

## ABHANDLUNGEN / ARTICLES

### **Insurance Law Issues Due to the Great East Japan Earthquake 2011**

(Part Two)

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### III. LIABILITY INSURANCE AND THE EARTHQUAKE

#### *1. The Exception Clause Interpreted by the Court*

It is obvious that no one is liable for the earthquake itself. However, for damages that resulted from the earthquake, someone's fault may have contributed to an occurrence of loss or its aggravation. In such a case, the faulty person can be held liable for the damages wholly or partly.

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\* As with Part One, the author hereby appreciates the assistance provided for by the practitioners with regard to the information reported in this article. The author remains solely responsible for the whole article.

If the liable person has insured himself for a liability that he may incur, he will be disappointed to find in the policy an exception clause that exempts the insurer from compensating any damages ‘due to ... the earthquake or eruption, or tsunami that is caused by these’. Therefore, liability insurance will be of no help for accidents resulting from the earthquake. In a case decided recently by the Tokyo District Court and then by the Appeals Court of Tokyo on appeal, the interpretation of such an exception clause was disputed.

In this case, the plaintiff suffered from the overflow of water from the upper floor of an apartment house in Tokyo after the Great East Japan Earthquake. The earthquake created a crack in the conduit of the water boiler placed in the room above the plaintiff, and the water came out of the crack. The seismic intensity in the relevant region of Tokyo registered 5-upper on the Shindo scale.<sup>1</sup> The plaintiffs alleged that no other water boiler was damaged in that area of Tokyo after the earthquake, and that the resident on the upper floor should be liable as the owner of a structure with a defect according to Art. 717 of the Civil Code.<sup>1a</sup> The District Court affirmed that the water boiler lacked the robustness to resist the earthquake that it should normally be equipped with and that such a lack of robustness constitutes a defect under Art. 717 of the Civil Code.<sup>2</sup>

As the resident on the upper floor insured herself for liability that she might incur as the owner of the house, the plaintiffs named the insurer as the second defendant and requested that the insurance proceeds be paid directly to them.<sup>3</sup> The insurer pointed to the exception clause that excluded damages due to the earthquake from the covered risk, but the District Court held that the clause should be narrowly interpreted not to exclude such risks of an earthquake that society should normally be prepared for. According to the District Court, this applies only to huge and extraordinary earthquakes that cause damages of too great a scale for the insurer to diversify. The District Court held that the seismic intensity of scale 5 was not large enough for the exception clause to be applicable.

On appeal, the Appeals Court reversed the decision and exempted the insurer based on the exception clause. The Appeals Court found that the term ‘earthquake’ was not qualified in any manner in the exception clause and that any damage having a reason-

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1 The Shindo scale is used in Japan to denote the intensity of an earthquake, i.e. the local effects and potential for damage produced by an earthquake on the Earth’s surface as it affects humans, animals, structure, and natural objects. (*The Editors*)

1a Civil Code, Art. 717 (1): If any defect in the installation or preservation of any structure on land causes damages to others, the possessor of such structure shall be liable to the victims to compensate for those damages; provided, however, that, if the possessor has used necessary care to prevent the damages arising, the owner must compensate for the damages (Translation from the Japanese Law Translation Database System).

2 Tokyo District Court, 20 October 2011, Hanrei Jihô no. 2147, p. 124.

3 Because the insurance policy provided no right of direct claim for the third-party victim, it was doubtful that the plaintiffs’ argument had a sound basis anyway. However, the plaintiffs alleged that they acquired the claim for the proceeds by agreement with the insured.

able causal link with an earthquake, whatever its scale, was excluded from the coverage. As against the argument of the plaintiffs that the general conditions should be interpreted to the disadvantage of the employer of the conditions, the court held that the argument was not valid in a case where there was no ambiguity in the term used and that the term 'earthquake' was clear and unambiguous.<sup>4</sup>

## 2. *Reallocation of Earthquake Risks by the Court*

The above case was not the first one on which the meaning of the term 'earthquake' in the exception clause was disputed. In one case resulting from an earthquake of magnitude 7.8 on Okushiri Island, an isolated northern island off the coast of Hokkaido, in 1993, the plaintiffs argued that the exception clause in the fire insurance policy should be applicable only to such an extraordinary earthquake that destroys the actuarial basis. The court did not accept this argument and held that any earthquake fell under the 'earthquake' in the exception clause because the term 'earthquake' entailed no qualifying phrase.<sup>5</sup> In another case, a victim of the Great Hanshin-Awaji Earthquake of 1995 argued that the 'earthquake' in the exception clause in the fire insurance policy should mean only 'such an earthquake that financially risks the insurer because of the simultaneous fire occurring in a wide area besides the shaking itself'. Here again, the court did not accept this argument by holding that such an argument implied a negative evaluation of an exception for earthquake risks, which the court did not agree with.<sup>6</sup> The Appeals Court of Tokyo of 2012 followed these precedents in adopting a textual reading of the exception clause, even though the insurance product at issue was not the same as in the previous cases.

More importantly, the narrow interpretation by the District Court, intended or not, re-allocated the risks from the earthquake between the parties to the insurance contract. While the liability rules of tort law determine what people should and should not do, the insurance policy reflects the arrangement that the parties made through promise and payment. The courts are not entitled to change the allocation of risks that the parties arranged *ex ante*, unless the text of the clause is ambiguous and can be read in two or more ways.

Maybe the decision of the District Court poses a valid question about the rationale for excluding risks from even a small and insignificant earthquake. It is not clear why such risks should not be covered by an ordinary insurance policy if there was no unusual accumulation of risks. Still, the conclusion of the District Court cannot be justified,

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4 Appeals Court of Tokyo, 19 March 2012, Hanrei Jihô no. 2147, p. 118. The Appeals Court also denied the validity of the alleged transfer of the claim for proceeds by agreement, by pointing out that it amounted to the prohibited trust for conducting a suit.

5 Hakodate District Court, 30 March 2000, Hanrei Jihô no. 1720, p. 33.

6 Kobe District Court, 3 September 2002, unpublished (searchable in the database on [http://www.courts.go.jp/search/jhsp0010?action\\_id=first&hanreiSrchKbn=01](http://www.courts.go.jp/search/jhsp0010?action_id=first&hanreiSrchKbn=01)).

because the Great East Japan Earthquake was indeed an extraordinary disaster that did cause an accumulation of risks. Even if the scale of shaking that the insured suffered was small, the damage caused was part of the abnormally accumulated risks that the insurer intended to exclude from the cover under the insurance policy. The question raised by the District Court may be valid if the insurer relies on the exception clause in the case of a small earthquake affecting only limited areas

#### IV. THE EARTHQUAKE AS CATASTROPHIC RISK

##### 1. *The System to Address Catastrophic Risks*

The earthquake is a natural disaster that can be a catastrophe if its scale is huge. As long as human beings have no means to prevent or avoid it, society must learn to cope with it. Theoretically, three mechanisms are known to cope financially with the catastrophe: liability rules (tort law), first-party insurance and public intervention.<sup>7</sup> In the context of the earthquake, tort law is useful only when someone's negligence contributed to the damages together with the earthquake, as in the case detailed in the previous section. As regards first-party insurance, commercial insurance is often unavailable or not sufficiently available, and public intervention such as Japan's earthquake insurance is becoming more and more popular among countries exposed to earthquakes and other natural disasters.<sup>8</sup>

The reasons usually given for why commercial insurance is not available for earthquake risks are the lack of actuarial basis, the huge volume of risks involved and the problem of adverse selection.<sup>9</sup> Although some economists doubt that these are true problems, even those economists admit that the insurance market does not work in practice, because it is impossible for commercial insurers to ensure a smooth flow of premiums over many years, while the catastrophic event requires a large amount of payment at one time.<sup>10</sup> Public earthquake insurance is needed to address such an inter-temporal financing problem.

Designing earthquake insurance as a mechanism of public intervention in a catastrophic event is not easy. On the one hand, even if the earthquake risk *ex ante* is not private information, and therefore the problem of adverse selection may not be rele-

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7 M. FAURE, Comparative and Policy Conclusions, in: M. Faure & T. Hartlief (eds.), *Financial Compensation for Victims of Catastrophes: A Comparative Legal Approach*, pp. 435 et seq. (Springer, Vienna, 2006).

8 E.N. GURENKO, Building Effective Catastrophe Insurance Programmes at the Country Level: A Risk Management Perspective, in: E.N. Gurenko (ed.), *Catastrophe Risk and Reinsurance: A Country Risk Management Perspective 8-9* (Risk Books, London, 2004).

9 Non-Life Insurance Rating Organization of Japan (NLIRO), *Earthquake Insurance of Japan*, p.23-25 (NLIRO, Tokyo, 2008). <http://www.nliro.or.jp/english/earthquake.html>.

10 D.M. JAFFEE & T. RUSSELL, Catastrophe Insurance, Capital Markets, and Uninsurable Risks, *The Journal of Risk and Insurance*, Vol. 64, No. 2, p. 205 at pp. 206-207 (1997).

vant,<sup>11</sup> it cannot be socially and politically acceptable to apply precisely differentiated rates of premium. The freedom of choosing a place to live is not without limit, especially in a country like Japan where the habitable land is limited. As a result, public earthquake insurance usually takes into account the 'element of solidarity'.<sup>12</sup> On the other hand, the need to give a right incentive to prevent or mitigate loss *ex ante* should not be ignored. The government's relief *ex post*, when anticipated, could induce society members to fail to make efforts in preparing for the disaster in advance.<sup>13</sup> Earthquake insurance, therefore, must be equipped with the appropriate incentive mechanism as well.

## 2. *Review of the Earthquake Insurance Scheme*

After the Great East Japan Earthquake, the earthquake insurance system was naturally put to review.<sup>14</sup> The elements mentioned in the previous section were all raised before and examined by the project team established for the review. The Project Team concluded their work in a Report published in November last year (2012).<sup>15</sup>

The Report identified urgently required reform as well as issues to be discussed further. The issue requiring urgent reform was related to intertemporal financing. As already mentioned (I.2. above, in *Part One*), Japanese earthquake insurance is a mixed system of public and private responsibilities. As a result of the payments made for the losses from the Great East Japan Earthquake, the amount of reserves made by private insurers decreased to less than half of the amount before the earthquake. This implies that an earthquake of the same scale occurring immediately could exhaust the reserves and affect the solvency of private insurers. Identifying this risk, the Project Team proposed that a mechanism to revise the amount of responsibility for the private sector without the decision of the Diet be introduced. Considering the need of democratic control over the budget, however, this revision would be a temporary measure only to avoid insolvency of private insurers.<sup>16</sup>

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11 ID., p. 206.

12 GURENKO, *supra* note 8, p. 9.

13 FAURE, *supra* note 7, pp. 443, 446.

14 In fact, the review had begun before the Great East Japan Earthquake, as part of the overall review of the government's special financial accounts (special reserves) under the Democratic Party government. The focus at that time was whether the system could be wholly or partly left to the commercial insurance market. However, after the earthquake, the circumstances totally changed and the agenda shifted to the sustainability of the system. Cf. S. KOZUKA, Japanese Earthquake Insurance in Context, in: *International Business Law in the 21st Century: Challenges and Issues in East Asia*, forthcoming.

15 *Jishin hoken seido ni kansuru purojekuto ūmu hōkoku-sho* [The Report of the Project Team on the Earthquake Insurance Scheme], dated 30 November 2012] (hereinafter 'the Report'). The Report is available only in Japanese:  
[http://www.mof.go.jp/about\\_mof/councils/jisinpt/report/index.htm](http://www.mof.go.jp/about_mof/councils/jisinpt/report/index.htm).

16 The Report, *supra* note 15, pp. 4-5.

Another issue discussed by the Project Team was the rate of the premiums. The current system differentiates the premiums by prefecture, based on the Probabilistic Seismic Hazard Map released by the government.<sup>17</sup> The Report of the Project Team emphasised the aspect of ‘social solidarity’ and endorsed shrinking the differences between the prefectures rather than differentiating even further.<sup>18</sup> The Report justified such a proposal by recent experiences, including earthquakes other than the Great East Japan Earthquake, which proved that the Probabilistic Seismic Hazard Map cannot be fully relied on. A careful reading of the Report, though, might find another connotation: the differences in the amount of premiums will be removed by raising the rate for the area that currently enjoys cheaper premiums.

The Project Team did not fail to consider introducing an incentive mechanism. The Report concluded that the discount in the premiums for those living in earthquake-proof houses be expanded and made more attractive to those insured.<sup>19</sup> On the other hand, the Project Team reversed its position about introducing a discount for inland residents in regions not exposed to the risks of tsunami and mentions it as ‘the issue to be discussed further’.<sup>20</sup> This compromised position may reflect the current situation: plans to relocate villages on the coast of north-eastern Japan, which have suffered from tsunami many times in history, to safer places inland are not making progress in the face of reluctance and opposition from the residents themselves.

The Project Team discussed many other issues, such as raising the insurable limit or offering earthquake insurance when a homeowner takes out a housing loan. However, it did not endorse an immediate reform. It is not an easy task to balance the social and political requirements (the ‘solidarity’ element) and behavioural reasonableness (the ‘incentive’ element) under the financial constraints of both the public and private sectors.<sup>21</sup> After all, coping with catastrophic loss is a well-known problem for which no one knows the right answer.

## CONCLUSION

The Great East Japan Earthquake was a true catastrophe. Its impact on Japanese society can never be forgotten, even after the physical and economic conditions are recovered (which has yet to be completed).

As this paper has argued, damages from the earthquake were not limited to the tsunami washing away houses and cars or the explosion of the nuclear power plant.

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17 NLIRO, *supra* note 9, pp. 54-55.

18 The Report, *supra* note 15, p. 12.

19 The Report, *supra* note 15, p. 13.

20 The Report, *supra* note 15, p. 13.

21 To fully understand why earthquake insurance cannot be built on the consideration of reasonableness alone, one must examine the function of the system in society. See KOZUKA, *supra* note 14.

Though not so much followed by the world's media, increased crime in the evacuated region or smaller accidents resulting in neighbourhood disputes are also outcomes of the earthquake. The lesson is that society must be prepared to cope with all these problems. The answer cannot be other than the adequate combination of tort law rules, commercial insurance and public intervention.

On the one hand, it is important not to mix up these three mechanisms. The interpretation of clauses in the insurance policy should not be confused with the interpretation of liability rules. The system of public intervention may need to consider the social and political elements, which the commercial insurance product does not care about. On the other hand, all these mechanisms need to be re-examined to see whether they are appropriately designed to address the risks of the earthquake. The insurers are advised to draft their exceptions clause precisely to reflect the abnormally enhanced risk. Public intervention has to be carefully designed so as not to give a wrong incentive for the people to neglect efforts of preventing and mitigating loss.

Finally, one cannot avoid thinking about social solidarity. The Japanese people often mentioned *kizuna* (literally 'bond') after the earthquake. If it means something more than emotional sympathy, society should not fail to substantiate its meaning through improving its social systems. The intelligence of society is now called for.

#### SUMMARY

*This article, consisting of two parts, reviews legal issues concerning compensation under insurance contracts for the economic loss incurred by the major earthquake off the Pacific coast of northeast Japan on 11 March 2011 and the following tsunami. The first part started with an overview over the damages caused and how the insurance industry responded to the disaster in general before it took up specific issues. Part Two continues the discussion by analysing how the Japanese courts dealt with the exception clause regularly found in insurance contracts that exempts the insurer from compensating damages due to earthquakes. It then discusses the need of public intervention to provide for an insurance while putting special emphasis on the question how such an insurance should be designed to avoid negative incentives.*

*(The Editors)*

## ZUSAMMENFASSUNG

*Dieser Beitrag, der aus zwei Teilen besteht, befasst sich mit den Rechtsfragen, die bei der versicherungsrechtlichen Bewältigung der Folgen des katastrophalen Erdbebens mit anschließenden Tsunami aufgetreten sind, das Japan am 11. März 2011 heimgesucht hat. Der erste Teil (ZJapanR Nr. 33) gab zunächst einen Überblick über die Schäden und die Reaktion der Versicherungsindustrie im Allgemeinen, um sich sodann speziellen Fragen zuzuwenden. Der zweite Teil des Beitrages setzt diese Diskussion fort und analysiert, wie die japanischen Gerichte die regelmäßig in Versicherungsverträgen zu findende Klausel interpretieren, vermittels derer die Versicherer eine Ersatzpflicht für erdbebenbedingte Schäden ausschließen. Ferner setzt sich der Verfasser mit der Notwendigkeit auseinander, aus diesem Grund von Seiten des Staates Versicherungsschutz zu leisten, wobei der Frage besondere Aufmerksamkeit geschenkt wird, wie dabei negative Anreizwirkungen vermieden werden können.*

*(Die Red.)*