FRAGMENTED RISK: AN INTRODUCTION

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Consider two potential paradoxes about the breadth and limits of insurance, one in property insurance and one under the Commercial General Liability ("CGL") policy.

Most homeowners have only the vaguest sense of the extent of coverage provided by their homeowners' insurance policy, particularly the breadth of coverage it provides. Using as an example the HO-3 policy, the most widely used policy, most homeowners would not be surprised to know that it covers physical damage to their home and its contents and their tort liability for accidents to visitors to their home. More likely they would be surprised to learn that it covers damage to their personal property "while it is anywhere in the world," medical expenses to visitors to the home or other persons injured "by the activities of the insured" even in the absence of the homeowners' legal liability to the visitors or other persons, and the homeowners' liability for personal injury for accidents unrelated to the home at all.

On the other hand, many homeowners are surprised to learn that much catastrophic damage to their home—precisely what they intended to insure against—is not covered by the policy. After natural disasters such as Hurricane Katrina or Superstorm Sandy, property owners and their insurers dispute whether damage was caused by wind or water, and in what sequence. Water damage from storms and many other sources typically is excluded under homeowners' policies, and increasingly broad anti-concurrent causation clauses attempt to exclude coverage for damage caused by wind and water. The problem is exacerbated because, although virtually all property owners have homeowners' insurance, large numbers of them do not purchase federal flood insurance, even if they are in flood-prone areas.[1]

Under the CGL policy, coverage is, as the policy's name suggests, "general." It covers a wide range of potential sources of liability of the insured, particularly for bodily injury, but also for "personal and advertising injury," only some of which has to do with advertising and is not personal in the sense of physical injury. At the same time, the CGL policy is now "commercial" and not, as in a prior iteration, "comprehensive."[2] It contains a long list of exclusions, and insurers attempt to expand the list by litigation and ultimately redrafting. What began with questions about coverage for pollution and asbestos has now spread to mold, Chinese drywall, and even climate change.

Each of these paradoxes reflects the tension between bundling and fragmenting risk. One of the great virtues of many modern insurance policies is that they bundle related risks. A homeowners' policy covers many risks of loss or liability related to owning a home, a CGL policy covers many of the business activities that may result in liability, and, in another context, a health insurance policy contains broad coverage, especially following the Patient Protection and Affordable Care Act. At least some of the limitations or exclusions logically involve large, relatively obvious categories of loss, such as liability arising from the use of a motor vehicle under a homeowners' policy and expected or intended losses in the ordinary course of business under the CGL policy.

Policyholders benefit from bundling risk because coverage is easier to purchase and more predictable, in that there are fewer gaps in coverage and those gaps that remain are more easily understood. Insurers benefit because they insure a large number of policyholders with related but not identical risk

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[1] *See* Donald T. Hornstein, *The Balkanization of CAT Property Insurance: Financing and Fragmentation in Storm Risks*, 11 RUTGERS J.L. & PUB. POL'Y 9 (2013).

[2] *See* Jeffrey W. Stempel, *Rediscovering the Sawyer Solution: Bundling Risk for Protection and Profit*, 11 RUTGERS J.L. & PUB. POL'Y 170 (2013); Harold Weston, *À la Carte Coverage. Unbundling Causes of Losses and Coverage Grants to Allow Consumer-Insured Selection*, 11 RUTGERS J.L. & PUB. POL'Y 38 (2013). Each article notes the shift from Comprehensive General Liability to Commercial General Liability.

profiles; thus, insurers' benefit from the law of large numbers and because policies covering more risks generate more premium dollars.[3]

At the same time, as the examples show, insurance policies fragment risk through exclusions, narrow definitions, and other limitations. Insurers fragment policies to exclude coverage for correlated risks where potential losses are high, to reduce premium costs to respond to market conditions, and to reduce potential liability for new and unanticipated risks.

Fragmented risk was the topic of a conference sponsored by the Rutgers Center for Risk and Responsibility ("RCRR") on March 1, 2013, and was the source of the articles in this issue of the Rutgers Journal of Law and Public Policy.[4] It is a theme that runs throughout many of the issues and controversies in insurance law, but one that has received insufficient attention. As part of the mission of the RCRR, the purpose of the conference was to engage academics, industry professionals, lawyers, and regulators in discussion of the issues that arise in bundling and fragmenting risk. My RCRR colleagues, Adam Scales and Rick Swedloff, and I are delighted with this symposium issue of the Rutgers Journal of Law and Public Policy. It makes the papers available to a wider audience and, by publishing them together, highlights the issue of fragmented risk.

As the papers by Jeffrey Stempel and Harold Weston demonstrate, the long-term trend in insurance in the United

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[3] The premium dollars can be invested over a long period of time until claims, even many large claims as in the asbestos cases, are paid out in inflation-devalued dollars. *See* Stempel, *supra* note 2.

[4] Other papers presented at the conference were Christopher C. French, *The Aftermath of Catastrophes: Valuing Business Interruption Insurance Losses*, 30 GA. ST. L. REV. (forthcoming Fall 2013) and Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 UCLA L. REV. (forthcoming 2014). We are also grateful to the commentators at the conference, whose participation enlivened the event and improved these papers: Thomas Considine, Chief Operating Officer of MagnaCare and former Commissioner of the New Jersey Department of Banking and Insurance; Professor Peter Kochenburger, University of Connecticut School of Law; and Dr. Steven Weisbart, Senior Vice President and Chief Economist at the Insurance Information Institute.

States has been toward bundling risk.[5] Stempel celebrates the triumph of Elmer Sawyer in replacing a multitude of narrower liability policies, notably Public Liability Insurance and Premises and Operations Insurance, with a single policy that was general and initially comprehensive. Weston recounts how homeowners' insurance originally was only fire insurance but now includes protection against a wide variety of perils and includes liability protection as well.[6] Automobile insurance policies have seen a similar pattern; generally, they are required to contain only low-limit liability and sometimes no-fault insurance, but they often include insurance on the vehicle itself and uninsured/underinsured motorist coverage.

A long-term trend is made up of many short-term trends, however, and a theme of the conference and papers is that insurers increasingly fragment risks. The papers suggest that the process of fragmentation occurs in different ways.

Property insurance's encounter with hurricanes and similar natural disasters illustrates a familiar pattern of explicit fragmentation of a particular risk. Flood insurance was widely offered until the Mississippi River flood of 1927, and floods from New Hampshire to California the following year demonstrated the problem of correlated risk. Over the next several decades, homeowners' insurance became more fragmented by expressly excluding water damage. Donald Hornstein's paper describes the parallel "hollowing out" of wind coverage in heavily affected states, with higher deductibles and lower coverage limits or the refusal of coverage altogether in high risk areas.[7] As a result, states have been forced to create their own insurers of last resort, but even those pools have provided limited coverage. The fragmentation has occurred through an iterative process of policy drafting, conflict and litigation, judicial interpretation, and redrafting. Hornstein describes how, as the water damage

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[5] Stempel, *supra* note 2; Weston, *supra* note 2. James Davey's paper provides an interesting contrast of a structural fragmentation in the sale of buildings insurance and contents insurance in the United Kingdom, with "no neat divide" between them. James Davey, *Fracturing and Bundling Risks: The Coverage Expectations of the 'Real' Reasonable Policyholder*, 11 RUTGERS J.L. & PUB. POL'Y 118(2013).

[6] Stempel, *supra* note 2.

[7] Hornstein, *supra* note 1.

exclusion ran up against the efficient proximate cause doctrine, insurers and their surrogate, the Insurance Services Office ("ISO"), introduced and expanded anti-concurrent causation clauses, which spawned further litigation and more redrafting.[8]

Natural catastrophes also provide a striking example of a low visibility process of implicit and even illicit fragmentation. As Michael Childress's article argues, fragmentation occurs not only at the front end of the insurance relationship, in drafting coverage and exclusions, but also at the back end, during the claims process; even when a policy covers a loss, insurers employ unfair claims practices to further diminish coverage.[9] Childress's experience after disasters in Australia and New Zealand and James Davey's more mundane anecdote about an incident arising from a colleague's dog demonstrate that as insurers have become multinational, so too have their claims practices.

Market forces also influence fragmentation. Especially because insurance, particularly personal lines, is mostly advertised and purchased with price as a principal factor, insurers have a strong incentive to offer coverage with gaps at a lower price rather than full coverage at a higher price. Moreover, as Davey points out, an insurer is unlikely to recapture all of the gains from a campaign to encourage full coverage, as policyholders might simply buy the full coverage from other insurers.[10] Fragmented risk even bedevils large commercial insureds, even though they should be in the best position to avoid it. Risk management theory suggests that large, sophisticated commercial entities can carefully assess risks and develop an optimal risk management strategy consisting of reducing some risks, insuring or otherwise transferring others, and accepting the rest. Childress suggests that brokers, who are presumed to act in the insureds' interests, often fail to procure full coverage, or coverage from the most reliable insurers, and may even subvert the claim process

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[8] *Id.*

[9] Michael Childress & Daniel Loucks, *The Hidden Conflict: The Secret Insurers Don't Tell Insureds*, 11 RUTGERS J.L. & PUB. POL'Y 89 (2013).

[10] Davey, *supra* note 5.

because of their own financial interest.[11] Stempel also points out that large insureds are not unitary entities, but rather include risk managers, whose short-term incentives may conflict with the firm's long-term goals.[12]

Fragmented risk presents three types of problems. First, policyholders are likely to be less knowledgeable about coverage under fragmented risks, which reduces the efficiency and effectiveness of the market for insurance. As Davey describes, consumers tend to be very bad purchasers of insurance — notwithstanding the elegance of expected utility theory — because they have inadequate information, they are poor judges of risk, and they do not act as rational maximizers.[13] Fragmented policies, particularly with poorly disclosed fragmentation, only make things worse.

Second, fragmenting produces gaps in coverage. Some policyholders can account for these gaps through riders or other coverage, conscious retention of risk, or other risk management techniques. Often, however, policyholders will not plan for the gaps, leaving the losses on themselves, on their victims in the case of liability policies, or on the public at large if the government absorbs part of the loss, either through direct aid or through residual market schemes that are not actuarially sound.

Third, fragmented policies generate more disputes about coverage. This creates uncertainty for insurers and insureds, and the disputes consume social resources as regulators and courts address them.

The papers offer a variety of solutions for the problems created by fragmented risk. Because insurance is largely distributed through the private market, a logical starting point is to improve the market for insurance by providing consumers more information. Disclosure has been a popular solution to imperfections in many consumer markets, with mixed success, but it is often suggested at least as a starting point. Davey and Weston explore various options, including "smart disclosure"

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[11] Childress & Loucks, *supra* note 9. Weston offers similar comments. Weston, *supra* note 2.

[12] Stempel, *supra* note 2.

[13] Davey, *supra* note 5.

and "a la carte coverage."[14] But as Weston recognizes, the market defects that lead to proposals such as these, especially including bounded rationality, also limit the likely effect.[15]

A more fundamental market solution is to restore a degree of market balance in at least some segments of the market. Hornstein describes a possible "maturing" of catastrophe insurance.[16] When the National Flood Insurance Program was reauthorized in 2012, for example, the legislation mandated a move away from government subsidies and toward actuarially sound pricing.[17] Combined with increased efforts at risk mitigation, that move might even lead private insurers to reenter the market, which could lead to the inclusion of catastrophe insurance in ordinary property insurance and, therefore, less fragmented policies.

Because of the limits of the market and the importance of insurance, here as elsewhere in the field, regulatory solutions may be required. Other common law countries have a more robust regulatory regime for consumer and market conduct issues than prevails in the United States. In the creation of policies, Davey describes the ability of the Financial Services Authority, under unfair terms legislation, to challenge terms and mandate their revision, including terms that fragment coverage.[18] In the resolution of disputes, Childress and Davey note the usefulness of regulatory ombudsmen as authoritative dispute resolution vehicles in Australia and the UK.[19] A different form of regulatory dispute resolution is to preempt disputes about particular fragmentation issues; Hornstein points out that the NFIP reauthorization directed the development of a protocol to allocate losses between wind and water on a geographic basis following storms.[20]

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[14] *Id.*; Weston, *supra* note 2.

[15] Weston, *supra* note 2.

[16] Hornstein, *supra* note 1.

[17] Predictably, politicians called for a delay at minimum in this movement, in order to prevent sticker shock to homeowners in high-risk areas.

[18] Davey, *supra* note 5.

[19] *Id.*; Childress & Loucks, *supra* note 9.

[20] Hornstein, *supra* note 1.

Most radically, Stempel proposes that regulators require homeowners' insurance policies to protect against the perils most often fragmented: flood and earthquake.[21] Importantly, he also would allow premiums for the newly bundled policies to be set at reasonable levels.[22] The result, he suggests, would be more predictability, fewer litigated disputes, better coverage, and, not incidentally, profits for insurers.[23]

The courts may have a role to play, too. Many of the disputes arising from fragmented risk result in litigation, often in the guise of policy interpretation and sometimes in other ways. Davey explains English courts' approach to contract interpretation generally and insurance policy interpretation in particular, and suggests that the insights of behavioral science can be used to improve those decisions.[24] Stempel notes and decries the trend toward formalist interpretation and suggests an interpretive approach that is more sensitive to the nature of the insurance relationship and the needs of society, particularly in light of fragmented risk.[25]

The problems presented by fragmented risk and the solutions proposed illustrate something very basic about insurance and its regulation. Most insurance is provided through the mechanism of the market. Although the market for insurance can be improved, market failures cannot be eliminated entirely, particularly for ordinary consumers, but often for sophisticated insureds, as well. Therefore, regulation is needed to improve the operation of the market and to correct more directly its failures. Too often, however, regulation has not been adequate to the task. The Fragmented Risk conference and these papers that were a product of it are exemplars of how the engagement of scholars and other professionals can better define and analyze the issues and thereby improve the effectiveness of insurance, the insurance market, and insurance regulation.

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[21] Stempel, *supra* note 2.

[22] *Id.*

[23] *Id.*

[24] Davey, *supra* note 5.

[25] Stempel, *supra* note 2.