

# Is There Any Value? Reevaluating Homeowners Insurance Valued Policy Laws

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## Abstract

*State valued policy laws for homeowners insurance are a notable exception to the principle of indemnity. These laws require that insureds receive the full face value of their insurance in the event of a total loss, irrespective of the face value's relationship to the house's actual cash value. This Paper explores the consequences of these laws, ultimately concluding that they actually hurt policyholders despite their pro-homeowner justification. With a combination of the first empirical test of the cost imposed by valued policy laws as well as theoretical arguments, this Paper finds that valued policy laws hurt insureds in several ways: insureds pay more than they otherwise would for insurance; insurers experience diminished incentives to engage in risk classification; and insureds cannot cheaply plan for unanticipated increases in housing prices. Justifications to continue valued policy laws have lost much of their force in light of modern insurance practices. Repealing valued policy laws could provide significant welfare gains to insureds while bringing homeowners insurance more in line with fundamental principles of insurance.*

<b>Introduction .....</b>	<b>2</b>
<b>I. The Development of Valued Policy Laws .....</b>	<b>5</b>
A. Valued Policy Laws Today .....	9
<b>II. Empirical Test: Do Valued Policy Laws Increase Premiums?.....</b>	<b>13</b>
A. Categorizing the States .....	14
B. Assembling a Dataset.....	17
C. Examining the Data.....	20
<b>III. Valued Policy Laws and Actual Cash Value: Differences Caused in the Marketplace.....</b>	<b>24</b>
A. More Expensive Premiums .....	25
B. Diminished Incentive for Risk Classification.....	31
C. Reduced Ability to Ensure Sufficient Coverage .....	36
<b>IV. Some Remaining Considerations .....</b>	<b>42</b>
A. Equitable Considerations .....	42
B. Voluntary Use of Valued Policy Laws .....	45
<b>V. Conclusion.....</b>	<b>48</b>
<b>Appendix.....</b>	<b>49</b>

## INTRODUCTION

A fundamental tenet of insurance law is that an insurance policyholder (the “insured”) should not profit from a covered loss. The prospect of this profit can lead the insured to try to promote a loss event or not take sufficient steps to prevent it. This phenomenon, known as “moral hazard,” is certainly undesirable from a social perspective.<sup>1</sup> Conceptions of equity and the promotion of properly functioning insurance markets suggest that deviations from the principle of indemnity require strong justifications.<sup>2</sup>

Homeowners insurance generally conforms to the principle of indemnity. The usual policy commits the insurer to compensating the insured for covered losses up to the policy’s specified face value amount, minus a deductible, in exchange for an annual premium. The default measurement for these losses is generally some form of the insured’s interest in the property that was lost such as actual cash value,<sup>3</sup> ensuring the insured will not profit from a covered loss. Nineteen<sup>4</sup> states, however, modify this typical arrangement by requiring that in the event of a total loss, generally of a home, from specified causes that vary by state but which include at least fire, the insurer must pay the insured the entire face value of the policy. This requirement holds regardless of the relationship between the policy’s face value and the actual value of the destroyed property, and regardless of alternative valuation clauses in the insurance contract less favorable to the insured.<sup>5</sup> These “valued policy laws” can result in the insured being better off in the event of a

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<sup>1</sup> See Steven Shavell, *On Moral Hazard and Insurance*, 93 Q.J. ECON. 541 (1979). These losses provide a transfer to the insured, but result in a loss of social welfare from the destroyed property.

<sup>2</sup> Insurance serves the important role of smoothing resources over time by providing compensation if losses are realized. This resource smoothing comes at the cost of lower overall expected resources, with the benefit of less variation in these resources. Profiting from losses increases the cost as well as the variation, making insurance more expensive. See, e.g., George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1539 (1987) (providing an excellent accessible primer on the functions of insurance markets).

<sup>3</sup> ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW 647-48, 657 (2007). Recently replacement cost coverage, where the insurer agrees to replace the property as long as sufficient levels of insurance, has arisen as a contractual alternative to actual cash value.

<sup>4</sup> The states are Arkansas, Florida, Georgia, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, North Dakota, Ohio, South Carolina, South Dakota, Tennessee, Texas, West Virginia, and Wisconsin. See *infra* Tables A2-A3 for a complete listing of states and relevant statutory sections.

<sup>5</sup> See, e.g., Michael J. Skeary, *Valued Policy Laws: A Comparative Analysis*, 44 TORT TRIAL & INS. PRAC. L.J. 1067, 1068 (2009); see also *Sun Mut. Ins. Co. v. Holland*, 2 Wills. 391 (Tex. App. 1884) (early statement of valued policy laws’ compulsory applicability).

total loss when the policy's face value exceeds the actual cash value of the loss, violating the principle of indemnity that is so important for efficient insurance markets.

Valued policy laws have been justified in several ways. First, they force insurers and insureds to agree on the value of insured property before any loss occurs. Agreeing on the value before loss with a valued policy should be an easier and more accurate process than trying to determine the property's value once it has already been destroyed with an actual cash value policy, which can involve significant uncertainty and cause costly disputes.<sup>6</sup> Second, related to the first, by fixing the insurer's liability equal to the policy's face value, valued policies prevent the insurer from opportunistically collecting premiums based on one value and then, in the event of a loss, arguing that the actual value of the covered property is less than the policy's face value.<sup>7</sup> Third, valued policies promote a social goal of deterring insurers from underwriting risky policies where the face value greatly exceeds the property's value.<sup>8</sup> And finally, valued policy laws have been seen as an equitable device to give insureds what they had been paying for; that is, if the insured was paying for \$100,000 face value coverage, he should receive \$100,000 in the event of a total loss.<sup>9</sup>

On the other hand, criticisms have been levied against valued policy statutes. If the insurer responds to valued policy liability by appraising more properties, these costs will be passed along to consumers in the form of higher premiums.<sup>10</sup> If instead insurers underwrite as usual, then the moral hazard generated by face values in excess of actual cash values may promote insureds to take steps to facilitate destruction of their property.<sup>11</sup> These criticisms have prompted legal academics to question the wisdom of valued policy statutes.<sup>12</sup>

Despite these justifications and criticisms and an active practice-related literature,<sup>13</sup> valued policy laws have lacked a rigorous academic analysis of their

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<sup>6</sup> See, e.g., *Ceballo v. Citizens Prop. Ins. Corp.*, 967 So.2d 811, 813 (Fla. 2007); *Tedford v. Security State Fire Ins. Co.*, 278 S.W.2d 89, 91 (Ark. 1955).

<sup>7</sup> See *Tedford*, 278 S.W.2d at 91.

<sup>8</sup> See, e.g., *Eckerd v. Country Mut. Ins. Co.*, 289 S.W.3d 738, 744 (Mo. App. E.D. 2009).

<sup>9</sup> KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION* 272 (2010).

<sup>10</sup> See, e.g., *id.*

<sup>11</sup> *Id.*; S. S. HUEBNER, *PROPERTY INSURANCE: A TEXTBOOK* 156-57 (1938).

<sup>12</sup> See ROBERT E. KEETON, *BASIC TEXT ON INSURANCE LAW* § 3.8 (1971) (concluding that "the principle of indemnity would be better served by repeal of valued policy statutes"); ABRAHAM, *supra* note 10, at 272-73; LEO P. MARTINEZ, *CASES AND MATERIALS ON INSURANCE LAW* 634 (2010); JERRY & RICHMOND, *supra* note 3, at 657-60 (2007).

<sup>13</sup> See, e.g., Skeary, *supra* note 5; Mitchell F. Crusto, *Louisiana Valued Policy Law: When Total Loss Equals Total Payment?*, LA. B.J., Aug./Sept. 2007, at 87; R. Jason Richards, *Florida's "Valued Policy" Law: Clarifying Some Recent Misconceptions*, FLA. B.J., Dec. 2005, at 18; John V. Garaffa, *Florida's "Valued Policy" Law: The Eye of the*

true impact on insurers and insureds. Such an analysis will prove particularly helpful, since a large number – approximately 35% – of U.S. households are subjected to valued policy laws,<sup>14</sup> meaning any costs imposed could be significant in aggregate. Further, homeowners insurance is one of the most prevalent forms of consumer insurance lines. Most mortgages require the homeowner to maintain a homeowners insurance policy, and those without mortgages also frequently insure their houses. Consequently, homeowners insurance is a massive industry, with over \$65 billion spent annually on premiums<sup>15</sup> and with homeowners insurance held by most homeowners.<sup>16</sup> Legislatively-created inefficiencies in an industry this substantial can therefore have significant repercussions. This Paper investigates valued policy laws' impact from both empirical and theoretical perspectives.

This Paper proceeds as follows. Part I describes the history of valued policy laws and how their function has changed over time. During this discussion, traditional arguments for and against valued policy laws are reviewed. Part II conducts an empirical test of whether valued policy laws increase insurance premiums. Part III then undertakes a detailed theoretical examination into how valued policy laws function in the market, exploring the traditional advantages and disadvantages of valued policy laws as well as several previously unconsidered costs. Many of valued policy laws' justifications are debunked, leaving a strong argument against their continued use. Part IV considers remaining non-market issues with valued policy laws, including whether equitable considerations truly provide support for their existence as well as why they occur voluntarily in non-homeowners insurance contexts. Part V concludes.

Three particular points should be kept in mind while reading this Paper. First, the Paper will refer to valued policies as applying to houses, although in some states the application is to a broader class of property.<sup>17</sup> Second, throughout much of the Paper valued policy laws are compared to actual cash value indemnity, since actual cash value is generally the alternative default measure in other states. Other forms of reimbursement that can be obtained by contract, in particular replacement cost

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*Storm*, FLA. B.J., April 2005, at 8; Kristin Hual & Michael Schofield, *Valued Policy Law: A Historical Perspective on the Compounding Equation*, TRIAL ADVOCATE Q., Summer 2005, at 1; Herbert J. Baumann, Jr., *Recovery Under the Valued Policy Law*, BRIEF, Winter 1989, at 45.

<sup>14</sup> See U.S. Census Bureau State-Level Housing Unit Estimates, *available at* <http://www.census.gov/popest/housing/housing.html> (last visited December 27, 2010). Author's calculations show that states with valued policy laws accounted for 37.1% of household units in 2000 and 38.0% of estimated household units in 2009.

<sup>15</sup> A.M. BEST CO., BEST'S AGGREGATES AND AVERAGES: PROPERTY-CASUALTY 388 (2010) [hereinafter BEST'S AGGREGATES].

<sup>16</sup> See, e.g., ALABAMA COOPERATIVE EXTENSION SYSTEM, HE-0665 HOMEOWNER'S INSURANCE, *available at* <http://www.aces.edu/pubs/docs/H/HE-0665/> (October 1998) (citing a 1986 study that found 95% of national homeowners carry homeowners insurance).

<sup>17</sup> See *infra* Table A2.

coverage, share many features with actual cash value and can be substituted for actual cash value in much of the forthcoming discussion. In circumstances where the analysis differs, these alternate damage measures are considered explicitly. And finally, it is important to remember that homeowners insurance, whether with a valued policy provision or not, insures the home and personal property but not land. When a person buys a house, he buys not only the structure but also its accompanying land. Although this price that is paid for the home plus land varies significantly over time as market conditions and consumer sentiments change, these price movements result from changes in the value of land. The value of the home itself, based on only the cost to build the house, moves much less, and it is this more stationary value that is insured by homeowners insurance policies.<sup>18</sup>

## I. THE DEVELOPMENT OF VALUED POLICY LAWS

Valued policy laws have a rich history. The first valued policy law was passed in Wisconsin in 1874<sup>19</sup> in response to insurers who were purportedly selling policies with face value greatly in excess of actual cash value.<sup>20</sup> Interestingly, insurance contracts had voluntarily contained clauses similar to valued policies, but insurers had systematically switched to actual cash value as a measure of indemnity in the 1870s because of the growth of fires in overinsured houses.<sup>21</sup> Once enacted by Wisconsin, statutory valued policies quickly caught on across the country, becoming enacted in 24 states by 1909.<sup>22</sup>

Figure 1

### States with Valued Policy Laws, By Year

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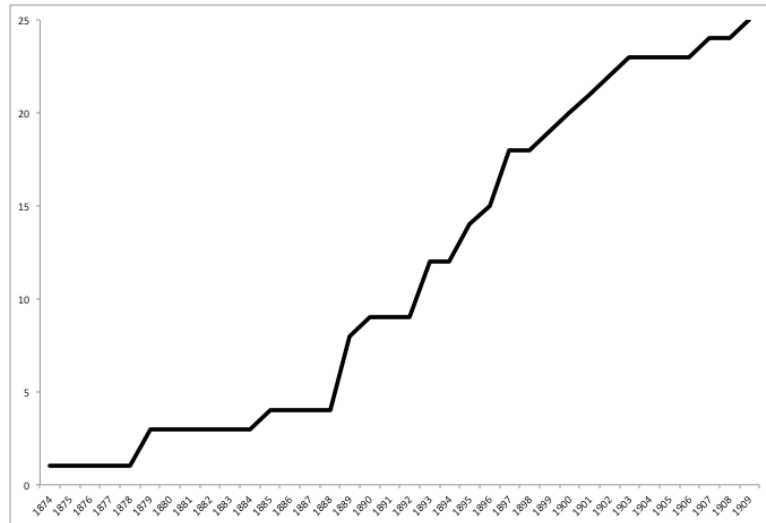
<sup>18</sup> A good index of home construction prices is maintained by Engineering News-Record, <http://enr.construction.com/economics/> (last visited March 27, 2011).

<sup>19</sup> See, e.g., *Seider v. O'Connell*, 612 N.W.2d 659, 671 (Wis. 2000). An in-depth history of Wisconsin's valued policy law is contained in SPENCER L. KIMBALL, *INSURANCE AND PUBLIC POLICY* 240-49 (1960).

<sup>20</sup> *Seider*, 612 N.W.2d at 671-72; Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 261 (1996).

<sup>21</sup> *Seider*, 612 N.W.2d at 671-72.

<sup>22</sup> Dates of enactment are derived from HAYDEN'S ANNUAL CYCLOPEDIA OF INSURANCE IN THE UNITED STATES 1903-1904 626-38 (1904) (hereinafter "1903-04 CYCLOPEDIA"; HAYDEN'S ANNUAL CYCLOPEDIA OF INSURANCE IN THE UNITED STATES 1913-1914 315-22 (1914); ANNUAL CYCLOPEDIA OF INSURANCE IN THE UNITED STATES 1920 201-02 (1920). There were minimal apparent changes in the states with and without valued laws from 1909 to at least 1964. See, e.g., the following years and corresponding pages of volumes from ANNUAL CYCLOPEDIA OF INSURANCE IN THE UNITED STATES showing no changes: 1938, 500-01; 1944, 559-60; 1949, 671-72; 1954, 707-08; 1956, 737-38; 1963, 737-38; 1964, 737-38. Montana passed its valued policy statute in 1959, outside of the time range shown above. MONT. CODE ANN. § 33-24-102 (2009). Several other states with valued policy laws also eventually eliminated them.



Despite the rapid spread of these laws, their passage was a very contentious issue at the time. They were often opposed both by insurers as well as by insurance commissioners, and they frequently failed to pass state legislative votes or were vetoed by state governors.<sup>23</sup> The text from the Colorado governor's veto in 1899 is indicative of this sentiment. In addition to expressing doubts regarding the law's inapplicability to partial losses or personal property, the governor wrote:

It is true that the opinions of owners of property differ widely on assessment day . . . yet inquiry of them, together with personal inspection, must combine to give the underwriter his best basis of value.

It may be that if this bill should become a law it would produce a class of property valuation experts whose estimates would be more nearly reliable than those of other men, but for the services of those experts the policy-holder would be compelled to pay. The increased rate necessarily resulting would be neither satisfactory nor borne with patience.

But independent of and beyond these considerations is the all-important fact that the bill ignores the fundamental principle of fire insurance and thereby transforms the contract from one of indemnity to one of wager and speculation . . . . A departure from this principle creates injustice, promotes dishonesty, and encourages crime. Incendiarism is sufficiently prevalent without offering legislative rewards for its occurrence . . . .

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<sup>23</sup> See, e.g., THE ANNUAL CYCLOPEDIA OF INSURANCE IN THE UNITED STATES, 1892-93 445 (1893) (recounting legislative developments in valued policy laws from 1892); 80 STANDARD 229, 231 (Mar. 3 1917) (quoting several state insurance commissioners and commissions critical of valued policy laws).

The increased burden which these laws impose upon the insurer is shifted by him upon the mass of policy-holders, and the community is the ultimate sufferer.<sup>24</sup>

Insurers similarly decried the laws, focusing particularly on apparent increases in intentional fires.<sup>25</sup> They ultimately grew so frustrated with the law that, when it passed in New Hampshire in 1885 (the fourth state to adopt such legislation), they withdrew from the state completely, leaving the people of New Hampshire without fire insurers.<sup>26</sup> Only in 1890 did they begin to return.<sup>27</sup>

Proponents of valued policy laws, on the other hand, emphasized them as an equitable method of ensuring that insureds received the full compensation for which they had been paying premiums. In addition, the laws would force insurers to exercise stricter control over their agents' writing inflated policies to receive higher commissions.<sup>28</sup> As written by a New Hampshire newspaper,

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<sup>24</sup> Governor Charles S. Thomas, Veto of Colorado Valued Policy Law (1899), reprinted in 1903-04 CYCLOPEDIA, *supra* note 22, at 635-36.

<sup>25</sup> W.P. Harford, *Valued-Policy Incendiarism*, 30 ANN. MEETING FIRE UNDERWRITERS' ASS'N OF THE NW. 101-04 (1899); see also A. F. DEAN, THE RATIONALE OF FIRE RATES: A STUDY OF THE PERSONAL INFLUENCES AFFECTING FIRE INSURANCE COST 103-05 (1901) (criticizing valued policy laws as promoting arson, and noting most vividly that these laws "put[] it in the power of the average man to strike a bonanza . . . with a lucifer match.") According to W.P. Hartford, loss ratios (the ratio of claims paid by insurers to premiums paid by insureds) increased significantly in states with valued policy laws after the laws were passed, suggesting that moral hazard behavior was greater than insurers had anticipated. However, this increase is also consistent with a move towards more-competitive rate setting. Although trends in loss ratios for states without valued policy laws are not provided, Mr. Harford mentioned the disturbing "tendency to reduce rates." W.P. Hartford, *supra* at 104. To the extent valued policy laws increase moral hazard, insurers should respond by increasing rates to preserve loss ratios; it seems unlikely that insurers would underestimate valued policy laws' influence on moral hazard in all states that passed the law, which would be required for the increase in loss ratios in states with valued policy laws to be due solely to moral hazard effects.

<sup>26</sup> *The Valued Policy Law: Home View of the New-Hampshire Fire Insurance Law*, N.Y. TIMES, Sept. 13, 1885 (quoting PORTSMOUTH TIMES (New Hampshire), Sept. 11, 1885); 1903-04 CYCLOPEDIA, *supra* note 22, at 627.

<sup>27</sup> 1903-04 CYCLOPEDIA, *supra* note 22, at 627.

<sup>28</sup> Agents' commissions were, and continue to be, typically proportional to the size and number of the policy sold. See, e.g., BUREAU OF LABOR STATISTICS, OCCUPATIONAL OUTLOOK HANDBOOK: INSURANCE SALES AGENTS 4 (2010-11 ed.) (2010), <http://www.bls.gov/oco/pdf/ocos118.pdf> (summarizing current compensation schemes).

No law enacted by our Legislature for years has made such a rumpus as the recently enacted “valued insurance policy,” so called . . . . What there is in the law to cause such a general uprising or combination against it does not appear to the plain common people of New-Hampshire. They see in it only a law to hold insurance companies to perform what they agree to do and what the insured have paid them for doing; that is, if they have insured a house . . . they shall pay that sum in case the property insured is totally destroyed by fire, and not, as is now frequently the case, undertake after the property is burned to show that it was not worth the sum they had insured upon it, and cause the insured to stand a lawsuit or accept a much less sum than that named in his policy of insurance. This course has so often been pursued by the insurance companies that, as we understand it, the people of the State have got out of patience and demand that some remedy be applied. Such appears to have been the origin of the recent law, and we confess that we can see no injustice toward the companies in this provision.

It is complained on the part of the companies that this provision gives them no protection against over insurance, and thus becomes a bounty on rascality. But this could only be by the connivance of the local agents of the companies, and the companies should see to it that their agents are worthy of trust and not make the insured suffer for the wrongdoing of those who are the servants of the companies.<sup>29</sup>

The conflict was ultimately brought before the United States Supreme Court when insurers challenged the main provisions of Missouri’s valued policy law in *Orient Ins. Co. v. Dagg*s.<sup>30</sup> Missouri’s valued policy law was typical of those in force at the time, requiring that for total losses, fire insurance damages be fixed at the policy value less depreciation.<sup>31</sup> A fire insurer challenged the law by asserting it violated the fundamental right to make contracts of insurance.<sup>32</sup> This right, the insurer claimed, hinged on insurance contracts being contracts of indemnity, and Missouri’s valued policy law converted indemnity contracts into “contracts . . .

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<sup>29</sup> *The Valued Policy Law: Home View of the New-Hampshire Fire Insurance Law*, *supra* note 26.

<sup>30</sup> 172 U.S. 557 (1899)

<sup>31</sup> HAYDEN’S ANNUAL CYCLOPEDIA OF INSURANCE IN THE UNITED STATES, 1899-1900, 622 (1900) (quoting MO. REV. STAT. § 6009 (1900)). Missouri’s valued policy law also required that partial fire losses were assessed proportionally to the policy value, and if a house was insured with several insurers, the insured could recover based on the full policy value from all of them. *Id.* (quoting MO. REV. STAT. §§ 6009, 6009a (1900)). While not all valued policy law states shared these latter provisions or the deduction for depreciation, these issues also did not arise in the Supreme Court challenge.

<sup>32</sup> *Orient*, 172 U.S. at 564-65.

having for their bases speculation and profit, 'contrary to the course of the common law.'"<sup>33</sup>

After asserting that valued policy laws have "never been condemned as . . . wager policies or as introducing elements of speculation," the Court dismissed the insurer's argument by determining that valued policy laws

do[] not present the alternative of wager policies to indemnity policies. The change is from one kind of indemnity policy to another kind, – from open policies to valued policies, – both of which are sanctioned by the practice and law of insurance, and this change is the only compulsion of the law. It makes no contract for the parties. In this it permits absolute freedom.<sup>34</sup>

The Court went on to observe that the only harm to insurers could come only from the failure to exercise proper care in ensuring homes were properly valued, which insurers should exercise regardless of the valued policy law.<sup>35</sup> Thus, because valued policy laws were not oppressive towards insurers, and because they achieved a valid legislative goal of assuring the insured of a fixed compensation, the infringement on contracting rights (to the extent there were any) was within states' legislative powers.<sup>36</sup> Consequently, judgment against the insurer was affirmed.<sup>37</sup>

*Orient* settled the constitutionality of valued policy laws, perhaps spurring the final flurry of states that adopted valued policy laws after 1899. Although a few states have since repealed them, valued policy laws have generally become an accepted feature of homeowners insurance policies remaining today in over one-third of the states.

#### A. Valued Policy Laws Today

Today among the states that have them, valued policy laws differ along some finer nuances, but all share several important common features: they apply at least in the case of total loss of a personal residence due to fire,<sup>38</sup> and the valued policy total loss provision cannot be waived in favor of

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<sup>33</sup> *Id.* at 565.

<sup>34</sup> *Id.* This is not the first time a major court had dismissed the argument that valued policies are an illegal form of wager contract. *See Lewis v. Rucker*, 2 Burr. 1167, 97 Eng. Rep. 769 (K.B. 1761). In this case, Lord Mansfield dismissed the argument that valued policies are in general a form of illegal wager, because to hold this way would have rendered the prevailing Marine Insurance Act void. Lord Mansfield did make an exception was made for policies that "much over-valued" the insured property. *Id.* at 1170-72.

<sup>35</sup> *Orient*, 172 U.S. at 565.

<sup>36</sup> *Id.* at 565-66.

<sup>37</sup> *Id.* at 567.

<sup>38</sup> *See, e.g., Jerry & Richmond, supra* note 3, at 658.

less-comprehensive indemnity by insurers or insureds.<sup>39</sup> Although several of the valued policy laws statutorily apply to “fire insurance,” they are almost always interpreted as applying to homeowners insurance more generally.<sup>40</sup> Some states extend the law to apply to personal (as opposed to only real) property,<sup>41</sup> to losses from additional causes beyond fire,<sup>42</sup> and to partial losses on a proportional basis.<sup>43</sup> In the case of several policies insuring a house for on aggregate more than its worth, some states assign total liability equal to the house’s value and allocate this liability pro-rata to each insurer,<sup>44</sup> while others award the insured the cumulative face value of the policies.<sup>45</sup> Insurers in some jurisdictions can deduct depreciation from the face value.<sup>46</sup>

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<sup>39</sup> See, e.g., *Grandview Inland Fruit Co. v. Hartford Fire Ins. Co.*, 66 P.2d 827, 834 (Wa. 1937) (ruling that “[t]he purpose of statutes of the character of the valued policy statute would be defeated if their effect could be avoided by contract”); Skeary, *supra* note 5, at 1068 (observing that “[i]n general, valued policy laws are not optional”). The only potential state where valued policy laws could be waived in favor of a less-protective damages measure is Louisiana. See *infra* notes 66-67 and accompanying text for discussion of Louisiana’s valued policy law

<sup>40</sup> The application to specifically fire insurance policies, rather than to homeowners policies or in general any policy covering a home, seems to stem from the early compartmentalization of the American insurance industry, in which insurers covered only narrow fields such as fire losses to homes. Only in 1950, once most valued policy laws had already been passed, did insurers begin moving towards the broader homeowners policies of today. Frederic J. Hunt, Jr., *Homeowners – The First Decade*, 49 PROCEEDINGS CASUALTY ACTUARIAL SOC’Y 12, 12-13 (1962). Consequently, because most homes today buy more comprehensive homeowners insurance instead of just fire insurance, states and insurers follow the spirit of the law by treating valued policy laws as applying to homeowners insurance even if the statute specifies only fire insurance. See, e.g., *Adams v. Tennessee Farmers Mut. Ins. Co.*, No. W2009-00931-COA-R3-CV, 2010 WL 1444477 (Tenn. Ct. App. Ap. 13, 2010); *Farmers-Merchants Bank & Trust Co. v. St. Katherine Ins. Co.*, 693 So.2d 876 (La. Ct. App. 1997), *writ denied*, 703 So. 2d 25 (La. 1997); *Vail v. Texas Farm Bureau Mut. Ins. Co.*, 754 S.W.2d 129 (Tex. 1988). *But see* *Landry v. Louisiana Citizens Property Ins. Co.*, 983 So.2d 66 (La. 2008) (overturning Louisiana precedent and deciding that valued policy law applied only to fire insurance, not more-general homeowners insurance that included fire coverage, even though insurer had already conceded that valued policy law applied to homeowners policy).

<sup>41</sup> E.g., MONT. CODE ANN. § 33-24-103 (2009) (extending valued policy law to non-automobiles that are specifically valued).

<sup>42</sup> E.g., KAN. STAT. ANN. § 40-905 (2000 & Supp. 2010) (applying valued policy law to fire, tornado, windstorm, and lightning losses).

<sup>43</sup> MO. ANN. STAT. § 379.140 - .150 (West 2002).

<sup>44</sup> E.g., S.D. CODIFIED LAWS § 58-10-10 (2004).

<sup>45</sup> MO. ANN. REV. STAT. § 379.140 - .150 (West 2002).

<sup>46</sup> *Id.*

While a primary goal of valued policy laws is to offer a measure of certainty to insureds in the event of a total loss, this certainty has been undermined in several ways. A menu of defenses available to insurers, difficulty in determining what is a “total loss,” and contention over appropriate damages associated with losses from simultaneous covered and uncovered events combine to make valued policy law coverage not as sure as might at first be expected or desired.

As is typical with most forms of insurance, homeowners insurers can challenge coverage for a variety of reasons including fraud, misrepresentation, collusion, mistake, an increase in risk, or criminal conduct by the insured such as intentional destruction of the house.<sup>47</sup> The idea is not only to promote low-cost and accurate pricing of premiums, which is greatly helped when the insurer can rely on information provided by the insured, but also to advance public policy against these types of behavior.<sup>48</sup> Intuitively from an efficient market-promoting perspective, these reasons should be cause for voiding coverage only when they lead to an unanticipated (by the insurer) increase in covered losses, since otherwise they should not be of relevance during contracting. We may still want to invalidate coverage in other cases on promoting public policy morality goals, but there may be less of a compelling reason to also allow insurers to benefit in those cases.<sup>49</sup> Because valued policy contracts’ liability is fixed at the policy’s face value, fraud, misrepresentation, collusion, and mistake should invalidate coverage only when they also lead to an increase in risk or intentional destruction. Such is not always the interpretation by courts, however.<sup>50</sup> Thus, simply because an insured has obtained valued policy coverage does not mean he is guaranteed recovery under a total loss due to covered causes.

When confronted with a claim, insurers can raise the above defenses, but they can also argue over whether a total loss has occurred. Recall that valued policy laws apply only under a “total loss;” liability for partial losses is

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<sup>47</sup> See *Tedford v. Security State Fire Ins. Co.*, 278 S.W.2d 89, 92 (Ark. 1955). These rights to void coverage are sometimes built directly into the valued policy law statute. See, e.g., MINN. STAT. § 65A.08 (2005). They also need not be shown directly. For instance, over-valuation can be presented as evidence of fraud, although on its own it will not be conclusive evidence. *Sullivan v. Hartford Fire Ins. Co.*, 34 S.W. 999, 1000 (Tex. Civ. App. 1896).

<sup>48</sup> See, e.g., Hugh R. Kincaid, *Problems Arising Under Valued Policy Insurance Statutes*, 12 ARK. L. REV. 184, 194 (1958).

<sup>49</sup> One reason may be that insurers are effective parties at bringing these suits, and in a competitive market any recoveries they gain will ultimately be passed back to insureds as lower premiums.

<sup>50</sup> See Skeary, *supra* note 5, at 1086-89 (discussing courts’ varying interpretations of the effect of misrepresentation and fraud).

generally determined by the actual cash value of the loss. Therefore, the certainty dictated by valued policy laws is lost in cases where the house has not been entirely wiped out. The question of whether a loss is a total loss is a question of fact<sup>51</sup> and is therefore, as with other issues decided by a jury, subject to uncertainty. Jurisdictions apply a variety of tests and combinations of tests, including whether the house has lost its identity, whether a reasonable uninsured would use remains of the house as a significant basis to restore it, whether the cost to restore the house exceeds its ultimate value, and whether local law requires condemnation of the house.<sup>52</sup> As suggested by their brief descriptions, the tests allow ample leeway for a jury to make the outcome unpredictable.

The final defense for insurers concerns the treatment of “concurrent causation” in valuing losses from both covered and excluded causes. This issue is not unique to valued policy laws, but rather is a feature of homeowners insurance more generally. Insurers often try to disclaim by contract any coverage for losses arising from both covered and excluded causes, although courts do not always enforce these provisions. Hurricane Katrina provides a recent example of this type of unpredictability. The hurricane brought fierce winds in addition to massive flooding from storm surge, and in many cases either the winds (a covered cause) or the surge (an excluded cause) could independently have caused the damage sustained. Courts in Mississippi and Louisiana interpreted the concurrent causation issue differently, with the Mississippi courts generally disallowing claims with an excluded concurrent cause and Louisiana at first seeking to uphold them.<sup>53</sup> Dealing with this complicated issue goes beyond the scope of this Paper,<sup>54</sup> but it is important to observe that concurrent causes add another degree of uncertainty to valued policy payments.

Certainly, circumstances have changed since valued policy laws were passed in the nineteenth and early twentieth centuries. Insurers have

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<sup>51</sup> See, e.g., *U.S. Fire Ins. Co. v. Boswell*, 82 S.W.2d 176, 178 (Tex. Civ. App. 1935).

<sup>52</sup> *Haught v. State Farm Gen. Ins. Co.*, No. 2:08 CV 20 DDN, 2009 U.S. Dist. LEXIS 64272, at 18-20 (E.D. Mo. July 27, 2009); see generally *Skeary*, *supra* note 5, at 1075-1084 (providing further discussion on these different tests); *Kincaid*, *supra* note 48, at 193-94 (same).

<sup>53</sup> Compare *Tuepker v. State Farm Fire & Cas. Co.*, No. 1:05CV559 LTS-JMR, 2006 WL 1442489 (S.D. Miss. May 24, 2006) with *In re Katrina Canal Breaches Consolidated Litigation*, 466 F.Supp. 2d 729 (E.D. La. 2006). The Louisiana decision was later overturned in *In re Katrina Canal Breaches Litigation*, 495 F.3d 191 (5th Cir. 2007), in which the insurer’s right to void claims from an excluded concurrent cause was upheld.

<sup>54</sup> For a more rigorous treatment, see, e.g., Joseph Lavitt, *The Doctrine of Efficient Proximate Cause, the Katrina Disaster, Prosser’s Folly, and the Third Restatement of Torts: Cracking the Conundrum*, 54 LOY. L. REV. 1 (2008).

developed low-cost methods of estimating home values with reasonable accuracy, and market competition and regulation provide deterrents to overly-opportunistic behavior by insurers. Do valued policy laws still serve valuable functions today? And how do these benefits compare with the costs these laws impose on insureds? The remainder of this Paper explores these issues through empirical and theoretical investigations. The next Part tests whether valued policy laws result in higher insurance premiums.

## II. EMPIRICAL TEST: DO VALUED POLICY LAWS INCREASE PREMIUMS?

One of the criticisms levied against valued policy laws is that they result in extra costs to insureds. These costs arise because of the moral hazard risk that would result if a house were insured for greater than its actual cash value. If these moral hazard costs imposed by valued policy laws exceed the cost to appraise a house and determine a precise face value (eliminating the moral hazard problem), insurers would appraise houses and pass this appraisal cost along to insureds.<sup>55</sup> Of course, if appraisal expenses exceed the avoided costs, then insurers would not appraise houses and instead price the expected moral hazard costs as increased premiums. With actual cash value indemnity, no such moral hazard exists. Houses insured for only their actual cash value need only a cursory appraisal, if any at all, because actual cash value compensation makes sure the insured experiences no moral hazard incentives regardless of how much his policy value might exceed his house value.

Valued policy laws should result in more expensive insurance contracts for comparable coverage for an additional reason. Payouts for a total loss with a valued policy should be at least as great as those in a policy based on actual cash value, so premiums in valued policy law states should be higher still.

On the other hand, valued policy laws can reduce costs in the event of a total loss. Since the damages amount has been fixed, costs associated with reconstructing a destroyed building's value and with resolving conflicts over the estimated value are eliminated with valued policies.<sup>56</sup>

The relative magnitudes of these competing costs and savings are unclear. We know that an upper bound for much of the costs imposed by valued policy laws could not exceed the cost of appraisals – approximately 15% of premiums<sup>57</sup> -

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<sup>55</sup> See, e.g., Thomas, *supra* note 24.

<sup>56</sup> See, e.g., ABRAHAM, *supra* note 10, at 271-72.

<sup>57</sup> Chubb, an insurer who offers specialized policies involving individual appraisals, charges premiums approximately 15% above competitors' rates, although some of this excess may be due to Chubb's niche market. Susan B. Garland, *Shock No. 2: Insurance Isn't Enough to Rebuild*, N.Y. TIMES, Mar. 23, 2003, § 3, at 8.

This comparison takes as a baseline that insurers are not already doing appraisals. This assumption is justified by historical developments before valued

because a valued policy insurer who could obtain net savings by appraising houses and mitigating moral hazard and post-loss litigation costs would gain a valuable competitive advantage in the market. (If the benefits of appraisals did not exceed their costs, then insurers would not use them.)

Although if a value is contested the resolution expenses will likely exceed the cost to have appraised the house, the percent of homeowners that experience a total loss is small, and the percent of these homeowners that would then contest a valuation is smaller still. Since it is impossible to know beforehand which house values will be contested, moral hazard may also not play a large enough role in homeowners insurance to justify expensive appraisals.<sup>58</sup>

Moreover, we do not observe either insurers or insureds voluntarily choosing valued policies when they are able to, which suggests the overall valued policy savings do not outweigh additional costs.<sup>59</sup> On balance, then, the monetary magnitude of savings from valued policy laws is likely small. We would then expect homeowners insurance premiums in states with valued policy laws to be higher than comparable premiums in states without these laws, with the difference reflecting moral hazard costs (capped by the cost of appraisals) and the higher damage payment measure.

To test this hypothesis, I first classify the states according to whether they have actual cash value or valued policy laws. Then, for state borders where one side has actual cash value indemnity and the other has a valued policy law, I obtain comparable homeowners insurance quotes from each side. By comparing the relative difference in these quotes across all these borders, I can determine whether valued policy laws are associated with increased insurance premiums.

#### A. *Categorizing the States*

The fifty states were categorized according to whether they had valued policy provisions for homeowners insurance. If the state code and administrative regulations did not contain a valued policy provision, the state was assumed to not be a valued policy state.<sup>60</sup> The categorization is illustrated below, with a complete table of categorizations and relevant code provisions and characteristics in the Appendix.

Figure 2

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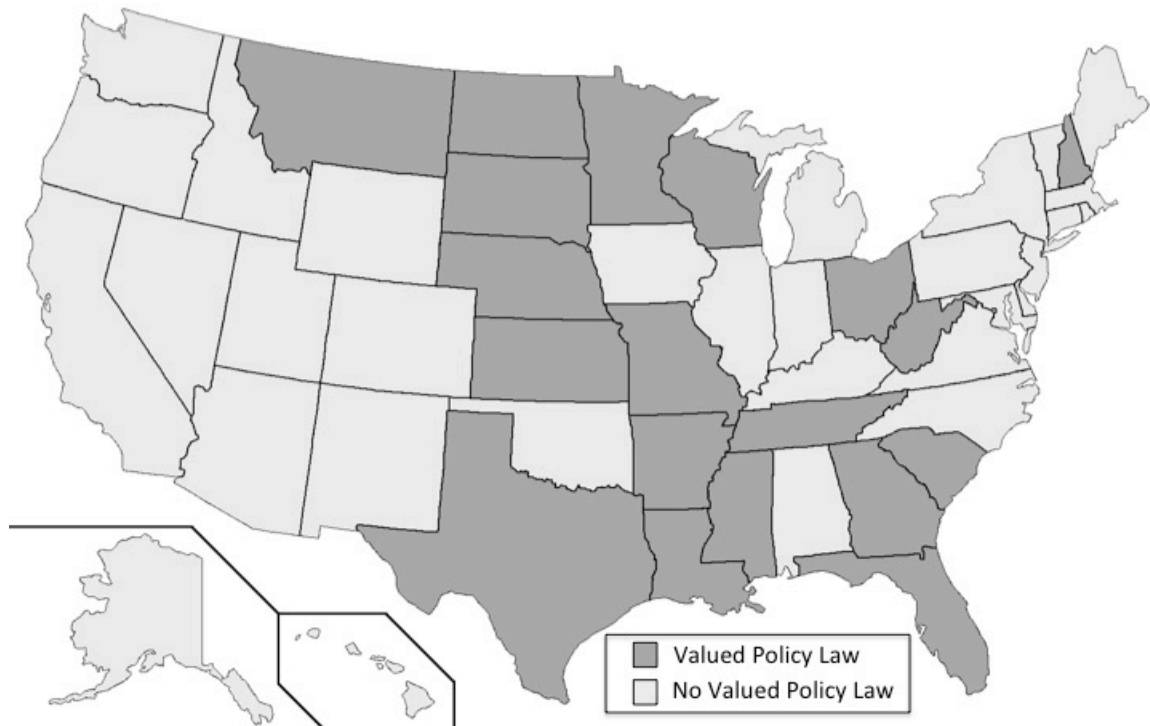
policy laws as well as by the conclusions drawn at the end of this Part. Although this assumption is not particularly important, without it the costs imposed by valued policy laws would be uncapped.

<sup>58</sup> The role of moral hazard is discussed more completely *infra* Part III.B.

<sup>59</sup> See *infra* Part IV.B for a discussion of when we see valued policies being used voluntarily in other circumstances, however.

<sup>60</sup> In some ambiguous cases, the existence of valued policy laws was verified directly with state insurance departments.

## Classification of States By Presence of Valued Policy Law



California, Vermont, Louisiana, and Tennessee presented some additional difficulty in categorization. California’s default measure of damages is fair market value, but insureds can opt into a valued policy measure if they pay for an appraisal.<sup>61</sup> Given the power of default provisions to influence behavior,<sup>62</sup> as well as most people’s relative lack of interest in or understanding of insurance law nuances,<sup>63</sup> it seems likely that most California policies are written with fair market

<sup>61</sup> CAL. INS. CODE §§ 2052, 2054 (West 2005).

<sup>62</sup> Several practical examples of this phenomenon are discussed in RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (2008).

<sup>63</sup> See, e.g., KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY* 1 (1986); JOHN G. DAY, *ECONOMIC REGULATION OF INSURANCE IN THE UNITED STATES* 64 (1970) (noting that insurance is “a subject matter which is unbelievably complex” involving “a vocabulary as unintelligible to the lay public as Sanskrit”); see also Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. \_\_\_ (forthcoming 2011) (arguing that homeowners insurers may exploit insureds’ ignorance when developing coverage contracts).

value damages. California is thus treated as not having a valued policy law for this analysis.

Vermont law similarly allows insureds to opt into valued policy contracts,<sup>64</sup> although unlike California, Vermont mandates that rates cannot be raised for these valued policy contracts and does not require the insured to pay for a pre-coverage inspection.<sup>65</sup> There is likely even less reason to treat Vermont as a valued policy law state than California; in addition to consumer indifference and lack of insurance knowledge, there is the incentive for insurance companies to refuse to write valued policies in Vermont or at least to refrain from publicizing them and instead use cheaper actual cash value policies. Any extra costs associated with valued policy damages must be borne by the insurance pool and result in less-competitive higher premiums relative to an insurer that issues no valued policies.

The following analysis treats California and Vermont as not having a valued policy law. In unreported results, treating California, Vermont, or both as having valued policies does not impact the significance of the conclusions that are drawn.

On the other side of the spectrum from California and Vermont, Louisiana allows insurers to opt out of valued policy contracts by specifying an alternative loss method.<sup>66</sup> If possible, it would seem within insurers' best interests to take advantage of this provision, but several recent cases stemming from hurricane damage show that they do not always do so.<sup>67</sup> In any event, as will be discussed

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<sup>64</sup> VT. STAT. ANN. tit 8, § 3961 (2009).

<sup>65</sup> *Id.* § 3967 (2002).

<sup>66</sup> LA. REV. STAT. ANN. § 22:1318 (2009). *See generally* Crusto, *supra* note 13 (analyzing Louisiana's valued policy law). The text of the statute is seemingly at odds with Louisiana's standard form fire insurance policy, which specifies "actual cash value of the property at the time of loss, but not exceeding the amount which it would cost to repair or replace the property . . . nor in any event for more than the interest of the insured . . ." LA. REV. STAT. ANN. § 22:1311 (2009). The relative codified position of the standard form and the valued policy provision in Louisiana's statutes, as well as Louisiana's re-enactment of its valued policy law in 1991, may suggest that Louisiana means to give substance to its valued policy law. Louisiana courts most recently have determined that valued policy laws are a default option however, overturning prior judicial precedent. *Compare* Landry v. Louisiana Citizens Property Ins. Co., 983 So.2d 66 (La. 2008) (holding valued policy law does not apply to homeowners insurance that offered fire protection) *with* Farmers-Merchants Bank & Trust Co. v. St. Katherine Ins. Co., 693 So.2d 876 (La. Ct. App. 1997), *writ denied*, 703 So. 2d 25 (La. 1997) (holding valued policy provision as non-waivable term in homeowners insurance policies).

<sup>67</sup> *See, e.g.*, Chauvin v. State Farm Fire & Cas. Co., 495 F.3d 232 (5th Cir. 2007); Caruso v. Allstate Ins. Co., No. 06-2613, 2007 WL 625830 (E.D. La. Feb. 26, 2007); Real Asset Mgmt., Inc. v. Lloyd's of London, 61 F.3d 1223 (5th Cir. 1995).

*infra*, online quotes for houses in Louisiana cannot be obtained, although as shown in Figure 2 this would be an issue for the analysis only if Louisiana were classified as not having a valued policy law, due to its sharing borders with only other valued policy law states. While it would make no difference in the foregoing analysis how Louisiana is treated, for completeness it is classified as a valued policy law state.

Unlike the above states, Tennessee has a valued policy rule for homeowners insurance, but the damages measure can be shifted to actual cash value if the insurer has the house inspected.<sup>68</sup> Tennessee's classification thus depends on whether insurers regularly inspect the house before issuing insurance. While Tennessee insurers do not inspect houses in every case,<sup>69</sup> it is not clear on balance before conducting the upcoming test what insurer behavior will be. The following analysis is conducted twice: once treating Tennessee as having a valued policy law, and once treating Tennessee as not having this law. Ultimately I will conclude that Tennessee should be treated as a valued policy law state.

### *B. Assembling a Dataset*

After the states have been categorized, the next step is to test whether states with valued policy laws have homeowners insurance premiums that differ significantly from states without valued policy laws. Obtaining data for this test was difficult. Insurers are understandably private with their data, since the data represent information the insurers use to set rates and compete in the marketplace. While insurers report to the National Association of Insurance Commissioners, these reports are aggregated at the state level and do not reach the individual, town, or county level necessary for empirical manipulation.<sup>70</sup> Additionally, insurer reports to states are often either confidential<sup>71</sup> or not sufficiently detailed.<sup>72</sup> Insurer filings including rate-setting information are often statutorily mandated to be

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Nevertheless, some insurers do avail themselves of the chance to opt for less-comprehensive damage measures. *See Landry*, 983 So.2d 66.

<sup>68</sup> TENN. CODE ANN. §§ 56-7-801 to -803 (2008). The insurer must inspect the house within 90 days of the policy's issuance.

<sup>69</sup> *See, e.g., Price v. Allstate Ins. Co.*, 614 S.W.2d 377 (Tenn. Ct. App. 1981) (a case where the insurer had not inspected insured's house prior to loss).

<sup>70</sup> *See* NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS ("NAIC"), 2008 HOMEOWNERS INSURANCE REPORT (2009) (a sample of the report, including data on total premiums for 2006, is available at

[http://www.naic.org/documents/research\\_stats\\_homeowners\\_sample.pdf](http://www.naic.org/documents/research_stats_homeowners_sample.pdf) (last visited March 20, 2011)); *see generally* e-mail from NAIC, Financial Statement Data Division, to Peter Molk (August 31, 2010) (on file with author) (describing level of detail in the NAIC report, and advising that data aggregated at a finer level has been unobtainable despite the Association's repeated requests).

<sup>71</sup> *See, e.g., VA. CODE ANN. § 38.2-1315.1(F)* (1950 & Supp. 2010) (treating as confidential any filings considered a work paper or connected to an actuarial report).

<sup>72</sup> Many states receive the same state-level data from insurers as is reported to the NAIC.

available to the public,<sup>73</sup> but this availability involves in-person visits to state insurance departments, as well as construction of rates from complicated and incredibly detailed rate filings.

The method chosen to solve these problems was to construct a dataset from a series of online quotes. This method has several attractive attributes: it is more practical than obtaining rate sheets from every state; it can be done at the individual address level; and it should tie fairly closely to actual marketplace rates, since online quotes have the option to follow-up with an insurance representative and buy the policy quoted online.

Although the market for providing homeowners insurance is generally competitive within the regulatory framework,<sup>74</sup> care was taken to choose quotes from insurers that would most likely represent a market rate across all states. Quotes were obtained from two insurers: Insurer B and Insurer A. Insurer B was chosen for its relatively-high pricing score from J.D. Power<sup>75</sup> as well as its large size<sup>76</sup> and hence significant presence in most states. Insurer A was chosen because it received the highest score for pricing and policy offerings from J.D. Power, which when coupled with its more modest size<sup>77</sup> and hence lack of market power means its quotes should provide consistent estimates of market rates.<sup>78</sup> Both companies featured a robust online quote system with several options to make quotes as comparable as possible.

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<sup>73</sup> See, e.g., CONN. GEN. STAT. ANN. § 38a-688(a)(5) (West 2007); Virginia Bureau of Insurance, *Virginia: Bureau of Insurance Rate and Form Review*, <http://www.scc.virginia.gov/division/boi/webpages/reviewrates.htm> (last visited January 5, 2011).

<sup>74</sup> See, e.g., Daniel Schwarcz, *Regulating Insurance Sales or Selling Insurance Regulation?: Against Regulatory Competition in Insurance*, 94 MINN. L. REV. 1707, 1757 (2010); Chao-Chun Leng, Michael R. Powers, & Emilio C. Venezian, *Did Regulation Change Competitiveness in Property-Liability Insurance? Evidence from Underwriting Profit and Investment Income*, 22 J. INS. REG. 57, 57 (2002); see also *infra* notes 106-107 and accompanying text (discussing profits in the property insurance industry).

<sup>75</sup> J.D. Power, *Homeowners Insurance Company Ratings*, <http://www.jdpower.com/Homes/ratings/homeowners-insurance-company-ratings/> (2010).

<sup>76</sup> Insurer B is a top-ten largest issuer of homeowners insurance according to A. M. Best, and a top-five largest stock property and casualty insurer as ranked by Fortune 500 for 2010. BEST'S AGGREGATES, *supra* note 15, at 394-96 (2010); Fortune 500, 2010: *Industry: Insurance: Property and Casualty (stock)*, <http://money.cnn.com/magazines/fortune/fortune500/2010/industries/182/index.html> (2010).

<sup>77</sup> Insurer A is outside of the top ten largest homeowners insurers. BEST'S AGGREGATES, *supra* note 15, at 394-96 (2010).

<sup>78</sup> J.D. Power, *supra* note 75.

Locations had to be chosen for which to retrieve insurance quotes. The first step was to isolate those state borders where the state on one side had a valued policy law and the state on the other did not. Once a border was determined, maps were visually examined to find comparably-sized towns or cities that ideally straddled the state border, or else were separated by as few miles as possible and connected by a major road to ensure the locations would be similar. When the state border followed a river, locations were chosen where separated by a bridge. Finally, residential addresses were chosen within each town or city. Google Maps Street View was used whenever possible and in most cases to ensure the residential areas were comparable.<sup>79</sup>

The above pairwise strategy, rather than a more general comparison with more available data such as average premium by state, was used to control for several characteristics that might vary by state and which would affect insurance premiums.<sup>80</sup> For example, to the extent one state has more coastal houses or higher overall crime rates than its neighbor, its average insurance premiums would be higher and a comparison of average rates would then miss the effect of valued policy laws. For the same reason, non-neighboring or dissimilar counties along state borders should also not be compared. By choosing neighboring locations of the same general size and character, variables such as crime rates and natural geographic features are held constant. This control comes at the expense of dataset size, yet it is the most accurate way to isolate the true effect of valued policy laws.

Using the above pairwise selection algorithm, 36 pairs of locations were manually found for Insurer A policies when Tennessee was treated as a valued policy state, and 37 were found when Tennessee was treated as not having a valued policy. Insurer B yielded four fewer quotes for each case than did Insurer A. The complete list of locations for which quotes were obtained is included in the Appendix. Online quotes could not be retrieved from either insurer for some extremely sparsely-populated areas, or for the entire states of Florida and Louisiana, or for Mississippi from Insurer A. Quotes obtained from the telephone were not substituted for these missing online quotes, because among other difficulties different insurance representatives from different states required dissimilar information for a quote, making it impossible to obtain comparable policies across state borders.

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<sup>79</sup> Inspection of several Connecticut rate filings in the SERFF electronic system shows that insurers delineate rates along fairly small geographic areas, particularly when near a body of water, suggesting this level of care is appropriate when determining locations.

<sup>80</sup> A pairwise discontinuity approach is often used when trying to ensure this type of control. See, e.g., Thomas J. Holmes, *The Effect of State Policies on the Location of Manufacturing: Evidence from State Borders*, 106 J. POL. ECON. 667 (1998) (using a similar technique).

Comparing quotes from several state pairs should eliminate state-specific effects and isolate the impact of valued policy laws on premiums. If other laws that influence premiums were correlated with a state having valued policy laws, then premiums might reflect these other laws as well. However, because there is no particular reason or evidence to suspect such a correlation to exist, we can be confident that analyzing pairs of several different states should provide a good indication of valued policy laws' influence on premiums. Of course, not all states' valued policy laws are equivalent and differ in some relatively small aspects,<sup>81</sup> but each should result in a higher premium than the premium in a typical state without a valued policy law.

Once pairs had been chosen, online quotes were manually retrieved for \$200,000 of coverage. Additional coverage options were then adjusted to make each quote of the pair as comparable as possible.<sup>82</sup> The quotes were compared by dividing the difference between the two premiums by the average of the two premiums. When this percentage difference in premiums was positive, the valued policy law state premium was higher. Insurer A, as a mutual company, sometimes showed expected dividends alongside the annual premium; these expected dividends were subtracted from the annual premium before comparison. Insurer B quotes did not feature any expected dividends.

While the quotes in each pair are comparable, quotes between companies should not be compared due to differing options and information used to construct the quote as well as the quotes' being retrieved over several different days, during which time rates might have changed.

### C. Examining the Data

The results of analyzing the data are summarized below. As can be seen, we can handily dismiss at any reasonable significance level a hypothesis of premiums in valued policy law states being more expensive than premiums in states without these laws. A geographic breakdown of the data with markers indicating the location of tested pairs, as well as a representation of the dispersal of paired premiums, are included below for Insurer B in the case of Tennessee as a valued policy law state. Similar figures for Insurer A are included in the Appendix, as is a table of complete addresses and corresponding premium differentials.

Tennessee Valued Policy Law (VPL) State		Tennessee Not VPL State	
Insurer B	Insurer A	Insurer B	Insurer A

<sup>81</sup> See *supra* notes 39-46 and accompanying text; see also *infra* Tables A2-A3 for a complete listing of states' valued policy laws.

<sup>82</sup> The list of coverage choices is available upon request.

VPL Higher/Total Count	18/33	14/37	19/32	13/36
Mean Difference (Positive = VPL higher)	2.17%	-3.36%	2.99%	-4.76%
Standard Error	31.5%	30.3%	30.5%	29.3%

Figure 3

Relative Border Premiums (Insurer B)

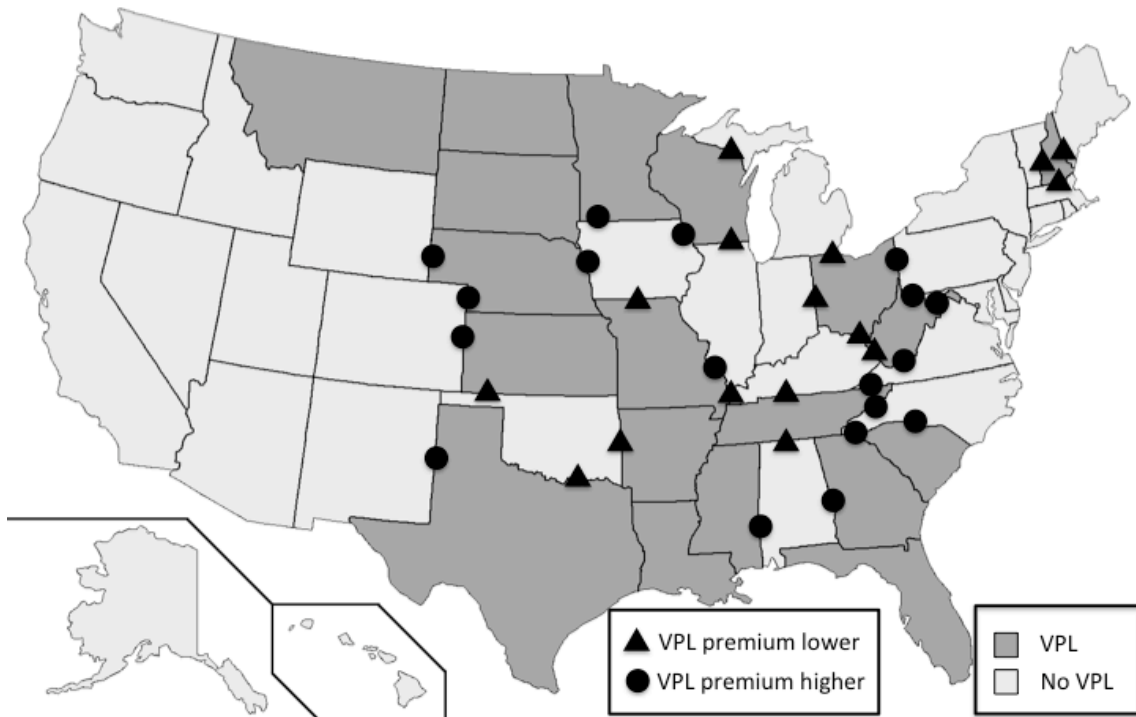
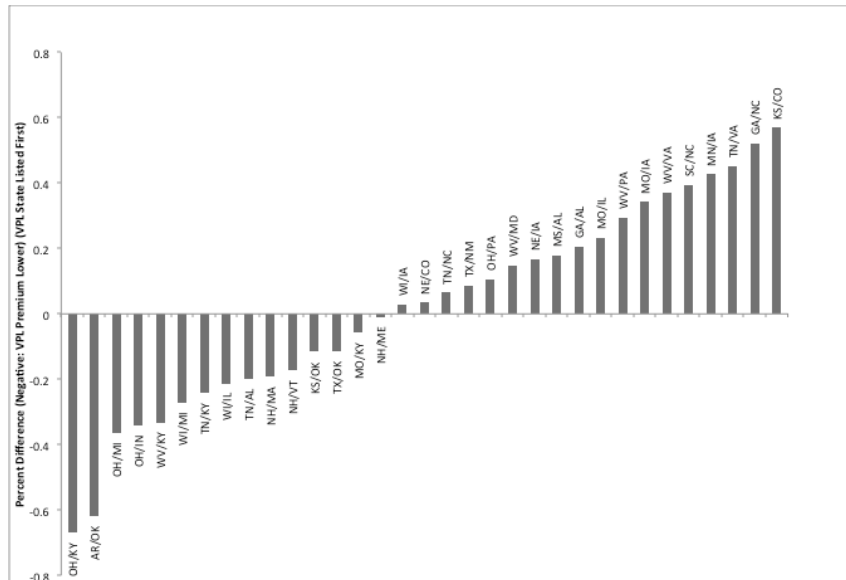


Figure 4

Distribution of Relative Border Premiums (Insurer B)



It is worthwhile to note in passing the surprising variability<sup>83</sup> in results between Insurer B and Insurer A, given homeowners insurance’s accepted status as a competitive industry.<sup>84</sup> Because of this competition coupled with standardized contracts and a good deal of data sharing,<sup>85</sup> one might expect premiums to be fairly similar. These data, however, show that insurers weight the same factors quite differently in calculating their premiums, which highlights the advantage to consumers of shopping around in this market before buying a policy.<sup>86</sup>

<sup>83</sup> This variability is readily apparent in Table A1.

<sup>84</sup> See *supra* note 74.

<sup>85</sup> Insurers use standard form contracts written by Insurance Services Office, which also collects and disseminates data pertinent to ratemaking with these contracts. See Insurance Services Office, *ISO Line-of-Insurance Programs*, <http://www.iso.com/Products/Policy-Language-and-Rules/ISO-Line-of-Insurance-Programs-loss-costs-rules-policy-forms.html> (last visited January 5, 2011); see also *infra* note 163 and accompanying text (discussion of standard form contracts in homeowners insurance).

<sup>86</sup> This advice is particularly salient in light of the fact that once obtaining insurance, insureds tend not to shop around thereafter. According to one study, only one-third of surveyed homeowners had switched their home insurer at least once during the entire time they had lived at their current home. Nabil A. Ibrahim & Mary F. Mobley, *Analysis of Client Retention in the Homeowners’ Insurance Business*, 7 J. PROF. SERVICES MARKETING 19, 23-24 (1991). Anecdotal evidence also supports consumers’ insurance stickiness. Despite increases in a particular homeowners insurance company’s Texas policies of 30%, an agent noted that “people are reluctant to change . . . and go with a company they don’t know.” Scott Nishimura, *State Farm Rate Increases Have More Tarrant Homeowners Shopping for New Insurance*, STAR-TELEGRAM (Fort Worth), Jun. 13, 2010, <http://www.star-telegram.com/2010/06/13/2261806/rate-increases-have-more-texans.html>.

Because of the relatively small dataset of only thirty to forty observations, we can confidently conclude only that premiums in valued policy law states are not greater than other premiums by a substantial amount; smaller-order differences cannot be detected. Nevertheless, we would expect to see these substantial differences if insurers in states with valued policy laws, but not in other states, responded to very large costs imposed by these laws by individually appraising houses before insuring them, as has been supposed.<sup>87</sup> Insurers, particularly in competitive industries,<sup>88</sup> would be expected to pass these costs along to consumers in the form of higher premiums. Thus, it is the case that insurers are acting the same regarding individual appraisals in states both with and without valued policy laws, and that the net costs imposed by valued policy laws, while still likely positive, are not so huge as to be detected with the relatively small dataset.

Of course, these conclusions can be drawn only for the two companies examined. However, they can readily be extended to the homeowners insurance market as a whole. In a competitive industry whose most salient feature to consumers is likely price, a single insurer could not long survive if it consistently deviated from the individual appraisal practices of its competitors; competition forces the insurers to behave the same.<sup>89</sup> And, since few consumers would prefer to pay for individual appraisals, insurers will not offer them in any state, since the savings (to both insurers and insureds) in reduced dispute costs after a loss from conducting them likely is dwarfed by their cost.<sup>90</sup> Anecdotal evidence provides

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<sup>87</sup> See, e.g., *supra* notes 10 and 24 and accompanying text.

<sup>88</sup> An insurer in a competitive industry earns little if any noncompetitive profit, and therefore could not absorb the cost associated with appraisals for long.

<sup>89</sup> If insureds could be segmented into a group that wanted individual assessments and a group that did not, and if the groups were large enough, then a market could exist for insurers that both did and did not offer these appraisals. In fact, this is what has occurred, with Chubb offering insurance with individualized assessments aimed at distinctive homes. See Garland, *supra* note 57. These policies come at a cost of approximately 15% above policies from other insurers, reflecting these additional contracting and appraisal costs. *Id.*

<sup>90</sup> The idea that insurers do not generally appraise houses before issuing policies has been confirmed with several informal conversations with insurance actuaries. See also Liz Pulliam Weston, *Is Your Home Underinsured? 8 Key Points*, <http://articles.moneycentral.msn.com/Insurance/InsureYourHome/IsYourHomeUnderInsured8KeyTests.aspx> (July 14, 2009) (citing an insurance analyst to assert that “the annual premiums paid on most policies are too small for insurers to spend much time doing a detailed assessment of customers’ needs.”) In addition, one can easily find instances of insureds suing insurers over failing to accurately appraise houses. See, e.g., Garland, *supra* note 57.

further support that insurers are not inspecting properties prior to loss, in any state.<sup>91</sup>

Knowing that insurers do not obtain individual appraisals but instead rely only on inexpensive rules<sup>92</sup> to calculate premiums has several ramifications. The first is that classifying Tennessee as a valued policy state is justified. Tennessee law requires that its valued policy law apply to houses that are not personally inspected by the insurer within ninety days of the policy's issuance,<sup>93</sup> so the insurance industry's policy against inspecting houses means Tennessee policies should be treated as valued policies.

The second is more interesting. If valued policy laws do not have the hoped-for effect of inducing insurers to personally inspect a house when deriving its value, policy face values in states with valued policy laws will no more accurately reflect true house values than will policy values in states without these laws. In this case, the difference in damages measure – whether determined by valued policy laws or by a measure similar to actual cash value – will result in significantly different market outcomes, with predominantly negative effects in valued policy law states.<sup>94</sup> The following Part explores what these differences will be.

### III. VALUED POLICY LAWS AND ACTUAL CASH VALUE: DIFFERENCES CAUSED IN THE MARKETPLACE

The choice of a valued policy law produces several undesirable effects in the insurance market. First, valued policy laws will result in more-expensive premiums to cover a comparable house than will actual cash value indemnity, other things equal. This additional expense is unquestionably harmful to consumers. Second, valued policy laws reduce an insurer's market incentive to engage in information-gathering, reducing the accuracy of risk classification. This loss of accuracy hurts some insureds while benefitting others. Third, valued policy laws limit insureds' ability to plan for unexpectedly high losses in a cost-effective manner. This restriction of choice also unquestionably hurts consumers. Finally, valued policy

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<sup>91</sup> See, e.g., *Horak v. Nationwide Ins. Co.*, No. CA 23327, 2007 WL 2119861 (Ohio App. 9 Dist. July 25, 2007). Informal conversations with insurance actuaries have further confirmed this point.

<sup>92</sup> These rules are based on information provided by the homeowner including age of house, type of construction, square footage, and prior loss record, as well as other general data obtained by the insurer such as distance from a shore or crime rates in the area. Although initially developing the rules and obtaining the data might be relatively expensive, when these costs are spread across numerous policies, the cost per policy will be quite low.

<sup>93</sup> TENN. CODE ANN. §§ 56-7-801 to -803 (2008).

<sup>94</sup> Even if insurers were inspecting houses in valued policy law states, valued policy laws will still have an undesirable effect, although the effect will be somewhat attenuated by the inspection, as will be shown in the following Part.

laws can lead to the same gambling behavior of any “wagering” insurance contract. This result is unquestionably harmful to society. Each of these negatives will be discussed in turn.

*A. More Expensive Premiums*

Valued policy laws will correspond to more-expensive insurance premiums than actual cash value indemnity for the same house.<sup>95</sup> Put briefly, a valued policy law measure results in at least as large a payment in the event of a loss as does actual cash value damages, and a significant determinant of premium levels is expected loss. I develop a formal model of insurance pricing below to explore this point fully.

Insurance premiums can be thought of as covering two components: the estimated discounted value of expected losses and loss-related expenses (the “pure premium”), and the operating costs and profits that the insurer earns (the “loading charge.”)<sup>96</sup> Formally, we have

$$P = \delta\mu + C + \Pi \tag{1}$$

where  $P$  is the premium,  $\delta$  is the discount rate,<sup>97</sup>  $\mu$  is the expected loss to the insurer,  $C$  is the operating costs in writing and servicing the contract, and  $\pi$  is the insurer’s profit. In the above equation,  $\delta\mu$  is the pure premium, while  $C + \Pi$  is the loading

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<sup>95</sup> While the difference should be appreciable, it is not significant enough to be picked up in the preceding empirical analysis, which was limited by a small sample size.

<sup>96</sup> The insurance model developed here generally follows the actuarial pricing models in S. HUN SEOG, *THE ECONOMICS OF RISK AND INSURANCE* 298-301 (2010).

<sup>97</sup> Because homeowners insurance policies are typically annual contracts, we would expect  $\delta$  to be close to 1.

charge. We assume  $C = cP + d$ , a fixed and proportional component,<sup>98</sup> while  $\Pi = \pi P$ ,<sup>99</sup> giving

$$P = \delta\mu + cP + d + \pi P \Rightarrow P = \frac{\delta\mu + d}{1 - c - \pi} \quad (2)$$

Increases in expected losses ( $\delta$ ), costs ( $c$  or  $d$ ), or the profit rate ( $\pi$ ) will increase the insurance premium. If we assume that costs<sup>100</sup> and profit rates are the same for writing a valued policy law policy as for writing an actual cash value policy, then the difference in premiums between a valued policy law and an actual cash value policy for the same contract will be

$$P_{VPL} - P_{ACV} = \frac{\delta(\mu_{VPL} - \mu_{ACV})}{1 - c - \pi} \quad (3)$$

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<sup>98</sup> For instance, if commissions are paid to an insurance broker, costs should be proportional to the premium. Costs will also include a fixed portion comprised of administrative expenses that are invariant to the size of the premium. Average total underwriting expenses for the homeowners insurance industry, which include both the proportional and fixed components, were 29.6% of premiums in 2009, with the majority comprised of proportional expenses. BEST'S AGGREGATES, *supra* note 15, at 396; *see also* Insure.com, Hidden Rivers of Incentive: How Agent Commissions Affect Your Insurance Shopping, <http://www.insure.com/articles/generalinsurance/agent-commissions.html> (2007) (finding a sampling of home insurers revealed commissions ranging from 10% to 30% of premiums).

<sup>99</sup> Profits should be proportional to either the price of the product sold ( $P$ ) or else to the money that is placed at risk ( $\mu$ ). Because  $P$  and  $\mu$  are proportional, profits are expressed in terms of  $P$  for convenience.

<sup>100</sup> We could imagine a situation where the proportional cost terms were different in states with and without valued policy laws. If insurers adjust commissions to keep agents earning on aggregate the same dollar amount in states with and without valued policy laws, then because premiums will be higher in valued policy law states then commissions (and hence the insurers' proportional costs) would be lower. For simplification I assume the proportional costs are the same; the circumstance where their potential difference could be important is considered *infra* notes 108-109 and accompanying text.

In essence this situation boils down to whether commission rates vary between states that impose onerous insurance requirements that raise premiums and states that do not. An analogous and perhaps more concrete example would be to ask yourself if when you leave a tip at a restaurant, assuming you calculate it as a percentage of the total bill including taxes, do you lower the percentage when you travel to a state with a higher sales tax? Comparing these visits to an inter-state restaurant chain presents the same type of question as comparing compensation for insurance agents.

That is, the premium difference will depend on the difference in the insurer's discounted expected losses, inflated by a factor depending on the proportional costs and profit rate. Let us now examine this difference in expected losses.

The insurer's expected losses equal the accumulation of losses times the probability of the loss occurring. Thus,

$$\mu = \int_0^V xf(x)dx + \int_V^\infty Vdx \quad (4)$$

where  $f(x)$  is the loss's probability distribution function and  $V$  is the policy's face value. For losses above the face value, the insurer pays only the face value in both valued policy and actual cash value contracts.<sup>101</sup>

Most states' valued policy laws take effect only in the event of a total loss.<sup>102</sup> Therefore, expected losses for insurers in valued policy and in actual cash value states should differ only when there is a total loss. Total losses make up the right-tail probabilities of  $f(x)$  and have their own expected value  $\tau$ . Because an insurer's losses are fixed for valued policy laws and are capped for actual cash value policies, we have

$$\tau_{VPL} = V = \int_0^V Vg(x)dx + \int_V^\infty Vdx \quad (5)$$

$$\tau_{ACV} = \int_0^V xg(x)dx + \int_V^\infty Vdx \quad (6)$$

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<sup>101</sup> For an additional fee, insurance contracts can include a "replacement cost" buffer where the insurer will pay a predetermined amount (such as 20%) beyond the face value for rebuilding if these rebuilding costs are unexpectedly high. These clauses appear in both valued policy law and actual cash value policies, however, and so will not affect valued policy insurers differently from actual cash value insurers. This extra replacement coverage generally takes effect only if rebuilding occurs; in valued policy law states the insured can opt to collect only the face value, not the additional buffer, if the face value exceeds losses. *See, e.g.,* *McGlone v. Midwestern Group*, 573 N.E.2d 92 (Ohio 1991); *see also infra* Part III.C for further discussion of the effect of replacement cost policies.

<sup>102</sup> *Cf.* MO. ANN. STAT. § 379.140 - .150 (West 2002) (imposing liability for partial losses proportionate to face value); N.D. CENT. CODE § 26.1-39-04 (2010) (same).

$$g(x) = \frac{f(x|\text{total loss})}{\Pr(\text{total loss})} \quad (7)$$

where  $V$  is still the policy's face value, and  $g(x)$  is the probability distribution function  $f(x)$  given that a total loss has occurred, normalized to the event of a total loss by Bayes's rule. Notice the similarity between (4) and (6). The difference between the two is that the probability distribution function in (6) is the probability distribution function applicable to a total loss only, while the probability distribution function in (4) is the general probability distribution function and hence incorporates (6).

Now, because for  $x \in [0, V)$  we have  $x < V$ , we must have  $\tau_{ACV} < \tau_{VPL}$  and hence  $\mu_{ACV} < \mu_{VPL}$  and  $P_{ACV} < P_{VPL}$ . In fact, we know that because valued policy and actual cash value insurer payments are the same for non-total losses,

$$\mu_{VPL} - \mu_{ACV} = \left[ V - \int_0^V xg(x)dx \right] \cdot \Pr(\text{total loss}) \quad (8)$$

so that, after substitution of (7) and (8) into (3), we have

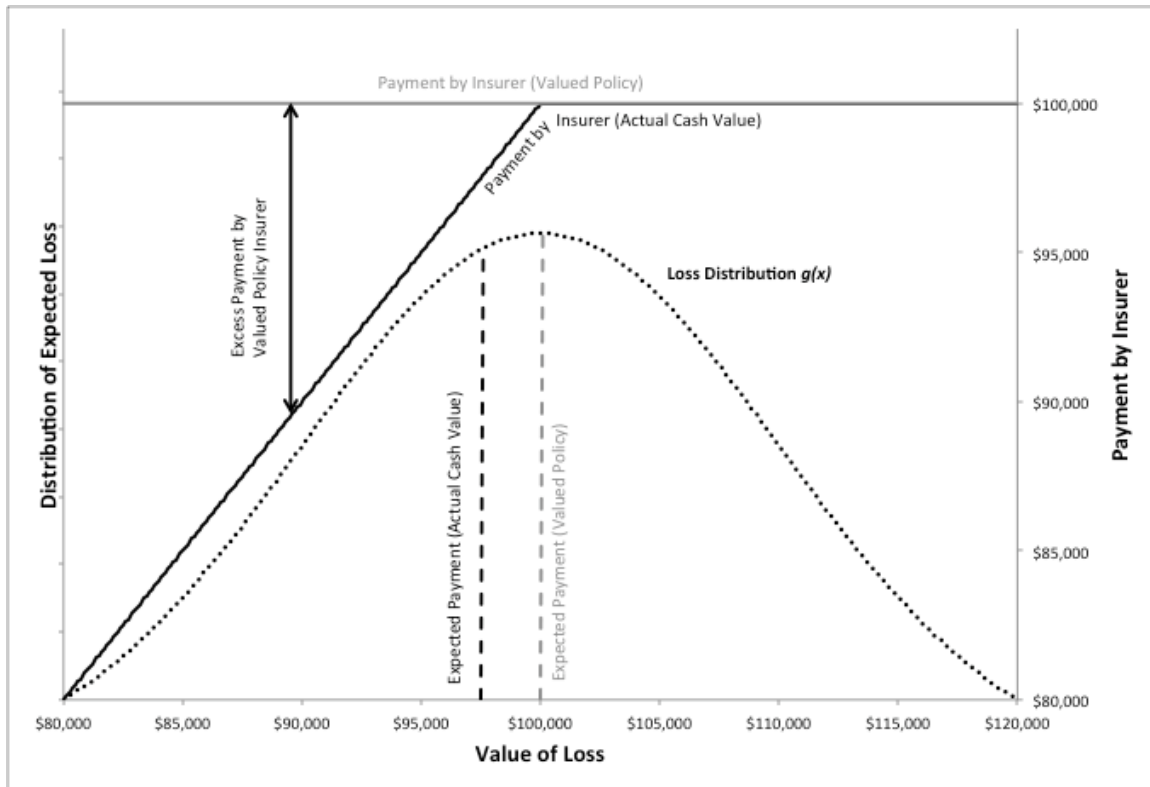
$$P_{VPL} - P_{ACV} = \frac{\delta \left[ V \cdot \Pr(\text{total loss}) - \int_0^V xf(x|\text{total loss})dx \right]}{1 - c - \pi} \quad (9)$$

Higher face value, proportional costs or profits, probability of total loss, and variance of this total loss increase this premium difference.

It will help to visualize the expected payment by an insurer given that a total loss has occurred. The following figure shows expected and actual total loss payments by an insurer for a \$100,000 face value policy when total losses are normally distributed around an expected value of \$100,000.

Figure 5

Hypothetical Insurer Loss Payments (Face Value Equals Expected Loss)



As we can see from the figure, an insurer's total loss expected payment will be lower for actual cash value policies than for valued policy law policies, reflecting the fact that an insurer of an actual cash value policy need pay only the actual cash value when the policy face value exceeds the loss.<sup>103</sup>

The fact that premiums in valued policy law states will be more expensive than comparable premiums in actual cash value states is not cause for concern on its own. After all, insureds also receive a higher expected payment, so premiums should be greater. There are at least two immediate downsides to these higher premiums, however.

<sup>103</sup> The figure depicts the ideal case where the value of losses can be determined with certainty. In practice, it is likely that for losses just below the policy face value, an insurer of an actual cash value policy will pay the full face value. We might expect this for a variety of reasons. It may be difficult for an insurer to measure with great precision the value of a loss, or an insurer might find the cost (both legal and reputational) to challenging close claims to exceed the potential savings. To the extent this occurs, the difference in expected losses between actual cash value and valued policy law policies will be somewhat mitigated. Nevertheless, insurers have still litigated cases where the actual cash value was close to the face value. *See, e.g., Seider v. O'Connell*, 612 N.W.2d 659 (Wis. 2000) (\$150,000 face value policy with actual cash value after deductible of \$129,053.39).

First, insureds must devote more of their budget to paying insurance premiums to get the same face value coverage, at the expense of other consumption or savings choices. Restricting budgets by requiring consumers to allocate more to their insurance hinders their ability to make optimizing decisions.<sup>104</sup>

More disturbing is the portion of the excess premiums that go towards covering insurer profits and costs. This amount, deduced from Equation (9), is

$$\pi \left( \frac{\delta \left[ V \cdot \Pr(\text{total loss}) - \int_0^V xf(x|\text{total loss})dx \right]}{1 - c - \pi} \right) + c \left( \frac{\delta \left[ V \cdot \Pr(\text{total loss}) - \int_0^V xf(x|\text{total loss})dx \right]}{1 - c - \pi} \right) \quad (10)$$

The first term in the sum represents the portion of the additional premiums that insureds must pay to cover additional profits of the insurer. States generally allow for these profits by statute,<sup>105</sup> sometimes up to 5% of the premium<sup>106</sup> although competitive forces may drive these profits lower.<sup>107</sup> This payment represents a pure transfer of wealth from insureds to insurers and so may be undesirable for other reasons.

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<sup>104</sup> Of course, if individuals are purchasing less than the optimal amount of insurance, inducing them to purchase additional coverage may improve consumer welfare. Nevertheless, valued policies do not accomplish this goal, since insureds receive no additional insurance protection. Rather, they gain a higher expected insurance payout, but only when this payout exceeds insurable losses anyway. A subsidy for insurance, such as allowing for the deduction of premiums, would be a better way to achieve a policy goal of encouraging insurance.

<sup>105</sup> See, e.g., COLO. REV. STAT. § 10-4-403(2)(a)(III) (2006 & Supp. 2010) (providing a rate allowance for a “reasonable profit.”)

<sup>106</sup> See Raymond D. Hill, *Profit Regulation in Property-Liability Insurance*, 10 BELL J. OF ECON. 172, 174 (1979). State regulators have moved away from allowing a flat 5% underwriting profit and have begun engaging in more sophisticated analysis. J. David Cummins, *Multi-Period Discounted Cash Flow Ratemaking Models in Property-Liability Insurance*, 57 J. RISK & INS. 79, 79-80 (1990).

<sup>107</sup> *Id.* at 175. Recent profits on underwriting have also averaged below 5%, although the September 11 2001 terrorist attacks provided several years of unexpectedly-large losses. Author’s calculations from Insurance Services Office Annual Reports on the Condition of the Property/Casualty Insurance Industry, available at <http://www.iso.com/Research-and-Analyses/Overview/Studies-and-Whitepapers.html> (last visited March 7, 2011). These figures represent just insurers’ returns on their underwriting; intervening investment returns augment profits.

The second term of the sum represents the portion of additional premiums that covers insurers' proportional costs, such as commissions. Recall that commissions, like profit rates, are also not insignificant; surveys suggest that commissions may constitute 10% to 30% of the premium amount.<sup>108</sup> Just as with the profit transfer above, this transfer from insureds to insurance agents or to insurers to cover other costs may catch the attention of those with certain public policy concerns.<sup>109</sup>

We have seen that valued policy laws will increase insurance premiums. Some of this increase reflects the higher expected payout insureds will receive, but a significant portion is comprised of taking money from insureds and putting it in the pockets of insurers and insurance agents. Since valued policy laws have been touted as pro-consumer legislation,<sup>110</sup> this result is surprising and runs counter to this stated goal. This transfer is not the only negative unintended effect of valued policy laws, however.

#### *B. Diminished Incentive for Risk Classification*

Another undesirable feature of valued policy laws is that they reduce insurers' incentive to engage in costly information gathering to promote accurate risk classification – the identification and sorting of insureds into pools based on their expected losses. Accurate segregation of insureds according to risk ensures that low-risk insureds do not subsidize high-risk insureds,<sup>111</sup> which not only promotes equity but also ensures the continued operation of insurance markets.<sup>112</sup>

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<sup>108</sup> See *supra* note 98.

<sup>109</sup> As discussed above, if insurers in valued policy law states reduce commission rates and hence proportional expenses in response to the increased premiums, then the amount of this transfer would be reduced. See *supra* note 100.

<sup>110</sup> See *supra* notes 6-8 and accompanying text.

<sup>111</sup> Because of property insurance regulation that restricts what information insurers can use or the rates they can charge certain risk types, there will still be cross-subsidization of consumers, although not necessarily from low-risk to high-risk. See J. David Cummins, *Property-Liability Insurance Price Deregulation: The Last Bastion?*, in *DEREGULATING PROPERTY-LIABILITY INSURANCE* 1, 2 (J. David Cummins, Ed., 2002).

<sup>112</sup> See Priest, *supra* note 2, at 1540-42. Professor Priest focuses on the problem of adverse selection, in which low-risk insureds drop out of the insurance market if they are grouped with high-risk insureds, leading to a breakdown of the market. See also George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, Q.J. ECON. 488 (1970) (seminal paper on adverse selection). Adverse selection should not be a particularly vexing problem for homeowners insurance, however, given that insurers are usually in a better position to identify homeowner risk than the homeowner is. In this case, low-risk homeowners will not recognize their low-risk status and will remain in the insurance market, even in the presence of inaccurate risk classification by insurers. See *infra* note 119 and accompanying text.

We examine this result with the aid of Figure 5 and the case of pre-appraisals. Imagine now that the distribution of losses reflects expected losses from several members of a risk pool assembled by an insurer, rather than the expected loss of one insured. The insurer knows the expected loss of the pool is \$100,000, but with the information the insurer has it cannot identify losses with any greater precision. Appraisals will enable the insurer to identify insureds in the tails of the distribution; these insureds have expected losses that differ from the \$100,000 mean. These tail distribution insureds can then be sold a policy whose face value more closely matches their expected loss. Because losses are capped at the face value with valued and actual cash value policies, removing insureds from the right tail of the distribution will not affect expected losses for the remainder of the pool. Removing insureds from the left tail, however, increases the insurer's losses from those remaining in the pool, since insureds with low valuations were subsidizing other insureds in the pool. Identifying losses with greater precision removes this subsidy and allows premiums to more closely reflect expected losses.

This precision comes at the cost of appraisals, however. Insurers have the incentive to classify risks with greater precision than their competitors to attract low-risk insureds at the competitors' market rate.<sup>113</sup> In the figure above, if an insurer could identify insureds in the left-tail distribution, the insurer could offer a premium slightly below the pool's market rate and profit from the fact that the insured has lower expected losses than the pool. Put more concretely, the insurer could charge this insured the market premium for a \$100,000 policy (derived from an expected \$100,000 loss) and profit because if a total loss occurs, the insurer (but not its competitors) knows the expected loss is only \$80,000. If more insurers correctly identified this insured, the premium would be bid down to that amount associated with an expected loss of \$80,000.

When the cost of acquiring this information exceeds the expected profit, however, the profit-maximizing insurer will refrain from gathering it.<sup>114</sup> The fact that insurers in the marketplace do not appear to be appraising houses before issuing policies<sup>115</sup> suggests that the costs of this inquiry must be greater than the competitive benefit.

The analysis so far has suggested that, contrary to intention, valued policy laws actually take away the market incentive for insurers to engage in any meaningful degree of risk classification. Because valued policy laws fix an insurer's expected liability for a total loss, there is no reason for an insurer to identify insureds in the left-tail of the distribution, since a policy with \$100,000 of face value coverage has the same expected loss regardless of the actual value of the loss.

However, there are less direct effects that may give insurers in valued policy law states the incentive to identify insureds in the left or right tail of the total loss

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<sup>113</sup> See, e.g., ABRAHAM, *supra* note 63, at 67-68, 78.

<sup>114</sup> *Id.*

<sup>115</sup> See discussion *supra* Part II.C.

distribution. Although the insurer's liability is uniform across all types in the risk pool given that a total loss has occurred, total losses may be more likely for those in the left extreme of the distribution than for those in the right, reflecting the moral hazard problem that insureds who stand to gain from a total loss (those in the left extreme) may take less preventative care against a loss than other insureds.<sup>116</sup> Contrary to the actual cash value indemnity case, insurers in valued policy law states have the incentive to isolate these left-tail individuals and charge them a *higher* rate for the same face value coverage or, equivalently, identify those with higher expected losses and charge a lower premium for the same coverage. Because actual cash value policies limit indemnity to the smaller of loss value or face value, moral hazard concerns with these policies are not present.

In the above example based on Figure 5, insurers could opt to adjust a policy's face value instead of fixing the face value and adjusting premiums. Competition along this dimension may not be particularly successful, however. As we have seen, with valued policy laws the desirable customer is the underinsured customer whose expected total loss exceeds the \$100,000 face value (those in the right tail of the distribution). If insurers have invested in accurately classifying this insured, their response would be to offer a higher face value than their competitors at the competitors' lower face value rate. Such an action may be interpreted hostilely by the insured as an attempt to upsell. It seems more likely that insurers would compete through adjusting premiums while keeping the face value fixed.

In actual cash value states, however, the desirable insureds are those whose expected total losses are less than the policy face value. An insurer who accurately classifies this insured would, like the valued policy law insurer, offer a higher face value at competitors' lower face value premium. Unlike valued policies, however, the actual cash value insurer would also offer a lower face value at a premium lower than competitors' premiums for that lower face value. Again, it is not clear how successful this competition through face value will be; offering higher face values than competitors may still be seen by insureds as attempts to upsell, while offering lower face values than the competition may be seen as providing inadequate coverage. Again, it seems likely that most competition will be through premiums with a fixed face value.

It is worth questioning how strong a motivator moral hazard concerns will be for a valued policy insurer. Theoretically, moral hazard would be a concern whenever the insured recognized that face value exceeded expected losses by even the smallest amount. In actuality, a total loss involves not only direct financial costs that are reimbursed by the insurer, but also additional uncompensated costs such as the inconvenience of moving or rebuilding a house or time spent in identifying and replacing the lost house. Insureds must therefore be more than minimally overinsured for moral hazard to be a concern and thus for a valued policy insurer to

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<sup>116</sup> Or, in more extreme cases, they may commit arson. See JERRY & RICHMOND, *supra* note 3, at 660 (observing "public concern over the widespread incidence of arson.")

have incentive to engage in additional risk classification. Nevertheless, cases where the insured value significantly exceeds the face value sometimes do arise.<sup>117</sup>

Additionally, the extent of moral hazard's impact on valued policy insureds' behavior requires insureds not only to be overinsured,<sup>118</sup> but also to possess better information about their type than do insurers. If insurers could identify an insured as having a policy value sufficiently in excess of expected total loss, the additional moral hazard risk would be priced into premiums, or the insurer could also refuse to write a policy with the inflated face value.

Yet upon reflection it seems highly unlikely that an insured would have better information about expected losses than his insurer.<sup>119</sup> Insureds buy insurance only sporadically, while insurers engage in house value estimation on a routine basis. Although an insured has more information about his house than an insurer, the insurer can void coverage if the insured misrepresents or conceals pertinent information.<sup>120</sup> Absent some sort of fraud by an agent, it seems more

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<sup>117</sup> See, e.g., *St. Paul Reinsurance Co., Inc. v. Irons*, 45 S.W.3d 366 (Ark. 2001) (home insured for full value with each of two insurers resulted in double recovery); *Florida Farm Bureau General Ins. Co. v. Voncille Jernigan*, No. 3:09cv145/MCR/EMT, 2010 WL 3927816, (N.D. Fla. Sept. 30, 2010) (recovering \$138,500 face value on home worth \$95,000); *Gamel v. Continental Ins. Co.*, 463 S.W.2d 590 (Mo. Ct. App. 1971) (recovering \$10,000 on \$800 house).

<sup>118</sup> All that is really required is that the insured *think* he is overinsured for moral hazard to take effect. Likely, insurers would develop decent intuition for the extent of this problem based on historical experience, and they would then price premiums accordingly.

<sup>119</sup> For the same reason, we should not be particularly concerned about adverse selection problems in the homeowners insurance market. See *supra* note 112. This was not always true, however, and was the motivation behind the formation of many current home insurers as mutuals. See RICHARD B. HEFLEBOWER, *COOPERATIVES AND MUTUALS IN THE MARKET SYSTEM* 162-176 (1980).

<sup>120</sup> See, e.g., VT. STAT. ANN. TIT 8, § 4205 (2009) (barring recovery to insureds whose false statements materially affect the risk or hazard being insured). The standard-form HO-3 policy, the most common homeowners insurance contract, voids coverage if an insured has

“1. Intentionally concealed or misrepresented any material fact or circumstance;  
2. Engaged in fraudulent conduct; or  
3. Made false statements;  
relating to this insurance.”

See INSURANCE SERVICES OFFICE, HO-3 POLICY FORM, *reprinted in* ABRAHAM, *supra* note 10, at 195, 210 (HO-3 policy); NAIC, *supra* note 70 (reporting that 82% of countrywide homeowner policies in 2006 were HO-3 policies); NAIC Staff, *1998 Home Insurance Average Premium*, 7 NAIC RES. Q., Summer 2001, at 17, 19 (reporting that 87% of

likely that an insurer could better identify a house's worth than could an insured,<sup>121</sup> and so it is unlikely that moral hazard concerns should be significant.

Valued policy liability might make a difference in promoting accurate risk classification by inducing insurers to keep closer watch over their agents. If an agent inflates the value of a house with actual cash value indemnity, perhaps to receive a higher commission,<sup>122</sup> the risk of loss to the insurer does not increase because as long as insureds recognize their reimbursement for loss is based on the value of loss, moral hazard from nominal overinsurance will not arise. Insurers in actual cash value states might then take a relatively permissive attitude towards agents who write inflated policies, whereas valued policy insurers would restrict this behavior to make sure insureds are not more risky than the insurer believes.

However, there are two problems to this argument. First, it relies on moral hazard that is unanticipated by the insurer, which may not be all that prevalent. Second, direct financial concerns are not the only motivator of insurance companies. An insurer who routinely overinsures in actual cash value states likely takes significant hits to its reputation and consumer satisfaction scores if it develops a legion of unhappy customers who were paid less than their policy's face value, even though this is all the law requires. Although an actual cash value insurer may not have the same direct incentive as a valued policy insurer who monitors agents to cut down on moral hazard risk, these reputational concerns likely act as an adequate deterrent. Moreover, there are alternative less-costly mechanisms to reign in rogue agent behavior. For instance, states could provide a cause of action against insurers to insureds who were sold policies inflated by an agent, or state regulators could revoke agent licenses if this behavior were engaged in too often.

Thus, paradoxically, valued policy laws seem to have the effect of diminishing the economic incentive for an insurer to engage in costly information gathering to produce more-accurate risk classification. We have examined this in the case of pre-appraisals, but the analysis can be extended to any costly information-gathering technique. It is therefore not surprising that, contrary to expectations, insurance premiums in valued policy states are not greatly more expensive than in other states due to the cost of pre-appraisals as found in Part II. We would expect premiums to more accurately reflect expected losses in actual cash value states than in valued policy law states, and therefore insurance will do a better job at accomplishing the goal of indemnity in these actual cash value states

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nationwide homeowners insurance policies as measured by exposure-years were HO-3 policies).

<sup>121</sup> Note that even if an insured knows the purchase price for his house, this purchase price also includes the value of any land, and it is difficult for insureds to separate the value of land from the value of the house, which is all that is insured.

<sup>122</sup> See *supra* note 98.

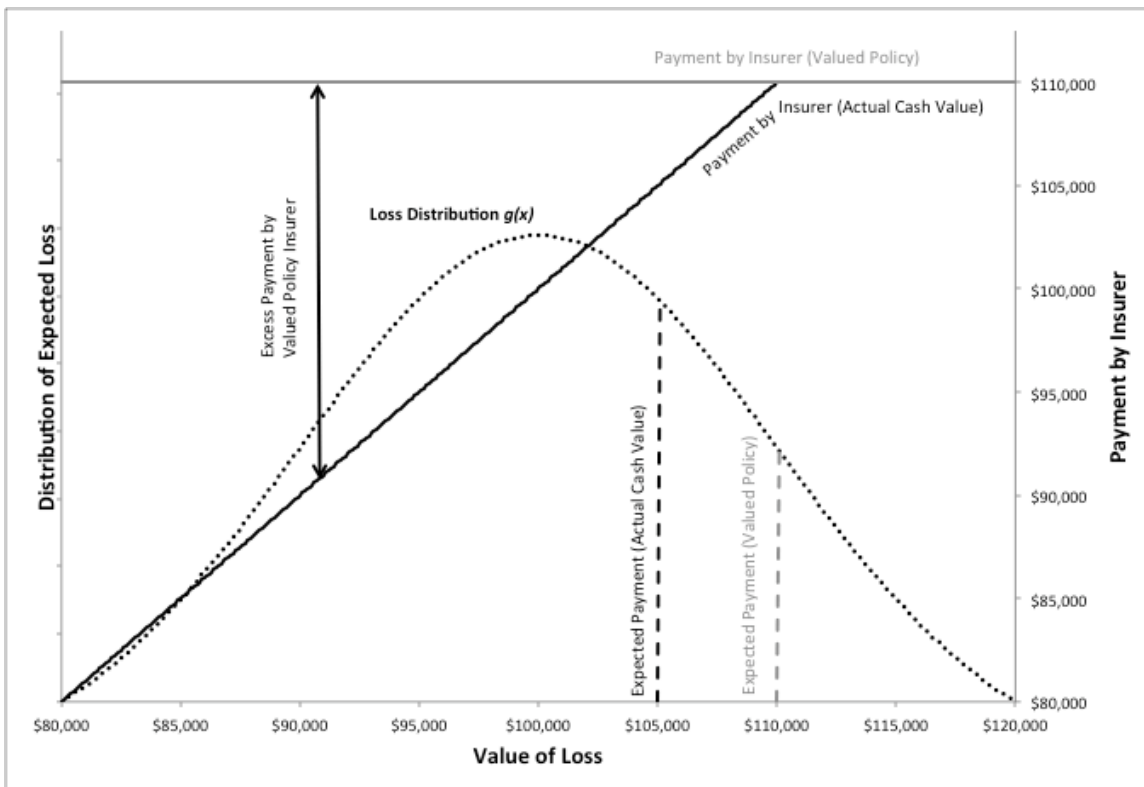
C. *Reduced Ability to Ensure Sufficient Coverage*

In addition to the drawbacks of valued policies discussed above, there is a final way that valued policy laws hurt insureds; they raise the expense to homeowners of ensuring their house is adequately insured in the case of unexpectedly high losses. Recent market developments have somewhat mitigated this problem, although they may undermine the policy goals behind valued policy laws in doing so.

Consider again an insured with the loss probability distribution of Figure 5 who wants to be sure of sufficient coverage not just of the *expected* total loss, but also of the lower probability high losses to the right of the expected loss. In the case of the normal distribution of Figure 5, half of the realized losses exceed the expected loss, so this desire on the part of insureds is very reasonable. To guarantee this coverage, he must buy a premium whose face value exceeds the expected loss. Figure 6 below shows the case when the face value is \$110,000, which covers approximately 85% of total loss realizations.<sup>123</sup>

Figure 6

Hypothetical Insurer Loss Payments (Face Value Exceeds Expected Loss)



<sup>123</sup> The face value could of course be raised to cover a greater proportion of total loss possibilities.

Compared to Figure 5, the difference in the insurer's expected payments between actual cash value and valued policy reimbursement in the event of a total loss in Figure 6 has increased, because the valued policy law insurer has a higher expected payment in approximately 85% of the total losses, compared to only 50% in Figure 5. This translates to the higher premium difference due to increased face value in Equation (9).

Moral hazard also may come into play to raise the premium difference still further. Moral hazard is not a concern when face value equals expected total loss as long as the insurer's information is at least as good as the insured's.<sup>124</sup> When the face value exceeds the expected total loss, however, valued policies may promote insured behavior consistent with moral hazard, since the insured may know that on average he will profit from a loss. When policy face value equals the expected total loss as in the case of Figure 5, a loss does not on average benefit the insured. Moral hazard acts only on valued policies, because actual cash value policies make sure an insured is never over-compensated in the event of a loss.

Risk aversion by insureds and non-financial costs such as the loss of a sense of security<sup>125</sup> would mean that insureds may take appropriate precautions even when they stood to gain on average, as long as the gain was uncertain. Furthermore, it is the particularly risk-averse individuals who should seek out additional coverage to ensure compensation even for low-probability high losses, and moral hazard is least likely a problem with these individuals. However, risk-averse individuals are not the only ones who would purchase excess coverage. Risk-loving people, or those with private knowledge about a heightened risk of total loss probability for their home, would also tend to purchase coverage beyond the expected loss. The desire to purchase additional coverage then sends contradictory signals to the insurer; the individual may be a risk-averse type and hence a good person to insure, or the individual may be a risk seeker or have private information and be a poor risk to insure. If the insurer cannot differentiate between these types,<sup>126</sup> then it should raise premiums beyond the amount indicated by the increased exposure, to take account of the increased likelihood of a loss.<sup>127</sup>

Ironically, it is precisely the states that have a thick right tail in the probability loss distribution – a higher chance of actual losses exceeding expected

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<sup>124</sup> See *supra* Part III.B for discussion of why this is likely to be the case.

<sup>125</sup> See, e.g., Baker, *supra* note 20, at 278.

<sup>126</sup> It is not obvious how an insurer could accurately differentiate. Although one method might be based on prior losses, with the idea that past losses indicate an increased risk, prior losses might also induce prospective risk-aversion in an individual who has suffered through a loss before. *But see infra* note 140 for one way insurers are addressing the problem with replacement cost policies.

<sup>127</sup> If the insurer did not raise premiums, then it may be patronized disproportionately by bad risks, an instance of the adverse selection issue mentioned *supra* note 112.

losses, and hence a greater need for over-insurance by insureds – that also have valued policy laws. Relatively-high probabilities of greater-than-expected losses will occur when the losses are correlated. Widespread total losses drives up replacement costs (and hence the actual cash value)<sup>128</sup> as building supplies and labor grow short. Hurricane-force winds have great destructive ability, yet an examination of Figure 2 reveals that the hurricane-prone states of Texas, Louisiana, Mississippi, Florida, Georgia, and South Carolina are all valued policy law states. These states are arguably the states where one would least want valued policy laws, so that insureds could relatively cheaply insure against low probability high losses.

As shown in Figure 6, insuring against low probability high losses widens the gap between valued policy and actual cash value policy premiums. By expression (10), we see that the greater is this difference, the greater are the costs that valued policy laws impose on consumers. Moreover, when premiums rise, insureds must devote a greater proportion of their income to their insurance, leaving less flexibility in their other consumption and savings decisions.<sup>129</sup> In addition, for valued policies, as the face value increases a smaller proportion of the premium is devoted to covering expected losses, while a larger portion becomes in effect a gamble, paying off if the face value exceeds the actual damages. Although the Supreme Court determined that valued policy laws have “never been condemned as . . . wager policies or as introducing elements of speculation,”<sup>130</sup> a case where the insured either will gain or lose under a total loss is certainly suggestive of a wager.<sup>131</sup> Wager contracts are generally void as a matter of public policy<sup>132</sup> for good reason<sup>133</sup> due to their potential to generate destructive behavior on the part of insureds. Policymakers should take a careful look to see if any potential valued policy law advantages outweigh the negatives of a wager contract.

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<sup>128</sup> Actual cash value can be thought of as replacement costs adjusted for depreciation, since any idiosyncratic features like location should be capitalized into land value.

<sup>129</sup> See *supra* note 104 and accompanying text.

<sup>130</sup> *Orient Ins. Co. v. Daggs*, 172 U.S. 557, 565 (1899).

<sup>131</sup> Decisions since the Supreme Court’s ruling in *Orient* have recognized this fact. See, e.g., *Tedford v. Security State Fire Ins. Co.*, 278 S.W.2d 89 (Ark. 1955) (quoting *Bright v. Hanover Fire Ins. Co.*, 92 P. 779 (Wash. 1907), which noted that “[t]o a certain extent the [valued policy] law undoubtedly gives legal sanction to wagering contract”); *Hunt v. General Ins. Co. of America*, 87 S.E.2d 34, 36 (S.C. 1955) (similar).

<sup>132</sup> See, e.g., *Duncan v. State Farm Fire & Cas. Co.*, 587 S.W.2d 375 (Tenn. 1979). The idea of wager contracts being void as a matter of policy go back at least as far as the 18<sup>th</sup> century with early English prohibitions in marine and life insurance. Act of 1746, St. 19 Geo. 2, c. 37 (Eng.) (marine insurance); Act of 1774, 14 Geo. 3, c. 48 (Eng.) (life insurance).

<sup>133</sup> But see Jacob Loshin, *Insurance Law’s Hapless Busybody: A Case Against the Insurable Interest Requirement*, 117 YALE L.J. 474 (2007) (arguing that the insurable interest prohibition reduces wagering at the expense of promoting other undesirable behavior by insurers).

Several states explicitly prohibit insureds from taking out insurance in amounts exceeding their insurable interest,<sup>134</sup> which some may worry makes the above discussion moot by prohibiting insureds from obtaining additional insurance above the expected loss. However, the above discussion has pointed out that the insurable interest is itself uncertain in value, and insureds should not be restricted to obtaining coverage of only a portion of possible loss outcomes by fixing their insurable interest at only the expected loss. In the example in Figure 6, even with a policy face value that exceeds expected losses, the insured is still underinsured in 15% of loss realizations. While it is a matter of policy to decide that the expense of potential moral hazard problems outweighs the benefit of additional coverage to risk-averse insureds, this policy carries more force if the insured seeks coverage beyond, say, 99% of loss events when moral hazard risk grows greatly but loss event coverage grows slowly and should not apply when insureds seek to extend coverage beyond only the expected value of a total loss.<sup>135</sup>

Apparently in recognition of insureds' desire to insure beyond mere expected loss, insurers in both valued policy and actual cash value states offer a "replacement cost" option that extends coverage, typically to 120% or 130% of face value,<sup>136</sup> if costs to repair or replace<sup>137</sup> exceed the face value.<sup>138</sup> In actual cash value states, these policies essentially remove depreciation's downward effect on actual cash values.<sup>139</sup> In valued policy states, however, the contingent replacement coverage acts as an attempt to solve the problem discussed above of separating the risk-

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<sup>134</sup> See, e.g., NEB. REV. STAT. § 44-601 to -602 (2004); OR. REV. STAT. § 742.200 (2009).

<sup>135</sup> A policy against insuring beyond expected losses carries *no* force in actual cash value states such as Oregon, which have no moral hazard problems.

<sup>136</sup> Insureds must maintain a specified minimum level of insurance for this additional replacement coverage to take effect, and insureds must also typically inform their insurer of repairs or additions that increase the house value by a specified amount, such as 5%.

<sup>137</sup> Typically the contract specifies that the insured must actually undertake the repairs or the replacement to receive the increased coverage.

<sup>138</sup> Some insurers used to guarantee unlimited replacement coverage as long as a minimum coverage was maintained, but this practice has largely disappeared. See, e.g., Karen M. Kroll, *Guaranteed-Replacement Coverage Fading Fast*, BANKRATE.COM, Oct. 12, 2004, <http://www.bankrate.com/brm/news/insurance/20041012a1.asp>; Christopher Oster & Jeff D. Opdyke, *Harsh Policies: Hit with Big Losses, Insurers Put Squeeze on Homeowners*, WALL ST. J., May 14, 2002, at A1.

<sup>139</sup> See generally Johnny Parker, *Replacement Cost Coverage: A Legal Primer*, 34 WAKE FOREST L. REV. 295 (1999) (discussing the difference between replacement and actual cash value policies). Courts do not always apply this idea, however, particularly when it would prove harmful to an insured. See, e.g., *Doelger & Kirsten, Inc. v. National Union Fire Ins. Co.*, 167 N.W.2d 198 (Wis. 1969) (finding that obsolete thirty year old alligator shears patterns, unused for ten years and with negligible market value, nevertheless had significant value equal to one-third of the pure replacement cost after accounting for depreciation and obsolescence).

averse insureds from risk-loving insureds.<sup>140</sup> The separation is not perfect however; insureds are still better off since they are compensated with a more-valuable, non-depreciated house in the event of a total loss.<sup>141</sup>

Of course, once a policy integrates indemnity based on the value of loss (in the case of replacement cost policies, the non-depreciated market value), valued policy laws' ability to provide consumer certainty and improve insurer behavior<sup>142</sup> is diminished. States with valued policy laws allow the insured to elect either the replacement payment (according to the terms of the insurance contract) or payment equal to the face value in the event of a total loss.<sup>143</sup> However, once replacement coverage is added to a policy, the policy's face value need no longer bear any close relation to the value of the house, and manipulation of the replacement coverage's terms can provide the same maximum coverage while rendering the valued policy laws essentially inoperative. Consider a consumer who desires \$100,000 maximum coverage. Without replacement cost, he would buy a \$100,000 face value policy and gain the valued policy law protection on the full \$100,000 face value. With a typical replacement cost policy providing coverage up to 130% of face value, the insurer could provide the same \$100,000 maximum coverage with a face value of only \$77,000, reducing the extent to which valued policy laws would apply. In the extreme case, if an insurer provided complete replacement coverage of the full value of replacement,<sup>144</sup> an insurer could still provide \$100,000 of maximum coverage using a policy with a face value of \$0<sup>145</sup> which would entirely negate application of valued policy laws, since the insured would never elect the face value reimbursement option.

In the extreme case, it is be clear that less-favorable replacement indemnity was being substituted for the valued policy measure, an action which courts would not allow.<sup>146</sup> Nevertheless, a moment's reflection shows that there is room for considerable gray area along the continuum between no replacement coverage and full valued policy coverage on the one hand, and the extreme full replacement coverage and no valued policy coverage example on the other. Because insurers have unique pricing models, it may be difficult to tell whether an insurer's offered face value is low because of its pricing system, or instead because of a substitution

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<sup>140</sup> See *supra* notes 126-127 and accompanying text.

<sup>141</sup> Because of the house's higher market value, the insured could conceivably monetize this gain by selling the more-valuable non-depreciated house and move to a depreciated one similar to what he had before the loss.

<sup>142</sup> See *supra* notes 28-29 and accompanying text.

<sup>143</sup> See, e.g., *McGlone v. Midwestern Group*, 573 N.E.2d 92 (Ohio 1991).

<sup>144</sup> Recall that insurers used to offer this coverage, although its use has dwindled. See *supra* note 138.

<sup>145</sup> In this example, the insurer would actually be providing more coverage, since the upper limit of covered losses is unbounded.

<sup>146</sup> Valued policy damages cannot be waived in favor of a measure less favorable to the insured. See *supra* note 5.

of replacement coverage for valued policy coverage. And because it is typically difficult for an insured to separate the value of his home from his entire property, let alone estimate the replacement cost of the home,<sup>147</sup> he will likely rely heavily on the value determined by the insurer. It is surely true that many, or perhaps most, insurers will issue policies with face values based on accurate estimates. However, since one of the motivations behind valued policy laws is a mistrust of insurers,<sup>148</sup> to the extent we see this mistrust as a valid concern, we should also be worried about substituting replacement coverage for valued policy coverage. An effective way to limit this substitution would be to cap the percent increase above face value that replacement coverage could provide; any cap should be set high enough to allow sufficient insurance of low-probability high losses, but the higher the cap, the less potential protection valued policy laws provide.

Replacement cost policies in valued policy states solve several of the problems discussed above associated with increasing the face value of a valued policy, which used to be the only method of insuring low-probability, high-dollar losses. Nevertheless, even ignoring the potential for abuse of replacement policy terms, because an insured with replacement coverage can opt for either face-value or replacement cost payment in a valued policy state<sup>149</sup> (and will presumably choose whichever is greater), replacement cost policies do not obviate the need to critically examine valued policy laws.<sup>150</sup> In particular, the consumer harms discussed *supra* Parts III.A&B apply in full force irrespective of whether insureds

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<sup>147</sup> Recently, some low-cost formula-based estimation systems have become available to consumers, but it is unclear how often they are used prior to purchasing a policy. *See, e.g.*, AccuCoverage, <http://www.accucoverage.com> (last visited March 13, 2011) (consumer-level replacement cost estimator run by Marshall & Swift, a prominent commercial provider of building cost data).

<sup>148</sup> *See, e.g., supra* note 29 and accompanying text; *see also* ERIC D. GERST, VULTURE CULTURE, 88-91 (2008) (describing several more modern cases of insurer fraud in multiple lines of insurance that might lead to some mistrust of insurers).

<sup>149</sup> *See, e.g., McGlone* 573 N.E.2d 92. If the insured could not opt for valued policy coverage, then the parties are effectively contracting around valued policy coverage, which would convert valued policy laws from compulsory to default. States with valued policy laws make them mandatory, however, as would be required given their traditional justification as a consumer protection device. *See supra* note 5.

<sup>150</sup> Some academics suggest instead that replacement cost coverage has counteracted the potential negative (and presumably the positive as well) effects of valued policy laws. *See* JERRY & RICHMOND, *supra* note 3, at 660 (asserting that “the increasing use of replacement cost coverage serves to diminish the importance of the controversy over valued policies.”) As has been shown throughout this Paper, however, because valued policy laws cause distortions by over-compensating when face value exceeds actual losses, and because optional replacement cost coverage takes effect only when losses exceed face value, valued policy laws’ impact is largely independent of the incidence of replacement coverage.

purchase optional replacement coverage, as long as there are cases where face value exceeds potential losses.<sup>151</sup>

#### IV. SOME REMAINING CONSIDERATIONS

The previous Part raised several concerns with valued policy laws, in the process debunking most of the traditional justifications for their existence. One final consideration – the idea of valued policy laws advancing the equitable goal of giving insureds what they paid for – has not yet been addressed.

Additionally, although valued policy provisions do not arise voluntarily in homeowners insurance contracts, they are frequently used by parties for marine insurance and for certain unique high-dollar personal property. A traditional conception of voluntary contract terms is that they represent an efficient agreement between parties, and so compulsory deviations from these terms therefore impose undesirable costs on the parties.<sup>152</sup> However, perhaps valued policies' use in marine insurance and unique personal property is a reflection of the insured being a sophisticated party in these markets, whereas in the homeowners insurance market insurers impose onerous indemnity terms on unsophisticated insureds. With this explanation, valued policy terms may actually be desirable for homeowners insurance, but due to the insurers' superior position they are not used. As will be shown, a more likely explanation for valued policies' voluntary use in markets other than homeowners insurance is that marine transport and certain personal property are significantly more difficult to value after a loss than is a house. Thus, although avoidance of post-loss valuation disputes has been offered as a benefit of valued policy laws in homeowners insurance,<sup>153</sup> its voluntary usage in situations where this benefit is great (marine insurance and certain personal property insurance), coupled with no voluntary usage in homeowners insurance where this benefit is smaller, suggests this justification is not compelling.

Each consideration is addressed in turn.

##### *A. Equitable Considerations*

One of the final justifications for valued policy laws is that they advance equitable considerations by providing insureds with payment based on what was being paid for.<sup>154</sup> Thus, if an insured is paying premiums for \$100,000 of face value coverage, he should be equitably entitled to the \$100,000 payment under a total loss,

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<sup>151</sup> See, e.g., *McGlone*, 573 N.E.2d 92 (example of one such case).

<sup>152</sup> These costs are particularly unwarranted when the contract does not inflict negative externalities on society, which would seem to be the case in homeowners insurance contracts.

<sup>153</sup> See, e.g., *ABRAHAM*, *supra* note 9, at 271-72.

<sup>154</sup> See *supra* notes 9 and 29 and accompanying text.

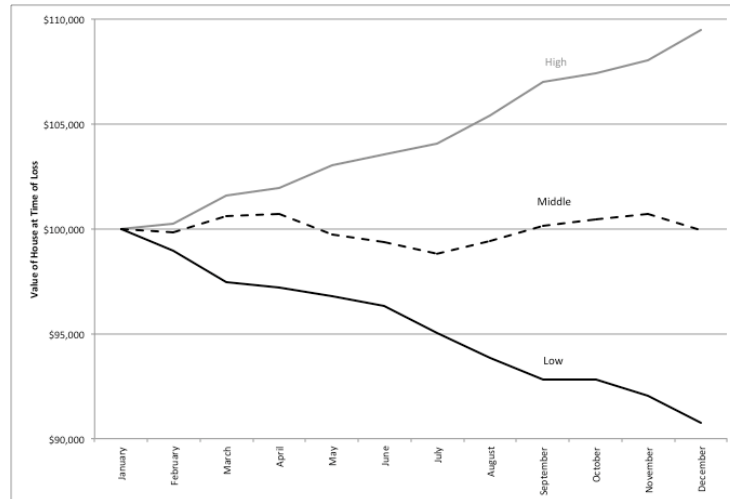
and not a smaller sum if it turns out his house was worth less than the \$100,000 face value.

While this principle seems quite compelling, it may not withstand a closer look. Even if at the particular time of loss the house was worth less than face value, the house was still covered up to the full face value during the entire time up until loss. It is not the case that the insured received only coverage equal to the lower realized face value over the life of the contract. Replacement costs, and hence actual cash value, can fluctuate over periods even as short as one year (the term of a typical homeowners insurance policy),<sup>155</sup> so it is entirely possible that if the loss had occurred at a different time of the year, the homeowner would have recovered an amount closer to the face value. Put differently, a home might have an actual cash value of \$100,000 in January and only \$92,000 the following December. A \$100,000 face value policy would then pay out \$100,000 if the home were lost in January but only \$92,000 if the home were lost in December in an actual cash value state. Yet the example shows that the insured actually received something from coverage in excess of the value at time of loss, for if the loss had occurred in January instead of the following December, recovery would have in fact equaled the face value. Even if the value of loss at any point in time never actually reaches the face value over the life of the contract, the insured was still covered up to face value during the contract period in case prices *had* risen. Figure 7 may make the point clearer, showing the case where a homeowner faces three equally likely possible future home price paths. Claiming the insured has an equitable entitlement to \$8,000 in the low case misses the point that in two-thirds of cases the insured would have recovered \$100,000.

Figure 7

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<sup>155</sup> For instance, a significant loss event such as a hurricane or forest fire would drive up replacement costs as materials and labor are in higher demand. Other market fluctuations also induce variability in these replacement costs; over the past twenty years, national average building costs have varied from an annual decrease of 2% from 2008-2009 to an annual increase of over 9% in 2003-2004. Author's calculations from Tim Grogan, *How To Use ENR's Cost Indexes*, ENGINEERING NEWS-RECORD, Mar. 29, 2010, at 60 (building cost index).



An equitable entitlement to \$100,000 when the actual cash value of the December loss was \$92,000 would require that potential losses never actually or had reason to possibly exceed \$100,000. Otherwise at the time the contract was entered, the insured benefitted from the “excess” coverage and should be reimbursed according to the contract.

Admittedly, this argument does not address the case where face value so greatly exceeds the expected loss that there is no realistic chance the actual loss could reach the face value through normal replacement cost fluctuations. In this case, equitable concerns can be addressed by first observing that coverage is determined by the expected loss. Recall Figures 5-6 above. When a policy’s face value exceeds the actual loss, the insured finds himself in the left tail of the loss distribution function. It is these individuals who result in the insurer’s expected loss being less than the face value, which reduces premiums for all insureds by the amount in Equation (9). Thus, although an actual cash value insured might not receive full face value in some losses, neither is the insured paying a premium that would support payment of full face value in every loss. An equitable entitlement to full face value payments would seem to require that the insureds are actually paying for it. In actual cash value states, the insured buys insurance that reimburses *up to* the face value in the event of a loss, not the face value in the case of a total loss.

Nonetheless, one could make a related equity argument that valued policy laws are beneficial because they honor the reasonable expectations of the insureds.<sup>156</sup> While this argument is typically invoked to force the insurer into providing coverage where the insured reasonably expected it,<sup>157</sup> it could also be applied to fix coverage at the level that could have been reasonably expected by insureds. For homeowners insurance, this level would be the policy face value. In

<sup>156</sup> See Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961 (developing the idea of reasonable expectations of insureds); ABRAHAM, *supra* note 63, at 103-125 (same).

<sup>157</sup> See ABRAHAM, *supra* note 63, at 103-125.

this case, valued policy laws might represent a cost-effective way of achieving this goal: indemnity is fixed at the policy face value for total losses because most insureds expect this level of reimbursement, and a costly case-by-case inquiry by courts into the individual's expectations is avoided. Instead of a court having to fix reimbursement at this face value, valued policy state legislatures efficiently push this upstream in the contracting process by requiring non-waivable valued policies.<sup>158</sup>

It is an interesting question to consider what the insured's reasonable expectations are in the event of a total loss. An equally compelling argument could be made that the typical homeowner who buys insurance generally wants (and expects) only to receive the full value of his house in the event of a total loss, or in the case of a replacement cost policy to rebuild the house if it burns to the ground. In a non-valued policy law state, when the policy face value exceeds this loss, the insured is still put in exactly the position he contracted for voluntarily: he receives the market or replacement value of his house (as long as he purchased sufficient coverage). The fact that this value is less than face value should not matter, since with the replacement coverage he will be in the same position as before the loss, and with actual cash value coverage he will receive payment that gives him equivalent buying power to what he had before the loss. The case where losses exceeding face value conflict with insureds' reasonable expectations of being completely compensated for a loss is also quite interesting, but it goes beyond the scope of this Paper.<sup>159</sup>

We therefore see that equitable considerations do not provide clear support for valued policy laws. While these laws could provide a measure of equity, this seems to depend on insureds' reasonable expectations for compensation in a total loss. Even if we find that reasonable expectations are to provide face value indemnity, instead of adopting valued policy laws and their concomitant costs,<sup>160</sup> a better alternative might be to allow voluntary contracting combined with consumer insurance education.

#### *B. Voluntary Use of Valued Policy Laws*

Interestingly, we do not see insurers or insureds voluntarily contracting for valued policies, yet valued policies occur without statutory mandate in marine insurance and coverage of hard-to-value personal items.<sup>161</sup> The lack of voluntary valued policies in homeowners insurance suggests the costs of these policies

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<sup>158</sup> If the policy provision were waivable, then insurers might be expected to waive the more restrictive coverage without insureds' awareness, which would then require courts to determine reasonable expectations, defeating this purpose of the valued policy law.

<sup>159</sup> Valued policy laws were designed to address the opposite case of overinsurance, not underinsurance.

<sup>160</sup> See *supra* Part III.

<sup>161</sup> JERRY & RICHMOND, *supra* note 3, at 657.

outweigh their potential savings, while in marine and certain personal item insurance, valued policies provide savings that outweigh their costs.

There are competing suggestions, however. One possibility is that insurers avoid valued policies in a response to, or an attempt to take advantage of, unsophisticated or less-informed insureds.<sup>162</sup> Even if insureds ultimately prefer valued policies, insurers may lack the incentive to adopt them if insureds in general remained ignorant of their policy's indemnity provision until after a loss occurs. And even if some sophisticated homeowners wanted valued policies, insurers' reliance on standard-form contracts<sup>163</sup> leaves no room to accommodate isolated desires.

Yet others have shown that insurers' use of standard-form policies may be more legend than fact; insurers regularly alter standard-form homeowners policies in important respects.<sup>164</sup> Further, some insurers offer products individually tailored to satisfy small pockets of the homeowners insurance market.<sup>165</sup> So, if valued policy laws did provide benefits that more-than-offset their costs, we would expect at least some sophisticated homeowners to obtain it, yet we do not.

An examination of valued policies' use in marine insurance and coverage of particular personal property provides additional insight into valued policies' non-voluntary use in homeowners insurance contracts.<sup>166</sup> In marine insurance, valued policies<sup>167</sup> similar to analogous homeowners insurance policies are traditionally obtained to insure the vessel, while the cargo is more often covered by actual cash value (formerly known as "open") policies.<sup>168</sup> The commonly accepted explanation

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<sup>162</sup> This type of argument was one of the original reasons valued policy laws were passed. *See supra* note 29 and accompanying text.

<sup>163</sup> *See* Schwarcz, *supra* note 63; Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. J. INS. L. 107, 124-25 (2007); *see generally* ABRAHAM, *supra* note 9, at 31-33 (providing narrative background on development of standard-form insurance contracts).

<sup>164</sup> Schwarcz, *supra* note 63.

<sup>165</sup> *See supra* note 101.

<sup>166</sup> The following is necessarily a simplification of the marine insurance picture that nevertheless presents the main points of marine insurance. As has been noted, "[t]he obscurity of the traditional statement of rules concerning the measure of recovery in marine insurance tempts those who master it to preserve its labyrinths as an ordeal of initiation for others who dare to intrude." KEETON, *supra* note 12, § 3.6(b).

<sup>167</sup> The distinction between valued and unvalued policies is today set forth in the Marine Insurance Act of 1906 §§ 27-28, 67-68. Marine Insurance Act, 1906, 6 Edw. 7, c. 41 (Eng.).

<sup>168</sup> WILLARD PHILLIPS, TREATISE ON THE LAW OF INSURANCE 307 (1823) (historical rule of thumb); ARNOULD'S LAW OF MARINE INSURANCE AND AVERAGE, 404-05 (Jonathan Gilman & Robert Merkin eds., 17th ed. 2008) (modern rule of thumb).

of valued policy's emergence in marine insurance is that valuation disputes can be particularly costly once the insured property has been lost at sea, so that valued policies' resolution of these disputes before a loss occurs is particularly valuable.<sup>169</sup> Given this intuitive reasoning, it makes sense for valued policies in marine insurance to often be limited to the value of the vessel only.

Invoices or bills of lading provide enduring, accurate, easily-obtainable estimates of a cargo's value, so that valued policies would not provide much benefit in terms of avoided valuation disputes after most cargo losses.<sup>170</sup> The value of the vessel is not as easily reconstructed and depends on market conditions, the vessel's condition, and subjective valuations that could quickly lead to valuation disputes if the vessel has already sunk before it was valued.<sup>171</sup> With homes, much of the perceived fluctuations in value are changes in the value of the land and not the value of the home, and reliable records often exist after a loss to reconstruct reasonable home value estimates.<sup>172</sup> Contrast this value stability with vessels, where the entire market fluctuation affects the value of the ship (rather than being absorbed by land) making ex-post valuation disputes more likely and more costly, and where information on the vessel's value may not be as easily attainable after the ship is lost.

In addition to marine insurance, valued policies are also voluntarily used to insure certain types of personal property. Yet it is typically only the personal property whose value is subject to large market and subjective fluctuations and is difficult to reconstruct after a loss, such as antiques or works of art, that is insured this way.<sup>173</sup> Again we can contrast this case where there are significant savings to be obtained by avoiding post-lost valuation disputes with the case of homes, where any post-lost valuation disputes will be rarer and less costly.

We therefore see an important difference between the circumstances where valued policies arise voluntarily and where they are forced upon insurers and homeowners by states. Valued policy laws' savings are most pronounced when the insured property is particularly difficult to value after a loss, since valued policies eliminate disputes over valuation after a loss occurs. Reflection on house prices plus the fact that these policies are not used voluntarily by those who have a choice suggest that these laws do not provide comparable savings in the homeowners insurance market. In fact, because insurer defenses create uncertainty in valued

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<sup>169</sup> ABRAHAM, *supra* note 9, at 272.

<sup>170</sup> PHILLIPS, *supra* note 168, at 307. Difficult-to-value cargo or cargo with particularly variable prices were more likely to be insured by valued policies. *Id.*

<sup>171</sup> *Id.*; ARNOULD'S LAW OF MARINE INSURANCE AND AVERAGE, *supra* note 168, at 404-05.

<sup>172</sup> Town land record offices often include helpful characteristics of the house, and prior assessments for property tax purposes could also be used to provide an estimate of the house's worth.

<sup>173</sup> JERRY & RICHMOND, *supra* note 3, at 657; *see also* Redlands Ins. Co. v. Lerner, 824 N.E.2d 1096 (Ill. App. Ct. 2005) (insurance of a painting).

policy homeowners insurance coverage,<sup>174</sup> valued policy laws may actually *create* ex-post disputes when face values exceed the value of the loss since the insurer has a chance of winning these cases.<sup>175</sup>

## V. CONCLUSION

Much of the conventional wisdom justifying the enactment and continued existence of valued policy laws is subject to question. This Paper has shown that equitable concerns may be less compelling than originally thought, and savings from resolving valuation disputes before a loss are small in the homeowners insurance market compared to markets where valued policies arise voluntarily, including marine insurance and certain personal property insurance. The case to continue requiring valued policies in homeowners insurance is significantly weakened.

On the other hand, the costs imposed by valued policy laws seem significant. The laws impose unambiguous losses on the average consumer through transfers to cover insurers' profits and costs. Further, higher premiums from valued policies restrict consumers' budget sets, requiring them to spend more on insurance at the expense of other consumption bundles. Although an empirical test lacked the power to identify these higher premiums due to a restricted dataset, a theoretical analysis provides a strong indication that these costs exist. Valued policies also impose non-financial costs. These costs include that the incentive for insurers to undertake accurate risk classification is diminished (raising equitable concerns and reducing the accuracy of insurance pricing) as well as potential incentives for insureds with overvalued policies to take insufficient measures in preventing losses.

The costs and benefits of valued policies are just as relevant today as they were during the nineteenth and twentieth centuries, even with today's movement towards replacement cost policies. Modern developments both in pricing accuracy and in market competitiveness have largely reduced the original benefits provided by valued policy laws while still imposing undesirable costs. Perhaps it is time states critically re-evaluated these laws to determine whether there is still a place for them in today's homeowners insurance markets.

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<sup>174</sup> See *supra* notes 47-54 and accompanying text.

<sup>175</sup> The fact that so many cases have been cited throughout this Paper suggests just how powerful this incentive is. These cases would not have arisen if valued policies were a conclusive measure of damages.

APPENDIX

Figure A1  
Insurer A Locations

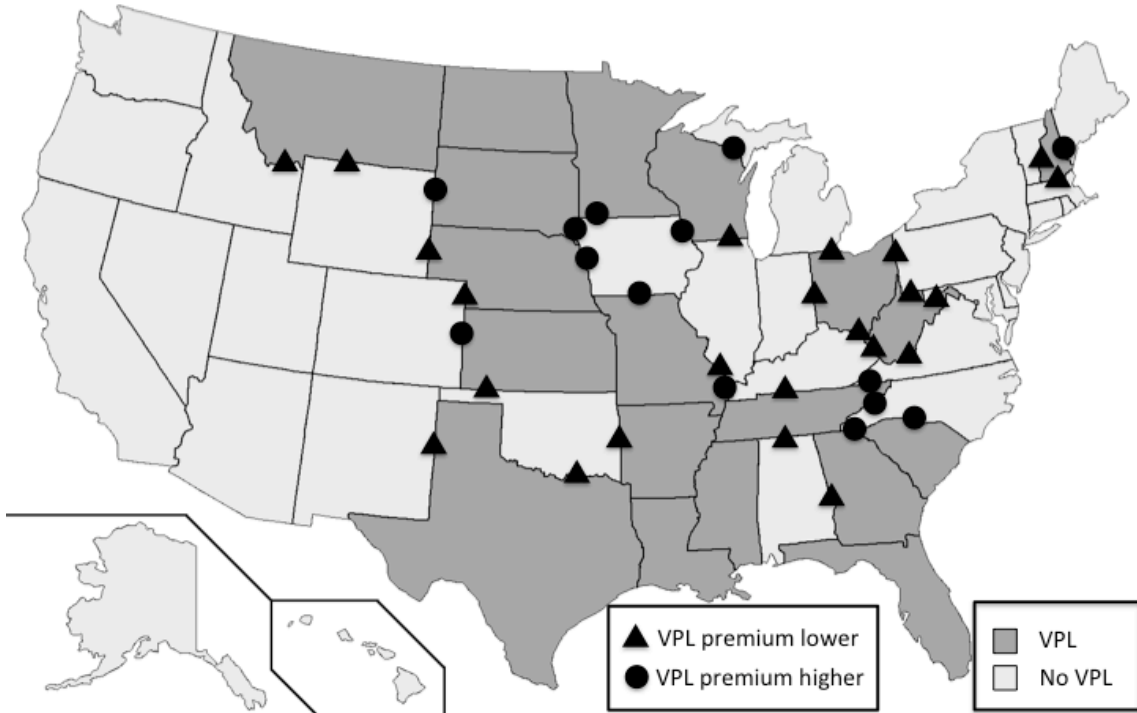


Figure A2

Distribution of Insurer A Premiums

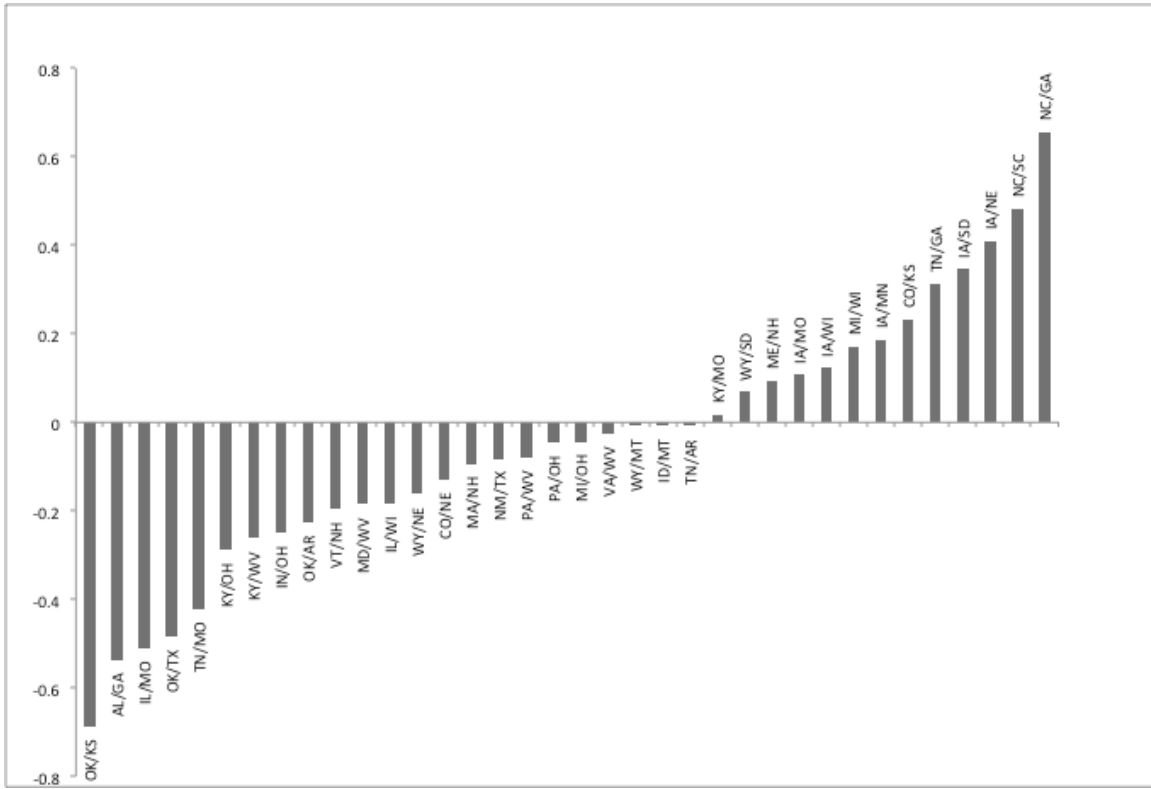


Table A1

## Locations and Difference in Premium Quotes

State Border (VPL State First)	Street Address	Town	State	Insurer A  Percent Difference (Positive: VPL higher)	Insurer B  Percent Difference (Positive: VPL higher)
AR/OK	330 Apple Valley Ln 189 Maple Dr	Fort Smith Pocola	AR OK	-22.57%	-61.75%
AR/TN	558 N 32nd St 1402 Fairview St	West Memphis Memphis	AR TN	-0.61%	13.82%
GA/AL	1616 1st Ave 1840 1st Ave	Columbus Phenix City	GA AL	-53.73%	20.54%
GA/NC	40 Mushroom Ln 137 Chastian Rd	Dillard Scaly Mountain	GA NC	65.71%	52.05%
GA/TN	426 W Gordon Ave 1412 E. 51st St	Rossville Chattanooga	GA TN	31.12%	13.77%
KS/CO	450 Rule Ave 450 3rd St	Kanorado Burlington	KS CO	23.11%	56.92%
KS/OK	150 S Calhoun Ave 450 Beaver St	Liberal Tyrone	KS OK	-68.86%	-11.30%
MN/IA	750 S Central Ave 1190 Chestnut Ave	Hills Larchwood	MN IA	18.66%	42.67%
MS/AL	2 Pinehurst Dr 896 6th St. W	Belmont Red Bay	MS AL	N/A	17.92%
MO/IA	10 S. 1st Ave 310 W. 3rd St	Mercer Lineville	MO IA	10.77%	34.21%
MO/IL	50 Good Hope St 50 Eastwood Dr	Cape Girardeau McClure	MO IL	-51.00%	23.35%
MO/KY	5 Gum St 450 6th St	Wyatt Wickliffe	MO KY	1.67%	-5.75%
MO/TN	2546 Magnolia St 685 Boothspoint Rd	Caruthersville Lenox	MO TN	-42.06%	4.29%
MT/ID	662 Yellowstone Ave 5150 Valley Dr	West Yellowstone Island Park	MT ID	-1.92%	N/A
MT/WY	150 Broadway Ave 240 5th St	Belfry Frannie	MT WY	-0.84%	N/A
NE/CO	250 S. Porter Ave 37540 Arcola St	Haigler Wray	NE CO	-13.01%	3.40%
NE/IA	450 E 7th St 350 4th St	South Sioux City Sioux City	NE IA	41.01%	16.67%
NE/WY	1325 Yorick Ave 2100 Grandview Dr	Morrill Torrington	NE WY	-16.16%	N/A
NH/MA	195 Dutton Rd 594 Pelham Rd	Pelham Dracut	NH MA	-9.32%	-19.10%

NH/ME	20 Winter St 5 Bridge St	Somersworth Berwick	NH ME	9.51%	-0.89%
NH/VT	6 Crawford Ave 124 Walsh Ave	West Lebanon White River Junction	NH VT	-19.48%	-17.36%
OH/IN	555 N. Walnut St. 565 N. Union St	Union City Union City	OH IN	-24.97%	-34.19%
OH/KY	664 S. 3rd St. 350 Etna St	Ironton Russell	OH KY	-28.80%	-66.98%
OH/MI	300 W State Line Rd 25 E Stateline Rd	Toledo Erie	OH MI	-4.38%	-36.40%
OH/PA	1250 Standard Ave 300 Bond St.	Masury Farrell	OH PA	-4.40%	10.63%
SC/NC	30250 Camden Ln 16204 Millsford Ct	Fort Mill Charlotte	SC NC	48.24%	39.40%
SD/IA	26650 Douglas Ave 1190 Chestnut Ave	Brandon Larchwood	SD IA	34.55%	N/A
SD/WY	1950 Meadow Ln 846 E Main St	Spearfish Sundance	SD WY	6.92%	N/A
TN/AL	26710 Elk St 26652 1st St	Ardmore Ardmore	TN AL	-43.80%	-19.84%
TN/KY	2404 Pendleton Dr 826 Decoy Ct	Clarksville Oak Grove	TN KY	-1.03%	-24.26%
TN/NC	1000 Buttermilk Ln 175 Rich Mountain Rd	Trade Zionville	TN NC	51.51%	6.64%
TN/VA	250 Grove Park Dr 80 Pine Circle Dr	Bristol Bristol	TN VA	28.69%	45.15%
TX/NM	254 1st St 310 State St	Farwell Texico	TX NM	-8.22%	8.59%
TX/OK	38 W Parnell St 450 Coleman Ave	Denison Colbert	TX OK	-48.38%	-11.30%
WI/IA	950 S Main St 250 Ann St	Prairie Du Chien McGregor	WI IA	12.34%	2.72%
WI/IL	1550 Turtle St 226 S Harrison Ave	Beloit South Beloit	WI IL	-18.34%	-21.31%
WI/MI	550 Agnes St. 1350 Long Ave	Niagara Kingsford	WI MI	17.09%	-27.10%
WV/KY	25 W 2nd Ave 255 Virginia Ave	Williamson South Williamson	WV KY	-26.10%	-33.20%
WV/MD	25 Maple Ave 21240 Queens Point Rd SW	Keyser Westernport	WV MD	-18.51%	14.67%
WV/PA	450 Camp Run Rd 650 Stewartstown Rd	Morgantown Point Marion	WV PA	-7.82%	29.54%
WV/VA	155 Walters Ave 135 1st St	Bluefield Bluefield	WV VA	-2.44%	37.13%

Table A2: States with Valued Policy Laws

State	Authority	Notes
Arkansas	ARK. CODE ANN. § 23-88-101 (1987 & Supp. 2010)	Does not cover personal property. Applies to losses from fire or natural disasters.
Florida	FLA. STAT. ANN. § 627.702 (West 2005 & Supp. 2010)	Does not cover personal property. Contradictory 2005 amendment seems to strip the law of much of its bite by capping insurer liability at replacement value. 2005 Fla. Sess. Law Serv. Ch. 2005-111, § 16 (West).
Georgia	GA. CODE ANN. §§ 33-32-4 to -5 (2005)	Fire insurance/losses only. Has been extended to homeowners insurance; <i>see</i> Marchman v. Grange Mut. Ins. Co., 500 S.E.2d 659 (Ga. Ct. App. 1998), <i>cert. denied</i> , No. S98C1410, 1998 Ga. LEXIS 980 (Ga. Oct. 2 1998). Refund premium difference if reimbursed less than face value for total loss if non-residential. Insurer can deduct depreciation. Actual cash value if loss occurs within 30 days of policy's effective date.
Kansas	KAN. STAT. ANN. § 40-905 (2000 & Supp. 2010)	Real property only. Applies to losses from fire, tornado, windstorm, or lightning. Applies after policy has been in force at least 60 days.
Louisiana	LA. REV. STAT. ANN. § 22:1318 (2009)	Applies to fire insurance/losses only, and to only immovable inanimate property. Statute allows insurer to opt out. <i>See</i> Landry v. Louisiana Citizens Property Ins. Co., 983 So.2d 66 (La. 2008). <i>But see</i> Farmers-Merchants Bank & Trust Co. v. St. Katherine Ins. Co., 693 So. 2d 876 (La. Ct. App. 1997), <i>writ denied</i> , 703 So. 2d 25 (La. 1997) (reaching opposite conclusion). Insurers have also generally assumed the law applies to homeowners insurance, although recently courts have decided the law does not, even if insurers do not argue this. <i>Watson v. Allstate Ins. Co.</i> , No. 07-3462, 2009 WL 1704730 (E.D. La.

		June 17, 2009); <i>Landry</i> , 983 So.2d 66.
Minnesota	MINN. STAT. § 65A.08 (2005)	Exception for MN FAIR residual plan, in which case insurer must refund excess premiums if face value is not paid.
Mississippi	MISS. CODE ANN. § 83-13-5 (1972)	Applies to fire insurance/losses only. Has been extended to homeowners insurance; see <i>Necaise v. U.S.A.A. Cas. Co.</i> , 644 So.2d 253 (Miss. 1992). Policies can be issued for a maximum term of 5 years.
Missouri	MO. ANN. STAT. § 379.140 - .150 (West 2002)	Applies to fire losses only. Insurer can deduct depreciation occurring after policy was written. If partial loss, insurer pays proportional to face value. Multiple policies all pay full value.
Montana	MONT. CODE ANN. §§ 33-24-102 to -103 (2009)	Applies to any covered loss of real property as well as to non-car personal property.
Nebraska	NEB. REV. STAT. § 44-501.02 (2004)	Applies to losses of real property due to fire, tornado, windstorm, lightning, explosion losses.
New Hampshire	N.H. REV. STAT. ANN. § 407.11 (2009)	Applies to fire or lightning losses only.
North Dakota	N.D. CENT. CODE § 26.1-39-04 to -05 (2010)	Applies to all covered losses. If partial loss, insurer pays proportional to face value.
Ohio	OH. REV. CODE ANN. § 3929.25 (LexisNexis 2010)	Applies to fire or lightning losses only. Insured likely can get face value if he elects not to repair/replace for replacement policy. See <i>McGlone v. Midwestern Group</i> , 573 N.E.2d 92 (Ohio 1991); <i>Myers v. Cincinnati Ins. Co.</i> , 561 N.E.2d 1060 (Ohio Ct. App. 1989) (interpreting older, similar version of Code).
South Carolina	S.C. CODE ANN. § 38-75-20 (West 2002 & Supp. 2009)	Applies to fire insurance/losses only. Has been extended to homeowners insurance; see <i>Nat'l Grange Mut. Ins. Co. v. Firemen's Ins. Co. of Newark, New Jersey</i> , 425 S.E.2d 754 (S.C. Ct. App. 1992). Insurers contribute pro-rata if multiple full-value policies.

South Dakota	S.D. CODIFIED LAWS § 58-10-10 (2004)	Applies to fire, tornado, lightning losses; insurers contribute pro-rata if multiple full-value policies. Applies after policy has been in force 90 days.
Tennessee	TENN. CODE ANN. §§ 56-7-801 to -803 (2008)	Applies to fire losses/insurance only. Has been extended to homeowners insurance; <i>see</i> Adams v. Tennessee Farmers Mut. Ins. Co., No. W2009-00931-COA-R3-CV, 2010 WL 1444477 (Tenn. Ct. App. Ap. 13, 2010). Valued policy law applies if property not personally inspected by insurer within 90 days of a policy's issuance.
Texas	TEX. INS. CODE ANN. § 862-053 (Vernon 2009).	Applies to fire losses/insurance only. Has been extended to homeowners insurance; <i>see</i> Vail v. Texas Farm Bureau Mut. Ins. Co., 754 S.W.2d 129 (Tex. 1988). Does not apply to personal property
West Virginia	W. VA. CODE ANN. § 33-17-9 (LexisNexis 2008)	Applies to any covered loss for fire insurance. Unclear whether it would be extended to homeowners insurance. Farmers' mutual insurance company policies are exempt by W. VA. CODE ANN. § 33-22-7(c) (LexisNexis 2008).
Wisconsin	WIS. STAT. ANN. § 632-05 (West 2004)	Applies to any covered loss on properties used primarily as dwellings.

Table A3: States without Valued Policy Law

<b>State</b>	<b>Authority</b>	<b>Notes</b>
Alabama		No mention.
Alaska		No mention.
Arizona	ARIZ. REV. STAT. ANN. §§ 20-1503 to -1504 (2010)	165 line policy (1943 New York standard form that features actual cash value indemnity).
California	CAL. INS. CODE §§ 2051-2052, 2054 (WEST 2005)	Fair market value; valued policy optional under §§ 2052, 2054.
Colorado		No mention.
Connecticut	CONN. GEN. STAT. ANN. §§ 38a-306 to -307 (West 2007)	165 line policy.
Delaware		No mention.
Hawaii	HAW. REV. STAT. ANN. § 431:10-210 (LexisNexis 2008)	165 line policy or equivalent.
Idaho	IDAHO CODE ANN. § 41-2401 (2010)	165 line policy.
Illinois		No mention.
Indiana		No mention.
Iowa	IOWA CODE §§ 515.109, .135 (2007)	165 line policy. Face value is prima facie but not conclusive evidence of value.
Kentucky		No mention.
Maine	ME. REV. STAT. ANN. tit. 24-A, § 3002 (1964 & Supp. 2010)	165 line policy.
Maryland		No mention.
Massachusetts	MASS. GEN. LAWS ch. 175, § 99 (2010)	165 line policy.
Michigan	MICH. COMP. LAWS ANN. § 500.2833 (West 2002)	Actual cash value.
Nevada		No mention.
New Jersey	N.J. STAT. ANN. § 17:36-5.20 (West 1994)	Actual cash value.
New Mexico		No mention.
New York	N.Y. INS. LAW §§ 3404, 3408 (McKinney 2007 & Supp. 2009)	Actual cash value/replacement (whichever is less).
North Carolina	N.C. GEN. STAT. §§ 58-43-10, 58-44-16 (2009)	165 line policy; excess premiums refunded if total loss is less than face value.
Oklahoma	OKLA. STAT. tit. 36, §§ 4803-4804 (West 1999 & Supp. 2010)	165 line policy; excess premiums refunded.

Oregon	OR. REV. STAT. § 742.058 (2009)	Excess premiums refunded.
Pennsylvania	40 PA. STAT. ANN. § 636 (1999 & Supp. 2010)	Actual cash value.
Rhode Island	R.I. GEN. LAWS § 27-5-3 (2008)	Actual cash value.
Utah	UTAH ADMIN. CODE r.590-190- 13 (1999)	Replacement or actual cost basis.
Vermont	Vt. STAT. ANN. TIT 8, §§ 3961, 3967 (2009)	Fire insurance only, at request of insured. Rate cannot be higher than rate for policy without this request under § 3967.
Virginia	VA. CODE ANN. §§ 38.2-2104 to -2107 (1950 & Supp. 2010)	165 line policy.
Washington	WASH. ADMIN. CODE § 284-20- 010 (1977)	165 line policy.
Wyoming	WYO. STAT. ANN. § 26-23-103 (2009)	Excess premiums refunded.