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The 2011 Japanese earthquake: how claims will be impacted by new Japanese Insurance Act

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Summary

The Japanese earthquake of 11 March 2011 and ensuing tsunami devastated the Tohoku region and caused unparalleled losses to the Japanese economy. As the area gradually recovers and reconstruction continues, the extent of losses to the Japanese and international insurance markets is becoming clearer. The large majority of the insurance claims are governed by Japanese law, so we therefore provide a profile of the losses, and highlight some adjustment issues and relevant provisions of the new Japanese Insurance Act.

Overview of losses

The 9.0 strength earthquake is the costliest natural catastrophe of all time, with overall economic loss estimated at approximately US$ 210bn. The Japanese Government predicts that the insured losses will reach 2.7 trillion Yen (USD 34.2bn) in total, which is less than the US$ 41bn insured loss from the 9/11 terrorist attacks and US$ 65bn from Hurricane Katrina.

Compensation paid to date is estimated at approximately 1.8 trillion Yen (USD 22.8bn), of which Japan's non-life insurance industry has paid approximately 58%, an estimated 1.05 trillion Yen (US$ 13.2bn), with much of the balance paid by the Kyosai mutual insurers. Whilst the majority of insured losses have been incurred by the Japanese market, it is estimated that approximately US$ 12bn of losses, around 35%, are reinsured internationally.

The life insurance sector has paid approximately 130 billion Yen (US$ 1.65bn) in life and personal accident claims, a figure lower than initially anticipated. It is at present unclear whether this shortfall is due to difficulties in processing claims or because the loss of life was lower than had initially been feared.

Contingent business interruption losses from the events on 11 March have affected businesses worldwide. The scale of losses appears to be substantial but is currently the largest unquantified element. Nevertheless, reports suggest that the earthquake has triggered large numbers of enquiries about business interruption cover for non-owned property damage.

Adjustment issues

Following the losses, the General Insurance Association of Japan (GIAJ) (equivalent to the UK Association of British Insurers (ABI)) came under pressure from the Japanese

Government for its members to pay claims as quickly as possible. This caused logistical difficulties for insurers given the limited number of loss adjusters in Japan. Although there is no official requirement for loss adjusters to be registered in Japan, insurers are expected to use GIAJ "Registered Property Loss Appraisers" unless there is a specific reason otherwise.

The key issues under any property insurances will be adjusting claims where policies exclude or provide different levels of cover for earthquake, tsunami and/or flood damage, or where exclusions for pollution or contamination may apply. Given problems with accessing certain areas, and the limited number of loss adjusters, this has resulted in losses under homeowner policies in certain regions being certified from satellite and aerial photographs rather than by a conventional adjustment process. Whilst most properties in these areas are likely to be subject to a total loss, this high level claim handling may result in regular adjustment issues being overlooked.

Similarly, given the number of people who are missing, and the records which have been destroyed, the Life Insurance Association of Japan announced soon after the loss that contractual indemnification provisions would not be applied. Therefore instead of the usual requirements to present a death certificate and medical report, most insurers have paid claims in respect of individuals who have been reported on a database of missing persons established after the earthquake.

These pragmatic and humanitarian responses to the earthquake are understandable given the scale of devastation caused. However, local insurers cannot rule out issues being raised when they seek to recover losses under their outwards reinsurances. It will therefore be interesting to see if a broader interpretation of what constitutes "proper and businesslike" adjustment of claims in these circumstances will be applied in respect of the reinsured's obligations under any follow the settlements clauses. Overall, it is in both parties' interests for insurers to keep their reinsurers informed as to the adjustment procedures in place and to provide regular claim updates.

Business Interruption

The adjustment of business interruption (BI) losses for commercial risks will inevitably give rise to familiar issues for large losses involving devastation over a wide area. Japan's tourist industry is one of the worst affected sectors, which is likely to raise similar issues to those illustrated in the English High Court's judgment in *Orient-Express Hotels v Assicurazioni Generali SPA (UK),* [2010] EWHC 1186 (Comm). The case was an appeal from an arbitration award in respect of loss to a hotel in New Orleans, Louisiana, arising from Hurricane Katrina.

In that case, the policy provided for the loss to be adjusted so that it would represent "*the result which but for the Damage would have been obtained during the relevant period*". 'Damage' was defined under the relevant policy as the damage to the premises in question.

Therefore, the loss was adjusted as if the hotel itself had not been damaged but the surrounding area had still suffered from Hurricane Katrina. The policy wording operated to the insured's detriment due to the loss of tourism resulting from the Hurricane, which allowed insurers to argue that even if the hotel had remained fully open it would have attracted few guests.

Whilst the *Orient Express* case was decided according to the specific wording in question, BI claims in general will be carefully assessed against the backdrop that the Japanese economy was in recession before the earthquake, and that the car manufacturing industry had been in decline since at least eight months before.

Other complex issues have been raised under contingent business interruption (CBI) policies covering insureds worldwide. These policies cover loss sustained to the insured's business by reason of one of its suppliers or customers suffering damage at their premises. Issues commonly arise as to the definition of "supplier", and whether this has to be a direct supplier or may include suppliers further away in the supply chain. As with regular BI losses, the physical damage must be of a type insured by the policy, so nuclear-related losses are likely to be excluded. The territorial limits must also be checked; for insureds with global organisations, it can be unclear whether CBI losses would be classified as occurring in Japan or in the place of the insured's affected operations, which may affect the level of cover provided.

Japanese Insurance Act

The adjustment of losses will be impacted significantly by the Japanese Insurance Act, which came into force in April 2010. This major piece of legislation replaced the Commercial Code of 1899, and the application of its provisions has not yet been tested in the Japanese courts.

Japanese culture has led to a strong aversion to litigation, which applies equally to the insurance environment. In addition, many insurers subscribe to an alternative dispute resolution scheme for financial institutions, which reduces court litigation further. As a result, there are only a handful of reported insurance law cases in Japan.

Given the unprecedented scale of the recent losses and devastation, it appears that local insurers are taking a pragmatic approach to dealing with claims, where the strict policy terms may not be applied. The vast majority of losses incurred by international (re)insurers arise under reinsurances of Japanese insurers, in respect of direct policies governed by Japanese law. The new Act applies to any (re)insurance policies subject to Japanese law, with exemptions for certain marine, aviation, cargo and nuclear risks.

Chapter 2 of the Act governs damage insurance contracts, which include most property and casualty policies. There are separate chapters of the Act covering life, personal accident and medical insurance classes. (Re)insurers should be aware that the mandatory provisions in the Act will overrule express policy terms. For consumer insurance, the Act also

introduces unilateral mandatory provisions, which will only overrule express terms where the mandatory provisions are in the insured's favour.

Some key provisions are as follows.

Non-disclosure and cancellation – Article 4 provides that an insured has a duty to disclose material information, although this is to be defined largely by the questions an insurer asks in the proposal process. Under Article 28, non-disclosures which are grossly negligent or in bad faith are actionable and entitle an insurer to cancel; however, a mere negligent non-disclosure would not. There is a one-month time limit for an insurer to exercise an actionable right of cancellation from the time it becomes aware of relevant facts. By Article 31, cancellation of policies (under Article 28) will only be retroactive where a claim has arisen in respect of damage caused by facts which were not disclosed at inception.

Mitigation of loss – Article 13 imposes an obligation on policyholders to mitigate any losses, requiring them to respond proactively to any damage. Whilst no remedy is stated for failure to mitigate, it would follow that the claim should be reduced by the net amount which could have been saved by mitigation. Article 23 imposes a parallel obligation on insurers to indemnify any related mitigation costs, although there is no guidance to specify that such costs should be necessary or reasonable.

Notice of claims – Under article 14, the insured has a general obligation to notify claims without delay, although no remedy is specified for a failure to do so. This could be significant where there are ongoing business interruption exposures, and it remains to be seen whether the courts will allow insurers to claim damages for delay in notification in such a situation.

Sequential/Concurrent Cause – Article 15 could prove to be important for the earthquake losses, as it provides that a sequential uncovered or excluded loss will not prevent an insurer being liable to indemnify damage which was first caused by a covered peril. Therefore, insurers could still be liable for damage if an excluded cause of loss, such as contamination or radiation exposure, follows a covered cause of loss, such as the earthquake or tsunami. It remains to be seen whether such loss will be apportioned between the covered and excluded perils. This provision is mandatory, and so will override any wording which seeks to exclude all losses with concurrent causes.

Deliberate acts – A potentially controversial provision is set out in article 17, which excludes losses caused by the insured's deliberate or grossly negligent acts. In principle, this term would clearly favour insurers, so it will be interesting to see how it is applied in practice.

Over-insurance – Where values have been agreed for insured items, these will in principle apply as the basis of any indemnity payment. However, insurers are given some protection by article 18, which provides that where the agreed value significantly exceeds the insurable value, the insurable value will apply.

Partial insurance – The concept of partial insurance is recognised by article 19 and is commonly used in Japan; for example, many household insurance policies will provide 50% cover in respect of earthquake losses. The article appears to provide for the indemnity to be adjusted in a similar way to adjustments by average where there is under-insurance, although in this case the partial insurance is intentional.

Contribution – The principle of contribution in the event of multiple insurances is enacted by article 20. This provides that when two or more insurances exist, each insurer would be liable for the full amount under their respective insurance contract if the other insurer has not paid the claim.

Subrogation – Subrogation principles and formulas are enacted via articles 24 & 25. Insurers may be surprised by the limitations imposed on the extent of their possible recovery, in particular where the insured amount is less than the amount of loss.

Time for payment – Under article 21, insurers are required to make prompt payment of losses, and will be liable for any delay after a reasonable period given the circumstances of the claim. By way of guidance, Standard Policies developed by an official insurance body state that payment must be made within 30 days of the necessary claim documents being presented, which is extended to 60 days if the Disaster Relief Act has been declared to apply.

Statute of limitations – Under article 95, the insured's right to demand payment of a claim, or a premium refund, will expire after three years from the date of loss. This is generally considered to be a mandatory provision which would override any shorter time limits in the policy.

Many of the above provisions of the Act are open to interpretation, so any guidance provided by the Japanese courts in disputes arising from earthquake-related claims will be valuable. In order to ensure a common understanding of claim handling procedures and how the Act will apply, international reinsurers are recommended to be proactive in requesting information and initiating discussions with local cedants. Reinsurers should also keep their retrocessionaires updated of the adjustment process so that any potential differences in approach can be resolved at any early stage.

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