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NOTE: Insurance Law's Hapless Busybody: A Case Against the Insurable Interest Requirement

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BIO: * AUTHOR. Yale Law School, J.D. 2007; Claremont McKenna College, B.A. 2003. Thanks to George Priest and Brian Wong for imparting wisdom without which this Note could not have been written. Thanks to Adam Banks for thoughtfully and patiently editing this Note. Most of all, thanks to Allison Lyzenga for listening to my many wild ideas and for encouraging me to put this one down on paper.

LEXISNEXIS SUMMARY:

... The law thus requires that policyholders have an "insurable interest" in the person or property they insure, and contracts lacking such an "insurable interest" are invalidated by courts as against public policy. ... Counterintuitively, the insurable interest doctrine actually creates its own moral hazard - an incentive for the insurer to overinsure. ... Ordinarily, the insurance contract would become less attractive to the insurer as the risk of loss due to moral hazard increases. ... And, as I have shown, even a relatively modest amount of ambiguity in the insurable interest doctrine can create an incentive for insurers to accept higher levels of moral hazard or take advantage of policyholders. ... In fact, insurers are most likely to take advantage of policyholders in cases where the insurable interest doctrine is ambiguous, since the uncertainty in the doctrine tends to increase the insurer's informational advantage over the policyholder. ... At least with respect to life insurance, this approach eliminates the perverse incentive for insurers to accept intolerably high levels of moral hazard, since the insurable interest doctrine would no longer permit insurers to evade payouts. ... The insurable interest doctrine is ordinarily justified on the ground that it prevents a negative externality, namely the risk to third parties caused by the insurance policy's moral hazard. ...

HIGHLIGHT:

ABSTRACT. For centuries, the law has prevented people from purchasing insurance on the life or property of strangers because such insurance contracts would give policyholders incentives to end the life or destroy the property in order to collect the insurance payout. The law thus requires that policyholders have an "insurable interest" in the person or property they insure, and contracts lacking such an "insurable interest" are invalidated by courts as against public policy. This Note presents an economic analysis of the insurable interest requirement, and argues that the doctrine creates perverse incentives that encourage the very practices the doctrine seeks to deter. In addition to failing on its own terms, the doctrine also invites unfairness and inefficiency in the insurance market. This Note concludes that the best way for courts to prevent insurance contracts on the life or property of strangers may be to refrain from invalidating such contracts in the first place.

TEXT:

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INTRODUCTION

In the Russian classic *Dead Souls*,ⁿ¹ a businessman invents a clever scheme to turn a legal quirk to his own advantage. The government taxes the gentry for every serf owned, but the government infrequently conducts the official census that counts taxable serfs. The businessman seeks to purchase dead serfs who remain on the tax rolls - reducing the owners' tax liabilities while enhancing the businessman's social standing on account of his newly acquired serfs. In defense of this distasteful-but-legal bargain, the businessman assures us, "You see, it's my practice never to depart from the letter of the law... . The law, sir - I'm speechless when confronted with the law."ⁿ² Truth being only slightly less strange than fiction, many observers have recently criticized the practice of corporations purchasing life insurance on their employeesⁿ³ and hedge funds purchasing the policies of wealthy seniors.ⁿ⁴ Detractors have labeled these practices "dead peasant" insurance,ⁿ⁵ and they have lamented the presence of "investors willing to bet on when [someone] will die."ⁿ⁶ Indeed, these practices evoke a discomfort akin to the purchase of dead serfs. And yet, just like the purchase of dead serfs, these practices are enabled and encouraged by the "letter of the law." That law is the "insurable interest" doctrine.

Some may find this charge puzzling, for the doctrine has long been thought to protect against the kinds of "dead peasant" practices decried above. The insurable interest doctrine requires that the person who holds an insurance policy have some significant interest in the continued existence of the person or property insured by the policy. In other words, one cannot purchase a life insurance policy on a stranger or a property insurance policy on the stranger's property. This insurable interest requirement dates back to nineteenth-century England, and it remains a well-entrenched principle of modern insurance law. Insurance policies that compensate beneficiaries upon the death of a person or [*477] destruction of property that the beneficiary does not have an interest in preserving give beneficiaries an incentive to murder the insured person or destroy the insured property. This incentive is a form of "moral hazard,"ⁿ⁷ and the purpose of the insurable interest doctrine is to eliminate such moral hazard by invalidating insurance policies thought likely to inflame it - policies that lack an "insurable interest."

This Note takes issue with the conventional view of the insurable interest doctrine and argues that the doctrine tends to undermine the very aim it purports to advance. Moreover, the doctrine encourages unfairness and inefficiency in the insurance market. These perverse consequences suggest that the doctrine may do more harm than good and that we ought to give serious consideration to abandoning it.

This conclusion runs against the grain of much insurance law scholarship. Many scholars share the view that "the history of insurance furnishes many illustrations of the abuse of freedom of contract."ⁿ⁸ In this view, "the legal system [stands] as a traffic policeman actively adjusting the rules in order to regulate" the insurance market.ⁿ⁹ Yet, this Note tells a different story by illustrating how insurance companies can abuse the legal rules that aim to regulate them, and how a return to freedom of contract - that is, a return to the discipline of the market - offers the more promising approach. When they act as "traffic policemen," judges create ex ante uncertainty about the enforceability of insurance contracts, and insurance companies can exploit this uncertainty to the detriment of policyholders and third parties.

This Note traces the unintended consequences of such uncertainty along three different dimensions. First, the potential that an insurance contract may be voided for lack of insurable interest creates perverse incentives that undermine the doctrine's own purpose of reducing moral hazard, causing the doctrine to fail on its own terms. When an insurance policy is invalidated for lack of insurable interest, the insurance company is relieved of its obligation to pay under the policy. The prospect of invalidation reduces the expected costs of a policy to an insurer and thereby encourages insurers to issue more such policies. Meanwhile, doctrinal uncertainty permits insurers to maintain the appearance of good faith for policies that are not clearly invalid when issued. Taken together, these dynamics create

perverse incentives that work to subsidize moral hazard rather than to discourage it.

[*478] Second, uncertainty about the doctrine's application creates an opportunity for insurers to exploit policyholders, thus impeding the goal of fairness in the insurance market. Here, uncertainty about the ultimate validity of an insurance policy with a questionable insurable interest permits insurers to issue policies that appear valid to policyholders, but that may nevertheless be deemed invalid by courts. The potential for invalidation decreases the value of the policy to the policyholder but increases the value to the insurer. Yet unsophisticated insurance purchasers may not anticipate that the insurable interest doctrine could ultimately render their insurance policies worthless.

Third, the imperfect relationship between the legal standard of "insurable interest" and the actual presence of moral hazard suggests that the doctrine may end up invalidating unobjectionable and mutually beneficial insurance contracts, thus impeding the goal of economic efficiency in the insurance market. Not all policies deemed to lack an insurable interest create an intolerable level of moral hazard. Hence, to the extent that "insurable interest" is an imperfect proxy for the existence of such moral hazard, the doctrine prohibits efficiency-enhancing activity without the offsetting benefit of reducing moral hazard.

The insurable interest doctrine, and its underlying "traffic policeman" approach, thus frustrate important goals along three key dimensions of insurance law - the doctrine's own purported goal of reducing moral hazard, the additional goal of fairness to insurance policyholders, and the general goal of economic efficiency in the insurance market. In light of these flaws, I suggest that the best way to fix the age-old doctrine may be simply to cast it aside. n10 [*479] Rather than acting as traffic policemen, courts should leave the policing to insurance companies themselves. Market pressures give insurance companies significant incentives to reduce intolerable moral hazard on their own, and they are better able to do so than courts. Eliminating the insurable interest doctrine would make insurers bear the cost of moral hazard rather than subsidizing the cost and thereby encouraging it.

Part I of this Note explains the history and traditional rationale for the insurable interest doctrine. Part II then introduces two complications to this rationale - first, the doctrine's inherent ambiguity, and second, the doctrine's inexact connection to the traditional concern of "moral hazard." Part III argues against the insurable interest doctrine, illustrating how the complications discussed in Part II generate perverse incentives, insurer exploitation, and general inefficiency. Part IV discusses three potential modifications to the insurable interest doctrine and argues that none of these modifications offers a fully satisfying solution. Finally, Part V explains why the insurable interest doctrine is unnecessary and suggests that abandoning the doctrine may be the best solution.

I. THE TRADITIONAL ACCOUNT OF THE INSURABLE INTEREST DOCTRINE

The law has long required that insurance policyholders have an "insurable interest" in the life or property they insure. Indeed, scholars have maintained that insurable interest "is the very warp and woof of the enforceability [sic] of insurance contracts." n11 Insurable interest usually functions as a defense employed by the insurer, justifying nonpayment after a particular insured event has come to pass. The insurer argues that the beneficiary of an insurance contract lacks the requisite insurable interest in the insured person or property. If a judge finds that the contract lacks an insurable interest, the judge will hold it void as against public policy. Deemed unenforceable, the contract no longer obliges the insurer to pay the promised amount to the beneficiary.

Although this doctrine of insurable interest remains well-entrenched in American statutory and common law, its origins and subsequent evolution tell a more complicated story. Under English common law, insurance contracts were enforceable even if they lacked an insurable interest. n12 This state of affairs [*480] persisted until 1746, when Parliament passed a statute outlawing "wagering" contracts on marine insurance. n13 The statute declared that "no assurance ... shall be made by any person ... on any ship ... by way of gaming or wagering ... and ... every such assurance shall be null and void to all intents and purposes." n14 A subsequent Act in 1774 extended this prohibition from marine insurance to life insurance: "Whereas ... the making insurances on lives ... wherein the assured shall have no interest, hath introduced a mischievous kind of gaming: ... no insurance shall be made by any person ... on the life ...

of any person ... wherein the person ... for whose ... benefit ... such policy ... shall be made, shall have no interest" n15

As the statutes' language reveals, the chief original purpose behind the insurable interest requirement was to prevent use of insurance contracts to gamble or speculate on ships and lives. The drafters of these statutes figured that this "mischievous kind of gaming" could be limited by striking down contracts lacking an insurable interest. n16 The insurable interest requirement would distinguish between contracts that sought to dampen the risk of actual future loss and those that instead sought to speculate on whether some future contingency would occur. Without an insurable interest, there would be no actual loss; the contract would thus be a pure gamble.

Despite the focus on gambling, however, the English statutes alluded to an additional rationale for the insurable interest requirement. According to this justification, contracts lacking an insurable interest create an incentive for the beneficiaries to destroy insured property or end insured lives. Hence, the Act of 1746 noted that insurance contracts lacking insurable interest "hath been productive of many pernicious practices, whereby great numbers of ships ... have ... been fraudulently lost." n17 This rationale for the insurable interest doctrine has come to be known as the concern of "moral hazard." If a policyholder does not have an interest in the continued life of a person covered by the policy, that person has the ill fortune of being worth more to the policyholder dead than alive; likewise, insured property is worth more destroyed than preserved. "Moral hazard" in the context of insurance law describes situations in which the existence of insurance increases incentives for loss. Although "moral hazard" is often used to refer to a policyholder's [*481] tendency to take less care in safeguarding her own insured property, it also applies more broadly to situations where a policyholder has insured the property or person of another. In this latter situation, the existence of moral hazard increases the risk of loss to those third parties insured by the policyholder. n18

Hence, in modern economic terms, the moral hazard created by an insurance contract lacking an insurable interest can be understood as a negative externality. n19 If A insures B such that B is the holder of an insurance policy on C's property or her life, and B has no interest in C, then B has an incentive to destroy C's property or life. Hence, the contract between A and B increases C's risk of loss, even though C is not party to the insurance contract. This risk burdens C with a cost for which she is not compensated.

Although Parliament's antigambling campaign initially overshadowed the moral hazard concern, subsequent evolution of the insurable interest doctrine reversed these priorities such that moral hazard is now thought to be the doctrine's primary rationale. The earliest reported American decision regarding insurable interest, handed down in 1815, did not cite the original English statute, but it did treat the insurable interest requirement as a dictate of public policy to be enforced by state common law. n20 By 1881, the Supreme Court, sitting in diversity jurisdiction, had merged the antigambling and moral hazard rationales, explaining that without an insurable interest, "the [life insurance] contract is a mere wager, by which the party taking the policy is directly interested in the early death of the assured." n21 Although this formulation of the doctrine's rationale retained the language of its antigambling predecessor, its thrust and substance rested on the modern moral hazard concern. The Court labeled insurance policies lacking insurable interests as "mere wagers," but all insurance policies are in some sense "wagers." Indeed, scholars have observed the "difficulty of upholding an analytical distinction" between wagering and insurance contracts, since every insurance contract assigns an expected value to a possible contingent outcome, and it allocates the risk of this outcome between the two parties to the contract. n22 The Court's modern formulation [*482] thus does not deride all insurance "wagers," but rather only those wagers that are harmful. And it takes the chief harm to be the risk of moral hazard imposed on third parties.

In a later case, Justice Holmes crystallized the moral hazard focus even more emphatically:

A contract of insurance upon a life in which the insured has no interest is a pure wager that gives the insured a sinister counter interest in having the life come to an end... . The very meaning of an insurable interest is an interest in having the life continue and so one that is opposed to crime. n23

One scholar has thus observed, "While all courts paid it lip service, those in the majority of jurisdictions seem to have seen the anti-gambling crusade as less compelling justification for invalidating ... insurance policies [lacking an insurable interest]." n24 Rather, moral hazard became the core concern, n25 and in [*483] the assessment of another leading insurance scholar, it remains "the predominant justification now given." n26

As the insurable interest doctrine migrated from England to America, it came to be understood primarily as a bulwark against moral hazard. In this conventional view, the parties to an insurance contract cannot be trusted to minimize moral hazards on their own. Judges must play the traffic policeman's role, wielding the insurable interest doctrine to invalidate insurance contracts that entail an unacceptable level of moral hazard and thereby pose a risk of harm to third parties.

II. CONCEPTUAL COMPLICATIONS

At first, the traditional logic behind the insurable interest doctrine appears quite compelling. Surely, insurance policies ought not give someone an incentive to destroy someone else's life or property. Viewed ex post, everyone would agree that a nefarious policyholder should not receive insurance payments earned through crime or fraud. Yet if it is to have any value, the insurable interest doctrine must do its work ex ante rather than ex post. Tort, fraud, and criminal law will punish policyholders found to have committed misdeeds. Hence, the traditional purpose of the insurable interest doctrine is to prevent those misdeeds from happening in the first place - by eliminating the ex ante incentives for their commission. Viewed from an ex ante perspective, however, the logic of the insurable interest doctrine must face up to two troublesome complications. The first complication is the practical difficulty of identifying the circumstances in which an insurable interest exists. It illustrates how application of the insurable interest doctrine will inevitably cause ex ante uncertainty and ambiguity. The second complication is the imprecise link between the legal definition of insurable interest and the actual presence of moral hazard.

Although "without the prerequisite of insurable interest, the [insurance] contract is unequivocally unenforceable," n27 an insurance contract's [*484] enforceability hinges on how the courts choose to define "insurable interest." And this task of definition has been highly equivocal. Indeed, confusion over the meaning of "insurable interest" began with the original invention of the doctrine, and such confusion has continued over centuries to the present day. Defining an "insurable interest" in the context of life insurance, the Supreme Court explained in 1881 that "there must be a reasonable ground, founded upon the relations of the parties to each other, either pecuniary or of blood or affinity, to expect some benefit or advantage from the continuance of the life of the assured." n28 Hence, an insurable interest can arise from "blood or affinity," or from a "pecuniary" interest. This sounds simple enough, but it raises far more questions than it answers: How much blood? How much affinity? What sorts of pecuniary interests? And how strong? Notice that these questions tend to require judges to distinguish between degrees of interest, rather than kinds. Making these distinctions can lead to ambiguity and uncertainty.

The law holds that you have an insurable interest in your immediate family, including your spouse and minor children. n29 Although this interest exists even if your husband is an abusive tyrant, many courts will find no insurable interest in your beloved grandmother, aunt, or son-in-law. n30 And although you have an insurable interest in your spouse, the courts are divided about whether the insurable interest is contingent on your spouse's consent. n31 And what about your fiancée? n32 What about unmarried cohabitation? n33 And [*485] what if you are a same-sex couple? n34 None of the answers to these questions are clear. Parents and children generally have insurable interests in each other - but only if the children are biological ones. For foster parents and stepchildren, the answer is: it depends. n35 Moreover, some courts have recognized insurable interests of love and affection between siblings, but others have not. n36

In the absence of "blood or affinity," you can still establish an insurable interest in someone if you can prove that you have a "reasonable expectation of pecuniary gain" from that person's continued life and well-being. n37 But what counts as a sufficient expectation? Here too, the answer remains murky. The courts have held that you have a pecuniary interest in your business partner. n38 But your interest may disappear if your partner is a slouch. n39 Although you may

have no interest in an unproductive partner, you might have an insurable interest in a former partner. n40 Moreover, an employer can have an insurable interest in an employee, but not just any employee. The employee must be "crucial to the operation of the employer's business." n41 The courts generally agree that a creditor has an insurable interest in the life of his or her debtor, but they have trouble telling you the amount of insurance a creditor will be permitted to hold. As one treatise unhelpfully but accurately warns, "each case [*486] has been decided on its own facts." n42 Hence, a familiar answer: it depends. It depends, also, in cases where your interest involves some other kind of contractual relationship. Here, you must be able to quantify your alleged economic benefit, and a court must deem it "substantial." n43 Finally, for all kinds of insurable interests in life, the courts disagree about whether an insurance contract requires an insurable interest only at the inception of the contract, or also at the time of the insured's death. Many courts require only an initial insurable interest; n44 others will disfavor such ephemeral interests. n45

For property insurance, defining insurable interest remains still more difficult. Since the early nineteenth century, courts have debated whether the insurable interest must involve a formal property right (the "legal interest" test), or whether the interest need only involve a factual expectation of economic gain (the "factual expectation" test). n46 In the 1805 case of *Lucena v. Craufurd*, two English judges famously disputed the issue, and various states continue to dispute it today. Historically, the "legal interest" test predominated, but a surge of cases in the 1980s made the "factual expectation" test the current majority rule. n47 According to that rule, the insurance beneficiary need not have a property right in the insured property; rather, the beneficiary need only expect to derive actual economic gain from the property's continued existence.

In the words of one observer, however, the debate between "legal interest" and "factual expectation" remains "one of the most ancient yet continuing controversies" engendered by the insurable interest doctrine. n48 Indeed, the failure to resolve this issue over the past 200 years suggests an inherent and irresolvable dilemma: because it looks only to objective legal rules to determine the existence of a property right, the "legal interest" test is easier to apply; but [*487] because people have many economic interests in property they do not formally own, it remains a poor yardstick for measuring a person's actual interest in a piece of property. Likewise, because it looks beyond formal property rights to one's real-world expectation in a piece of property, the "factual expectation" test better reflects actual interests in property; but because it requires discerning a subjective expectation, it remains hopelessly difficult to apply. Neither the underinclusive "legal interest" rule nor the vague "factual expectation" standard provides a measure of insurable interest that can be both accurate and predictable. The modern "factual expectation" test usually requires that the economic expectation be "substantial" n49 - and therein lies the rub. Determining what counts as a substantial "factual expectation" involves a necessarily subjective, fact-bound, case-by-case approach. n50 Moreover, not only must an insurable interest exist, but the "indemnity" principle of property insurance requires that the amount of the insurance be no greater than the "value" of the insurable property interest. n51 Of course, this question of valuation has been controversial. n52

In both life and property insurance, therefore, the definition of insurable interest is erratic, ambiguous, and inconsistent. Such difficulties produce ex ante uncertainty about the ultimate validity of a given insurance contract in two ways. First, many elaborations of the insurable interest doctrine are simply uncertain at their core. For example, the "reasonable expectation of pecuniary gain" standard for life insurance and the "substantial factual expectation" standard for property insurance both apply a principle - expectation - that depends heavily on the specific facts of a particular piece of property or personal relationship. There may be nearly as many different expectations as there are relationships. Second, even in areas where the insurable interest doctrine takes the form of rules rather than standards, the rules remain unpredictable. Some questions are simply unsettled, with many jurisdictions that have yet to express a clear view on some relationships - including, for example, cohabiting couples, fiances, and same-sex couples. On other questions, the courts have created uncertainty by changing their minds. For [*488] example, many courts have shifted over time from the legal interest test to the factual expectation standard for property insurance. n53

Because it remains a difficult task to determine whether an insurable interest exists, parties to insurance contracts often bargain in the shadow of uncertainty. One insurance company general counsel observed this sense of uncertainty, noting that the definition of insurable interest remains "vague and inconsistent" and that the courts have given insurers

"little guidance" as to when an insurable interest may exist. n54 Indeed, it has always been so: in 1891, one treatise writer called the insurable interest doctrine "false, artificial and confusing"; n55 in 1918, another scholar lamented the "great diversity of judicial opinion"; n56 in 1948, another observer noted the "sharp conflict of authority"; n57 by 1986, the definition of insurable interest was still "contradictory and vague." n58 Despite two centuries of change and common law evolution, the chief defining characteristic of the insurable interest doctrine has been its persistent uncertainty. The doctrine amounts to a pile of inconsistent rules teetering upon the shaky foundation of an indeterminate standard. Writing in 1856, one court noted that "it would be difficult to lay down any general rule as to the nature and amount of interest which the assured must have." n59 And so it remains.

In addition to this problem of definition, the traditional justification for the insurable interest doctrine must face up to another hard reality. The purpose of the doctrine is to limit moral hazard, but the link between insurable interest and moral hazard remains inexact. Even if we could be sure that an insurance contract has an insurable interest, the presence of such an interest does not necessarily reduce the contract's level of moral hazard. Rather, insurable interest is simply a doctrinal proxy used by courts to invalidate insurance contracts assumed to pose an intolerable level of moral hazard. Yet, insurable interest is neither a necessary nor a sufficient indicator of an intolerable level of moral hazard. In many situations, other factors limit the amount of moral hazard caused by a supposed lack of insurable interest. For example, a large [*489] company that insures a nonessential employee may still have plenty of reasons not to murder the employee - among them, the fact that disappearing employees would be bad for business. Likewise, a court may find that a person has no insurable interest in her favorite aunt, but that person may nevertheless have every reason to keep her aunt alive. Finally, a court may hold that merchant Joe has an insufficient expectation of economic gain from farmer Bob's field, but as best friends and longtime neighbors, Joe may have every reason not to set fire to Bob's field.

Conversely, the presence of an insurable interest is no guarantee that the insurance contract's moral hazard will be acceptably low. Some other motive may be stronger than the insurable interest. For example, a secretly despised spouse or a piece of property that the owner never liked in the first place may be at risk. In these cases, the insurance contract would heighten the moral hazard, despite the presence of an insurable interest. Moreover, the presence of an insurable interest may in some instances actually increase the level of moral hazard, since it can provide cover for criminal intent. n60 Where lack of insurable interest might have been probative of criminal guilt, the presence of insurable interest can cover it up. A recently procured insurance policy on a murdered immediate family member is easier to explain than one on a stranger.

Ultimately, insurable interest remains simply one factor in the moral hazard calculus, and it may even cut both ways. A true estimate of an insurance contract's moral hazard would require weighing both aggravating and mitigating factors. It would also require a judgment about the acceptable level of total moral hazard that should be tolerated. It cannot be true that any amount of moral hazard is intolerable, even where the moral hazard risk is externalized upon third parties. Property law, for instance, permits remainders after life estates without reservation. If the grantor devises a life estate to A, followed by a remainder to B, the grantor gives B an incentive to hasten A's death. Yet, this is a moral hazard the law is willing to tolerate. Moreover, every insurance contract entails moral hazard, and this includes all third-party insurance contracts n61 where an insurable interest exists. Only a total prohibition on third-party insurance would completely eliminate the externality. Hence, the insurable interest doctrine functions simply as a [*490] shorthand proxy for the existence of an intolerable degree of moral hazard. It remains, however, a very rough one.

III. HOW THE INSURABLE INTEREST DOCTRINE FAILS

Despite the insurable interest doctrine's purpose of reducing moral hazard, the doctrine falls out of step with its aspirations in two ways. First, inherent ambiguity in the definition of "insurable interest" creates ex ante uncertainty about whether a given insurance contract will ultimately be found enforceable. Second, the inexact link between insurable interest and moral hazard suggests that the insurable interest doctrine can only be a rough proxy for intolerable levels of moral hazard. Although these complications to the traditional account of the insurable interest doctrine have hardly remained secret over the years, their implications have not been fully appreciated. This Part examines three such implications, which together make the case against the insurable interest doctrine. In particular, this Part will show how

the two uncertainty and moral hazard complications work together in pernicious ways to undermine the doctrine.

A. Perverse Incentives

The most startling consequence of the insurable interest requirement is the perverse incentive it creates for insurers to accept higher levels of moral hazard than they would tolerate in the absence of the doctrine. Counterintuitively, the insurable interest doctrine actually creates its own moral hazard - an incentive for the insurer to overinsure. This incentive, in turn, increases the likelihood that insurers will issue risky policies with higher levels of moral hazard. The insurable interest doctrine's result thus tends to undermine its very purpose.

Recall that contracts invalidated for lack of insurable interest become void and do not obligate the insurer to pay out its promised compensation. The courts disagree about whether the insurer must refund premiums in such cases. ⁿ⁶² If the insurer does not refund the premiums, its net gain from the invalidated contract would be equal to the total amount of the premiums paid; if the insurer does refund the premiums, the insurer's net gain would be zero, [*491] resulting in no net loss. ⁿ⁶³ In either case, the insurer would be in a better position if the contract were invalidated than if the contract were enforced. If the insurance contract were deemed enforceable because of a valid insurable interest, then the insurer would bear a net loss, consisting of the total payout minus premiums paid. Striking down contracts for lack of insurable interest allows the insurer to escape its promised payment obligations.

The prospect that an insurance contract will be invalidated for lack of insurable interest therefore reduces the expected cost of an insurance contract to the insurer. ⁿ⁶⁴ A simplified example illustrates this point. Assume that a given insurance contract has a 50% chance of being invalidated for lack of insurable interest. Assume also that the insured event has a 20% likelihood of occurring and would require the insurer to pay out \$ 100 if the event occurred. Without the insurable interest requirement, the expected cost of the insurance contract to the insurer would be \$ 20 ($20\% * \$ 100$). With the insurable interest requirement, however, the expected cost of the contract drops to \$ 10 ($20\% * 50\% * \$ 100$). Hence, the insurable interest doctrine effectively subsidizes risky contracts. Moral hazard increases the probability that the insured event will come to pass, but the insurable interest doctrine reduces the probability that an insurer will owe a payout. As long as the probability of invalidating an insurance contract is greater than zero, the actual cost of the contract (in our example, \$ 20) will always be more than the costs for which the insurer can expect to be held liable (in our example, \$ 10). The difference between these two costs represents the subsidy the insurable interest doctrine creates for the insurer. If the insurer can purchase its risk at a subsidized discount, it is likely [*492] to purchase more of it by accepting insurance contracts with higher levels of moral hazard. ⁿ⁶⁵

We can refine this analysis by introducing a few additional complications. The first involves the relationship between insurable interest and moral hazard. Just like the law, insurers also want to minimize moral hazard and reduce risk. ⁿ⁶⁶ Ordinarily, the insurance contract would become less attractive to the insurer as the risk of loss due to moral hazard increases. Yet, the contract also becomes more attractive to the insurer as the likelihood of invalidation for lack of insurable interest increases. Hence, as long as the probability of invalidation increases by more than the probability of loss due to moral hazard, each additional unit of moral hazard represents a marginal gain for the insurer. Figure 1 illustrates the phenomenon; the shaded area above the line shows the gain to the insurer.

[*493]

Figure 1.
INSURER'S GAIN FROM CONTRACT LACKING INSURABLE INTEREST

Since insurable interest is at best a rough proxy for moral hazard, there will inevitably be instances where the increased probability of invalidation is greater than the increased probability of moral hazard - the shaded area in Figure 1. Indeed, ironically, the more aggressively courts apply the insurable interest doctrine, the higher the probability of invalidation, and thus the larger the shaded area becomes.

So far, I have assumed that insurers incur no liability for issuing invalid contracts in bad faith. If an insurer issues a contract with the knowledge that it clearly contains no insurable interest, the insurer may be held liable. ⁿ⁶⁷ However, as shown above, the insurable interest doctrine remains so ambiguous that many cases will not be clear. There will be plenty of cases with a probability sufficiently low - say, 80%, as illustrated in Figure 1 - to make a plausible claim that an insurable interest exists. Hence, the insurer would still have an incentive to accept a marginal unit of moral hazard so long as the probability of invalidation (that is, the ex ante obviousness of the lack of insurable interest) remains below 80%. This highlights the central role of doctrinal uncertainty in creating the perverse ex ante incentive: the incentive will not exist if the contract clearly lacks an insurable interest, nor will it exist if the contract clearly contains one. Rather, the incentive thrives in the uncertain [*494] area in between. ⁿ⁶⁸ The ambiguity and inconsistency built into the insurable interest doctrine guarantee that this area remains significant.

B. Potential Exploitation

If the insurable interest doctrine creates perverse incentives that exacerbate the moral hazards of third-party insurance contracts, the costs of this flaw in the doctrine fall squarely on the shoulders of the third party. The moral hazard in such a third-party insurance contract creates an externality, and more moral hazard means a greater externality. ⁿ⁶⁹ This realization might be enough on its own to cast doubt on the insurable interest doctrine, since it turns the avowed purpose of the doctrine on its head. Yet, the doctrine works additional mischief as well. The doctrine imposes costs not only on third parties, but also on the holders of insurance policies. The insurable interest doctrine creates an opportunity for insurers to exploit less sophisticated insurance purchasers by acquiring what amounts to an embedded option while capturing the entire value of that option. Thus, the insurable interest doctrine also impedes goals of fairness and equity in the insurance market.

One scholar has posed, but not answered, a "most curious" question: "Why is this insurable interest requirement not expressly identified and fully explained in present-day life insurance applications and policies?" ⁿ⁷⁰ In light of the murky insurable interest doctrine, why don't insurance contracts clarify, ex ante, their insurable interest requirements? On a similar note, one might also wonder why insurers have recently bemoaned the practice of investors purchasing the life insurance policies of wealthy seniors when the insurers might have prevented the practice through stipulations in the insurance [*495] contracts. ⁿ⁷¹ An answer to these "curious questions" lies in the fact that insurers may prefer the insurable interest doctrine's uncertainty to any more certain alternatives negotiated through ex ante bargaining. The doctrine permits a sly practice that might be called "the insurable interest two-step": First, sell your customer an insurance contract with as much willful indifference to insurable interest requirements as doctrinal ambiguity will allow. Second, if the insured event comes to pass, claim that the contract had no insurable interest after all and escape obligation for payment. This two-step allows insurers to exploit unsophisticated policyholders, and the insurable interest doctrine's ambiguity acts as a willing accomplice. If the doctrine were entirely clear, the two-step would be transparent, but ambiguity provides cover that makes the two-step appear less nefarious than it may be.

This potential for exploitation can be sharpened by thinking of the insurable interest doctrine as creating an embedded option in the insurance contract. ⁿ⁷² An embedded option is an opportunity to take some future action in response to an eventuality that remains presently uncertain. ⁿ⁷³ One may have no desire to take the action at the present time, but the ability to take the action can become desirable if circumstances change in the future. Hence, the choice of whether to challenge the insurance contract for lack of insurable interest amounts to an option held by the insurer - an option to breach without paying damages. If the insured event never happens, the insurer has no need to exercise its option. If the event does happen, however, the insurer can exercise its option by invalidating the contract for lack of insurable interest. Of course, the value of the insurer's option is limited by the fact that the insurer might fail to convince a court to invalidate the contract. ⁿ⁷⁴ However, the option value increases as the probability of invalidation increases, and even a relatively [*496] modest probability of invalidation may still make the option quite valuable to the insurer.

Of course, there is nothing inherently wrong with an insurance contract that gives one party certain embedded options. The problem, however, comes if the option holder is able to expropriate the value of the option from the other party. The insurer's option to breach with a significant probability of avoiding damages greatly increases the total value

of the insurance contract to the insurer while simultaneously reducing the value of the contract to the policyholder. In a perfectly competitive market, the option value would be reflected in a reduced contract price (i.e., insurance premium) paid by the policyholder. In such a market, the embedded option would have no significant fairness consequences, since competition would force the insurer to pass on any gains from the option to the insurance purchaser.

However, this is not likely to happen in the insurance market, where significant information asymmetries exist between insurers and policyholders. n75 Spotting an embedded option created by the insurable interest requirement demands considerable legal expertise about the intricacies of the insurable interest doctrine and the likelihood of its application to a particular case. Moreover, valuing the cost of the option to the policyholder is even more difficult than spotting it. Although an insurance company may employ an army of lawyers, most insurance purchasers do not. n76 Unlike explicit options written into contracts, embedded options operate such that the "option seller may be much less likely to realize exactly what she is trading or the nature of the risk she accepts." n77 Because of this information asymmetry, the insurable interest doctrine may cause the insurance policy purchaser to buy insurance for much more than it is actually worth. n78 Figure 2 illustrates the effect of an option held by the insurer but unperceived by the purchaser:

[*497]

Figure 2.
EFFECT OF INSURER'S EMBEDDED OPTION

If the policyholder overlooks the cost of the option, the parties will trade at $Q<1>$ and $P<1>$. However, since the insurer's option reduces the value of the insurance to the policyholder, the option shifts the policyholder's actual demand curve to the left. If the policyholder had perfect information about the insurer's embedded option, the parties would trade at $Q<2>$ and $P<2>$. Instead, the policyholder ends up purchasing more insurance at a higher price than she desires. In sum, the insurable interest doctrine, by enabling the insurable interest two-step, creates an opportunity for insurers to take advantage of less-sophisticated insurance purchasers. Insurers can secure a valuable embedded option without having to compensate the unsuspecting policyholders who may learn only after the fact that their contract is worth much less than they had bargained for.

[*498]

C. General Inefficiency

So far, this Note has demonstrated how the insurable interest doctrine creates perverse incentives for insurers to issue insurance policies that increase the risk of moral hazard to third parties and how the insurable interest doctrine gives insurers an opportunity to exploit policyholders. A third problem with the insurable interest doctrine concerns the inefficiency the doctrine can create in the insurance market as a whole, negatively affecting both insurers and policyholders. This inefficiency occurs particularly in situations, unlike those discussed in the previous two sections, where no uncertainty surrounds application of the insurable interest doctrine or where both parties to the insurance contract have sufficient information. In these situations, the concerns about perverse incentives and exploitation become less significant, but a different concern emerges: in these cases, the insurable interest doctrine is too effective. It overreaches by invalidating insurance contracts which, under its own rationale of moral hazard, do not need to be invalidated.

Here, the chief culprit is the inexact relationship between insurable interest and moral hazard. To the extent that insurable interest acts as an imperfect proxy for intolerable levels of moral hazard, it creates a gap between contracts with a legitimately intolerable level of moral hazard and those with a tolerable level but that are nevertheless swept into the insurable interest doctrine's net. This area between insurable interest and moral hazard includes cases where an insurance contract contains an insurable interest, but a judge erroneously finds that it does not, as well as cases where an

insurance contract lacks an insurable interest, but nonetheless does not create an intolerable amount of moral hazard. As shown in Part II, there may be a considerable number of cases in this area.

If the parties are well-informed and can be reasonably sure that the insurance contract will be invalidated for lack of insurable interest, they will not enter into the contract in the first place. Hence, in this instance, the insurable interest requirement acts as an arbitrary and undesired cap on the kinds of insurance consumers may desire and insurers may be willing to provide. Where insurance contracts do not pose a high risk of moral hazard, and thus will have no socially harmful effect, the insurable interest requirement will prevent parties from securing the benefits of these benign contracts. When both parties to the insurance contract are prevented from engaging in mutually beneficial trade, deadweight loss and inefficiency result.

In sum, this inefficiency results from the regrettable but inevitable fact that insurable interest remains an imperfect proxy for moral hazard. Of course, any attempt to avoid contracts that pose intolerable levels of moral hazard will inevitably have to rely on such proxies, and any proxy will inevitably be [*499] overinclusive in some respects. The particular degree of moral hazard in an insurance arrangement cannot be estimated with perfect accuracy on a case-by-case basis. Hence, one could argue that the inefficiency discussed here may simply be a cost that must inevitably be paid in order to avoid or reduce the moral hazard inherent in insurance contracts. The insurable interest doctrine may not be perfectly efficient, the argument goes, but it remains the most efficient option available.

However, this defense of the insurable interest doctrine rests on the questionable assumptions that insurable interest is the best judicial proxy for moral hazard and that judges, acting as "traffic policemen," are the best entities to be wielding such proxies. Although insurable interest may be the best possible judicial proxy, I argue in Part V that insurance companies themselves are likely to do a better job than judges at detecting and evaluating moral hazard - and at discovering potentially superior proxies. As we will see, using the insurable interest doctrine to ferret out moral hazard is less efficient than the alternatives.

IV. POSSIBLE SOLUTIONS

This Note has shown how the insurable interest doctrine can undermine its own purpose by creating perverse incentives that increase the moral hazard risk to third parties; how the doctrine can cause unfairness by encouraging insurers to use their information advantages to exploit insurance purchasers; and how the doctrine can foster inefficiency by invalidating certain insurance contracts that pose no intolerable moral hazard risk. Contrary to initial assumptions, and perhaps a bit counterintuitively, the insurable interest doctrine actually hurts the very third parties it seeks to protect - as well as hurting, in different ways, both actual parties to the insurance contract. One may reasonably wonder, however, whether these consequences can be avoided by repairing the traditional insurable interest doctrine rather than abolishing it. This Part considers three possible improvements - a clearer doctrine, stronger insurer tort liability, and third-party standing to challenge insurance contracts - and explains how none of these improvements offers a fully satisfying solution.

A. Clearer Doctrine

The most obvious improvement to the insurable interest doctrine would be to clarify the doctrine's ambiguities. This would reduce ex ante uncertainty about whether an insurable interest exists in a given case, and it would thus reduce the perverse incentives that increase moral hazard and constrain the ability of insurers to take advantage of policyholders. Over the years, many [*500] observers have bemoaned the doctrine's ambiguity and have called for courts to speak with more clarity and consistency in defining what counts as an insurable interest. n79

It remains telling, however, that these calls for clarity have emerged repeatedly with every successive generation of new scholars and lawyers over multiple centuries - and that the calls for clarity have met with little success. This does not inspire confidence that the doctrine can suddenly be made clear after all. As hinted in Part II, the ambiguity problem runs deeper than the need to simply get the rules right and stick to them. Rather, the insurable interest doctrine's

persistent ambiguity inheres in the very concept of "insurable interest" itself. Although the doctrine works in a binary way, either invalidating contracts that lack an insurable interest or enforcing contracts that contain one, the concept of insurable interest is not binary. Insurable interest is a question of degree, not kind; it asks us to measure the magnitude of our interests in relationships with those around us. Any attempt to distill this messy reality into a neat set of binary doctrinal rules will inevitably fail. Application of the insurable interest doctrine thus requires reliance on the subjective standard that remains at its core.

This difficulty can be seen in the age-old debate over whether to apply a "legal interest" rule or "factual expectation" standard to determine the insurable interest in property. n80 Reacting to the artificial formalism of the "legal interest" test, midcentury realists called for the doctrine to become more flexible - and thus more standard-like. n81 Yet, as I have shown, uncertainty is the cost of such realism, n82 and too much uncertainty can create perverse incentives that swallow the entire purpose of the insurable interest standard. Courts have heeded the advice of the realists and moved from the "legal interest" rule to the "factual expectation" standard. Perhaps this move toward more uncertainty could be reversed and some satisfying and more certain rules [*501] could be found to replace it. n83 Yet, even so, a more rule-like approach would come with problems of its own - problems of formalism and overinclusiveness, which the insurable interest realists have justifiably criticized. n84 In contrast to the flexible "factual expectation" standard, a more rule-like doctrine would artificially narrow the situations in which an insurable interest is found to exist. The doctrine would therefore be overinclusive to the extent it would invalidate insurance contracts that would have otherwise been deemed valid.

In sum, the insurable interest doctrine cannot escape the ambiguity inherent in the concept of "insurable interest." And, as I have shown, even a relatively modest amount of ambiguity in the insurable interest doctrine can create an incentive for insurers to accept higher levels of moral hazard or take advantage of policyholders. Moreover, even if the doctrine could be made much clearer and more predictable, this result would inevitably make the insurable interest requirement more overinclusive, and thus more likely to reduce the efficiency of the insurance market by invalidating insurance contracts where no intolerable moral hazard actually exists.

B. Insurer Tort Liability

Another possible approach would be to hold insurers liable in tort for issuing insurance policies where the insurer knows that the policyholder lacks an insurable interest. n85 Most jurisdictions already recognize an "implied duty of fair dealing" in insurance contracts, and they have interpreted this duty as [*502] creating a tort cause of action against insurers who act in "bad faith." n86 Hence, insurer tort liability might prevent insurers from using the insurable interest doctrine to take advantage of policyholders.

The problem with this approach, however, is the familiar one of doctrinal ambiguity. Insurers can use ambiguity in the insurable interest doctrine to argue that they were in fact acting in good faith. It would not be enough for a policyholder merely to show ex post that the insurance contract lacked an insurable interest. n87 To establish bad faith, courts tend to require evidence of "intentional" and "reckless disregard" for policyholders, and courts resist bad faith actions where the disagreement over a claim is "fairly debatable." n88 Unfortunately for policyholders, many questions related to insurable interest are fairly debatable. To prevail, a policyholder would have to show that the insurer intentionally issued an insurance policy which the insurer knew lacked an insurable interest. n89 In light of uncertainty surrounding the insurable interest doctrine, these situations would be rare. In fact, insurers are most likely to take advantage of policyholders in cases where the insurable interest doctrine is ambiguous, since the uncertainty in the doctrine tends to increase the insurer's informational advantage over the policyholder. Where the doctrine is clear, the policyholder is more likely to know what her legal entitlements are. Ironically, then, insurer tort liability would be least powerful in precisely those cases where it is most needed.

C. Third-Party Standing

The final possible modification to the insurable interest doctrine would expand restrictions on who is entitled to raise

the insurable interest claim. In [*503] most states, only the insurer can raise the insurable interest defense, and thus benefit from invalidation of the insurance contract. In a few states, however, the estate of the deceased can claim the life insurance payout. n90 At least with respect to life insurance, this approach eliminates the perverse incentive for insurers to accept intolerably high levels of moral hazard, since the insurable interest doctrine would no longer permit insurers to evade payouts. Although this approach remains the minority view among courts, it has garnered support from a number of scholars. n91 However, even if this expansion of standing to raise the insurable interest claim may be the most promising modification to the insurable interest doctrine, it remains problematic in a number of ways.

Many courts have resisted third-party standing on the ground that it violates "privity of contract" principles by allowing the insurance contract to be challenged by someone who is not a party to it. n92 Ordinarily, nonparties do not have standing to challenge a contract. This reasoning has been dismissed as a kind of rigid and unnecessary formalism. n93 The dismissal, however, overlooks a significant and legitimate concern. If the party entitled to the insurance payout under the contract did not have a hand in causing the person's death, third-party standing would take the insurance payout from the innocent party and transfer it to the estate of the deceased. Third-party standing would thus punish the innocent and give a windfall gain to the undeserving. One can understand why courts would seek to avoid this inequitable result.

This noncompensatory wealth transfer would simultaneously fix the perverse incentives of insurers and increase the tendency for the insurable interest doctrine to ensnare policyholders - solving one problem while inflaming another. Insurers would be indifferent to the presence of an insurable interest, while unsophisticated policyholders would continue to suffer from their lack of information about the intricacies of the insurable interest doctrine. The trap for the unwary would remain, the difference simply being that the third party's estate would collect the spoils. The inherent ambiguity in the insurable interest doctrine would generate a litigation bonanza for third-party estates. Moreover, well-informed policyholders who anticipate the possibility of litigation would likely avoid any contracts involving uncertain insurable interests. In these cases, the insurable interest doctrine [*504] would inefficiently overdeter. Meanwhile, the perhaps larger group of uninformed policyholders would continue to purchase insurance policies at a higher price than they would be willing to pay with more information. In sum, third-party standing fixes the insurable interest doctrine's most grievous problem - the tendency to undermine its own purpose of preventing moral hazard - while exacerbating the doctrine's other problems.

V. A RADICAL SUGGESTION

I have shown the insurable interest doctrine's unintended consequences, and I have considered how efforts to tinker with the doctrine fail to wholly fix the doctrine's flaws. It is worth considering, then, whether we might be better off eliminating the doctrine altogether. This remains a radical suggestion, given the doctrine's ancient provenance and exalted status. Yet, it deserves serious consideration. Although we should not expect any legal doctrine to operate flawlessly, our task remains a comparative one: does the insurable interest doctrine work better or worse than the unregulated market it seeks to replace? This Part argues that the market would work better. Insurers have both the incentive and the ability to avoid moral hazard on their own, and insurers will likely do a better job of reducing moral hazard than courts. Hence, the best way to advance the purpose of the insurable interest doctrine may simply be to get rid of it.

To understand the incentives at play in the insurance market, one needs a rudimentary understanding of how insurance works and why insurers have an interest in reducing moral hazard themselves. Insurance is a mechanism for shifting and reducing the uncertainty of probabilistic loss. An insurance company's customers pay a set premium in exchange for the company's promise to pay compensation if a loss occurs. Moreover, the amount of the premium paid will be set equal to the expected value of the loss, plus administrative costs. Consumers thus trade risk for certainty - predictable premiums and compensation instead of worry about whether future loss might occur. n94 Why would an insurer want to purchase risk, and how can the insurer profit from it? This purchase may initially seem like gambling, but it is not. If consumers simply lent their money to a gambler, they would receive no certainty that the gambler would have enough money to pay in the event of a loss. Unlike a gambler, an insurance company profits by acquiring the risk

of its consumer, converting this raw risk into certainty, and then selling the [*505] certainty back to the consumer in the form of premiums that equal the expected cost of payouts. The insurer acquires the consumer's risk, not simply as a gamble, but because the insurer is better than the consumer at reducing it. In this way, one can think of an insurance company as acting like a factory in the manufacturing business, where the product it manufactures is certainty.

The insurance company uses two key mechanisms to turn risk into certainty - aggregation and segregation. First, the insurance company aggregates a large number of uncorrelated (i.e., statistically independent) risks together. This process takes advantage of the law of large numbers, which holds that the distribution of probabilities clusters around the mean as the size of a sample increases. In other words, what seems random and risky in an individual case can become predictable in the aggregate. It might be difficult for me to know the odds of my particular house burning down, but an insurance company can much more easily and accurately predict the odds of thousands of houses burning down each year.

Despite aggregation, however, people pose varying levels of risk depending on their circumstances. An insurance company can use aggregation to predict reliably the probability of loss for a group of aggregated risks, but it would face a problem known as "adverse selection" if it charged every consumer premiums based on the average risk of the aggregated group. Low-risk people whose individual risk fell below the average would pay more in premiums than their individual probability of loss; high-risk people above the average would pay less. If the disparity between the premiums paid and the risk level of low-risk people becomes too great, these people will drop out of the risk pool. n95 Hence, as one scholar has put it, "insurers are competing over the relatively low-risk insureds of any risk pool, who are likely to select that insurer most precisely able to price the risk the insured brings to the pool." n96 With adverse selection, the insurance company would not be able to give its low-risk customers the certainty they demand because it would not be able to charge them premiums equal to their expected loss. In other words, the insurance company would have manufactured certainty in the aggregate, but it could not provide this certainty to individual customers. Hence, in order to refine this aggregate certainty into individual certainty, insurance companies employ a mechanism called "segregation." Insurers segregate higher and lower risks into narrowly defined risk pools, thus reducing the range of risks contained in any one pool. The closer low-risk people are to the average risk of the pool, the less tendency [*506] there will be for adverse selection. Accordingly, insurance companies best provide certainty to their low-risk customers by setting premiums as closely as possible to the probability of loss for the low-risk members of the pool. Aggregation and segregation together help produce this certainty.

Turning to the matter of moral hazard, if we think of an insurance company as a factory that manufactures certainty, we can think of moral hazard as a wrench thrown into the machinery. Moral hazard is commonly defined as the tendency for an insured party to take less care to avoid an insured loss than the party would have taken if the loss had not been insured, or even to act intentionally to bring about that loss. n97 Moral hazard thus puts upward pressure on the risk of loss for any given risk pool and threatens to cause adverse selection as those insureds most susceptible to moral hazard increase the risk of the pool. To prevent adverse selection effectively, insurers must pursue two strategies. First, they try to skim insureds with high risks of moral hazard out of the risk pool and segregate them into higher-risk pools with higher premiums. This effectively forces insureds to internalize the risk of moral hazard by paying premiums equal to the expected cost of the loss plus the cost of moral hazard. In this situation, the insured does not gain from her moral hazard since she pays for the cost of it. Alternatively, if the insurer cannot effectively segregate out of the risk pool those at higher risk of moral hazard, the insurer will do everything possible to reduce the moral hazard itself. Rather than passing on the cost of moral hazard to the insured, the insurer will bear the cost by way of adverse selection. Insurance companies use a number of devices to reduce moral hazard, including deductibles, coinsurance, coverage limits, and coverage exclusions. n98

Insurance companies thus make their money by manufacturing and selling certainty, and their ability to compete in the market for certainty depends on their ability to reduce or internalize moral hazard. The more successfully they do so, the more profitable they will be. Most observers agree that insurance companies have a powerful incentive on their own to control moral hazard. n99 If insurers are obliged to pay out when losses occur, insurance companies will internalize the cost of moral hazard - even where that cost falls on third [*507] parties. n100 This concern for moral hazard

explains many common insurer practices that have arisen not from judicial imposition, but rather from the insurance market itself. For example, many life insurance policies contain a suicide exclusion, denying payouts for death by suicide for the first two years of coverage.ⁿ¹⁰¹ Many insurers reduce fire insurance premiums for homes with smoke alarms. Property insurance often requires deductibles. And so on.

The insurable interest doctrine is ordinarily justified on the ground that it prevents a negative externality, namely the risk to third parties caused by the insurance policy's moral hazard. Hence, one might argue that even if the insurable interest doctrine works imperfectly it still offers some worthwhile protection to third parties that they would not receive in the doctrine's absence. However, there is reason to think that third parties might be better off without the doctrine. As demonstrated in Part III, the net consequence of the ambiguous insurable interest doctrine may be to increase, rather than reduce, the total amount of moral hazard externalized upon third parties. At the same time as the doctrine deters potentially hazardous insurance contracts where there is clearly no insurable interest, it encourages potentially hazardous insurance contracts where the existence of an insurable interest is less certain. But even assuming that clear cases predominate over unclear cases, the insurer's own incentive to reduce moral hazard is likely to offer at least as much protection when lack of insurable interest is clear and moral hazard is high. If this is the case, third parties are better off without the insurable interest doctrine and the offsetting moral hazard costs that doctrinal ambiguity creates.

The insurer's incentive to reduce moral hazard protects third parties by ensuring that policyholders either internalize the risk to third parties or do not receive coverage on high-risk policies at all. As the preceding discussion illustrates, an insurance company, in the absence of the insurable interest doctrine, could potentially issue a risky policy on the life or property of a third party. But it will only do so if it can segregate such a policy into a risk pool with high premiums that compensate for the high risk of loss. These high premiums force policyholders to internalize the moral hazard cost and make the purchase of such high-risk policies unattractive. Alternatively, if an insurance company [*508] cannot adequately segregate such high-risk policies and thereby effectively internalize the risk of moral hazard, it will simply deny coverage.

If, as this Note has argued, insurers' incentives naturally align with the insurable interest requirement's policy of reducing moral hazard, then the only remaining question involves the relative capacities of courts and insurers to effectively further this goal. Courts fare poorly in this reckoning, applying inconsistent and unpredictable rules, creating perverse incentives, fostering unfair exploitation, and breeding inefficiency. The transaction costs of litigation and judicial enforcement add additional problems for courts. The insurable interest doctrine functions analogously to a sort of ill-defined coverage exclusion - albeit one drawn up *ex post*. Courts have no particular expertise in assessing degrees of risk. In fact, the inconsistent state of the insurable interest doctrine suggests that judges are not well-equipped to think in probabilistic terms. Attempting to convert the probabilistic notion of moral hazard into an abstract, binary rule about "insurable interest" inevitably spawns a tangle of smaller rules, standards, and exceptions that bear at best a convoluted connection to the original notion of moral hazard. Courts have no rigorous way of assessing whether "insurable interest" - by which I mean the bloated doctrinal apparatus constructed to define the term - is in fact the best proxy for moral hazard. Perhaps other, less abstract proxies could be found to do the job better. However, if judges continue to apply the insurable interest doctrine, we will never know. "Insurable interest" is the rule, and judges get paid to follow rules.

Insurers, however, do not get paid simply to follow rules. They get paid to reduce uncertainty by assessing risk. In setting premiums and segregating risk pools, insurers have become experts at doing exactly what the insurable interest requirement asks judges to do - identify and avoid intolerable levels of risk. Indeed, this task, which includes the effort to reduce moral hazard, amounts to the very *raison d'être* for insurance underwriters in the first place. Insurance companies collect large amounts of data on probabilities of loss, and they remain in the best position to tease out the most effective proxies for risk of loss due to moral hazard. Unlike judges, insurers think in probabilistic terms, and are best able to act on judgments of probability once made. There is, perhaps, one simple reason why insurers have not yet done more to find better proxies to reduce moral hazard in third-party contracts: as long as the insurable interest doctrine exists, insurers do not have to. As this Note has argued, the doctrine subsidizes risky third-party contracts, reducing the need for insurers to worry about moral hazard at all. In a most perverse irony, the insurable interest

doctrine has thus been paying insurers not to do their job.

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CONCLUSION

Nobody would claim that the insurance market, or any market, functions perfectly. Indeed, there are areas in which the market legitimately calls out for regulation. In those areas, the law's "traffic policeman" may play a vital role. Here, however, we have seen a different side of the traffic policeman. When it comes to the insurable interest doctrine, he looks a bit more like a hapless busybody. Although the insurable interest doctrine seems to make sense at first glance, it may not survive its own inherent ambiguity. As a result, the doctrine generates perverse incentives that undermine its own purpose, creates an opportunity for insurers to take advantage of policyholders, and generally reduces the efficiency of the insurance market. Moreover, efforts to alter the doctrine do not entirely resolve the difficulties, and the insurance market has substantial incentives to further the purposes of the doctrine on its own. In light of this, the radical suggestion to jettison the doctrine may not be so outlandish after all. At the very least, it makes clear that we ought to begin rethinking a doctrine that has been taken for granted for a very long time.

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Legal Topics:

For related research and practice materials, see the following legal topics:

Insurance LawLife InsuranceInsurable InterestsExpectation of Pecuniary AdvantageInsurance LawLife InsuranceInsurable InterestsWager ContractsInsurance LawProperty InsuranceInsurable Interests

FOOTNOTES:

n1. Nikolai Gogol, *Dead Souls* (David Magarshack trans., Penguin Books 1961) (1842).

n2. *Id.* at 45.

n3. See Susan Lorde Martin, *Corporate-Owned Life Insurance: Another Financial Scheme that Takes Advantage of Employees and Shareholders*, 58 U. Miami L. Rev. 653 (2004); see also Ellen E. Schultz & Theo Francis, *Worker Dies, Firm Profits - Why? Many Companies Insure Staff, Yielding Benefits on Taxes*, *Bottom Line*, Wall St. J., Apr. 19, 2002, at A1.

n4. See Charles Duhigg, *Late in Life, Finding a Bonanza in Life Insurance*, N.Y. Times, Dec. 17, 2006, at A1.

n5. Charity Rush, *Comment, Corporate-Owned Life Insurance (a/k/a "Dead Peasant" or "Dead Janitor")*

Policies): Has Texas Buried the Insurable Interest Requirement?, 41 Hous. L. Rev. 135, 136 (2004).

n6. Duhigg, *supra* note 4.

n7. See *infra* notes 17-26 and accompanying text.

n8. Friedrich Kessler, Grant Gilmore & Anthony T. Kronman, *Contracts: Cases and Materials* 627 (3d ed. 1986).

n9. Morton J. Horwitz, *The Transformation of American Law, 1780-1860*, at 237 (1977) (discussing the views of a nineteenth-century insurance treatise author).

n10. The insurable interest doctrine has garnered the most attention in the context of controversial "corporate-owned life insurance" policies, with scholars arguing that the insurable interest requirement should be used to prevent companies from purchasing policies on the lives of their employees. See Michael J. Henke, *Corporate-Owned Life Insurance Meets the Texas Insurable Interest Requirement: A Train Wreck in Progress*, 55 *Baylor L. Rev.* 51 (2003); Martin, *supra* note 3; Rush, *supra* note 5. Two scholars have undertaken economic analysis of the insurable interest doctrine, but their analyses defend rather than criticize the doctrine. See Samuel A. Rea, Jr., *The Economics of Insurance Law*, 13 *Int'l Rev. L. & Econ.* 145 (1993); George Steven Swan, *The Law and Economics of Company-Owned Life Insurance (COLI): Winn-Dixie Stores, Inc. v. Commissioner of Internal Revenue*, 27 *S. Ill. U. L.J.* 357 (2003). To the extent scholars have critiqued the insurable interest doctrine at all, they have merely lamented the doctrine's ambiguity or argued for a particular change in the substance of the doctrine as applied in particular instances. See, e.g., Franklin L. Best, Jr., *Defining Insurable Interests in Lives*, 22 *Tort & Ins. L.J.* 104 (1986); Emeric Fischer, *The Rule of Insurable Interest and the Principle of Indemnity: Are They Measures of Damages in Property Insurance?*, 56 *Ind. L.J.* 445 (1981); Bertram Harnett & John V. Thornton, *Insurable Interest in Property: A Socio-Economic Reevaluation of a Legal Concept*, 48 *Colum. L. Rev.* 1162 (1948); Edwin W. Patterson, *Insurable Interest in Life*, 18 *Colum. L. Rev.* 381 (1918); Peter Nash Swisher, *The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 *Drake L. Rev.* 477 (2005); Note, *Castle Cars, Inc. v. United States Fire Insurance Co.: The Bona Fide Purchaser's Insurable Interest in Stolen Property*, 68 *Va. L. Rev.* 651 (1982).

n11. Harnett & Thornton, *supra* note 10, at 1163.

n12. See Frederick H. Cooke, *The Law of Life Insurance* § 58, at 91 n.1 (New York, Baker, Voorhis & Co. 1891) (listing cases) ("It is worthy of note that the doctrine, though commonly supposed to be a common law doctrine, is not, viewed in the light of its origin, a common law doctrine at all ...").

n13. Act of 1746, 19 Geo. 2, c. 37, § 1 (Eng.).

n14. *Id.*

n15. Act of 1774, 14 Geo. 3, c. 48, § 1 (Eng.).

n16. *Id.*; see also Act of 1746 § 1 (referring to "a mischievous kind of ... wagering").

n17. Act of 1746 § 1.

n18. In both single-party and third-party situations, moral hazard may include not only the risk of loss due to carelessness, but also risk due to fraud or other willful actions.

n19. See Swan, *supra* note 10, at 379-80.

n20. *Lord v. Dall*, 12 Mass. (11 Tyng) 115 (1815).

n21. *Warnock v. Davis*, 104 U.S. 775, 779 (1881).

n22. Roy Kreitner, *Speculations of Contract, or How Contract Law Stopped Worrying and Learned To Love Risk*, 100 Colum. L. Rev. 1096, 1121 (2000). The presence of an insurable interest makes such contracts differ only in this respect: insurance compensates for loss, i.e., the lost interest; wagering seeks a pure "windfall" gain.

Yet one quickly sees the circularity of this distinction. It defines wagering contracts as those lacking insurable interest, and thus not compensatory, but it does not explain why we should care whether or not a contract is compensatory. It thus merely restates the insurable interest requirement without justifying it. Naturally, then, the search for such justification collapses into the more substantial concern of moral hazard. A better way to distinguish insurance from wagering would emphasize the fact that insurance contracts aim to reduce overall risk, rather than merely allocate it. See *infra* notes 94-96 and accompanying text (discussing aggregation and segregation mechanisms for reducing risk). This better distinction, however, does not necessarily require an insurable interest. See *infra* Part V.

n23. *Grigsby v. Russell*, 222 U.S. 149, 154-55 (1911).

n24. *Kreitner*, *supra* note 22, at 1123. The primary cause of this shift probably involved the difficulty of analytically distinguishing insurance from wagering. The distinction simply could not be sustained in a meaningful way. See *supra* note 22 and accompanying text. Additionally, however, the shift likely reflected growing toleration of financial speculation (i.e., "wagering") as well as a growing acceptance of insurance as a legitimate means of savings and investment. *Kreitner* has noted that "the connection between gambling and insurance had at one time threatened the insurance industry directly by contaminating insurance, labeling it an illegitimate and destructive social force." *Kreitner*, *supra* note 22, at 1115. In order to legitimize insurance, advocates had to persuade people that insurance did not involve morally illicit "wagering," and the insurable interest doctrine was a means of avoiding the label. Yet, as insurance became more respectable and speculation became more tolerable, the need for this semantic game dissipated. Chronicling this shift, *Kreitner* concludes that today "the normative question of the legitimacy of specific types of transactions is not played out by arguing over whether they are gambling (everyone is willing to admit they are), but rather, is displaced into the question of how they should be regulated" *Id.* at 1137. The modern focus on moral hazard thus reflects this modern question.

n25. See, e.g., *Getchell v. Mercantile & Mfr.'s Mut. Fire Ins. Co.*, 83 A. 801, 802 (Me. 1912) ("A. should not be allowed to insure for his own benefit B.'s property in which A. has no concern, and by the loss of which A. would not be directly and financially affected. To hold otherwise would be to increase the moral hazard and to permit one man to profit by the losses of another."), quoted with approval in *Tischendorf v. Lynn Mut. Fire Ins. Co.*, 208 N.W. 917, 920 (Wis. 1926); see also *Teague-Strebeck Motors, Inc. v. Chrysler Ins. Co.*, 1999-NMCA-109, P 29, 127 N.M. 603, 985 P.2d 1183, 1193 ("Given current societal attitudes toward gambling, the moral-hazard concern appears to be the stronger peg on which to hang the insurable-interest doctrine today.").

n26. Kenneth S. Abraham, *Insurance Law and Regulation* 201 (4th ed. 2005).

n27. *Harnett & Thornton*, *supra* note 10, at 1163.

n28. *Warnock v. Davis*, 104 U.S. 775, 779 (1881).

n29. *Swisher*, supra note 10, at 498-99; see also, e.g., *Dixon v. W. Union Assurance Co.*, 164 S.E.2d 214, 218-19 (S.C. 1968) (noting that a parent has an insurable interest in a son); *Tromp v. Nat'l Reserve Life Ins. Co.*, 53 P.2d 831, 833 (Kan. 1936) (noting that a wife has an insurable interest in a husband).

n30. See *Swisher*, supra note 10, at 499.

n31. *Id.* at 500-01.

n32. Older precedents hold that a fiancée has a love and affection interest. See *Green v. Sw. Voluntary Ass'n*, 20 S.E.2d 694, 696-97 (Va. 1942) (holding that a fiancée has an insurable interest in the life of the insured). However, the premise of these old cases has since been undermined by modern abolition of actions for breach of promise to marry. See *Swisher*, supra note 10, at 508-10 (discussing the evolution and characterizing the older precedents as "archaic").

n33. See *Rakestraw v. City of Cincinnati*, 44 N.E.2d 278, 280-82 (Ohio Ct. App. 1942) (concluding that a girlfriend has an interest in a live-in boyfriend, but mostly on account of her financial dependence); 3 Lee R. Russ & Thomas F. Segalla, *Couch on Insurance* § 43:23, at 43-27 (3d ed. 1995) ("There must be indices of sufficient closeness between the two so that it can be said that the beneficiary has an interest in the continued life of the insured.").

n34. The issue of insurable interest for same-sex couples, even if sanctioned by civil unions, remains "largely unresolved." *Swisher*, supra note 10, at 507-08.

n35. Insurable interest in this instance usually requires some kind of special economic circumstances. See Carol Schultz Vento, Annotation, *Insurable Interest of Foster Child or Stepchild in Life of Foster or Step Parent, or Vice Versa*, 35 A.L.R.5th 781 (1996).

n36. See Carl T. Drechsler, Annotation, Insurable Interest of Brother or Sister in Life of Sibling, 60 A.L.R.3d 98, 113-15, 118-20 (1974). Compare *Century Life Ins. Co. v. Custer*, 10 S.W.2d 882 (Ark. 1928) (finding brother's affection for his brother sufficient to establish insurable interest), with *Lewis v. Phoenix Mut. Life Ins. Co.*, 39 Conn. 100 (1872) (finding brother's affection insufficient).

n37. *Rubenstein v. Mut. Life Ins. Co. of N.Y.*, 584 F. Supp. 272, 278 (E.D. La. 1984).

n38. See Ferdinand S. Tinio, Annotation, Insurance on Life of Partner as Partnership Asset, 56 A.L.R.3d 892 (1974).

n39. See, e.g., *Block v. Mylish*, 41 A.2d 731, 735 (Pa. 1945) (requiring "reasonable ground ... to expect some [pecuniary] benefit or advantage from the continuance of the life of the assured" (quoting *Warnock v. Davis*, 104 U.S. 755, 779 (1881))).

n40. Compare *Atkins v. Cotter*, 224 S.W. 624, 626 (Ark. 1920) (finding that insurable interest survives dissolution of a partnership), with *Stillwagoner v. Travelers Ins. Co.*, 979 S.W.2d 354, 359 (Tex. App. 1998) (holding "that insurable interest does not survive the relationship that created it").

n41. *Russ & Segalla*, supra note 33, § 43:13, at 43-16; see also *Mayo v. Hartford Life Ins. Co.*, 220 F. Supp. 2d 794 (S.D. Tex. 2002) (finding that Wal-Mart had no insurable interest in its rank-and-file employees).

n42. William R. Vance & Buist M. Anderson, *Handbook of the Law of Insurance* § 32, at 201 (3d ed. 1951).

n43. Swisher, supra note 10, at 521-22.

n44. See *id.* at 523-24 (noting, but criticizing, the majority rule that an insurable interest need only exist at the inception of the contract).

n45. See, e.g., *Stillwagoner v. Travelers Ins. Co.*, 979 S.W.2d 354, 359 (Tex. App. 1998) (holding that "insurable interest does not survive the relationship that created it"). This approach also finds favor with academic commentators. See Swisher, *supra* note 10, at 523-31.

n46. Compare *Le Cras v. Hughes*, (1782) 99 Eng. Rep. 549 (K.B.) (applying "factual expectation" test), with *Lucena v. Craufurd*, (1805) 127 Eng. Rep. 630 (H.L.) (applying "legal interest" test).

n47. See *Delk v. Markel Am. Ins. Co.*, 81 P.3d 629, 636 (Okla. 2003) (adopting the "factual expectations" test, but observing that American jurisdictions "are divided" on which test to use).

n48. John F. Dobbyn, *Insurance Law in a Nutshell* 82 (3d ed. 1996).

n49. See, e.g., N.Y. Ins. Law § 3401 (McKinney 2007).

n50. See Russ & Segalla, *supra* note 33, § 42:1, at 42-5 ("The resolution of an insurable interest dispute will turn on specific and unique facts as they pertain to the particular relationship. A single fact can alter whether one party to the relationship has an insurable interest.").

n51. Robert E. Keeton & Alan I. Widiss, *Insurance Law* § 3.1(a), at 135 (1988) ("Almost all types of insurance are designed to provide no more than reimbursement for an insured... . The concept that insurance contracts shall confer a benefit no greater in value than the loss suffered by an insured is usually referred to as the "principle of indemnity.").

n52. See Fischer, *supra* note 10, at 462-66 (discussing three different methods of valuation used by judges).

n53. See, e.g., *Cecil v. Nationwide Ins. Co.*, No. 83-966, 1984 U.S. Dist. LEXIS 23209, at 4 (W.D. Pa. Sept. 28, 1984) ("The law of Pennsylvania in this area is somewhat confused, and there appears to be no clear statement in the cases as to which theory governs in Pennsylvania.").

n54. Best, *supra* note 10, at 112.

n55. Cooke, *supra* note 12, § 58, at 90.

n56. Patterson, *supra* note 10, at 381-82.

n57. Harnett & Thornton, *supra* note 10, at 1164.

n58. Best, *supra* note 10, at 106.

n59. *Loomis v. Eagle Life & Health Ins. Co.*, 72 Mass. (6 Gray) 396, 399 (1856).

n60. Harnett & Thornton, *supra* note 10, at 1182-83.

n61. The term "third-party insurance" is often used to refer to liability insurance. This Note, however, uses the term more broadly to describe any insurance policy under which one person is entitled to receive payouts upon the death of another person (i.e., the third party), or the destruction of another person's property. This is the situation in which the insurable interest requirement becomes relevant.

n62. Compare, e.g., *Am. Mut. Life Ins. Co. v. Mead*, 79 N.E. 526 (Ind. App. 1906) (refusing disgorgement of premiums), with *Commonwealth Life Ins. Co. v. George*, 28 So. 2d 910 (Ala. 1947) (permitting disgorgement of premiums). See generally Keeton & Widiss, *supra* note 51, § 3.3(d), at 160-62 (discussing the issue and noting "relatively few judicial decisions" on the question).

n63. In order to simplify the analysis, I put aside transaction costs, such as the costs of litigation. Litigation costs would raise the cost to the insurer of invalidating an insurance contract for lack of insurable interest. However, contracts with questionable insurable interests would still remain more valuable to the insurer than contracts with clear insurable interests so long as the reduction in the contract's expected cost (due to the

prospect of invalidation) is positive, even taking into account the expected cost of litigation. Moreover, even where the insurer's litigation costs may exceed the benefits to be gained by challenging the contract, litigation costs will also raise the cost to the beneficiary of enforcing such contracts. Hence, even where litigation costs are great, the parties are likely to settle, and the amount of the settlement is likely to be less than the full value of the contract.

n64. Discussing the implications of uncertainty in a different context, one scholar has explained that "uncertainty occurs whenever people cannot be sure what legal consequences will attach to each of their possible courses of action." John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 Va. L. Rev. 965, 968 (1984). Hence, in an uncertain situation, "from the [potential litigant's] point of view the rule of law is that distribution of probabilities." *Id.* at 970.

n65. If one posits a perfectly competitive insurance market, the incentive for insurers to overinsure may diminish somewhat. In such a situation, the insurer's gain from the potential invalidation of the insurance contract would be passed along to insurance purchasers in the form of lower premiums. Insurers may not capture the full value of the subsidy, and their incentives to overinsure may thus be reduced. However, this objection probably does not go very far for two reasons. First, the underlying assumption of a perfectly competitive insurance market is highly unrealistic. Courts and commentators have long observed significant information asymmetries between insurers and purchasers in the insurance market, and such asymmetries make it possible for the insurer to capture a significant amount of the subsidy. See *infra* notes 75-77 and accompanying text. Although even consumers who do not understand the terms of an insurance contract have good information about the contract's price, the competitiveness of the insurance market may still be limited by consumer search costs and by tacit collusion. Second, even under the unlikely assumption that the insurer passes the entire subsidy on to the policyholder, the insurable interest requirement would have a neutral effect at best. Insurers would be indifferent to the absence of insurable interest, but they would still not be averse to it. Hence, even if it did not actively encourage moral hazard, the doctrine would still fail to discourage it.

n66. See *infra* Part V.

n67. See *infra* notes 85-88 and accompanying text.

n68. Undermining the traditional economic justification for the insurable interest requirement, this phenomenon supports the theory that "when [the certainty] assumption is abandoned ... many traditional conclusions of the law-and-economics literature can no longer be defended on economic grounds." Calfee & Craswell, *supra* note 64, at 965-66. It also casts doubt on the more general economic justification for striking down contracts as against public policy. Dismissing the objection that the potential for contract invalidation creates incentives for sophisticated parties to make unenforceable contracts with ignorant parties, one scholar notes that "courts can mitigate this behavior ... by allowing damages against parties that knew or should have

known better." Note, A Law and Economics Look at Contracts Against Public Policy, 119 Harv. L. Rev. 1445, 1460 (2006). Uncertainty makes it impossible to know better.

n69. See *supra* notes 17-19 and accompanying text.

n70. Swisher, *supra* note 10, at 540.

n71. The New York Times stated that insurance executives worry that such practices "may cripple [the] industry," and noted that insurance companies have attempted to block such practices by raising the insurable interest doctrine to prevent payouts. Duhigg, *supra* note 4.

n72. See Ian Ayres, *Optional Law: The Structure of Legal Entitlements* (2005) (discussing how option theory can explain the structure of legal rights); see also Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 Colum. L. Rev. 1428 (2004) (applying option theory to contract remedies). The relationship between option theory and the invalidation of contracts as against public policy does not yet appear to have garnered scholarly attention. However, the discussion here builds on a useful recent article applying option theory to the interpretation of vague and indefinite contracts. See George S. Geis, *An Embedded Options Theory of Indefinite Contracts*, 90 Minn. L. Rev. 1664 (2006).

n73. Geis, *supra* note 72, at 1669-1703, 1669 n.21.

n74. Cf. *id.* at 1698 (noting how such an option differs from a conventional option).

n75. See James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 Ariz. St. L.J. 995, 1047 (1992) (noting a "general understanding that the average insurer is much more sophisticated and knowledgeable than the average insured"). Indeed, asymmetric information, caused by the fact that insurers are repeat players and insurance contracts are highly complex, has been one common justification for the rule that ambiguous terms in insurance contracts should be interpreted against the insurer. *Id.* at 1047-59.

n76. See *id.* at 1047 n.201 ("The insured's use of an attorney to review a proposed insurance contract is

unheard of at the level of consumer insurance contracts.").

n77. Geis, *supra* note 72, at 1704.

n78. One might argue that the policyholder need not understand the value of the contract's terms so long as she knows its price. In a perfectly competitive market, insurers would bid down the price until it reflected the actual low value of the contract given its dubiously enforceable terms. There are two problems with this objection. First, consumer search costs and tacit collusion may still limit the competitiveness of the market. Second, even if price competition ensures that a policyholder gets what she pays for, imperfect information about contract terms would still mean that the policyholder does not get what she bargains for. The policyholder may pay a lower price for a policy that is worth less, but the policyholder's failure to realize that it is worth less will cause her to rely on the insurance to her detriment. Assuming that the insurance will cover the insured risk, the policyholder will not avail herself of insurance substitutes, such as savings and investment, to cover the unknown, uninsured risk. Hence, even with perfect price competition, the policyholder would incur this reliance cost.

n79. See *supra* text accompanying notes 55-59.

n80. See *supra* notes 46-48 and accompanying text.

n81. In an article whose title called for a "socio-economic reevaluation" of the "legal interest" test, two scholars worried that "legal rules will calcify and become divorced from basic social values." Harnett & Thornton, *supra* note 10, at 1162. They added: "In order to prevent this deterioration into a set of fixed and unyielding 'principles,' constant and vigilant reevaluation of concepts is necessary to enable legal concepts to keep pace with adjustments in external variables." *Id.*

n82. See generally Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 *Duke L.J.* 557, 569 (1992) ("[A] standard requires a prediction of how an enforcement authority will decide questions that are already answered in the case of a rule.").

n83. Cf. Carol M. Rose, *Crystals and Mud in Property Law*, 40 *Stan. L. Rev.* 577, 580 (1988) (observing the cyclical nature of common law shifts between standards and rules, the inevitable "blurring of clear and distinct property rules with the muddy doctrines of 'maybe or maybe not'" followed by "the reverse tendency to try to

clear up the blur with new crystalline rules").

n84. See Kaplow, *supra* note 82, at 590-93 (noting that the shift from standards to rules trades uncertainty for over-and underinclusiveness).

n85. This can be considered a stronger version of the controversial doctrine holding that insurers can be estopped from raising an insurable interest defense if they acted in some way that amounted to a waiver of the insurable interest requirement. See, e.g., *McGehee v. Farmers Ins. Co.*, 734 F.2d 1422 (10th Cir. 1984) (holding that knowledge of insurer amounts to waiver of insurable interest requirement). Many courts, however, refuse to apply waiver and estoppel doctrines to contracts against public policy. See, e.g., *Beard v. Am. Agency Life Ins. Co.*, 550 A.2d 677, 687-88 (Md. 1988); *Liverpool & London & Globe Ins. Co. v. Bolling*, 10 S.E.2d 518, 522 (Va. 1940); see also *Russ & Segalla*, *supra* note 33, § 41:7, at 41-15 ("The rule prevails in many jurisdictions that where a life insurance policy is void at its inception because the beneficiary lacks insurable interest, it cannot be rendered valid or enforceable by waiver or estoppel ...").

n86. See Roger C. Henderson, *The Tort of Bad Faith in First-Party Insurance Transactions: Refining the Standard of Culpability and Reformulating the Remedies by Statute*, 26 U. Mich. J.L. Reform 1, 26-30 (1992); see also Ben Kingree & Louise Tanner, *Life Insurance as Motive for Murder*, 29 Tort & Ins. L.J. 761, 764 (1994) (discussing cause of action against insurers for negligent issuance of insurance, where insurers "unreasonably imperil the lives of their insureds").

n87. Cf. *Christian v. Am. Home Assurance Co.*, 577 P.2d 899, 905 (Okla. 1977) ("We recognize that there can be disagreements between insurer and insured on a variety of matters such as insurable interest, extent of coverage, cause of loss, amount of loss, or breach of policy conditions.").

n88. *Anderson v. Cont'l Ins. Co.*, 271 N.W.2d 368, 376-77 (Wis. 1978).

n89. A negligence standard would be no better. Under even a negligence standard, an insurer's inability to predict that a court would find an insurable interest would likely be a sufficient defense. So long as there remains some uncertainty, it would be difficult to hold that a reasonable insurer should have known that an insurable interest did not exist.

n90. Texas has the most well-established system. See, e.g., *Mayo v. Hartford Life Ins. Co.*, 220 F. Supp. 2d

714, 784-85 (S.D. Tex. 2002); see also Rush, *supra* note 5, at 155-57 (explaining the mechanics of the Texas approach).

n91. See Robert H. Jerry, II, *Understanding Insurance Law* § 47[b], at 328 (3d ed. 2002); Keeton & Widiss, *supra* note 51, § 3.3(c)(1), at 156; Swisher, *supra* note 10, at 532-37.

n92. See, e.g., *Hicks' Estate v. Cary*, 52 N.W.2d 351 (Mich. 1952).

n93. See Swisher, *supra* note 10, at 532.

n94. Consumers generally value certainty because they are risk averse. See generally Robert Cooter & Thomas Ulen, *Law and Economics* 48-52 (5th ed. 2008) (explaining how risk aversion drives the demand for insurance).

n95. They can do this by switching to another insurer who can insure them for lower premiums, or by abandoning insurance in favor of other methods of risk avoidance. See *id.* at 65-67.

n96. George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 Yale L.J. 1521, 1545 (1987).

n97. Abraham, *supra* note 26, at 7.

n98. *Id.*

n99. See, e.g., *id.* ("Insurers attempt to combat ... moral hazard with a variety of devices."); Cooter & Ulen, *supra* note 94, at 53 ("Every insurer is aware of this [moral hazard] problem and has developed methods to minimize it."); George L. Priest, *Insurability and Punitive Damages*, 40 Ala. L. Rev. 1009, 1025 (1989) ("No one would contest that it is in the interest of an insurer (as well as of the society) for the insurer to encourage all feasible precautions to reduce the likelihood of unintended harm.").

n100. Cf. Priest, *supra* note 99, at 1023-26 (explaining why insurers, out of concern for moral hazard, exclude intentional action from liability insurance coverage).

n101. Although "omni-present," the exclusion is typically limited to two years. *Id.* at 1024 & n.56. It remains unclear whether this limitation arises from insurers' decision that two years is enough to control moral hazard, or instead from regulatory or judicial pressure to expand coverage. *Id.* at 1024 n.56.