory form review presumably slows innovation by creating extra costs for such innovation (i.e. the costs of negotiating with regulators) for approval.

7. See Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263, 1270–72 (2011) [hereinafter Schwarcz, *Reevaluating*].

8. See *id.* at 1314 (finding that “five carriers among the sixteen studied employ policies that are substantially less generous than the [ISO] HO3 policy” and that all five are national in scope and rely on captive agent distribution systems).

9. See Michelle Boardman, *Penalty Default Rules in Insurance Law*, 40 FLA. ST. U. L. REV. 305, 305 (2013) [hereinafter Boardman, *Penalty Default Rules*].

property damage.¹⁰ The majority of American homeowners pay hundreds, if not thousands, of dollars a year for the promises contained in homeowners insurance policies that are nearly or completely identical to the ISO HO3 policy.¹¹

The Article's empirical analysis of this industry standard homeowners policy proceeds in two phases. The first, and more straightforward, component of the analysis systematically tracks the evolution of each of the hundreds of terms within the ISO HO3 policy since its inception approximately fifty years ago.¹² During that time, the ISO HO3 policy has undergone major revisions five times: in 1975, 1984, 1990, 1999, and 2010.¹³ To track the evolution of these policies, I break up each of these five versions of the ISO HO3 policy into hundreds of discrete terms.¹⁴ I then compare each term of each policy version to the corresponding term in the prior version, tracking every term that was changed in a policy revision and whether that change restricted coverage, expanded coverage, or had mixed results regarding the scope of coverage. This analysis demonstrates that the length and complexity of the standard form homeowners policy has increased substantially over time, but at a gradually decreasing rate.¹⁵ It also reveals that changes in standard policy language have expanded and restricted coverage in roughly equal measure.

These findings set the stage for the Article's empirical heart, which links changes in insurance policy provisions to caselaw that may plausibly have triggered those changes. To do so, I—along with a team of research assistants—first isolated each individual policy term that was materially altered in one of the five revisions to the ISO homeowners policy.¹⁶ For each of these material alterations, we then located all cases on Westlaw that quoted key words from the term that was revised and that had been published

10. See ABRAHAM & SCHWARCZ, *supra* note 6, at 196.

11. See *Facts + Statistics: Homeowners and Renters Insurance*, INS. INFO. INST., <https://www.iii.org/fact-statistic/facts-statistics-homeowners-and-renters-insurance> (last visited Nov. 29, 2020).

12. See *infra* Section II.B.

13. See text accompanying *infra* notes 121–27.

14. See *infra* Section II.B.

15. See *infra* Part III.

16. See *infra* Part III.

between the date of the revision and the date of the prior revision.¹⁷ We then individually examined each of these cases and eliminated any cases where the published opinion suggested that the parties did not contest the meaning of the term. Having eliminated the false positives, we then recorded a variety of the remaining cases' features, including the type of court that issued the opinion and the prevailing party. To provide a control measure against which to compare these results, we repeated this process for a random subset of policy terms that were not revised in the relevant ISO homeowners policy revision. As detailed below, the resulting data support a range of inferences regarding when and how caselaw interpreting insurance policy language prompts revisions to that language.¹⁸

To be sure, this methodology has limitations. First, it focuses solely on correlations between changes in policy language and insurance coverage litigation, and it therefore cannot definitively establish causation. Although a causal link between published caselaw regarding a term's meaning and that term's subsequent revision is the most natural explanation for the findings, other explanations for this correlation are also plausible. For instance, it is possible that the very reason that a term is frequently litigated is because it is flawed in ways that would inevitably have prompted contractual change.¹⁹ Second, this approach focuses solely on identifying whether changes to policy language were potentially linked to caselaw, rather than the related question of whether policy terms were left unchanged notwithstanding relevant caselaw. Others have demonstrated that at least some insurance policy terms are indeed heavily litigated but nonetheless remain unchanged in insurers' policies.²⁰

17. We include buffer periods of two years on either end to account for potential time lags. *See infra* Part III.

18. For further methodological detail, *see infra* Section II.B.

19. *See infra* Section II.B.

20. In particular, Michelle Boardman and Christopher French have both written about the evolution of insurance policies over time, focusing on instances when insurers retain policy language that courts have criticized or that has effectively lost its meaning. *See* Michelle E. Boardman, *Contra Proferentem: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105, 1113–14, 1117 (2006) [hereinafter Boardman, *Contra Proferentem*] (arguing that insurers often choose not to redraft terms that courts have found ambiguous because they value the certainty produced by these rulings more than the costs associated with providing expanded coverage, particularly because they can pass these costs on to policyholders); Michelle E. Boardman, *The Unpredictability of Insurance Interpretation*, 82 LAW & CONTEMP.

With these caveats in mind, the data suggest that judicial caselaw has indeed played a vital role in prompting material changes to the standard form homeowners policy throughout its approximately fifty-year evolution.²¹ Over this time, materially altered terms were linked to approximately twice as many cases interpreting their meaning as compared to unchanged terms.²² These differences are statistically significant at a 99% confidence level when aggregated across all policy revision years.²³

The data also reveal a number of additional notable trends. First, caselaw appears to play an increasingly important role in prompting material changes to the homeowners policy; both the average number of cases linked to material modifications (relative to unchanged terms) and the overall percentage of material modifications that are linked to caselaw (also relative to unchanged terms) increased over time.²⁴ Second, coverage-expanding modifications to policy language were no more likely to be linked to caselaw than the control group of unchanged terms.²⁵ By contrast, both coverage-restricting modifications and modifications

PROBS. 27, 29 (2019) (arguing that courts do not always appreciate that an insurance policy term found to be ambiguous may not be redrafted, may be impossible to redraft effectively, or may be redrafted in a way that harms consumers); Christopher C. French, *Insurance Policies: The Grandparents of Contractual Black Holes*, 67 DUKE L.J. ONLINE 40, 42–43 (2017) [hereinafter French, *Insurance Policies*] (arguing that four specific insurance policy terms – (1) “Sue and Labor” Clauses, (2) “Ensuing Loss” Clauses, (3) “Non-Cumulation” Clauses, and (4) the “Sudden and Accidental” Pollution Exclusion—constitute “contractual black holes” because they are used repeatedly in insurance policies notwithstanding the fact that they have lost any discernable meaning); Christopher C. French, *Understanding Insurance Policies as Noncontracts: An Alternative Approach to Drafting and Construing These Unique Financial Instruments*, 89 TEMP. L. REV. 535, 547–48 (2017); Christopher C. French, *The Butterfly Effect in Interpreting Insurance Policies*, 82 LAW & CONTEMP. PROBS. 47, 47–49 (2019) (discussing various ways in which judicial interpretations of insurance policies can have ripple effects, including by prompting redrafting that may trigger new disputes); see also Stephen J. Choi, Mitu Gulati & Robert E. Scott, *The Black Hole Problem in Commercial Boilerplate*, 67 DUKE L.J. 1, 7 n.16 (2017) (speculating that insurance policies may in some cases contain contractual blackholes). See generally John F. Coyle, *The Butterfly Effect in Boilerplate Contract Interpretation*, 82 LAW & CONTEMP. PROBS. i (2019) (exploring the various ways in which judicial interpretations of contracts can have unexpected ripple effects, which may include prompting redrafting).

21. See *infra* Part III.

22. Depending on the revision year, each term that is materially changed is linked to an average of between 1.8 to 4.5 cases that are likely to have played a role in prompting the revision. By contrast, the average number of cases linked to unchanged terms ranged from .93 to 1.88 depending on the year.

23. See *infra* Section III.B.

24. See *infra* Section III.B.

25. See *infra* Section III.B.

with mixed effects on the scope of coverage were, on average, linked to more cases than the control group.²⁶ Third, policyholders need not prevail in the majority of coverage disputes for those disputes to be linked to changed policy language.²⁷ However, policyholder success in at least one case during the relevant time period appears to be an important contributor to contractual change.²⁸

Collectively, these results suggest that courts play a pivotal role in forcing insurers to spell out their contractual relationship with policyholders more precisely.²⁹ This revision process is apparently impacted by regulators, market intermediaries, or reputational concerns, as ISO regularly incorporates compromise terms into updated versions of their policies.³⁰ Ultimately, then, the “penalty default” approach of insurance law – which penalizes drafters for ambiguities either by interpreting them in favor of coverage or by adopting a relatively policyholder-friendly default rule – seems to produce important and sensible long-term results in shaping ordinary consumers’ insurance coverage, at least for the majority of insurers that hew closely to the ISO HO3 form.

The Article’s findings have additional normative implications when considered in light of earlier research showing that homeowners policy forms that depart significantly from the ISO HO3 policy often systematically restrict coverage.³¹ In particular, the comparatively even-handed evolution of the ISO HO3 policy suggests that states should require homeowners policies to provide coverage that is no less generous than that contained within this

26. See *infra* Section III.B.

27. See *infra* Section III.B.

28. See *infra* Section III.B.

29. On penalty default rules in general, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 97–100 (1989). On the use of penalty default rules in insurance, see Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 545 (1997); Boardman, *Penalty Default Rules*, *supra* note 9; Tom Baker & Kyle D. Logue, *Mandatory Rules and Default Rules in Insurance Contracts*, in RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW 377, 379–83 (Daniel Schwarcz & Peter Siegelman eds., 2015).

30. See Daniel Schwarcz, *Coverage Information in Insurance Law*, 101 MINN. L. REV. 1457, 1471–76 (2017) [hereinafter Schwarcz, *Coverage Information*] (providing several examples when insurers redrafted policy provisions in response to judicial determinations that a policy was ambiguous).

31. See Daniel Schwarcz, *Reevaluating*, *supra* note 7.

presumptive industry default policy.³² Adopting this approach would parallel states' creation of a mandatory fire insurance policy in response to individual fire insurers hollowing out coverage from their policy more than a century ago.³³ It would do so, however, by piggybacking on the evolution of the ISO HO3 policy in response to decades of caselaw and resulting revisions.

Outside of the insurance domain, this Article's findings support emerging research in the empirical contracts literature suggesting that the evolution of standard form contracts varies significantly across different contractual settings.³⁴ The Article's findings also suggest that the impact to consumers of contractual innovation generally, and judicially prompted innovation in particular, may depend on various market-specific factors, including the prominence of industry-wide standardized forms and the extent to which regulators and market actors can directly or indirectly influence the contract revision process.³⁵

This Article proceeds as follows. Part I provides a brief overview of the literature on the evolution of standard form contracts. Part II turns to the specific context of homeowners insurance policies, providing key background and laying out in detail the Article's methodology for studying the role of caselaw in shaping the evolution of this vitally important consumer contract. The results of the empirical inquiry are presented in Part III. Finally, Part IV discusses the implications of these results both for insurance law specifically and for contract law more generally.

32. See *infra* Part IV.

33. See *infra* Section IV.A.2.

34. For instance, consumer-oriented standard form contracts like homeowners insurance policies and end user license agreements for software products may be relatively more likely to evolve in response to judicial pressures than sophisticated financial contracts. See Marotta-Wurgler & Taylor, *supra* note 4, at 240; Dari-Mattiacci & Marotta-Wurgler, *supra* note 4, at 4–5.

35. See John Coyle, *A Short History of the Choice-of-Law Clause*, 91 U. COLO. L. REV. 1147, 1209 (2020) (“[T]he process of contractual change can vary depending upon a range of variables – including, but not limited to, the nature of the contract provision at issue, the type of agreement, the identity of the drafter, the geographic location where the contract is prepared, and the centralized or decentralized nature of the drafting community – and that a great deal depends upon context.”).

I. INNOVATION IN STANDARD FORM CONTRACTS

In recent years, legal scholars have increasingly recognized the importance of understanding the processes by which contracts are drafted and redrafted over time. The resulting literature has found that certain sophisticated financial contracts are often resistant to change, even in the face of clearly relevant caselaw.³⁶ At the same time, there is evidence that some types of contract terms—particularly consumer-oriented contracts, like end user license agreements—can evolve relatively quickly in the face of relevant market, technological, or interpretive shocks. This Part briefly summarizes this literature, dividing the field between studies of sophisticated financial contracts and investigations of consumer-oriented standard form contracts.

A. Innovation in Sophisticated Commercial Contracts

Legal scholars have devoted extensive attention to understanding the processes by which sophisticated commercial contracts like bond covenants evolve over time. This literature suggests that many of these contracts are resistant to change, even in the wake of important and clearly relevant legal, market, or technological developments.³⁷ When sophisticated financial

36. See *infra* note 37.

37. Contractual stickiness has perhaps been most clearly demonstrated in the context of sovereign bond contracts. See Stephen J. Choi, Mitu Gulati & Robert E. Scott, *Variation in Boilerplate: Rational Design or Random Mutation?*, 20 AM. L. & ECON. REV. 1, 17 (2018) (exploring reasons for the stickiness of the pari passu clause in sovereign bond contracts); Stephen J. Choi & G. Mitu Gulati, *An Empirical Study of Securities Disclosure Practice*, 80 TUL. L. REV. 1023, 1023 (2006); Choi & Gulati, *supra* note 3, at 945 (finding that it took approximately three years for New York issuances of sovereign bond contracts to adopt revised “unanimous action clauses” after Ecuador restructured its debt without achieving unanimous consent by creatively interpreting its contracts’ terms but that countries thereafter quickly herded towards new language); Choi, Gulati & Posner, *supra* note 3, at 1–6. A number of studies have also examined these issues in the context of commercial bond contracts. See Kahan & Klausner, *supra* note 3, at 713. For instance, pari passu clauses were routinely included in sovereign bond contracts even though market participants held widely diverging views on the term’s meaning and holdout creditors had successfully invoked the clause to insist on preferential payouts in numerous sovereign debt restructurings. Even after a highly prominent case finally resolved the actual meaning of pari passu clauses in a case that many suggest upended the markets’ understanding of this clause, it took years for sovereign bond contracts to adjust their terms in response. See Anna Gelper, Mitu Gulati & Jeromin Zettelmeyer, *If Boilerplate Could Talk: The Work of Standard Terms in Sovereign Bond Contracts*, 44 LAW & SOC. INQUIRY 617, 621–23 (2019); see also John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 133 (2014) (examining

contracts do eventually respond to legal or market developments, they often do so quickly and dramatically, as parties herd towards new standard terms.³⁸

There are numerous potential reasons that terms in financial contracts may be sticky, even in the wake of relevant judicial decisions impacting their meaning or implications.³⁹ Perhaps the most frequently emphasized explanation is that standardized contract terms may result in positive network externalities.⁴⁰ Under this theory, firms' use of a particular contract term is more valuable to the extent that other firms have used that term in the past and continue to use that term in the future.⁴¹ Another explanation for contractual stickiness is that innovating firms generally cannot prevent rivals from free-riding on their drafting efforts, which reduces firms' incentives to invest in revising contract language.⁴²

innovations in the contracts governing venture capital financing of Silicon Valley companies in the wake of technological shifts); Matthew Jennejohn, *The Architecture of Contract Innovation*, 59 B.C. L. REV. 71 (2018) (examining innovation M&A contracts and showing how this innovation often occurs through collaboration rather than through the use of structured modules); Robert Anderson & Jeffrey Manns, *The Inefficient Evolution of Merger Agreements*, 85 GEO. WASH. L. REV. 57, 61 (2017) (arguing that innovation in merger agreements is highly path-dependent, resulting in "systematic inefficiencies in the acquisition agreement drafting process which raises costs and risk to clients"); Julian Nyarko, *Stickiness and Incomplete Contracts* (Feb. 24, 2020) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3446206.

38. See Choi & Gulati, *supra* note 3, at 933 (describing herding of parties to revised unanimous action clauses after issuance of Mexican bonds in 2003); see also Kahan & Klausner, *supra* note 3, at 713 (showing herding in event risk covenants, which protect bondholders from events like leveraged buyouts that could dilute their value). In some cases, sophisticated commercial parties herd around contractual language that is not suboptimal so much as meaningless. Such contractual black holes can occur when contracting parties routinely incorporate standardized boilerplate into their contracts that has not been litigated or otherwise subject to dispute. See Choi, Gulati & Scott, *supra* note 20, at 8–15.

39. See Peter B. Rutledge & Christopher R. Drahozal, "Sticky" Arbitration Clauses? *The Use of Arbitration Clauses After Concepcion and Amex*, 67 VAND. L. REV. 955, 977–83 (2014) (describing eleven different reasons why contracts may be sticky).

40. See *id.* (noting this is dominant theory/explanation for contract stickiness).

41. For instance, maintaining the same boilerplate as many other firms means that this language is likely to have a clear and predictable meaning in the marketplace and among courts. It also may reduce the costs of hiring future professional service providers who will be familiar with these terms and how they interact with other terms or issues. See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 786–89 (1995); see also Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347 (1996).

42. Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 286 (1985);

Other potential impediments to contractual innovation include the risk that redrafting may send a negative signal to third parties,⁴³ may result in agency costs for potential innovators like lawyers,⁴⁴ or may complicate the ability of markets to price and invest in the associated instruments.⁴⁵

Despite these impediments, the terms of sophisticated commercial contracts do of course change at times in response to market, technological, or judicial shocks.⁴⁶ Market intermediaries often play a significant role in this evolution. Intermediaries like securities underwriters and trade organizations can overcome some of the collective action problems that ordinarily inhibit contractual evolution.⁴⁷ For instance, they can communicate the perspectives of parties impacted by contract terms and pool the resources of competing firms to draft model contract terms.⁴⁸ These terms can then potentially be quickly and widely adopted by numerous firms at once, thus overcoming network effects.⁴⁹

B. Innovation in Mass-Market Standard Form Consumer Contracts

Consumer-oriented standard form contracts are, of course, drafted and agreed to in a much different set of circumstances than

Avery Wiener Katz, *Standard Form Contracts*, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 502, 503 (Peter Newman ed., 1998).

43. See Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 655–60 (2006); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 608 (1998).

44. See Claire A. Hill, *Why Contracts Are Written in “Legalese,”* 77 CHI.-KENT L. REV. 59, 60 (2001).

45. See Gus De Franco, Florin P. Vasvari, Dushyantkumar Vyas & Regina Wittenberg-Moerman, *Similarity in the Restrictiveness of Bond Covenants*, 29 EUR. ACCT. REV. 665, 665 (2020) (finding that “bonds with more similar covenant restrictiveness receive lower yields at issuance” and “are characterized by greater liquidity in the secondary market”).

46. See John C. Coates IV, *Why Have M&A Contracts Grown? Evidence from Twenty Years of Deals* (Harvard John M. Olin Ctr. for L., Econ., & Bus., Discussion Paper No. 889, 2016; Eur. Corp. Governance Inst., Law Working Paper No. 333/2016, 2016).

47. Kevin E. Davis, *The Role of Nonprofits in the Production of Boilerplate*, 104 MICH. L. REV. 1075, 1086 (2006). For instance, both the adoption and the abandonment of event risk covenants was driven by underwriters. By contrast, in sovereign debt contracts, the eventual market shift away from collective action clauses was driven by attorneys — particularly those working for issuers. See Marotta-Wurgler & Taylor, *supra* note 4, at 247. In-house counsel, in particular, may be more willing to push innovation than outside law firms because they experience more of the upside of such innovation.

48. See Kevin E. Davis, *Contracts as Technology*, 88 N.Y.U. L. REV. 83, 97 (2013).

49. See *id.*

sophisticated financial contracts. For this reason, it is hardly surprising that empirical research suggests that drafting parties select different types of terms in these two settings.⁵⁰ Yet compared to the literature examining innovation of sophisticated financing contracts, remarkably few studies examine contract innovation in mass-market standard form contracts. However, the studies of consumer-oriented standard form contracts that do exist suggest that these contracts may not always be as sticky as their commercial counterparts.

The leading empirical studies of contractual innovation in the consumer context focus on mass-market end user license agreements (EULAs) for software products.⁵¹ In this setting, individual firms have often amended their contracts in response to a variety of considerations, including litigation outcomes.⁵² Firms appear to be more likely to revise EULA terms when they learn new information about the impact of those terms through customer and employee feedback or court decisions.⁵³ On average, changes to EULA terms tend to be pro-seller and to result in longer contracts.⁵⁴

50. See, e.g., Theodore Eisenberg, Geoffrey P. Miller & Emily Sherwin, *Mandatory Arbitration for Customers but Not for Peers: A Study of Arbitration Clauses in Consumer and Non-consumer Contracts*, 92 JUDICATURE 118, 118 (2008) (finding that firms are more likely to include mandatory arbitration provisions in consumer-oriented contracts than in their contracts with other large firms).

51. Marotta-Wurgler & Taylor, *supra* note 4, at 240; Dari-Mattiacci & Marotta-Wurgler, *supra* note 4.

52. Marotta-Wurgler & Taylor, *supra* note 4, analyzed changes in the EULAs of 247 different companies in 2003 and 2010, focusing on 32 specific terms. They found that approximately 40% of firms materially changed at least one core term in these agreements, with some firms materially revising more than ten of the identified terms. In general, larger and growing firms were more likely to change their contracts during the study period. The study also found that one important driver of firms' contract changes was published caselaw relevant to the enforceability of the underlying term. To reach this conclusion, it first attempted to measure the likelihood that a given term would be enforced by measuring the ratio of the cases enforcing a term to the total number of times that its enforceability was disputed in the caselaw. Acknowledging the limits of this approach, the article also focused on the impact of a single landmark case finding that one particular type of term in the study was enforceable. Under either approach, the analysis concluded that firms were more likely to adopt terms when those terms were more likely to be enforced by courts, and more likely to drop terms that courts were less willing to enforce. See *id.*

53. See Dari-Mattiacci & Marotta-Wurgler, *supra* note 4, at 4-5 (finding that sellers are more likely to revise EULA terms that offer an opportunity to learn).

54. See Marotta-Wurgler & Taylor, *supra* note 4, at 244. The extent of the pro-seller bias increased if terms that merely informed consumers of their rights without substantively altering those rights were excluded from the calculus. However, the spread in the pro-seller bias of contracts increased over the study's time period, indicating decreased

Outside of the EULA studies, there is mixed evidence regarding the extent to which mass-market standard form contracts are sticky. For instance, in the wake of several high-profile Supreme Court cases limiting state efforts to restrict pre-dispute arbitration clauses and class action waivers,⁵⁵ many commentators speculated that firms would dramatically increase their usage of these terms.⁵⁶ However, a study of franchise agreements found that only a small number of firms amended their contracts to include these terms.⁵⁷

As a theoretical matter, there are various reasons to suspect that certain types of mass-market consumer contracts may be relatively less sticky than sophisticated commercial contracts. For instance, firms may have more opportunities to learn about the impact of terms in consumer-oriented contracts, which are used in so many more transactions than sophisticated financial contracts.⁵⁸ Alternatively, firms may be better able to coordinate changes to standardized consumer contracts because these contracts can

standardization of terms over time as some subset of firms revised their contracts to become more consumer friendly. *Id.* at 261. Meanwhile, younger firms, growing firms, and firms with in-house counsel were more likely to change their contracts in a pro-seller direction. *Id.*

55. See *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011) (holding that the Federal Arbitration Act preempts state court decisions invalidating class arbitration waivers as unconscionable); *Am. Express Co. v. Italian Colors Rest.*, 570 U.S. 228 (2013) (holding that arbitral class action waivers were enforceable notwithstanding the possibility that such waivers might make it economically infeasible to secure relief).

56. See, e.g., Myriam Gilles & Gary Friedman, *After Class: Aggregate Litigation in the Wake of AT&T Mobility v. Concepcion*, 79 U. CHI. L. REV. 623, 629 (2012); Jean R. Sternlight, *Tsunami: AT&T Mobility LLC v. Concepcion Impedes Access to Justice*, 90 OR. L. REV. 703, 718 (2012).

57. See Rutledge & Drahozal, *supra* note 39, at 955–56. The study focused on two samples of franchise agreements to determine whether arbitration clauses or class action waivers became more common in franchise agreements in the two years after *Concepcion* was published in 2011. It found that only a small number of firms changed their contracts to include arbitration clauses, with the percentage of such firms increasing between 1% and 5%, depending on the sample. Among the firms that did use arbitration clauses, there was a larger percentage increase in firms that also included a class action waiver (from 78% to 87%). See *id.* at 990–91. As the authors suggest, one plausible reason for the lack of a shift to class action waivers is that firms preferred this outcome given the low risk of class action lawsuits and the possibility that franchisors valued the option of being able to litigate disputes with franchisees. *Id.* at 986. Moreover, in a supplemental analysis to evaluate the possibility of stickiness as an explanation for their findings, the authors report that approximately 80% of firms changed at least one of their contract terms in either 2011 or 2012 and approximately 10% of firms changed at least 10 of their terms in at least one of the two years. See *id.* at 1004.

58. See Dari-Mattiacci & Marotta-Wurgler, *supra* note 4. See generally David A. Hoffman, *Relational Contracts of Adhesion*, 85 U. CHI. L. REV. 1395 (2018) (exploring how firms may change their contracts after interacting with consumers).

frequently be changed unilaterally, with minimal costs or opposition from consumers.⁵⁹

II. INVESTIGATING INNOVATION OF HOMEOWNERS INSURANCE POLICIES

Each year, millions of consumers purchase homeowners insurance policies to protect their homes, possessions, and wealth. These contracts constitute the sole consideration that consumers receive in exchange for their upfront payment of hundreds or thousands of dollars in premiums.⁶⁰ Homeowners insurance policies are consequentially of vital importance to domestic commerce. But as Section A of this Part makes clear, homeowners policies are also drafted and revised within an institutional and legal context that makes them a particularly interesting subject for studying contractual innovation. In particular, many insurers use contracts that largely or completely replicate an industry-wide standard form, and the dominant mode of insurance policy interpretation is specifically designed to prompt clarification of what is covered by these contracts. With this context in mind, Section B develops a two-phase methodology for studying the role of courts in the innovation of the presumptive industry standard homeowners policy. Phase One consists of systematically tracking the development of the hundreds of terms and conditions within the ISO homeowners policy across each of its five major revisions over the last roughly fifty years. Phase Two then attempts to link changes to these terms to relevant caselaw regarding the meaning of the changed term.

A. Key Factors Potentially Impacting Innovation of Homeowners Policies

Like all contracts, homeowners insurance policies are drafted and revised within a distinct institutional and legal context. Two elements of this context are particularly noteworthy in understanding the process by which the homeowners policy has

59. See David Horton, *The Shadow Terms: Contract Procedure and Unilateral Amendments*, 57 UCLA L. REV. 605, 648–53 (2010) (exploring ways in which companies can unilaterally amend the terms of consumer-oriented contracts in ways that consumers rationally ignore).

60. See Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389, 1404 (2007).

evolved over the last half-century.⁶¹ First, until recently, virtually all insurers selling homeowners coverage in the United States used a policy form that nearly or completely replicated the Insurance Services Office's (ISO) model HO3 form.⁶² Second, the dominant interpretive rule of insurance law – that ambiguities are interpreted against the drafter – is specifically designed to prompt insurers to clarify ambiguous policy language.⁶³ Taken together, these two factors suggest that insurance policies may be less sticky than other types of standard form contracts.

1. *The evolution of the ISO HO3 policy*

The standardization of the homeowners policy dates back to the mid-twentieth century.⁶⁴ Until the 1950s, insurers typically sold packages of property insurance forms to insureds, each of which covered individual perils, like fire, wind, and burglary.⁶⁵ Although some insurers experimented with selling multi-line policies in the 1930s and '40s, these efforts were variable and generally did not

61. Also noteworthy is the fact that insurance policies are subject to an unusual, if not unique, state regulatory regime. *See supra* note 6.

62. *See* Thomas L. Wenck, *The Historical Development of Standard Policies*, 35 J. RISK & INS. 537, 541 (1968); Michelle Boardman, *Insuring Understanding: The Tested Language Defense*, 95 IOWA L. REV. 1075, 1091 (2010) [hereinafter Boardman, *Tested Language Defense*] (describing the “hyperstandardization” of insurance policies); Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. INS. L.J. 107, 125 (2008) (“[I]n some lines of insurance, all insurance companies provide identical coverage on the same take-it-or-leave-it basis.”); JEFFREY W. STEMPEL, 1 LAW OF INSURANCE CONTRACT DISPUTES § 4.06[b], at 4-37 (2d ed. Supp. 2005); Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 543 (1996); Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13, 18 (1993); James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. STATE L.J. 995, 996 (1992) (“The only part of the standard policy that is generally customized to the consumer-insured is the Declaration Sheet . . . [T]here is little, if any, freedom to negotiate the standardized language of the insurance contract that determines the scope of coverage.”); Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1153 (1990) (“But automobile and property owner’s liability insurance contracts are standardized across insurers in a form few insureds have the power or experience to bargain around.”).

63. *See, e.g.*, Boardman, *Penalty Default Rules*, *supra* note 9, at 305.

64. *See generally* INS. SERVS. OFF., HOMEOWNERS INSURANCE: THREATS FROM WITHOUT, THREATS FROM WITHIN (1996) [hereinafter ISO, THREATS FROM WITHOUT]; Eugene L. Lecomte, *History of the Property Insurance Policy*, 40 CHARTERED PROP. & CAS. UNDERWRITERS J. 226 (1987).

65. *See* ISO, THREATS FROM WITHOUT, *supra* note 64.

include liability insurance.⁶⁶ By the 1950s, however, insurers increasingly realized that consumers were attracted to multi-line, bundled policies that offered protection from a range of risks associated with home ownership.⁶⁷

Individual insurers' efforts to offer such bundled coverage faced two key hurdles, however. First, insurers' experimentation with bundled homeowners policies often confused consumers, state regulators, and insurance agents.⁶⁸ This experimentation also prompted concern that the fine print within complicated policy forms would not match the coverage that insurers were marketing.⁶⁹ Indeed, competing insurers' hollowing out of coverage within their policies' fine print had prompted many states to require decades earlier that fire insurance policies conform to prescribed models detailed in statute or regulation.⁷⁰ Second, individual insurers that experimented with unique bundled homeowners policies faced difficulties in accurately predicting future losses.⁷¹ Insurers had long relied on aggregate loss data to help predict losses: such data were much more robust than any individual insurer's loss data, and hence much more reliable.⁷² But such industry-wide data became less reliable as insurers combined historically distinct coverages, especially as they altered these coverages to nest together.⁷³

To address these problems, insurers formed the national Multi-Line Insurance Rating Bureau (MLIRB) in 1964.⁷⁴ The primary goal of this organization was to develop and maintain standardized multi-peril forms.⁷⁵ The insurer-developed rating agency thereafter published a series of multi-line peril policies for

66. *See id.*

67. *See id.* *See generally* Jeffrey W. Stempel, *Rediscovering the Sawyer Solution: Bundling Risk for Protection and Profit*, 11 RUTGERS J.L. & PUB. POL'Y 170 (2013).

68. *See* ISO, THREATS FROM WITHOUT, *supra* note 64.

69. *See id.*

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

71. *See* ABRAHAM & SCHWARCZ, *supra* note 6.

72. *See* Daniel Schwarcz, *Ending Public Utility Style Rate Regulation in Insurance*, 35 YALE J. ON REGUL. 941 (2018).

73. *See id.*

74. *See* ISO, THREATS FROM WITHOUT, *supra* note 64, at 49. *See generally* Curtis M. Elliott, *The Best Insurance for Your Home and Belongings*, CHANGING TIMES: KIPLINGER MAG., July 1966, at 17, 17-20.

75. *See* ISO, THREATS FROM WITHOUT, *supra* note 64.

homeowners, which it labeled HO1, HO2, HO3, etc.⁷⁶ The rating agency continually tweaked these policies through the late 1960s in response to feedback from a variety of groups. Nonetheless, these versions of homeowners insurance policies were criticized by stakeholders as excessively confusing and technical.⁷⁷

In 1971, the insurance industry founded ISO as a national, non-profit, unincorporated association of insurers to replace the prior patchwork of rate-making bureaus, including the MLIRB.⁷⁸ As one of its first major initiatives, ISO created a task force to redraft the MLIRB's homeowners policies.⁷⁹ In 1975 ISO completed these revisions, which it unveiled a year later as part of the organization's larger 1976 Homeowners Program.⁸⁰ The updated homeowners policies were designed to simplify and streamline the MLIRB's homeowners policies and retained the designations of HO1, HO2, HO3, etc.⁸¹ Throughout the early and mid-1980s, the ISO HO3 policy increasingly came to dominate the market for homeowners coverage, with alternative forms in the program (like the HO1 and HO2) fading in popularity.⁸² Subsequently, ISO published major updates to the ISO HO3 policy form in 1984, 1990, 1999, and 2010.⁸³

ISO's internal process for updating insurance policy forms has changed dramatically over the last fifty years. Prior to 1994, ISO was controlled by its member insurers, which included approximately 1,400 U.S. property and casualty insurers.⁸⁴

76. See ISO, THREATS FROM WITHOUT, *supra* note 64. The original Homeowners Program had just three options, which were the predecessors of the later HO1, HO2, and HO5. By the mid- to late 1960s (if not earlier), the Homeowners Program had expanded to five options, including the predecessor of HO3, which had to be taken together with option 4—a personal property coverage that could be bought separately by renters, for instance. See MULTI-LINE INSURANCE RATING BUREAU, HOMEOWNERS POLICY PROGRAM (1970).

77. See ISO, THREATS FROM WITHOUT, *supra* note 64.

78. See D.C. DEP'T OF INS., SEC. & BANKING, REPORT OF EXAMINATION AS OF DECEMBER 31, 2011: EXAMINATION REPORT PREPARED BY INDEPENDENT CONTRACTORS OF RISK AND REGULATORY CONSULTING, LLC WITH REGARD TO THE MULTI-STATE MARKET CONDUCT EXAMINATION OF ISO, 2-4 (2013) [hereinafter ISO EXAMINATION REPORT].

79. See ISO, THREATS FROM WITHOUT, *supra* note 64.

80. See *id.*; see also ROY C. MCCORMICK & WALLACE L. CLAPP, JR., HOMEOWNERS 76 POLICY PROGRAM GUIDE (1979).

81. See ISO, THREATS FROM WITHOUT, *supra* note 64.

82. See *id.*

83. ISO has routinely published various endorsements that can be combined with base policies. In many cases, language from these endorsements has ultimately been incorporated into the base form during one of the major revisions.

84. See *Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 772 (1993).

Consistent with this structure, its policy revision process was operated through committees of insurance representatives.⁸⁵ On occasion, ISO would release supplemental documents explaining its rationales for specific policy revisions.⁸⁶ In 1994, however, insurer control of ISO was limited as part of a settlement of a long-standing federal antitrust lawsuit.⁸⁷ ISO subsequently became an independent for-profit corporation in 1997, which is now owned by its parent company Verisk Analytics.⁸⁸ Since that time, ISO has carefully guarded information about its internal procedures for updating insurance policy forms, providing only general information about this process, such as statements that it considers “input from insurers and producers.”⁸⁹

Although homeowners insurers historically used the ISO HO3 form with minimal changes, some large modern insurers have developed proprietary policies that depart in substantial ways from this form.⁹⁰ Many insurers – particularly smaller carriers – take the standard ISO HO3 policy form, place their own logo on it, and may even tweak the language occasionally.⁹¹ But all the important coverage provisions and exclusions are the same.⁹² Increasingly, however, a handful of national carriers substantially alter key terms of the ISO HO3 policy in their own policy forms.⁹³ In most cases, but certainly not all, these changes systematically limit coverage.⁹⁴

85. See *id.* at 773–76 (describing the process of competing insurers revising ISO’s CGL policy).

86. See, e.g., David A. Gauntlett, *Recent Developments in Intellectual Property Law and Insurance*, 30 TORT & INS. L.J. 503, 521–22 (1995).

87. ABRAHAM & SCHWARCZ, *supra* note 6, at 178.

88. See ISO EXAMINATION REPORT, *supra* note 78, at 3.

89. See ISO’s *New Homeowners 2000 Insurance Program Overhauls Coverages to Reflect Court Decisions and Lifestyle Changes*, VERISK (May 17, 2000) [hereinafter VERISK, *Homeowners 2000*], <https://www.verisk.com/archived/2000/iso-s-new-homeowners-2000-insurance-program-overhauls-coverages-to-reflect-court-decisions-and-lifes/>.

90. See Schwarcz, *Reevaluating*, *supra* note 7, at 1308–17.

91. See *id.* at 1314.

92. See *id.*

93. See *id.* at 1280–308.

94. See *id.* at 1308–17.

2. *The penalty-default approach of insurance law*

Courts routinely state that ordinary principles of contract law guide the interpretation of insurance policy terms.⁹⁵ Despite such sweeping proclamations, insurance policy interpretation is uniquely influenced by the *contra proferentem* canon, which is often described as the “first principle of insurance law.”⁹⁶ Under this rule, ambiguities in insurance policy language are interpreted against the drafter, who is virtually always the insurer.⁹⁷ According to most courts and commentators, the central rationale for *contra proferentem* is that it holds the potential to induce insurers to draft their insurance policies more clearly so as to avoid ambiguities.⁹⁸ In other words, the rule is intended to operate as a “penalty default rule.”⁹⁹

Contra proferentem is not the sole penalty default rule of insurance law. In fact, many, if not most, rules of insurance law can appropriately be classified as penalty default rules.¹⁰⁰ Starting with the “default” nature of these rules, there is no doubt that most insurance law doctrines can be altered by clear and relevant language within the insurance policy.¹⁰¹ As for their status as “penalties,” many default rules of insurance law—ranging from those governing liability insurers’ duty to defend,¹⁰² concurrent

95. See, e.g., *Interstate Fire & Cas. Co. v. Dimensions Assurance Ltd.*, 843 F.3d 133, 137 (4th Cir. 2016); *Naquin v. Elevating Boats, L.L.C.*, 817 F.3d 235, 238 (5th Cir. 2016); *W.C. & A.N. Miller Dev. Co. v. Cont’l Cas. Co.*, 814 F.3d 171, 176 (4th Cir. 2016).

96. Abraham, *supra* note 62, at 531; see Fischer, *supra* note 62, at 996.

97. See JEFFREY W. STEMPEL & ERIK S. KNUITSEN, STEMPEL AND KNUITSEN ON INSURANCE COVERAGE 14-101 to -02 (2019); RESTATEMENT OF THE L. OF LIAB. INS. § 4 (AM. L. INST. 2019).

98. See Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653, 660 (2013); Baker & Logue, *supra* note 29, at 379-83; Boardman, *Penalty Default Rules*, *supra* note 9, at 318; Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171, 207-08 (1995); see also *Neal-Pettit v. Lahman*, 928 N.E.2d 421, 425 (Ohio 2010) (“Allstate, as the drafter, is responsible for ensuring that the policy states clearly what it does and does not cover.”).

99. Ayres & Gertner, *supra* note 29, at 91, 120 n.147.

100. Schwarcz, *Coverage Information*, *supra* note 30, at 1474.

101. See Baker & Logue, *supra* note 29, at 379-83; RESTATEMENT OF THE L. OF LIAB. INS. § 1 (AM. L. INST. 2019).

102. See Charles Silver, *Basic Economics of the Defense of Covered Claims*, in RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW 438 (Daniel Schwarcz & Peter Siegelman eds., 2015).

causation,¹⁰³ or subrogation¹⁰⁴—are arguably designed to provide relatively expansive coverage so as to prompt insurers that do not intend for these results to redraft their contracts accordingly.¹⁰⁵

Moreover, most of the penalty default rules of insurance law—including both the general principle of *contra proferentem* and various more specific insurance law doctrines—have particular force when it comes to consumer-oriented insurance, like homeowners insurance policies.¹⁰⁶ For instance, some courts have adopted a “sophisticated policyholder exception” to the *contra proferentem* rule.¹⁰⁷ Others have suggested that, when it comes to insurance policies issued to ordinary consumers, *contra proferentem* applies irrespective of extrinsic evidence suggesting that the insurer maintained a relatively narrow understanding of ambiguous policy language.¹⁰⁸

There is no doubt that these penalty default rules of insurance law have indeed caused insurers to redraft portions of their homeowners insurance policies in response to unfavorable judicial opinions.¹⁰⁹ For instance, ISO and insurers redrafted the HO3 policy’s limited collapse exclusion multiple times in response to unfavorable judicial opinions.¹¹⁰ Similarly, the anti-concurrent causation language in the ISO HO3 policy has been redrafted on

103. Erik S. Knutsen, *Confusion About Causation in Insurance: Solutions for Catastrophic Losses*, 61 ALA. L. REV. 957 (2010).

104. Alan O. Sykes, *Subrogation and Insolvency*, 30 J. LEGAL STUD. 383 (2001).

105. See Schwarcz, *Coverage Information*, *supra* note 30, at 1474.

106. Oxford Realty Grp. Cedar v. Travelers Excess & Surplus Lines Co., 160 A.3d 1263, 1271 (N.J. 2017) (“Similar to the doctrine of *contra proferentem*, the doctrine of reasonable expectations is less applicable to commercial contracts.”).

107. See *In re Deepwater Horizon*, 728 F.3d 491, 499 (5th Cir. 2013) (noting that while Texas has never recognized a sophisticated insured exception to *contra proferentem*, it has long recognized that this rule is “partially derivative of the unequal bargaining power typical in many negotiations over insurance contracts,” which might justify such an exception). See generally Hazel Glenn Beh, *Reassessing the Sophisticated Insured Exception*, 39 TORT TRIAL & INS. PRAC. L.J. 85 (2003); Jeffrey W. Stempel, *Reassessing the “Sophisticated” Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807 (1993).

108. See, e.g., *Winter v. State Farm Mut. Auto. Ins. Co.*, 328 P.3d 665, 669 (Mont. 2014); *Bidwell v. Shelter Mut. Ins. Co.*, 367 S.W.3d 585, 589 (Ky. 2012); *Badger Mut. Ins. Co. v. Schmitz*, 647 N.W.2d 223, 233–34 (Wis. 2002).

109. See ISO, THREATS FROM WITHOUT, *supra* note 64 (noting that changes in the language of the ISO homeowners insurance policy have frequently been motivated by court decisions producing results that were inconsistent with underwriters’ intent).

110. See Schwarcz, *Coverage Information*, *supra* note 30, at 1474; *Rosen v. State Farm Gen. Ins. Co.*, 70 P.3d 351, 363–64 (Cal. 2003) (discussing policy language governing collapse that insurers specifically redrafted in response to prior adverse coverage determinations).

several occasions in response to cases finding coverage when insurers intended a different result.¹¹¹ So too has the ISO HO3 exclusion for water damage.¹¹² Other isolated examples of insurer redrafting in apparent response to judicial decisions—both in the homeowners insurance policy and in other types of insurance policies—are not hard to locate. Moreover, ISO itself has noted on multiple occasions that it considers court decisions when updating insurance policy forms.¹¹³

On the other hand, there are also numerous examples of insurers clinging to historic policy language that courts have repeatedly found either to be ambiguous or subject to a policyholder-friendly penalty default rule.¹¹⁴ Perhaps the most well-known examples involve the relatively sparse language in the liability section of the ISO HO3 policy (as well as many other liability insurance policies) governing insurers' duty to defend cases alleging liability that may or may not ultimately result in coverage.¹¹⁵ Other examples of language in the homeowners policy that insurers have not redrafted in response to unfavorable court decisions include clauses governing ensuing loss¹¹⁶ and actual cash value recovery.¹¹⁷

Insurers' failure to re-draft terms that courts have previously found to be ambiguous or subject to policyholder-friendly default rules can be explained by several considerations. First, the very process of courts finding policy language to be ambiguous or

111. See 5 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 53.04[1][b][i] (2020) ("Following judicial decisions that a homeowner's policy covers a loss even where caused in part by an excluded peril, many standard homeowner's insurance policies were revised to include anti-concurrent cause provisions.").

112. See Charles M. Miller, *ISO Changes Water Damage Exclusion in HO3: Is There Now Coverage for Storm Surge Under the 2000 Version?*, 1 WHITE PAPER, <https://www.uphelp.org/sites/default/files/ISO%20CHANGES%20WATER%20DAMAGE%20EXCLUSION%20IN%20HO3.pdf> (last accessed Jan. 23, 2021).

113. See, e.g., VERISK, *Homeowners 2000*, *supra* note 89 ("We came up with the new program after an extensive review of court rulings and lifestyle changes among an expanding and aging population," said Michael Fusco, ISO's executive vice president – insurance services.").

114. See Boardman, *Contra Proferentem*, *supra* note 20, at 1113–14, 1117; French, *Insurance Policies*, *supra* note 20, at 40.

115. See ABRAHAM & SCHWARCZ, *supra* note 6, at 615–16.

116. See *id.* at 266–67; see also *Leep v. Trinity Universal Ins. Co.*, 261 F. Supp. 3d 1071, 1085 (D. Mont. 2017); *Bartram, LLC v. Landmark Am. Ins. Co.*, 864 F. Supp. 2d 1229, 1232–33 (N.D. Fla. 2012).

117. See ABRAHAM & SCHWARCZ, *supra* note 6, at 284–87.

subject to a specific penalty default rule can result in that language taking on a settled and predictable judicially constructed meaning, which insurers can price in their subsequent policies.¹¹⁸ By contrast, redrafting policy language in response to judicial opinions can be risky due to the prospect that the redrafted policy language will yield results in coverage disputes that insurers did not anticipate. Second, redrafting policy language can be costly, both because redrafted policy language generally must be approved by state insurance regulators and because redrafting may result in courts making negative inferences about prior versions of policy language that may apply in ongoing disputes.¹¹⁹

B. Methodology for Assessing the Role of Courts in the Evolution of the Homeowners Insurance Policy

Assessing the role of caselaw in prompting innovation in the ISO HO3 homeowners policy requires two analytically distinct steps. The first, and more straightforward, step is to systematically track the evolution of this contract over time. The second, more complex, step is to assess the extent to which caselaw is likely to have played a significant role in prompting changes to terms when they occurred.

1. Phase One: Tracking innovation in the ISO HO3 policy

The first step in the empirical analysis involves systematically tracking the evolution of the ISO HO3 insurance policy, which has operated as the presumptive industry-wide policy since the early 1980s.¹²⁰ To do so, I first acquired from various libraries copies of the five major ISO revisions to the HO3 base policy form,¹²¹

118. See Boardman, *Contra Proferentem*, *supra* note 20, at 1113–14.

119. See JEFFREY W. STEMPEL, 1 STEMPEL ON INSURANCE CONTRACTS § 2.06[j], at 2-130 (Aspen 3d ed. 2006) (“Changing the standard form insurance policy is a somewhat arduous process, requiring contributions from legal, claims, actuarial, and other industry personnel as well as from customers and state insurance regulators.”).

120. See ISO, *THREATS FROM WITHOUT*, *supra* note 64.

121. I did not include any of the myriad endorsements to these policies that ISO publishes. Some insurers will require that specific endorsements be included with their base policies. In some cases, this reflects local risks, state-specific practices, or individual insurers’ preferences. In other cases, mandatory endorsements become widespread among insurers nationally. When this occurs, the relevant provisions of the endorsements are sometimes incorporated into the base ISO policy at the time of the next major revision.

from 1975,¹²² 1984,¹²³ 1990,¹²⁴ 1999,¹²⁵ and 2010.¹²⁶ I also secured a copy of ISO's 1971 HO3 policy, which was drafted and revised by the organization's predecessor, MLIRB, throughout the 1960s.¹²⁷

Having acquired these six versions of the HO3 policy, I then created a protocol for defining individual terms in each of these documents. To do so, I followed prior research by relying on the outline structure within the contracts themselves.¹²⁸ In particular, I treated all language that was contained within the third outline level of each "Section" of the policies as individual terms.¹²⁹ Thus, for example, B.8.a and B.8.b in the Definitions section were separate "terms." However, where the policies broke down outline numbers or letters to the fourth outline level or beyond, the separate sections of the outline were treated as individual terms if, and only if, the aggregate number of lines in that section of the policy was ten or more. Thus, Sections B.1.a.1 and B.1.a.2 would be treated as separate terms if Section B.1.a contained ten or more lines of text in total.

122. HO3, ed. 12-75, INS. SERVS. OFF. (1975).

123. Homeowners 3: Special Form, ed. 4-84, INS. SERVS. OFF. (1984).

124. Homeowners 3: Special Form, HO 00 03 04 91, INS. SERVS. OFF. (1990).

125. Homeowners 3: Special Form, HO 00 03 10 00, INS. SERVS. OFF. (1999).

126. Homeowners 3: Special Form, HO 00 03 05 11, INS. SERVS. OFF. (2010).

127. HO3, ed. 9-71, INS. SERVS. OFF. (1971); *see supra* Section II.A. For the 1971 HO3 policy, I included two endorsements that were intended to supplement this policy: (i) the standard New York fire insurance policy and (ii) an endorsement specifying the conditions of coverage. *See* INS. INFO. INST., SAMPLE INSURANCE POLICIES FOR PROPERTY AND LIABILITY COVERAGES: PREPARED FOR COLLEGE STUDENTS IN ADVANCED COURSES (1966).

128. *See* Schwarcz, *Reevaluating*, *supra* note 7.

129. The full protocol was as follows. First, each separate provision down to the third outline level of the policy "Sections" was treated as an individual term. Outline levels were generally apparent from the explicit outlining of the policy, such as B.8.a and B.8.b. In some cases, however, the outline level was implicit from the structure of the policy's headings. Thus, the additional coverages on page 4 of the 1990 policy is the first outline level in the section, even though it is not preceded by "D" or "IV." Second, when the policy broke down sections beyond the third outline level, those subdivisions were each treated as separate terms if, and only if, the aggregate number of lines in that section (including the umbrella terms) of the policy was ten or more. Third, an "umbrella section" that was either before or after subdivided text was itself treated as a separate term if it contained 10 or more words. Otherwise, this umbrella language was treated as part of the same term as the nearest outline provision to which it applied.

After subdividing the policies into individual “terms,” I¹³⁰ then assessed how each of these terms changed coverage relative to the corresponding term in the previous version of the HO3 policy.¹³¹ I coded each term in each of the five ISO revisions to the HO3 policy using the following scheme¹³²:

Code	Description
0	No change in policy language.
1	Change to punctuation, formatting, or location of policy text or to wording choice that does not plausibly alter text’s meaning.
2	Change that may alter policy’s meaning and that restricts the scope of coverage in all relevant claims settings. ¹³³
3	Change that may alter policy’s meaning by expanding the scope of coverage in some relevant claims settings and restricting it in others.
4	Change that may alter policy’s meaning by expanding the scope of coverage in all relevant claims settings.
5	Change that only alters the amount of coverage provided by changing numerical quantities, such as increasing coverage for certain property from \$500 to \$1000.

130. I performed all of the defining of terms and coding of changes to these terms myself. However, I occasionally had a trained research assistant do the first draft, which I then carefully double-checked.

131. For new provisions, this inquiry required assessment of how the new term impacted coverage relative to the absence of the term. In a small number of cases, a policy revision completely removed a preexisting term. Where this happened, an additional “shadow term” was added to the later policy to indicate the removal of that term.

132. In performing this coding, I adhered to three supplemental principles. First, global changes to a policy (such as the hyphenation of a term) were treated as a single change, coded in the first term in which they appear but not thereafter treated as an independent change. Second, changes to cross references (either numerical or text reproduced verbatim from a prior section) were not treated as a change apart from the term that triggered the need for the changed cross reference. Third, for new coverages that clearly did not exist in prior policy versions, restrictions on the scope of the new coverage were still treated as expansions of coverage.

133. Evaluating the impact of any particular change on the generosity of coverage can be complicated when a term interacts with other terms, as is common with definitions, for instance. In these cases, the impact of a particular change is evaluated against the baseline of the coverage that the updated policy would have provided had the term in question not been altered.

2. Phase Two: Linking innovation in the ISO HO3 policy to published caselaw

Phase Two of the analysis focused on linking changes in the ISO HO3 policy found in Phase One to any caselaw that may plausibly have prompted those changes. To accomplish this, I relied on a team of trained research assistants, acting under my supervision and review, to implement the following protocol.

First, we isolated each individual policy term (as defined above) that had been coded as a 2,¹³⁴ 3,¹³⁵ or 4¹³⁶ in Phase One, as only these terms had been materially altered from the prior version of the policy in a way that could plausibly have been influenced by caselaw.¹³⁷ For each of these material alterations, we then located all published and unpublished cases available on Westlaw during the relevant timeframe (as defined below) that quoted a portion of the term as it was drafted prior to the revision. To ensure that we captured the vast majority of such cases, we searched for cases that contained, within a single sentence, five key words (excluding articles) drawn from the policy term that had been revised.¹³⁸ We are confident that this method generally captured the vast majority of cases implicating policy language that was revised in subsequent policies, as any such cases are virtually certain to quote the relevant policy language before applying it to a particular coverage dispute.

Because we were only interested in cases that may have been causally connected to the changed terms, we restricted the search to cases released within two years after the date of the updated

134. Change that may alter policy's meaning and that restricts the scope of coverage in all relevant claims settings.

135. Change that may alter policy's meaning by expanding the scope of coverage in some relevant claims settings and restricting it in others.

136. Change that may alter policy's meaning by expanding the scope of coverage in all relevant claims settings.

137. Although terms coded as 5—meaning that there was a change that only altered the amount of coverage provided by changing numerical quantities—did indeed constitute material changes, we reasoned that such changes could not have plausibly been related to caselaw.

138. This approach did not work in the rare instances when entirely new provisions were added to an updated policy; in these instances, we used a reduced number of key terms from the new term to attempt to locate caselaw that might have triggered the addition. Additionally, in a few instances, an individual term included more than one sentence. In such cases we adjusted the search accordingly to span two sentences.

policy and two years prior to the publication of the revised policy. For instance, for a material change implemented in the 2010 HO3 policy, we searched for caselaw quoting the 1999 version of the changed term, but only if this caselaw was made publicly available between 1997 and 2012. We decided to start two years before the publication of the unrevised policy to reflect the fact that cases released shortly before publication of a finalized policy revision may influence the subsequent policy revision. Meanwhile, we extended the search two years past publication of the policy with revised language to reflect the fact that some litigation may prompt contractual change before it results in a publicly available opinion if, for instance, preliminary court decisions foreshadowed the ultimate result.

After locating these cases, we then made several adjustments to avoid false positives and potential double counts. In particular, we eliminated any cases where the opinion suggested that the parties did not contest the meaning of the changed term.¹³⁹ We reasoned that such cases had no potential bearing on the subsequent change in policy language.¹⁴⁰ To avoid double counting individual cases, we also eliminated any intermediate or trial court cases where a higher court had released a decision that was also linked to the changed term.¹⁴¹

Having eliminated the false positives and problematic double counts, we then recorded a variety of the remaining cases' features. In addition to tracking the aggregate number of cases we found that met the above criteria – with a self-imposed limit of ten cases per term¹⁴² – we recorded the type of court that issued the opinion and

139. We included cases that involved contestation of the exact same insurance language in the context of a non-homeowners policy, so long as the language was not further specified or defined in the policy at issue in the case in a way that differed from its treatment in the homeowners policy.

140. For instance, in some cases, courts quoted policy language in the facts section of the opinion, but this policy language had nothing to do with the legal issue that the court addressed in the opinion.

141. However, we did record when individual cases were linked to multiple different changes in terms using our protocol, and we also counted such cases towards the limit of ten cases for each of those terms.

142. The number of terms that had more than ten cases linked to them varied. For the terms that were materially changed, the number of terms that were capped at ten case links were as follows: in 1975 there were 9 capped terms, in 1984 there were 14 capped terms, in 1990 there were 6 capped terms, in 1999 there were 40 capped terms, and in 2010 there were 12 capped terms. There were many fewer capped terms in the control data of terms that were

whether the insurer, policyholder, or neither party prevailed with respect to their preferred meaning of the policy language. We imposed the cap of ten cases for practical reasons, as several terms resulted in hundreds of cases that could not all be reviewed. In instances where this cap was hit, we examined cases in the order of how recently they were published within the relevant time frame.

As a control measure, we applied this same methodology to policy terms that ISO left unchanged in each policy revision. This allowed us to isolate the increased (or decreased) amount of caselaw for changed terms relative to unchanged terms. To implement this approach, we isolated from each policy revision fifty random terms that had not been materially altered from the prior policy iteration.¹⁴³ We then repeated the process described above for each of these terms; we searched for all cases released between the revision dates of the two comparison policies (with the two-year buffers added) that contained, within a single sentence, five key words drawn from the term. We then eliminated all cases in which the parties did not contest the meaning of the term.

3. Caveats and limitations of methodology

This methodology, of course, has important limitations. First, the approach only yields evidence of correlation rather than causation. It is possible that, in some cases, there is no causal link between heightened amounts of caselaw regarding a term's meaning and ISO's subsequent decision to materially alter that term. For instance, it may be that the very reason that a term was relatively heavily litigated was because it was flawed in ways that would inevitably have prompted contractual change.¹⁴⁴ But while

not materially changed. Here, the number of capped cases were as follows: in 1975 there were no capped terms, in 1984 there were 4 capped terms, in 1990 there were 6 capped terms, in 1999 there were 3 capped terms, and in 2010 there were 5 capped terms.

143. We also excluded from the control group terms that were part of global changes to the policy but were coded as zeroes because they appeared after the first term in which the global term appeared.

144. Another possible non-causal explanation for any correlation between cases and policy revisions is that terms that are litigated are relatively likely to have significant implications for coverage, a consideration which also impacts the likelihood of policy revision. Although plausible, this explanation also seems unlikely to substantially explain the results. The primary difficulty with this theory is that the importance of a policy term does not, in itself, seem to have a substantial impact on the frequency of policy revisions. It is in precisely the case of particularly important terms that the costs of redrafting—including securing regulatory approval and increasing the risk of unintended

it is impossible to reject this possibility for every materially changed term, it is highly unlikely that this can systematically explain the results. To the extent that a term was inherently problematic in a way that would inevitably have prompted change, one would have expected this change to have been made relatively early in the evolution of the HO3 policy.

A second important limitation of the methodology is that it does not seek to evaluate how often published caselaw fails to prompt changes in policy language. As noted earlier, several scholars have emphasized various instances when cases that produce seemingly unfavorable results for insurers fail to prompt relatively straightforward fixes.¹⁴⁵ Thus, while the results can demonstrate whether courts have played a significant role in the evolution of insurance policy language, they cannot demonstrate that this effect is inevitable or consistent with respect to individual terms; to the contrary, the various instances of relatively limited policy language change in the face of relevant and significant amounts of caselaw suggest quite the opposite.¹⁴⁶

A third limitation of the methodology is that it does not attempt to evaluate the relative importance of different types of policy changes. Thus, it groups together all changes that expand coverage and all changes that restrict coverage, even though some of these changes are obviously more consequential than others. For this reason, comparing the number of coverage expansions to coverage restrictions may not fully capture the ultimate impact of those changes on the generosity of coverage.

Finally, an important caveat to this Article's methodology is that, as discussed earlier, some insurers are increasingly departing in significant ways from the ISO HO3 policy.¹⁴⁷ Consequently, the results track the evolution of actual homeowners policies that are

consequences—may be greatest. Nor is it obvious that litigated cases disproportionately involve broadly consequential terms. A policy term may be consequential enough in a single case to warrant the costs of litigation, even though it comes up relatively infrequently. Moreover, coverage disputes involving relatively important policy terms may be disproportionately likely to settle before any case is published, as insurers may fear that a negative precedent can have broad implications.

145. See Boardman, *Contra Proferentem*, *supra* note 20, at 1113–14, 1117; French, *Insurance Policies*, *supra* note 20, at 40.

146. See Boardman, *Contra Proferentem*, *supra* note 20, at 1113–14, 1117; French, *Insurance Policies*, *supra* note 20, at 40.

147. See Schwarcz, *Reevaluating*, *supra* note 7.

employed across the country only among a (still quite large) subset of insurers. As discussed in Part IV, this caveat has important normative implications, as it suggests that lawmakers, courts, and regulators should strongly consider promoting greater standardization of insurance policies by requiring insurers to use homeowners policies that are no less generous than the ISO HO3 form.¹⁴⁸

III. RESULTS: EVIDENCE OF COURTS' SUBSTANTIAL ROLE IN PROMPTING INNOVATION OF HOMEOWNERS INSURANCE POLICIES

The dominant homeowners insurance policy in the United States has evolved substantially over its fifty-year lifetime as the ISO HO3 policy. These changes have undoubtedly made the policy longer and more complex. But they have had a more mixed impact on the scope of coverage provided to homeowners: sometimes expanding coverage, sometimes restricting it, and often adopting intermediate positions that potentially have both coverage-expanding and coverage-restricting features. Section A of this Part reviews these results from Phase One of the study. Section B then presents the results of Phase Two, providing evidence that judicial caselaw has played a substantial role in guiding the evolution of the modern homeowners policy. This role, moreover, seems to have increased over time as the HO3 policy has matured. Notably, caselaw appears to have played a much stronger role in prompting changes that either restrict coverage or else that had mixed impacts on the scope of coverage; by contrast, changes that unambiguously expanded coverage were no more likely to have been linked to caselaw than unchanged terms.

A. The Evolution of the ISO HO3 Policy over Time

The length and complexity of the ISO HO3 homeowners policy has increased over time, but at a gradually decreasing rate. This is well illustrated by Figure 1, which shows that the total number of terms in each version of the policy continually increased until 1999 but leveled off in the 2010 revision. These trends are also reflected in the total number of pages in each policy revision,

148. See *infra* Section IV.A.

which increased from 8 pages (1971), to 12 pages (1975), to 15 pages (1984), to 18 pages (1990), to 22 pages (1999), to 24 pages (2010).

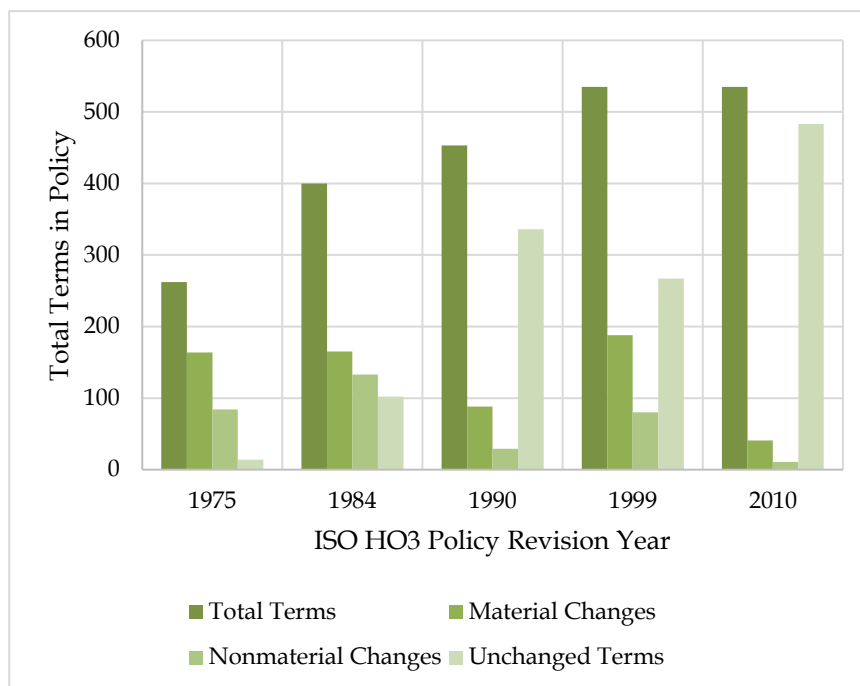


Figure 1: HO3 Term Changes over Time

The decreased rate of change in the homeowners policy is evident not only by the aggregate number of terms in each policy revision but also by the percentage of terms that were materially altered in each revision. Material alterations encompass all changes that received Codes 2, 3, 4, or 5 in each revision. Figure 2 charts the percentage of such terms, as compared to the percentage of terms that were either immaterially altered (received a Code 1) or left unchanged (Code 0) in each revision. As it illustrates, the percentage of terms that were materially altered has generally decreased over time, albeit with a blip in the data for the 1999 revision. But even the 1999 revision had a smaller percentage of material changes to its terms than the 1975 or 1984 revisions.

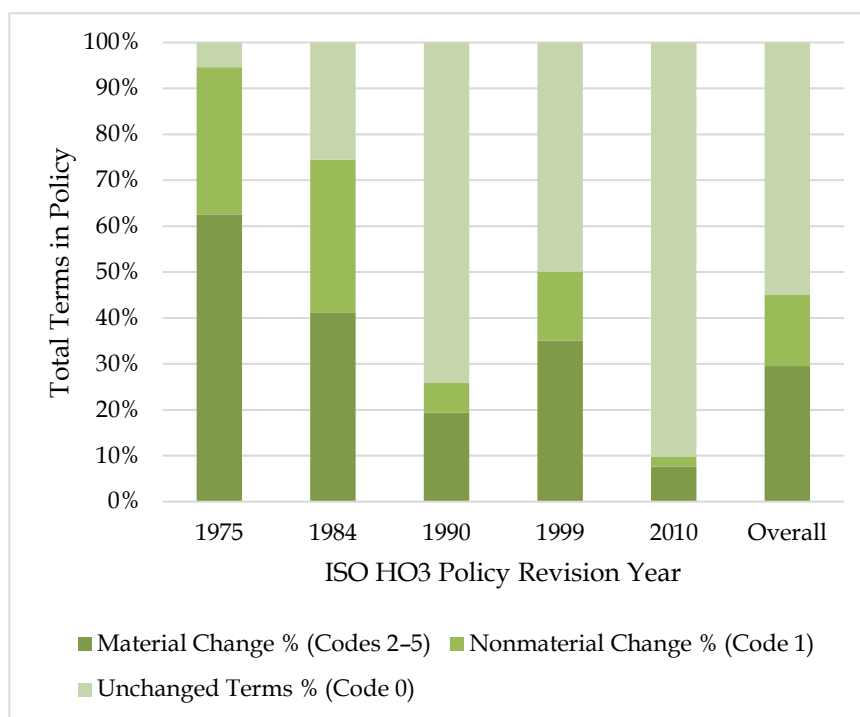


Figure 2: Percentage of Policy Terms Materially Altered

Focusing just on non-quantitative material alterations to policy language—a category that encompasses changes coded as 2, 3, or 4, and which is referred to below as “modified terms”—these changes were slightly more likely to restrict coverage than to expand coverage.¹⁴⁹ As Figure 3 illustrates, the percentage of modified terms that unambiguously restricted coverage ranged from 32% to 63% of total modified terms for each policy revision year. But in each revision, a meaningful percentage of modified terms—between 17% and 35%—unambiguously increased the scope of coverage, and a substantial percentage—between 43% and 20%—had a mixed or unclear impact on the scope of coverage.

149. Changes that only altered the amount of coverage provided by changing numerical quantities, and thus received a code of 5, consistently expanded coverage, typically by increasing coverage limits for discrete items.

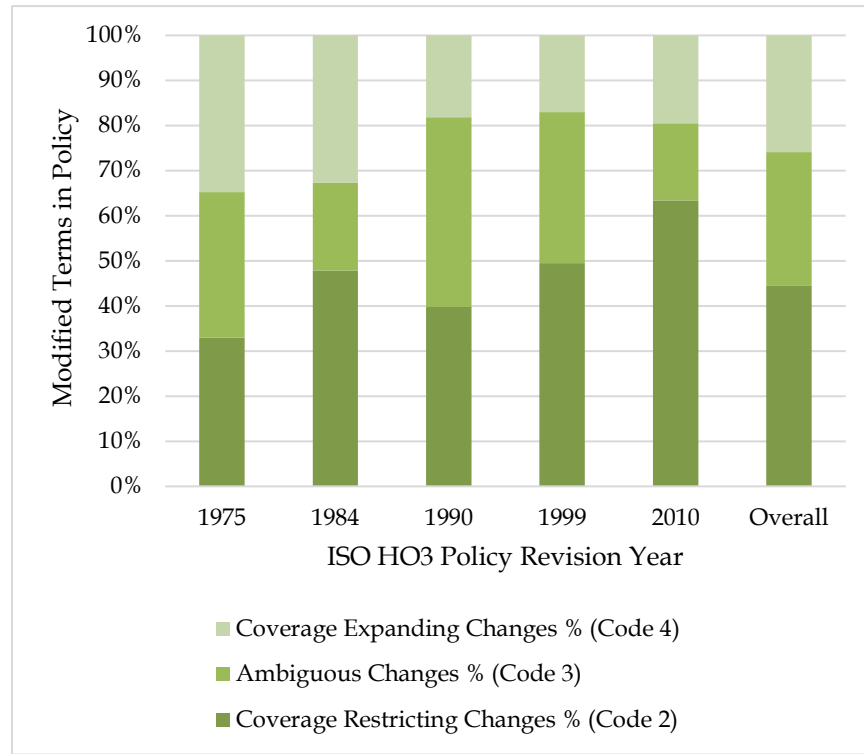


Figure 3: Impact of Modified Terms on Scope of Coverage

Although modified terms were only moderately more likely to restrict coverage than to expand it, the percentage of changes that restricted coverage relative to other types of material textual changes has increased over time. Indeed, as illustrated by Figure 4, the ratio of coverage-expanding changes to coverage-restricting changes has decreased in every revision. Another illustration of this point is that the total number of modified terms that unambiguously restricted coverage (Code 2) oscillated between 30 and 100, while the number of changes that unambiguously expanded coverage (Code 4) declined from around 50 in the 1975 revision to 7 in the 2010 revision.

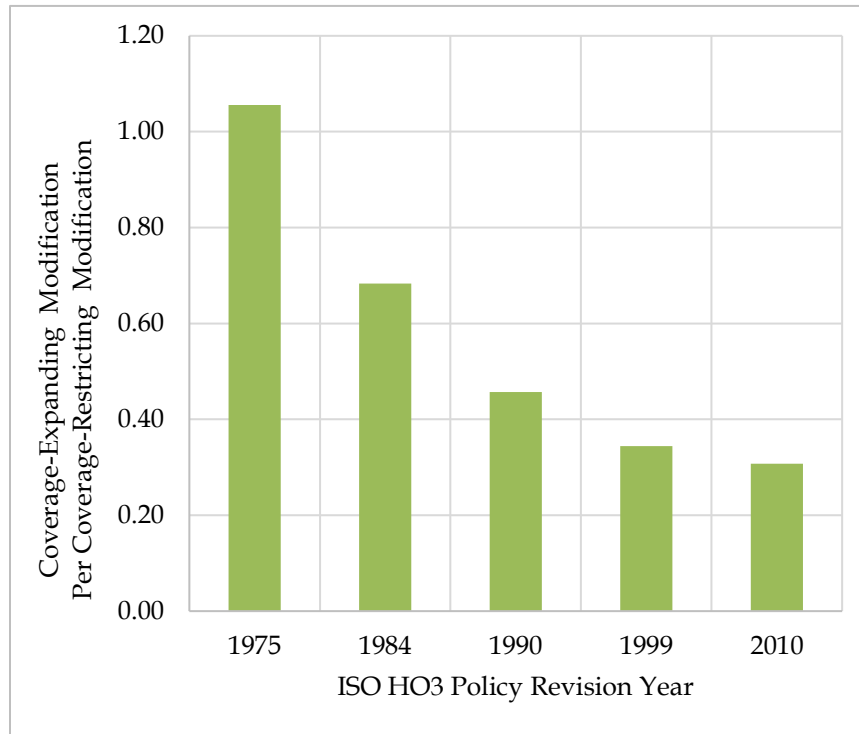


Figure 4: Ratio of Coverage-Expanding Modifications to Coverage-Restricting Modifications

B. The Role of Caselaw in Prompting Changes to the Homeowners Policy

The ISO HO3 policy has clearly changed significantly over time. This Section assesses the role of courts in this evolution. To do so, it attempts to link modified terms containing material, textual alterations—coded as 2s, 3s, or 4s in Phase One—to published caselaw. The total number of such modified terms for each policy revision is reported in Figure 5.

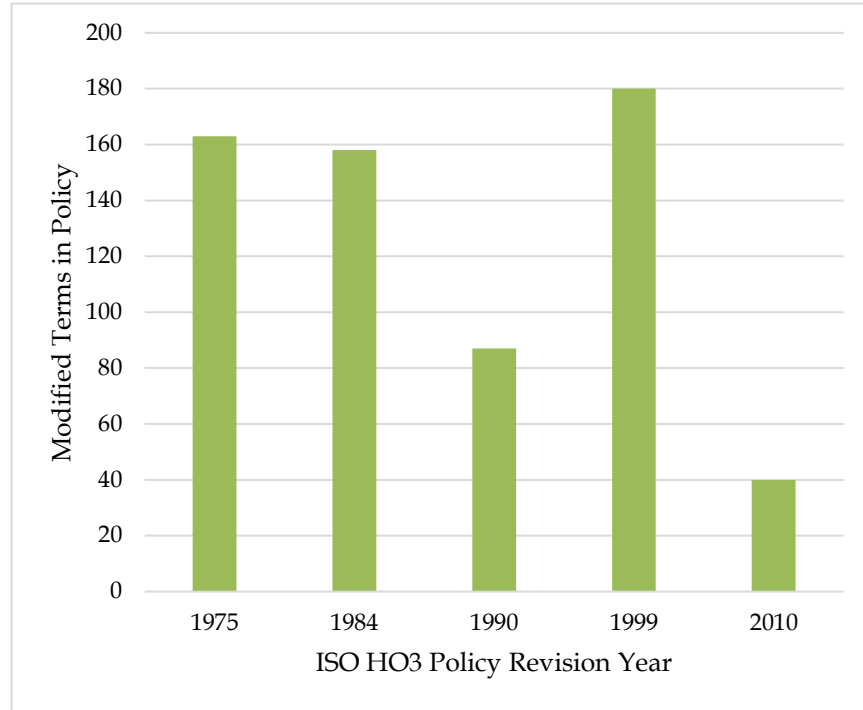


Figure 5: Total Number of Modified Terms

The data suggest that judicial caselaw has played a major role in prompting material textual changes to the ISO homeowners policy. The best way to see this is in Figure 6, which reports both the average number of cases linked to modified terms and the average number of cases linked to unchanged policy terms (i.e., terms that were coded 0). Recall that a case was linked to a term if (i) it quoted portions of the term's policy language, (ii) in the time period between when the term was changed and the last policy revision, and (iii) individualized analysis concluded that the parties contested the meaning of the quoted policy language.¹⁵⁰ As Figure 6 shows, the average number of cases linked to modified terms varied from roughly 1.8 to 4.5 depending on the policy year. By contrast, the average number of cases linked to unchanged terms ranged from .93 to 1.88 depending on the year. Collapsing all five revisions of the HO3 policy, terms with materially altered text were linked with approximately twice as many cases relative to

150. See *supra* Section II.B.

unchanged terms.¹⁵¹ These differences between the number of case links for modified and unchanged terms are statistically significant.

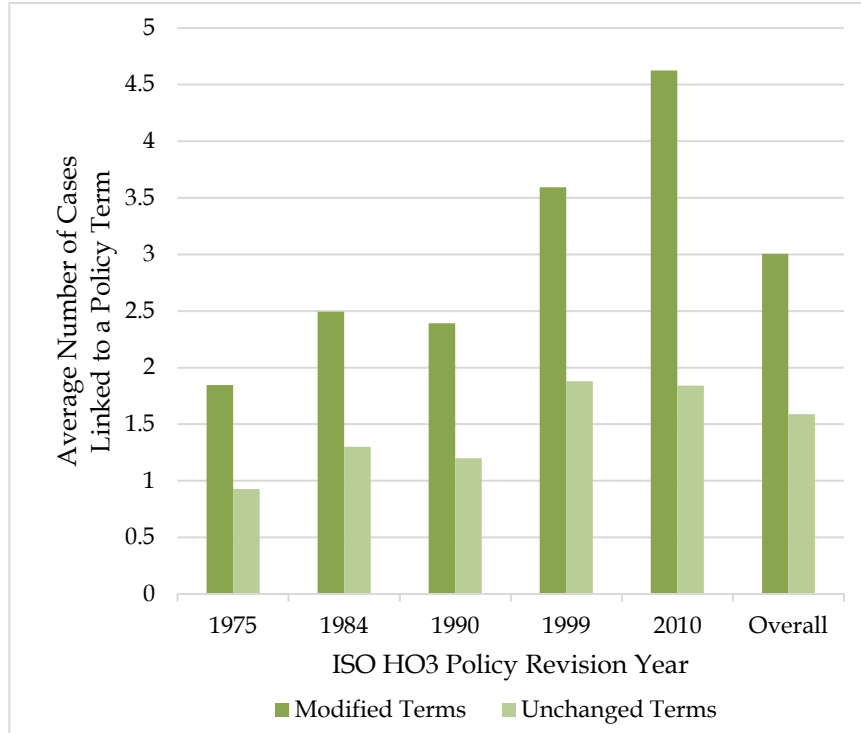


Figure 6: Average Number of Cases Linked to Modified Terms Relative to Unchanged Terms

Indeed, for each revision year other than 1975, the difference between the average number of case links for modified and unchanged terms is statistically significant at a 98% confidence level.¹⁵² When considered across all five policy revisions, the statistical significance of the gap between these two categories is well over 99%.¹⁵³

151. Because we capped at ten the number of case links for each textual change, these figures cannot be explained by a very large number of cases associated with a small number of alterations.

152. These calculations were performed using a simple T test for samples with unequal variances.

153. Moreover, the results understate the average number of case links for changed terms as a result of the self-imposed cap of ten case links per term. *See supra* note 142.

The importance of caselaw in prompting contractual innovation is reinforced by Figure 7, which reports the total percentage of modified and unchanged terms that were linked to at least one case.

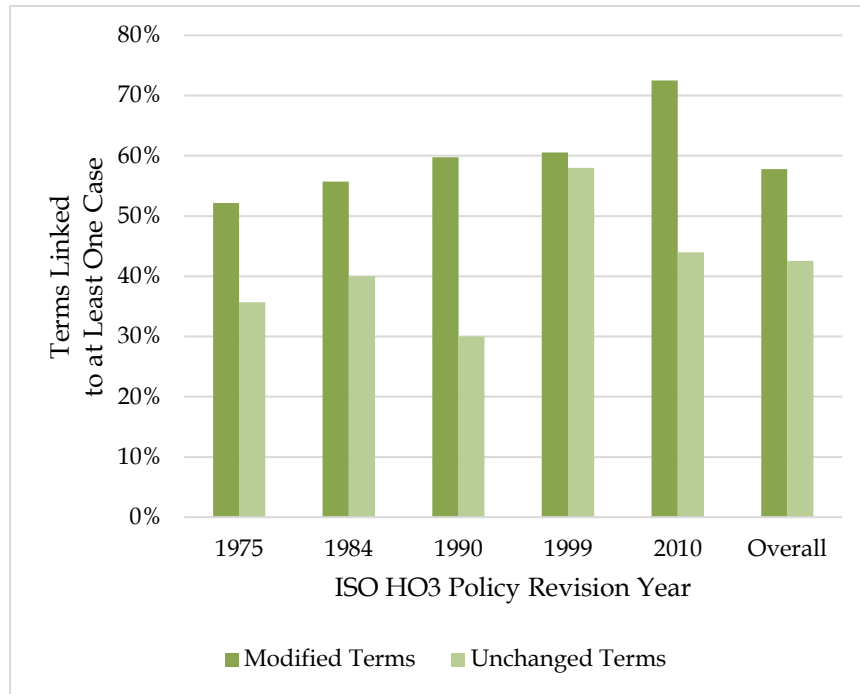


Figure 7: Percentage of Modified Terms and Unchanged Terms Linked to at Least One Case

As Figure 7 reports, in every revision year, modified terms were more likely than unchanged terms to be linked to at least one case.

Although the number of terms that had more than ten cases linked to them varied, this cap disproportionately impacted changed terms relative to the unchanged control terms. For the terms that were materially changed, the number of terms that were capped at ten case links were as follows: in 1975 there were 9 capped terms out of approximately 160 materially altered terms; in 1984 there were 14 capped terms out of approximately 160 materially altered terms; in 1990 there were 6 capped terms out of approximately 90 materially altered terms; in 1999 there were 40 capped terms out of approximately 180 materially altered terms; and in 2010 there were 12 capped terms out of approximately 80 materially altered terms. In total, then, approximately 12% of changed terms were capped. For terms that were not materially changed, the number of capped cases (out of 50 total control terms for each revision) were as follows: in 1975 there were no capped terms, in 1984 there were 4 capped terms, in 1990 there were 6 capped terms, in 1999 there were 3 capped terms, and in 2010 there were 5 capped terms. Thus, only approximately 7% of unchanged terms were capped at ten.

Overall, 58% of modified terms were linked to at least one case, whereas 43% of unchanged terms were linked to at least one case.

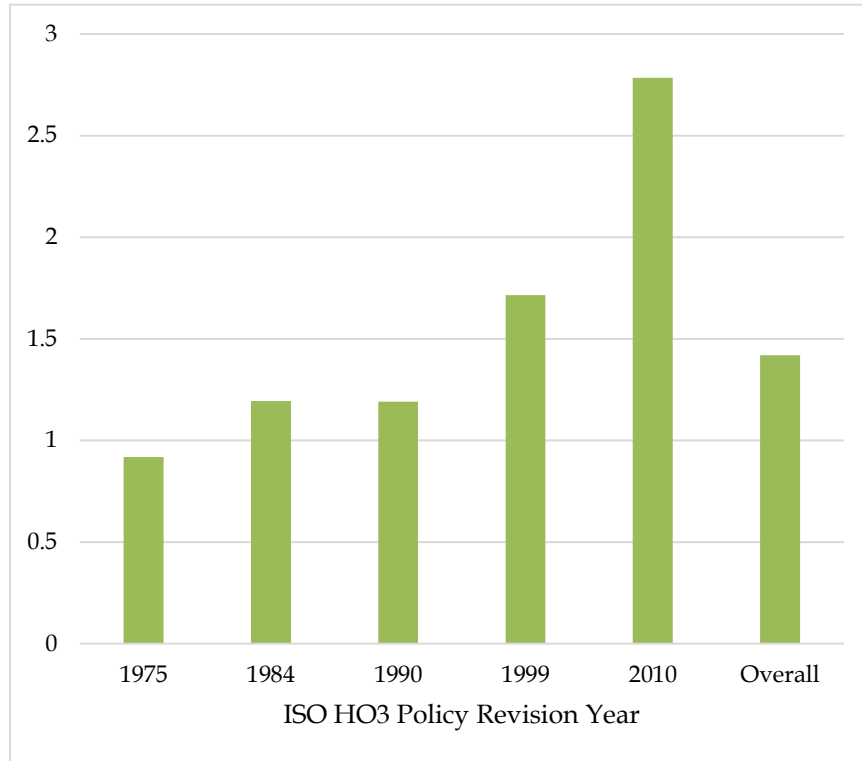


Figure 8: Difference in Average Number of Cases Linked to Modified and Unchanged Terms

The data also suggest a second trend: caselaw seems to have played an increasingly important role in prompting material textual changes to the ISO homeowners policy. As illustrated in Figure 8, the average number of cases linked to a modified term relative to the average number of such case links for unchanged terms has steadily increased with each HO3 update, with the slight exception of the 1990 revision.

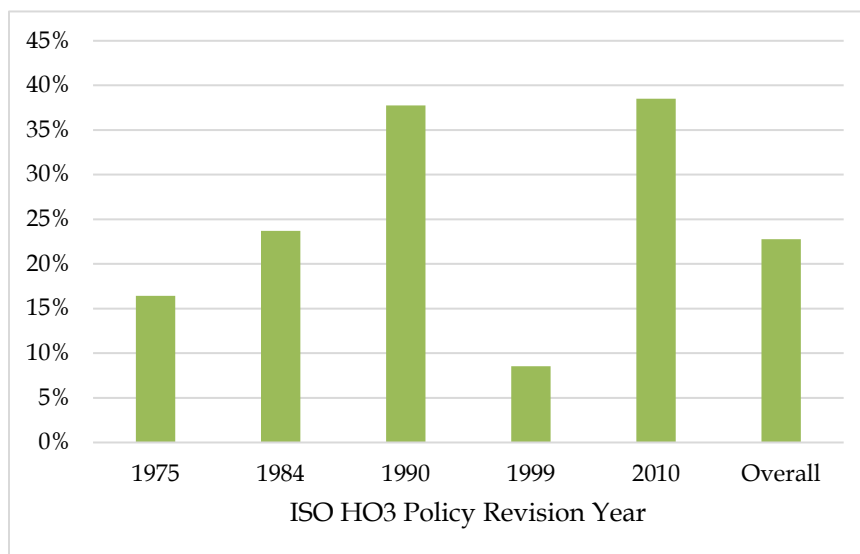


Figure 9: Difference in Percentage of Modified Terms and Unchanged Terms Linked to at Least One Case

Similarly, Figure 9 shows that – with the notable exception of 1999, when a high percentage of unchanged terms were linked to at least one case – the difference between the percentage of modified terms and unchanged terms linked to caselaw has increased in each revision year. Of course, these trends are much more speculative than those above, given that the number of data points for changes over time is limited to the five times that the ISO HO3 policy has been revised.

Interestingly, caselaw seems to have played a much more prominent role in prompting modified terms that restrict or have a mixed impact on coverage than in prompting changes that expand coverage. This conclusion is reflected in Figure 10, which breaks down the average number of cases linked to three different types of modified terms: (i) those that unambiguously restrict coverage (Code 2), (ii) those that have ambiguous or mixed implications with respect to the scope of coverage (Code 3), and (iii) those that unambiguously expand coverage (Code 4). The Figure also reports the average number of cases linked to terms that were left unchanged (Code 0). As the data in Figure 10 suggest, modified terms that restricted coverage generally had the greatest number of

case links, followed closely by modified terms that had an ambiguous impact on the scope of coverage. By contrast, changes that expanded coverage in the ISO HO3 policy were linked on average to a much lower number of cases, which was only slightly larger than the average number of case links for the control group of terms that were unchanged.

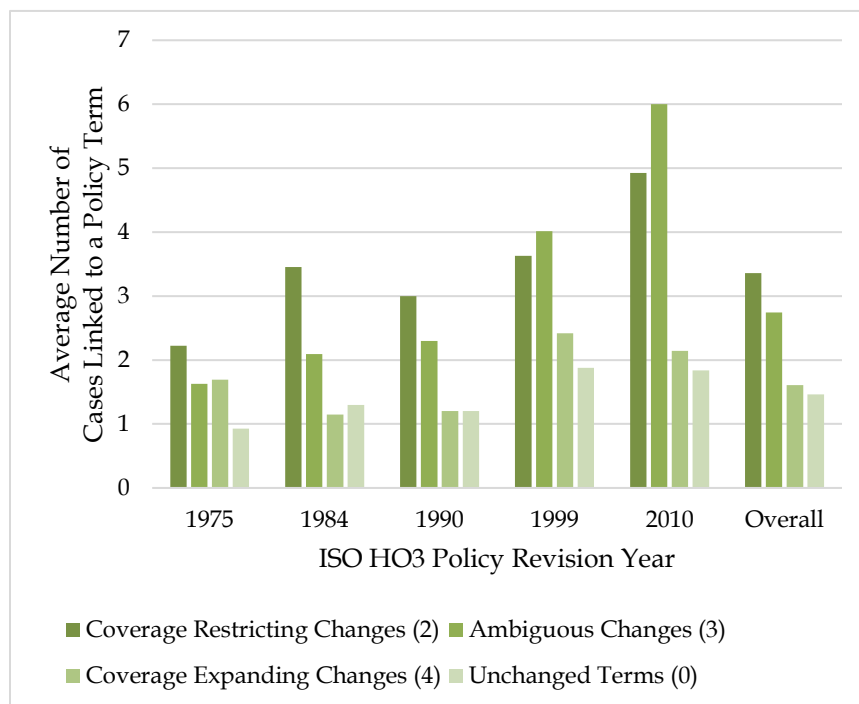


Figure 10: Average Number of Case Links per Modified Terms and Unchanged Terms

The comparatively weak link between caselaw and coverage-expanding modifications is also illustrated by Figure 11. This Figure shows that a majority (51%) of the coverage-expanding modifications were not linked with any cases, as was also true for the unchanged policy terms (57%). By contrast, only about 40% of coverage-restricting (Code 2) and ambiguous (Code 3) modifications were not linked to any cases. Similarly, a much smaller percentage of coverage-expanding modifications were

linked to ten or more cases (3%) than was true for ambiguous (13%) or coverage-restricting (20%) modifications.¹⁵⁴

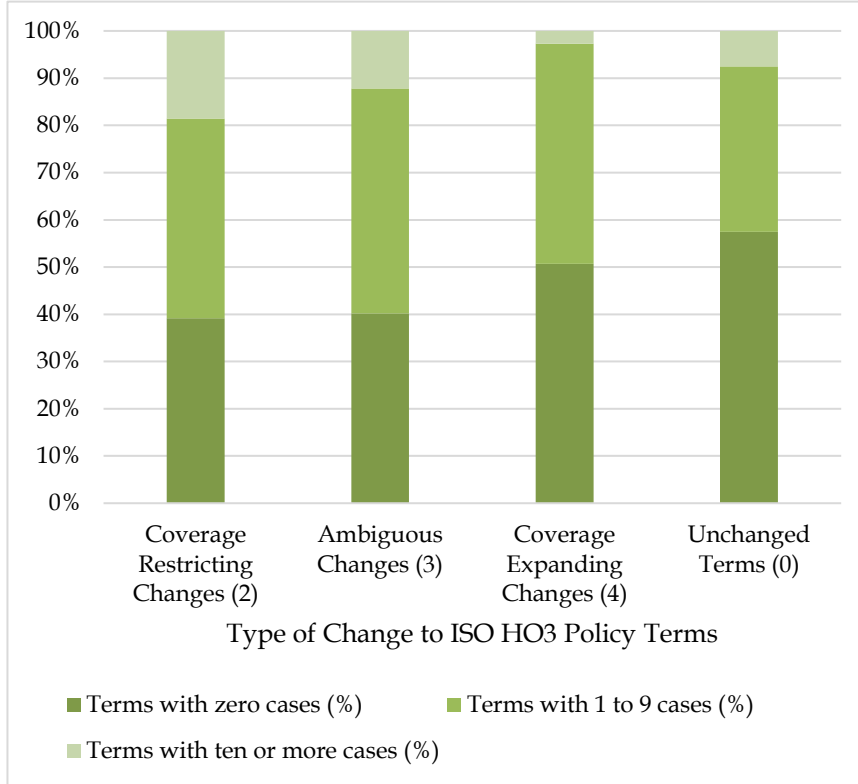


Figure 11: Number of Case Law Links for Modified Terms and Unchanged Terms

Not surprisingly, much of the caselaw that was linked to both material textual modifications and unchanged terms came from state appellate courts.¹⁵⁵ As illustrated in Figure 12, 53% of the cases linked to modified terms came from state intermediate appellate courts, 24% of these cases came from state supreme courts, and 21% came from federal courts. These breakdowns are very similar to the breakdown of cases that were linked to unchanged terms—52% of which came from state intermediate courts, 15% of which came

154. In fact, a smaller percentage of coverage-expanding textual revisions were linked to ten or more cases than the percentage of control terms that is this cap (7%).

155. The relative composition of different types of court decisions does not appear to depend on whether the modification is coverage expanding, coverage restricting, or ambiguous.

from state supreme courts, and 24% of which came from federal courts. These data suggest that the type of court issuing a relevant opinion does not, in and of itself, substantially influence the likelihood that a judicial opinion will prompt contractual change.

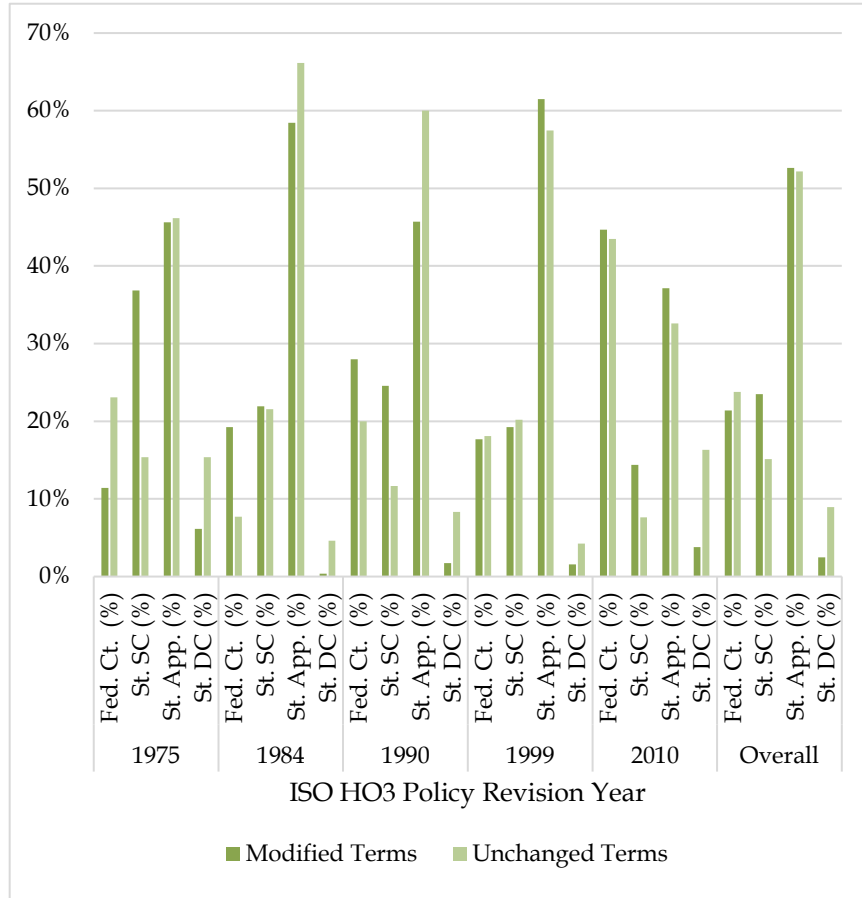


Figure 12: Types of Cases Linked to Terms, by Court

Another notable finding is that policyholders need not consistently prevail in coverage disputes for those disputes to be linked to changed policy language. To the contrary, as reported in Figure 13, insurers prevailed in almost half of all the cases linked to modified terms, a win percentage that was only slightly lower than the baseline win percentage in cases that were linked to unchanged policy terms.

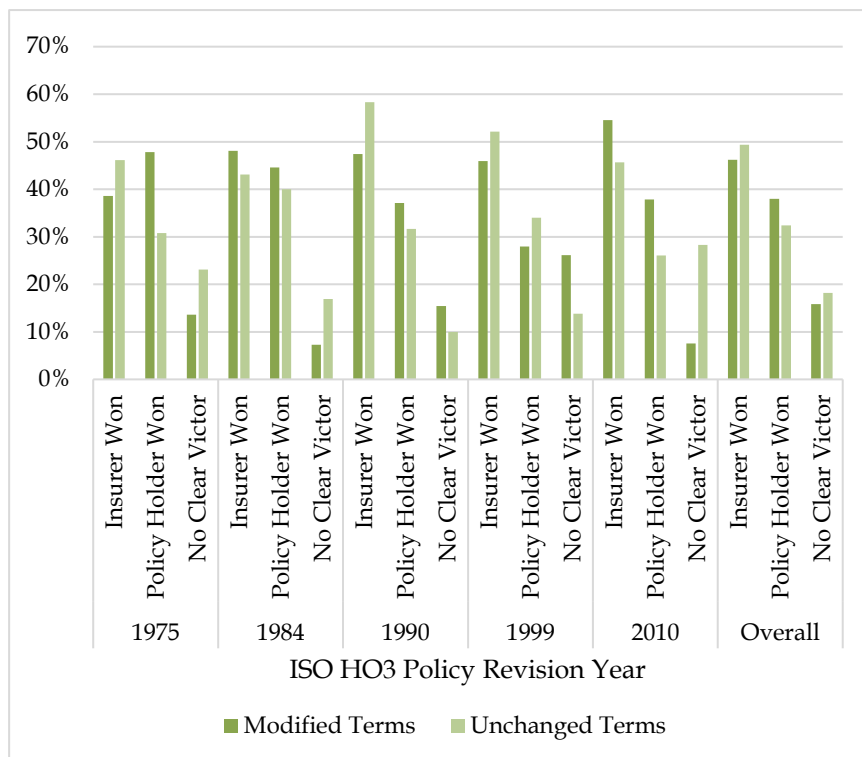


Figure 13: Prevailing Parties in Cases Linked to Terms

The relevance of the mere fact that a term produces litigation, as opposed to who ultimately wins the case, is also suggested by Figure 14. That Figure shows that the type of changes that insurers make to their policy forms are not generally impacted by whether insurers or policyholders prevail in the underlying lawsuits.

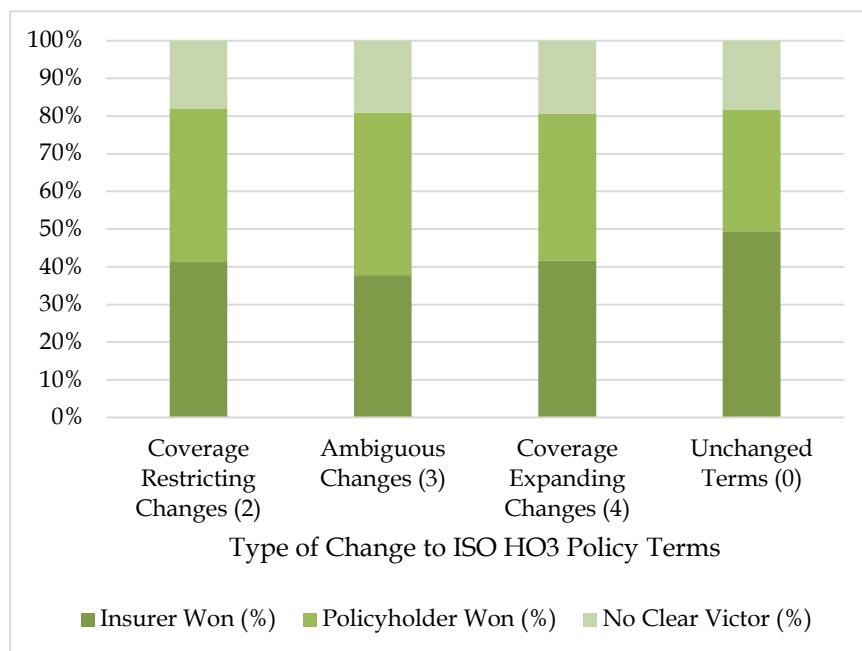


Figure 14: Overall Case Link Breakdown by Outcome

Although policyholders need not consistently prevail to prompt material textual changes in policy language, it does appear that it makes a difference with respect to the likelihood of redrafting if policyholders consistently lose coverage disputes. This point is reflected in Figure 15, which reports that approximately 44% of policy modifications were linked to caselaw that included at least one clear policyholder victory. By contrast, only 21% of the unchanged policy terms were linked to caselaw that included a clear policyholder victory.

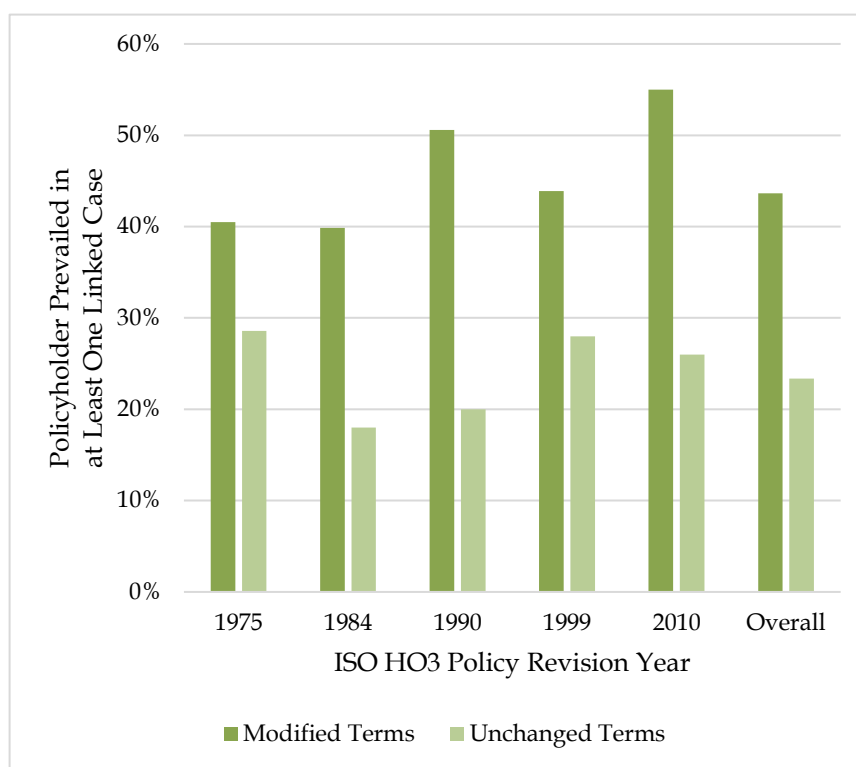


Figure 15: Modified and Unchanged Terms Linked to at Least One Case Where Policyholder Prevailed

IV. IMPLICATIONS FOR INSURANCE AND CONTRACT LAW

Part III suggests that courts have played a major role in shaping the modern homeowners insurance policy. This Part considers the implications of this fact, both for insurance law specifically and for contract law more generally. With respect to the former, it argues that judicially prompted innovation of the ISO HO3 form has promoted more efficient and fair insurance markets, at least for the majority of insurers that continue to rely on policies that closely track the ISO form. For this reason, courts should continue to embrace penalty default rules, like *contra proferentem*, that maximize insurers' incentives to redraft unclear or ambiguous policy language. Section A of this Part also reviews prior research demonstrating that penalty default rules in insurance law have worked less well when it comes to homeowners forms that

substantially depart from the ISO model. The Section argues that, taken together, these findings suggest that states should consider requiring homeowners insurers to use policies that are at least as generous as the ISO HO3 policy.

Section B broadens the analysis to consider the implications of the Article's findings for the empirical literature on contract innovation. Against the backdrop of this literature, the Article's results suggest that different types of contracts can evolve quite differently: whereas sophisticated financial contracts like sovereign bond covenants may be sticky and change through herding, consumer-oriented form contracts may be more likely to evolve steadily in response to judicial pressures. But even within broad categories like consumer and business-oriented contracts, market and institutional structures have a significant impact on the pace and nature of contractual innovation generally and judicially prompted innovation in particular.

A. Insurance Law

1. Insurance law's penalty default rules and the ISO HO3 policy

Insurance policies are often described as contracts of adhesion that are drafted by insurers and offered to consumers on a take-it-or-leave-it basis.¹⁵⁶ But as Part III demonstrates, courts have played a major role in the evolution of the ISO HO3 policy due to their embrace of penalty default rules like *contra proferentem*.¹⁵⁷ This role has ultimately served the collective interests of both insurers and consumers, for two essential reasons.

First, the data clearly demonstrate that, over its fifty-year evolution, the ISO HO3 policy has become longer, more precise, and more fully specified as a result of judicial scrutiny.¹⁵⁸ Not surprisingly, ambiguous, non-specific, and confusing policy language can frequently prompt coverage disputes: insurers have natural incentives to interpret unclear language so as to limit coverage, whereas policyholders have precisely the opposite

156. See, e.g., Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943); Randall, *supra* note 62, at 125; Fischer, *supra* note 62, at 996.

157. See *supra* Section III.B.

158. See *supra* Section III.A.

incentives.¹⁵⁹ Such coverage disputes are costly for all involved: aside from the obvious legal costs that these clashes produce, they also leave insureds who have recently suffered a loss in a state of prolonged uncertainty and stress.¹⁶⁰ Additionally, the legal costs that insurers incur in these disputes are likely passed on to their policyholders at least partially in the form of increased premiums.

Precise and specific homeowners policies help to limit the likelihood of these costly and taxing coverage disputes. Perhaps most obviously, clear and specific policy language allows insurance adjusters and claims supervisors to more reliably and quickly determine their insurer's coverage obligations.¹⁶¹ Just as importantly, however, such clarity empowers consumers—often with the help of family, friends, or advisors—to decipher their coverage rights relatively clearly after a loss has occurred.¹⁶² This is because state law generally requires insurers that deny a claim or issue a reservation of rights letter to promptly provide a written explanation for their decision that quotes the relevant policy language.¹⁶³ Whereas policyholders rarely read policy language closely when they first purchase coverage,¹⁶⁴ they can and often do

159. See JAY M. FEINMAN, *DELAY, DENY, DEFEND: WHY INSURANCE COMPANIES DON'T PAY CLAIMS AND WHAT YOU CAN DO ABOUT IT* (2010).

160. See Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735 (2009).

161. Insurers rarely deny coverage when clear and precise policy language requires the provision of such coverage, as doing so exposes them to the threat of punitive damages for a bad faith denial of a claim. See Mark J. Browne, Ellen S. Pryor & Bob Puelz, *The Effect of Bad-Faith Laws on First-Party Insurance Claims Decisions*, 33 J. LEGAL STUD. 355 (2004); Danial P. Asmat & Sharon Tennyson, *Does the Threat of Insurer Liability for "Bad Faith" Affect Insurance Settlements?*, 81 J. RISK & INS. 1 (2014).

162. See Schwarcz, *Coverage Information*, *supra* note 30, at 1494–98; Boardman, *Tested Language Defense*, *supra* note 62.

163. See Schwarcz, *Coverage Information*, *supra* note 30, at 1496; see, e.g., ARK. CODE ANN. § 23-66-206(13) (2020); COLO. REV. STAT. § 10-3-1104 (2015); FLA. STAT. ANN. § 626.9541 (2019).

164. To be sure, the increasing length and complexity of the ISO HO3 policy has made it even more difficult for consumers to fully read and understand that policy at the time of purchase. But consumers do not read and/or understand even relatively short standard form contracts. See Yannis Bakos, Florencia Marotta-Wurgler & David R. Trossen, *Does Anyone Read the Fine Print? Consumer Attention to Standard-Form Contracts*, 43 J. LEGAL STUD. 1, 4 (2014). The increasing length and complexity of the HO3 policy is thus unlikely to change this result for the vast majority of consumers. For those consumers who do wish to have a better sense of what their policy covers at the time of purchase, the solution is not a misguided attempt for a more "readable" and "simplified" insurance policy, but the design of a standardized summary disclosure form that contains the key details consumers care about. See Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in*

read this language closely when trying to understand whether they have been rightly denied insurance proceeds.¹⁶⁵

To be sure, precision and specificity in homeowners policies would do little to advance consumer interests if they only operated to restrict coverage. But the second reason that judicial scrutiny has improved insurance markets is that it has prompted revisions to the ISO HO3 policy that reasonably balance consumers' desire for protection against insurers' legitimate need to minimize dangers like moral hazard and adverse selection.¹⁶⁶ Rather than inexorably narrowing coverage, the data show that judicially promoted revisions to the ISO HO3 policy have resulted in terms that have a mixed impact on coverage almost as often as they have produced terms that unambiguously restrict coverage.¹⁶⁷ The data also show that unambiguous expansions of coverage are relatively common, though these changes appear not to be driven by caselaw.¹⁶⁸

The lack of a clear link between unambiguous coverage expansions and court cases is consistent with the conclusion that judicial scrutiny of the ISO HO3 policy has prompted reasonable and even-handed coverage revisions. This is because coverage expansions in response to judicial decisions typically manifest themselves not as changes in policy language, but instead as the retention of policy language, notwithstanding caselaw finding that language is ambiguous. Insurance law's penalty default rules are specifically designed to expand coverage when the policy itself is ambiguous or contains gaps.¹⁶⁹ Meanwhile, as noted above, affirmatively redrafting ISO policy terms to produce this result is both costly and risky.¹⁷⁰ For these reasons, it is easier for insurers to

Insurance Consumer Protection, 61 UCLA L. REV. 394, 420–25 (2014) [hereinafter Schwarcz, *Transparently Opaque*].

165. See generally Hoffman, *supra* note 58, at 1412 (“Most argue, in one form or another, that even if terms don’t affect behavior ex ante, they certainly can ex post.”).

166. See *supra* Section III.A.

167. See *id.*

168. See *supra* Section III.B. This is especially true early in the ISO HO3 policy's evolution. Later in the policy's evolution, coverage restrictions start to outpace coverage expansions. But this is consistent with the fact that, as the contract has matured, an increasingly large percentage of revisions are prompted by court cases. This trend, in turn, can best be explained by the fact that decades of revisions have left little need for contract revisions in the absence of changed circumstances, like relevant court cases.

169. See ABRAHAM & SCHWARCZ, *supra* note 6, at 58–59. See generally Ayres & Gertner, *supra* note 29, at 90.

170. See *supra* Section II.A.2.

expand coverage in response to judicial scrutiny simply by retaining language that courts have repeatedly found ambiguous,¹⁷¹ rather than by explicitly altering the ISO form.¹⁷²

The tendency of changes to the ISO HO3 policy to both increase precision and reasonably balance consumer and insurer interests is not surprising. There are good reasons to believe that detailed and precise terms in the ISO HO3 policy facilitate the ability of consumer proxies, like state regulators and market intermediaries—such as agents, brokers, journalists, consumer activists, and academics—to understand exactly what is and is not covered by the homeowners policy and to advance consumer interests accordingly. For instance, a clear term limiting coverage for mold-related claims may prompt a regulator to withhold approval of the policy form unless coverage is extended for specific mold losses that are unlikely to involve moral hazard.¹⁷³ Alternatively, such an exclusion may prompt insurance agents to object that this type of change will make it harder to sell coverage. These possibilities, of course, impact how ISO drafts coverage restrictions in the first place.

By contrast, it is much harder for regulators or market intermediaries to advocate for more coverage-expansive terms in policies containing extensive gaps or ambiguities. Not only is there the problem of “spotting” the existence of an important gap or ambiguity in the first place, but it’s also hard to anticipate the various ways in which such gaps and ambiguities may become relevant in different claims settings.¹⁷⁴ And even in the rare cases when regulators and intermediaries identify potential ambiguities or gaps, they often cannot predict how insurers will respond when a claim is actually made.¹⁷⁵ By forcing these issues to be addressed

171. See Boardman, *Contra Proferentem*, *supra* note 20, at 1113–14, 1117; French, *Insurance Policies*, *supra* note 20, at 40; ABRAHAM & SCHWARCZ, *supra* note 6, at 615 (noting that courts have “created a body of common law rules” governing the duty to defend, and “[a]pparently insurers can live with the results, as they have not revised their policies to alter” them).

172. Of course, such redrafting would be optimal because it would enhance the form’s precision and specificity, as described above.

173. See Schwarcz, *Coverage Information*, *supra* note 30, at 1492–94. State insurance regulators in most states can refuse to approve homeowners policy forms. *See id.*

174. *See generally* Schwarcz, *Coverage Information*, *supra* note 30, at 1474.

175. For example, in attempting to justify the inclusion of an “absolute pollution exclusion” in commercial general liability policies, the industry claimed that “the language of the exclusion was drafted with unrealistic breadth to ensure its effectiveness,” but “it

clearly within the four corners of the industry standard policy, judicially prompted innovation thus effectively “activates” the ability of market intermediaries and regulators to represent consumer interests. It is for precisely this reason that judicially prompted changes to the ISO HO3 policy often result in revisions that have a mixed impact on the scope of coverage.¹⁷⁶

In sum, insurance law’s embrace of penalty default rules generally, and *contra proferentem* in particular, appears to have played a major role in causing the ISO homeowners insurance policy to become clearer and more precise.¹⁷⁷ This contractual innovation, in turn, has facilitated compromise regarding the scope of coverage provided by that policy while empowering consumers and their advisers to accurately and quickly understand their coverage rights after a loss has occurred. For these reasons, insurance law should continue to embrace strong penalty default rules.¹⁷⁸

2. Penalty default rules and non-ISO homeowners policies

Although the evolution of the ISO HO3 policy has largely served consumer and insurer interests alike, the same cannot be said for the recent emergence of proprietary homeowners policies that depart significantly from ISO forms.¹⁷⁹ To be sure, like the ISO HO3 policy, these proprietary forms often have the benefits of precision and completeness described above.¹⁸⁰ But as I have

would not be literally enforced against insured[s] in cases where doing so would be inconsistent with basic understanding about the policy.” Jeffrey W. Stempel, *Unmet Expectations: Undue Restriction of the Reasonable Expectations Approach and the Misleading Mythology of Judicial Role*, 5 CONN. INS. L.J. 181, 235–36 (1998).

176. See *supra* Section III.B.

177. Although policyholders need not consistently prevail for caselaw to prompt changed policy language, they must have a significant chance of winning for this result to obtain. See *supra* Section III.B. Indeed, policy revisions were much more likely than control terms to be linked to at least one clear policyholder victory. See *id.* Additionally, cases with plausible arguments are much more likely to prompt published caselaw, as opposed to summary dismissals in unpublished opinions. See, e.g., Bert I. Huang & Tejas N. Narechania, *Judicial Priorities*, 163 U. PA. L. REV. 1719 (2015).

178. But see Rappaport, *supra* note 98, at 207–08 (arguing that *contra proferentem* does not ultimately promote effective and efficient insurance markets).

179. See generally Schwarcz, *Reevaluating*, *supra* note 7 (exploring in depth the prevalence and characteristics of homeowners policies that depart significantly from the ISO HO3 policy).

180. See *id.*

explored at length in prior work, these policies typically do not embrace compromise positions when it comes to changes in coverage; to the contrary, they often systematically restrict coverage relative to the ISO HO3 form.¹⁸¹

The reason for this different result is that, unlike changes to the ISO policy, innovation in proprietary forms is not well policed by regulators and market actors. Because of ISO's historically dominant role in drafting homeowners insurance policies, an immense amount of attention is devoted to revisions of these forms. For instance, numerous trade publications for brokers, agents, lawyers, and underwriters publish articles about revisions to major ISO programs, like the homeowners program.¹⁸² Copies of these updated ISO forms are published in materials that are used to train aspiring insurance lawyers, agents, and underwriters.¹⁸³ Perhaps even more importantly, state regulators often spend a great deal of time reviewing proposed revisions to the ISO HO3 policy.¹⁸⁴ This is because ISO itself, in order to facilitate insurer use of these documents, secures regulatory approval of its policy forms in every state in the country that requires such approval.¹⁸⁵ Knowing that these filings have disproportionate influence on consumers, state regulators often review these filings carefully and demand various concessions, which are reflected in state-specific endorsements.¹⁸⁶ This regulatory review process is presumably aided by state insurance regulators' relative familiarity with prior versions of ISO

181. *See id.*

182. *See, e.g.,* Miller, *supra* note 112; Patrick Wraight, *How Does the Homeowners' Policy Deal with Trees?*, INS. J.: ACAD. J. (Oct. 11, 2017), <https://www.insurancejournal.com/blogs/academy-journal/2017/10/11/466847.htm>; Patrick Wraight, *4 Reasons Your Insured Wants Ordinance or Law Coverage*, INS. J.: ACAD. J. (Jan. 3, 2018), <https://www.insurancejournal.com/blogs/academy-journal/2018/01/03/475878.htm>.

183. *See, e.g.,* ABRAHAM & SCHWARCZ, *supra* note 6, at 197–223; TOM BAKER & KYLE D. LOGUE, *INSURANCE LAW AND POLICY* (4th ed. 2017); INS. INFO. INST., *supra* note 127; MCCORMICK & CLAPP, JR., *supra* note 80.

184. *See New ISO Residential Property Policy Forms Approved*, TEX. DEP'T INS. (Sept. 6, 2014), <https://www.tdi.texas.gov/orders/co020741.html>; VERISK, *Homeowners 2000*, *supra* note 89.

185. *See, e.g.,* *ISO Files Insurance Policy Forms and Rules Insurers Can Use for Terror Coverage Under New Federal Backstop Law*, VERISK (Dec. 4, 2002), <https://www.verisk.com/archived/2002/iso-files-insurance-policy-forms-and-rules-insurers-can-use-for-terror-coverage-under-new-federal-ba/>.

186. *See, e.g.,* *New ISO Residential Property Policy Forms Approved*, *supra* note 184 (describing rigorous regulatory review of ISO HO3 policy form submissions, including numerous concessions made by ISO to secure regulatory approval for use of form in Texas).

homeowners forms, which allows them to quickly grasp a revision's structure and the potential implications of its proposed changes.

By contrast, regulators and market intermediaries are poorly situated to police innovation in proprietary forms that significantly depart from ISO forms. Whereas ISO forms operate as a single point of focus because of their historical dominance in homeowners insurance markets, individual insurers are often able to escape rigorous regulatory and market scrutiny of their policy forms.¹⁸⁷ This is because many, if not most, state insurance regulators simply do not have the resources to carefully review and understand the implications of numerous different individual carriers' company-specific forms.¹⁸⁸ It is one thing to carefully review a handful of changes to the long-dominant industry form with which regulators have worked for decades; it is quite another to review changes to numerous different companies' individual forms, which have their own unique structure and internal logic.

The different levels of scrutiny that ISO policy revisions and revisions to individual insurers' proprietary policies receive are even more stark when it comes to market intermediaries. Individual insurers' changes to their proprietary forms are largely invisible to most market actors: these changes are not typically covered by industry periodicals or taught in classes for industry professionals.¹⁸⁹ In fact, it is incredibly difficult even to secure copies of individual insurers' proprietary forms, which carriers do not generally make available online or allow to be reprinted in industry sources.¹⁹⁰ Additionally, very few people—including many insurance agents—know how each of these proprietary

187. See generally Schwarcz, *Reevaluating*, *supra* note 7, at 1318–37 (outlining the difficulty in obtaining company-specific forms).

188. See BIPARTISAN POL'Y CTR., *IMPROVING U.S. INSURANCE REGULATION* 18–19 (2017).

189. See generally Schwarcz, *Reevaluating*, *supra* note 7, at 1328–37 (discussing the lack of available information regarding the content of individual insurers' proprietary policies).

190. See Schwarcz, *Transparently Opaque*, *supra* note 164, at 425–26. See generally RUTGERS CTR. FOR RISK & RESP., *ESSENTIAL PROTECTIONS FOR POLICYHOLDERS* 10–17 (2019), https://epp.law.rutgers.edu/sites/epp/files/EPP-full-2019_0.pdf (recommending taking action to protect consumers and provide online resources); RUTGERS CTR. FOR RISK & RESP., *ESSENTIAL PROTECTION FOR POLICYHOLDERS STATE RANKINGS OF HOMEOWNERS INSURANCE PROTECTIONS: BUYING INSURANCE* (2017), <https://epp.law.rutgers.edu/sites/epp/files/EPP%20Buying%20insurance.pdf> (finding that “[o]nly five states make homeowners insurance policy forms available online” and “[a]bout a dozen states provide some tool that consumers can use to compare policy terms”).

policy forms differ from the ISO HO3 policy.¹⁹¹ For these reasons, market and regulatory forces do much less to effectively constrain change to these company-specific forms than to the ISO HO3 policy.

Insurers' increasing use of proprietary forms that depart significantly from the ISO standard creates numerous market problems even apart from their tendency to systematically reduce coverage in ways that consumers do not understand. Most importantly, varying policy forms undermine the extent to which consumers can make trade-offs on issues about which they are relatively informed, like price and customer service.¹⁹² This is because they prevent consumers from making apples-to-apples comparisons among competing carriers.¹⁹³ Meanwhile, such variety does not plausibly promote meaningful consumer tradeoffs between coverage and price nor enhance efficient contractual innovation precisely because so few policyholders have even a rudimentary understanding of whether their insurance policy departs from ISO language and, if so, the implications of these departures. Varying policy forms also undermine the capacity of consumers, regulators, and market intermediaries to develop and communicate clear understandings of what is and is not covered by homeowners insurance; although innumerable sources provide generalized answers to this question, most specific coverage questions can only be answered by explaining that "it depends on your policy language."¹⁹⁴

States should respond to these vast differences in the evolution of ISO consumer-oriented insurance policies and company-specific proprietary policies by considering the very same solution that they adopted over a century ago—when they required fire insurers to offer coverage that was no less generous than that contained within a standard policy.¹⁹⁵ These rules have become largely obsolete as a

191. Schwarcz, *Reevaluating*, *supra* note 7, at 1328–37.

192. See Schwarcz, *Transparently Opaque*, *supra* note 164, at 420–27.

193. See Abraham L. Wickelgren, *Standardization as a Solution to the Reading Costs of Form Contracts*, 167 J. INSTITUTIONAL & THEORETICAL ECON. 30 (2011).

194. See, e.g., NAT'L ASS'N OF INS. COMM'RS, A CONSUMER'S GUIDE TO HOME INSURANCE 1 (2010).

195. See Lecomte, *supra* note 64, at 228–29. In fact, many states continue to require that fire insurance included within homeowners insurance policies be no less generous than statutorily-prescribed forms. See, e.g., *Watson v. United Servs. Auto. Ass'n*, 566 N.W.2d 683, 692 (Minn. 1997). Interestingly, many states also required life insurers to issue a standard

result of the evolution of the bundled homeowners policy, which provides protection from numerous perils in addition to fire, as well as liability protection.¹⁹⁶ By elevating ISO homeowners insurance policies from presumptive and historical default into a legally-required minimum floor of coverage, states could reinvigorate this historical solution to the problem of varying policy forms that hollow out coverage.¹⁹⁷ And they could do so by piggy-backing on the various benefits of judicially prompted innovation of the ISO HO3 form.¹⁹⁸

To be sure, there are plausible objections to completely standardizing homeowners insurance policies. For instance, doing so would indeed limit choice for the small segment of consumers who trade off coverage terms and price when shopping for coverage. This concern is partly addressed by allowing insurers to provide more expansive coverage than the ISO HO3 policy, but this would not address the preferences of consumers who would choose less expansive coverage for lower premiums. Another potential concern is that converting the ISO HO3 policy form into a state-required minimum could complicate ISO's revision process while empowering a private company to set legal standards. Here too, however, there is at least a partial solution: state law could require insurers to offer coverage at least as generous as a specific version of the ISO HO3 policy rather than dynamically incorporating by reference updated versions of the policy that were produced after the law's passage.¹⁹⁹ Doing so would ensure that state legislatures, rather than just the ISO, would have to affirmatively approve changes to the HO3 policy before those changes became part of the state-required floor for coverage.

life insurance policy in the earlier twentieth century for similar reasons. *See* Coyle, *supra* note 35, at 1163.

196. *See supra* Section II.A.

197. *See* Schwarcz, *Reevaluating*, *supra* note 7, at 1340–43.

198. *See id.* at 1341 (noting that a major consideration in whether states should adopt mandatory floors for coverage is whether states could work with ISO to design a workable floor based on an ISO model).

199. *See* Daniel Schwarcz, *Is U.S. Insurance Regulation Unconstitutional?*, 25 CONN. INS. L.J. 191, 197 (2018) (discussing problems associated with state insurance law's dynamic incorporation by reference of NAIC standards).

B. The Varied and Context-Specific Role of Courts in the Evolution of Form Contracts

Aside from its implications for insurance law, this Article's results also help to advance the burgeoning empirical literature on contractual innovation.²⁰⁰ First, the results suggest that while standard form contracts may be resistant to change in many domains, this result is hardly inevitable. Although the evolution of the homeowners insurance policy has surely been gradual—spanning well over fifty years—it has also been relatively responsive to court cases.²⁰¹ Moreover, the various instances when homeowners insurance policies have not changed in response to relevant court cases are best understood as an affirmative decision by insurers to expand coverage, rather than as evidence of irrational contractual stickiness.²⁰²

Perhaps not surprisingly, this pattern of innovation in homeowners insurance policies is more consistent with evidence regarding the evolution of consumer contracts than sophisticated commercial contracts. As discussed in Part I, sophisticated financial instruments like sovereign bond contracts often exhibit patterns of prolonged stickiness paired with sudden change prompted by mass herding to new terms.²⁰³ By contrast, innovation in the most closely studied, consumer-oriented form contracts—EULAs—appears to be relatively robust. This is especially true when firms can observe the impact of policy language through judicial decisions or changes in consumer behavior.²⁰⁴ Because virtually all terms in homeowners policies fit this description, the patterns of innovation exhibited by the ISO HO3 policy are consistent with these findings.

The emerging evidence thus suggests that, other things being equal, consumer contracts are more likely than sophisticated commercial contracts to exhibit gradual but persistent innovation, particularly with respect to relevant caselaw. This possibility can be explained in a variety of ways from a theoretical perspective. For instance, drafters of consumer-oriented contracts may be relatively

200. *See supra* Part I.

201. *See supra* Part III.

202. *See supra* Section III.B.

203. *See supra* Section I.A.

204. *See Dari-Mattiacci & Marotta-Wurgler, supra* note 4, at 4–5.

less worried about the potential signaling effect of revising contract terms, as most consumers are unlikely to be responsive to these types of signals given that they do not read contracts in the first place. Alternatively, drafters of consumer contracts may not internalize the benefits of contract standardization across time, which principally benefits consumers. Yet another possibility is that free-riding on contract innovation is easier to overcome in the context of consumer-oriented contracts, as consumer-facing firms tend not to compete with one another based on contract terms.

The divergent evolution of the ISO HO3 policy and individual insurers' proprietary policies also helps to shed light on the direction and impact of innovation in consumer-oriented contracts. As with innovation of EULA contracts, revisions to homeowners policies have tended to result in longer and more complex contracts.²⁰⁵ But while changes to both EULA terms and proprietary homeowners policies tended to be pro-seller, the impact of innovation in the ISO HO3 policy was more balanced between consumer and seller interests. Consistent with the substantial theoretical literature on the efficiency of standard form contracts,²⁰⁶ these trends tend to suggest that innovation of consumer forms is more likely to be balanced to the extent that this innovation can be easily policed by informed and unbiased consumers, market intermediaries, and government actors. As suggested earlier, such policing is much more difficult when it comes to heterogeneous consumer contracts that are crafted by individual firms than when it comes to a single, dominant form contract that is the presumptive industry default, like the ISO HO3 policy.²⁰⁷

CONCLUSION

Homeowners insurance policies are among the most important standard form consumer contracts in the United States. The historical dominance of one particular version of this contract – the ISO HO3 policy – offers a unique opportunity to understand how

205. See *supra* Section I.B, Part III.

206. See generally Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1217–18 (2003); Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1376–77 (2004).

207. See *supra* Section IV.A.

this contract has evolved over time. Meanwhile, the relatively recent tendency of several large, national insurers to depart from this standard form offers unique insights into how consumer contracts evolve under different market and institutional conditions. Exploiting these elements of the homeowners insurance market, this Article demonstrates that the ISO HO3 policy has evolved consistently over time in response to caselaw, in ways that largely promote the joint interests of insurers and consumers. By contrast, insurers that have jettisoned the ISO form in favor of divergent proprietary policies have tended to revise their policies to systematically restrict coverage. These divergent paths offer important lessons both for insurance law and for the burgeoning empirical literature on contract innovation.

