UNDERINSURANCE: A Consumer Fraud, *Not* an Agent Error or Omission

**By Jerry Ramsey and Brian Heffernan*

The phenomenon of "underinsurance" has recently become the subject matter of legal analyses - and for good reason. In the aftermath of the 2003 Southern California firestorms, it has become blatantly apparent that the occurrence of underinsurance is not happenstance in nature. To the contrary, the problem is systemic and has manifested globally. The primary focus of underinsurance legal analyses has been on the liability of insurance agents and brokers for underinsuring risks.[1] This is understandable given that the law has evolved and developed in much the same way. In *Desai v Farmers Insurance Exchange* (1996) 47 Cal.App.4th 1110, the Court rejected the insurer's argument that it could not be held liable for misrepresentations of its agent regarding the scope and extent of insurance coverage. In *Desai*, the agent's misrepresentations and liability were imputed to the insurer under theories of ratification and ostensible authority.[2]

While the evolution of the law has been helpful in establishing a legal duty on the

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[1]See *Liability of insurance agents and brokers for under-insuring residential properties,* Scott Glovsky, *The Advocate Magazine*, March 2004, p29; also see *Liability of insurance agents and brokers for malpractice,* Ricardo Echeveria and Douglas Carasso, *The Advocate Magazine*, December 2003, p29. These excellent papers should be read to gain an understanding of the nature and duties of "agents" and "brokers".

[2]47 Cal.App.4th @ 1120. Also see *Paper Savers, Inc. v John David Nacsa* (1996) 51 Cal.App.4th 1090

part of agents - who function at the retail end of the chain - practitioners should be careful not to fall into the trap of viewing the source of the problem as derelict agents. In fact, the ultimate purveyor of the product - the insurer - would love for the trier of fact to buy into this very line of thinking in underinsurance litigation. The view that underinsurance is merely the product of an agent error or admission is based on faulty reasoning, at best, and more likely a concerted insurance defense strategy to push liability on to semi-independent agents so as to diminish the insurer's direct and significant exposure to the policyholder. In many cases, the insurance industry would be tickled if the trier of fact were to find that an agent was merely "negligent" as opposed to finding misrepresentation or fraud. There is ample evidence of this even in the immediate aftermath of the 2003 firestorm and in the initial pleading stage of underinsurance litigation. A recent article in a major San Diego newspaper quoted the Farmers Group, a major player in the San Diego wildfires with significant underinsurance exposure, as explaining that "there are 'bound to be some disagreements' after a major wildfire."[3] Similarly, Farmers' demurrers to underinsurance litigation seek to defeat the existence of a legal duty by arguing that "Plaintiffs face a serious uphill battle on this underinsurance issue" (because) "it is well settled California insurance law that the insured – not the insurer – is solely responsible for determining and obtaining the level of coverage desired."[4]

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[3]San Diego Tribune, April 2, 2004, *After the Fires: Homeowners Sue their insurer*, By Jeanette Steele, staff writer.

[4]Demurrer of Truck Insurance Exchange, Superior Court Case No. GIE021050, pleading filed April 13, 2004, @ 1:12

The insurers rely principally on the case of *Gibson v Geico* (1984) 162 Cal.App.3d 441 which does suggest that the insured has the duty to select his policy limits. The *Gibson* case is extremely misleading and wholly inappropriate in the context of a first party property policy and loss. In *Gibson*, the plaintiff-insureds contended that their insurer failed to make available or otherwise inform them of the availability of "underinsured motorist" coverage. The plaintiffs also alleged that the insurer failed to inform them that their med pay coverage limits of $3000 were inadequate in light of greatly increased medical costs over the 22-year period that the policy had been renewed.[5] The plaintiffs in *Gibson* went too far in arguing that insurers owed a duty to advise of *other* insurance available in the marketplace from competitors of the insurer.[6] The court understandably held that such a duty would convert insurers into brokers[7] and would remove from the insured any burden to take care of his own financial needs and expectations in entering the marketplace and choosing from among the competitive products available".[8] The adage of "bad facts make bad law" is apt in the circumstances of the *Gibson* case. It is difficult to feel much concern for an insured who claims his UIM and Med Pay Limits were too low. These coverages involve third party liability losses

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[5]*Gibson v Geico* (1984) 162 Cal.App.3d 441, 447

[6]*Gibson, supra,* @ p451

[7]A "broker" is the agent of the insured. *Insurance Code* §31. See Scott Glovsky article, supra, footnote 1 re: distinction between a "broker" and an "agent".

[8]*Gibson* @ 451

sustained by the insured and the financial consequences are uniquely within the knowledge of the insured.

Conversely, in the case of a first party policy covering an insured's home, the insured typically has no idea how much protection will be required in order to effectuate full indemnification in the event of a catastrophic loss. Moreover, insurers not only hold themselves out as experts in this very arena, their business practice and policy language[9] actually *require* that the insured submit to the insurer's evaluation and assessment of the coverage limits required for the risk. When is the last time that anyone walked into their agent's office to purchase homeowners insurance and was asked "Well how much would you like?". Insurers would have the trier of fact believe that the transaction was akin to buying a dozen eggs at the general store. And when the insured's policy only provides enough money to replace[10] six or seven of the dozen, the carriers' argument is that the insured should have known better (per *Gibson v Geico*) or, that the agent simply made an honest mistake in miscounting how many eggs were in that dozen. The argument is hollow when one considers the reality of the circumstances presented and the contractual

[9]i.e. Farmers "Extended Replacement Cost" promise: *"We will pay to repair or replace covered loss under Coverage A - Dwelling up to 125% of the limits of insurance for Coverage A - Dwelling. You **must** agree to comply with the following additional policy provisions: You **must** insure your dwelling to 100% of the replacement cost".* Farmers "Guaranteed Replacement Cost provision similarly required as a condition precedent that *"You (the insured) have insured your dwelling and separate structures to 100 % of their replacement cost **as determined by our Building Replacement Cost Guide**"* (***emphasis*** added for illustration)

[10]See infra re: "Replacement" - a key term and promise which forms the underpinning of the plaintiffs' argument for coverage in underinsurance litigation.

promise of "Replacement Cost" made by the insurer.

The circumstances of purchasing homeowners coverage are seemingly simple and straightforward. The insured (and his lender) desire coverage which effectuates replacement of the asset in the event of a catastrophic loss such as fire. The firestorms have revealed, to the surprise of an inordinate amount of Southern California insureds, that their understanding of the term "replacement" differs markedly from that of the insurance industry. Insureds understand the term replace to mean just that - to replace. Courts have logically defined "replacement" to mean "restoration to a condition substantially the same as that existing before the damage was sustained"[11] Insurers, however, have a different definition which contemplates a financial limitation which effectively provides the insureds with as little as 50% of the true cost to replace their home. This scenario was completely undisclosed and has left policyholders standing on their land in a pile of ashes in a state of total despair. By limiting their exposure to stated policy limits selected by the insurers themselves, insurers have in effect sold what is known as an "actual cost" or "valued" policy, an insurance product which is wholly inconsistent with "replacement cost" coverage and which is designed to defeat the favorite demon of the insurance industry, so-called "betterment".[12] Why didn't insurers

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[11]*Northwestern Nat'l Ins. Co. v Cope* (1969) 448 S.W.2d 717, 719; Appleman, *Insurance Law and Practice* §4004 @ 710 (6th ed.) California has recently confirmed a similar understanding: "Replacement cost is the estimated cost to construct, at current prices, a building with *utility equivalent* to the building being appraised, using modern materials and current standards, design and layout." *Fire Insurance Exchange v Superior Court* (2004) 116 Cal.App.4th 446, 468 (*emphasis* original)

[12]*Dupre v Allstate* (2002) 62 P.3d 1024,1030 cited favorably in *Fire Insurance Exchange v Superior Court* (2004) 116 Cal.App.4th 446

simply disclose this basic fact? Because the consuming public demands the product of "Replacement Cost" coverage. Consumers don't want six or seven eggs when their loss is a dozen and they don't want to be out of money during the rough framing stage of their rebuild effort. The "Replacement Cost" label moves product, deceptively.

"Replacement Cost" has a common sense and legally recognized meaning. The promise was made with no intent on delivering as is evidenced in the case of the 2003 firestorms. Thus, a classic case of consumer fraud.

The genesis of the problem was correctly identified in a recent article[13] as being the result of the Northridge earthquake wherein insurers sustained massive losses resulting from their issuance of so-called "Guaranteed Replacement Cost" policies. In the aftermath of Northridge, the industry began issuing what it phrases as "Extended Replacement Cost" coverage in an effort to decrease benefits to policyholders in the event of a loss. In Extended Replacement Cost coverage a particular policy limit is established and is represented to be the actual "Replacement Cost" figure - the same procedure involved in the issuance of "Guaranteed" Replacement Cost coverage. This number is established by the agent of the insurer using the insurer-issued software and pricing. The so-called "Extended Replacement Cost" feature serves as a buffer adding an additional degree of coverage ranging between 25% and 125% or even more of the stated policy limits. The ostensible purpose of this buffer is to provide some form of protection in the event of "unforeseen" contingencies such as increases in material or labor pricing. As we

[13]See footnote 1, Scott Glovsky article

are seeing in the aftermath of the 2003 firestorms, even with this so-called "Extended" limit many insureds are left holding the bag with insufficient limits to effectuate replacement of their homes.

Before proceeding further, the underinsurance issue would not be done justice if we were to cavalierly and naively accept the insurance industry's deceptive marketing techniques and nomenclature. The term "Guaranteed", in the context of a Replacement Cost policy, is superfluous. In fact, isn't that the case with any bona fide promise? If you purchased a dozen eggs at the market, came home and found only six or seven in the carton, would it be a valid defense that the promise of a dozen was not "guaranteed"? Could your house painter cease efforts after painting the first story of your two story house because he had not "guaranteed" to paint the entire house? Similarly, if an insured is promised "Replacement Cost" coverage, is that promise heightened or diminished by the inclusion or deletion of the term "Guaranteed"? Should an insured's "reasonable expectations" tell her that "Extended" Replacement Cost will provide her with a lesser degree of replacement than "Guaranteed" Replacement or simply "Replacement"? Buying into this house of cards defies common sense, yet this is the very core of the coverage analysis which judges will be asked to enforce as a matter of law in interpreting insurers' contractual obligations for firestorm losses. And don't forget that we are not dealing with eggs nor painting services in an underinsurance case. The defendant insurer owes a quasi-fiduciary duty as a matter of law. When you look at this problem from this common sense perspective, it becomes obvious that this is far from a case of mere negligence and is much more accurately labeled as a case of Negligent Misrepresentation (making a promise with no reasonable basis for believing in the same) or Promissory Fraud (making a promise with no intention whatsoever of performing).

It will be interesting to gauge the reactions of those honest and competent agents who actually care about their clients in response to their principle's defense that the source of the problem is one of "agent error and omission". After all, these agents are using laptops emblazoned with the insurance company's logo and loaded with company-issued pricing software and they are trained by the company and constricted by the company's underwriting guidelines. In fact, we have encountered fire victims and insureds of major carriers in this state who actually did have the good sense to request higher coverage limits, their agent was more than happy to submit the request for additional coverage and such request was flatly denied by the insurer. This shocking example leads to the next topic.

Selling the Underinsurance Dilemma to the Skeptical Trier of Fact

It is one thing to explain a classic example of consumer fraud in an article to an audience of trial lawyers who know all too well the tricks and machinations of insurance companies, but it is entirely another to explain the issue to a potentially skeptical audience. Let's face it, San Diego is conservative - this is Republican country[14], and the exposure of consumer fraud in some instances may have to be done in a manner which is the equivalent of the anvil hitting the road runner in the head. All kidding aside, some

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[14]See *The buckraking trial lawyer,* San Diego Union Tribune, January 23, 2004, by Joseph Perkins

degree of skepticism is understandable irrespective of one's socio-political perspective on life. The fundamental question which is logically on everyone's mind is "why on earth would the purveyor of any product, whether it be a widget or insurance coverage, do anything to discourage a consumer from purchasing more of that product?" "After all", skeptics will say, "why would an insurance company want to turn down additional premium?" These logical questions likely have several explanations. The first can be categorized as one of "market share". We are encountering neighborhoods where virtually 90% of a given territory will all be insured by the same carrier. The agent in that neighborhood was likely a hustler and did a great job of marketing the widget he brought to the marketplace. Never forget for even a moment that insurance companies are financial institutions, not indemnification specialists. Their business objective is to raise significant amounts of capital and to invest that capital for a profit. Once an agent has a potential insured in his office for a price quote the last thing he wants is for the customer to run down the street to his competitor because they got a quote for literally $50 a year less. The incremental increase in premium for raising coverage from, say, $250,000 to $350,000 is relatively *de minimis*. And the agent only gets a minority portion of that increase in premium. Therefore, the risk of scaring off the insured to a competitor is far too great to justify attempting to truly "insure to value". Insurers and agents keep prices competitive by understating the amount of coverage necessary to indemnify homeowners for the "replacement" loss of their homes. 20th Century Insurance Company went belly up after the Northridge earthquake as the result of this very tactic.[15] The fact is that once the carrier has your $800 premium for $250,000 in coverage, it isn't worth the additional $100,000 in exposure to charge another $50 in premium, nor is it worth the risk that the consumer will flee to a competitor. This related, secondary factor can be categorized as "exposure avoidance".

With no statutory duty to insure to value and the perceived lack of a legal duty, insurers thus far have had little incentive to be the first one to step up to the plate and do the right thing - insuring to value. To do so could price that insurer out of the market. Thus, the problem self-perpetuates itself, the carriers continue to make money doing business dishonestly and the ramifications are not appreciated until a catastrophic event such as the 2003 firestorms occurs. The number of underinsurance victims is significant if not staggering and far in excess of the contingency of "there are bound to be some disagreements". Insurers of underinsured fire victims are in for a rude awakening when they meet their customers and victims in a court of law. The conservative bent of this geographic region may come back to haunt the industry. These victims are not litigious and many were of the same school of thought that would seemingly support tort reform. If you have ever represented a doctor as plaintiff (notorious lawyer haters) you know what we are talking about when we say there is no stronger believer than a convert. Reagan was once a Democrat. We have encountered folks whose resistance to lawsuits was akin

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[15]In 20th Century's case, the carrier reinsured to the stated amount of the policies but its guaranteed replacement cost exposure grossly exceeded the stated and reinsured limits resulting in financial disaster. 21st Century no longer writes homeowners coverage in California. Larger carriers are not quite as reckless but nonetheless engage in a modified form of this phenomenon.

to a religious conviction. Six months after the firestorms, however, the reality of the situation is beginning to sink in. If the plaintiff trial lawyer in an underinsurance case is to accurately demonstrate how this scenario occurred, falling into the trap of "agent error or admission" would be a disservice to the client and to the system at large. The stated purpose of a consumer trial lawyers is to secure a just result for the client and to make the world a better place. Proper representation of the client and fulfillment of this professional objective requires every trial lawyer to assess underinsurance issues in the manner suggested above. Labeling a classic consumer fraud as "negligence" or "E&O" does a disservice to firestorm victims who have been defrauded and are truly in need and does little to prevent the recurrence of the same program in the future. And if that doesn't grab you, then consider that you just might be facilitating the very defense the insurance industry intends to assert.

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*Jerry Ramsey and Brian Heffernan are partners in the Los Angeles law firm of Engstrom, Lipscomb & Lack where they try insurance bad faith and coverage actions on behalf of policyholders.