

# Liability Rule Failures? Evidence from German Court Decisions

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Since 2007, all insurance intermediaries face negligence liability that is supposed to reallocate risks and set economic incentives. Nonetheless, further measures are taken to improve consumer protection. So, the question arises does the liability rule influence the agents behavior, or not, and does it influence in the intended way, or not? Do court cases provide evidence for failure of the current liability rule? Based upon an economic analysis of liability rules, aspects concerning potential failures can be derived. An analysis of twelve verdicts suggests that understatement of intermediary responsibility as well as a potential overstatement of the consumer responsibility yields suboptimal results. Often, missing documentation reinforces that tendency.

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# 1 Introduction

The debate about implementing institutional change to improve counseling and advice by insurance intermediaries in Germany is ongoing. For example, the discussion about the remuneration schemes (Focht et al., 2013; Hofmann and Nell, 2011), commissions or fee-for-advice, as well as the cap on commissions for private health insurances since 2012<sup>1</sup> indicate an attempt to counter the trend of opportunistic behavior due to asymmetric information. Since 2007, laws have also regulated the market for insurance intermediary services in Germany and all agents and brokers face negligence liability that reallocates risks and sets economic incentives.

In Germany, as in all of Europe, the liability rule arises from EU directives<sup>2</sup> and accounts for failures resulting from neglect of information, counseling and documentation duties. Similar duties exist in the United States even though liability is not explicitly codified. Since individual states regulate insurance in the U.S. (Randall, 1999), the details of regulation matters differ from state to state. Nevertheless, many U.S. courts recognize that insurance agents, as well as insurance brokers, have a duty to exercise reasonable skill, care and diligence (e.g. *Dimeo v. Burns, Brooks & McNeil*; similar *Meridian Title Corp. v. Gainer Grp.*)<sup>3</sup>. Furthermore, intermediaries are held liable if they fail to procure the requested coverage (e.g. *Dreibelbiss Title Co., Inc. v. MorEquity, Inc.*; also *Shea v. Jackson*)<sup>4</sup>. Pasich and Smith Thayer (2010) state that brokers were held liable in a variety of circumstances which include not only the failure to procure coverage, but also cases in which the broker did not take measures to avoid a coverage dispute. U.S. courts also require consumers to read insurance policies (*Kirk v. R. Stanford Webb Agency, Inc.*)<sup>5</sup>, to provide all relevant information (*Dahlke v. Zimmer Ins. Agency*)<sup>6</sup>, and to deliver proof of negligence (*Bayly, Martin & Fay v. Pete's Satire*)<sup>7</sup>. Arkansas law even obligates the consumer to "educate herself concerning her insurance" (*Mans v. Peoples Bank*)<sup>8</sup> unless a special relationship exists. Thus, U.S. courts recognize certain requirements applicants and policyholders have to fulfill in order to not be held responsible for contributory negligence (*Kirk v. R. Stanford Webb Agency, Inc.*). Even though the remainder of this paper deals with German legal rules, the liability issues and

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<sup>1</sup>Gesetz zur Novellierung des Finanzanlagenvermittler- und Vermögensanlagenrechts (VermAnlGEG) December 06, 2011 (Federal Law Gazette Part I No.63, page 2481) becoming effective on 01/01/2012.

<sup>2</sup>(2002/92/EG)

<sup>3</sup>*Dimeo v. Burns, Brooks & McNeil, Inc.*, 6 Conn. App. 241, 504 A.2d 557 (1986), cert. denied, 199 Conn. 805, 508 A.2d 31 (agents); *Ursini v. Goldman*, 118 Conn. 554, 173 A. 789 (1934) (brokers); *Meridian Title Corp. v. Gainer Grp., LLC*, 946 N.E.2d 634, 637 (Ind. Ct. App. 2011), also *Craven v. State Farm Mutual Automobile Insurance Co.*, 588 N.E.2d 1294, 1296 (Ind. Ct. App. 1992) and *Humiston v. Rowley*, 512 .W.2d 573, 574-75 (Iowa 1994).

<sup>4</sup>*Dreibelbiss Title Co., Inc. v. MorEquity, Inc.*, 861 N.E.2d 1218, 1222 (Ind. Ct. App. 2007); also *Shea v. Jackson*, 245 A.2d 120 (D.C. 1968).

<sup>5</sup>*Kirk v. R. Stanford Webb Agency, Inc.*, 75 N.C. App. 148, 330 S.E.2d 262, rev. denied, 314 N.C. 541, 335 S.E.2d 18 (1985).

<sup>6</sup>*Dahlke v. Zimmer Ins. Agency*, 245 Neb. 800, 515 N.W.2d 767 (1994); *Manzer v. Pentico*, 209 Neb. 364, 307 N.W.2d 812 (1981).

<sup>7</sup>*Bayly, Martin & Fay v. Pete's Satire*, 739 P.2d 244 (Colo. 1987).

<sup>8</sup>*Mans v. Peoples Bank of Imboden*, 340 Ark. 518, 10 S.W.3d 885 (2000).

aspects of contributory negligence are quite similar to topics discussed in U.S. insurance law.

European insurance liability regulations aim for an improvement of consumer protection. Nonetheless, the ongoing discussion generates additional ideas and rules to strengthen consumers' position even more. So, the question arises, does the liability rule influence the agent's behavior at all or, at least in the intended way, or does it not?

Analyses of different liability rules are well established (e.g. (Adams, 1985);(Shavell, 1987);(Miceli, 2004)), and liability rule failures are well-known in the law and economics literature. Endres (1991) gives a detailed overview. For instance, a liability rule does not produce the intended outcome if the consumer cannot provide the necessary proof of causality between the intermediary's fault and the resulting damage. In Germany, regional and higher regional courts (Land- und Oberlandesgericht) were involved in lawsuits concerning counseling with misinformation in the last several years. The present paper analyzes twelve verdicts and seeks to provide evidence for failure of the current liability rule. It therefore contributes to the discussion of regulation in this field.

The paper is organized as follows: First, the current liability rule and the rule concerning contributory negligence are stated in Section 2. The economic considerations of negligent liability rules are presented as well as potential failures. The third section introduces twelve court decisions based upon "new" liability rule. Furthermore, the section provides an analysis of the cases based upon the theoretical findings and extracted parameters, as well as a discussion of results. Section 4 presents the conclusion.

## 2 Legal Rules and Economic Analysis

As a result of market interventions by the European Union in 2001<sup>9</sup>, intermediaries throughout Europe now face liability concerning counseling activities. In Germany, the EU directive was implemented into German law via a reformation of the Insurance Contract Act (VVG).<sup>10</sup> This section states the specific design of the current liability rule, including contributory negligence issues. Additionally, this section introduces the economic view on these kinds of liability rules.

### 2.1 The Current Liability Rule in Germany

The liability rule is stated in § 63 VVG<sup>11</sup>. It represents the basis for a claim.

*"The insurance intermediary shall be obligated to compensate for loss incurred by the person wishing to take out insurance on account of a breach of one of the duties under section 60 or section 61. This shall not apply if the insurance intermediary is not responsible for the breach of duty."*[§ 63 VVG]

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<sup>9</sup>Directive 2002/92/EG

<sup>10</sup>Insurance Contract Act (Versicherungsvertragsgesetz (VVG)) November 23, 2007 (Federal Law Gazette Part I, page 2631), becoming effective on 01/01/2008; last changes 07/27/2011 (Federal Law Gazette Part I, page 1600) with effect from 08/04/2011.

<sup>11</sup>§ = section.

The negligence rule uses wording that expresses defense of contributory negligence referring to every insurance intermediary independent of the legal type. As far as brokers are concerned, this liability rule is *lex specialis* compared to the general liability rule defined in German law, § 280 para.1 BGB<sup>12</sup>. Importantly, the rule defines new personal liability with respect to all types of agents, either tied to only one company, or in cooperation with multiple insurers (Dörner, 2010, § 63 recital 1). The obligatory indemnification is basically triggered by a breach of one out of four duties (Dörner, 2010, § 63 recital 5,8). First, each intermediary has to base advice upon a sufficient number of contracts. Whereas a broker has to refer to the entire market, an agent has to select a contract from his particular basis (Schmidt, 2011, p.271). Of course, a tied agent has only one insurer to select from whereas another agent might be able to choose between several insurers and contracts. Thus, the requirement becomes more stringent the less an intermediary depends on a single insurer. Once an intermediary restricts the basis, the consumer has to be informed otherwise liability ensues. A third duty relates directly to risk assessment, the advice given and the corresponding reasons; likewise, it effects every intermediary. Last, each intermediary has to fulfill specific documentation requirements. Documentation is supposed to state the content of the counseling interview, as well as the reasoning behind advice given. Missing documentation lessens the burden of proof from the consumers' point of view (Dörner, 2010, § 63 recital 12).

Despite implementation of concrete duties, the legislation did not formulate a special regulation concerning the plea of contributory negligence (Oetker, 2012, § 254 recitals 7-9). Thus, § 254 BGB is applicable.

*“(1) Where fault on the part of the injured person contributes to the occurrence of the damage, liability in damages as well as the extent of compensation to be paid depend on the circumstances, in particular to what extent the damage is caused mainly by one or the other party.*

*(2) This also applies if the fault of the injured person is limited to failing to draw the attention of the obligor to the danger of unusually extensive damage, where the obligor neither was nor ought to have been aware of the danger, or to failing to avert or reduce the damage. The provision of section 278 applies with the necessary modifications.”*[§ 254 BGB]

Basically, the section states a victim faces contributory negligence whenever it disregards the due care standard expected from a judicious individual (Oetker, 2012, § 254 recital 30). The relevant standard of due care refers to an objective level, thus the behavior of any comparable consumer. The individual knowledge and situation is not the decisive factor. The plea of contributory negligence is a defense for injurers (Miceli, 2004) and results in partial compensation only whenever the consumer carelessly violates a duty. The resulting compensation rate depends upon the severity of the default.

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<sup>12</sup>German Civil Code (Bürgerliches Gesetzbuch (BGB)) version January 02,2002 (Federal Law Gazette Part I, page 42,2909, 2003 I page 738) last changes June,26 2013 (Federal Law Gazette Part I, page 1805).

## 2.2 Economic Analysis

A liability rule is supposed to govern the behavior of the involved parties. Depending on the design of the liability rule, additional costs are either generally implemented or the law establishes a relationship between a specific due care standard and the need to cover those costs. As pointed out in the previous subsection, the current law provides a rule that accounts for negligence with a defense of contributory negligence. The economic theory of law and economics provides a theoretical framework to analyze different kinds of liability regimes. First, the basic model will be introduced. Afterwards, different reasons the rules might be not effective are considered.

### 2.2.1 The Basic Model

Intuitively, it can be stated that if no liability rule is in place, the intermediary basically has no incentive to avoid poor counseling, except for avoiding damage to their reputation (Shavell, 1987, p.11). In that case the consumer has to bear the entire cost, which leads to a high care level on the consumer's side. The present liability rule is supposed to reallocate the risk of poor counseling in a decentralized, preventive way and to sanction any violations (Rehbinder, 1992). The rule states an intermediary is responsible for mistakes which result from not obeying the assigned due care standard, but the liability is only triggered if the victim, in this case the consumer, is not liable for contributory negligence. The definition of the negligence rule demands a due care level that is defined by law and hence exogenous. Even though the legislation might be mistaken about the level, let's assume a correct estimation while considering the basic model. Furthermore, let's assume risk neutral individuals with complete and symmetric information, as well as perfect competition (Endres, 1991, p.14).

A victim (Y) might suffer a loss  $L$  with a probability  $\rho$ <sup>13</sup>. In order to avoid the loss, the victim can take precautions  $y$  that give rise to avoidance costs  $c_y(y)$ . Those costs are assumed to be a linear function depending on the level of precaution. On the one hand, the more preventive care the victim takes, the higher the resulting avoidance costs. On the other hand, a high precaution level reduces the expected harm  $ES = \rho \cdot L$ . On the contrary, the injurer (X) is also able to prevent harm by precautions  $x$ . The care level determines the necessary avoidance costs  $c_x(x)$  but also reduces the degree of expected damages. Thus, the total costs amount to:

$$K^G = c_x(x) + c_y(y) + ES(x, y). \quad (1)$$

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<sup>13</sup>The whole section refers to Endres (1991) and Adams (1985).

The aim of tort law is to reallocate the risks in a way that the total costs are minimized (Schäfer and Ott, 2012, p.184). Minimization of equation (1) yields the following optimality conditions for  $x^*$  and  $y^*$

$$\frac{\partial c_x}{\partial x} = -\frac{\partial ES}{\partial x}; \quad (2)$$

$$\frac{\partial c_y}{\partial y} = -\frac{\partial ES}{\partial y}. \quad (3)$$

$x^*$  and  $y^*$  represent the efficient due care levels that are ideally required by law. From the victim's and the injurer's point of view, is it individually rational to obey the given standard? To answer that question, the individual cost functions become relevant. Without any liability rule the victim has to bear the entire expected harms. Due to the liability rule, the individual cost functions contain a parameter  $\phi$  that allows for a reallocation of the risk as stated in equations (4) and (5):

$$K_x^G = c_x(x) + \phi ES(x, y), \quad (4)$$

$$K_y^G = c_y(y) + (1 - \phi) ES(x, y). \quad (5)$$

The stated liability rule shifts the risk burden onto the injurer if he does not at least opt for the given due care standard,  $x^*$  in this case. Additionally, the victim has to choose  $y^*$  at least. Therefore,  $\phi$  takes the values 0 or 1, respectively. It has to be recognized that this basic model of the negligence liability rule does not account for a splitting of the damages. In this simple model, either the victim or the injurer has to account for the whole damages.

$$\phi = \begin{cases} 0 & : x \geq x^* \\ 0 & : x < x^* \text{ and } y < y^* \\ 1 & : x < x^* \text{ and } y \geq y^* \end{cases}$$

Figure (1) illustrates the liability rule; Graph a) refers to the intermediary whereas Graph b) illustrates the consumer's perspective. Under the assumption that the victim chooses  $y^*$ , the injurer has to bear cost amounting to  $K_x^G$  as long as the precaution level  $x$  is less than  $x^*$ . If he obeys the given due care standard by choosing  $x^*$  the costs immediately drop to  $K_x^{min}$  since only the avoidance cost have to be considered. As the avoidance cost function is strictly increasing, it is reasonable to select a care level as small as possible. Therefore, the relevant cost function approaches its minimum at  $K_x^{min}$ .

If, however, the victim is liable for contributory negligence ( $y < y^*$ ) the relevant cost function reduces to  $c_x(x)$ . Hence, any standard below  $x^*$  is now preferable. Thus, the injurers', i.e. the intermediary, optimal choice depends upon the action the victim takes. The consumer has to bear the entire costs  $K_y^G$  (Figure (1b)) if either the injurer selects  $x \geq x^*$  or the victim itself does not comply with the legal requirements,  $y < y^*$ . From Table (1) it can be concluded that the consumer has a dominant strategy to choose  $y^*$ . Even if the injurer fulfils the requirements it is rational to select  $y^*$  because it minimizes the victim's total costs, hence, inequality  $c_y(y) + ES(x^*, y) > c_y(y^*) + ES(x^*, y^*)$  applies.

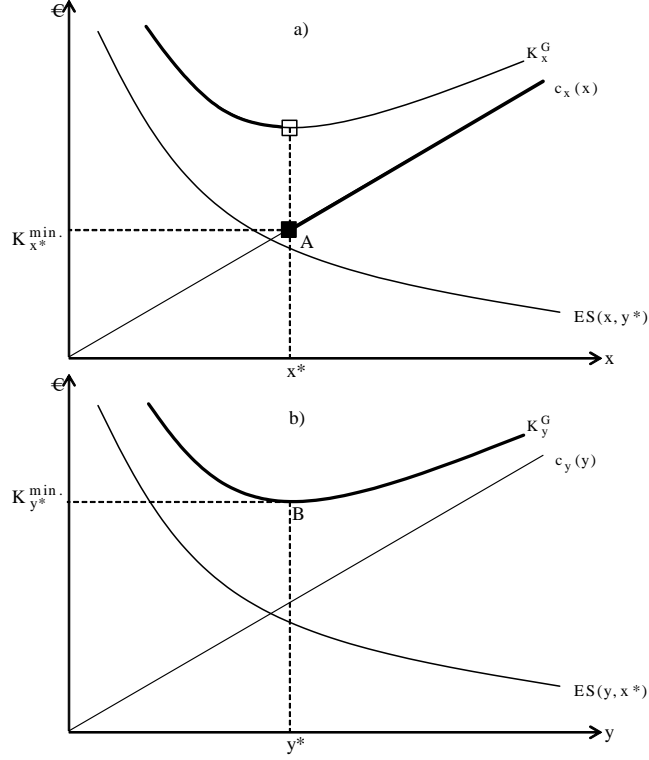


Figure 1: Negelence rule

| Victim    | Injurer             |                           |
|-----------|---------------------|---------------------------|
|           | $x < x^*$           | $x = x^*$                 |
| $y < y^*$ | $c_y(y) + ES(x, y)$ | $c_y(y) + ES(x^*, y)$     |
| $y = y^*$ | $c_y(y^*)$          | $c_y(y^*) + ES(x^*, y^*)$ |

Table 1: Victim: Dominant Strategy  $y^*$

In sum, the victim complies with the legal requirements and picks  $y^*$ . For a given action  $y^*$ , it is optimal for the injurer also to comply. Therefore, a negligence liability with contributory negligence redistributes the risk allocation in an efficient way. The individual choices result in a socially efficient equilibrium  $(x^*, y^*)$ .

As stated earlier, the basic model does not account for the splitting of damages. The question is, does the consideration of a rate changes the results concerning the efficiency of the present liability rule? Basically, injurer and victim have to split damages if neither of them fulfilled the defined care level. Thus, instead of taking only the values of 0 or 1,  $\phi$  can now take on all values in between, according to a previously defined allocation formula. According to Endres (1991) and Adams (1985), the assumption of a relative deviation is feasible. First, the percentage of deviation has to be calculated. In a second step, those percentages have to be referred to the entire magnitude of carelessness in

order to determine the individual rates. As a result,  $\phi$  can take the values as following:

$$\phi = \begin{cases} 0 & : x \geq x^* \\ 1 & : x < x^* \text{ and } y \geq y^* \\ \frac{\frac{x^*-x}{x^*}}{\frac{x^*-x}{x^*} + \frac{y^*-y}{y^*}} & : x < x^* \text{ and } y < y^* \end{cases}$$

The question, “Does an (efficient) equilibrium results despite the splitting of damages?”’ can best be analyzed by using a cost matrix. Table (2) shows the matrix and the relevant costs that arise from equations (4) and (5). Therefore, if the injurer/ intermediary chooses  $x = x^*$  he has to calculate with avoidance costs only when any other choice results in higher cost, but depends on the action of the victim/ consumer. The depicted arrows in Table (2) point at the individual choice given the action of the other player<sup>14</sup>. Since the selection of  $x^*$  and  $y^*$  is always cost minimizing, the efficient equilibrium evolves. Hence, the introduction of rates does not change the incentive structure compared to the basic model of negligence liability with contributory negligence.

|                              |           | Care level injurer (Intermediary)                                    |   |
|------------------------------|-----------|--|---|
|                              |           | $x < x^*$  | $x = x^*$                                       |
| Care level victim (Consumer) | $y < y^*$ | $c_x(x) + \phi \cdot ES(x, y)$<br>$c_y(y) + (1-\phi) \cdot ES(x, y)$ | $c_x(x^*)$<br>$c_y(y) + 1 \cdot ES(x^*, y)$     |
|                              | $y = y^*$ | $c_x(x) + 1 \cdot ES(x, y^*)$<br>$c_y(y^*)$                          | $c_x(x^*)$<br>$c_y(y^*) + 1 \cdot ES(x^*, y^*)$ |

Table 2: Splitting of damages: efficient equilibrium

### 2.2.2 Liability Rule Failures

A liability rule fails if it is not possible to harmonize the collective and the individual rationalities (Wätzold, 1998, p.163). Endres (1991) found that different failures might affect the efficiency of the liability rule. In particular, if the expected harms and the expected compensation payments diverge, the estimation of the costs and/or losses is biased, or the court defines a suboptimal due care level, it might be individually rational to ignore the level of due care. Table (3) summarizes those aspects.

The first aspect in Table (3) deals with situations in which expected damages and expected compensation payments differ, for example in cases that lack a causal relationship between the fault and the damage. In this case, the theory predicts either an inefficient care level because it might be optimal for the injurer to select a care level which is too low compared to the efficient standard (Endres, 1991, p.65), or the difference in actual and expected damages is small and the socially optimal care level turns out to be the best choice. The causal relationship has to be definable (Endres, 1991) in order to avoid this failure. Additionally, the specific design of the causality is crucial for the effect of

<sup>14</sup>This equilibrium only forms if one applies Nash strategies. Any other equilibrium concept (e.g. MinMax) results in a different equilibrium. Additionally no mixed strategies are analyzed.



| Failure   | Because of...  | Effect on due care levels  |
|---|--|--|
| 1. Expected losses $\neq$ expected compensation payments                      | lack of causality, no accountability of loss possible, no monetary value for loss, limitation of liability | $(x^*, y^*)$ or $(x_2(< x^*), y_1(< y^*))$ ; depending upon the degree of underestimation  |
| 2. Objective losses $\neq$ subjective losses                                  | Informational deficits concerning the estimation of losses.  | underestimation: $(x_1(< x^*), y^*)$ , $(x = 0, y(x = 0))$ or no equilibrium;<br>overestimation: $(x^*, y_2(> y^*))$   |
| 3. Definition of suboptimal care levels $(\bar{x}, \bar{y})$ by institutions. | Informational deficits concerning the estimation of losses.  | underestimation: $\bar{x}(< x^*)$<br>overestimation:<br>- if $\bar{x} \gg x^*$ and $\bar{y} = y^* \rightarrow (x^*, y^*)$<br>- if $\bar{x} = x^*$ and $\bar{y} \gg y^* \rightarrow (x = 0, y(x = 0))$<br>- if either $\bar{x} > x^*$ and/or $\bar{y} > y^*$<br>$\rightarrow$ no equilibrium<br>- if both care levels are overestimated ('>' and '>>'), only inefficient equilibria can be reached:<br>$(x = 0, y(x = 0))$ or $(x(\bar{y}), \bar{y})$ |

Table 3: Overview of different liability rule failures according to Endres (1991)

the liability rule (Rehbinder, 1992, p.50). Thus, it is important how the burden of proof is allocated between the parties. Therefore, as it might be impossible to determine the causality in each case, both players might calculate with a pro rata liability only, which could yield suboptimal care levels.

Consider the situation to be such that the intermediary expects a punishment in some cases only. The expectations are formed because the agent that the consumer will succeed in proving poor counseling only in some cases. Additionally, the intermediary might expect counseling failure to remain undetected in several cases; therefore, he calculates with a fraction of the expected damages ( $ES$ ), only. The cost functions of injurer and victim change to equations (6) and (7) whereas  $\alpha$  represents a discounting factor.

$$K_x^G = c_x(x) + \alpha ES(x, y) \quad (6)$$

$$K_y^G = c_y(y) + (1 - \alpha) ES(x, y) \quad (7)$$

Figure (2) depicts the potential discount from the intermediary's perspective. If the discount is low ( $\alpha < 1$ ) the intermediary expects total costs to be  $K_{x_1}^{\min.exp_1}$ . Since these costs are higher than those resulting from choosing the care level  $x^*$  ( $K_{x^*}^{\min}$ ), it is rational to select the efficient care level. However, if the discount is high ( $\alpha \ll 1$ ), the intermediary expects total cost to be as high as  $K_{x_2}^{\min.exp_2}$ . In this situation it is individually rational to choose  $x_2 < x^*$ . If the consumer believes the discount holds, he will select a care level  $y_1$  that exceeds  $y^*$  because of the substitutability of the care level assumed. Obviously, it depends upon the intensity of the discount ( $\alpha$ ) whether it becomes rational to disobey the due care level  $x^*$ .

The second aspect mentioned in Table (3) relates to informational deficits concerning the estimation of losses. Thus, it might be the case that individually expected losses differ from objectively expected losses. The analysis is quite similar to the previous one, except that informational deficits concerning losses might affect both parties. Consider first the case in which both parties underestimate expected losses. Similar to the

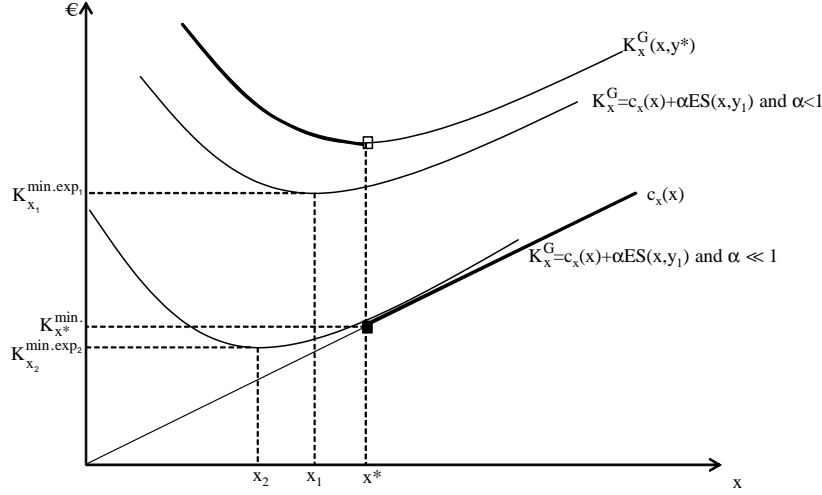


Figure 2: Discounting expected damages

situation of discounting the costs, it depends upon the degree of underestimation if it is individually rational to ignore the given care level  $x^*$  or to select a level  $x_1 \neq x^*$ . Assuming first that it is not cost minimizing behavior to disobey the care level, hence, the intermediary chooses  $x^*$  and has to pay avoidance cost only. In this situation, the consumer has to bear all costs. Because of the underestimation of losses and the substitutability of care levels, the consumer selects a care level  $y_1 < y^*$ . However, when accounting for contributory negligence, the care level  $y_1$  is too low. Accordingly, the intermediary can not be held liable and the best response is not to provide any carefulness at all ( $x = 0$ ). The consumers best response to  $x = 0$  is  $y(x = 0)$  which might exceed  $y^*$ . Independent of the true value of  $y$ , it is not possible to reach equilibrium because both possibilities result in a circular process. In comparison, a situation in which it is individually rational to ignore the stated level  $x^*$  and, therefore, to minimize the total costs results in an equilibrium if  $y^*$  is the best response of the consumer. Nevertheless, the equilibrium  $(x_1(< x^*); y^*)$  is inefficient. If, on the other hand, the consumer chooses  $y_1 < y^*$ , the best response of the intermediary would be to not provide any carefulness ( $x = 0$ ), which induces an increase of care on the consumers' side. If that care level ( $y(x = 0)$ ) exceeds  $y^*$ , the cycle restarts; if the care level stays below  $y^*$ , another inefficient equilibrium is reached at  $(x = 0, y(x = 0))$ .

Now, consider the case in which both parties overestimate the losses. In this case it is individually rational from the intermediary's point of view to select  $x^*$  because he has to pay avoidance costs only. The consumer has to bear all costs and, therefore, minimizes total costs. Due to the overestimation of losses, the minimum of the (assumed) total costs is always located to the right of the efficient care level. Hence, the consumers choice is  $y_2 > y^*$ . The equilibrium consists of the pair  $(x^*, y_2)$ .

Third, it is doubtful that the jurisprudence has all relevant information to determine the efficient due care levels  $x^*$  and  $y^*$  without any mistakes. If the standard falls below

the efficient level the intermediary will fulfill that requirement doubtlessly because the avoidance costs are always lower than the total costs. In the case of overstretched levels of due care, the intermediary and consumer reactions are not clear since they depend upon the severity of the overestimation. For further analysis, let  $\bar{x}, \bar{y}$  be the care levels defined by courts. For example, if the court excessively<sup>15</sup> overstates the care level of the intermediary ( $\bar{x} \gg x^*$ ) but sets the level of the consumer at the optimal standard ( $\bar{y} = y^*$ ), efficiency occurs. Figure (3) illustrates the reasons. If no mistake happens, the intermediary will choose  $A'$  which corresponds to standard  $x^*$ . The consumer has to bear all costs and selects  $D'$  which is the best response. Now, the court defines a care level  $\bar{x}$ . If the intermediary fulfills that standard, he is no longer liable, but has to pay avoidance costs  $c_x(\bar{x})$  as represented in point  $C$ . By disobeying the exogenously given care level  $\bar{x}$  the intermediary will be held liable, has to calculate with  $K_x^G$  and will select the cost minimizing option, hence, point  $A$ . Since the injurer chooses the efficient care level  $x^*$  in point  $A$ , the victim's best response is to select  $y^*$ . Thus, the socially optimal combination of care levels arises.

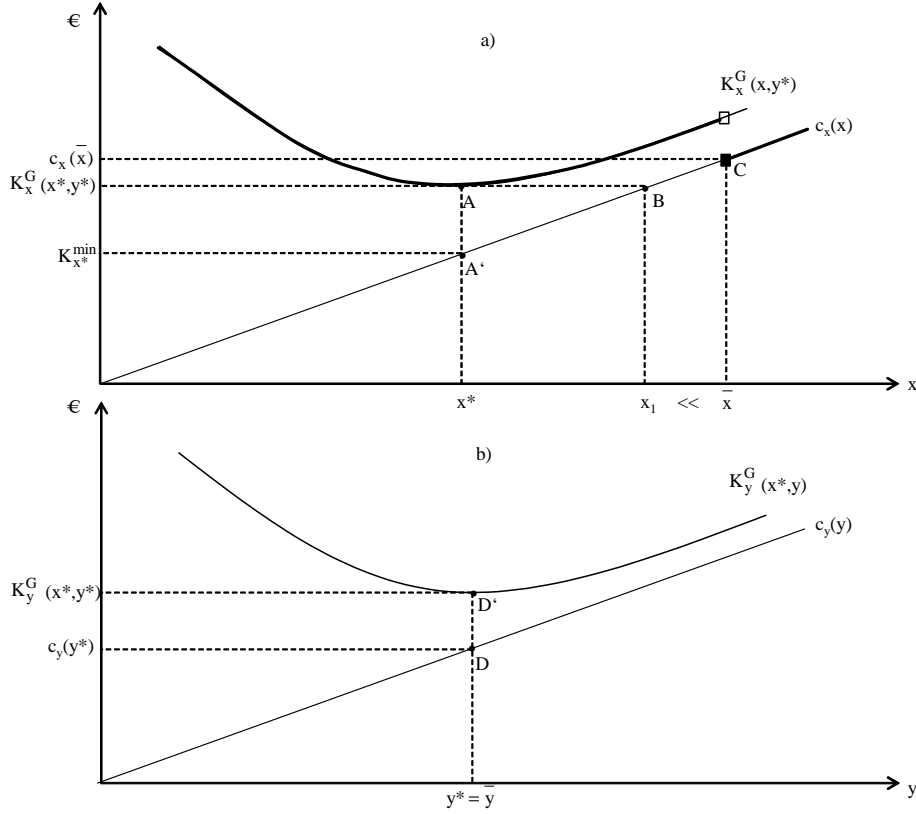


Figure 3: Efficiency even though the care standard  $\bar{x}$  is overstated

But, Figure (3) also suggests the result might differ if the court defines a care level between  $x^*$  and  $x_1$ . In those cases it is cost minimizing to fulfill that care level and

<sup>15</sup>Differentiation of moderate inefficient care levels (e.g.  $\bar{x} > x$ ) and excessive inefficient levels e.g. ( $\bar{x} \gg x$ ).

select the care level, even though it exceeds the efficient one. Figure (4) and Table (4) depict the dynamics of a potential convergence towards equilibrium which will never be reached in this case.

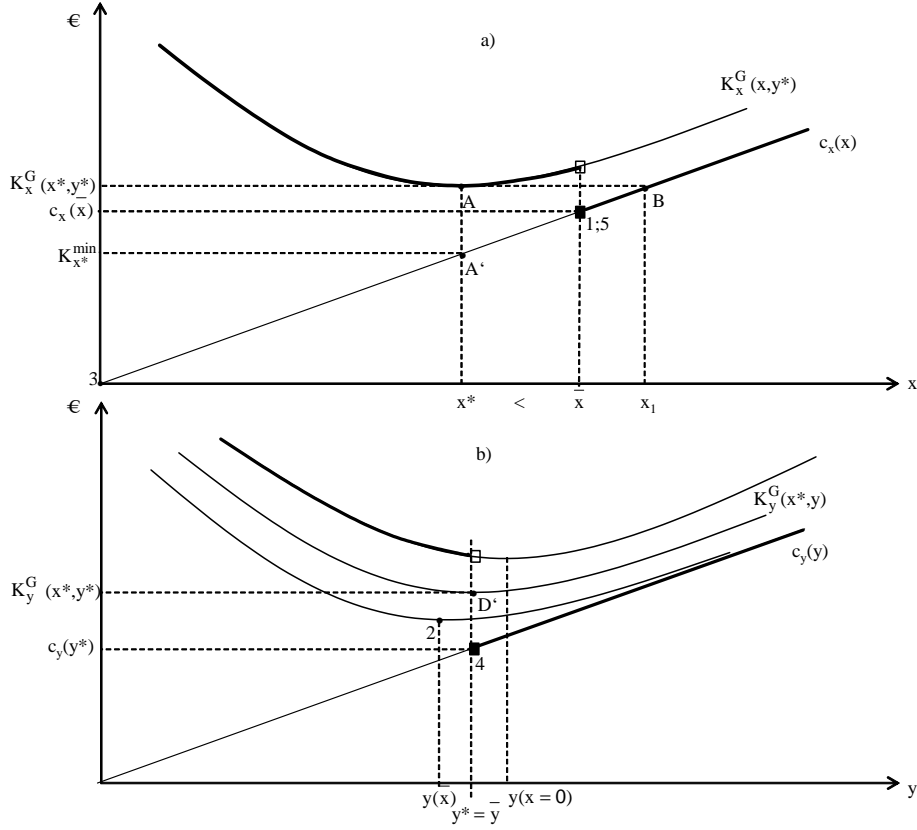


Figure 4: No efficiency because the care standard  $\bar{x}$  is overstated

As shown in Figure (4), the intermediaries' best choice is to select care level  $\bar{x}$  that corresponds to point 1 in graph a). Because of that choice and the substitutability of care levels, the consumer faces decreased total costs, and a downward shift of total costs in graph b). Since  $\bar{x}$  exceeds  $x^*$  the consumer minimizes the total cost, which corresponds to point 2 in graph b). However, that choice falls below the care level  $\bar{y}$ , which represents the required care level of contributory negligence, and the intermediary cannot be held liable any more. Therefore, the intermediaries best response is to choose a care level of zero, because it minimizes the avoidance costs; this corresponds to point 3 in graph a). Without any care in the intermediaries' responsibility, the total costs that the consumer faces increases so that their minimum exceeds the defined (and also efficient) care standard. Therefore, the best response to  $x = 0$  is to choose  $y^* = \bar{y}$  which is shown in point 4 of graph b). Now, the intermediary can be held liable and has to figure out if it is best to fulfill or to breach the required care level  $\bar{x}$ . That choice brings the analysis back to its starting point 5 = 1 in graph a). Hence, the process of adjustment never stops and no equilibrium can be reached. The same result is stated in Table (4) in which the circular reasoning becomes even more obvious.

|          |                       | Intermediary   |  |
|----------|-----------------------|--|--|
|          |                       | fulfils $\bar{x}$  | does not fulfil $\bar{x}$                              |
| Consumer | fulfils $y^*$         | $c_x(\bar{x})$<br>$\downarrow c_y(y^*) + ES(\bar{x}, y^*)$               | $c_x(x^*) + ES(x^*, y^*)$<br>$c_y(y^*)$                |
|          | does not fulfil $y^*$ | $c_x(\bar{x})$<br>$\downarrow c_y(y(\bar{x})) + ES(y(\bar{x}), \bar{x})$ | $c_x(x=0)$<br>$\uparrow c_y(y(x=0)) + ES(x=0, y(x=0))$ |

Table 4: No equilibrium because of cyclical pattern

The analysis suggests it might be possible to obtain efficiency even if the information on the due care level is biased and, therefore, set suboptimal. Endres (1991) analyzed several different combinations of suboptimal standards and found that only in the case of an excessively overstated care level on the intermediaries side, i.e.  $\bar{x} \gg x^*$  (Figure (3)), efficiency can be restored when assuming a negligence liability with contributory negligence. Table (3) states the results of other combinations of given care levels briefly.

### 3 Court Cases

The previous section outlined the present liability rule and introduced economic considerations about the incentive structures of both the intermediary and the consumer. Without any failures, the negligence rule with the defense of contributory negligence yields efficient due care standards. As pointed out in subsection 2.2.1, the general functionality of negligence liability with contributory negligence is independent of whether the losses are shared or not. Additionally, a potential rate can be calculated in different ways and the final decision about the sharing of losses rests on the court. Due to those considerations, the analysis of the cases does not account for rates and focuses on the effects of liability rule failures instead. This section introduces twelve verdicts that are analyzed and tested on whether they provide evidence for liability rule failures. The twelve cases represent verdicts from regional and higher regional courts<sup>16</sup> in Germany and are publicly available via different online databases such as *dejure.org* or *beck-online*<sup>17</sup>. Thus, plaintiff and defendant are anonymous as are all witnesses; therefore, it is not necessary to pay attention to any further data protection issues. Due to de-personalization, the only distinction concerning the intermediaries' type is the one of broker versus agent. The agents are not further differentiated. All cases refer to § 63 VVG or the analogous § 43c VVG (previous version) as basis for a claim. These verdicts represent all cases that decided and published based upon the “new” rules through December 2013. The “old” judgments on inefficient counseling include either only brokers, or refer to *culpa in contrahendo* (Kieninger, 1998); hence, a liability that refers to the process of contractual negotiation. Therefore, the effect of that regulation is much less precise compared with the explicitly stated duties in §§ 60,61 VVG.

For organization, categorization and codification of the verdicts, the scientific software Atlas.ti version 7.1. was used. The codes were generated according to the elements

<sup>16</sup>Regional Court = Landgericht (LG); Higher Regional Court = Oberlandesgericht (OLG).

<sup>17</sup><http://dejure.org> and <http://beck-online.beck.de>

stated in the §§ 60,61 VVG which specify duties. Additionally, the element of contributory negligence was added. To identify failures, codes concerning the burden of proof, and the causality between a potential fault and the resulting damage were generated. Last, statements related to the care levels of both the intermediary and consumer were considered.

The remainder of this section deals with the analysis of different cases. It is questionable if it is possible to find evidence for failures of the liability rule. Most important is the possibility that courts identify a breach of duty. This is perhaps the main question because the legal terms of §§ 60,61 VVG have to be interpreted. The interpretation of the statutes, thus the definition of a to-be standard, might yield an overstatement or an understatement of the intermediary's due care level. Also, the plea of contributory negligence seems worth analysing. Primarily, the care level that has to be provided by the consumer is important because it has to be determined by the judges as well. Therefore, this section seeks to answer the question, "Do the courts define optimal due care standards?"

### 3.1 Case No. 1

In this case, the consumer cancelled a tax privileged, long-term life insurance contract and took out a retirement insurance scheme. He is not married, and has no children. Unfortunately, the contract the intermediary provided does not fit the consumer's situation because only a married partner or the consumer's children could be entitled to receive benefits upon the consumer's death. Also, any premature payments are excluded. The court granted the claim<sup>18</sup>.

The court stated the to-be standard as follows. The intermediary must consider the individual and financial situation of the consumer. Furthermore, the consumer has to be informed about the financial disadvantages resulting from the termination of the life insurance contract. Since the "old" contract was endowed with tax benefits, the intermediary must provide information about the changed rules because "new" contracts do not include such benefits any more. Additionally, the consumer needs to know the differences concerning termination and potential cash-in values (Ablauf- und Rückkaufswert) of both contracts. It is the intermediary's duty to provide that information, as well as the information about payments in the case of death with respect to the different stages of the contract, i.e. prior to the pension payments (deferment period), or during the payment period.

By stating those requirements, the court has to consider the intermediary's avoidance costs as well as the consequences of poor counseling in terms of expected damages. As far as avoidance costs are concerned, the court must evaluate the difficulty of gathering and providing relevant information from the intermediary's point of view.

First, in the consumer's case, the tax benefit is valuable because of a high wage tax classification for unmarried employees. To reveal someone's civil status is neither difficult, nor costly. Therefore, it can be expected that an intermediary would seek information on the

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<sup>18</sup>5 U 502 10/76 OLG Saarland; 04/13/2011

marital status of the consumer. Second, the circumstances of tax privileges are known by the intermediary because the written verdict states the retirement insurance scheme was primarily suggested because of that detail. Hence, the requirement to be informed about the individual and financial situation of the consumer does not represent an excessive demand. Also, an intermediary as an expert in insurance matters knows about the financial disadvantages of the termination of long-term life insurance contracts. He is obligated to explain the calculations of potential surrender values (Rückkaufswert), at least to inform about deductions resulting from the coverage of commissions and administrative costs. Since the intermediary receives the commissions, it is feasible to expect him to know that those are covered with the first premium payments. The third requirement states that the intermediary must inform the consumer about the different stages and periods of insurance contracts. Of course, this knowledge is considered to be expert know-how. However, the general distinction of deferment period (Aufschubzeit) and the period in which the actual pension is received, is inherent to pension insurances in general and not a special characteristic of the specific situation. Thus, it is not costly to provide that information. Last, the spouse could not be entitled to receive the payments because the contract must meet the requirements of the *Income Tax Act* that excludes that possibility. Again, that detail is not contract specific and, therefore, part of the expert's knowledge. Thus, as far as avoidance costs are concerned, the court did not overburden the intermediary.

Next, the court also has to determine the effect of different care levels and resulting expected damages. The court mentions the consequences of the advice as follows: additional administrative costs, no refund in the case of death during the deferment period, and no possibility to entitle the spouse to the pension payments. In addition to the losses from the cancellation of the contract, the court considered the relevant facts to calculate the damages. Finally, turning to the possibility of contributory negligence on part of the consumer, the verdict does not provide any evidence about a potential fault in this case. However, it is stated that the insured is obligated to read the policies and insurance conditions, but the court also noticed the difficult matter of taxes, survivor's benefits and long term insurance policies in general.

Figure (5) summarizes what happened in this case. The intermediary did not fully recognize that the consumer wanted financial security for himself once he retires, but also a survivors' benefit for his unmarried partner. The verdict provides evidence that from the broker's point of view, the main focus of attention was on the pension claim for the insured. Therefore, the broker underestimated the consequences of that detail which results in a downward shift of the expected damages. From the intermediary's point of view, it is rational to choose point B instead of A if the underestimation of losses is large. In this case, the court corrected that error and the broker is held liable because  $x_1 < x^*$ . Due to this correction, it is optimal for the consumer to choose  $C$  instead of  $D$  which minimizes the total cost if the consumers consider the underestimation of losses on the intermediaries part as given. All in all, the liability rule could have worked if it was not for the underestimation of losses by the intermediary.

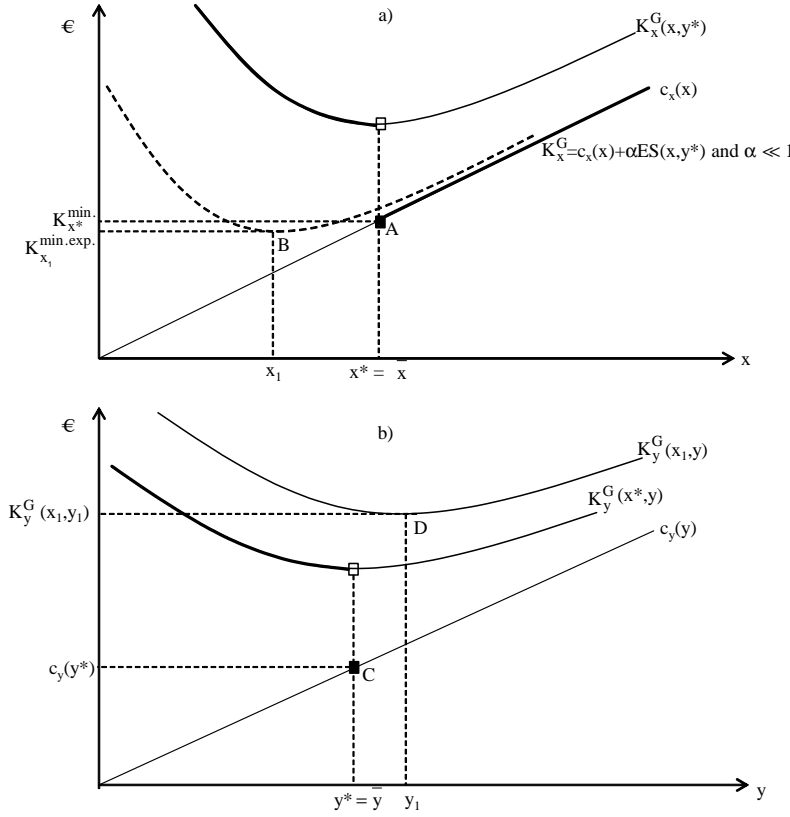


Figure 5: Underestimation of expected damages

### 3.2 Case No. 2

The consumer demanded insurance for a used RV, which he financed partially by way of credit. The agent sold partial insurance coverage and the mandatory liability insurance, exactly how a former recreational vehicle had been covered. Unfortunately, the RV was destroyed in a self-inflicted accident shortly after the policy was taken out<sup>19</sup>. The case was dismissed.

Again, the court needs to state to-be standards in order to interpret the legal duties. From the verdict follows that the court does not assign any counselling duties to the agent in this case. The decision is justified by the facts that automobile insurance is not a complex product, nor was it the first time the consumer bought such insurance. Thus, the court defines a care level  $\bar{x} = 0$ . That definition follows from the fact that the court considers the probability of a damage to be zero because the products are not complex and the consumer has some experience in taking out automobile insurances. Hence, the total costs reduce to the avoidance costs ( $c_x(x)$ );  $x = 0$  corresponds to point *B* in Figure (6a)).

Concerning the consumer's duties, the court decided that the consumer is conversant with the differences of partial and full coverage insurance, respectively. Furthermore, it

<sup>19</sup>20 U 131/09 OLG Hamm; 12/04/2009



Figure 1 consists of two graphs, (a) and (b), illustrating the determination of the optimal location of a firm.

Graph (a) shows the optimal location  $x^*$  on the horizontal axis ( $x$ ). The vertical axis is labeled  $\epsilon$ . The marginal cost curve  $c_x(x)$  is a straight line starting from the origin  $B$ . The marginal revenue curve  $ES(x, y^*)$  is a downward-sloping curve. The intersection of  $c_x(x)$  and  $ES(x, y^*)$  is marked with a square at  $x^*$ . The corresponding value on the vertical axis is  $K_{x^*}^{\min.}$ . A point  $A$  is marked on the  $c_x(x)$  curve at  $x^*$ .

Graph (b) shows the optimal location  $y^*$  on the horizontal axis ( $y$ ). The vertical axis is labeled  $\epsilon$ . The marginal cost curve  $c_y(y)$  is a straight line starting from the origin. The marginal revenue curve  $K_y^G(x=0, y)$  is a downward-sloping curve. The intersection of  $c_y(y)$  and  $K_y^G(x=0, y)$  is marked with a square at  $y^*$ . The corresponding value on the vertical axis is  $K_y^G(x=0, y_1)$ . A point  $C$  is marked on the  $c_y(y)$  curve at  $y^*$ . A point  $D$  is marked on the  $K_y^G(x^*, y)$  curve at  $y_1$ .

Generally, it can be assumed that intermediaries have a better knowledge about different policy types. Since credit financing usually calls for full insurance coverage, the counseling interview should include that issue. As credit financing could represent an instance in which the consumer might not consider the consequences, it does not seem feasible to expect counseling with no effects. Due to the assignment of a suboptimal care level which resulted in victim liability, the intermediary had no incentive to choose the socially optimal level. Therefore, if consumers anticipate courts will hold them responsible in any case, the liability rule fails because the intermediary's care level is too low and the resulting care level of the consumer will generally be too high.

### 3.3 Case No. 3

Because of the swimming pool in her backyard, the consumer put emphasis on the insurability of water pipes. In order to update the conditions of the residential building policy, she switched to a more current tariff. The intermediary's answer to the question concerning the inclusion of water pipes reads as follows, "All water pipes are covered." Later on, a rain drain and two mix-water pipes broke and caused a huge amount of damage. Contrary to the consumer's expectations, the loss was not covered. The court dismissed the case<sup>20</sup>.

The court noted the answer to the question about the inclusion of all water pipes was wrong. Nevertheless, it is also stated that the intermediary was not obligated to any advice given since the interview dealt with an update of conditions only. As to the court's argumentation, counseling duties merely arise in the case of "new" contracts; updates are foreclosed. Furthermore, the consumer should neither demand information about the single rules and regulations of the agent, nor can she reasonably expect the intermediary to extend the coverage beyond the policy. Indeed, the court wants the consumer to read the policy and to figure out the included and excluded damages. Above all, it is expected that consumers reflect about efficiency considerations because, from the insurer's point of view, some damages cannot be covered in a cost-efficient way, including rain drains. Returning to the point that the court does not assign any duties to the agent, because the contract in question represents an update only: hence, the court assigns a care level  $\bar{x} = 0$ . As in the previous case, the consumer has to bear all costs and is held liable regardless of whether she is careful or not. In this case, it is questionable if the agent has to correct the wrong assumptions about the degree of coverage even though the contract is not "new". However, the verdict draws the attention to another aspect that seems worth noting, the expectations about the knowledge and actions of the consumer. As already mentioned, the consumer has to figure out inclusions and exclusions. Additionally, it is expected that the consumer interprets the agent's statement correctly, as for example the comment on the coverage of the pipes, which was, obviously, not correct. In order to comply with those expectations the consumers need a profound knowledge of insurances in general, and special know-how concerning residential building policies. Without expert knowledge, it is doubtful the consumer can perform the necessary action at reasonable costs. Thus, the actual avoidance costs are higher than assumed in the verdict. Figure (7) shows one possible effect of an underestimation of consumer avoidance costs, but depending on the intensity of the effects other outcomes might result, starting with a situation in which both consumer and intermediary choose the efficient care standards  $(x^*, y^*)$  that correspond to point  $A$  and  $B$  in Figure (7a and b), respectively. As stated in the verdict, the avoidance costs are underestimated, yielding a suboptimal care level  $\bar{y}$  which corresponds with point  $C$  in Figure (7b). It can easily be seen that the resulting avoidance cost in  $C$  are higher than the total costs in  $B$ ; therefore, it is individually rational to select  $B$ , thus ignoring the requested care level  $\bar{y}$ . By ignoring the stated standard, the individual chooses the efficient care level, which minimizes social total costs. The consumer's choice, however,

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<sup>20</sup>33 O 136/10 LG Ingolstadt; 12/29/2010

excuses the intermediary from liability in this case. Consequently, the agent minimizes his avoidance costs and selects point  $D$  ( $x = 0$ ) in Figure (7a). Since the care levels are assumed to be substitutable, the total costs  $K_y^G$  increase. Thus, the consumer has to compare the costs resulting from point  $E$  with the cost at the care level  $\bar{y}$ . In this case, the consumer still prefers to override the care level and pick  $E$ . The intermediary is still not liable because  $y_1 < \bar{y}$  and does not adjust his actions. The resulting equilibrium is  $x = 0$  and  $y_1 > y^*$ , hence inefficient. Of course, the result is driven by the intensity of the effects; therefore, the question if it might be possible to reach efficient equilibrium becomes important. The answer to that question is no. The analysis results either in a circular argument, or in too much care on the consumer's side.

### 3.4 Case No. 4

Even though the consumer already owned a pension insurance scheme with a disability add-on, the intermediary advised the client to cancel the existing policies in order to take out a unit-linked life insurance policy and a separate disability income scheme. In contrast to the prevalent remunerations system, the two contracts were sold as net-policies (Nettopolice), and an additional payment contract was drawn up. The court granted the case but obligated the consumer to take out a policy comparable to the cancelled contract<sup>21</sup>.

The verdict focuses upon two different issues. First, the court had to deal with the advice given concerning the insurance policies. Second, the information about the additional payment contract was questionable<sup>22</sup>. Concerning the insurance policies, the court states a broker has to inform clients about costs and benefits resulting from cancellation of current policies. As soon as alternative products are presented the broker has to present similarities and differences in detail. On the contrary, the consumer is not obligated to know the extent of economic consequences. Are the due care levels over-predicted or under-predicted? Is a broker able to present the costs and benefits of a cancellation in a way that a consumer can assess the economic consequences? Furthermore, can a broker provide information at reasonable costs? If not, the court would underestimate the broker's avoidance costs. In order to know about losses concerning potential surrender values of insurance policies, the broker has to be conversant with the calculation of administrative costs especially in the field of personal insurances. Since those costs also include commissions paid to compensate the intermediary's work, it can be expected a broker informs his client about several deductions from the first few payments. Of course, costs are also relevant when cancelling a contract. Therefore, the inversion of the previous argument results in an obligation to inform the consumer about consequences of premature payments resulting from the deductions of commissions and administrative costs from the first couple of payments.

As far as the consumer is concerned, it is questionable to reasonably expect she knew about the losses incurred with premature cancellation of personal insurance contracts.

<sup>21</sup>12 U 56/11 OLG Karlsruhe; 09/15/2011

<sup>22</sup>Since the paper deals with miscounseling in insurance matters, the analysis will concentrate on the advice that is concerned with the insurance policies, only.

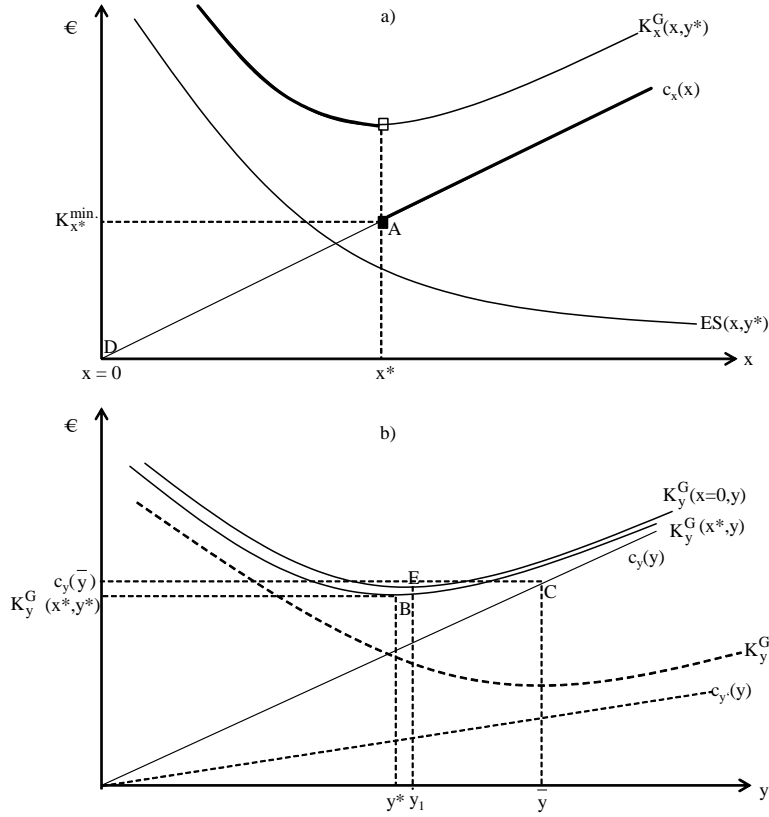


Figure 7: Underestimations of consumers' avoidance costs

The verdict states the consumer was aware about potential deductions; however, she did not realize the actual amount lost due to administrative costs and commissions. Importantly, the court states a consumer does not need to know the precise loss amount, however, a consumer must be informed about losses resulting from cancellation in general. Additionally, the fact that intermediaries earn money by selling insurance policies supports the previous statement, especially because the court views the commission factor to be common knowledge. Indeed, consumers cannot reasonably expect an advice for free. To summarize, the court only demands general knowledge about usual compensations schemes as well as general knowledge about usual payment terms, hence the defrayal of commissions and other costs out of the first premiums paid.

### 3.5 Case No. 5

The consumer, a self-employed manufacturer, held a health care insurance policy as well as insurance to cover daily allowance in case of sickness. Because of an increase in premiums, the consumer contacted the broker and demanded a change in insurance conditions that would result in lower payments. As a consequence, the consumer took out a new contract that only provides basic coverage and excludes any daily allowance for sickness; the premium was reduced by 266.81 € per month. Later, as the consumer

became sick and realized the coverage for daily in case of sickness had been excluded from his new contract. The case was dismissed<sup>23</sup>.

In this case, the court stated the to-be standard as follows: the intermediary has to inform the client about potential risks that result from a downgrade in insurance coverage. Referring to the consequences of a cancellation, however, no further advice is required because the insurance contract obviously expired, as did the promised coverage. The information about risks concerning the downgrade does not ask too much of an intermediary because he is considered an expert in insurance matters. So, the verdict provided evidence that the broker's care level is not estimated incorrectly. What about the imposed requirements on the consumer? Are they too demanding? First, the court expects the consumer to realize a cancelled contract does not provide any further indemnification payments. Indeed, that requirement does not ask too much. However, the court also requires the consumer to read the policy and documents associated with his insurance coverage. In contrast to the first argument, it is more likely that the to-be standard a consumer should adhered to is overextended in the second requirement. However, the consumer is a self-employed manufacturer who knows about the importance of daily sickness allowances and is used to reading and understanding commercial correspondence. Therefore, the verdict does not provide evidence for any mistake by the court.

### 3.6 Case No. 6

The next case concerns an insurance contract for a consumer who planned to convert a bungalow and refurbish the roof. Since the bungalow would be without a roof for a time, he had to consider the danger of heavy rain. Therefore, the consumer demanded an appropriate insurance policy to cover losses that might occur to the furniture, walls and flooring materials. However, the chosen insurance policy did not cover losses of the old structure of the bungalow, thus sustained damage due to rainfall was not covered. The court dismissed that case<sup>24</sup>.

The court states the to-be standards according to a judgment known as the "trustee decision"<sup>25</sup>. The broker has to deliver a suitable insurance coverage to meet the consumer's wishes and needs. In this case, the broker had to search for an insurance to cover damages due to rainfall at the replacement value. According to the requirements, the court states there was a counseling failure. Therefore the court did not overestimate, or underestimate, the care level. As long as it is possible to evaluate the risk and find an adequate coverage, or to provide the information that no such coverage exists, the broker is able to meet the requirements. In this case additional agreements to include damage at the buildings structure are quite usual.

However, the court decision draws the attention to another aspect since the broker was not held liable even though the advice was found lacking. As the insurance was supposed to cover damages resulting from extreme weather conditions, loss due to usual rainfall

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<sup>23</sup>5 U 337/09 OLG Saarland; 01/27/2010

<sup>24</sup>14 U 129/10 OLG Schleswig; 09/16/2011

<sup>25</sup>Federal Court of Justice (of Germany) 5/22/1985 IV ZR 190/83)

is not insured. Thus, the cause-and-effect link between poor counseling and the loss is missing since damages due to regular weather conditions do not represent an insured risk. Therefore, wrong advice was not the reason for the omitted indemnification. A missing causality might affect the individual's behavior because it can yield an underestimation of expected damages as already pointed out in section 2.2.2. Since insurance coverage that includes extreme weather conditions is more expensive, than coverage that excludes those events, it is easier to sell the "regular" coverage. Therefore, if the missing causality is a major issue in many losses resulting from rain, the intermediaries might tend to underestimate the expected losses, in particular if in the majority of the cases the weather condition itself is the crucial issue. The corresponding effects are shown in Figure (2) in Section 2.2.2 and yield a care standard that falls below the efficiency level  $x^*$ .

### 3.7 Case No. 7

A consumer cancelled his private health insurance, including nursing care, after almost 25 years in order to take out a new contract. Only after the consumer received the information that a small amount of his old-age reserves could be transferred into the new contract, he realized his coverage had changed for the worse. The case was granted<sup>26</sup>. Whereas, the regional court did not hold the intermediary liable, the higher regional court decided in favor of the consumer. The court defined the to-be standards as follows. First, the intermediary must recognize the need for counseling advice. Second, the differences between the old and the new insurance conditions have to be analyzed and shall be communicated. Additionally, the agent must provide information about the non-transferability of the old-age reserves as well as information about the resulting economic consequences. Last, the agent has an obligation to expose gaps in coverage. In comparison, the consumer fulfilled his duties by handing the relevant documents to the agent. In addition, the court did not hold consumer responsible to double-check the agent's advice. Quite rightly, the judges recognized the complex matter of this kind of insurance.

In contrast to the regional court, the higher court realized the consumer is suffering, or will suffer a loss in the future because of the advice he received from the broker. Whereas the regional court underestimated the expected damages and ended up applying a care level, which was too low compared to the optimal one, the higher regional court identified the damages that occur today and will occur in the future. For example, the new contract does not cover a treatment by a head physician nor does it cover a private patient suite. Those losses evidently occur today. The non-transferability of the old-age reserve represent damages which will be noticeable in the future but still have to be considered when determining the care level. Thus, the higher regional court corrected the underestimation of expected damages by the regional court and solved the problem of a suboptimal care level.

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<sup>26</sup>25 U 3343/11 OLG München; 06/22/2012

### 3.8 Case No. 8

In order to cover risks from his profession as a stove maker and floor-tiller, the consumer wanted to take out new professional liability insurance because the old one ended. As a result, the broker suggested a policy that covered risks of manufacturing companies and especially those related to stove making. However, after signing the contract the consumer noticed floor tiling was not mentioned explicitly in the policy. He informed the broker about that mistake and believed the problem would be solved as a result of his complaint. Shortly after the policy was taken out, the insured was held liable for damage by water that occurred in the aftermath of his work as a floor tiller. Because the profession was still not included in the policy, the insurance company refused the payment. But, the court granted this case<sup>27</sup>.

The court affirmed the liability of the broker in this case because he neglected his duties, which are stated as follows. The broker must evaluate the risk individually and self-initiated. Furthermore, any gap of insurance coverage must be mentioned. In this case, the missing liability coverage for risks due to tile setting must be detected and abated. It is questionable if the broker had knowledge of the additional professional activities other than stove making. Since the client's letterhead reads "Fireplaces and Tiles" and the old professional insurance policy included both professions, it is expected that the broker ask about the actual activities performed by the insured. Because of the complex matter of professional liability insurance, the court did not assign any duties to the consumer. Also, the relationship between broker and consumer is such that the insured can rely upon the intermediary's statements. Importantly, the court did not explicitly state a duty to give any information to the broker about the floor tiling activities, even though the consumer did so in the present case. Thus, the courts argumentation requires the broker to be informed, but on the other hand did not require general information to be submitted on the part of the consumer. Hence, it can be argued that in general the broker has to ask the consumer about his profession. The obligation of the client to provide information becomes relevant when the broker clarifies the client isn't building stoves with tiles, but that he, in addition to installing stoves, sells floor tile-setting services. It cannot be expected for a broker to realize both professions are carried out independently. Consequently the general statement a consumer has no obligation to fully inform the broker about all activities and services, result in a care level that is too low. Since the provision of that information is nearly priceless, the court overstated the avoidance costs. This case, therefore, represents a situation in which the care level of the consumer is too low,  $\bar{y} < y^*$ , and the care level of the broker is overstated,  $\bar{x} > x^*$ . This situation is depicted in Figure (8) by the broken lines in comparison to the socially optimal care levels  $x^*$  and  $y^*$ .

What is the result of such a setting with regard to the formation of equilibrium? Hence, it is a question of the existence of equilibrium in general. In addition, is the comparison to the equilibrium considered socially optimal? First, let's consider the broker's reaction. Due to an overestimation of avoidance costs, the required care level exceeds the optimal one. Depending on the degree of the over-assessment, different reactions become possible.

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<sup>27</sup>11 U 907/10 OLG Brandenburg; 10/23/2012

First, let's assume the required standard exceeds the optimal one, but still falls below point  $A$  in Figure (8), so that  $c_x(\bar{x}) < K_x^G(\bar{x})$ . As long as the inequality holds, the intermediary will fulfill the required care level. Because of the substitutability of care levels, the consumers' total costs shift down (Figure (8b)) and the best response to  $\bar{x} > x^*$  is  $y_1 < y^*$ , point  $B$  <sup>28</sup>. However, as long as  $y_1 > \bar{y}$ , the broker is liable for not meeting the given standard and has to take all costs into account even though the stated care level on the consumer's side falls below the optimal one. Therefore, it is always optimal to fulfill the standard  $\bar{x}$ . To summarize, in this setting equilibrium is reached in which  $\bar{x} > x^*$  and  $y_1 < y^*$ . The second possibility of reactions is quite similar to the first one, but results in a cyclical pattern of adjustments. Assume that because of the substitutability of  $x$  and  $y$ , the consumer's best response to  $\bar{x} > x^*$  is still  $y < y^*$  but now  $y_2 < \bar{y}$  <sup>29</sup>. In this situation, the broker is no longer liable and, therefore, it is optimal to minimize avoidance costs. Hence, the broker has an incentive to choose  $x = 0$ . With  $x = 0$ , the consumer minimizes total costs and chooses  $y(x = 0) > y^* > \bar{y}$ . But, since the court determined a standard  $\bar{x}$  that is fulfilled by the broker, the cycle restarts. In a third setting, the stated care level  $\bar{x}$  overshoots the optimal level to a great extent so that  $c_x(\bar{x}) > K_x^G(\bar{x})$ . Under these circumstances it is optimal for the broker to choose  $x^*$  and consider total costs. This is the case in each care level that exceeds  $A$  in Figure (8a)). The best response to  $x^*$  is  $y^*$ , but the consumer is compensated as well if he chooses the suboptimal  $\bar{y}$ . Since the consumers' avoidance costs have a positive slope throughout, he minimizes costs by choosing the suboptimal care level. However, as long as the broker has to compensate the consumer the best response is always to select  $x^*$  under the given circumstances. The resulting equilibrium is not the efficient one because the consumer's care level will be too low.

### 3.9 Case No. 9

A firm wanted to bid on a public construction project and had to provide proof of insurance covering risks for a specific amount. In order to provide insurance, the company relied upon the services and knowledge of a broker who gave the impression he was conversant with the matter of construction and building risks. Because the tendered documents were written in French, the broker's employees misunderstood the amount and content of the necessary insurance coverage. The construction firm's bid was not considered for the bid because the documents were incomplete. However, it turned out their bid would have been accepted if it were not for the missing insurance. Even though the broker argued that knowledge about foreign insurance law as well as the ability to translate the documents from French to German overstates the care level, and cannot be reasonably expected, the court held him liable <sup>30</sup>.

The court expected the broker to inform his customer about his inability to provide the requested information based upon the provided documents. There was no exception or limit on the range of duties required of the broker due to language barriers or foreign

<sup>28</sup>Recall that the intermediary is not liable, thus, the consumer won't be compensated.

<sup>29</sup>In Figure (8) this case is indicated by  $y_2$  that is located somewhere below  $\bar{y}$ .

<sup>30</sup>10 U 724/11 OLG Koblenz; 10/17/2011



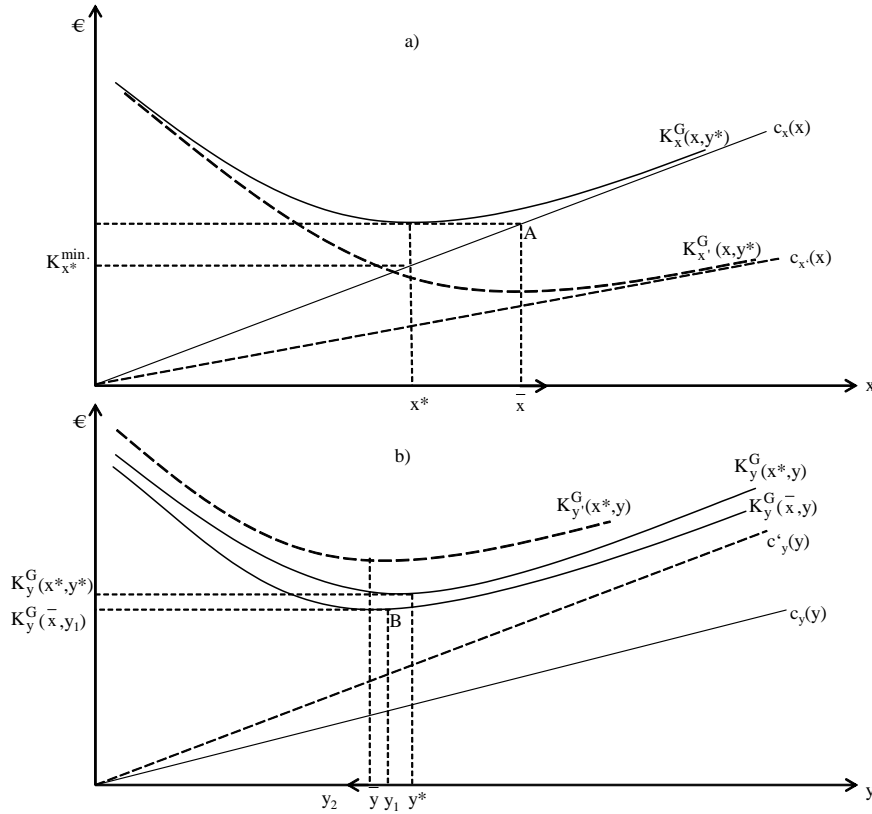


Figure 8: Overestimation  $x$  along with an under assessment of  $y$

rules. As far as the customer's side is concerned, the court states the expectations to provide all relevant information. In the present case, the customer supplied the broker with everything. However, additional information was available to the construction firm that they did not present, but might have been helpful in that it could have clarified requests. In this case, the court determined the care levels without any evident mistakes. The broker did not inform his customer about the inability to provide the requested coverage even though he received all relevant information but could not translate the documents properly. It is not too much to require of the broker since he could have asked his client to translate the documents, or hire a professional translator. On the consumer's part, the court expected him to provide all documents, which he did. Similar to the determination of the broker's costs, the requirement to provide all documentation did not overstate the avoidance costs in this case.

### 3.10 Case No. 10

In this case the intermediary was the plaintiff and the insured was the defendant, making the role distribution slightly different than in the other cases. The analysis and argumentation remains unchanged since the court's main concern in the case was the determination of care levels.

The agent sold unit-linked life insurance as well as unit-linked pension insurance as net-policies together with an additional payment contract to secure the agent's remuneration. At that time, the consumer earned about 500€ as a nurse. The consumer became unemployed five months after the insurance contract concluded, and the contracts were cancelled; however, the remuneration contract remained untouched. The court granted the case<sup>31</sup>.

How did the court state the to-be standards? What costs does present verdict refer to? First, starting with the requested care level of the agent, since net-policies with additional payment contracts represent an atypical form of agents' remunerations, a duty to counsel exists. In particular, it is important to note that the payment contract was distinctly separate from the insurance contract, so even if the consumer canceled the insurance policy the remuneration contract remained in place, and the agent's avoidance costs are affected. By offering net-policies, the agent realized his remuneration had to be paid separately. In this case, the agent sued the consumer for the debt, even though the insurance contract was cancelled. Thus, the intermediary was aware of the persistence of the additional contract. Second, the verdict addresses the consumer's awareness of net-policies and the resulting difference in remuneration payments. The court stated the consumer did not need to be conversant with the consequences of payment contracts since those represent an atypical form of remuneration. Of course, the inversion of the argument yields that consumers are aware of the remuneration of brokers and agents in general. Using this as a starting point, the court did not over assess the avoidance costs of the consumer because it can be reasonably expected that consumers know intermediaries are paid for advice via premium payments. However, the consumer cannot be expected to know about or understand that the atypical contractual obligation requires her to pay remuneration regardless of the existence of the insurance contract.

### 3.11 Case No. 11

The consumer requested insurance for a residential building, a house, which needed redevelopment and therefore was not permanently occupied. Three months before the insurance contract was signed, an adjacent building burned down. The broker who filed the form did not mention an existing previous insurance contract, nor did he mention the fire. When the main building caught fire the same year, the insurance refused the payment due to willful deceit.<sup>32</sup>

In this case, it was quite obvious the court expected the broker to act as a stakeholder for the consumer. As the broker completed the application form, it is his fault that neither the previous insurance contract, nor the fire were mentioned. Thus, the court expected the broker to fully inform his potential insurance client about the risks and other relevant circumstances associated with the application. The question became, did the broker have knowledge about those issues? If not, was it expensive to discover the relevant information? Despite the fact that the consumer informed the broker about the previous loss and the other insurance policy, an on-site inspection would have made

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<sup>31</sup>16 S 46/11 LG Wuppertal; 04/03/2012

<sup>32</sup>20 U 1643/19 OLG München; 03/09/2011

the fire evident because of the ruined building. This brings us to the court's stated expectations respect to the consumer: the obligation to provide information. Of course, the consumer is expected to make private information available to the broker. Both the previous fire as well as the former policy were pieces of private information the consumer was aware of. Since the application dealt with those aspects, the consumer knew of their importance. Therefore, the court does not hold the consumer responsible to mention extraneous private information because the application asked for the information.

### **3.12 Case No. 12**

Initially the consumers, an elderly couple, contacted the agent in order to take out a supplementary dental insurance. During the counseling process the consumers gave all of their insurance documents to the agent for analysis. As a result, the agent recommended the couple purchase insurance to cover funeral expenses; at the same time, he helped them cancel an existing term life insurance. The man died in the following year at age 74 and the insurance paid 1.833,67€ to the widow, a sum about 13.500€ less than the value of the cancelled term life insurance. Primarily, the court deemed the widow was not in a position to contest a counseling mistake as she was a beneficiary of the contract, and the court dismissed the case.<sup>33</sup>.

Nevertheless, the court mentioned requirements that refer to both the care level of the agent as well as the care level of the consumer. First, the analysis of insurance documents did not include any concrete counseling advice. The agent did not call upon special trust because he did not act especially on behalf of the consumer. The agent's advice resulted in the substitution of term life insurance with insurance to cover funeral expenses, but the term life insurance would have covered those costs as well as what the widow was entitled to. To substitute one for the other in the contract caused additional costs because of commissions and administrative fees, thus the funeral expense coverage was a costly alternative. The consumer would have been better off without the advice. The court did not recognize the underestimated losses which resulted from the agent's poor counseling. The expectation on the consumer's care level was the following. Implicitly, the court stated a consumer has to read documents before signing them. The widow stated she trusted the agent and therefore signed the prepared documents without reading them. Furthermore, the couple followed a newspaper advertisement to contact the agent for advice on dental insurance and they must have realized that he only specialized in selling products of one type of insurance, dental. Thus, the court assumed the consumers could distinguish the intermediaries by type with all the consequences. Therefore, the court underestimated the care level of the agent. In the case of the elderly couple, the court's assessment of their responsibility was too high because the cost to collect information about the intermediary's type was high. Hence, the analysis of this case is similar to Case No. 3. If one assumes it is common knowledge to know the difference types of intermediaries, and therefore no overestimation of avoidance costs happens, the socially optimal equilibrium can still not be reached because of the underestimation

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<sup>33</sup>18 U 114/12 OLG Hamm; 05/06/2013

of the expert's care level. The best response to  $\bar{x} < x^*$  would be  $y_1 > y^*$ .

### 3.13 Discussion

The main question of this section was do the verdicts provide evidence for failure of the liability rule. The decision about care level is especially a major issue because the courts are deciding how to interpret legal terms. As the analyses show, the answer is ambiguous. Basically, verdicts are based on the presentation, description and information of costs and benefits. Of course, this statement is fairly aggregated. The costs can be further divided into losses that result from cancellation of an existing contract and costs that directly arise from the selected contract such as premiums or the intermediary's remuneration. For example, in Case No. 1, the financial situation of the consumer is such that a cancellation of the existing tax-privileged life insurance contract was not advised. Also, in Case No.4, the court states negligence because the intermediary did not inform about all consequences, financial and fiscal, that result from a change of insurance policy and company. Likewise, the jurisdiction expects the intermediary to advise against the replacement of a health insurance contract if existing old-age reserves cannot be transferred, which would result in an increase of future costs (Case No. 7). As far as the remuneration is concerned, the intermediary has to inform about any agreement that differs from the traditional compensation scheme (Case No. 10). When it comes to the benefits of insurance policies, the intermediary is expected to know all benefits and exclusions of the insurance policy he sells. Additionally, he has to share the information with the consumer in an adequate way, which definitely excludes a simple presentation of the product information sheet (Case No. 4). Furthermore, being an expert, the intermediary is supposed to recognize and inform about obvious gaps in coverage.

Are the expectations overstated? The first section discusses due care levels that are too high as one out of several reasons for the failure of the liability rule. Considering an information-based error term, it is important for the intermediary to be able to obtain the necessary information on costs and benefits easily and at reasonable costs. Being an expert, the intermediary has the ability to inform the consumer about the consequences that result from the replacement of contracts. All stated examples do not require knowledge or information that is not available, or is disproportionately costly to gather. Differences between life insurance policies, or the possibility that the tax status of older contracts is preserved does not represent a challenge to an expert in insurance matters. Taking the general availability of information as a granted, one might ask why the jurisdiction denied liability in some cases. Perhaps the due care level is understated. In that case it would be cost minimizing for the intermediary to fulfill the required level  $x < x^*$  although the socially optimal level is not met. For example, in Case No. 2, the court deemed the intermediary faultless because it is assumed that the consumer knew the differences between possible automobile insurance policies, even the fact that the RV was partially financed did not trigger an intermediary's duty to counsel according to the courts. On the other hand, from the intermediary's point of view it would be easy to gather and process information about the difference in policies as well as information

about additional risk that arises from credit funding. Therefore, it is expected that he share that information with the consumer. The requirements stated by the court therefore represent an understatement of the due care level. In Case No. 3, the court denied the right to compensation because the consumer only demanded an update of an existing contract, regardless that specific questions concerning the coverage of water pipes remained unclear and unanswered. As in the previous case, the requirement to inform about exclusions from insurance coverage is understated because the consumer erred in understanding the insurance terms. Since the stated exclusions represent common standards the consumer's mistake is obvious. It is expected that an intermediary clarify the conditions.

§ 254 BGB constitutes a contributory negligence that has to be considered. The question is, "To what extent is the consumer at fault concerning the damage that occurred" The first distinction is a rather simple one. Contributory negligence is explicitly mentioned in some cases in which the court states, "The insurant may trust the intermediary's statements" However, the verdicts also points at some general expectations the consumer must fulfill. Thus, without explicitly referring to the standard of contributory negligence, the jurisdiction implicitly states the consumer's due care with respect to the level of information giving and information gathering. First, the courts state the expectation that the consumer read the send documents that include the General Conditions of Insurance (GCI), the insurance policy or the documentation of the counseling interview itself. Admittedly, the courts distinguish between the complexities of the products. For instance, in Case No. 1 the court required a consumer read the GCI, but not if those conditions are as complex as the present ones. On the contrary, automobile insurance is considered highly standardized; therefore, the court assumes some reasonable knowledge about those contracts. Additionally, it is assumed consumers have information about the prevalent rules and standards of certain insurance plans. For example, the insurant has to provide usual preventive measures of rain coverage if the roof of a house is reconstructed (Case No. 6). Whereas it is assumed that the consumer has knowledge about the traditional remuneration schemes (Case No. 4), a consumer is not at fault if he does not know the concept of net-policies and an extra compensation contract (Case No. 10). Furthermore, the provision of information by the consumer is another objective. In Case No. 9, the insurant has to bear a contributory negligence because he did not yield all printed forms of a bidding procedure to the intermediary, but by handing all relevant insurance documents to the agent, the consumer expects the necessary information will be extracted as stated in Case No. 7.

To summarize, the cases provide some evidence that courts tend to understate the care level of intermediaries. The source of the rule failure is either an underestimation of losses or an overestimation of avoidance costs. As the analyses of the cases suggests, both aspects are important. At the same time, the consumer's knowledge in insurance matters is challenged because they are expected to have information about usual regulations and rules. The cases point to an underestimation of avoidance costs by the courts, which yields too high of a due care standard. Nevertheless, it must be recognized that courts

seem to be able to detect lies and deceit, as some verdicts point out. Also, there are verdicts in which the courts distinguish between avoidance costs and expected damages, and therefore “ask the right question” as far as economic considerations are concerned. Hence, the question arises: “Can courts be expected to go through a learning process that eliminates failures in the long run?” Posner and Sunstein (2006) apply the Condorcet Jury Theorem to the question, “Should courts refer to previous judgments in order to make the right decisions” The Condorcet Theorem uses the law of large numbers and holds if single decision makers make independent choices with a probability larger than 50% they are correct. Therefore, the larger the group gets, the better the decisions. Thus, applying the theorem to court decisions, the consultation of other judgments can provide additional information and increase the chance that the ruling is correct. Posner and Sunstein (2006) state three conditions that must be met in order trigger the learning process. First, decision makers have private information and base their choice on those. Second, the situation has to be similar; hence, comparable. Last, the decision that serves as additional reference has to be independent from other judgments (i.e. the decision shall not use information of other judgments itself). However, if the courts are systematically biased or are in a cascade (not independent) their decisions should be ignored (Posner and Sunstein, 2007). Referring to the court decisions in this paper, a learning process is not precluded per se. Verdicts in which the defendant is a broker refer to the the “trustee decision”<sup>34</sup> by stating the right to-be standards. On the other hand, verdicts in which other types of intermediaries are involved do not refer to a “common” decision. However, since the liability rule sets the right incentives, once the courts ask the right question a learning process will presumably eliminate the source of failure.

## 4 Conclusion

Inadequate counseling is an important problem around the world; however, the European Union issued a directive in 2001 to strengthen consumer protection by providing a legal claim concerning poor counseling. Additionally, the legislator specified duties concerning information, counseling and documentation requirements. Those duties are supposed to solve the problems that occur from asymmetrically distributed information by vaguely prescribing a due care standard. Such standards are also required in the U.S., as stated in the introduction. The main difference is that the stated duties have to be interpreted by European courts in order to apply the existing liability rule. From an economic perspective the liability rule now forces the intermediary to take all costs that result from his advice into consideration. Without any errors, negligence liability maximizes social welfare, but ongoing discussion about even more regulatory activities in this field might signal a failure of the liability rule.

The analysis of the twelve verdicts regarding potential failures of the liability rule shows that courts tend to understate intermediaries’ due care level. The requirements concerning the particular duties are low if one considers the intermediary an expert in insurance matters and keeps the availability of information as well as the costs in mind. The un-

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<sup>34</sup>Federal Court of Justice (of Germany) 5/22/1985 IV ZR 190/83 (Sachwalterurteil))

derstatement yields a care level that is not socially optimal. Is contributory negligence an issue? Explicitly, no; but the courts state requirements concerning the provision and processing of information. Thus, the consumers have to fulfill a care standard too. Generally, the requirements are such that a consumer can act appropriately. It can be expected that a consumer provide the relevant information and questions phrases that are unclear. However, it cannot be expected that a consumer has expert knowledge and discovers failures, gaps or inconsistencies in their insurance coverage. Therefore, the inappropriate processing of information that some decisions refer to might overstate the due care standard for consumers. The result is that consumers do not fulfill the standards and induce the intermediary to reduce his care level. In this case, neither the consumer nor the intermediary picks a care level that is socially optimal.

The analysis suggests an understatement of intermediaries' duties as well as a potential overstatement of consumers' duties will yield socially suboptimal results. The too often missing documentation reinforces that tendency. Therefore, the effect of the liability rule could improve if courts carefully considered these aspects. Especially, concentration upon the availability of relevant information and the appropriateness of resulting costs could help eliminate the problem of care levels that are too low. Other regulation activities may become obsolete and won't cause additional redistribution costs.

Nevertheless, this analysis only represents a starting point. If more cases were available to examine, it would be possible to analyze certain aspects of the failure of the liability rule in greater detail.

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