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A Unified Theory of Insurance Risk

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A UNIFIED THEORY OF INSURANCE RISK

Leo P. Martinez *

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ABSTRACT

There exists a high degree of uncertainty as to the boundaries and role of risk in the framework of contract law. This uncertainty exists even in the context of insurance law where the subject of the contract is necessarily the commodity of risk. While risk has been probed and examined as a matter of business strategy by several prominent studies and by experts who have catalogued human thought regarding risk, risk has not been the subject of systematic examination in the legal sphere. What follows is a reexamination of how we deal with the concept of risk within insurance law. My aim is to show that an insured's behavior, the notion of risk, and basic insurance law doctrine are all related.

I begin by analyzing how general contract law has handled risk and note the limitations of contract law as applied to insurance due to its core: risk. Next, I examine the essence of the insurance bargain by focusing on risk as a commodity, and look at insurance risk in light of basic contract principles. Because describing risk as a commodity is of little value without understanding what risk is, I then discuss what risk means in the insurance context and what it does not mean. This illuminates both the role of risk and the role of the insured in the insurance bargain. Lastly I use the role of the insured and the notion of risk as a commodity to explain how several insurance law doctrines can be traced to and explained by fundamental principles of contract law. Relying on these principles, the examination will show that an insured's ability to alter the risk calculus made by the insurer should, as a matter of contract law, have consequences.

INTRODUCTION

It is an axiom of insurance law that an insurance policy provides coverage for *risk* of loss. Despite this premise, there exists a high degree of uncertainty as to the boundaries and role of risk in the framework of insurance law.¹ This uncertainty has been probed and examined as a matter of business strategy by several prominent studies and by experts who have catalogued human thought regarding risk.² Risk has not, however, been the subject of systematic examination in the legal sphere. Indeed, risk is imperfectly expressed in statute,³ case law,⁴ and policy language.⁵

My modest aim is to reexamine how we deal with the concept of risk within insurance law. I begin by analyzing how general contract law has handled risk and note the limitations of contract law as applied to insurance due to its core: risk. Next, I examine the essence of an insurance bargain by focusing on risk as a commodity and look at insurance risk in light of basic contract principles. My characterization of risk as a commodity is merely a shorthand description for a contract that has, as a primary component, the assumption of risk by the other party. Because describing risk as a commodity is of little value without understanding what risk is, I then discuss what risk means in the insurance context and what it does not mean. This serves to illuminate both the role of risk and the role of the insured in the insurance bargain. Lastly, I use the role of the insured and the notion of risk as a commodity to explain how several insurance law doctrines can be traced to and explained by fundamental principles of contract law.

At its core, my examination will show that an insured's ability to alter the risk calculus made by the insurer should, as a matter of contract law, have consequences. Insurance policies are contracts which deal with the commodity of risk. Though it is a given that an insured has little flexibility in striking the insurance bargain because it is an adhesive agreement with set terms not to be tinkered with, the insured is nonetheless bound by the contract principle that requires a party to refrain from doing anything that would interfere with the other

¹ RICHARD V. ERICSON & AARON DOYLE, UNCERTAIN BUSINESS: RISK, INSURANCE, AND THE LIMITS OF KNOWLEDGE 5 (2004).

² *Id.*; PETER L. BERNSTEIN, AGAINST THE GODS (1996) (aptly subtitled *The Remarkable Story of Risk*).

³ See *infra* notes 45–49.

⁴ See *infra* notes 20–51.

⁵ See *infra* notes 43–44.

party's ability to obtain the benefit of that bargain. While this simple idea seldom finds voice in the literature or in cases, it serves to explain the bases of many core insurance concepts.

I. CONTRACT LAW AND RISK

In his influential work, *The Costs of Accidents: A Legal and Economic Analysis*, then Dean Guido Calabresi undertook a systematic examination of the effect of insurance on substantive tort law.⁶ This contribution has been much discussed in the past thirty years, and Calabresi's book was aptly the subject of a law review symposium several years ago.⁷ However, the effect of insurance law on substantive contract law and the effect of contract law on substantive insurance law are not given equal attention.⁸ The thrust of this paper is that contract law has been overlooked or at least forgotten in the formulation of basic insurance doctrines.⁹ This is not to suggest that the pro-insured doctrines extant are not justified as exceptions to the general application of contract law in the insurance context. After all, even sophisticated parties represented by counsel often lack the ability to bargain meaningfully about the terms of insurance policies.¹⁰ Rather, a focus on fundamental principles is useful to explain the underpinning of basic insurance law doctrines.

In laying out the contract law roots of selected insurance law doctrines in this article, my intent is not to describe a new theory of coverage defense for insurers. It is simply to explain in simple terms the contract law roots of common insurance law doctrines that seldom are the subject of critical examination.

⁶ GUIDO CALABRESI, *THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS* (1970).

⁷ Symposium, *Calabresi's The Costs of Accidents: A Generation of Impact on Law and Scholarship*, 64 MD. L. REV. 1 (2005).

⁸ Jeffrey W. Stempel, *The Insurance Policy as Thing*, 44 TORT TRIAL & INS. PRAC. L.J. 813, 869 n.1 (2009). Professor Jeffrey W. Stempel, a prominent insurance law scholar, has neatly cataloged the "insurance policy as contract" literature.

⁹ I argue that this is true in spite of the "traditional and dominant conception of insurance" as a contract transferring a risk of loss to a party in the business of selling such contracts. See Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653, 658 (2013).

¹⁰ *E.g.*, *Queen City Farms v. Cent. Nat'l Ins. Co.*, 882 P.2d 703, 712 (Wash. 1994) (citing *Boeing Co. v. Aetna Cas. & Sur. Co.*, 784 P.2d 507 (1990) (standard form insurance policies are interpreted "in accord with the understanding of the average purchaser even if the insured is a large corporation with company counsel"))).

Thus, I am not advocating a kind of textual hyper-literalism. Indeed, the inability of humans to express themselves with precision underlies much of contract law, and this article should not be viewed as an optimistic perspective about the ability of parties, no matter how sophisticated, to accurately and completely memorialize agreements. Excessive focus on the text can lead to incorrect or unfair results when measured against the contract as a whole. Instead, the contract law principles are used here as the background to trace back and explain common insurance law doctrines.

Similarly, insurance policies are and remain consumer contracts. Although individual consumers do not possess the same bargaining power over policy terms as in other contractual relationships, the insurance market itself can create more effective and protective, rather than exploitive, terms in the insurance policy.¹¹ If consumers are informed about the content of available policies, and act to maximize their coverage on the basis of that information, insurance companies generally have an incentive to draft efficient contracts even when individual assent is lacking.¹² Alternatively, “[i]f consumers are systematically uninformed about standard contract terms, or biased with regard to processing information about those terms, then insurance policies may indeed be exploitive in the absence of government intervention.”¹³ Professor Daniel Schwarcz suggests that the unique qualities of the insurance contract create a significant possibility that “comparatively small levels of imperfect consumer behavior can lead to inefficient policy terms,” and as a result, insureds are similarly vulnerable to exploitive contracts as in other consumer relationships.¹⁴

Finally, these observations apply to insureds who act within a reasonable zone of behavior. The behavior of an insured which increases risk beyond that assumed by an insurer should have consequences. For this reason, many policies include “increase in hazard” provisions to ensure that the insurer will only be liable for the risk it actually assumed in the contract.¹⁵ However, courts often police these provisions to ensure that they are not used to deny coverage to a policyholder who

¹¹ Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389, 1402 (2007).

¹² *Id.* at 1402–03.

¹³ *Id.* at 1403.

¹⁴ *Id.* at 1405.

¹⁵ See Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263, 1283 (2011).

has only moderately increased the risk of loss; many courts require a “substantial change of circumstances materially increasing the risk” for such provisions to be enforceable.¹⁶ Even though a policyholder’s negligence increases the risk of loss, it does not always do so enough to warrant adverse consequences for the policyholder. Indeed, many policies, including homeowners insurance, exist to cover losses that are the result of negligence.¹⁷ Absent increase in hazard provisions, the traditional insurance doctrines I outline become yet more important in policing adverse behavior by insureds.

To be sure, courts frequently recognize the congruence between insurance policies and contracts.¹⁸ At the same time, there is seldom much analysis that discusses the necessary consequences of this characterization as a matter of contract law.¹⁹ Indeed, the recognition that insurance policies are contracts is either directed to some necessary adjunct of contract law or to some undesirable aspect of contract law.

It is worth noting at the outset that as a discipline, contract law has been chary of risk. A significant body of contract law is devoted to the specific difficulty of dealing with risk and determining which party should bear the consequences of actualized risk. In this sense, risk is an undesirable consequence of dealing with other parties. Several historic cases support this thesis. These cases include *Raffles v. Wichelhaus* and *Hadley v. Baxendale* as well as the more modern *Aluminum Company of America (“ALCOA”) v. Essex Group*. These cases are discussed in turn.

In *Raffles v. Wichelhaus*,²⁰ a court was faced with the uncertainty created by the parties in their contract for the sale and purchase of cotton. The ambiguity stemmed from the fact that the cotton was to be shipped on a vessel named

¹⁶ *Id.* at 1284.

¹⁷ *Id.* at 1283.

¹⁸ *See, e.g., J.A. Brundage Plumbing & Roto-Rooter, Inc. v. Massachusetts Bay Ins. Co.*, 818 F. Supp. 553, 556 (W.D.N.Y. 1993), *vacated*, 153 F.R.D. 36 (W.D.N.Y. 1994); *Montrose Chemical Corp. v. Admiral Ins. Co.*, 913 P.2d 878, 888 (Cal. 1995).

¹⁹ Hazel Beh & Jeffrey W. Stempel, *Misclassifying the Insurance Policy: The Unforced Errors of Unilateral Contract Characterization*, 32 *CARDOZO L. REV.* 85 (2010) (Professor Stempel and Professor Hazel Beh, who is prominent in her own right, have examined the effect of the bilateral/unilateral distinction in contracts and its consequent effect on substantive insurance law. Theirs is a step in the right direction. Professors Beh and Stempel argue that the unilateral contract principle (the exchange of a promise for performance) has been misapplied in insurance law.).

²⁰ *Raffles v. Wichelhaus*, (1864) 159 Eng. Rep. 275 (Exch. Div.); 2 Hurl. & C. 906.

“Peerless.” Unbeknownst to the parties, there was more than one ship named “Peerless,” and during the two month difference in time in which the ships were to arrive in Liverpool, the price of cotton changed to the point that the contract offered a significant economic advantage to one party at the expense of the other.²¹ Because there was no basis for assigning the risk of the miscommunication on one party over the other, the contract was simply declared unenforceable.²² The unintended irony is that by declaring the contract unenforceable, the court effectively placed the risk of loss on the adversely affected party.

In *Hadley v. Baxendale*,²³ a mill operator sued a courier after the courier failed to promptly deliver a broken crank shaft to the manufacturer for repair. The mill operator claimed that because of the courier’s delay in making the delivery, his plant was forced to shut down for five days longer than would otherwise have been the case. As such, the mill operator sought recovery for lost profits. In determining a remedy, the court set forth the rule that recovery for damages is possible if either: (1) the damages arise naturally or within the contemplation of the parties, or (2) there were special circumstances that were communicated to the other party.²⁴ In finding that the mill owner could not recover damages for lost profits, the court reasoned that “such loss would neither have flowed naturally from the breach of this contract . . . nor were the special circumstances, which, perhaps, would have made it a reasonable and natural consequence of such breach of contract, communicated to or known by the defendants.”²⁵ The court was faced with deciding who was in a better position to assume the risk that accompanied the parties’ interaction and, ultimately it concluded that the mill operator was better suited to the task.

In *Aluminum Company of America (“ALCOA”) v. Essex Group*, ALCOA entered into a sixteen-year agreement with Essex to smelt Essex’s alumina, thereby converting the alumina into molten aluminum.²⁶ ALCOA hired then-economist

²¹ DOUGLAS G. BAIRD, *CONTRACTS STORIES* 34 (2007) (“There were reports of at least eleven ships called Peerless sailing the seven seas at the time, for the name was a popular one.”).

²² *Raffles*, 159 Eng. Rep. at 375.

²³ *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145 (Exch. Div.); 9 Ex. 341.

²⁴ *Id.* at 147.

²⁵ *Id.* at 151. Note that the facts of the case seem to contradict the application of the principle enunciated in the case. The text of the *Hadley v. Baxendale* decision suggests that the mill operator did in fact notify the courier that the shaft needed to be delivered immediately.

²⁶ *Aluminum Co. of America v. Essex Group, Inc.*, 499 F. Supp. 53, 57 (W.D. Pa. 1980).

Alan Greenspan to assist in creating a pricing formula for the agreement. Under Greenspan's guidance, a pricing mechanism was ultimately developed under which the price of aluminum was to be linked to three separate factors, one of them being ALCOA's production costs other than labor.²⁷ Unfortunately for ALCOA, the OPEC oil embargo occurred soon after, causing the price of energy—a component of the pricing mechanism—to increase precipitously. This resulted in losses to ALCOA of over \$75 million by the tenth year of the agreement.²⁸

In its decision, the court stated:

[W]here parties enter a contract in a state of conscious ignorance of the facts, they are deemed to risk the burden of having the facts turn out to be adverse, within very broad limits. Each party takes a calculated gamble in such a contract. Because information is often troublesome or costly to obtain, the law does not seek to discourage such contracts.²⁹

Surprisingly, however, the trial court went on to decide that because the parties had projected that profits would vary between one cent and seven cents per pound upon entering the contract, the price term should be reformed in order to ensure that ALCOA would earn no less than one cent per pound as profit.³⁰ Even an expert such as Alan Greenspan was unable to adequately deal with the risk inherent in entering into such an agreement.

In each of the preceding conventional cases, the uncertainty created by less than complete information was a problem to be dealt with as a matter of substantive contract law. The solution in each of the cases was to declare the contract unenforceable on its terms or, in the final example, to remake the contract on terms that were not agreed to by either party.³¹ As stated at the outset, courts frequently

²⁷ *Id.* at 58.

²⁸ *Id.* at 59.

²⁹ *Id.* at 68.

³⁰ *Id.* at 80.

³¹ The *ALCOA v. Essex* case serves as an example where reformation of a contract was preferable to forfeiture. The approach, in smoothing out what might otherwise be excessively adverse consequences of the seeming risk allocation of insurance policies, is a solution that suggests itself when the insured faces forfeiture (and insurer windfall) or the insurer faces major disruptions in its *ex ante* risk management calculus. While this is a foray that is perhaps better left to a subsequent examination, it at least provides the basis for further refinement.

recognize the congruence between insurance policies and contracts. Risk, the core of the insurance bargain, is an uncomfortable concept with which contract law wrangles.

II. THE INSURANCE BARGAIN

As much as contract law in general may wrestle with the element of risk, it is necessary to reorient the body of insurance law to the notion that an insurance policy is first and foremost a contract. While this approach has gained currency, it has largely escaped reflection and critique. Professor Susan Randall, one of the few scholars to tackle the topic, has recently undertaken a comprehensive critique of the proposition that insurance policies are contracts.³² She argues persuasively against the trend for two reasons: first, the trend ignores the fact that insurance policies are contracts of adhesion in which the insured has little bargaining power, and second, insurance policies are highly regulated which further relegates the notion of the insured's bargaining power to the absurd.³³ Professor Jeffrey Stempel also takes the same general approach in suggesting that an insurance policy, in addition to being a contract, is a social institution that affects risk management, deterrence, and compensation functions.³⁴

Although I largely agree with Professor Randall's and Professor Stempel's cogent analyses, in one sense they go too far. That is, an insured's freedom of action within the insurance bargain is such that contract law principles remain very much relevant despite the nature of the adhesive and heavily regulated insurance bargain. Accordingly, I begin with a focus on risk as a commodity and go on to explore its relationship, within the insurance bargain, to several common insurance law principles: the insurable interest requirement, the fortuity doctrine, the known loss principle, the intentional act exclusion, and moral hazard.

The insurance bargain, at its core, is a relatively simple one. The bargain between the policyholder and the insurer is one that explicitly involves risk.³⁵ To

³² Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. INS. L.J. 107 (2007).

³³ *Id.* at 107-08.

³⁴ See Tom Baker, *Risk, Insurance, and the Social Construction of Responsibility*, in TOM BAKER & JONATHAN SIMON, *EMBRACING RISK* 33, 35-36 (2002) (discussing insurance as a form of social responsibility); Jeffrey W. Stempel, *The Insurance Policy as Social Instrument and Social Institution*, 51 WM. & MARY L. REV. 1489 (2010); see Stempel, *supra* note 8 (discussing a products liability approach to insurance policies).

³⁵ As a starting point, I adopt Professor Abraham's definition of risk as "the possibility of injury or loss." KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY*

paraphrase the *Restatement Second of Contracts* section 1, an insurance policy is simply a set of promises for the breach of which the law gives a remedy, or for performance of which the law in some way recognizes an enforceable duty.³⁶ In particular, an insurance policy involves the exchange of a policyholder's payment of money in the form of premiums in return for an insurer's agreement to assume risk. This assumption of risk almost always involves the payment of money, subject to some agreement to cover the loss that might attend the risk.³⁷ As a result of this bargain, the policyholder pays a small amount in return for being insulated against some defined calamity, which would otherwise cause the policyholder a large loss. The insurer is able to make a profit by entering into similar bargains with other policyholders. Indeed, as Professor Kenneth Abraham describes, "[t]he very idea of insurance involves a group of individuals or entities in an indirect relationship, without any contract specifying the terms of that relationship."³⁸ If the covered peril occurs, the insurer is able to absorb any covered loss that might occur by effectively distributing the loss among the policyholders.³⁹ In the happy event that the covered peril does not occur, the insurer is free to keep the premiums without any expenditure to cover loss. The trick for insurers in all of this is to balance projected premium income, investment income, projected loss payments and actual loss payments. However, the risk involved in insurance often is not calculable except in hindsight, further contributing to the challenge of accurately determining the degree of risk assumed in a given insurance policy.⁴⁰ Moreover,

1-2 (1986). As will be seen, his simple formulation is easily up to the task of defining risk as a matter of contract law. See also Tom Baker, *The Shifting Terrain of Risk and Uncertainty on the Liability Insurance Field*, 60 DEPAUL L. REV. 521, 522 (2011) ("Insurance is an 'uncertain business,' characterized by competition for premiums that pushes insurers into the unknown.").

³⁶ See RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981).

³⁷ In the case of liability insurance, the insurer also generally pays the costs of defending the insured from suits brought by third parties. *Pekin Insurance Co. v. Wilson*, 237 Ill. 2d 446, 450-51; 930 N.E.2d 1011, 1014 (2010) (describing insurance policy's insuring clause with duty to indemnify and defend); *Aerojet-General Corp. v. Transport Indemnity Co.*, 17 Cal. 4th 38, 56-58, 70 Cal. Rptr. 2d 118, 128-29, 948 P.2d 909 (1997) (describing typical commercial general liability insurance policies); *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 272, 54 Cal. Rptr. 104, 109, 419 P.2d 168 (1966) (describing insurer's undertaking in a liability insurance policy); Douglas R. Richmond, *Liability Insurers' Right to Defend Their Insureds*, 35 CREIGHTON L. REV. 115 (2001) (explaining a liability insurer's duties to indemnify and defend).

³⁸ Abraham, *supra* note 9, at 656.

³⁹ ABRAHAM, *supra* note 35.

⁴⁰ Baker, *supra* note 35 ("[I]nsurance risks very often are not reliably calculable except in hindsight, at which point the risk has already been transformed into an all-too-measurable loss.").

“[e]ven as liability insurers develop technologies that would better predict the losses of a stable risk pool, competition reshapes companies’ risk pools, so that they operate just beyond the edge of their knowledge.”⁴¹ This is the science and art of underwriting and actuarial calculations.⁴²

This simple formulation of the insurance bargain masks the fact that insurance law has had an uneasy relationship with the concept of risk. Surprisingly, risk is a concept that finds no mention in the standard insurance policy. For example, of the six standard insurance forms issued by the non-profit Insurance Service Office, none contain a definition of “risk.”⁴³ Of the six forms, only one even contains the word “risk” and even that is a collateral reference apart from the basic insuring agreement.⁴⁴

Legislatures have shed little light on the subject of risk. For example, Connecticut’s General Statute section 10 provides:

“Insurance” means any agreement to pay a sum of money, provide services or any other thing of value on the happening of a particular event or contingency or to provide indemnity for loss in respect to a specified subject by specified perils in return for a consideration. In any contract of insurance, an insured shall have an interest which is subject to a risk of loss through destruction or impairment of that interest, which risk is assumed by the insurer and such assumption shall be

⁴¹ *Id.* at 538.

⁴² JEFFREY W. STEMPER, *LAW OF INSURANCE CONTRACT DISPUTES* § 1.05[a] (2d ed. 2002).

⁴³ These forms include: Commercial General Liability Coverage Form CG 00 01 07 98; Homeowners Policy Form 2—Broad Form HO 00 02 04 91; Homeowners Policy Form 3—Special Form HO 00 03 04 91; Personal Auto Policy Form PP 00 01 06 98; Boiler and Machinery Coverage Form BM 00 25 11 85; and Farm Property Coverage Form FP 00 10 01 87.

⁴⁴ That policy is the Homeowners Policy Form 3—Special Form HO 00 03 04 91 which defines the scope of Coverage A and Coverage B as follows:

Section I—Perils Insured Against
Coverage A—Dwelling and Coverage B—Other Structures
We insure against risk of direct loss to property described in Coverages A and B only if that loss is a physical loss to property.

Homeowners Policy Form 3—Special Form HO 00 03 04 91 at 6, available at <http://www.mullerinsurance.com/resources/Homeowners3SpecialForm.pdf> (emphasis added).

part of a general scheme to distribute losses among a large group of persons bearing similar risks in return for a ratable contribution or other consideration.⁴⁵

In a similarly long-winded fashion, the New York Code provides that:

[An] “[i]nsurance contract” means any agreement or other transaction whereby one party, the “insurer”, is obligated to confer benefit of pecuniary value upon another party, the “insured” or “beneficiary”, dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event.⁴⁶

California’s relevant statute is more succinct but less direct on what insurance risk actually is. Section 22 of the California Insurance Code defines insurance as “a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event.”⁴⁷ Case law supplies the missing ingredients. California courts have interpreted Insurance Code section 22 as requiring two elements: “(1) a risk of loss to which one party is subject and a shifting of that risk to another party; and (2) distribution of risk among similarly situated persons.”⁴⁸

The way California arrived at its case-supplemented definition is instructive. Recognizing that Insurance Code section 22 sets forth only the minimum requirements to establish that a transaction is insurance for the purposes of regulation, the California courts adopted the “principal object and purpose” test as a tool to determine whether a given transaction constitutes insurance or not.⁴⁹

The reason for this approach is that the statute is overbroad—it could include many arrangements that involve some aspect of risk shifting and yet are not commonly viewed as involving insurance. Put another way, the background is that all contracts have the capacity to shift risk to the other party but it does not follow

⁴⁵ CONN. GEN. STAT. § 38a-1(10) (2008).

⁴⁶ N.Y. INS. LAW § 1101(a)(1) (2008).

⁴⁷ CAL. INS. CODE § 22 (2008).

⁴⁸ *Truta v. Avis Rent A Car System, Inc.*, 238 Cal. Rptr. 806, 811 (Cal. Ct. App. 1987) (quoting *Metro. Life Ins. Co. v. State Bd. of Equalization*, 652 P.2d 426, 428 (Cal. 1982)).

⁴⁹ *Cal. Physicians’ Serv. v. Garrison*, 172 P.2d 4, 16 (Cal. 1946); *Truta*, 238 Cal. Rptr. at 811.

that all contracts are necessarily insurance. For example, in *Transportation Guarantee Co. v. Jellins*, the California Supreme Court held that a lessor's truck rental business does not amount to the business of insurance simply because the lessor is obligated to maintain the trucks and keep them in good operating order, thus shifting the risk from consumers to the rental company.⁵⁰

This theme has been consistently followed since the *Jellins* case. Indeed, California courts have been steadfast in this observation: the mere fact that the elements required under Insurance Code section 22 (risk shifting and risk distribution) are satisfied does not necessarily mean that an agreement constitutes insurance for the purposes of insurance regulation.⁵¹ For example, in *Truta v. Avis Rent A Car System, Inc.*, Avis leased automobiles under a contract by which lessees paid for a "collision damage waiver" ("CDW").⁵² The CDW provided that if a leased automobile was damaged, the lessee would not be responsible for the first \$1,000 of damage.⁵³ The plaintiff, Truta, alleged that the existence of the CDW meant that Avis was engaged in the business of insurance in California.⁵⁴ Although the court acknowledged that Avis' CDW might very well meet the risk shifting and risk distribution requirements of Insurance Code section 22, it did not follow that the CDW necessarily constituted insurance for the purposes of regulation.⁵⁵ Citing *Keeton on Insurance Law*, the court opined that insurance regulatory laws were not to be "properly construed as aimed at an absolute prohibition against the inclusion of any risk-transferring-and-distributing provisions . . . for the sale or rental of goods."⁵⁶ After affirming that California case law amply supported the use of the "principal object and purpose" test, the court concluded that

. . . [t]he principal object and purpose of the transaction before us, the element which gives the transaction its distinctive character, is the rental of an automobile. Peripheral to that primary object is an option, available to the lessee

⁵⁰ 174 P.2d 625, 631–32 (Cal. 1946).

⁵¹ See *Cates Constr., Inc. v. Talbot Partners*, 980 P.2d 407, 422–25 (Cal. 1999); *Truck Ins. Exch. v. Amoco Corp.*, 41 Cal. Rptr. 2d 551, 556 (Cal. Ct. App. 1995); *Truta*, 238 Cal. Rptr. at 811–12.

⁵² *Truta*, 238 Cal. Rptr. at 808.

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.* at 811.

⁵⁶ *Id.* (citing ROBERT E. KEETON, BASIC TEXT ON INSURANCE LAW § 8.2(c), at 552 (1st ed. 1971)).

for additional consideration, to reallocate the risk of loss (up to the sum of \$1,000) to the lessor in the event the vehicle sustains damage during the rental term.⁵⁷

Noting that the CDW did not involve indemnity of the lessee for damages to a third party, the *Truta* court also observed that there was no public interest to be protected.⁵⁸ That is, no person outside of the contractual relationship, an injured victim for example, was affected by the CDW. Accordingly, the court held that the leasing of automobiles, even with the CDW, did not constitute insurance for the purposes of statutory regulation.⁵⁹ This approach has survived as a key part of California insurance law.

Major insurance treatises today uniformly deal with the definition of insurance by resorting to this same principal object and purpose test.⁶⁰ The Appleman treatise provides the broadest definition of insurance, discussing three separate tests that are used to define this area of law. The first, the “substantial control test,” represents the traditional view. It incorporates five elements, which are (1) an insurable interest, (2) an insured event (the peril), (3) a risk transfer to the insurer, (4) distribution of risk by the insurer among a large group, and (5) payment of a premium—a consideration—to the insurer for the promise to assume the risk of loss.⁶¹ It most nearly resembles the California Insurance Code section 22 approach of focusing on risk shifting and risk distribution.

The Appleman treatise also covers what it describes as the “principal object” test. This test defines insurance as requiring that risk distribution be a relatively significant and central feature of a commercial transaction.⁶² In contrast, a commercial transaction would not be deemed insurance if risk shifting and risk

⁵⁷ *Id.* at 814.

⁵⁸ *Id.* at 813.

⁵⁹ *Id.* at 814.

⁶⁰ The *Truta* approach has been cited with approval by a number of subsequent California courts. See *Auto. Funding Group v. Garamendi*, 7 Cal. Rptr. 3d 912, 915 (Cal. Ct. App. 2003); *Truck Ins. Exch. v. Amoco*, 41 Cal. Rptr. 2d 551, 556 (Cal. Ct. App. 1995). The most recent case citing *Truta* with approval was decided December 23, 2003 and it employs *Truta*'s principal purpose and object test. See *Garamendi*, 7 Cal. Rptr. 3d 912.

⁶¹ ERIC MILLS HOLMES & MARK S. RHODES, *HOLMES' APPLEMAN ON INSURANCE* 2D § 1.4, at 22–23 (2d ed. 1996).

⁶² *Id.* at 31.

distribution were simply incidental and ancillary to the other elements which give the transaction its distinctive nature.⁶³ Citing *Truta*, the Appleman treatise notes that a significant indication that an arrangement is *not* insurance is the absence of an obligation to indemnify third parties.⁶⁴

The final test discussed in the Appleman treatise is really a supplemental inquiry. This test, the “regulatory value” test, calls for evaluating and balancing the interests protected in the transaction with the purposes and policies of state regulatory insurance laws.⁶⁵ This test essentially replicates the concluding part of *Truta*, which discusses whether the public interest is affected.

The Keeton and Widiss treatise states that “[a]lthough risk transference and risk distribution are among the basic characteristics of almost all insurance transactions, the resolution of a dispute about what constitutes insurance usually is predicated on additional factors or considerations.”⁶⁶ Indeed, according to them, risk transference and risk distribution alone have not been deemed sufficient to constitute insurance.⁶⁷ In a sense, they echo the observation made by the California courts outlined above.

Finally, Dean Robert Jerry of the University of Florida School of Law goes even further by stating that “[a]s a general matter, it is clear in the cases that the existence of indemnification in the relationship, without more, is not enough to establish that insurance is involved.”⁶⁸ He goes on to state that “[t]he question turns, not on whether risk is involved or assumed, but on whether that or something else which is related in the particular plan is its principal object and purpose.”⁶⁹

Like the California case law, the cited treatises uniformly acknowledge that the existence of risk shifting and distribution is insufficient, in and of itself, to establish that a particular transaction constitutes insurance. These treatises also

⁶³ *See id.* at 34–35.

⁶⁴ *Id.* No explanation is provided, in such event, as to the existence of first-party insurance.

⁶⁵ *Id.* at 40.

⁶⁶ ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES* 4 (1988).

⁶⁷ *See id.* at 6.

⁶⁸ ROBERT H. JERRY II & DOUGLAS R. RICHMOND, *UNDERSTANDING INSURANCE LAW* 20 (5th ed. 2012).

⁶⁹ *Id.* (citing *Jordan v. Group Health Ass’n*, 107 F.2d 239, 247–48 (D.C. Cir. 1939)).

discuss the central role played by the principal object and purpose test in determining what comprises insurance. For example, Dean Jerry aptly sums up by (1) observing that all contracts involve the allocation of risk and (2) concluding that without the principal object and purpose test, literal application of a risk shifting and risk distribution standard would cause too many contracts to become regulated when they were not intended to be.⁷⁰

Dean Jerry's summation is instructive. The preceding analysis, which attempts to characterize some contracts as "insurance" and some as not insurance, as in *Truta*, seeks to define insurance for a limited purpose—to see if a given arrangement is subject to regulation as insurance. The characterization does not and should not affect the enforcement of the contract between the parties. For example, the car rental contracts in *Truta* are perfectly enforceable according to their terms even though they are not subject to regulation by the California Department of Insurance.

III. RISK IN INSURANCE POLICIES

Although risk has not been the subject of much curiosity in the body of insurance law, the deepest inquiry on this topic appears in what has come to be considered a classic article in insurance law, *Fortuity: The Unnamed Exclusion*.⁷¹ In this article, Stephan Cozen and Richard Bennett, lawyers in a prominent Philadelphia law firm, defined insurance as a mechanism used to transfer and distribute risk.⁷² Their work clearly embraced the idea that risk was central to the idea of insurance.⁷³ While their observation was not an altogether novel one, Cozen and Bennett were the first to systematically analyze what is meant by risk in the insurance context.

According to Cozen and Bennett, risk was an abstract term difficult to define.⁷⁴ Despite this difficulty, they were nonetheless willing to define what risk was not: it was not certainty.⁷⁵ Their turn of phrase was succinct: "If risk is central

⁷⁰ *Id.* at 14, 27.

⁷¹ Stephen A. Cozen & Richard C. Bennett, *Fortuity: The Unnamed Exclusion*, 20 FORUM 222 (1984–85).

⁷² *Id.* at 224.

⁷³ *Id.*

⁷⁴ *Id.* (citation omitted).

⁷⁵ *Id.*

to insurance, then certainty is antithetical to it.”⁷⁶ It followed, in their view, that the concept of fortuity was essentially an expression of uncertainty.⁷⁷ Because a lack of fortuity could result in an exclusion of coverage, fortuity was effectively treated like any other express exclusion. Fortuity, then, was the unnamed exclusion that formed the title of their article.⁷⁸

Cozen and Bennett’s article has remained influential over the nearly thirty years of its existence. Since its publication, it has been cited in a myriad of scholarly journals.⁷⁹ In addition, their article has been cited by a number of courts.⁸⁰ In the ultimate compliment, the Supreme Court of Washington invoked the title of Cozen and Bennett’s article in stating that “the fortuity principle is sometimes called the unnamed exclusion.”⁸¹

Unfortunately, however, Cozen and Bennett’s influence has come at a price. The price has been a mischaracterization of the concept of risk and fortuity, as opposed to *uncertainty*, that lies at the core of their article. It is not their formulation that requires refinement—after all, insurance fundamentally deals with risk—but rather, it is their taxonomy. In their article, Cozen and Bennett equated fortuity with uncertainty. This is understandable considering that their thoughts tracked the prevailing wisdom at the time. For example, in one of the first cases in the United States to describe the concept of fortuity, the court explained that “the perils insured against are *risks* It covers a risk, not a certainty.”⁸² However, risk is not the equivalent of uncertainty.

⁷⁶ *Id.*

⁷⁷ *Id.* at 225.

⁷⁸ *Id.* The concept remains unnamed. In the six standard Insurance Services Office policies discussed above the word fortuity is not found. More recently, one commentator has substantiated Cozen and Bennett’s conception of the fortuity doctrine, defining it as a “contingency or uncertainty with respect to the risk insured.” Matt W. Holley, *The “Fortuity Doctrine”: Misapplying the Known Loss Rule to Liability Insurance Policies*, 41 TEX. TECH L. REV. 529, 529 (2009) (citation omitted).

⁷⁹ See, e.g., James L. Knoll & Randy L. Arthur, *Property Insurance: No Solution for Pollution*, 17 B.C. ENVTL. AFF. L. REV. 231, 273 n.244 (1990); Michael Sean Quinn, *Fortuity, Insurance, and Y2K*, 18 REV. LITIG. 581, 588 n.24 (1999); Keith Witten, *‘Barn Burning’ and What Can Be Done to Prevent It*, 22 TORT & INS. L.J. 511, 513 n.8 (1987).

⁸⁰ *City of Burlington v. Indem. Ins. Co. of N. Am.*, 332 F.3d 38, 48 (2d Cir. 2003); *Aluminum Co. of Am. v. Aetna Cas. & Sur. Co.*, 998 P.2d 856, 879 (Wash. 2000).

⁸¹ *Aluminum Co. of Am.*, 998 P.2d at 879.

⁸² *Mellon v. Fed. Ins. Co.*, 14 F.2d 997, 1002 (S.D.N.Y. 1926) (quoting *British & Foreign Marine Ins. Co. v. Gaunt*, (1921) 2 A.C. 41 at 57 (Lord Summer)).

In 1921, Frank Knight, a University of Chicago economist, posited that uncertainty was “radically distinct from the familiar notion of Risk [sic], from which it has never been properly separated.”⁸³ Essentially, Knight saw uncertainty as an omnipresent phenomenon.⁸⁴ Knight eloquently expressed his view in his book *Risk, Uncertainty, and Profit*: “We live only by knowing *something* about the future; while problems of life, or of conduct at least, arise from the fact that we know so little.”⁸⁵

Knight’s observation has been tacitly validated in a recent work that describes the uncertainty inherent in the fundamental business of insurance.⁸⁶ That is, the insurance bargain is a business relationship based on probabilities. An insurer seeks to insulate itself, insofar as it can, from the randomly occurring event that makes its business a risky proposition. For example, the actuarial tables used in life insurance demonstrate that some “uncertainties” are not so risky at all. With a large enough statistical sample, a life insurer takes much of the uncertainty out of its end of the bargain—it can predict with much the same confidence as a Las Vegas casino what its loss experience is very likely to be.⁸⁷ The life insurer can then price its premiums so as to account for its expected payout and still be able to pocket a handsome sum for its efforts—all the while providing some form of security to its policyholders. In this sense, a life insurance policyholder faces a great deal of uncertainty in terms that Frank Knight would describe as the problems of life about which we know so little.⁸⁸ The life insurer, in contrast, faces little uncertainty because probability theory provides it very precise—read certain—information.⁸⁹

⁸³ BERNSTEIN, *supra* note 2, at 218–19 (quoting FRANK KNIGHT, *RISK, UNCERTAINTY AND PROFIT* (1921)).

⁸⁴ KNIGHT, *supra* note 83, at 199.

⁸⁵ *Id.*

⁸⁶ ERICSON & DOYLE, *supra* note 1 (outlining the risks inherent in underwriting life, disability, earthquake, and terrorism insurance).

⁸⁷ See Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 247 (1996).

⁸⁸ See KNIGHT, *supra* note 83, at 199.

⁸⁹ “[M]athematicians transformed probability theory from a gamblers’ toy into a powerful instrument for organizing, interpreting, and applying information. As one ingenious idea was piled on top of another, quantitative techniques of risk management emerged that have helped trigger the tempo of modern times.” BERNSTEIN, *supra* note 2, at 4.

What is clear, however, is that the risk that the insurer deals with is very different than the uncertainty—the possibility of loss—that the insured seeks to avoid.⁹⁰

Using the degree of insurer risk as a means of categorizing insurance products, life insurance can be seen to occupy one end of a wide spectrum in which the key variable is the relative size of the statistical sample. Thus, the relatively large number of deaths that occur in any given year provides life insurers a fairly large statistical sample upon which to base premium rates. Fire insurance occupies some place in the broad middle of this spectrum. The reason for this placement, however, is not that probability plays a lesser part but because the incidence of fires is significantly less than the mortality rate. The statistical sample—the relative incidence of fires—is smaller and makes the fire insurer's calculus less certain.

Finally, earthquake insurance is an extreme example of the industry practice of underwriting risks that demonstrate a high degree of uncertainty.⁹¹ The insurer's uncertainty is magnified by the small statistical sample.⁹² In turn, insurer uncertainty is significantly increased because earthquakes with sufficient magnitude to cause substantial losses are somewhat rare.⁹³ In this sense, the insured is more like the Las Vegas gambler who hopes to hit it rich with one pull of the slot machine lever. In contrast, the insurer hopes to avoid the "hit" with earthquakes.

Cozen and Bennett were tantalizingly close to the realization that risk and uncertainty are different in the insurance context. Broadly, they recognized that the concept of fortuity had been ignored in several different respects.

First, Cozen and Bennett saw the courts as reluctant to use the lack of fortuity to allow an insurer to escape liability.⁹⁴ According to them, "courts have

⁹⁰ Ericson and Doyle make the point that the science of underwriting can be inexact. It is, however, the insurer's sole decision as to whether its science is sound or not. The insurer's decision has nothing to do with the legal concept of risk. As the authors state, "[b]eneath the veneer of certainty, life insurance is a very uncertain business . . . uncertainty is pervasive for a number of interconnected reasons. Actuarial data on mortality and morbidity are often crude and of limited applicability in local underwriting contexts. Aggregate actuarial knowledge is always compromised in the practical decision making of each insurance company competing in local markets." ERICSON & DOYLE, *supra* note 1, at 47. They also state that "while insurers act as a bulwark against uncertainty, they also play a key role in fostering it." *Id.* at i.

⁹¹ *Id.* at 180.

⁹² *Id.*

⁹³ *Id.* at 181.

⁹⁴ Cozen & Bennett, *supra* note 71, at 223.

consistently paid lip service to the concept [of fortuity], while finding a variety of reasons to rule in favor of the insured.”⁹⁵ They believed that an insured’s burden of proving fortuity was but a slight hurdle inasmuch as few cases existed in which courts found a loss to be non-fortuitous.⁹⁶

Cozen and Bennett’s pique at courts’ reluctance to use fortuity as a way for insurers to escape responsibility is perhaps explained by the idea that the insurance bargain is, in fact, not affected by the seeming lack of fortuity. In the few cases in which courts have accepted a fortuity defense, the circumstances involved either some form of intentional conduct on the part of the insured, or a loss that had already occurred.⁹⁷ The courts’ willingness to accept the fortuity defense appears to have been a result of the insured’s role in altering his probabilities, rather than the existence of a non-fortuitous event.⁹⁸

Second, Cozen and Bennett believed that the courts had mischaracterized the role of fortuity by converting it from an objective to a subjective concept. Instead of determining fortuity based on an evaluation of whether a particular loss was certain to occur (an objective standard), courts were increasingly looking to *whether the insured was aware* that the loss was certain to occur (a subjective standard).⁹⁹ The authors believed that viewing fortuity through the eyes of the insured had the effect of favoring the insured.¹⁰⁰ As Cozen and Bennett propounded, “[a] physical certainty . . . is *legally ‘fortuitous’* so long as the insured

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Hedtcke v. Sentry Ins. Co.*, 326 N.W.2d 727, 738 (Wis. 1982) (holding insurance coverage is not available for intentional conduct because it is non fortuitous); *RLI Ins. Co. v. Maxxon Southwest, Inc.*, 265 F. Supp. 2d 727, 730 (N.D. Tex. 2003) (citations omitted) (stating the doctrine of fortuity bars coverage where the insured procured insurance they knew they were committing acts for which they could potentially be found liable).

⁹⁸ *See RLI Ins. Co. v. Maxxon Southwest, Inc.*, 108 Fed. App’x 194, 199 (5th Cir. 2004) (holding that the fortuity doctrine barred coverage for the insureds because “the insureds knowingly engaged in conduct which they knew and intended would economically harm” the party filing suit against them in the underlying action); *Univ. of Cincinnati v. Arkwright Mut. Ins. Co.*, 51 F.3d 1277, 1284 (6th Cir. 1995) (holding that “when an insured makes a deliberate decision to take an action that produces known consequences and causes predictable damage to its property, the damages sustained are not the result of a fortuitous event covered under an all-risk insurance policy”); *Two Pesos, Inc. v. Gulf Ins. Co.*, 901 S.W.2d 495, 502 (Tex. App. 1995) (holding that insured’s claim was precluded because the risk of liability was known at the time the insurance policy was obtained from the insurer).

⁹⁹ Cozen & Bennett, *supra* note 71, at 223.

¹⁰⁰ *Id.*

was unaware that it was going to happen.”¹⁰¹ Cast in a different way, Cozen and Bennett would seem to at least tacitly accept the idea that an insured cannot affect the probabilities upon which the insurer makes its calculations to take on a particular risk, for to do so would violate the insurance bargain.

The preceding two propositions can easily be explained on grounds apart from a doctrine of fortuity by disassociating risk from uncertainty. As stated above, an insurer can take steps towards managing risk, sometimes transforming seemingly uncertain situations into those that ultimately involve very little uncertainty. This is distinct from the uncertainty, or potential for incurring losses, that insureds seek to minimize through the vehicle of insurance.

Third, Cozen and Bennett also thought the concept of fortuity was being misconstrued because they believed the courts were conflating the concept of fortuity with the rules of causation.¹⁰² That is, they were concerned with the problem of coverage in cases where a loss is caused by more than one event, only one of which might be covered by an insurance policy. In their view, by allowing coverage in those cases that involved a non-fortuitous, and therefore uncovered, cause where there was also a concurrent covered cause, the concept of fortuity was being eviscerated by the courts.¹⁰³ According to them, California was the worst offender because it allowed coverage of a non-fortuitous loss even when the non-fortuitous loss was a “substantial, or even a predominant, contributory factor.”¹⁰⁴ As the authors scornfully stated, “the insured need not demonstrate that negligence was the ‘prime’ or ‘moving’ cause.”¹⁰⁵

California’s experience can be explained by the simple observation that covered causes and causation have always been problem areas. This point is illustrated by Hurricane Katrina and the dispute surrounding the covered wind damage and the uncovered flood damage that it caused.¹⁰⁶ The historic difficulty with concurrent covered and uncovered causes, however, sheds little light on the concept of risk in insurance law.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ See *In re Katrina Canal Breaches Litig.*, 495 F.3d 191 (5th Cir. 2007).

IV. THE INSURANCE BARGAIN AND THE INSURED

A. *The Unique Role of the Insured*

Cozen and Bennett's conception of fortuity really reflects the role that the insured plays in the insurance relationship. While uncertainty is inherent in the contractual assumption of risk by an insurer, this aspect is not germane to the insured's ability to affect the relationship. The role of the insured as a separate and distinct actor in the relationship between insurer and insured is an additional matter to consider. As stated above, the business relationship is based on probabilities. It is based on the insurer's calculus of the relative probabilities of harm that might occur in a large population. On the other hand, the insured's role in the relationship is ostensibly a neutral one. The insured is, or should be, a passive player who simply waits for covered peril to occur.¹⁰⁷

B. *Reconciling Insurance Doctrine with the Bargain Involving Risk*

The difficulties with reconciling insurance law doctrine and risk occur when the insured influences or attempts to influence the probabilities involved. These difficulties are represented by various doctrines that have, as a common theme, the insured playing a role which affects the basic probability of loss undertaken by an insurer. These include the insurable interest doctrine, fortuity, known loss, the intentional acts exclusion, and moral hazard. In each case, the doctrine or principle that each touches on goes to the heart of the insurance bargain. Accordingly, I look at each of several enumerated doctrines or principles from the perspective of the insured's role and her ability to influence the outcome in a way not contemplated by the parties. This examination will demonstrate that the behavior of an insured, which increases risk beyond that assumed by an insurer, has repercussions, apart from the increase in risk provisions discussed above.

Before beginning an analysis, it is useful to distinguish such actions by policyholders that increase the risk of the insurance bargain from the law of bad faith. As used in this article, the two doctrines are not synonymous. Contracts implicitly require cooperation between the parties and rely on the doctrine of good faith to prevent "opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule."¹⁰⁸ Good faith is an implied promise in every contract "not to take opportunistic advantage in a way that could

¹⁰⁷ In this respect, I do not count affirmative measures an insured might take to avoid or mitigate loss.

¹⁰⁸ *Market St. Assocs. Ltd. P'ship v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991).

not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties.”¹⁰⁹ It serves that function by “approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute.”¹¹⁰ This article does not deal with this kind of opportunistic behavior, which is better policed with sanctions for breach of the covenant of good faith and fair dealing.¹¹¹ Instead, the focus of this article is on the insured’s ability to alter the risk of loss undertaken by the insurer.

If we accept the notion that an insurer is making a calculated gamble, not in the sense of gaming, but in the sense of assessing the probability of loss spread out over a large number of similarly situated persons, then an insured who affects the probability of loss in some material way has essentially failed to meet a basic assumption upon which the insurer entered the bargain. The insured should not be allowed to play this probabilistic game if she is playing with loaded dice.

This is not a novel concept. Implicit with any contract is the idea that no party to the contract will willfully take any action that interferes with another party’s ability to perform. It would offend common sense and fairness to permit a plaintiff to recover damages for a breach of contract by another party when the breach is occasioned by the plaintiff’s hand. This doctrine was expressed by Professor Arthur L. Corbin, who stated:

One who unjustly prevents the performance of the happening of a condition of his own promissory duty thereby eliminates it as such a condition. He will not be permitted to take advantage of his own wrong, and to escape from liability for not rendering his promised performance by preventing the happening of the

¹⁰⁹ *Id.* (citing *Kham & Nate’s Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1357 (7th Cir. 1990)).

¹¹⁰ *Id.*

¹¹¹ Indeed, in California an insured is not even subject to an insurer’s claim of bad faith. In *Kransco v. Am. Empire Surplus Lines Ins. Co.*, the court held that an insured’s breach of the covenant of good faith is not a recognized affirmative defense for an insurer to absolve itself from liability. 97 Cal. Rptr. 2d 151, 166–67 (Cal. 2000). The insurer, on the other hand, does have a duty of good faith and fair dealing that is “unconditional and independent of the performance of [the insured’s] contractual obligations.” *Id.* at 160 (citing *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 578 (Cal. 1973) (emphasis in original)). This seemingly inconsistent treatment of the insured and insurer does not mean, as a matter of contract law, that there are no adverse consequences for actions of the insured. First, because bad faith claims are generally based on acts occurring post-formation of a contract, the insured is still subject to consequences arising from his or her actions at the formation stage of a contract. Second, an insured’s breach of *express* terms under the insurance policy may raise a number of contract defenses for the insurer, including the voiding of coverage. *Id.* at 166–67.

condition on which it was promised. *One who himself induces the failure of the other to perform within the time agreed upon cannot take advantage of such failure, either by enforcing a prescribed penalty or forfeiture, or by claiming damages for breach.*¹¹²

Professor Williston was of the same mind. He stated that “[i]t is a principle of fundamental justice that if a promisor is himself the cause of the failure of performance either of an obligation due him or of a condition upon which his own liability depends, he cannot take advantage of the failure.”¹¹³

This “prevention doctrine” described above by Professors Corbin and Williston is incorporated in the comments following *Restatement (Second) of Contracts* section 245, which provides that

[w]here a duty of one party is subject to the occurrence of a condition, the additional duty of good faith and fair dealing imposed on him under § 205 may require some cooperation on his part, either by refraining from conduct that will prevent or hinder the occurrence of that condition or by taking affirmative steps to cause its occurrence.¹¹⁴

¹¹² ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 767 (1961) (emphasis added).

¹¹³ SAMUEL WILLISTON, WILLISTON ON CONTRACTS § 677 (4th ed. 1993).

¹¹⁴ RESTATEMENT (SECOND) OF CONTRACTS § 245 (1981). This principle was further expressed by the Court of Appeals of New York in *Patterson v. Meyerhofer*, 97 N.E. 472, 473 (N.Y. 1912), in which the Court stated:

In the case of every contract there is an implied undertaking on the part of each party that he will not intentionally and purposely do anything to prevent the other party from carrying out the agreement on his part. This proposition necessarily follows from the general rule that a party who causes or sanctions the breach of an agreement is thereby precluded from recovering damages for its non-performance or from interposing it as a defense to an action upon the contract. Where a party stipulates that another shall do a certain thing, he thereby impliedly promises that he will himself do nothing that may hinder or obstruct that other in doing that thing.

Furthermore, when the insurance policy is viewed through the lens of contract law, one can see that the insured attempting to obtain coverage for a known loss is committing a kind of fraud, which should invalidate the policy because it has compromised the meeting of the minds required for contract formation, not because a general notion of public policy has been violated. Holley, *supra* note 78, at 529, 531.

The application of this doctrine in the context of insurance will aid in the reconciling of insurance law doctrine and the commodity of risk.

1. The Insurable Interest Doctrine

It is a tenet of insurance law that an insured is required to have an interest in the subject matter as a prerequisite to recovery.¹¹⁵ The insurable interest doctrine would seem to be a prime example of my thesis, that is, that the insurable interest requirement is a mechanical way of assuring that the insured or beneficiary is motivated to not affect the insurance bargain. The insurable interest doctrine was first applied to marine insurance policies in eighteenth century England when Parliament passed the first act requiring insurance policies to have an insurable interest.¹¹⁶ The policy rationale was to deter and prevent parties from wagering on whether a ship and its cargo would make it to the intended destination.¹¹⁷

In the preamble to that first act, Parliament declared that the lack of an insurable interest requirement in insurance policies encouraged a “mischievous kind of gaming or wagering, under the pretense of assuring the risque on shipping” and that this frustrated the insurer’s ability to assess the risk.¹¹⁸ This formulation is entirely consistent with the idea that parties to a contract should not have a role in altering the probabilities of harm.¹¹⁹ The problem with respect to case law is that most of the cases that discuss the doctrine (and there are a lot) do not discuss the underlying policy rationale. The closest formulation is that no person should be allowed to benefit from his or her wrongdoing.¹²⁰ However, even this formulation

¹¹⁵ LEO P. MARTINEZ, *INSURANCE LAW* 538 (6th ed. 2010).

¹¹⁶ 1-1 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 1.05 [hereinafter NEW APPLEMAN]. Parliament passed the first act requiring an insurable interest in 1746. *Id.* See Anthony Alt, *SPIN-Life Insurance Policies: A Dizzying Effect on Human Dignity and the Death of Life Insurance*, 7 AVE MARIA L. REV. 605, 610 (2009); JERRY & RICHMOND, *supra* note 68, at 260–65.

¹¹⁷ NEW APPLEMAN, *supra* note 116. Additionally, Parliament sought to prevent fraud (i.e. the intentional destruction of cargo) by requiring an insurable interest.

¹¹⁸ Act of 1746, St. 19 Geo. 2, c. 37, § 1 (Eng.).

¹¹⁹ This is self-evident in the case of life insurance. Thus, a life insurance beneficiary who murders the insured has skewed the insured’s actuarial life expectancy and deserves not to recover. *See, e.g.,* Bernstein v. Rosenthal, 671 P.2d 979, 980–81 (Colo. Ct. App. 1983) (holding that evidence of a coroner’s report and death certificate sustained a finding that the beneficiary had killed the insured and was therefore prevented from taking under the policy, even though there had been no criminal conviction); Prudential Ins. Co. of Am. v. Athmer, 178 F.3d 473 (7th Cir. 1999) (discussing the problem of beneficiaries who murder the insured).

¹²⁰ *Prudential Ins. Co. of Am.*, 178 F.3d at 475 (Posner, J.).

arguably articulates a different public policy consideration. That is, wrongdoing should be subject to some form of punishment or sanction. This is apart from the contract law idea that a party to a contract should not do anything to interfere with another party's rights under the contract.

In the same way, although the idea that there is a public policy against engaging in wagers in the guise of insurance is intriguing in itself, wagering is entirely different from the idea that public policy should also discourage insureds or beneficiaries (in the case of life insurance) from doing anything that alters the risk assumed by the insurer in the transaction.¹²¹ Dean Jerry and Doug Richmond have recognized this dichotomy by noting that it is debatable whether the insurable interest requirement is needed to deter wagering and they observe, "where the person purchasing the insurance lacks an insurable interest, the risk underwritten by the insurer is greater; it is in the insurers' self-interest to avoid this additional risk."¹²² While it is not a good thing to allow an insured to alter the underlying assumptions of the insurance bargain (a predictable amount of risk), Jerry and Richmond take the view that insurers are adept at policing this problem.¹²³

2. Fortuity

Case law is replete with statements that fortuity is a requirement in insurance policies.¹²⁴ As Professor Jeffrey Stempel flatly states, "Insurers will usually be successful only if they are writing coverage for fortuitous events."¹²⁵ It is said that the concept of fortuity is inherent in insurance contracts.¹²⁶ Insurance is intended to protect individuals from the economic effects of the unanticipated occurrence of accidents.¹²⁷ As noted above, in one of the first cases in the United States to

¹²¹ Peter Nash Swisher, *The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 *DRAKE L. REV.* 477, 536 (2005) (wagering is the overriding concern addressed by the insurable interest requirement in life insurance); JERRY & RICHMOND, *supra* note 68, at 262 (Parliament's articulated concern was gaming). A modern-day wagering problem is well-discussed in a recent article. Alt, *supra* note 116, at 605.

¹²² JERRY & RICHMOND, *supra* note 68, at 258.

¹²³ *Id.*

¹²⁴ *Scottsdale Ins. Co. v. Travis*, 68 S.W.3d 72, 75 (Tex. App. 2001) (citing *Two Pesos, Inc. v. Gulf Ins. Co.*, 901 S.W.2d 495, 502 (Tex. App. 1995)).

¹²⁵ STEMPEL, *supra* note 42, at 1–32.

¹²⁶ Cozen & Bennett, *supra* note 71, at 223.

¹²⁷ *Chu v. Canadian Indem. Co.*, 274 Cal. Rptr. 20, 25 (Cal. Ct. App. 1990) (citations omitted) ("Insurance typically is designed to protect contingent or unknown risks of harm, not to protect against harm which is certain or expected.").

describe the concept of fortuity the court explained that “the perils insured against are *risks* It covers a risk, not a certainty.”¹²⁸

The term fortuity encompasses the idea of insuring a risk or an event that may occur by chance.¹²⁹ Cozen and Bennett wrote, “[t]o be compensable, the loss must be fortuitous, which is to say that it must be caused by a fortuitous event.”¹³⁰ “Fortuitous event” is defined as

an event which *so far as the parties to the contract are aware*, is dependent on chance. It may be beyond the power of any human being to bring the event to pass; it may be within the control of third persons; it may even be a past event, such as the loss of a vessel, *provided that the fact is unknown to the parties*.¹³¹

Professor Stempel is closest to the mark with his succinct definition of fortuity as the equivalent of chance.¹³² According to him, if the losses are intended or expected by the policyholder, they are therefore not the result of chance.¹³³ Still, Professor Stempel does not go as far as I do with the suggestion that fortuity should be relegated to the ash heap.

The case law and legal scholarship have consistently described the doctrine of fortuity as a “requirement” of insurance, as a “public policy” matter of insurance law, or as “inherent” in insurance.¹³⁴ As is developed below, only the latter comes close to accurately describing the role of fortuity in insurance law.

¹²⁸ *Mellon v. Fed. Ins. Co.*, 14 F.2d 997, 1002 (S.D.N.Y. 1926). This view persists even today. One recent commentator repeats the mantra that fortuity is required of all insurance policies. Holley, *supra* note 78, at 530. He follows this by observing “that insurance is intended to cover risks, not certainties.” *Id.* He goes on to argue that fortuity has no application in liability insurance policies because the risk of a third party action is inherently uncertain. *Id.* at 535.

¹²⁹ BLACK’S LAW DICTIONARY 680 (8th ed. 2004).

¹³⁰ Cozen & Bennett, *supra* note 71, at 225 (citing *Avis v. Hartford Fire Ins. Co.*, 195 S.E.2d 545, 548 (N.C. 1973)).

¹³¹ *Compagnie des Bauxites de Guinee v. Ins. Co. of N. Am.*, 724 F.2d 369, 372 (3d Cir. 1983) (citing RESTATEMENT OF CONTRACTS § 291 cmt. a (1932)) (emphasis in original).

¹³² STEMPEL, *supra* note 42, at 1–32.

¹³³ *Id.* at 1–33.

¹³⁴ *Churchill v. Factory Mut. Ins. Co.*, 234 F. Supp. 2d 1182, 1188 (W.D. Wash. 2002) (citations omitted) (opining that the public policy of preventing fraud requires fortuity with regard to insurance loss); *Scottsdale Ins. Co. v. Travis*, 68 S.W.3d 72, 75 (Tex. App. 5th Dist. 2001) (citations omitted)

Keeton and Widiss took the public policy route in their treatise. They saw fortuity as “imposed by the courts as a matter of public policy when there is no express limitation set forth in the applicable insurance policy”¹³⁵ Unfortunately, they do not describe the contours of the public policy that is involved. Dean Jerry’s fine text, *Understanding Insurance Law*, describes fortuity as a requirement of the insurance bargain, going as far as to state that “[t]he public policy underlying the fortuity requirement is so strong that if the insurance policy itself does not expressly require that the loss be accidental courts will imply such a requirement.”¹³⁶ At the same time, Dean Jerry concedes “at a certain point the logic of the fortuity requirement begins to unravel at the edges.”¹³⁷

The elusiveness of the problem causes me to focus on the insurance bargain itself. The nature of the insurance bargain is an exchange of money for the assumption of risk. In this context the parties recognize that the assumption of risk by an insurer is the commodity—if it can be described as such—being sold. If that is the case, to describe fortuity as a “requirement” misses the point. In that sense, fortuity is no more “required” in an insurance policy than is an automobile “required” in a sale of a Ferrari. In each case, the subject of the bargain—the assumption of a risk in the former example and the Ferrari in the latter example—is part of the contract itself. That being the case, there should be no additional “requirement” that the assumption of risk or the Ferrari is part of the contract. As Professor Kenneth Abraham puts it:

To the extent that policy language already satisfactorily reflects the fortuity requirement, making reference to the requirement as if it were not entirely subsumed within applicable policy language could only risk implying incorrectly to decision makers that they had two decisions to make, one applying policy

(holding that “fortuity is an inherent requirement of all risk insurance policies”); *Hedtcke v. Sentry Ins. Co.*, 326 N.W.2d 727, 737 (Wis. 1982) (citations omitted) (maintaining public policy goals of fortuity doctrine include avoiding profit from wrongdoing, deterring crime, and avoiding fraud against insurers); Douglas G. Houser, *Y2K: A “Fortuitous” Loss?*, 36 WILLAMETTE L. REV. 29, 32 (2000).

¹³⁵ KEETON & WIDISS, *supra* note 66, at 475.

¹³⁶ JERRY & RICHMOND, *supra* note 68, at 413–14.

¹³⁷ *Id.* at 418.

language and the other applying the separate and additional requirements of a legal rule regarding fortuity.¹³⁸

To suggest “fortuity” is a separate concept apart from the insurance bargain simply is untenable. At best, it does little to aid in understanding the idea of fortuity.

Similarly, the reliance on a “public policy” justification as an explanation of fortuity misses the mark. There appears to be nothing truly inherent in the insurance bargain that supports a public policy rationale for fortuity. It may very well be that an insurer would agree to cover non-fortuitous losses. Such a business model might not be prudent or wise, but public policy does little to police improvident bargains entered into by sophisticated parties. This is illustrated by a cousin of the fortuity doctrine, the known loss doctrine.

3. Known Loss

With the background provided by the fortuity discussion, the known loss doctrine is easy to place in the framework as it is closely related to fortuity. Broadly, the fortuity doctrine bars coverage for known losses.¹³⁹ The idea behind fortuity is that insurance is intended to cover losses that occur by chance. At the same time, there seems to be no legal barrier to the enforcement of a contract which is *not* insurance from covering a known loss.

An example of the foregoing is so called “retroactive insurance.” Retroactive insurance provides a way for a policyholder to receive a number of benefits from an insurance policy for an event that has already occurred.¹⁴⁰ In addition to indemnity, these benefits might include claims-handling expertise, systematic and consistent treatment of claimants, and, sometimes, special tax benefits.¹⁴¹ Where

¹³⁸ Kenneth S. Abraham, *Peril and Fortuity in Property and Liability Insurance*, 36 TORT & INS. L.J. 777, 781–82 (2001).

¹³⁹ See *Summers v. Harris*, 573 F.2d 869, 872 (5th Cir. 1998); *Inland Waters Pollution Control, Inc. v. Nat'l Union Fire Ins. Co.*, 997 F.2d 172, 175–77 (6th Cir. 1993); *Montrose Chem. Corp. v. Admiral Ins. Co.*, 913 P.2d 878, 904 (Cal. 1995); *Scottsdale Ins. Co.*, 68 S.W.3d at 75 (citing *Burch v. Commonwealth Mut. Ins. Co.*, 450 S.W.2d 838, 840–41 (Tex. 1970)).

¹⁴⁰ Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1899 n.53 (1991); Michael L. Smith & Robert C. Witt, *An Economic Analysis of Retroactive Liability Insurance*, 52 J. RISK & INS. 379 (1985).

¹⁴¹ Dean Jerry and Doug Richmond discuss the particular example of the 1981 MGM Grand fire. JERRY & RICHMOND, *supra* note 68, at 390 n.64 (explaining that retroactive insurance is enforceable, notwithstanding the doctrine of fortuity, where loss was certain, but the amount of loss and the time the loss would be compensated were not certain). See Donald Arthur Winslow, *Tax Avoidance and the*

retroactive insurance is involved, there seems to be no real question of whether such a bargain is valid—even if the loss is known. At least one commentator notes the absence of statutory limitations on retroactive insurance and expresses surprise at the absence of a market of such a product.¹⁴² Hence, the public policy grounds advanced to support a known loss doctrine appear weak indeed.¹⁴³

To refine the notion of the insurance bargain further, it makes sense that a conventional insurance policy would not cover a known loss. This is not founded on public policy grounds; rather, it is a violation of the insurance bargain itself. The insured has sought coverage for an event that was no longer subject to the rules of probability. At the same time, where an insurer is aware of the loss and voluntarily issues a policy covering such loss, public policy should place no impediment on coverage when the insurer has the opportunity to account for the change in the probability.¹⁴⁴

4. Intentional Acts

Insurance policy language, some state statutes, and case law exclude coverage for the intentional acts of policyholders and insureds. It is even possible for an insurer to avail itself of the intentional act exclusion by showing that the nature of a tort committed by its insured has an element of intentional wrongdoing.¹⁴⁵

Definition of Insurance: The Continuing Examination of Captive Insurance Companies, 40 CASE W. RES. L. REV. 79, 121 (1990) (discussing the tax aspects of insurance).

¹⁴² Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697, 748–50 (2005) (citing the MGM Grand hotel fire as an example).

¹⁴³ Perhaps the real issue with respect to the known loss principle is the classification of contracts as insurance for the purposes of regulation as in *Truta*. See *Truta v. Avis Rent A Car System, Inc.*, 238 Cal. Rptr. 806, 811 (Cal. Ct. App. 1987) (quoting *Metro. Life Ins. Co. v. State Bd. of Equalization*, 652 P.2d 426, 428 (Cal. 1982)).

¹⁴⁴ Dean Jerry and Doug Richmond acknowledge as much by the observation that “economic exchanges between parties of equal bargaining power should be enforced, assuming the transaction does not implicate some sort of public policy concern.” JERRY & RICHMOND, *supra* note 68, at 457. My mild disagreement is that I do not believe there is an articulated public policy concern that would otherwise affect this bargain. See also Holley, *supra* note 78, at 532 (maintaining that if both parties are aware that the loss has occurred, there is no impediment to coverage as the contract is valid and enforceable).

¹⁴⁵ *Allstate Ins. Co. v. Tankovich*, 776 F. Supp. 1394, 1397 (N.D. Cal. 1991) (insurer is not liable for a loss caused by the *willful act of the insured*); *State Farm Fire & Cas. Co. v. Drasin*, 199 Cal. Rptr. 749, 751 (Cal. Ct. App. 1984) (malicious prosecution not covered because it has an element of intentionality). I put in this category the increasingly common “criminal acts” exclusion. I focus on intentional acts because it is the broader concept.

Although the intentional injury doctrine seems to be widely accepted, those experienced with the vagaries of insurance law know that application of this doctrine is not an exercise in accurate prediction.¹⁴⁶ At the surface, the intentional acts exclusion would seem to invite a straightforward application of the doctrine, that the nature of the insurance bargain does not leave room for a policyholder or an insured to unfairly influence the basis on which an insurer makes its probability calculations. Ultimately, I think this is the correct result. However, the context in which the intentional acts exclusion applies does not, at first glance, simplify the analysis. The public policy underpinnings of the exclusion have been treated with varying degrees of import by the courts. Courts have had difficulty defining intentional conduct that falls within policy exclusion language.¹⁴⁷ Dealing with various aspects of the exclusion, such as the role of third parties, the duty to defend, and the desire to compensate victims, further complicates the application of the exclusion. As a result, the application of the intentional conduct doctrine has proved vexing for both policyholders and insurers in such disparate areas as employment discrimination, intellectual property infringement, and criminal sexual misconduct.

The contractual limitation on intentional acts is contained, by way of example, in the standard Commercial General Liability Policy (CGL) form, which provides that:

[C]overage is excluded for “bodily injury” or “property damage” that is expected or intended from the standpoint of the insured. This insurance does not apply to personal and advertising injury that is caused by or at the direction of the insured with the knowledge that the act would violate the rights of another and would inflict “personal and advertising injury.”

¹⁴⁶ JERRY & RICHMOND, *supra* note 68, at 413–55. Worth noting is that Dean Jerry and Doug Richmond, who cannot be said to be prolix, take more than 40 pages to explain the vagaries of the intentional acts exclusion.

¹⁴⁷ “[I]n *Gray v. Zurich Insurance Co.*, the California Supreme Court subjected an exclusion for losses caused by the insured’s intentional acts to the rigorous rules applicable to exclusions generally . . .” and examining whether the exclusion language was conspicuous, plain and clear. See James M. Fischer, *The Exclusion From Insurance Coverage of Losses Caused by the Intentional Acts of the Insured: A Policy in Search of Justification*, 30 SANTA CLARA L. REV. 95, 105 (1990).

The interpretation of this intentional act exclusion language follows a predictable path in California.¹⁴⁸ The general antipathy towards coverage exclusions has led California courts to narrowly construe the text of most standard intentional injury exclusions contained in liability insurance policies. Thus, California courts have generally resorted to interpretations of the exclusion that avoid their effect. For example, in the classic case of *Gray v. Zurich Insurance Co.*, the California Supreme Court held that insurance policy language which excluded coverage for “bodily injury or property damages caused intentionally by or at the direction of the insured” was sufficiently ambiguous to be characterized as surrounding the insured “by concentric circles of uncertainty.”¹⁴⁹ This, coupled with the doctrine of “reasonable expectations” articulated in an earlier case, *Steven v. Fidelity and Casualty Company of New York*, made the suddenly inconspicuous and unclear provision hard to enforce.¹⁵⁰

More recently, the California Supreme Court had occasion to interpret the exclusionary clause in a similar case. In *Safeco Insurance Co. of America v. Robert S.*, the court held that an exclusionary clause, which broadly excluded “illegal” acts, could not be construed to exclude a crime by equating the word “illegal” to mean “criminal.”¹⁵¹ Hence the insured’s conviction of involuntary manslaughter was, remarkably, held not to be within the ambit of the word “illegal.”¹⁵² Without

¹⁴⁸ “The experience of California courts in applying § 533 of the Insurance Code is typical of the evolution of a rule of law by way of dicta.” Donald F. Farbstein & Francis J. Stillman, *Insurance for the Commission of Intentional Torts*, 20 HASTINGS L.J. 1219, 1246 (1969).

¹⁴⁹ 419 P.2d 168, 170, 174 (Cal. 1966). This approach was also followed in a New York case in 1991, *Fitzpatrick v. American Honda Motor Co., Inc.* In *Fitzpatrick*, the New York Court of Appeals went beyond New York’s general approach and asserted that “the insurer must provide a defense if it has knowledge of facts which potentially bring the claim within the policy’s indemnity coverage.” 575 N.E.2d 90, 92 (N.Y. 1991). The court explained that exclusive reference to the third party’s complaint, albeit for a potentially intentional act, might lead the insurer to avoid its obligations under the insurance contract. *Id.*

¹⁵⁰ 377 P.2d 284, 288 (Cal. 1962). See also Robert H. Jerry II, *Insurance, Contract, and the Doctrine of Reasonable Expectations*, 5 CONN. INS. L.J. 21 (1998). Dean Jerry explores the development of the Doctrine of Reasonable Expectations within insurance law, beginning with Judge Keeton’s 1970 Harvard Law Review article, which identified the principle that the insured’s reasonable expectations should be recognized. *Id.* The Doctrine of Reasonable Expectations protects the weaker party in a contract transaction by charging insurers with a duty to honor the insured’s reasonable expectations. *Id.* Dean Jerry concludes that the doctrine should apply not only to insurance law, but to contract law principles in general. *Id.*

¹⁵¹ 28 P.3d 889, 893–95 (Cal. 2001).

¹⁵² *Id.* at 894.

explicit mention of the statute, the court effectively interpreted the policy as excluding only intentionally caused injury.¹⁵³ Again, the court chose to avoid application of the exclusion by characterizing the “ambiguous” language as incapable of being given a reasonable meaning under established rules of contract construction. The exclusion was thus deemed unenforceable.¹⁵⁴

Surprisingly, while the intentional acts exclusion is widely cited by courts in most jurisdictions, the statutory framework to support the doctrine is nearly nonexistent. This is especially surprising because of the widely articulated public policy rationale underpinning the exclusion. Apparently the public policy is not so strong as to have motivated legislatures to act. Only three states have codified the doctrine in statute to date. Two of the three states, California and North Dakota, share the similar statutory language.¹⁵⁵ California’s Insurance Code section 533 provides that “[a]n insurer is not liable for a loss caused by the willful act of the insured; but he is not exonerated by the negligence of the insured, or of the insured’s agent or others.”¹⁵⁶ The existence of these statutes has meant that courts commonly disallow an insurer from agreeing to cover acts excluded by such statutes.¹⁵⁷

In addition to California and North Dakota, Massachusetts has also chosen to make the intentional acts exclusion a statutory requirement. Massachusetts General Laws 175 section 47 departs from the language used by the California and North Dakota statutes and adopts a loftier, more aspirational tone. It provides that “no company may insure any person against legal liability for causing injury, other than bodily injury, by his deliberate or intentional crime or wrongdoing, nor insure his

¹⁵³ *Id.* at 900. See also *Minkler v. Safeco Ins. Co. of Am.*, 232 P.3d 612, 614 (Cal. 2010) (holding that an exclusionary clause barring coverage for injury that was “expected or intended by an insured,” read in conjunction with a severability clause, is not applicable in a case where the insured negligently fails to prevent the intentional acts of another insured).

¹⁵⁴ *Safeco Ins. Co. of Am. v. Robert S.*, 28 P.3d 889, 895 (Cal. 2001).

¹⁵⁵ See CAL. INS. CODE § 533 (West 2012).

¹⁵⁶ See *Nuffer v. Ins. Co. of N. Am.*, 45 Cal. Rptr. 918, 925 (Cal. Ct. App. 1965) (demonstrating that a “wilful act” within the meaning of this section means something more than ordinary negligence or the mere intentional doing of an act; the existence of an intent to injure is relevant). North Dakota’s Insurance Code provides “[a]n insurer is not liable for a loss caused by the wilful act of the insured; but the insurer is not exonerated by the negligence of the insured, or of the insured’s agent or others.” N.D. CENT. CODE § 26.1-32-04 (2011) (substituting “the insurer” for the word “he”).

¹⁵⁷ See *Shell Oil Co. v. Winterthur Swiss Ins. Co.*, 15 Cal. Rptr. 2d 815, 830–31 (Cal. Ct. App. 1993); *Ohio Cas. Ins. Co. v. Clark*, 583 N.W.2d 377, 385 (N.D. 1998).

employer or principal if such acts are committed under the direction of his employer or principal.”¹⁵⁸ Massachusetts courts have been just as clear in adhering to this statutory guideline that disallows coverage for intentional acts.¹⁵⁹

As we have developed some sophistication in the analysis of insurance law doctrines, the import of the intentional acts exclusion has increased, due in part to the basic nature of the exclusion and its consequent overarching effect.¹⁶⁰ Therefore, despite the fact that only three states have enacted statutes with regard to the intentional injury exclusion, public policy firmly establishes the doctrine in the vast majority of jurisdictions. Indeed, the public policy articulated by courts in most states tends to be in harmony with the statutory language adopted by California, North Dakota, and Massachusetts. In Illinois, New York, and Florida, for example, case law abounds in which courts have clearly indicated that indemnification of an intentional act would run contrary to accepted notions of public policy.¹⁶¹

As will be examined below, a great deal of inconsistency accompanies the public policy underpinnings of the intentional acts exclusion. This same discrepancy can be seen in the courts’ attempts to define intentional conduct that falls within policy exclusion language. As Dean Jerry states, “the exclusion has not been an easy one to apply in many situations.”¹⁶² A few examples will help illustrate the point.

In *Tomerlin v. Canadian Indemnity Company*, a case in which the complaint alleged an intentional battery, the California Supreme Court held that the insurer was estopped from denying liability under the policy because of the representations of its agent attorney.¹⁶³ The court stated, “[a]lthough an insurer may not indemnify against liability caused by the insured’s wilful wrong, defendant’s liability here

¹⁵⁸ MASS. GEN. LAWS ch. 175, § 47 (2008).

¹⁵⁹ See *Andover Newton Theological Sch. v. Cont’l Cas. Co.*, 566 N.E.2d 1117 (Mass. 1991).

¹⁶⁰ Fischer, *supra* note 147, at 99 (1990). See also JERRY & RICHMOND, *supra* note 68, at 441 (“[A]fter the mid-1960s] it became common to find liability policies stating that coverage would not exist for [acts] intended from the standpoint of the insured.”).

¹⁶¹ See, e.g., *Windmill Pointe Village Club Ass’n v. State Farm General Ins.*, 779 F. Supp. 596, 598 (M.D. Fla. 1991), *rev’d and vacated*, 978 F.2d 774 (11th Cir. 1993); *State Farm v. Leverton*, 732 N.E.2d 1094, 1097 (Ill. App. Ct. 2000); *Litrenta v. Republic Ins.*, 665 N.Y.S.2d 679, 680 (N.Y. App. Div. 1997).

¹⁶² JERRY & RICHMOND, *supra* note 68, at 441.

¹⁶³ 394 P.2d 571, 577 (Cal. 1964) (citations omitted).

does not arise from a contract executed prior to plaintiff's wilful misconduct, but from an estoppel which arose *after* it. Recovery under a subsequent estoppel does not offend such public policy."¹⁶⁴

The California Supreme Court's decision in *Gray v. Zurich*, discussed above, provides another example of the unpredictability that surrounds the application of the intentional acts exclusion. In reaching its decision, the *Gray v. Zurich* court distinguished the duty to defend from the duty to indemnify, stating that:

[insurance] statutes forbid only contracts which indemnify for "loss" or "responsibility" resulting from wilful wrongdoing. Here we deal with a contract which provides for *legal defense* against an action charging such conduct; the contract does not call for indemnification of the insured if the third party plaintiff prevails.¹⁶⁵

Based on this distinction, the court held that "the present contract does not offend [public policy because] . . . a contract to defend an [insured] upon mere accusation of a wilful tort does not encourage such wilful conduct."¹⁶⁶ So, once an insurer has undertaken the duty to defend and the third party prevails, "the insurer can [then] raise the noncoverage defense previously reserved. In this manner the interests of insured and insurer in defending against the insured party's primary suit will be identical; the insurer will not face the suggested dilemma."¹⁶⁷

Pursuant to the *Gray* holding, the court in *Montrose Chemical Corp. v. Superior Court*,¹⁶⁸ held that as long as the plaintiff which sued Montrose could show that the "'possibility' exist[ed] that Montrose was negligent, the insurers must immediately defend unless and until they can conclusively establish" that Montrose intentionally or deliberately caused environmental contamination.¹⁶⁹ According to

¹⁶⁴ *Id.* at 577–78 (citation omitted).

¹⁶⁵ 419 P.2d 168, 177 (Cal. 1966).

¹⁶⁶ *Id.*

¹⁶⁷ *Id.* at 178.

¹⁶⁸ 861 P.2d 1153 (Cal. 1993).

¹⁶⁹ Paula L. Harrington, Note, *The Duty to Defend in California After Montrose Chemical Corporation v. Superior Court: Is the California Supreme Court Protecting Policyholders or Encouraging Litigation and the Early Settlement of Unworthy Claims?*, 31 CAL. W. L. REV. 165, 179 (1994) (quoting *Montrose Chem. Corp.*, 861 P.2d at 1161).

one commentator, Paula Harrington, “[e]ven where the facts learned from all sources overwhelmingly point to intentional conduct, the insurer is not free to unilaterally deny a duty to defend without facing a court ruling that it must defend based on a mere possibility of coverage.”¹⁷⁰

It should be noted, however, that regardless of how broadly an insurer’s duty to defend claims of intentional acts is defined under the *Gray* test, that duty is not infinite. In *Gray*, the insurer had a duty to defend because of the possibility of a judgment against the insured based upon nonintentional conduct.¹⁷¹ However, that is not always the case. Ultimately,

The insurer’s duty to defend is linked to coverage under its policy; an insurer’s promise to defend its insured against even groundless, false or fraudulent suits does not affect this basic principle. An insurer’s contractual obligation to defend baseless, meritless or specious claims does not mean that it is bound to defend claims that its policy does not cover. . . . No matter how broadly construed an insurer’s duty to defend might be, an insurer has no duty to defend when there is no potential for coverage under *any* theory.¹⁷²

Courts outside of California have had no less difficulty developing a bright line test for determining when an insurer has a duty to defend an insured against allegations of an intentional act. Recent decisions in Michigan have held that insurance coverage is not precluded as a matter of law under the intentional acts exclusion unless the insured intended both the act and the injury.¹⁷³ In Louisiana, the State Supreme Court established that an injury is barred from insurance coverage only when the insured has the subjective intent to cause a specific injury.¹⁷⁴ Unfortunately, however, these tests do little to provide consistency in the

¹⁷⁰ *Id.* at 191.

¹⁷¹ *Gray*, 419 P.2d 168.

¹⁷² Douglas R. Richmond, *Reimbursing Insurers’ Defense Costs: Restitution and Mixed Actions*, 35 SAN DIEGO L. REV. 457, 460 & n.17 (1998) (emphasis added).

¹⁷³ See *Arco Indus. Corp. v. Am. Motorists Ins. Co.*, 531 N.W.2d 168 (Mich. 1995); *City of Bronson v. Am. States Ins. Co.*, 546 N.W.2d 702 (Mich. Ct. App. 1996); *Auto-Owners Ins. Co. v. Harrington*, 538 N.W.2d 106 (Mich. Ct. App. 1995); Charles W. Browning, *Annual Survey of Michigan Law*, 43 WAYNE L. REV. 1033, 1064–77 (1997).

¹⁷⁴ *Breland v. Schilling*, 550 So. 2d 609, 611 (La. 1989). See J. Lobrano, *Recent Development: Breland v. Schilling: The Intentional Act Exclusion Clause in the General Liability Policy—What Did You Intend?*, 65 TUL. L. REV. 443, 446–47 (1990).

application of the exclusion. In a case that was resolved by the Eleventh Circuit, juveniles were playing a “BB gun game” which ultimately caused an eye injury.¹⁷⁵ The court held that the intentional act exclusion did not apply if the nineteen year-old insured’s intentional act caused harm when his intent was to cause no harm.¹⁷⁶ Yet, in a Kansas case, the intentional act exclusion applied if the eleven year-old insured knew the consequences were substantially certain to result from his act.¹⁷⁷

The tendency to find coverage in the face of intentional acts cannot to be underestimated. Even a criminal conviction of fraud may not preclude the duty to defend. In *United States v. Weiner, W., L., and B.* were each convicted on several fraud counts of violating Federal securities laws.¹⁷⁸ They belonged to an accounting firm that maintained a professional liability policy with St. Paul Fire and Marine Insurance Company.¹⁷⁹ Civil suits for damages, some of which were based on negligence, were then filed against W., L., and B.¹⁸⁰ St. Paul asked the court to declare that it need not provide W., L., and B. with a defense.¹⁸¹ It referred to a clause in the professional liability policy excluding liability for “dishonesty, misrepresentation, or fraud.”¹⁸² The court reversed summary judgment in favor of the insurer because “[d]espite the defendants’ criminal convictions, the possibility remained that St. Paul had a duty to defend the civil actions brought against the defendants.”¹⁸³

In contrast, the heinous nature of sex crimes would appear to provide a straightforward resolution of the intentional acts exclusion. Indeed, in *J.C. Penney Casualty Insurance Co. v. M.K.*, the California Supreme Court held that “insurers are not required to indemnify their insureds for damages caused by an insured’s sexual molestation of a child.”¹⁸⁴ Even though before trial the third party dismissed

¹⁷⁵ *Allstate Ins. Co. v. Steinemer*, 723 F.2d 873, 874 (11th Cir. 1984).

¹⁷⁶ *Id.* at 877.

¹⁷⁷ *See Bell v. Tilton*, 674 P.2d 468 (Kan. 1983).

¹⁷⁸ 578 F.2d 757, 763 (9th Cir. 1978).

¹⁷⁹ 606 F.2d 864, 866 (9th Cir. 1979).

¹⁸⁰ *Id.* at 866, 869.

¹⁸¹ *Id.* at 865–66.

¹⁸² *Id.* at 867.

¹⁸³ *Id.* at 869.

¹⁸⁴ 804 P.2d 689, 690 (Cal. 1991).

all claims of intentional tort and pursued only claims of negligence, the court concluded “there is no coverage as a matter of law. . . . [E]very court to decide this issue under California law has held that a homeowner’s insurance policy does not provide liability coverage for child molestation.”¹⁸⁵ In the court’s view, “[s]ome acts are so inherently harmful that the intent to commit the act and the intent to harm are one and the same.”¹⁸⁶

The absolute and seemingly intuitive pronouncement made by the California Supreme Court in the *J.C. Penney Casualty Insurance Co. v. M.K.* case has since been tempered. In *National Union Fire Ins. Co. v. Lynette C.*, for example, the California Court of Appeal concluded that the insurer had a duty to provide coverage for the insured when, based on a jury verdict, she negligently failed to use reasonable care to prevent the sexual molestation of a child by her husband.¹⁸⁷ The exclusionary clause of the policy protected the insured unless a final judgment established “acts of active or deliberate, licentious, immoral or sexual behavior committed by the Insured with actual licentious or immoral purpose and intent were material to the cause of action.”¹⁸⁸ Construing broadly any ambiguities in the policy in favor of the insured, the court found that the exception to the policy exclusion could be reasonably read to protect one insured against claims based on a second insured’s (the husband’s) sexual conduct as long as the first insured had not directly engaged in the conduct.¹⁸⁹ The court held that this comported with the reasonable expectations of an ordinary person and therefore the insurer had the duty to provide coverage under the language of the policy.¹⁹⁰ Additionally, the court held that coverage under these circumstances would not violate public policy since the insured did not directly engage in intentional or criminal acts, only negligent conduct.¹⁹¹ Here the court cited California Insurance Code section 533,

¹⁸⁵ *Id.* at 693.

¹⁸⁶ *Id.* at 698. See also *Reagan’s Vacuum Truck Serv., Inc. v. Beaver Ins. Co.*, 37 Cal. Rptr. 2d 89 (Cal. Ct. App. 1994) (no potential for coverage for intentional torts of intentional concealment and aggravated injury and intentional infliction of emotional distress).

¹⁸⁷ 279 Cal. Rptr. 394 *passim* (Cal. Ct. App. 1991).

¹⁸⁸ *Id.* at 396.

¹⁸⁹ *Id.* at 396–97.

¹⁹⁰ *Id.* at 398.

¹⁹¹ *Id.* at 402.

which “expressly provides that an insurer is not exonerated by the negligence of the insured.”¹⁹²

As the foregoing illustrates, analysis of the intentional injury exclusion can be unexpectedly difficult. Decisions regarding the intentional acts exclusion are further complicated by three primary practical difficulties. First, the intentional acts exclusion in the context of liability insurance necessarily involves a third party claimant whose complaint shapes the scope of a policyholder’s coverage. Second, the analysis of exclusions for intentional conduct in the context of liability insurance often implicates not only the insurer’s duty to indemnify but also its duty to defend. Third, the public policy favoring compensation for victims colors the denial of coverage for insureds.

a. The Third Party’s Role

The first factor that complicates application of the intentional acts exclusion is that liability coverage for an insured’s torts necessarily involves a third party claimant whose complaint shapes the scope of an insured’s coverage. The difficulty is created by the myriad of different analytical approaches courts use in

¹⁹² *Id.* at 401. *Accord* Horace Mann Ins. Co. v. Barbara B., 846 P.2d 792, 797–98 (Cal. 1993).

Following this thread, the Supreme Court of Wisconsin in *Loveridge v. Chartier*, 468 N.W.2d 146 (Wis. 1991), held in part that statutory rape of a consenting sixteen year old female was not harmful as a matter of law, and that allowing insurance coverage for *negligent* transmission of a sexually transmitted disease would not violate public policy. *Id.* at 157–58. In response to the nationwide increase in similar claims, many homeowner’s policies now include an “STD” exclusion.

In another California Appeals court decision, *State Farm & Casualty Co. v. Eddy*, the court found that the insurer had a duty to defend the insured against a complaint which alleged both negligent and intentional torts, specifically the infliction of genital herpes on a third party by way of voluntary sexual intercourse. 267 Cal. Rptr. 379, 380–81 (Cal. 1990). Eddy argued that he had believed at the time that he did not have herpes and had not intended nor expected to transmit the disease. *Id.* The intentional acts exclusion of the policy would defeat coverage only if the consensual act of intercourse resulted in an intended harm, done with a “preconceived design to inflict injury.” *Id.* at 384. Since the issue of Eddy’s subjective intent was a triable issue of material fact for the jury to decide, the court held that, as a matter of law, the insurer had a duty to defend against the complaint since it could potentially be required to indemnify for Eddy’s negligence. *Id.* at 381–82.

The capricious nature of the cases dealing with sex crimes is illustrated by California’s response to a similar situation. After Hollywood-star Rock Hudson’s death from an AIDS-related illness, his partner prevailed in a lawsuit for damages in which the jury found that Hudson had concealed his HIV status and continued to have high-risk sex. *Aetna Cas. & Sur. Co. v. Shefft*, 989 F.2d 1105, 1106 (9th Cir. 1993). The jury awarded \$14,500,000 in compensatory damages. *Id.* The state administrator sued Hudson’s liability insurer for coverage, but the court held that high-risk sex is an intentional act which is inherently harmful and therefore uninsurable. *Id.* at 1109.

determining coverage, each of which treat the third party complaint in a different manner. For example, the most common form of coverage assessment considers “eight corners,” consisting of the complaint and the insurance policy.¹⁹³ With this approach, the courts are freed of the need to ascertain facts extrinsic to the eight corners.¹⁹⁴ At the other extreme is the approach in which evidence extrinsic to the eight corners plays a much greater role.¹⁹⁵ The breadth of the latter has led to the tendency of the judiciary to look at liability insurance policies as “litigation insurance,” which has had the effect of forcing insurer participation with little regard for the intentional acts exclusion.¹⁹⁶ Accordingly, California courts have established a duty to defend when there is a “potential” for coverage.¹⁹⁷ As is always the case, there exist other approaches scattered between these two extremes.¹⁹⁸

For purposes of this article, one related and significant difficulty will be sidestepped. This is not a trivial oversight. Reliance on the complaint introduces considerable uncertainty into the equation because a third party might resort to “artful” pleading simply to bring a deep pocket, in the guise of the insurer, into the fray. If the plaintiff alleges covered offenses such as misappropriation of trade

¹⁹³ Ellen S. Pryor, *The Tort Liability Regime and the Duty to Defend*, 58 MD. L. REV. 1, 23 (1999).

¹⁹⁴ Am. Alliance Ins. Co. v. Frito Lay Inc., 788 S.W.2d 152, 153–54 (Tex. App. 1990). Under this approach, “[t]he duty to defend is not affected by facts ascertained before suit, developed in the process of litigation, or by the ultimate outcome of the suit.” *Id.* at 154. One commentator has suggested that this approach is the majority approach, and notes that other states generally applying this standard (albeit by different names) include Florida, Illinois, Minnesota, New York, Ohio, and Washington among others. Willy E. Rice, *Insurance Contracts and Judicial Discord Over Whether Liability Insurers Must Defend Insureds’ Allegedly Intentional and Immoral Conduct: A Historical and Empirical Review of Federal and State Courts’ Declaratory Judgments—1900–1997*, 47 AM. U. L. REV. 1131, 1152–54 (1998).

¹⁹⁵ Alaska requires a defense based on facts “known or reasonably ascertainable.” *Cont’l Ins. Co. v. U.S. Fid. & Guar. Co.*, 528 P.2d 430, 434 (Alaska 1974). Indiana similarly examines “the allegations of the complaint coupled with those facts known to or ascertainable by the insurer after reasonable investigation.” *Trisler v. Ind. Ins. Co.*, 575 N.E.2d 1021, 1023 (Ind. Ct. App. 1991).

¹⁹⁶ See *Gray v. Zurich*, 419 P.2d 168, 176 n.15 (Cal. 1966). *Gray* held that a “[d]efendant cannot construct a formal fortress of the third party’s pleadings and retreat behind its walls. . . . [C]ourts do not examine only the pleaded word but the potential liability created by the suit.” *Id.*

¹⁹⁷ See, e.g., *Montrose Chem. Corp. v. Admiral Ins. Co.*, 913 P.2d 878 *passim* (Cal. 1995).

¹⁹⁸ *Hawkeye-Sec. Ins. Co. v. Clifford*, 366 N.W.2d 489, 491 (S.D. 1985) (holding that ambiguous pleadings do not preclude coverage if it “arguably appears from the face of the pleadings in the action against the insured that the alleged claim, if true, falls within policy coverage”); *Aetna Cas. & Sur. Co. v. Sunshine Corp.*, 74 F.3d 685, 688 (6th Cir. 1996) (opining that, notwithstanding the eight corners rule, a poorly drafted complaint does not necessarily preclude coverage).

secrets, as well as uncovered offenses such as patent infringement, the insurer may be required to cover defense costs for the entire action.¹⁹⁹ Conversely, a third party might draft the complaint in such a way as to discourage an insurer from coverage, thereby leaving the would-be insured without an insurer-funded defense.

The artful pleading problem is especially problematic in those jurisdictions that rely more nearly on the eight corners approach.²⁰⁰ By excluding extrinsic evidence of coverage or non-coverage, such jurisdictions depend on a third party's pleading to an exaggerated extent.²⁰¹ While, in my judgment, this cedes too much power to third parties, my working assumption is that the various approaches for analyzing the scope of coverage account for the vagaries of pleading and, if they do not, they are cognizant of the oversight.²⁰²

b. The Duty to Defend

A second factor affecting the application of the intentional acts exclusion is that the exclusion implicates not only the insurer's duty to indemnify but also its duty to defend. Thus, courts have limited application of the intentional injury exclusion to an insurer's obligation to indemnify an insured and not to an insurer's duty to defend.²⁰³ Part of the justification for this view lies in the fact that coverage often is not or cannot be determined until a suit is resolved and thus the duty to defend must necessarily be much broader than the duty to indemnify.²⁰⁴

¹⁹⁹ See *John Deere Ins. Co. v. Shamrock Indus., Inc.*, 696 F. Supp. 434, 440 (D. Minn. 1988).

²⁰⁰ In *Horace Mann Ins. Co. v. Barbara B.*, the California Supreme Court dismissed the possibility that artful pleading would influence the outcome of these kinds of cases. 846 P.2d 792, 799 (Cal. 1993). Justice Baxter in a concurring opinion and Justice Arabia in a dissenting opinion both voiced skepticism about this aspect of the opinion. *Id.* at 801–05.

²⁰¹ Susan Randall, *Redefining The Insurer's Duty to Defend*, 3 CONN. INS. L.J. 221, 222–23 (1997) (third party's lawyer can manipulate coverage); Gregor J. Schwinghammer, Jr., *Insurance Litigation in Florida: Declaratory Judgments and the Duty to Defend*, 50 U. MIAMI L. REV. 945, 973–74 (1996) (insurer is trapped in the “formal fortress” of the third party's complaint).

²⁰² Some courts are quick to ferret out pleadings drafted for the purpose of bringing an insurer into a dispute. See *Linebaugh v. Berdish*, 376 N.W.2d 400, 406 (Mich. 1985) (negligence claim in the context of sexual misconduct was “a transparent attempt to trigger insurance coverage”).

²⁰³ See *Gray v. Zurich*, 419 P.2d 168, 176–77 (Cal. 1966) (insurer has a duty to defend insured's assault).

²⁰⁴ Guy William McRoskey, *The Rule in a Contribution Action Between Third-Party Insurers Wherein the Plaintiff Insurer Seeks Reimbursement of Defense Costs from the Defendant Insurer After a Collusive Fraud on the Plaintiff Insurer Under California Law*, 36 SAN DIEGO L. REV. 797, 809 (1999).

In the past, courts have had difficulty separating an insurer's duty to defend from its duty to indemnify. Insurers often claim that a duty to defend is contingent upon a finding that the insurer is bound to indemnify the insured. However, a determination that there is a duty to indemnify is often not possible at the outset of a suit because it is often unclear whether a third party claim falls within the boundaries of the indemnification policy until the suit is concluded. At best, these kinds of contentions are difficult to resolve.²⁰⁵ In *Gray v. Zurich*, the court held that "[s]ince the instant action presented the potentiality of a judgment based upon nonintentional conduct, and since liability for such conduct would fall within the indemnification coverage, the duty to defend became manifest at the outset."²⁰⁶ Of paramount importance in that case was the duty to defend.

c. Victim Compensation

While the policy underlying the intentional acts exclusion appears to be straightforward, the application of the public policy rationale is not as simple as it may seem. This is illustrated by a significant variant of the public policy rationale—the compensation of victims. Professor James Fischer has framed the issue clearly, "to the extent tort law retains vestiges of retribution or punishment of

²⁰⁵ The *Gray* court found that:

the nature of the obligation to defend is itself necessarily uncertain. Although insurers have often insisted that the duty arises only if the insurer is bound to indemnify the insured, this very contention creates a dilemma. No one can determine whether the third party suit does or does not fall within the indemnification coverage of the policy until that suit is resolved. . . . [Thus, t]he carrier's obligation to indemnify inevitably will not be defined until the adjudication of the very action which it should have defended. Hence the policy contains its own seeds of uncertainty; the insurer has held out a promise that by its very nature is ambiguous.

Gray, 419 P.2d at 171.

²⁰⁶ *Id.* at 176. Intellectual property infringement also introduces a wrinkle in this context. One commentator has observed:

[f]or most insureds, particularly for intellectual property litigation, the duty to defend is more important than the duty to indemnify. Many intellectual property cases settle with little or no money changing hands. The expense of defending a lawsuit is far greater than the cost of most settlements. Moreover, by compelling an insurer to defend, an insured may also win the indemnity battle. Insurers that understand economic reality know that it often costs less to contribute to settle a case than to defend it.

Richard L. Antognini, *What You Need to Know About Intellectual Property Coverage*, 31 TORT & INS. L.J. 895, 901 (1996).

the tortfeasor as end purposes, indemnification is thought to interfere with the achievement of” the public policy goals of deterring intentional wrongdoing.²⁰⁷ Professor Fischer argues, however, that “the ‘no indemnification’ policy rests on the erroneous assumption that payment in these cases benefits the insured. The reality is otherwise Any payment under the policy would go to the victim with the insurer in turn subrogated to the victim’s claim against the insured to the amount of the payment.”²⁰⁸ For example, in *Young v. Brown*, a Louisiana case involving the criminally negligent shooting of a man with a shotgun, the court held that the intentional acts exclusion should not be applied in third party claims.²⁰⁹ In reaching its decision, the court determined that the traditional public policy considerations regarding the indemnification of intentional acts should be balanced against the public policy concern for compensating the victim. Using this analysis, the court concluded that the welfare of the innocent victim was of greater importance, and thus, allowed for indemnification in the name of public policy—a public policy that the court found to trump the policy supporting the intentional acts exclusion. This view of the public policy justification of the intentional acts exclusion colors its application in even the simplest of situations.

To be sure, the policy that supports exclusions for intentional acts has had an uneasy existence. For example, this public policy underpinning is thought to be inapplicable where punitive damages are imposed for “conduct which is neither illegal nor intentional.”²¹⁰ While this is an unexceptional proposition, it is also guided, in part, by the idea that a denial of coverage in many cases is a denial of compensation to an injured third party. Indeed, some have argued that because the exclusion operates to the disadvantage of injured third parties, the intentional acts exclusion should not be applied in the case of third party claims.²¹¹ Despite the

²⁰⁷ Fischer, *supra* note 147, at 111.

²⁰⁸ *Id.* at 111–12.

²⁰⁹ 658 So. 2d 750, 753 (La. Ct. App. 1995).

²¹⁰ John D. Boyle, *Insurance Coverage for Punitive Damages and Intentional Conduct in Massachusetts*, 25 NEW ENG. L. REV. 827, 839 (1991) (discussing coverage for these damages outside the context of the “intentional acts exclusion”). The court in *Dykstra v. Foremost Ins. Co.* wrote, “[s]ince insurance is designed to protect against contingent or unknown risks of harm, rather than harm that is certain or expected, it is well settled that intentional or fraudulent acts are deemed purposeful rather than accidental and, therefore, are not covered under a [commercial general liability] policy.” 17 Cal. Rptr. 2d 543, 545 (Cal. Ct. App. 1993) (citations omitted); see McRoskey, *supra* note 206, at 869.

²¹¹ Rice, *supra* note 196. Professor Rice asserts that courts often allow their biases toward certain classes of victims to influence their judgments, and that too many victims go uncompensated for their injuries because courts declare the insurer has no duty to defend. *Id.* at 1136. He proposes legislation that

uncertain landscape in which the intentional injury exclusion is applied, however, it is certain that the doctrine is firmly entrenched in insurance law. While the difficulty in actual application of the doctrine is well chronicled, there is no significant movement to second-guess the policy underlying this doctrine.

5. Moral Hazard

The role of moral hazard in insurance law, at least for purposes of this article, is an attenuated one. Moral hazard as expressed in this context refers to the danger that the very availability of insurance effectively increases the risk that the peril insured against will occur.²¹² This phenomenon is easiest to see in the case of liability or third-party insurance. The fact that the losses occasioned by my negligent driving can be offset by liability insurance may very well encourage me to take more risks. Still, as is developed below, the effect of moral hazard is such that the encouragement of risky behavior is often offset by other considerations.²¹³ This is true in first-party insurance relationships and is likely true in many third-party relationships.

In the case of first-party insurance, the existence of earthquake coverage on my personal residence does not change my behavior because I have no meaningful way to alter the outcome of my bargain. The role of moral hazard in this context is *de minimis*. Similarly, while malpractice insurance is available to shield me from my legal missteps, I am more motivated to do good legal work by the desire to maintain a good reputation and my desire to do the best legal work that I can do for my clients. In this case, while I can meaningfully alter the outcome of my bargain, there are significant countervailing considerations that outweigh any attraction in taking chances. In neither of these cases am I tempted to take more risk because of the existence of insurance.²¹⁴

requires insurers to defend policyholders even when a third party complaint alleges an intentional act. *Id.* at 1218.

²¹² Baker, *supra* note 87, at 238 (“What moral hazard means is that, if you cushion the consequences of bad behavior, then you encourage that bad behavior.”); Jacob Loshin, *Insurance Law’s Hapless Busybody: A Case Against the Insurable Interest Requirement*, 117 YALE L.J. 474, 480–81 (2007) (moral hazard refers to insured’s lax care for property insured against loss).

²¹³ I grant that this overstates the case. Professor Tom Baker may well have captured the essence of the concern with his pithy comment “people behave differently when they bear the costs of their misfortune than when they do not.” Baker, *supra* note 34, at 45. My point is that good behavior can often be attributed to costs apart from the insurance context.

²¹⁴ Baker, *supra* note 87, at 279 (for insurance to reduce care, insureds must be capable of modifying relevant behavior).

While I concede that an insured can affect the insurance bargain under the guise of moral hazard, the main point of focus is not the moral hazard itself but rather that the insured has the ability to affect the bargain.²¹⁵ In this respect, moral hazard introduces nothing new. Additionally, to the extent that the availability of insurance creates a cognizable moral hazard, this encouragement of risky behavior, if it exists, can be taken into account by insurers. That is, it can be part of the calculus that an insurer considers in accepting a class of risk.²¹⁶ This being the case, it follows that moral hazard plays no significant role in the view of the insurance bargain taken by this article.

CONCLUSION

This article begins with a simple premise. Insurance policies are unique contracts that deal with the commodity of risk. An insured, to be sure, is subject to a great many constraints in striking the insurance bargain. The bargain is one of adhesion and the policy itself is rife with terms with which even sophisticated parties cannot tinker. Within this bargain, however, the insured is nonetheless bound by the contract doctrine that calls for a party not to do anything that would interfere with the other party's ability to obtain the benefit of that bargain.

As demonstrated above, the insured's ability to alter the risk calculus made by the insurer should, as a matter of contract law, have consequences. Several insurance law doctrines can be traced to these contract law fundamentals and can, indeed, be readily explained by reference to these fundamentals without much manipulation. While insurance law can be impenetrable, impenetrability is not an impediment to basic understanding of doctrine and the application of these doctrines in a common-sense way. Thus, a return to fundamentals is a useful exercise to make insurance doctrine comprehensible to a broader audience.

²¹⁵ As Professor Abraham observes, the insured's advantage over an insurer in this regard is the result of the asymmetric allocation of information to the insured. ABRAHAM, *supra* note 35, at 35. One commentator suggests that one of the foci of moral hazard is not an orientation to individuals, but rather a matter which creates societal incentives which affect the insurance bargain. Deborah A. Stone, *Moral Hazard: Insurance as Moral Opportunity*, 6 CONN. INS. L.J. 11, 13 (1999).

²¹⁶ Baker, *supra* note 87, at 250 (insurers can weed out bad actors).