THE INDEMNITY PRINCIPLE: From a Financial to a Functional Paradigm

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Abstract

Although the indemnity principle is well-accepted, its customary meaning has not kept up with insurance practice. This paper explores the evolution of the indemnity principle in the context of property insurance in the United States. When property insurance was standardized in the 19th century, "indemnity" had a strict, financial meaning. An insured was only entitled to receive actual cash value for a loss, less depreciation. This ensured that insureds received a financial recovery equal to the value of their property prior to the loss. This approach to indemnity was developed in the context of concerns about the morality of insurance, its association with gambling, and the risk of moral hazard. In the 20th century, the financial approach for indemnity often left insureds without sufficient resources to rebuild. Courts and the insurance industry responded by providing replacement cost coverage, which became the standard in the U.S. property market by the 1960s. Replacement cost coverage, however, is inconsistent with the financial version of the indemnity principle. By replacing damaged property with new materials without regard for depreciation, the insured receives a financial benefit from the loss. This paper contends that this shift in the market represents a paradigm shift from the financial approach to a pragmatic, functional approach to indemnity. The consequences of this shift are that exclusions need to be reevaluated for their theoretical grounding, that innovative products may be more easily made consistent with the indemnity principle, and that moral hazard needs to be addressed independently of the indemnity principle.

Introduction

One of the cardinal principles of insurance is "indemnity." As one commentator noted nearly 100 years ago, "insurance is essentially a contract of indemnity, and from this cardinal principal arise many of its distinctive characteristics." (Richards, 1909, at 27-28) William Vance, the esteemed insurance law scholar, put it this way: "The purpose of insurance is indemnity, and

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indemnity only, and, whenever it is applied to any other purpose, such use is a perversion of the true principle, and introduces a wrongful and immoral element of speculation that promotes fraud and crime." (Vance, 1904, at 21)[1] The courts have agreed. For example, the Texas Supreme Court commented: "Indemnity is the basis and foundation of insurance coverage not to exceed the amount of the policy, the objective being that the insured should neither reap economic gain nor incur a loss if adequately insured." (Crisp v. Security National Ins. Co.)

This paper explores the indemnity principle primarily in the context of property insurance, where the indemnity principle primarily developed. (Richards, 1922, at 72) The principle is certainly at the heart of property insurance, as "All authorities hold that property insurance is a contract of indemnity." (Fischer, 1981, at 448; Elliott, 1896, at 20) This article contends that the indemnity principle evolved over time from a strict, financially-oriented concept to a more flexible, pragmatic one. It asserts that this evolution represents a paradigm shift in the way the insurance industry thinks about indemnity. The second section explores the historical roots of the indemnity principle in property insurance. Section three traces the evolution of property insurance to replacement cost coverage and argues that this shift reflects a different way of thinking about indemnity. Section four considers the implications of this paradigm shift.

Historical Roots: a Strict Financial View

A. Early Fire Insurance

The earliest property insurance insured against damage from fire. This kind of insurance, however, did not develop without resistance. In the earliest days of insurance in the United States, prior to 1666, fire insurance was scorned and viewed as an immoral resistance of Divine Providence and a source of serious temptation toward negligent or even fraudulent conduct. (Baker, 1996) After a grand conflagration destroyed London in 1666, fire insurance began to gain greater acceptance. (Oviatt, 1972, at 40)

The nascent fire insurance industry was, of course, very unsophisticated. Instead of relying on data analysis to calculate and classify risks, early underwriters used more simplistic rules of thumb, such as refusing to insure property with trees in front (trees were a barrier to firefighters' access to the property), to classify risks. (Oviatt, 1972, at 43) In 1790s Pennsylvania, there were only two classes of risks–building composed wholly of brick and stone and those which were not–and an 1810 Hartford Fire Insurance Co. policy listed only four classes of risks. (Oviatt, 1909, at 12) In contrast, by the early 20th century over 100 classes of risk were in use. (Bissell, 1909, at 97) Fire insurance in early 19th century America "was chance, pure and simple. There were no data by which the costs and the charge could be brought into anything like proportionate relations." (Oviatt, 1972, at 45)

[1] In later editions of the work, Vance dropped the morally-charged language. (Vance, 1951).

In 19th century America, a string of catastrophic fires provided the incentive and context for modern fire insurance. In 1835, New York was ravaged by a great fire that destroyed 674 buildings and caused damage of $15 million. In 1871, the Chicago fire caused damage of $140 million, and in Boston a year later, 776 buildings were destroyed by fire at a cost $75 million. (Oviatt, 1972) These fires were made worse by the prevalence of wooden construction-including the popular mansard roof–and unsophisticated fire prevention techniques. Horses-drawn water carts could hardly prevent the spread of a determined fire. One commentator attributed the large amount of annual fire loss to "characteristic American carelessness . . . [and] the hurried, optimistic spirit that erects temporary buildings of flimsy materials in confident expectation that growth will soon require their replacement." (Brearley, 1916, at vi-vii) Regardless of the cause, state legislatures reacted by enacting building codes prohibiting wooden construction and requiring fireproof construction materials such as brick. (Huebner, 1982, at 261)

These fires also spurred the growth of the fire insurance industry. In the mid-19th century, new insurance companies sprang up rapidly. (Vance, 1930, at 29) In New York, for example, seventy new fire insurance companies appeared in 1865. (Brearley, 1916) These quick-start companies were quickly vanquished by large-scale fires, their reserves (if any) quickly depleted, their insureds left holding worthless policies. This in turn created more animosity and distrust of insurance companies.

In 1866, insurance companies came together to form the National Board of Fire Underwriters to promote uniformity in policies and to improve the state of the insurance business. (Brearley, 1916, at 1-17; Oviatt, 1972, at 53-56) The Board began "a determined crusade" against the mansard roof (Oviatt, 1972, at 34) and other hazardous constructions, and created a Model Building Law. (Brearley, 1916, at 80) The Board also "insure[d] adequate rates and proper forms" were used throughout the nation, creating a uniform policy which ultimately failed to gain favor. (Oviatt, 1972, at 53, 56) Despite lukewarm reception of its uniform policy, the National Board successfully stabilized rates, thus reducing cut-throat competition which had driven insurers to slash rates and which had destabilized many insurance companies. The National Board marks the beginning of a trend toward uniformity and largess in the insurance business.

About twenty years later, in 1886, four years after New York passed a law requiring fireproof construction, the New York Standard Fire Insurance Policy was created. (Elliott, 1902; Bissell, 1909) Considered by some to be "the most important contract in the world," the New York Standard Fire Insurance policy helped provide stability and uniformity and was a major accomplishment. (Rumsey, 1922, at 41) It dictated that insurers would not be liable beyond the policy's limit and only for actual losses suffered. It also established that an insurer's liability would not exceed the actual cash value of the insured property before the loss or damage. (Rumsey, 1922, at 44) The New York Standard Fire Insurance Policy has been widely adopted in full or in part in the U.S. (McNabb, 2000, at 568-69) The Standard policy was revised in 1918 (Barbour, 1943) and again in 1943. (The 1943 Standard Fire Insurance Policy, 1944) Each revision left the "actual cash value" language essentially untouched but modified other portions of the contract. For example, the moral hazard clauses were reduced and eventually eliminated completely, and the ordinance or law exclusion ceased being an "exclusion" and was moved to the first paragraph of the policy, bolstering the actual cash value measure of insurers' liability.

B. The Strict, Financial Approach to Indemnity

The actual cash value approach of the New York Standard Fire Insurance Policy reflects a strict, financial sense of indemnity, which is the traditional view. (Parker, 1999; Huebner, 1982, at 42) This was consistent with the traditional view in the 19th century that lost or damaged property generally was not to be replaced with new property. (Elliott, 1896, at 21; Willett, 1909, at 49) A scholar stated in 1904 that "indemnity means that the financial loss to the insured is to be made good (but not exceeding the amount stated in the policy), and in no case is he to receive a profit or advantage by reason of the loss." (Gross, 1972, at 145) Although the New York Standard Policy measured actual cash value three different ways, all three methods included a deduction for depreciation. (Parker, 1999) Insureds were not allowed to recover depreciation because doing so would give them a windfall–they would receive new property in place of old.

The strict, financial approach to indemnity was a product of the cultural environment in which the New York Standard Fire Insurance Policy developed. This cultural environment consisted of three main concerns: whether insurance was consistent with contemporary understanding of morality, whether insurance would improperly tempt insureds to become involved in immoral conduct (moral hazard), and whether insurance was distinct from gambling.

Initially, the very concept of fire insurance was regarded as an improper interference with Divine Providence. (Baker, 1996) If a person suffered a catastrophe, it was considered to be God's will. This hostility towards insurance was overcome in part by the practical consequences of catastrophic fires, (Oviatt, 1972, at 40) and in part by effective marketing of insurance as morally sound and consistent with positive moral values of self-reliance and thrift. (Baker, 1996) Nevertheless, society continued to view insurance through a "moral" lens, (Baker, 1996; Vance, 1904, at 21) requiring that insurance policies be carefully designed to avoid the appearance of immorality. This resulted in a strict view of indemnity that prevented insureds from receiving more than they had prior to the loss.

Closely related to this general concern about morality was a more specific concern about moral hazard. (Baker, 1996, at 253; Goble, 1937, at 411) Society was concerned that fire insurance "encouraged carelessness on the part of property owners, and induced such a relaxation of care and diligence in the protection of property as operated disastrously to the public generally." (Wood, 1878, at 5) Because of this concern, in the mid-19th century Massachusetts refused to allow insurers to insure for more than 75% of a property's value to prevent "fraudulent losses"; insureds had to co-insure the rest. (Liscom v. Boston Mutual Fire Ins. Co.) Thus, merely entering into an insurance arrangement supposedly generated moral hazard.

The seriousness of moral hazard is evidenced by "moral hazard" clauses inserted into insurance policies during the 19th century. (Goble, 1937) These clauses voided policies entirely if the insured somehow created a moral hazard after the contract was executed. For instance, the 1886 standard policy included nine "moral hazard clauses," which voided the entire policy if violated.

Concerns about moral hazard were heightened by the inability of insurers to use risk data as a basis for underwriting. Nineteenth century insurance was unsophisticated, as was 19th century America. Statistical data was unavailable, and the system for setting rates and calculating and classifying risks could not rely on scientific guidance. (Pfeffer, 1972, at 16) Consequently, 19th century insurance turned to something more familiar - morality and individual character. (Baker, 1996)

Added to these concerns about moral hazard was the perception that fire insurance could be a form of gambling or wagering. (Wood, 1878, at 89-91) Wagering policies, where a party had no interest in the insured property, were invalid and "vicious and evil in their tendencies . . . and . . . noxious and dangerous." (Ruse v. Mutual Benefit Life Ins. Co.) Wagering policies would lead to "a demoralizing system of gaming, [and] furnish strong temptations to the party interested to bring about, if possible, the event insured against." (Ibid.) Under no circumstances could an insured insure property in which he did not have an interest. Although lottery proceeds funded the Colonial Army in 1776 and Harvard and Yale University, lotteries were banned completely in the United States by 1900. (North American Association of State & Provincial Lotteries) Moral people simply did not receive something for nothing.

The adoption of a strict, financial indemnity theory addressed these concerns while at the same time allowing the pragmatic benefits of insurance. By limiting the recovery to precisely what the insured had prior to the loss, insurance policies avoided the temptation to cause a loss because such a loss would not convey a benefit. Similarly, reducing the amount of recovery to what the insured had prior to the loss distinguished insurance from gambling. The insured's recovery would not convey any extra benefit, the "winnings" that would be received from gambling.

Evolution

A. Emergence of Replacement Cost Coverage

As a result of this historical setting, the strict, financial approach to indemnity became the paradigm in the 19th century. This paradigm was reflected by the use of actual cash value as the basis for calculating losses under property insurance policies. Although there were some exceptions to actual cash value that developed in the 20th century, even by the mid-20th century the majority rule was that insurers were liable for the actual cash value of damaged property, stated as "replacement cost, less depreciation." (Fischer, 1981, at 454; Valuation and Measure of Recovery Under Fire Insurance Policies, 1949, 825-26) Around the middle of the 20th century, however, this changed and in the latter half of the 20th century, replacement cost coverage became the majority rule. The change in coverage was driven by the market, without consideration of the indemnity principle. But, because replacement cost is inconsistent with the traditional view of indemnity, it reflects a shift in the industry's view of indemnity. This section begins with the weakness that developed with actual cash value, and traces the rise of replacement cost coverage, noting factors that contributed to its development and its success.

Although actual cash value policies are consistent with the traditional indemnity paradigm, the use of that valuation created an under-insurance problem for as many as 90% of homes. (Mangan, 1992) Because the costs of construction increase over time, deducting for depreciation "would make the sum insufficient to complete the repairs and would leave the building unfinished." (Third National Bank v. American Equitable Ins. Co.) This significantly diminishes the value of the insurance in a pragmatic sense, even though the insured is financially indemnified.

This weakness led to the development of replacement cost coverage. "Replacement Cost insurance . . . is any type of coverage under which the insurance company agrees, in effect, to pay the difference between actual cash value and full replacement cost. What is insured, therefore, is depreciation . . . ." (Higgins v. Ins. Co. of North America) During the early part of the 20th century, courts had begun to recognize the under-insurance problem and to impose replacement cost coverage on policies with actual cash value terms. The Pennsylvania Supreme Court, for example, challenged the old rule and held that the measure of an insurer's liability is the replacement cost without deducting for depreciation. (Fedas v. Ins. Co. of State of Pennsylvania) The court noted that insureds could not otherwise afford to rebuild. Other courts agreed. In 1936 and 1938, the Georgia Court of Appeals (North River Ins. Co. v. Godley) and the Montana Supreme Court (McIntosh v. Hartford Fire Ins.) respectively refused to deduct depreciation from the loss valuation.

In these cases were the seeds of replacement cost coverage and the move away from the financial approach to indemnity. The more functional approach to indemnity was reflected in a

1943 Tennessee court decision where the court refused to deduct depreciation, stating that doing so "would make the sum insufficient to complete the repairs and would leave the building unfinished; and this would fall short of the indemnity contracted for in the policy." (Third National Bank v. American Equitable Ins. Co.) This sense of "indemnity" was a functional one, rather than a financial one. The insured needed a finished building to be indemnified even if that required the insured to receive a financial benefit. The Florida Supreme Court reached a similar conclusion in 1949, stating that the insurer must "restore the property to its condition prior to the loss" and remarking that "[c]ertainly it was not intended that the repairs should be made with [old] materials." (Glen Falls Ins. Co. v. Gulf Breeze Cottages, Inc.)

In this same time period, insurers began offering replacement cost coverage or endorsements. In 1943, "depreciation insurance" was offered on structures with "slight moral hazards attached to them." (Jordan, 1990, at 18) By 1949, replacement cost coverage was common enough to constitute a "minority" approach to the majority rule of actual cash value, and seven states, including New York, had authorized replacement cost coverage. (Valuation and Measure of Recovery Under Fire Insurance Policies, 1949, at 826, 832) Replacement cost coverage caught-on quickly. "Replacement cost coverage . . . became virtually standard equipment on the building item of all of the forms and packages which broadened dwelling coverage in the 1950-60 period." (Hedges & Williams, 1961, at 291)

B. Replacement Cost and Indemnity

Replacement cost coverage is fundamentally at odds with the financial view of indemnity. It allows the insured to receive more in a financial sense than he or she had prior to the loss. This is because new materials used to replace damaged property are generally worth more than the old materials, resulting in a financial benefit to the insured. (Parker, 1999, 317-18; Fischer, 1981, at 470; Jordan, 1990, at 17) Because of this conflict, at least one commentator suggested that "replacement cost coverage is not . . . insurance." (Hedges & Williams, 1961, at 9)

On the other hand, replacement cost coverage fulfills indemnity in a functional sense. By allowing the insured to rebuild, it provides the insured with property that has the same functionality prior to the loss. As one commentator put it, "replacement cost insurance . . . is justified because most homeowners simply cannot afford to pay the cash difference between the replacement cost and the actual cash value of damaged property." (Parker, 1999, at 299; Travelers Indemnity Co. v. Armstrong) Thus, although replacement cost is inconsistent with the indemnity principle from a financial standpoint, it actually promotes indemnity from a functional standpoint. (cf. Reader, 1987, at 282, 284)

By moving to this more functional orientation that allows insureds to receive a financial benefit, replacement cost creates a more significant moral hazard problem. Because insureds receive this financial benefit, it creates an incentive for carelessness or even fraudulent behavior.

Nevertheless, replacement cost coverage has become the standard. So what has become of the historical concerns about moral hazard? Those concerns have become less significant because of cultural, technological and market changes.

1. Cultural Changes

Cultural preoccupation with morality in general and moral hazard in particular has eroded over time. This is not to say that morality is no longer an important concept or that there is no place for public morals. Rather, the point is that the realm for "amoral" conduct within society is much greater. Society has become more tolerant of varying behaviors in many areas historically considered within "morality." (Eadington, 1998, at 58) Perhaps the best example for purposes of this analysis is society's significantly greater tolerance for gambling, one of the "evils" with which insurance sought to avoid association.

Although society's acceptance of gambling has gone through cycles over time, (Montpas, 1996, at 165-66 & n.15) until relatively recently there has always been significant societal resistance to gambling. (Dunstan, 1997, at Part II) The latest cycle, however, "is characterized by the legal and social acceptance of gambling." (Montpas, 1996, at 165 & n.20) Like other "moral" issues, individuals "are far more prone to define their own concepts of right and wrong." A 1995 survey found that over 90 percent of respondents viewed gambling as "acceptable for anyone, or acceptable for others, but not for themselves." (Eadington, 1998, at 58) Gambling has gained acceptance as "a form of entertainment rather than a vice." It has become "so pervasive that only two states, Hawaii and Utah, do not have some form of legalized gambling." (Montpas, 1996, at 166) In light of this acceptance of gambling, society is no longer concerned that financial benefits to insureds who suffer losses are somehow "immoral."

This greater cultural tolerance is also reflected by changes in insurance policy construction. Nineteenth century insurance policies contained moral hazard clauses that, if violated, voided the entire insurance contract. For instance, an insured could not insure his property to its full value if he owned only a partial interest or he would be overinsured, which would create an unacceptable moral hazard and void the policy. These provisions were designed to create a disincentive to "the danger of incendiarism involved in offering the insured a profit, as opposed to mere indemnity, where a fire loss occurs when the policyholder's interest is less than that which was the basis of valuation of the policy." (Recent Statutes, 1942, at 1229) The original New York Standard Fire Policy from 1886 contained fourteen moral hazard clauses, but those were cut to five in 1918. (Rumsey, 1922, at 49; Federowicz v. Potomac Ins. Co.) Although a drafter of the 1918 revisions considered the remaining five clauses of "vital importance," they were completely removed from the form twenty-five years later. (The 1943 Standard Fire Insurance Policy, 1944)

The elimination of the moral hazard clauses is consistent with the evolution of the indemnity principle to a more pragmatic approach. Because numerous insureds regularly violated these clauses, their policies were technically void, yet their conduct posed no "moral" risk. (Goble, 1937; The 1943 Standard Fire Insurance Policy, 1944, at 78) Insureds rarely burned their own homes (in 1930, for example, less than 1% of fire loss was attributable to arson). (Huebner, 1930, at 297-300) Dropping the clauses was considered "a laudable forward step . . . in line with the trend to make the product fit the consumer rather than to try to make the consumer fit the product." (Patterson, 1946, at 368 (emphasis added)) By making insurance more consistent with the consumer's needs, the industry implicitly moved towards a more pragmatic approach to indemnity.

Another indication that the morality of insurance was no longer important and that a more pragmatic approach to indemnity was developing comes from a change in a major insurance law treatise. In the first edition of his treatise printed in 1904, William Vance stated,

The purpose of insurance is indemnity, and indemnity only, and, whenever it is applied to any other purpose, such use is a perversion of the true principle, and introduces a wrongful and immoral element of speculation that promotes fraud and crime. If a person . . . procures insurance upon his property greater than its value, he is under constant temptation to destroy his own property, and this temptation, which is all too frequently yielded to, not only is injurious to public morals.

(Vance, 1904, at 21) By the third edition printed in 1951, Vance abandoned completely this morality-charged language. (Vance, 1951)

2. Technological Changes

At the same time that the cultural context for indemnity was changing, technological advances made it possible to underwrite on a more scientific basis. The strict 19th century indemnity principle developed at a time when insurance was unsophisticated, the industry was unstable, and insurers lacked data. Insurance companies quickly developed, and folded, and fires ravaged wooden towns. One reason that a strict indemnity theory was needed to control moral hazard was because early insurance companies lacked information and knew little.

As the insurance industry grew during the late 19th and 20th centuries, morality took a back seat to a "populational, actuarial understanding of the world." (Baker, 1996, at 259) In 1898, insurance companies were called to work together to investigate and calculate scientific, uniform ratings and classes in order to set fire insurance rates. New technological developments in areas such as "power, heat and light ma[de] it necessary that all these subjects should be thoroughly investigated as to their fire hazards." (Smith, 1898, at 828) Another commentator noted that "[w]e should have for our guidance . . . a scientific and systematic classification of the facts which our concrete experience has developed." (Ostrander, 1898, at 542) Thus, insurers focused on developing accurate, scientific methods. (Fouse, 1904, at 67, 71)

The rating system provides an example of industry evolution. Late 19th century insurance rates were determined in two ways: underwriters inspected property and exercised judgment, or followed "carefully prepared and more or less scientific schedules." (Bissell, 1909, at 95) These scientific schedules were recent developments, and eventually became the industry standard such that by the early 20th century, the subjective "judgment system was . . . rapidly giving way before the use of highly complex and specialized schedules." (Bissell, 1909, at 95) By 1930, hundreds of construction features and building uses were taken into account in setting ratings, (Huebner, 1930, at 7) and several complicated ratings schedules were either in use or in development. (Huebner, 1930, at 245) The more data that was gathered and analyzed, the less insurers needed to rely on assumptions of character and morality.

Today, a large-scale economic view of insurance based on economics and information, not morality, prevails. (Baker, 1996) Large-scale economic forces and trends are more important than the individual moral decisions of each insured. (Baker, 1996, at 270-72) It is simply too expensive and impractical to investigate and process each individual insured's moral character. And in the final analysis, the size of the insurance industry minimizes the risks posed by a few immoral insureds. Today, almost anyone is insurable if they are willing to pay the higher rates that accompany reckless behavior. In addition, individual morality is less of a concern because risks are better understood and calculated. Insurance today is based on vast amounts of information, collected and analyzed by sophisticated specialists. Rather than focus on the small minority of immoral insureds, insurance follows larger economic forces, thus reducing the need for an indemnity principle which guards against moral hazard.

Even though these technical developments diminished the significance of morality-based underwriting, moral hazard remains a concern. According to one scholar, "11.4% of residential fires and 26.7% of non-residential fires are of suspicious origin, and the dollar loss exceeds $1 billion annually." (Huebner, 1982, at 106) Deductibles are one mechanism intended to address moral hazard. In addition, replacement cost policies include other provisions intended to address moral hazard. For example, the "repair or replace" requirements prevent insureds from receiving the full value of replacement cost unless and until they actually rebuild. (Higgins v. Ins. Co. of N. Am.)

3. Market Changes

Changes in market forces also played a role in eroding the concerns about moral hazard. Demand for broader insurance coverage grew through the Twentieth century. For example, while "[c]overage against indirect losses was almost unheard of" in the Nineteenth Century, by 1947 "a tremendous field of indirect damages coverage ha[d] been developed." (O'Connor, 1972, at 229, 231) By the late Twentieth century "all-risk" insurance was available (Hecker & Goode, 1986), and extended coverage endorsements were developed. (Cann, 1944, at 3) Liability insurance went through a similar evolution. Insurance became widely available during the Twentieth century and then was expanded to cover more than just accidents, "culminating in the comprehensive liability policy." Liability coverage was further expanded to go beyond traditional bodily injury coverage to include coverage for economic losses through insurance for errors and omissions. (O'Connor, 1972, at 231)

Judicial opinions favoring the replacement cost measure over an actual cash value measure created an additional incentive for moving towards the replacement cost measure. (An Insurance Policy Providing for Replacement of Fire Damaged Structures With New Materials, 1948, at 849, 852) Because some courts were refusing to enforce the reduction of compensation for depreciation, insurers were forced to provide replacement cost coverage in some cases even though the policy had been underwritten as actual cash value coverage. Consequently, insurers found that it was in their interest to offer the more expansive replacement cost coverage in exchange for a higher premium or some other market advantage (such as market share).

Insurance coverage for power plants provides a specific example of broadening property insurance coverage. Initially, the coverage was limited to steam boilers used to generate power. In time, coverage was expanded to include almost any kind of industrial machines. From that point, coverage was further expanded so as to include indirect damages such as loss of use, consequential damages, and business interruption. (O'Connor, 1972, at 231)

The demand for broader coverage, and the insurers desire to meet this demand, put pressure on the traditional notions of moral hazard. Broadened coverage created a greater risk that policyholders would engage in risky behavior. Nevertheless, in an effort to satisfy customers and to sell more insurance, insurers were willing to face such a risk. These market changes did not, of course, occur in isolation, but were occurring simultaneously with cultural and technical changes that also eroded concerns about moral hazard.

Implications of the Paradigm Shift

While the paradigm for what constitutes "indemnity" has clearly shifted from the financial to the functional, this shift happened without direct consideration of the paradigm or the implications of such a shift. This was because the shift was driven in large part by market demand for broader insurance coverage, facilitated by changes in technology and the cultural environment that provided greater tolerance for moral hazard concerns. This section now turns to a brief discussion of the implications of the paradigm shift.

A. Re-Evaluation of Provisions: Ordinance & Law Exclusion

Because the standard property insurance policy was developed under the financial paradigm, its provisions generally reflect that paradigm. With the shift in paradigm, the various provisions of the policy based on the old paradigm need to be re-evaluated. The provisions most directly affected by the shift in paradigm were those which motivated the shift, namely, those dealing with the evaluation of the loss. Moving from Actual Cash Value to Replacement Cost clearly reflects the shift in paradigm, but because that was the basis for the shift, those provisions are already in harmony with the new paradigm.

Other provisions also reflect the paradigm and should be re-evaluated. Perhaps the best example of this is the Ordinance & Law exclusion. The 1886 New York Standard Fire Insurance Policy included an exclusion, set forth in lines forty-one and forty-two, limiting an insurer's liability for losses or increased costs caused by ordinances or laws. (Vance, 1904, at 484) For example, if an explosion destroys a factory and the insured attempts to rebuild, the insured may encounter a law, passed subsequent to the factory's initial construction, which requires that future construction consist of different, perhaps fireproof, building materials. The law does not cause the initial loss, but it does increase rebuilding costs. Insurers may not wish to bear the increased costs and thus may limit their liability, through an ordinance or law exclusion, to the costs of rebuilding less the increased costs imposed by the new building law.

This exclusion was an example of the traditional indemnity principle in the financial paradigm. Because that paradigm required that insureds recover no more than the exact financial value of their lost or damaged property, the indemnity principle suggested that an insured should not receive coverage for the cost of compliance with the current ordinances and law.

In 1918, the New York Standard policy was redrawn and the ordinance or law exclusion was moved. It no longer resided alongside other exclusions; instead, the ordinance or law language was moved to the first paragraph and positioned immediately behind the "actual cash value" language. This move is instructive. The ordinance or law language was not so much a special exclusion, as a logical deduction from, and consequent of, the traditional indemnity principle. A drafter of the 1918 policy noted that the ordinance or law exclusion was moved because it "should follow the [actual cash value] clause which it qualifies instead of being forty lines removed from it." (Rumsey, 1922, at 45) The actual cash value language expressed the traditional indemnity principle - an insurer's liability could not exceed the actual cash value of the property destroyed. The ordinance or law language was a further expression of this principle - an insurer's liability could not exceed the actual cash value of the property destroyed, even if new building laws imposed new construction costs. Thus what was previously an exclusion became a restatement or reinforcement of the traditional indemnity principle.

Today, the ordinance or law language has been returned to the exclusion portion of all-risk policies. (Sade & Cossolini, 1986) However, it continues to serve the purpose of limiting the scope of the indemnity. As one commentator put it: the exclusion "prevent[s] the insured from gaining a windfall through the operation of government regulation." (Ibid., at 232) This purpose is no longer justified. With the acceptance of replacement cost coverage and the more functional paradigm for indemnity, concerns about a "windfall" and the related moral hazard are substantially diminished. All replacement cost coverage provides a "windfall" to the insured because it replaces old materials with new. Nevertheless, this windfall is widely accepted because the indemnity is a more functional one. The new materials, while perhaps better than the old, are necessary to have a functioning structure. Similarly, new construction in compliance with applicable ordinances and laws should be provided so that the insured property has the same functionality as it did prior to the loss.

Because of the high cost of compliance with changes in ordinances and law, enforcement of the exclusion results in large-scale underinsurance. (Banham, 1994) The courts have begun to recognize this problem and are somewhat less willing to enforce the exclusion. Following Hurricane Andrew, for example, State Farm was required to pay actual replacement costs despite ordinance or law exclusion where new building laws required all new construction to have special, costly foundations. (Wood, 1994) In light of the paradigm shift, this exclusion should be re-evaluated as to whether it continues to serve a legitimate purpose.

B. Flexibility to Develop Innovative Insurance Products

A second implication of the paradigm shift is greater flexibility to develop more innovative insurance products. The functional approach to indemnity allows consideration of an objective to be accomplished by insurance beyond a specific financial concern. This allows insurance products that in some fashion create a "windfall" for an insured so long as they meet some other legitimate purpose. Business interruption insurance is good illustration. On one hand, business interruption insurance allows a "windfall" because it allows an insured to receive their income stream without undertaking the usual effort required to earn that income. But where the income stream is needed to keep the business going, it serves a legitimate, functional need. By using this more pragmatic approach to the concept of indemnity, insurers may be able to develop many other products that address risk without being limited to notions of reimbursement for financial losses.

C. Reconsideration of Moral Hazard

A third implication of the paradigm shift is a need for reconsideration of moral hazard. The shift in the paradigm reflects an erosion of insurers concerns about moral hazard, which has resulted in products that create greater risks. This shift means that insurers can no longer rely on the indemnity principle as a mechanism to address moral hazard. As a result, moral hazard needs to be addressed in its own right, especially as new products are development that may provide even greater opportunities for insureds to benefit from their losses. Insurance providing replacement cost coverage has begun to address this concern. Most policies, for example, require that compensation be used to actually rebuild the property or be subject to a reduction for depreciation. It remains to be seen whether such measures are sufficient. Our point here simply that moral hazard should be analyzed and addressed directly without reliance on the indemnity principle.

Conclusion

The indemnity principle, as reflected by modern insurance products, has changed from its original conception. Although it was originally construed in a strict, financial sense, so as to avoid the possibility that an insured would obtain a "windfall" of benefit from an insured loss, that approach resulted in under-insurance. As a result, market demand and judicial decisions began to provide for broader insurance coverage. This coverage is not consistent with the original sense of indemnity, but is consistent with a functional approach to indemnity. While the insured may be better off after a loss in a financial sense, the indemnity principle is not violated because the insured is returned to its functional condition prior to the loss. This shift in the paradigm has not previously been identified, and its implications deserve further study. Those implications include a need to re-evaluate insurance policy provisions, the opportunity to develop innovative insurance products, and a requirement that moral hazard be addressed in its own right rather than as a component of the indemnity principle.

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