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Principles of Insurance Law

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PRINCIPLES OF INSURANCE LAW

FOURTH EDITION

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Preface

There have been a number of important developments in liability insurance, property insurance, and life and health insurance that have significantly impacted insurance law. Accordingly, our Fourth Edition of *Principles of Insurance Law* has been substantially revised and updated in order to offer the insurance law student and practitioner a broad perspective of both traditional insurance law concepts and cutting-edge legal issues affecting contemporary insurance law theory and practice. We have retained the organization substantially begun in the Third Edition, with fifteen chapters, a division that enables an expanded scope of topical coverage and also segments the law of insurance in a manner more amenable to study, as well as facilitating recombination and reordering of the chapters as desired by individual instructors. We believe that this Fourth Edition is the most comprehensive insurance law course book available, a book that is both reflective and practical. In crafting the book's contents, we strived to maintain a realistic balance between insurance law theory and practice.

At the same time, we have retained the progressive and cumulative sequence of the previous editions:

- Introductory material;
- recent and landmark illustrative judicial cases; as well as
- applying, questioning, and testing these principles in relevant Notes, Questions, and Problems.

The "Notes and Questions" sections have been expanded and updated, usually containing one or more Problems, allowing insurance law students to apply their cumulative knowledge of insurance law topics to "real life" situations and legal disputes, and to make the type of difficult decisions with which a practicing attorney or judge would be faced.

Like the Third Edition, the Fourth Edition contains comprehensive introductory and orientation material. In particular, basic axioms of contract construction and insurance policy interpretation are discussed in greater detail (Chapter 2) to assist in orienting students to the case material (no matter how much the student may have daydreamed during first-year Contracts). In addition, history of insurance is examined in detail, as are the underlying concepts and theory of insurance (Chapter 1). As compared to earlier editions, considerably more attention is given to the definition of insurance and concepts of risk shifting, risk distribution, and risk management.

Materials concerning state and federal regulation of insurance are moved to an earlier section of the casebook (Chapter 3). Instructors may, of course, present casebook material in whatever order best fits the pedagogy of their own respective classes. We also realize that many instructors, particularly in a two-credit insurance course, will minimize coverage of insurance regulation.

Chapter 4 addresses insurance contract formation in significant detail. The Fourth Edition continues the tradition of earlier editions in devoting succinct but sustained analysis to issues of insurable interest (Chapter 5), warranties and representations (Chapter 6), waiver and estoppel (Chapter 7), and causation (Chapter 8).

The Fourth Edition of *Principles of Insurance Law* retains broad coverage of life and health insurance, property insurance, and liability insurance issues. In order to make the casebook both more comprehensive and more accessible, the division of Chapters is organized more according to types of insurance products: property insurance (Chapter 10), liability insurance (Chapter 11), life and health insurance (Chapter 12), and automobile insurance (Chapter 13), as well as reinsurance and excess insurance (Chapter 15).

The casebook also provides a separate chapter on insurance bad faith (Chapter 14), with extensive treatment of the issue. Chapter 9, which discusses the duties of insurer and policyholder after loss, also gives considerable attention to problems that can arise for policyholder, insurer, and counsel in their "tripartite relationship" during litigation or claims adjustment.

The new edition further includes new and expanded treatment of important insurance law developments that have taken place since the prior edition:

- New caselaw about property insurance and recent mass disasters (i.e. Hurricane Katrina, valued policy laws);
- new cases highlight the problems of the innocent co-insured in property insurance contexts;
- new material about business interruption insurance (as played out in the aftermath of the 9/11 World Trade Center disaster);
- a re-organization of Chapter 8 (causation and accident) with updated cases;
- new cases and a re-organization of Chapter 13 (automobile insurance);
- a re-organization of Chapter 15 (Insurance Layers), including moving "other" insurance issues to this chapter; and
- new treatment of regulation (Chapter 3), including discussion of the Dodd-Frank Wall Street Reform and Consumer Protection Act, as well as new information about federal flood insurance, terrorist insurance, and updates relevant to ERISA cases.

The casebook also provides more extensive treatment than most coursebooks regarding:

- The critical role of insurance binders as temporary forms of insurance, as illustrated in the World Trade Center property insurance dispute resulting from the horrific terrorist attack of September 11, 2001;
- the continuing debate between "legal formalists" and "legal functionalists" for "the heart and soul of insurance contract law";
- what constitutes a policyholder's "reasonable expectation" regarding coverage;
- the current property and liability insurance "crisis";
- risk management and self-insurance issues;
- emerging, and frequently conflicting, caselaw concerning the intersection of insurance law and federal antidiscrimination regulation;
- the Court's *State Farm v. Campbell* decision, which struck down a $145 million punitive damages award in an insurance bad faith claim as well as setting more restrictive parameters for the recovery of punitive damages generally;
- new issues over the dividing line between "tangible" property typically covered under a property insurance policy and "intangible" property, which is typically excluded — an issue of increasing importance in the digital and cyber age;

- refinement of liability insurance law regarding trigger of coverage, duty to defend, reimbursement of defense costs, and apportionment of insurer and policyholder responsibility for liability payments;
- the difficult-to-harmonize decisions concerning when a loss arises out of the "use" of an automobile;
- insurer bad faith and the availability, if any, of actions against a policyholder for "reverse bad faith"; and
- the degree to which excess insurance and reinsurance may be subject to modified approaches to insurance policy construction.

The Fourth Edition includes a new co-author, Professor Erik S. Knutsen, of Queen's University Faculty of Law in Kingston, Ontario, Canada.

The authors gratefully appreciate and acknowledge the research assistance of the students who helped make *Principles of Insurance Law* a reality. Hilary Barrett Muckelroy (UNLV — Class of 2005) deserves special thanks for her excellent work as primary research assistant for the Third Edition. Thanks also to Mary Langsner (UNLV — Class of 2013), (Michael Newby, CPCU (Richmond — 2004), Kathleen Wilde (UNLV — Class of 2011), Shannon Gallo (UNLV — Class of 2010), Angela Morrison (UNLV — Class of 2005), Tabitha Fiddyment (UNLV — Class of 2003), Erin Spicer (Queen's — Class of 2012), and Jonathan Chen (Queen's – Class of 2012).

Thanks also to our long-suffering families and to our respective colleagues at Richmond, UNLV, and Queen's, all of whom are probably more than a bit puzzled at our constant fascination with insurance — an interest we hope students will grow to appreciate as they read the materials in this casebook. Special thanks to UNLV Wiener-Rogers Law Library Director Jeanne Price and Assistant Director David McClure.

Insurance is often regarded as a topic that induces a feeling of "stirring cement with my eyelids" (to use Oliver Wendell Holmes's memorable description of first-year law school), even as compared to other parts of the law school curriculum. We beg to differ. Insurance involves many of the most intellectually interesting issues in modern law as well as topics central to modern human existence: life; death; greed; money; property; business; cars; homes; family; lawsuits; deals made and broken; steadfastness; and sharp dealing. It's all there in insurance law. We hope we have captured some significant part of this rich picture in *Principles of Insurance Law*.

Welcome to the fascinating and challenging world of insurance law!

Jeffrey W. Stempel
Peter N. Swisher
Erik S. Knutsen
June 2011

Chapter 1

INSURANCE HISTORY AND FUNDAMENTAL CONCEPTS

§ 1.01. INTRODUCTION

Insurance has historically been something of a Rodney Dangerfield of the law. To put it in the famous[1] comedian's vernacular, insurance "don't get no respect" — at least not compared to constitutional law, anti-discrimination, legal theory, jurisprudence, and the various "isms" and "law ands" that often captivate both students and faculty in the academy.[2] One leading academic expert on insurance even includes in his treatise a self-deprecating story of being introduced at a social gathering as "boring" solely on the basis of his vocation.[3] If lawyers and teachers cannot embrace insurance as an appealing subject, it should come as no surprise that most laypersons think of insurance as boring.[4]

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[1] At least for folks as old as the authors, Rodney Dangerfield qualifies as a famous, or at least well-known, comic. For the benefit of younger readers, we simply note that Dangerfield was primarily a standup comic who appeared in some movies (perhaps most notably *Caddyshack*) and that his standard comic pose is one of a loser who (you guessed it) "don't get no respect," as evidenced by the self-deprecating stories he proceeds to tell during his routine.

[2] In separate writings we have quoted with a mixture of approval and bemusement the observations of Seventh Circuit Judge Richard Posner, who once stated:

> Disinterested legal-doctrinal analysis of the traditional kind remains the indispensable core of legal thought, and there is no surfeit of such analysis today. I daresay that many legal scholars who today are breathing the heady fumes of deconstruction, structuralism, moral philosophy, and the theory of the second best would be better employed studying the origins of the *Enlow-Ettleson* doctrine or *synthesizing the law of insurance.*

See Richard A. Posner, *The Decline of Law as an Autonomous Discipline: 1962–1987*, 100 Harv. L. Rev. 761, 777 (1987), quoted in Jeffrey W. Stempel, Law Of Insurance Contract Disputes xxvii (2d ed. 1999 & Supp. 2002), Jeffrey W. Stempel, Interpretation Of Insurance Contracts xxvii (1994), and Peter Nash Swisher, *Judicial Rationales in Insurance Law: Dusting Off the Formal for the Function*, 52 Ohio St. L.J. 1037 (1990). Although we agree with the sentiment that insurance law should get more attention in the academy, we also want to make it clear that insurance law, like any other legal topic, can often be better understood and implemented through application of learning from other realms of the law or fields other than law. For example, Judge Posner's insurance law and coverage opinions have also proven to be most interesting and informative and frequently apply his favorite "law and" subdiscipline — law and economics. One of us, while admiring Judge Posner's work, has also suggested that it might benefit from greater consideration of nonlegal learning other than economics. *See* Jeffrey W. Stempel, *An Inconsistently Sensitive Mind: Richard Posner's Cerebration of Insurance Law and Continuing Blind Spots of Econominalism*, 7 Conn. Ins. L.J. 7 (2000-2001).

[3] *See* Robert H. Jerry, II, Understanding Insurance Law § 1, at 3, n.7 (3d ed. 2002). Notwithstanding that he is the co-author of a competing casebook, we find Prof. Jerry an interesting, even scintillating colleague. There is solidarity among the fraternity of the disrespected.

[4] Popular business writer Andrew Tobias, author of the best-selling *The Only Investment Guide*

At the risk of sounding defensive, we contend insurance is not boring. Since no law school has yet been possessed of the wisdom to make insurance a required course, we (along with your classroom instructor) will have to convince you. Insurance is of prime importance to modern economies that depend on effective risk management as well as upon production, transportation, sales, service, and technology. It is a practical necessity of conducting business, at least for industrialized nations. Insurance is also one of the leading sources of capital formation and investment (insurers have to do something with all the premiums we pay).

Even those who maintain that insurance is boring must nonetheless concede it is important. "If insurance was a country, it would have the third biggest economy in the world." *See* Aaron Doyle & Richard Ericson, *Five Ironies of Insurance*, *in* THE APPEAL OF INSURANCE 226 (Geoffrey Clark, Gregory Anderson, Christian Thomann & J. Matthias Graf von der Schulenburg, eds. 2010) (citing Evan Mills, *Insurance in a Climate of Change*, SCIENCE, Aug. 12, 2005, at 1040–44). "The insurance policy is created and designed to play a particular role in social and economic activity" and operate as key components in the operation of everyday life as well as the economic consequences of activity. *See* Jeffrey W. Stempel, *The Insurance Policy as Social Instrument and Social Institution*, 51 WM. & MARY L. REV. 1489, 1495–513 (2010). The ability of insurance to affect conduct is so great that it has been compared to governments not only in sheer size but also in its practical power. *See* RICHARD ERICSON, AARON DOYLE & DEAN BARRY, INSURANCE AS GOVERNANCE (2003). The author of the promotional material for one recent (and excellent) collection of essays on insurance was not exaggerating:

> [I]nsurance is a global economic colossus and a fixture in the developed countries of the world. But neither the financial clout of the insurance industry nor its ubiquity conveys the full measure of its social and political influence. The insurance industry has in fact become a primary agent of discipline and control over public and private behaviours by imposing upon them the criterion of insurability. By tracing the boundaries of acceptable (and compensated) from unacceptable (and uncompensated) risk, insurers directly or indirectly govern people, products, and markets, and by this process become one of the most powerful and pervasive agents of social and economic control.

See Book Jacket Description to THE APPEAL OF INSURANCE, *supra*.

Sometimes the necessity of insurance is legally imposed. For example, the financial responsibility laws of every state require automobile insurance as a condition of owning and driving a car. Similarly, banks will not lend money for a home purchase unless the property is insured — both against physical perils such as fire and against defects in the title to the property. Major construction projects usually will not receive the required government permits without proof of insurance, including a surety's performance and payment bonds to protect against

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You'll Ever Need and a most readable but now out-of-print book for laypersons about insurance (*The Invisible Bankers* (1982)), notes that when a friend found out that Tobias's next project was a book about insurance, the friend screamed at him: "Insurance? Insurance is boring." With friends like these . . . .

contractor failure or delays in completion.[5]

In other instances, the law may not directly require insurance but the legal, social, and business framework makes it a practical necessity. No responsible business can operate without some form of risk management and protection against property loss or liability claims. Large businesses may be able to do this through "self-insurance" but most commercial entities need to buy conventional insurance for their possessions and liability insurance to protect them from potentially crippling lawsuits.[6] Insurance even touches the realm of popular culture in that sports franchises and entertainment companies routinely have substantial life and disability insurance on star players.[7] New insurance products designed to fill particular niches emerge almost daily. *See, e.g.*, Rachel M. Zahorsky, *Policy Matter: Firm Plans Insurance Against Evidence Loss*, A.B.A. J., Mar. 2011, at 31 (Lexington Insurance, a part of giant American International Group, better known as AIG, "plans to offer extended policies to guard against spoliation tort claims against clients that are often entrusted with property that can affect the outcome of a court case." Currently, nine states "recognize spoliation tort claims for the destruction of or failure to preserve evidence that is necessary to litigation.").

Many of the most important government programs consuming much of state and federal budgets are in essence insurance programs of a sort: social security; medicare; medicaid.[8] Chapter 3 discusses regulation of insurance as insurance and also touches upon the intersection of private insurance and public legislation.

In short, insurance runs over, under, behind, and through most everything in modern industrial society,[9] particularly in the United States, which shows a

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[5] Technically, suretyship (the promise to respond to the obligation of another) is not insurance. At least that has been the historical conventional wisdom in the law. However, the modern trend is to treat suretyship as the equivalent of insurance for purposes of regulation and contract enforcement. Chapter 13, *infra*, discusses suretyship in general while Chapter 11 discusses the current status of the application of bad faith liability to sureties and insurers.

[6] This includes not only the traditional tort liability that may attach from slip-and-fall problems on the policyholder's premise and auto accidents involving a company driver, but also statutory liability. *See* Reed Abelson, *Surge in Bias Cases Punishes Insurers, and Premiums Rise*, N.Y. Times, Jan. 9, 2002, at C1, col. 2.

[7] *See* Richard Sandomir, *Costlier Contracts Send Insurance Costs Soaring*, N.Y. Times, Dec. 14, 2000, at C23, col. 4; David Wharton & Lisa Dillman, *At Today's Salaries, It's Tough to Risk It; Stratospheric Contracts Are Convincing More Teams to Pay Big Money to Cover the Possible Loss of Elite Players*, L.A. Times, Aug. 5, 1999, at D1. The same is true regarding insurance for actors and other performers, although there are some occasional limitations beyond merely the high premiums that may be required to insure a highly paid figure working for an expensive team or costly movie. *See Lohan is Uninsurable: Director*, Bus. Ins., Dec. 6, 2010, at 22 (actress with well-publicized troubles allegedly lost movie role "because she is uninsurable") (imagine Charlie Sheen's situation). And even the insurable poses some risk by definition. *See Jolie's 'Salt' Wins Insurer's Award for Riskiest Film of 2010*, www.advisen.com, Feb. 11, 2011 (originally reported by Dow Jones Newswires) (actress Angelina Jolie's "decision to do her own stunts earned her movie the dubious honor, since an injury to a star can force a halt in production and cost $250,000 a day or more"). Fireman's Fund, which "insures four of every five movies to come out of Hollywood" frequently had a representative on the scene monitoring the stunts.

[8] *See, e.g.*, Mark C. Weber, *Disability Rights, Disability Discrimination, and Social Insurance*, 25 Ga. St. U. L. Rev. 575 (2009).

[9] In 2010, for example, there were 950 "natural catastrophes, in which an estimated 295,000 people

fondness for insurance that outpaces even that of Western Europe and Japan.[10] In addition to the mainstream, relatively standard insurance products discussed at length in this casebook, there is a plethora of specialized insurance products for specialized submarkets.[11]

As with any other activity, the result of insurance initiatives can sometimes be unintended consequences. "For instance, insurers insisted that a guard dog be hired to protect a collection of hundreds of rare teddy bears in Somerset, England. Unfortunately, the Doberman Pinscher recommended by the insurers went on a rampage and shredded dozens of the teddy bears he was supposed to protect." *See* Doyle, *Five Ironies of Insurance, supra* (footnoted omitted). Where insurance is unavailable, the consequences can be significant.[12]

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were killed and losses of more than $130 billion were incurred, $37 billion of which was insured. *See Hindsight*, Risk Mgmt., Jan./Feb. 2011, at 46. Among the larger disasters: the Chile Earthquake/Tsunami of Feb. 27 ($8 billion), European Winter Storm Xynthia Feb. 26–28 ($3.1 billion), the Christchurch, New Zealand Earthquake of Apr. 9 ($12.7 billion), and two U.S. hailstorms producing nearly $4 billion in damages. Although property losses like this are most visible, lost economic productivity due to worker disability costs much more annually (an estimated $43 billion).

Loss and injury is, of course, everywhere — and much of it is insured, amounting to large financial commitments by insurers, even where not expected by those outside the field. *See, e.g., Oh, Deer! West Virginia Heard Costing Insurers $44 Million a Year*, Ins. J., Jan. 13, 2011, *available at* www.insurancejournal.com; *California Storms Cause $10M in Damage; More Rain on Way*, Ins. J., Dec. 28, 2010, *available at* www.insurancejournal.com (fast-moving but hardly unusual storm causes significant damage); *Insurers Feeling Pain of Dog Bites*, www.advisen.com, Aug. 19, 2010 (originally reported in N.Y. Times) (Total dog bite insurance payments of $412 million in 2009, up from $387.2 million in 2008, based on more than 16,500 claims averaging $24,000.). And where there's loss and insurance money, there also may be fraud. *See New Jersey Jury Convicts Man in Bogus Insurance Scheme*, Ins. J., Dec. 16, 2010, *available at* www.insurancejournal.com; *Suspicious Claims Rose 12% in Q3, Insurers Report*, Ins. J., Dec. 16, 2010, *available at* www.insurancejournal.com.

[10] Even though many commercial entities are large enough and wealthy enough to self-insure, they nonetheless tend to purchase insurance. *See* Victor P. Goldberg, *The Devil Made Me Do It: The Corporate Purchase of Insurance*, 5 Rev. L. & Econ. 541 (2009) (noting that in addition to seeking protection and managing cash flow through insurance, companies may find that "their contractual counterparties — buyers, lessors, and lenders — require that they carry insurance") (italics of abstract removed).

Because of their extensive involvement in all aspects of social and economic life, insurers are often in the forefront of emerging issues. *See, e.g.*, Swiss Re, *Weathering Climate Change: Insurance Solutions for More Resilient Communities* (2010) (major insurer materials addressing issues of climate change). The pervasive presence of insurance also creates a situation in which insurers may become participants in larger tort law and policy issues. *See* Amanda Bronstad, *Toyota's Latest Headache: Insurers Join the Queue: They Seek Reimbursement for Accident Claims They Paid Out* [due to alleged sudden acceleration problems with Toyota vehicles], Nat'l L.J., Jan. 10, 2011, at 1.

[11] *See Lexington Expands Product Liability with Product Recall Endorsement*, Ins. J., Jan. 11, 2011, *available at* www.insurancejournal.com; *Zurich Introduces Insurance Policies for Defendants in Contract Litigation*, Ins. J., Aug. 3, 2010, *available at* www.insurancejournal.com; *In Economic Downturn, Divorce Insurance and Co-Habiting on the Rise*, www.advisen.com, Oct. 15, 2010 (originally appearing in Washington Post).

[12] *See Firefighters Let Home Burn; Owner Didn't Pay Fee*, www.advisen.com, Oct. 5, 2010 (homeowner's failure to pay locality's $75 fire protection fee, a form of insurance, results in fire department refusing to suppress home fire, leading to loss of home) (the resident did have homeowner's insurance "but not enough to cover everything lost or to rebuild — *see* Andrew G. Simpson, *Tennessee Tragedy: Family Had No Fire Service but Had Some Insurance*, Ins. J., Oct. 5, 2010, *available at* www.insurancejournal.com); *Insurance Could End Ore. Civil War Re-Enactments*, www.advisen.com,

For example, insurance was an important legal aspect of the terrorist attacks of September 11, 2001. In the aftermath of the fall of the World Trade Center towers arose a major dispute between the policyholder landlord[13] and property insurers regarding the value of the destroyed property and whether the incident was one occurrence (due to one terrorist plot) or two occurrences (due to two separate airplane strikes felling two separate buildings).[14] Because insurance on the property was written in an amount of $3.6 billion per occurrence, the answer to this "boring" question of insurance law is worth more than the gross national product of many nations.[15]

In addition, the September 11 tragedy served as a wake-up call for the insurance industry as well as for the nation as a whole. Prior to September 11, property and liability insurance did not exclude coverage for terrorist acts although, as discussed

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Sept. 1, 2010 (increased insurance needed due to lifting of cap on damages for state-assisted events forces Civil War re-enactment groups using state property to increase insurance coverage and pay correspondingly higher premium).

[13] New York real estate mogul Larry Silverstein, who held a long-term lease on the property. The Port Authority of New York and New Jersey is the entity that actually "owns" the World Trade Center site.

[14] *See* Jeffrey W. Stempel, *The Insurance Aftermath of September 11: Myriad Claims, Multiple Lines, Arguments over Occurrence Counting, War Risk Exclusions, the Future of Terrorism Coverage, and New Issues of Government Role*, 37 Tort & Ins. L.J. 817 (2002) (reviewing insurance issues arising in wake of September 11 terrorism and specifically addressing World Trade Towers dispute, concluding that two insured occurrences took place). The divisiveness of the occurrence issue is reflected among the authors. Professor Swisher, who has been retained as an expert by one of the WTC insurers, believes the terrorism was one occurrence. If casebook authors cannot agree, who can expect policyholder and insurers to agree with so much at stake? The trial court in the matter found one occurrence (under particular language found in some of the policies at issue), but refused insurer motions for summary judgment where policy language was viewed as less clear and unable to foreclose the possibility that a reasonable factfinder would deem the two air attacks as two occurrences. *Compare SR Int'l Bus. Ins. Co. v. World Trade Ctr. Props. LLC*, 222 F. Supp. 2d 385 (S.D.N.Y. 2002) (holding as a matter of law that policy with language defining occurrence as "all losses or damages that are attributable directly or indirectly to one cause or to one series of similar causes "defines September 11 damage to WTC Towers as one occurrence), *with SR Int'l Bus. Ins. Co. v. World Trade Ctr. Props. LLC*, 2003 U.S. Dist. LEXIS 1103 (S.D.N.Y. Jan. 29, 2003) (policy ambiguous as to meaning of occurrence when policy speaks of a "series of losses . . . arising out of one event"); *SR Int'l Bus. Ins. Co., Ltd. v. World Trade Center Properties LLC*, 222 F. Supp. 2d 385 (S.D.N.Y. 2002) (policy ambiguous where referring to merely an "occurrence"). Eventually, a jury found two occurrences for insurance policies in where the "batching" language was absent.

On another insurance law issue, the court ruled that the Air Transport Stabilization Act passed to protect airlines in the wake of September 11, a statute that makes Manhattan the exclusive jurisdiction for September 11 litigation, does not preclude enforcement of an appraisal clause in an affected policy. *See SR Int'l Bus. Ins. Co. v. World Trade Ctr. Props. LLC*, 2002 U.S. Dist. LEXIS 15272 (S.D.N.Y. Aug. 19, 2002). This suggests that arbitration agreements would be similarly enforceable and that litigation is not mandated in first instance by the Aviation Security Act. The battle over insurance coverage continued for years. *See WTC's Silverstein Fights $1.2 Billion Settlement in Sept. 11 Property Damage Case*, www.advisen.com, Oct. 21, 2010 (developer challenges apparent settlement "over concern that it could exhaust coverage limits before his own company's related claims are addressed.").

[15] In addition to the discussion of fortuity in this Chapter, Chapters 8 and 11 discusses in more detail the concept of an insured "occurrence" or event and the tendency of the law to look more at the "causes" of a loss rather than the "effects" of the loss. For example, if one were to take an effects-orientation to the WTC dispute, there would be at least one occurrence per building damaged at the multi-building site. But not even the policyholder is asserting this large a number of occurrences.

at greater length below, exclusion of war-related risks was a standard provision of most standard policies. After September 11, billionaire Warren Buffett, reputedly the world's second-richest person and the effective controlling owner of one of the world's largest reinsurers (a reinsurer is a company that insures insurers against loss; *see* Chapter 15)[16] publicly lamented that his company and other insurers had been foolish to fail to exclude terrorism risks without at least demanding a higher premium in return for terrorism coverage. And remember — there was a frighteningly destructive terrorist attack on the World Trade Center in 1993 and yet insurers generally continued to write coverage — even on landmark properties — without a specific terrorism exclusion and without an increase in premium. Some insurers or counsel have argued that excluding coverage for acts of war also excludes coverage for terrorist acts. But, as we shall see below, courts have almost uniformly rejected such arguments well before September 11, so much so that leading insurance executives such as Buffett and Maurice "Hank" Greenberg, former CEO of the mammoth American International Group, publicly ridiculed the idea that a war risk exclusion could also function as a terrorism exclusion.[17] But after September 11, insurers were not inclined (at they might have been prior to that date) to simply charge an additional premium to allow them to invest funds for possible payout later on terrorism claims.

The magnitude of the September 11 claims — estimated at more than $40 billion of insured losses[18] — prompted the industry to demand government backing of

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[16] As discussed more fully in Chapter 15, *infra*, reinsurance is insurance purchased by front line insurers so that the initial insurer has some sharing of the risk with other insurers, particularly if covered losses are larger than anticipated. For very large or less predictable risks, reinsurance is considered a practical necessity for most insurers. Even though insurance companies are essentially amalgamations of money, only the largest insurers are thought capable of taking on very large or dangerous risk without reinsurance in place to support it if disaster strikes. The law generally recognizes this. For example, even in states that restrict an insurer's right to cancel an insurance policy, the insurer is often permitted to cancel if it loses its reinsurance and thus no longer is comfortable with the risk exposure.

[17] *See* Stempel, *Insurance Aftermath of September 11, supra*, at 843–65 (reviewing history and rationale of war risk exclusion, case law of exclusion, and concluding war exclusion would not apply to claims arising out of September 11 terrorism).

[18] According to the Insurance Information Institute, September 11 losses approximate $40.2 billion, apportioned among different types of insurance as follows:

- $2.7 billion (7% of the total insured losses) in life insurance losses;
- $3.5 billion (9% of the losses) in property insurance on World Trade Towers Buildings 1 & 2;
- $6.0 billion (15%) in other property insurance losses;
- $11.0 billion (27%) in business interruption losses;
- $500 million (1%) in aviation hull losses;
- $3.5 billion (9%) in aviation liability claims;
- $10.0 billion (25%) of "other liability" insurance claims;
- $2.0 billion (5%) workers compensation claims;
- $1.0 billion in event cancellation claims.

See Robert P. Hartwig, *Terrorism Leaves WTC Insurers Exposed*, National Underwriter, Aug. 19, 2002 (Prop. & Cas. ed.), at 16.

Note that this number would be even higher if not for the action of Congress in the immediate aftermath of the tragedy. On September 22, 2001, less than two weeks after the terrorism, Congress enacted the Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230, H.R. 2926 (107th Cong., 1st Sess.). Sections 101 through 107 provide disaster relief for U.S.-based terrorism insurance. Insurers achieved their goal in part when Congress enacted the Terrorism Risk Insurance Act of 2002, signed into law on November 26, 2002. The Act

> renders all existing terrorism exclusions null and void, and requires all property and casualty insurers to offer policyholder terrorism insurance for two years [extendable for a year at the discretion of the Secretary of the Treasury] The terrorism coverage offered must not "materially differ from the terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of terrorism." When offered, the terrorism coverage premium must be clearly and conspicuously disclosed to policyholders. Act §§ 103 & 105.
>
> The Act does not provide coverage pricing guidelines. States, however, can invalidate any rates determined to be excessive, inadequate, or unfairly discriminatory. Act § 106. Policyholders can decline the offered terrorism coverage. For an insurer to reinstate any terrorism exclusion, however, the insured must sign an authorization or decline to pay (within 30 days) the terrorism coverage premium. Act § 105.
>
> The Act establishes a program within the Treasury Department under which the Federal government shares the risk of loss from future foreign terrorist attacks. If an act, certified to be a foreign act of terrorism, causes losses in excess of $5 million, participating insurers pay a certain amount in claims — a deductible — before Federal assistance becomes available. For losses above the deductible, the government coverage is 90%, while the insurer contributes 10%. Losses covered by the program are capped at $100 billion, and the program permits the government to recoup the amounts paid by virtue of a surcharge on all policyholders.

See Sherilyn Paster, Ira M. Gottlieb & Pranita A. Raghavan, *An Overview of the Terrorism Risk Insurance Act of 2002*, Mealey's Emerging Insurance Disputes, Dec. 17, 2002, at 29–30. Subsequent revisions to the Act are discussed in Chapter 3 regarding insurance regulation.

Although September 11 "hardened" the insurance market and made coverage more expensive and less available generally, insurers and policyholders continued to do business, with a considerable amount of terrorism coverage still in force. Insurers responded to the new uncertainty over "mega" or "ultra-destructive" terrorism by raising prices, putting limits on the amount of terrorism risk insured, and excluding terrorism outright where the risk is seen as too great. Although some

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passenger airlines. Section 408 provides that the liability of the airlines "arising from the terrorist-related aircraft crashes" of September 11 "shall not be in an amount greater than the limits of the liability coverage maintained by the air carrier."

Depending on one's point of view, this is either expeditious action by Congress or a rash bailout. It is certainly a massive public subsidy for a particular segment of private industry. Note that even if an airline was dramatically underinsured, this statute would still limit the carrier's liability. Sometimes the most effective risk management program may be political clout. *See also* Stempel, *Insurance Aftermath of September 11*, *supra*, at 828–30 (suggesting that liability claims against airlines for lax security may well have succeeded and even permitted successful claims by non-passengers in view of reasonable possibility that suicidal terrorists might attempt to use a hijacked airplane as a weapon).

policyholders are undoubtedly upset about these developments, few appear to have constricted their activities or closed their doors due to this new problem of insurability and risk management. In the meantime, insurers have been attempting to increase their ability to predict and spread terrorism risk in accordance with historical risk distribution principles discussed below.[19]

On a more mundane, less tragic, and occasionally almost comical level, insurance also frequently involves a gallery of rogues attempting to perpetrate scams in order to collect insurance benefits. One "high-end" example (if that's not an oxymoron) is Martin Frankel, described in the popular press as something of a nerd who perpetrated a multi-million scam of international proportion (and also found that he no longer had trouble getting dates after he became rich by misappropriating other people's money).[20] More pedestrian perhaps was Rev. Roland Gray, a Harvey, Illinois Baptist minister, who was sentenced to four and one-half years in prison for "faking at least 14 auto accidents to defraud insurance companies of more than $450,000."[21] Arguably less reverent was Andrea Cabiale of Turin, Italy, who was charged with "arranging at least 500 bump-and-stop car accidents involving young female drivers, in largely unsuccessful attempts to date them." Found in Cabiale's apartment were "2,159 photographs of female car owners and their damaged vehicles." On the scale of deviancy, insurance fraud perpetrators rank with the most eccentric of the human race and insurance-related problems deal with a host of fascinating situations.

Although insurance, like any area of the law, has its "dog bite cases," these too can be pretty interesting.[22] Certainly, insurance can be exotic or even glitzy. Insurers have covered "Betty Grable's legs and Bruce Springsteen's voice, both of which proved to be good bets." *See* Michael D. Goldhaber, *The Flop! A Nightmare on Court Street*, AM. LAW., May 2003, at 91 (describing some not-so-good bets made by insurers in selling coverage for financially unsuccessful movies or "flop insurance"). Of course, one silver lining of a flop insurance dispute, or most any insurance dispute, is that it provides work for starving lawyers. Well, perhaps not so starving. According to an account of the litigation surrounding insurance covering a handful of "failed" movies, counsel fees were expected to exceed $100 million. *Id.* at 91.

In light of all this, how can anyone say insurance is boring? Even if insurance lacks the drama of presidential impeachment or constitutional equal protection, it is

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19 *See* Joseph B. Treaster, *The Race to Predict Terror's Costs*, N.Y. TIMES, Sept. 1, 2002, at B3, col. 2 (discussing efforts of industry consultants to build economic models for calculating terrorism risks so that insurers may underwrite and price such risks effectively).

20 *See* ELLEN JOAN POLLOCK, THE PRETENDER (2002); Ellen Joan Pollock, *The Pretender: A Look at the Strange World of Martin Frankel*, WALL ST. J., Jan. 7, 2002, at C1, C10 ("Gawky, with a deathly pallor, [Frankel] was not a looker. But he attracted women by appearing to absorb himself in their problems and needs. And, of course, there was the money.").

21 *News of the Weird: No Accident*, LAS VEGAS SUN, Aug. 16, 2002, at 12B. In his defense, Rev. Gray told the court that he considered himself a "man of God" who "got a little confused."

22 *See* Diane Richardson, *Bite Claims Can Dog Insurance Companies*, NATIONAL UNDERWRITER, May 14, 2001 (Prop. & Cas. ed.), at 10.

sufficiently pervasive and important that lawyers should have a basic understanding of its operation and legal framework.

A basic orientation to insurance — its history, its function, its typical operation, its key concepts, and its standard policies — is an essential first step in studying insurance. This chapter attempts to set forth these basic concepts in the operation of insurance.

§ 1.02. THE HISTORICAL BACKGROUND AND NATURE OF INSURANCE

Insurance in some form has existed for centuries. Insurance broadly defined is simply a form of risk shifting and risk spreading among persons. When prehistoric tribes hunted dangerous prey in packs or divided precious goods among several members for safe keeping, these cooperative ventures also acted to spread the risk of injury or loss among the tribe and to shift the risk of loss from the individual to the group.

As society became more organized and mercantile, this sort of "insurance-in-kind" became more express. For example, trade caravans and Phoenician and Greek merchants (circa 300 B.C.) expressly divided their goods among different carriers and agreed to jointly share losses if the caravan was attacked or a ship lost in a storm.[23] Some authorities trace marine and casualty insurance to the Babylonian Code of Hammurabi (circa 2250 B.C.). In the merchant city-states of the Venice, Genoa, and Florence (circa 1300–1700), insurance became a more detailed and monetary industry, with financiers expressly receiving money in exchange for a promise for reimburse possible losses befalling a trade shipment.

By 1400, there were statutes regulating insurance in these cities. The Italian custom of making written contracts of insurance spread throughout Europe, in part because of the commerce of the Hanseatic League (circa 1300–1500). The modern term insurance "policy" is derived from the Italian word "poliza," which means a "folded writing." Barcelona appears to have had a reasonably well-established market for life insurance by the 15th century as well. *See* Geoffrey Clark, *The Slave's Appeal: Insurance and the Rise of Commercial Property, in* The Appeal of Insurance 57–58 & nn.25–27 (Geoffrey Clark et al. eds. 2010).[24] *See also* Geoffrey Clark, Betting on Lives (1999) (expansive tracing of rise of life insurance, with focus on England).

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[23] For a brief but lively review of insurance history, *see* Andrew Tobias, The Invisible Bankers (1982). For more extensive historical background, *see* Anthony Brown, Lloyd's of London (1975). For an updated but slightly polemical look at Lloyd's and its reaction to the "asbestos coverage crisis" of the 1980s and internal strive at Lloyd's, *see* Adam Raphael, Ultimate Risk (1995). Several successful suits by Lloyd's passive investors alleged mismanagement, favoritism, or occasionally even fraud by the active managers of certain Lloyd's syndicates.

[24] A depressing, scandalous aspect of the rise of insurance practice included insurance on slaves shipped across the Mediterranean and the Atlantic, a practice that when highlighted in the infamous case of the *Zong* (a ship on which the captain threw injured and sick slaves overboard in 1781 as part of what appears to have been an insurance scam) helped to fuel abolitionist public sentiment in England. *See* Clark, *The Slave's Appeal*, *supra*.