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VOLUME 23

2016-2017

NUMBER 2

CONTENTS

ARTICLES

- REGULATION BY
GOVERNMENT-SPONSORED
REINSURANCE IN CATASTROPHE
MANAGEMENT *Qihao He* 291
- REMEDIES FOR BREACH OF THE
PRE-CONTRACT DUTY OF DISCLOSURE
IN CHINESE INSURANCE LAW *Zhen Jing* 327
- AGREEING IN THE SHADOW OF THE
POLICY: HOW CORPORATE INSURANCE
POLICIES IMPACT THE RESOLUTION OF
GOVERNMENTAL INVESTIGATIONS INTO
CORPORATE CRIME *Beth Olsen* 349

REGULATION BY GOVERNMENT-SPONSORED REINSURANCE IN CATASTROPHE MANAGEMENT

QIHAO HE*

I. INTRODUCTION

For over a century, reinsurance has been the preferred vehicle to shed primary insurers' catastrophe risk exposure.¹ The Cologne Reinsurance Company was the first professional reinsurance company, founded in 1842 following a catastrophic fire in Hamburg the same year.² Insurers have an increasing demand for more financial capacity when underwriting catastrophic risks. For example, reinsurers paid primary insurers 60 percent of the insured losses from the September 11 terrorist attacks, 65 percent from Hurricane Katrina, and 40 percent from Hurricane Sandy more recently.³

With respect to catastrophic risks, reinsurance's role takes several forms. Reinsurance can take a significant portion of the insured losses from primary insurers, diversify catastrophe risks globally, supply underwriting assistance, and regulate insurers' behavior to promote risk mitigation.⁴

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¹ Rajna Gibson, Michel A. Habib, & Alexandre Ziegler, *Financial Markets, Reinsurance, and the Bearing of Natural Catastrophe Risk*, SWISS FIN. INST., U. ZURICH 1, 2 (2007), https://www.researchgate.net/publication/228810986_Financial_Markets_Reinsurance_and_the_Bearing_of_Natural_Catastrophe_Risk.

² *An Introduction to Reinsurance*, SWISS RE (July 12, 2002), http://www.swissre.com/publications/An_introduction_to_reinsurance.htm.

³ FED. INS. OFF., U.S. DEP'T OF TREASURY, THE BREADTH AND SCOPE OF THE GLOBAL REINSURANCE MARKET AND THE CRITICAL ROLE SUCH MARKET PLAYS IN SUPPORTING INSURANCE IN THE UNITED STATES 15 (2014), <http://www.treasury.gov/initiatives/fio/reports-and-notice/Documents/FIO%20-%20Reinsurance%20Report.pdf>.

⁴ See generally Marcos Antonio Mendoza, *Reinsurance as Governance: Governmental Risk Management Pools as a Case Study in the Governance Role Played by Reinsurance Institutions*, 21 CONN. INS. L.J. 53 (2014); Aviva Abramovsky, *Reinsurance: The Silent Regulator?*, 15 CONN. INS. L.J. 345, 346, 373 (2009); Veronique Bruggeman, Michael Faure & Tobias Heldt, *Insurance Against Catastrophe: Government Stimulation of Insurance Markets for Catastrophic Events*, 23 DUKE ENVTL. L. & POL'Y F. 185, 186 (2012); VÉRONIQUE BRUGGEMAN, COMPENSATING CATASTROPHE VICTIMS: A COMPARATIVE LAW AND ECONOMICS APPROACH 130 (2010); David M. Cutler & Richard J. Zeckhauser, *Reinsurance for Catastrophes and Cataclysms*, in THE FINANCING OF

These roles often go beyond risk transfer and risk financing and expand to risk regulation for primary insurers. The former role has been discussed at length in law and economics literature,⁵ but regulation by reinsurance has not been widely discussed and has even qualified as problematic. Moreover, private reinsurance has come under scrutiny due to catastrophe insurance cycles that may lead to insurance unavailability and excessive prices, especially after a major event.⁶

Government-sponsored reinsurance, which marries the merits of both the government and private reinsurance, has gained increasing attention in the law and economics literature, and these programs have increased substantially in practice. Many countries use government-sponsored reinsurance to address catastrophe risks, including France (Caisse Centrale de Réassurance), Australia (Australian Reinsurance Pool Corporation), Japan (Japan Earthquake Reinsurance Co., Ltd.), Turkey (Turkish Catastrophe Insurance Pool), Netherlands (Nederlandse Herverzekeringsmaatschappij voor Terrorismeschaden), Thailand (National Catastrophe Insurance Fund), United States (Terrorism Risk Insurance Program and the Florida Hurricane Catastrophe Fund), Belgium (Caisse nationale des Calamités and the Terrorism Reinsurance and Insurance Pool), and Denmark (Terrorism Insurance Pool for Non-Life Insurance).⁷ Most of the reinsurance programs cover natural disasters. Meanwhile, many questions about those government-sponsored reinsurance programs have been raised. Why does the government adopt reinsurance as an intervention tool for catastrophe risks? Why might the government be motivated to structure its financial support in this manner rather than in others, such as providing direct compensation to victims of catastrophes? How could the reinsurance industry help regulate catastrophe insurers? How well have government-sponsored reinsurance programs worked? And have government-sponsored reinsurance programs resulted in any unintended

CATASTROPHE RISK 254 (Kenneth A. Froot ed., 1999); FED. INS. OFF., U.S. DEP'T OF TREASURY, *supra* note 3, at 1.

⁵ Many articles are discussing reinsurance as risk transfer and compensation to catastrophes victims. See Véronique Bruggeman, Michael G. Faure & Karine Fiore, *The Government as Reinsurer of Catastrophe Risks?*, 35 THE GENEVA PAPERS ON RISK AND INS.-ISSUES AND PRACTICE 369, 378 (2010); David Durbin, *Managing Natural Catastrophe Risks: The Structure and Dynamics of Reinsurance*, 26 THE GENEVA PAPERS ON RISK AND INS.-ISSUES AND PRACTICE 297 (2001); Cutler & Zeckhauser, *supra* note 4, at 237; J. David Cummins, *Reinsurance for Natural and Man-Made Catastrophes in the United States: Current State of the Market and Regulatory Reforms*, 10 RISK MGMT. & INS. REV. 179, 193 (2007).

⁶ Durbin, *supra* note 5, at 297-300.

⁷ Bruggeman, et al., *supra* note 4.

consequences?

To discuss all these questions is not possible within the scope of this Article. This Article will mainly argue why the Chinese government should adopt government-sponsored reinsurance and how to expand regulation by reinsurance to achieve optimal catastrophe risk management. The Article begins by introducing basic principles of reinsurance. Next, the Article explores the main regulatory techniques of reinsurance which offer primary insurers incentives to underwrite appropriately and mitigate risk. Then, the Article discusses reasons why the private reinsurance market cannot provide adequate coverage for catastrophe risks and the arguments for government-sponsored reinsurance. Next, the Article examines and compares several typical government-sponsored reinsurance programs, including programs in France (Caisse Centrale de Réassurance (CCR)), Japan (Japanese Earthquake Reinsurance Scheme (JERS)), and Turkey (Turkish Catastrophe Insurance Pool (TCIP)), in which primary insurers are regulated by reinsurance. Finally, the Article argues that China should adopt government-sponsored reinsurance to address catastrophe risks, and the possibility and feasibility of regulation by government-sponsored reinsurance in China is addressed.

II. REINSURANCE BASICS

A. INTRODUCTION OF REINSURANCE

Reinsurance can be understood simply as insurers' insurance. Under an insurance contract, a policyholder is protected from loss by transferring risk to an insurer; analogously, under a reinsurance contract, an insurer (the cedent or ceding company) is protected from exposure by transferring risk to a reinsurer.⁸ From the demand perspective, there are many theoretical explanations for a primary insurer's decision to purchase reinsurance. For example, Hoerger, Sloan, and Hassan consider that the motive for reinsuring is to avoid bankruptcy, even for an insurer that is not averse to risk (a risk-neutral insurer).⁹ According to other explanations, insurers demand reinsurance if they face catastrophic losses, insufficient

⁸ FED. INS. OFF., U.S. DEP'T OF TREASURY, *supra* note 3, at 1.

⁹ They use their model to assess how the insurer's surplus, size, and volatility of losses affect the amount of reinsurance the primary insurer purchases. *See generally* Thomas J. Hoerger, Frank A. Sloan & Mahmud Hassan, *Loss Volatility, Bankruptcy, and Insurer Demand for Reinsurance*, 3 J. OF RISK AND UNCERTAINTY 221, 221-222, 225 (1990).

underwriting capacity, higher loss volatility, lower surplus-to-premium ratios, or in the course of retiring from a territory or class of business.¹⁰

From the supply perspective, reinsurance is available from many sources, both domestic and abroad. The providers generally include professional reinsurers, pools and syndicates, direct insurers, and government agencies, which are not mutually exclusive.¹¹ For example, many direct insurers are legally empowered to sell reinsurance, and they still purchase extra reinsurance from foreign professional reinsurers.

There are two broad categories of reinsurance agreements: treaty reinsurance and facultative reinsurance. Treaty reinsurance covers broad groups of policies and binds the cedent to cede a specific portion of the risk of an entire class of business, such as all property coverage written by the cedents, to a reinsurer through one contract.¹² Compared to treaty reinsurance, facultative reinsurance is often used to cover specific and catastrophic risks¹³ because facultative reinsurance allows reinsurers to engage in significant underwriting prior to placing the policy and enables primary insurers to spread the risks of catastrophic losses that would otherwise be beyond their underwriting capacity.¹⁴

B. REINSURANCE FOR CATASTROPHE INSURERS

In the property-casualty market, the role of reinsurance is more apparent following catastrophes than after other perils. Catastrophes have a low probability of occurrence but cause very significant human and financial losses. Insurers are reluctant to underwrite catastrophes and even exclude these risks from coverage. The general theoretical explanation for why primary insurers do not cover catastrophe losses is that losses from these events are too large and too highly correlated for insurers to bear

¹⁰ KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION: CASES AND MATERIALS* 739 (2005); Patrick Brockett, Robert C. Witt & Paul R. Aird, *An Overview of Reinsurance and the Reinsurance Markets*, 9 J. OF INS. REG. 432 (1991); BERNARD L. WEBB, CONNOR M. HARRISON & JAMES J. MARKHAM, *INSURANCE OPERATIONS* 2 (1997).

¹¹ Bernard L. Webb, *Reinsurance as a Social Tool*, in 1 ISSUES IN INS. 403, 413-414 (Everett D. Randall ed., 1987).

¹² BARRY R. OSTRAGER & MARY KAY VYSKOCIL, *MODERN REINSURANCE LAW AND PRACTICE* 2-4 to 2-7 (2d ed. 2000).

¹³ ROBERT H. JERRY, II, *UNDERSTANDING INSURANCE LAW* 1016-1018 (4th ed. 2007); GRAYDON S. STARING, *THE LAW OF REINSURANCE* 14-16 (2015).

¹⁴ BARRY OSTRAGER & THOMAS NEWMAN, *HANDBOOK ON INSURANCE COVERAGE DISPUTES* 991 (12th ed. 2004).

them.¹⁵ For primary insurers, losses from catastrophes do not satisfy the conditions of statistical independence and hence are not locally insurable.¹⁶ Reinsurance plays a major role in making catastrophes insurable and serves an important function as protection against the accumulation of losses from catastrophes.¹⁷ For reinsurers, because of their ability to diversify globally, catastrophe risks can be characterized as globally insurable.¹⁸ For example, the risk of hurricanes in the United States is independent of the risk of earthquake in China. This provides the economic motivation for reinsurers to aggregate catastrophe risks over geographic regions and different catastrophe lines.¹⁹ By diversifying losses across the world, catastrophes may not impose unbearable losses on the reinsurer when compared to its overall book of business, making it possible for reinsurers to provide coverage and pay losses.²⁰

While primary insurance tends to be a local business, reinsurance is more of an international business, especially for catastrophic risks.²¹ For example, in 2005, Hurricane Katrina caused around \$90 billion in insured property losses in the United States, of which non-US reinsurers paid approximately \$59 billion.²² Because US primary insurers can access the global reinsurance market, they are able to provide coverage and pay

¹⁵ “When losses are highly correlated, insurers’ claims experience is expected to be lumpy – the presence of one claim implies a likelihood of many claims. Several years may result in no claims, but some years will have gigantic levels of claims, and the strain of being prepared for a disaster year means insurers must either charge high premiums, or face the risk of bankruptcy. The conventional wisdom is that insurers choose to exclude these risks from coverage, rather than expose themselves to the year-to-year uncertainty endemic to correlated risks.” See Peter Molk, *Private Versus Public Insurance for Natural Hazards: Individual Behavior’s Role in Loss Mitigation*, in RISK ANALYSIS OF NATURAL HAZARDS (Paolo Gardoni et al. eds., Springer, 2015); see also Jerry, II, *supra* note 13; ABRAHAM, *supra* note 10.

¹⁶ Cummins, *supra* note 5, at 181-182.

¹⁷ FED. INS. OFF., U.S. DEP’T OF TREASURY, *supra* note 3, at 1.

¹⁸ Dwight Jaffee, *Catastrophe Insurance*, in RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW, 166-167 (Daniel Schwarcz & Peter Siegelman eds., 2015).

¹⁹ *Id.*

²⁰ Cummins, *supra* note 5, at 182.

²¹ Cutler & Zeckhauser, *supra* note 4, at 237.

²² GLOBAL REINSURANCE FORUM, GLOBAL REINSURANCE: STRENGTHENING DISASTER RISK RESILIENCE, 8, 11 (2014), <https://www.hannover-re.com/306809/global-reinsurance-forum-grf-report-2014.pdf>.

claims.²³ The United States is not an isolated example; reinsurers have assumed a large portion of insured natural catastrophe losses in the world. For example, in 2011, global insured catastrophe losses reached \$110 billion, and reinsurers assumed more than half (Figure 3). The largest reinsurers are in Europe and the Caribbean and are not confined to domestic reinsurers.²⁴

In addition, reinsurers have developed new products such as catastrophe bonds, catastrophe derivatives, contingent capital, sidecars, and other hybrid products to facilitate new capital flows from the capital market into the reinsurance market.²⁵ As a result, capital in the reinsurance market has generally been increasing year-over-year for most of the past decade (Figure 2).²⁶ For example, as of mid-2014, global reinsurance capital amounted to \$570 billion (\$511 billion is classified as traditional capital and \$59 billion as alternative capital).²⁷ This accessible outside capital enables reinsurers to assume more insured catastrophe losses.

²³ Cummins, *supra* note 5, at 184.

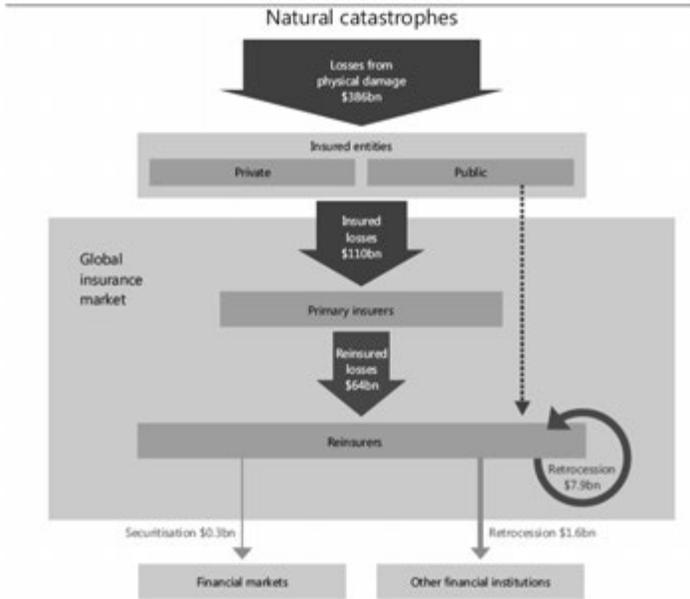
²⁴ Europe is the origin of reinsurance business, and in Europe, the insurance tax laws do allow tax-deductible reserves against future losses. In the Caribbean, a number of countries have created special tax havens. *See* Jaffee, *supra* note 18, at 167.

²⁵ Catastrophe bonds are risked-linked securities that transfer catastrophe risks from insurers to investors through fully-collateralized special purpose vehicles (SPV). Catastrophe derivatives are financial contracts used to spread catastrophe risk to capital market investors that derive value from the value of financial instruments, events or conditions; for example, the event can be a wind storm making landfall within a certain distance of a given location. A contingent capital arrangement is a type of financing that is arranged before a loss occurs. Sidecars are special purpose vehicles formed by insurance and reinsurance companies to provide additional capacity to write reinsurance, usually for property catastrophes and marine risks. *See* Partner Re, *A Balanced Discussion on Insurance Linked-Securities* (2008), www.partnerre.com; Cummins, *supra* note 5, at 195.

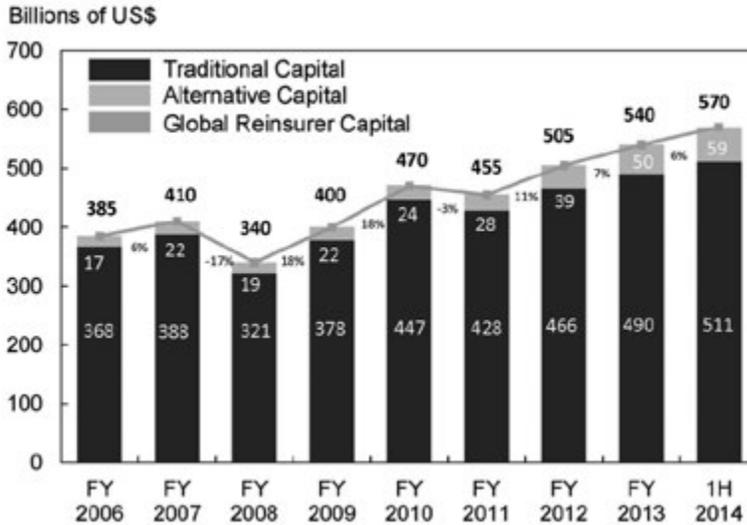
²⁶ Cummins, *supra* note 5, at 193-194.

²⁷ AON BENFIELD, THE AON BENFIELD AGGREGATE 3 (2014), http://thoughtleadership.aonbenfield.com/Documents/201409_aba_1h_2014.pdf.

Figure 1. Catastrophe risk transfer in the international reinsurance market, 2011²⁸



²⁸ Sebastian Von Dahlen & Goetz Von Peter, *Natural Catastrophes and Global Reinsurance—Exploring the Linkages*, 2012 BIS Q. REV. 23, 27 (Dec. 10, 2012), http://www.bis.org/publ/qtrpdf/r_qt1212e.pdf.

Figure 2. Global reinsurer capital, 2006–2014²⁹

III. REGULATORY ACTIVITIES OF REINSURANCE

In many respects, reinsurance often goes beyond pure risk transfer and expands to help solve catastrophic risk management issues through serving as an enforcer of compliance with government regulations and reinsurance contracts.³⁰ A major difficulty with catastrophe reinsurance is moral hazard, a problem also encountered by primary insurance vis-à-vis policyholders. It is logical for primary insurers to change their behavior as soon as the risk is fully ceded to the reinsurer. As a private regulator, reinsurance provides incentives for the primary insurers to engage in mitigation and prevention of catastrophe losses, and thus reduce moral hazard. Reinsurance has a direct and significant impact on the business operation of primary insurance and even an indirect impact on the insureds, from contract design such as pricing, through underwriting and issuing of a

²⁹ AON BENFIELD, THE AON BENFIELD AGGREGATE: RESULTS FOR THE SIX MONTHS ENDED JUNE 30, 2014, 3 (2014), http://thoughtleadership.aonbenfield.com/Documents/201409_aba_1h_2014.pdf.

³⁰ Guido Funke, *The Munich Re View on Climate-Change Litigation*, in LIABILITY FOR CLIMATE CHANGE? EXPERTS' VIEWS ON A POTENTIAL EMERGING RISK 22, 23 (Munich Re 2010); Lawrence Samplatsky, *The Role of Reinsurance in Life Insurance Industry* 23 (2003) (unpublished LLM master thesis, University of Connecticut) (on file with author).

policy, and ending with agreeing or refusing to pay for a claim.³¹ This part introduces four main tools that almost all reinsurers use to one degree or another to control moral hazard: loss-sensitive premiums, the duty of utmost good faith, providing risk management service, and indirect regulation of insureds. To be clear, I do not contend that these activities will exclusively solve moral hazard, nor do I contend that moral hazard management provides an adequate description for addressing catastrophe risk. However, by supplying both the incentive and the know-how that primary insurers often lack, reinsurance can realize value enhancing.

A. LOSS-SENSITIVE PREMIUMS

Catastrophes usually cause numerous claims at the same time. Insurers tend to pass on correlated losses to their reinsurers and thus the moral hazard problem becomes severe.³² Traditionally, reinsurers could control moral hazard by monitoring primary insurers' business operations, including their underwriting activities and claims settlements. More importantly, reinsurers could use loss-sensitive premiums to control moral hazard. Loss-sensitive premiums generally refer to the situation where "the price of reinsurance is sensitive to concurrent reinsurance losses and to the prior period's losses total and reinsured losses."³³ Loss-sensitive premiums require that reinsurance premiums should reflect an actuarially fair cost and integrate into general techniques like deductibles, co-payments, and "ex post settling up."³⁴ Neil Doherty and Kent Smetters have proved that reinsurers can control moral hazard effectively by using loss-sensitive premiums when the insurers and reinsurers are not affiliates (i.e., not part of the same financial group).³⁵ They present a multiperiod principal-agent model of the reinsurance transaction and test it empirically. They find strong evidence for the use of loss-sensitive premiums when the insurer and reinsurer are not affiliates, and their results show that price controls can limit moral hazard.³⁶ Since insurers and reinsurers are generally not

³¹ Mendoza, *supra* note 4; Abramovsky, *supra* note 4; Samplatsky, *supra* note 30, at 23.

³² Neil Doherty & Kent Smetters, *Moral Hazard in Reinsurance Markets*, 72 J. OF RISK AND INS. 375 (2005).

³³ *Id.* at 382.

³⁴ *Id.* at 375-376; Loss-sensitive premium is also called the actuarially fair premium, or risk-based pricing. See Cutler & Zeckhauser, *supra* note 4, at 260.

³⁵ Doherty & Smetters, *supra* note 32.

³⁶ *Id.*

affiliates in underwriting catastrophe risks,³⁷ using loss-sensitive premiums is an effective regulatory tool for reinsurers to control moral hazard.

Is using loss-sensitive premiums feasible in practice? The answer could be yes, thanks to risk-sharing mechanisms developed by reinsurance and less rate regulation in reinsurance transactions. First, several effective risk-sharing mechanisms are often introduced for catastrophe reinsurance premium design. The first one is retrospective rating, which adjusts premiums based on losses incurred during the policy period.³⁸ The second one is experience rating, which adjusts premiums based on losses in previous periods and which is useful when retrospective rating is not available.³⁹ Furthermore, although catastrophe perils are relatively rare, when series data on losses and claims is missing, the alternative method is using exposure-based modeling, which relies on scientific information and expert opinion; claims experience is only used to check and calibrate the model.⁴⁰ Second, compared to primary insurance, reinsurance markets are lightly regulated except in a few countries such as the United Kingdom, where reinsurers are regulated in the same way as direct insurers.⁴¹

B. THE DUTY OF UTMOST GOOD FAITH

Primary insurers' duty of utmost good faith is the core principle of the reinsurance relationship.⁴² Utmost good faith is an expressive phrase borrowed from Roman law, *uberrima fides*, which is defined as the "most abundant good faith; absolute and perfect candor or openness and honesty; the absence of any concealment or deception, however slight."⁴³ The reinsurance premium is less than the primary insurance premium; otherwise, primary insurers would have no incentives to underwrite such risk. Thus reinsurers cannot duplicate the costly but necessary efforts of the primary insurer in evaluating risks and handling claims. Through obligating

³⁷ See *id.* at 378 ("Insurance of natural catastrophes is often undertaken by regional or national primary insurers and reinsured by national or international reinsurance firms.").

³⁸ *Id.* at 375-376.

³⁹ *Id.* at 382-384.

⁴⁰ SWISS RE, UNDERSTANDING REINSURANCE: HOW REINSURERS CREATE VALUE AND MANAGE RISK 12 (2005), <http://www.grahambishop.com/DocumentStore/SwissRe%20Understanding%20reinsurance.pdf>.

⁴¹ Cummins, *supra* note 5, at 201.

⁴² See BARRY R. OSTRAGER & MARY KAY VYSKOCIL, MODERN REINSURANCE LAW AND PRACTICE 91 (2014).

⁴³ *Utmost Good Faith*, BLACK'S LAW DICTIONARY (6th ed. 1990).

primary insurers to act in good faith, reinsurers can control moral hazard through “invisible” monitoring without high cost.⁴⁴

The duty of utmost good faith requires the primary insurer to disclose all material facts which may affect the subject risk.⁴⁵ Those material facts may include the reinsured’s underwriting process; the reinsured’s amendment, renewal, or commutation in the placing of reinsurance; the payment of claims; and whether risks have been ceded fraudulently contrary to a treaty or representations.⁴⁶ As one court has stated, “[I]nsurance authorities are agreed that a ceding company, which is in possession of all the details relating to the risk, is required to exercise the utmost good faith in all its dealings with the reinsurer.”⁴⁷ This places the reinsurer in the same position as the reinsured “to give him the same means and opportunity of judging...the value of risks.”⁴⁸ To be notable, utmost good faith requires the insurer to provide timely notice of claim in some courts,⁴⁹ because it permits the reinsurer “to reserve properly, to adjust premiums to reflect the loss experience under the reinsurance contract, and to decide whether to exercise the option of becoming associated with the ceding insurer in the handling and disposition of the claim.”⁵⁰

As the core principle of the reinsurance relationship, the utmost good faith is enforced by many mechanisms. The first mechanism is the specific reinsurance contract provisions. It is a kind of private legislation since the parties to the reinsurance contract are sufficiently sophisticated. For example, reinsurers often include the “audit and inspection clauses” in the reinsurance contract which require “the reinsured’s records relative to the contract sessions to be always open to the reinsurer at reasonable times.”⁵¹ Such clauses guarantee and protect reinsurers’ access to their reinsured’s underwriting and claims handling practices. The second

⁴⁴ In the reference to utmost good faith as the “invisible” monitoring force, the concept is borrowed from the metaphor of “the invisible hand” used by Adam Smith in economics.

⁴⁵ STEVEN PLITT, ET AL., 1A COUCH ON INSURANCE § 9:17, at 82-83 (3d ed. 2010).

⁴⁶ STARING, *supra* note 13, at 151-152.

⁴⁷ *Nw. Mut. Fire Ass'n v. Union Mut. Fire Ins. Co. of Providence*, 144 F.2d 274, 276 (9th Cir. 1944) (requiring disclosure of all material facts).

⁴⁸ *Sun Mut. Ins. Co. v. Ocean Ins. Co.*, 107 U.S. 485, 510 (1883).

⁴⁹ *See e.g., Fortress Re, Inc. v. Jefferson Ins. Co.*, 465 F. Supp. 333 (E.D.N.C. 1978), *aff'd*, 628 F.2d 860 (4th Cir. 1980); *Liberty Mut. Ins. Co. v. Gibbs*, 773 F.2d 15 (1st Cir. 1985).

⁵⁰ BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, § 16.02, at 563 (5th ed. 1992).

⁵¹ STARING, *supra* note 13, § 15:8, at 333-334.

mechanism is court enforcement. The court often recognizes that primary insurers' failure to act in utmost good faith offers the reinsurer a defense to its reinsurance obligation.⁵² More importantly, the court requires of primary insurers such behavior as a condition precedent to reinsurers' performance of indemnity obligation.⁵³ In the case of catastrophes in which reinsurance is triggered by extremely large dollar-value claims, primary insurers will undoubtedly take the enforcement of utmost good faith into serious consideration. A third mechanism by which reinsurance promotes efficiency is longer-term relationship controls. Reinsurance is generally not a one-off deal but conducted as a long-term relationship. Long-term relationships bond both parties, and the reinsurer can increase the effectiveness of its monitoring because the reinsurer can use past experience to set future prices and terms, or even to refuse to underwrite.⁵⁴

C. PROVIDING RISK MANAGEMENT SERVICE

Reinsurers can act not only as capital suppliers but also as risk management service providers. For relatively simple products, reinsurers may simply act as capital suppliers. As for complex products, such as underwriting catastrophic risks, reinsurers may take a more active role, more analogous to product-design consultants, through facultative reinsurance.⁵⁵ Since reinsurers deal with different catastrophe lines among geographic regions in the world, they are in a better position to share their experiences with the ceding companies. Providing risk management service for the primary insurers can take several forms: (1) *Entry into the market*. Global reinsurers can help potential new market participants remove entry barriers, especially for those in developing countries, and allow insurers to enter this new market slowly by initially reinsuring a large portion of their risks.⁵⁶ (2) *Product design and underwriting assistance*. Reinsurers can supply expert knowledge to new market participants and provide related data to develop a pricing model for a new product.⁵⁷ For example, from 1998 to 2002, Swiss Re, cooperating with Beijing Normal University, completed the Digital Map of China Catastrophe Events, which includes

⁵² See e.g., *Liquidation of Union Indemn. Ins. Co. v. Am. Centennial Ins. Co.*, 674 N.E.2d 313, 319-320 (N.Y. 1996).

⁵³ See e.g., *Unigard Sec. Ins. Co., Inc. v. N. River Ins. Co.*, 4 F.3d 1049, 1054 (2d Cir. 1993).

⁵⁴ Abramovsky, *supra* note 4, at 383-384 n. 144.

⁵⁵ Samplatsky, *supra* note 30, at 26.

⁵⁶ Patrick Brockett, Robert C. Witt & Paul R. Aird, *An Overview of Reinsurance and the Reinsurance Markets*, 9 J. INS. REG. 3, 432, 440-444 (1991).

⁵⁷ Samplatsky, *supra* note 30, at 26.

historical data on geography, weather, and so on, since the twelfth century.⁵⁸ This digital map has been very helpful for the pricing of catastrophe insurance. (3) *Claims processing*. Reinsurers can review the basis of insurers' decisions, and reinsurance contracts allow the reinsurer to opt out of an insurer's decision to deny coverage. The judgment of a reinsurer typically provides guidance to ceding insurers that can prevent violations of unfair claims practices acts.⁵⁹

D. INDIRECT REGULATION OF INSUREDS

Besides primary insurers, reinsurers may even regulate behaviors of insureds and control their moral hazard.⁶⁰ Generally speaking, reinsurers have no direct contract relationship with the insureds. Because reinsurers and insureds are parties to a secondary indemnity agreement, reinsurers do not usually pay the original insureds.⁶¹ However, under the fronting agreement arrangement,⁶² the reinsurer might have the opportunity to regulate the insureds, even indirectly. The main purpose of the fronting agreement is to allow a reinsurer who is not locally licensed to do business.⁶³ One New York court described a fronting agreement as an arrangement where an insurer issued a policy on a risk "with an

⁵⁸ XI GUO & XINJIANG WEI, *The Difficulties and Solutions for Issuing Catastrophe Bonds in China*, 8 FRONTIERS L. CHINA 521, 550-553 (2013) (2005).

⁵⁹ Samplatsky, *supra* note 30, at 35-39.

⁶⁰ The reinsurer has strong incentives to regulate the insureds. Some primary insurance policy includes "cut-out" provisions which allow a direct action by the insureds against the reinsurer. "Cut-out" provisions allow "an endorsement to an insurance policy or reinsurance contract which provides that, in the event of the insolvency of the insurance company, the amount of any loss which would have been recovered from the reinsurer by the insurance company (or its statutory receiver) will be paid instead directly to the policyholder, claimant, or other payee, as specified by the endorsement, by the reinsurer." See REINSURANCE ASS'N OF AM., *Fundamentals of Property and Casualty Reinsurance*, 32 (2016), <http://www.reinsurance.org/files/public/07FundamentalsandGlossary1.pdf>.

⁶¹ DAVID M. RAIM, JOY L. LANGFORD, DANIEL W. GERBER, AARON J. AISEN & CHRISTOPHER H. BROWN, *NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE* § 40.01 (2007).

⁶² Despite the slightly pejorative terms used in this arrangement, there is nothing illegal in a domestic insurer acting as a front for the unauthorized insurer. In fact, so long as all other regulatory goals are met, these relationships can allow for a significant increase in insurance capacity. See RAIM ET AL., *supra* note 61, at §40.04(5).

⁶³ *Union Sav. Am. Life Ins. Co. v. North Central Life Ins. Co.*, 813 F. Supp. 481, 484 (S. D. Miss. 1993).

understanding that another party will insure it.”⁶⁴ Therefore, the risks underwritten by a primary insurer who has made the fronting agreement with a reinsurer will be assumed in the end by the reinsurer.⁶⁵ In other words, the reinsurer will be responsible for the entire amount that it is required to pay under the original policy. Generally, the licensed insurer will receive a fee for acting as the “front,”⁶⁶ while the reinsurers can act as insurers to regulate insureds through risk-based pricing, contract design, claims management, and refusal to insure.

IV. REASONS FOR GOVERNMENT-SPONSORED REINSURANCE FOR CATASTROPHES

The previous section explored the main regulatory techniques of reinsurance which control primary insurers’ moral hazard and offer them incentives to underwrite appropriately and mitigate risk. This leads to the issue of how government-provided reinsurance works and how it differs from regulation by private reinsurance. Before answering these questions, a prerequisite discussion should be why the government is involved in catastrophe reinsurance and why not leave all catastrophe reinsurance to the private market. The main rationale offered to justify governments’ sponsoring catastrophe insurers and acting as reinsurers of catastrophe risks is the imperfections of private reinsurance.

Underwriting cycles show the imperfection of private reinsurance. The phenomenon of the underwriting cycle, which refers to the tendency of insurance markets to go through alternating phases of “hard” and “soft” markets, is an important characteristic of insurance markets.⁶⁷ Hard markets are usually triggered by capital depletions resulting from underwriting catastrophic losses of unexpected magnitude.⁶⁸ Figure 3 shows the infamous cyclical nature of property-casualty insurance from the

⁶⁴ *Allendale Mut. Ins. Co. v. Excess Ins. Co.*, 970 F. Supp. 265, 267 n.2 (S.D.N.Y. 1997).

⁶⁵ *Reliance Ins. Co. v. Shriver, Inc.*, 224 F.3d 641, 643 (7th Cir. 2000) (describing a fronting agreement as a “well-established and perfectly legal scheme” where policies are issued by state-licensed insurance companies and then immediately reinsured to 100 percent of face value).

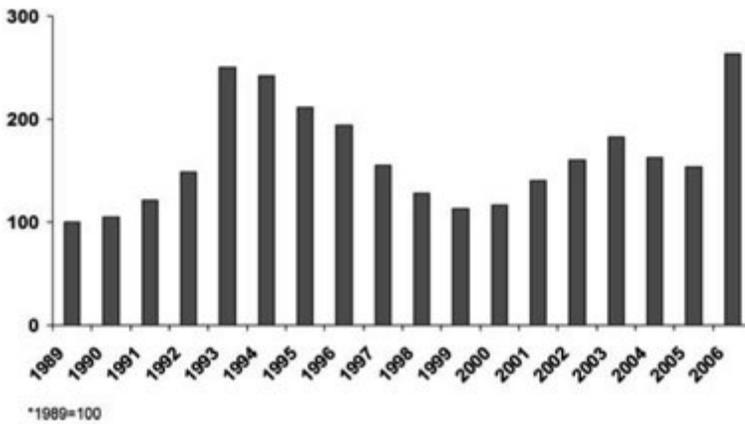
⁶⁶ *Venetsanos v. Zucker, Facher & Zucker*, 638 A.2d 1333, 1337 (N.J. Super. Ct. App. Div. 1994).

⁶⁷ Hard market leads to decreased supply but increased premium whereas in a soft market, coverage supply is plentiful and prices decline. *See* DAVID CUMMINS & OLIVIER MAHUL, *CATASTROPHE RISK FINANCING IN DEVELOPING COUNTRIES: PRINCIPLES FOR PUBLIC INTERVENTION*, 55 (2009).

⁶⁸ Cummins, *supra* note 5, at 179-220.

years following 1989. It clearly indicates that reinsurance prices are cyclical.⁶⁹ The hard market in the 1990s was caused by Hurricane Andrew (1992). The magnitude of losses from Andrew took insurers by surprise, and thirteen insurance companies even went bankrupt primarily as a result of capital depletions.⁷⁰ After the catastrophe, insurance companies improved loss estimation and risk management capabilities; insurers and catastrophe modeling firms revised upward their expectations of future hurricane losses.⁷¹ Accordingly, prices of reinsurance increased for the 1993 renewals.

Figure 3. US catastrophe reinsurance: rate on line index⁷²



To some extent, reinsurers are facing similar financing limitations to those faced by primary insurers.⁷³ During periods of hard markets, there

⁶⁹ Reinsurance prices increased and supply contracted following the 1992 Hurricane Andrew, paralleling the market response to later 2005 hurricane seasons.

⁷⁰ A.M. Best Company, *2006 Annual Hurricane Study: Shake, Rattle, and Roar* (May 2006).

⁷¹ Cummins, *supra* note 5, at 192.

⁷² The rate on line is a pricing concept, which is found by dividing the contractual reinsurance premium by the reinsurance limit and converting the result into a percentage. See Kenneth Froot, *The Intermediation of Financial Risks: Evolution in the Catastrophe Reinsurance Market*, 11 RISK MGMT. AND INS. REV. 281, 281-294 (2008);

⁷³ Many primary insurers do not have enough capital and surplus themselves to survive catastrophes, and they have to rely upon the reinsurance market to recompense catastrophic damages. See VERONIQUE BRUGGEMAN, COMPENSATING

is often insufficient reinsuring capacity. Why are so few assets allocated to catastrophe reinsurance? Since the market distortions appear to be more supply- (reinsurer) than demand- (primary insurer) related,⁷⁴ explanations for imperfections in the reinsurance market mainly consider supply restrictions. The explanations below are well documented in the law and economics literature.

First, informational asymmetries between capital providers and reinsurers about exposure levels and reserve adequacy can result in high costs of capital during hard markets.⁷⁵ It might be more costly for reinsurers to raise additional funds since capital providers cannot clearly separate performance into event losses and reinsurers' skill in peril selection.⁷⁶ Irrational investor behavior, such as investor "trend following," may also decrease the supply of capital to reinsurance after a major catastrophe.⁷⁷ The consensus in the economics literature is that shortages are driven by capital market and insurance market imperfections that prevent capital from flowing freely into and out of the reinsurance corporations in response to catastrophic losses.⁷⁸

A major catastrophe may deplete reinsurer capital and surplus, and require some time to replenish.⁷⁹ Without additional funds from capital providers, such depletion of equity capital is likely to result in raised premiums for reinsurance, which are above the expected loss of such

CATASTROPHE VICTIMS: A COMPARATIVE LAW AND ECONOMICS APPROACH 136 (2010).

⁷⁴ According to a set of demand–supply equilibrium points, graphed in terms of price and quantity of reinsurance provided, Froot shows a strong negative correlation between price and quantity supplied emerges. It suggests that supply shocks are the main driver rather than demand—a decline in supply results in an increase in price and decline in quantity of risk transfer. See Froot, *supra* note 72.

⁷⁵ CUMMINS & MAHUL, *supra* note 67, at 194.

⁷⁶ Kenneth Froot, *The Market for Catastrophe Risk: A Clinical Examination*, 60 J. OF FIN. ECON. 529, 529–571 (2001).

⁷⁷ Investor trend following refers to the situation that investors expect recent performance to continue, as a result, they tend to buy exposures that have recently performed well and to sell those that have not. *Id.*

⁷⁸ Ralph Winter, *The Dynamics of Competitive Insurance Markets*, 3 J. OF FIN. INTERMEDIATION 379–415 (1994); David Cummins & Patricia M. Danzon, *Price Shocks and Capital Flows in Liability Insurance*, J. OF FIN. INTERMEDIATION 6 (1): 3–38 (1997); David Cummins & Neil A. Doherty, *Capitalization of the Property-Liability Insurance Industry: Overview*, J. OF FIN. SERVICES RES. 21 (1–2): 5–14 (2002); CUMMINS & MAHUL, *supra* note 67, at 194.

⁷⁹ Froot, *supra* note 72, at 285.

coverage.⁸⁰ Using empirical evidence from the year following Hurricane Andrew for those insurers that had greater exposure to the southeastern United States and to hurricanes wherever they occur, Froot demonstrates that reinsurance “prices rise most where quantities decline most.”⁸¹

Second, reinsurers may have market power, and supply shortages and high prices after catastrophes may occur because reinsurers have no incentive to increase their capital. By putting less money at risk and preventing new entry, incumbent reinsurers keep prices high.⁸² The former Massachusetts Insurance Commissioner argued that market power among reinsurers is the main reason that catastrophe reinsurance has proved more profitable than insurance.⁸³ Barriers to entry are also relevant to the market power story.⁸⁴ The absence of entry barriers tends to suggest that there is no market power; it is entry barriers that permit sellers to keep prices above marginal costs. Froot has provided empirical evidence to support the hypothesis that there was considerable entry into the reinsurance market in the 1990s.⁸⁵

Third, the corporate form of reinsurance ownership may also contribute to short supply in the reinsurance market in the wake of catastrophes.⁸⁶ Corporations create agency costs because managers’ (“agents”) interests may not perfectly align with those of shareholders (“principals”). Managers act in many ways that do not maximize the corporation’s value, but instead advance their personal financial interests.⁸⁷

⁸⁰ Frank A. Sloan & Lindsey M. Chepke, *Reinsurance*, in *MEDICAL MALPRACTICE* 247, 252-253 (2008).

⁸¹ Froot, *supra* note 76.

⁸² Froot, *supra* note 76, at 559.

⁸³ *Id.*

⁸⁴ *Id.* at 560.

⁸⁵ Froot notes that the 1990s were not crisis years, but sellers could have been poised for entry when and if prices of reinsurance rose. *Id.*

⁸⁶ Froot, *supra* note 72, at 287. See HOWARD KUNREUTHER, MARK V. PAULY & THOMAS RUSSELL, DEMAND AND SUPPLY SIDE ANOMALIES IN CATASTROPHE INSURANCE MARKETS: THE ROLE OF THE PUBLIC AND PRIVATE SECTORS, Paper prepared for the MIT/LSE/Cornell Conference on Behavioral Economics 17-18 (2004) (suggesting that capital suppliers may believe that the high losses they experienced are not random which reflects reinsurer mismanagement).

⁸⁷ Froot, *supra* note 76, at 567; Frank A. Sloan & Lindsey M. Chepke, *Reinsurance*, in *MEDICAL MALPRACTICE*, 247-276, 253 (2008).

V. GOVERNMENT-SPONSORED CATASTROPHE REINSURANCE PROGRAMS: EXAMPLES

Section III described the tools available to reinsurers in regulating insurers and the underwritten catastrophe risks. We saw that through contract design (loss-sensitive premiums), utmost good faith, providing risk management service, and indirect regulation of insureds, reinsurance has the capacity to perform a social function that is regulatory in nature: less moral hazard on the part of primary insurers and better preparedness on the part of insureds. Section IV explained why much of the reinsurance for catastrophe risks in the world is sponsored by the government. Compared with the capital shortfall of private reinsurers, the government can channel capital effectively and quickly after catastrophes since it can raise money through taxes or borrow money by issuing debt or government bonds.⁸⁸ This part examines how government-sponsored reinsurance programs work. Government-sponsored reinsurance is increasingly welcomed by law and economics scholarship as a way to manage catastrophic risks.⁸⁹ Meanwhile, government-sponsored reinsurance has increased substantially in practice, and many programs are often established when primary-insurance markets break down. It is not possible within the scope of this Article to critically analyze all of the programs that exist, some of which were mentioned in the introduction. Accordingly, this discussion will be limited to the French CCR, the Japanese JERS and the Turkish TCIP. As these examples demonstrate, there is wide variation in the nature and extent of regulation through catastrophe reinsurance across different countries.

Government-sponsored reinsurance is a kind of public-private partnership that marries the merits of both government and reinsurance.⁹⁰ The origins of such partnerships can be traced to the nuclear liability conventions which emerged in the 1960s.⁹¹ Government-sponsored reinsurance programs have since expanded to many lines of insurance,

⁸⁸ Cutler & Zeckhauser, *supra* note 4, at 258-259.

⁸⁹ See e.g., Bruggeman, Faure & Heldt, *supra* note 4, at 212; Howard Kunreuther & Erwann Michel-Kerjan, *Managing Catastrophic Risks through Redesigned Insurance: Challenges and Opportunities*, In HANDBOOK OF INS., 517, 523 (George Dionne ed., 2013); Bruggeman, Faure & Fiore, *supra* note 5, at 374.

⁹⁰ Howard Kunreuther & Mark Pauly, *Rules Rather than Discretion: Lessons from Hurricane Katrina*, 33 J. OF RISK & UNCERTAINTY 101, 1112-113 (2006); Saul Levmore & Kyle D. Logue, *Insuring Against Terrorism--and Crime*, 102 MICH. L. REV. 268, 314 (2003).

⁹¹ The Price-Anderson Act, concerning nuclear facilities, is an example of this model. See Bruggeman, Faure & Fiore, *supra* note 89, at 376.

including medical malpractice,⁹² expropriation insurance,⁹³ crop insurance programs,⁹⁴ and terrorism insurance after the September 11 terrorism attack.⁹⁵ Since the government has substantial credit capacity due to its ability to raise money through tax or borrow money by issuing debt far more readily than private insurers or reinsurers,⁹⁶ it is widely recognized that the government can help address catastrophic risks in some respects, and can thus be used to support the failures of the primary insurance market.⁹⁷

A. THE FRENCH CCR

The French government-sponsored reinsurance for natural disasters takes the form of subsidized government reinsurance with mandatory private primary insurance.⁹⁸ In France, private insurers offered little

⁹² For example, New Jersey enacted the New Jersey Medical Malpractice Reinsurance Association in 1976, and any member of the association could be approved by the association to write malpractice coverage. The insurer would then be reinsured by the association either in full or in part. See Vincent R. Zarate, *N.J. Malpractice Unit Activated*, J. OF COM. 9 (1977).

⁹³ For example, in the U.S., expropriation insurance written by the Overseas Private Investment Corporation (OPIC) was a purely governmental program, and eventually OPIC turned the program over to private insurers, with OPIC functioning only as a reinsurer. See Bernard Webb, *Reinsurance as a Social Tool*, in ISSUES IN INS. 279, 326 (1984).

⁹⁴ For example, the Federal Crop Insurance Corporation (FCIC) is authorized to provide reinsurance for “all risks” crop written by private insurers. See 1980 U.S.C.C.A.N., 5949.

⁹⁵ After 11 September 2001, when airline risks became more difficult to insure, the U.S. federal government guaranteed insurance coverage. See Kenneth Abraham, *United States of America. Liability for Acts of Terrorism under US Law in TERRORISM, TORT L. AND INS.: A COMP. SURVEY*, 176–188 (B. A. Koch ed. 2004).

⁹⁶ Louis Kaplow, *Incentives and Government Relief for Risk*, 4 J. OF RISK AND UNCERTAINTY 167, 167-175 (1991).

⁹⁷ See John V. Jacobi, *Government Reinsurance Programs and Consumer-Driven Care*, 53 BUFF. L. REV. 537 (2005); Daniel A. Schenck, *Next Step for Brownfields Government Reinsurance of Environmental Cleanup Policies*, 10 CONN. INS. L.J. 401 (2003); Mark A. Hall, *Government-Sponsored Reinsurance*, 19 ANNALS HEALTH L. 465 (2010); Bruggeman, Faure & Heldt, *supra* note 89, at 39; Kunreuther & Michel-Kerjan, *supra* note 89, at 517, 546.

⁹⁸ Lorilee Medders, Kathleen McCullough & Verena Jäger, *Tale of Two Regions: Natural Catastrophe Insurance and Regulation in the United States and the European Union*, 30 J. INS. REG. 171, 184 (2011).

coverage for natural catastrophe risks, and the government intervened through ad hoc assistance in the aftermath of disasters until 1982.⁹⁹ The 1982 disaster law required private insurers to underwrite catastrophic risks and permitted them to cede those risks to CCR, the state-guaranteed reinsurer.¹⁰⁰ To gain the benefit of the government guarantee, CCR pays an annual “premium” to the government (Article R. 431-16-2 Insurance Code), similar to private retrocession.¹⁰¹

CCR provides a coverage system which compounds twofold layers based on two separate treaties: a 50 percent quota share treaty and a stop-loss treaty with an unlimited governmental guarantee.¹⁰² Those risks not covered by the quota share treaty are subject to the stop-loss treaty. The stop-loss treaty with an unlimited governmental guarantee enables primary insurers to underwrite high severity hazards.

Loss-Sensitive Premiums. Loss-sensitive premiums require that reinsurance premiums should reflect an actuarially fair cost and reinsured losses. CCR offered coverage on identical terms and a rather low price to all ceding companies in the first fifteen years as a result of benefits from an unlimited guarantee from the French Treasury.¹⁰³ In 1997, CCR revised its reinsurance terms because of the deterioration of the claims figures and changes in the primary insurance market. It began to move forward to loss-sensitive premiums setting, and its rating of the “stop-loss” covers was decided based upon each individual insurer’s loss record.¹⁰⁴

Such loss-sensitive premiums setting represents a good start, but it still has a long way to go. With the governmental guarantee, CCR charges relatively lower premiums to primary insurers than other private reinsurance companies and thus crowds them out of the market.¹⁰⁵ On the

⁹⁹ David Moss, *Courting Disaster? The Transformation of Federal Disaster Policy since 1803*, NAT’L BUREAU OF ECON. RES., 307, 345 (Kenneth A. Froot, eds. 1999).

¹⁰⁰ Decree No. 82-706 of 10 August 1982 on the Reinsurance Operations for the Natural Catastrophe Risks by the *Caisse Centrale de Re-assurance*. Application of Article 4 of the Act No. 82-600 of 13 July 1982, JORF 11 August 1982. See Bruggeman, Faure & Fiore, *supra* note 5, at 379-380.

¹⁰¹ Suzanne Vallet, *Insuring the Uninsurable: The French Natural Catastrophe Insurance System*, in *Catastrophe Risk and Reinsurance: A Country Risk Management Perspective*, 199, 206 (Eugene N. Gurenko ed. 2004).

¹⁰² Medders, McCullough & Jäger, *supra* note 98, at 184.

¹⁰³ Vallet, *supra* note 101, at 211.

¹⁰⁴ Such price setting does not include quota share treaty. *Id.* at 211-212.

¹⁰⁵ Erwann Michel-Kerjan, *Catastrophe Economics: The National Flood Insurance Program*, 24 J. ECON. PERSP. 165, 183-184 (2010) (“The CCR is not a monopolistic disaster reinsurer. In fact, there are several reinsurers writing business

other hand, it will be the taxpayers who ultimately pay CCR's unlimited coverage that can offset damages.¹⁰⁶ France's relatively moderate exposure to natural disasters makes the operation of CCR suitable to France. It is still questionable to what extent CCR is capable of dealing with the next mega-catastrophe.

The Duty of Utmost Good Faith. The duty of utmost good faith is enforced by two mechanisms in the operation of CCR. First, the 50 percent quota share treaty of CCR contributes to primary insurers' performance of the duty of utmost good faith. Primary insurers have to retain half of the risks themselves under the 50 percent quota share treaty, which gives them an incentive to underwrite appropriately.¹⁰⁷ Second, the long-term relationship between CCR and the ceding companies also contributes to the performance of the duty of utmost good faith. As the state-guaranteed reinsurer, CCR has operated several decades and has abundant records of the ceding companies. Such experiences help CCR effectively monitor primary insurers' performance of utmost good faith.

Providing Risk Management Service. It is unclear whether CCR provides risk management services for the ceding companies. Nonetheless, as one of the top twenty reinsurance carriers in the world with an AAA rating from Standard & Poor's, CCR clearly has expertise in risk management.¹⁰⁸ Dealing with ceding companies of different sizes, differing legal forms, and various types of portfolios, CCR is in a better position to share its experiences in managing catastrophe risk and providing coverage for multiple types of natural hazards.

Indirect Regulation of Insureds. Since CCR is licensed to conduct business in France, there is no need for a fronting agreement arrangement. There is no empirical evidence of its indirect regulation of insureds.

B. THE JAPANESE JERS

The Japanese government-sponsored reinsurance for earthquakes takes the form of the government providing reinsurance capacity. JERS was established based on the Act on Earthquake Insurance in 1966 enacted after the Niigata earthquake in 1964.¹⁰⁹ Primary insurers issue standard

with primary reinsurers in France."); see Medders, McCullough & Jäger, *supra* note 98, at 184.

¹⁰⁶ Medders, McCullough & Jäger, *supra* note 98, at 185.

¹⁰⁷ Suzanne Vallet, *The French Experience in the Management and Compensation of Large scale Disasters*, in CATASTROPHIC RISKS AND INS. 293, 300 (2005).

¹⁰⁸ Medders, McCullough & Jäger, *supra* note 98, at 184.

¹⁰⁹ OECD, DISASTER RISK FINANCING IN APEC ECONOMIES 73 (2013),

residential policies which cover losses to personal dwellings and contents caused by earthquakes and volcanic eruptions and then cede these risks to JERS.¹¹⁰ JERS is a specialized reinsurance company but backed by the Japanese government. It can also be seen as an earthquake reinsurance pool, retaining a portion of the liability and retroceding the rest to private insurers (based on their market share) and to the Japanese government through reinsurance treaties.¹¹¹ To be clear, JERS only covers personal residential, not commercial, earthquake insurance.

The professional reinsurance business operations are all managed by JERS, not the Japanese government. Nevertheless, the successful operation of JERS depends on a commitment from the Japanese government, which provides significant reinsurance capacity as a last resort.¹¹² It can be illustrated by the aggregate limit of indemnity for earthquake insurance liabilities (JPY 6.2 trillion), which is shared by the private insurers and the government among different layers. The first layer, which covers earthquake insurance liabilities up to JPY 85 billion, is totally compensated by JERS; the second layer, which covers earthquake insurance liabilities over JPY 85 billion and up to JPY 348.8 billion, is compensated by equal contributions by the Japanese government (50 percent) and JERS and private insurers (due to retroceded risk from JERS; 50 percent); and the third layer, which covers earthquake insurance liabilities from JPY 348.8 billion to JPY 6.2 trillion, is mostly compensated by the Japanese government (99.6 percent) and a very small share by private insurers (0.4 percent) (Figure 4).¹¹³ If the earthquake insurance liabilities of one peril exceed JPY 6.2 trillion, residential policyholders' claims are reduced proportionately following the provisions of the Act on Earthquake Insurance.¹¹⁴

http://www.oecd.org/daf/fin/insurance/OECD_APEC_DisasterRiskFinancing.pdf.

¹¹⁰ Yuichi Takeda, *Government as Reinsurers of Last Resort: The Japanese Experience*, in *CATASTROPHE RISK AND REINSURANCE: A COUNTRY RISK MANAGEMENT PERSPECTIVE* 225-237 (Eugene N. Gurenko eds. 2004).

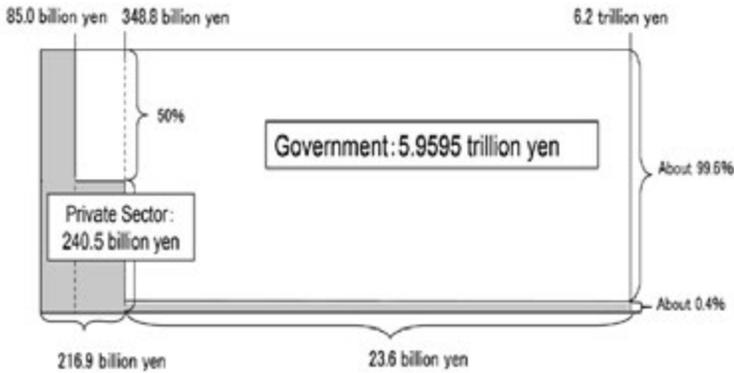
¹¹¹ Michael Faure & Jing Liu, *The Tsunami of March 2011 and the Subsequent Nuclear Incident at Fukushima: Who Compensates the Victims*, 37 *WM. & MARY ENVTL. L. & POL'Y REV.* 129, 149 (2012).

¹¹² Takeda, *supra* note 110.

¹¹³ *Id.*; OECD, *supra* note 109.

¹¹⁴ See OECD, *supra* note 109, at 73.

Figure 4. Risk allocation under the Japanese Earthquake Reinsurance Scheme¹¹⁵



Loss-Sensitive Premiums. Making the premiums loss-sensitive is one of the most challenging tasks for a public-private partnership. This is no exception for JERS. The reinsurance price of JERS is not market-based but determined by the Japanese government. The premiums are not loss-sensitive, but set to follow a general fair-value principle.¹¹⁶

The Duty of Utmost Good Faith. Primary insurers' duty of utmost good faith is extremely important for JERS. The primary insurers could cede 100 percent of the underwritten earthquake insurance exposure to JERS.¹¹⁷ If primary insurers underwrite inappropriately, JERS will assume all the bad risks. According to the requirement of utmost good faith, the primary insurers should disclose all material facts which may affect the subject risk. In order to enforce such a requirement, the Japanese government stipulated that all rating work is set solely by the Non-Life-Insurance Rating Organization of Japan (NLIRO) and not by primary insurers.¹¹⁸ The NLIRO has to file materials setting, modifying and revising the base rates to the Financial Supervisory Authority for

¹¹⁵ *Id.*

¹¹⁶ Currently the details of JER reinsurance contracts are not fully disclosed, except the names of the counterparties and the amount of reinsurance. It is difficult to supply the basic elements of the general fair-value principle. Some anecdotes from the Japanese insurance industry imply that affordability and sustainability are both important considerations of this principle. See Takeda, *supra* note 110, at 231.

¹¹⁷ THE GENEVA ASSOCIATION, INSURERS' CONTRIBUTIONS TO DISASTER REDUCTION—A SERIES OF CASE STUDIES 7, 48 (Meghan Orié & Walter R. Stahel eds., 2013).

¹¹⁸ Takeda, *supra* note 110, at 230-231.

approval.¹¹⁹ Under this approach, JERS is able to access the underwriting materials of its ceding companies. Besides this arrangement, the duty of utmost good faith is also enforced by reinsurance treaty provisions. The Earthquake Reinsurance Treaty between JERS and private insurance companies includes the retrocession provision, which provides that primary insurers cede their underwritten risks to JERS, and JERS in turn retrocedes the risks in the second layer to the primary insurers and the Japanese government with equal portion.¹²⁰ Retroceding 50 percent of the risk in the second layer to primary insurers contributes to their performance of the duty of utmost good faith.

Providing Risk Management Service. One purpose of establishing JERS is to facilitate loss mitigation and a recovery process through the insurance industry. However, in practice, the NLIRO, rather than JERS, undertakes major service works for primary insurers.

Indirect Regulation of Insureds. Since JERS is licensed to conduct business in Japan, there is no need for a fronting agreement. JERS has incentives to regulate insureds' behavior and awareness of earthquake risks because primary insurers cede 100 percent of the risks to JERS. For example, JERS uses deductibles to enhance individuals' risk mitigation efforts.¹²¹

C. THE TURKISH TCIP

Compared to CCR and JERS, the Turkish government does not establish a specific reinsurance company to assume catastrophe risk. The Turkish government provides contingent liquidity support when the payments of claims exceed TCIP's capacity.¹²² It could be regarded as reinsurance since it is the last resort. The first layer reinsurance arrangement under the mechanisms of TCIP is the international reinsurers, which assume the transferred risks from TCIP. Therefore, the regulatory techniques of reinsurance include both international reinsurers and the Turkish government.

¹¹⁹ *Id.* at 234.

¹²⁰ K. KAWACHIMARU, NON-LIFE INSURANCE RATING ORGANIZATION OF JAPAN, *Disaster Risk Management in Japan*, in CATASTROPHIC RISKS AND INSURANCE 303, 318 (2005).

¹²¹ If the premium exceeds \$550 per policy, this amount is the deductible; otherwise the deductible is equal to the premium of the policy. See Youbaraj Paudel, *A Comparative Study of Public-Private Catastrophe Insurance Systems: Lessons from Current Practices*, 37 GENEVA PAPERS 257, 278 (2012).

¹²² EUGENE GURENKO, EARTHQUAKE INSURANCE IN TURKEY: HISTORY OF THE TURKISH CATASTROPHE INSURANCE POOL, xi-xii (2006).

In 1999, Governmental Decree Law No. 587 on Compulsory Earthquake Insurance (“Decree Law”) came into force and gave birth to TCIP in the aftermath of the devastating Marmara earthquake.¹²³ TCIP is a public-private partnership (Figure 5). Insurance companies act as agents to TCIP and cede 100 percent of all risks acquired by TCIP, and they receive a commission from the pool.¹²⁴ TCIP transfers risks to international reinsurers through sharing pools under the management of international reinsurance companies, like Munich Re.¹²⁵ The claims payment of TCIP is dependent on international reinsurance and on the amount of funds collected (partially from the government).¹²⁶ The board of directors represents the government, experts, and insurance companies. The administrative body of TCIP is the General Directorate of Insurance within the Prime Ministry Under-Secretariat of the Treasury, but the business operation is managed by Milli Reasürans (“operational manager”), a national reinsurance company.¹²⁷

¹²³ *Id.* at 87-95.

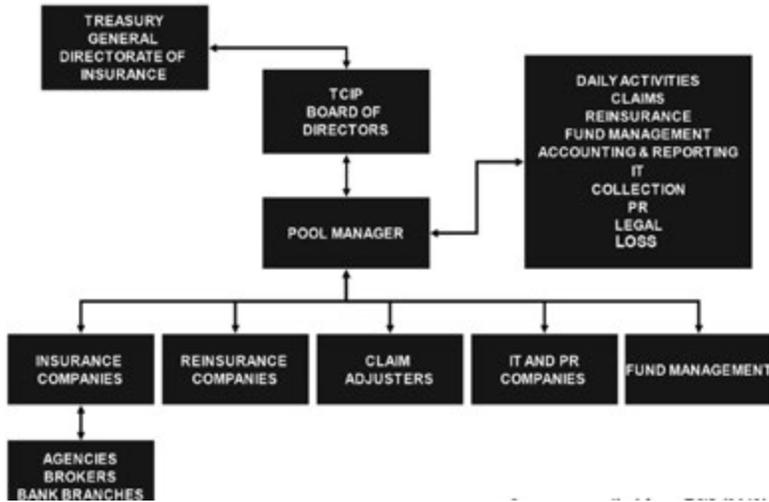
¹²⁴ See Johann-Adrian von Lucius, *A Reinsurer’s Perspective on the Turkish Catastrophe Insurance Pool (TCIP)*, in *CATASTROPHE RISK AND REINSURANCE: A COUNTRY RISK MANAGEMENT PERSPECTIVE* 217, 219 (Eugene N. Gurenko, eds. 2004) (stating that the TCIP supplies earthquake insurance to homeowners, and covers losses caused by earthquakes and earthquake-related catastrophes, such as fires, explosions, landslides, and tsunamis); Burcak Başbuğ-Erkan & Ozlem Yilmaz, *Successes and Failures of Compulsory Risk Mitigation: Re-evaluating the Turkish Catastrophe Insurance Pool*, 39 *DISASTERS* 782, 789 (2015).

¹²⁵ Başbuğ-Erkan & Yilmaz, *supra* note 124, at 782.

¹²⁶ It would only be triggered by an event equivalent to an earthquake in Istanbul with a 200-year return period (technically, an earthquake with an exceedance probability of 0.5 percent). See GURENKO, *supra* note 122, at xi.

¹²⁷ Başbuğ-Erkan & Yilmaz, *supra* note 124. All of its business functions—from sales to reinsurance to claim management—are subcontracted to the private insurance industry, and the TCIP has no public employees. See GURENKO, *supra* note 122.

Figure 5. Organizational chart of the Turkish Catastrophe Insurance Pool¹²⁸



Loss-Sensitive Premiums. Since the business operation of TCIP follows a market-oriented approach, and its underwritten risks are transferred to international reinsurers, it is reasonable for international reinsurers to charge loss-sensitive premiums to control the moral hazard of TCIP. Loss-sensitive premiums require that reinsurance premiums should reflect an actuarially fair cost, and they constrain TCIP to underwrite appropriately. With the burden from the reinsurance, TCIP adopts a differential risk-based pricing approach and imposes construction maintenance obligations on the insured in the policies to mitigate underwritten losses.¹²⁹

The Duty of Utmost Good Faith. Primary insurers play a different role in TCIP compared to their role in the French CCR or the Japanese JERS. Primary insurers act as agents to TCIP, and the pool assumes all the earthquake risks.¹³⁰ The duty of utmost good faith is not suitable for primary insurers. In contrast, TCIP transfers risk to international reinsurers.

¹²⁸ Başbuğ-Erkan & Yılmaz, *supra* note 124.

¹²⁹ Article 14 of Governmental Decree Law No. 587 on Compulsory Earthquake Insurance (“The owner who causes or allows the building and each independent section thereof to be altered contrary to the related design and in a way that will affect the load-bearing system, loses his entitlement to compensation in as much as the actual loss arises or increases because of such reason.”).

¹³⁰ von Lucius, *supra* note 124.

From the perspective of international reinsurers, it requires TCIP to perform the duty of utmost good faith. The organizational structure of TCIP, to some extent, might guarantee its performance through public-private partnership.

Providing Risk Management Service. Reinsurers play an important role as consultants, especially in the conception of TCIP. As a matter of fact, TCIP was formed with the cooperation of the World Bank, the Turkish Government, Milli Re, reinsurance brokers, and Munich Re.¹³¹ International reinsurers play an important role in providing risk management services and contribute to the operation of TCIP and catastrophe risk management in Turkey.

Indirect Regulation of Insureds. Since international reinsurers, such as Munich Re, are licensed to conduct business in Turkey, there is no need for a fronting agreement arrangement. There is no empirical evidence that TCIP indirectly regulates insureds.

D. CONCLUDING REMARKS

Controlling moral hazard and providing incentives to loss control benefit both reinsurers and primary insurers. Such efforts will encourage ceding companies to regulate behaviors of policyholders, decrease cost for ceding companies, and enhance profits for reinsurers. It is a win-win strategy for both reinsurers and primary insurers. Compared to private reinsurers, government-sponsored reinsurance meets more challenges to fulfill regulatory techniques due to political pressures and other constraints. Table 1 summarizes the regulation by government-sponsored reinsurance among the three countries in the preceding discussion.

¹³¹ WORLD FORUM OF CATASTROPHE PROGRAMMES, NATURAL CATASTROPHES INSURANCE COVER: A DIVERSITY OF SYSTEMS 163-164 (2008). http://www.wfcatprogrammes.com/c/document_library/get_file?folderId=13442&name=DLFE-553.pdf.

Table 1. Comparison of regulation by government-sponsored reinsurance

	French CCR	Japanese JERS	Turkish TCIP
Loss-sensitive premiums	Partially	No	Yes
The duty of utmost good faith	Yes	Yes	Probably
Providing risk management services	Not clear	Not clear	Yes
Indirect regulation of insureds	No	Yes	No

This table shows that no government-sponsored reinsurance fully performs regulatory techniques. It seems that the Turkish TCIP is subject to less moral hazard than the French CCR and the Japanese JERS. TCIP cedes risks to international reinsurers following a loss-sensitive premiums approach and thus has more incentives to underwrite appropriately, such as identifying “bad risks,” enforcing building codes, and educating the public to raise their awareness to catastrophe risk. Meanwhile, international reinsurers not only helped found TCIP, but also worked as consultants to supply risk management services. The application of regulatory techniques of reinsurance helps TCIP work sustainably. For example, TCIP supplies a model solution, especially for developing and middle-income countries where rigorous catastrophe risks exist.

Different from TCIP, the French CCR and the Japanese JERS are both government-sponsored reinsurance institutions and not involved with other private reinsurance companies. Although they do not adopt loss-based premiums due to political pressures, they are better in enforcing primary insurers’ duty of utmost good faith than TCIP. CCR’s system is particularly suitable to France for several reasons. The first reason is cultural influence. In France, people value the national solidarity principle and are tolerant of cross-subsidies between different classes of risk and different regions, both of which guarantee a single-rate price for reinsurance. The second reason is social adequacy and affluence. As a developed and high-income country, the French government has more capacity to sponsor policyholders. The third reason is the moderate exposure to disasters. None of the twenty-five worst natural disasters

recorded, including earthquakes, typhoons, and tsunamis, occurred in France.¹³² In addition, during the last several decades (1970–2013), none of the natural disasters which caused the top ten insured catastrophe losses occurred in France.¹³³

Japan faces more severe catastrophe risks than France because of the frequent occurrence of earthquakes and tsunamis. The establishment of the Japanese JERS is the compromise between the government and the insurance industry: the government provides reinsurance capacity as a last resort and facilitates insurance affordability.¹³⁴ There is no doubt that JERS refuses loss-sensitive premiums but follows a general fair-value principle for price setting. Under such a situation, JERS pays more attention to monitoring primary insurers' performance of duty of utmost good faith and indirect regulation of insureds to control moral hazard and mitigate losses.

VI. EXPANDING REGULATION BY GOVERNMENT-SPONSORED CATASTROPHE REINSURANCE TO CHINA

This Article has reviewed the imperfections of private reinsurance, mainly due to the apparent shortage of reinsurance capital, especially during hard markets. Also discussed were government-sponsored reinsurance programs in France, Japan, and Turkey, which represent both high-income and middle-income countries. The focus now is to explore the possibility of expanding regulation by reinsurance to China.

A. THE ISSUE OF THE GOVERNMENT'S PROVIDING REINSURANCE CAPACITY IN CHINA

Section IV has explained the imperfections of the private reinsurance market for catastrophe risks, but these market failures are not sufficient to justify any and all government intervention: there are many different forms of government-provided reinsurance, some of which may be ineffective (no efficiency gains achieved) or even detrimental (causing efficiency losses).¹³⁵ One popular approach to government intervention is

¹³² Josef, *25 Worst Natural Disasters Ever Recorded*, LIST 25 (Aug. 26, 2013), <http://list25.com/25-worst-natural-disasters-recorded/5/>.

¹³³ *Natural Catastrophes and Man-Made Disasters in 2013: Large Losses from Floods and Hail; Haiyan Hits the Philippines*, SWISS RE 5 (2014), http://institute.swissre.com/research/overview/sigma/1_2014.html.

¹³⁴ Takeda, *supra* note 110.

¹³⁵ David Cummins & Olivier Mahul, *Catastrophe Risk Financing in Developing*

to provide a government bailout to victims, including ad hoc direct payment and establishing compensation funds. This type of ex-post bailout is known as the Whole-Nation System and generally seen as problematic.¹³⁶ Another popular approach to government intervention is government-provided insurance. Compared with ex-post government bailouts, this type of government intervention looks more attractive, since an ex-ante insurance approach could accumulate reserves and may provide incentives to mitigate losses before disasters if associated with risk-based premiums. However, this type of government intervention is also generally seen as problematic.¹³⁷ Even for China, where private catastrophe insurance has not yet developed, the government should facilitate private insurance rather than provide government insurance. The Chinese government could adopt a reinsurance regime for catastrophes or provide reinsurance capacity as a last resort. Such arrangements and intervention provide considerable incentive for primary insurers to control moral hazard and mitigate losses associated with catastrophic disasters.

Right now, China has begun to stimulate the development of catastrophe insurance to complement government action in addressing catastrophe risks. The government's provision of reinsurance capacity would also be a response to the concern and demand of private insurers and reinsurers.

The current insurance industry has few incentives to underwrite catastrophe risks partly due to scarce insurance and reinsurance capacity. In 2013, the Third Plenary Session of the Eighteenth Communist Party of China Central Committee promulgated the "Decision of the Central

Countries: Principles for Public Intervention, THE WORLD BANK 76 (2009), <http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/CATRISKbook.pdf>; see also W. Neil Adger, Nigel Arnell, & Emma Tompkins, *Successful adaptation to climate change across scales*, 15(2) *Global Environmental Change* 85 (2005).

¹³⁶ Simply speaking, the problems include undercutting potential victims' incentives for risk prevention and loss mitigation; posing a heavy fiscal burden for the government and may cause negative distributional effects; leading to political inefficiencies and etc.

¹³⁷ For example, government-provided insurance always delivers a subsidy that private insurance does not give and inflicts two distortions: (1) regressive redistribution favoring affluent policyholders; and (2) inefficient investment in residential property by locating too many assets in vulnerable areas. Some scholars have reviewed and examined two government-provided insurance programs: (1) the National Flood Insurance Program; and (2) Florida's state owned Citizens Insurance, and found that both perceptions of government-provided insurance performance along two normative metrics: fairness and efficiency, are wrong. See Omri Ben-Shahar & Kyle Logue, *The Perverse Effects of Subsidized Weather Insurance*, 68 *STAN. L. REV.* 571 (2016).

Committee of the Communist Party of China on Some Major Issues concerning Comprehensively Deepening the Reform,” which expressly stated that “we will establish an insurance system for catastrophe risks.” In 2014, catastrophe insurance program trials were launched in Shenzhen, in the Pearl River Delta (a densely populated metropolitan area and also one of the world’s most disaster-prone regions), and in the Chuxiong region in the southwestern province of Yunnan, known to be prone to earthquakes.¹³⁸ However, private catastrophe insurance is one of the least developed lines in China. For example, after the 2008 Great Sichuan Earthquake, only 0.3 percent of the total losses were covered by insurance companies.¹³⁹ Private insurers do not have the capital to fully cover catastrophe losses. The total capital of China’s property insurance companies is much lower than the total amount of losses caused by natural disasters. Table 2 shows the existence of this big gap. Moreover, the China Insurance Regulatory Commission has implemented China’s Risk-Orientated Solvency System as of 2015.¹⁴⁰ The new solvency regime requires insurers, like the Solvency II Directive in the European Union, to hold sufficient capital in their reserves, especially the capital for catastrophe risks that they are facing.¹⁴¹ In order to underwrite catastrophe risks, insurers have an increasing demand for more financial capacity and share a significant portion of the insured losses with reinsurers.

¹³⁸ *China says testing catastrophe insurance system*, REUTERS (Aug. 20, 2014), <http://www.businessinsurance.com/article/20140820/NEWS04/140829990?AllowView=VDI3UXk1T3hDUFNCbkJiYkY1TDJaRUt0ajBRV0ErOVVHUT09#>.

¹³⁹ *Establishing catastrophe insurance system faces acceleration*, CHINA YOUTH DAILY (March 14, 2011), http://zqb.cyol.com/html/2011-03/14/nw.D110000zgqnb_20110314_1-05.htm?div=-1.

¹⁴⁰ Wenhui Chen, *C-ROSS under the Market-oriented Reform and Economy Globalization*, SWISS RE (2014), http://media.swissre.com/documents/CROSS_under_the_market_ChenWenhui_Dec15.pdf.

¹⁴¹ *Id.*

Table 2. Capital of main Chinese property insurers compared to natural disaster losses (billions of US \$)

	2007	2008	2009	2010
Net capital of main insurers	5.5	5.1	6.9	9.0
Natural disaster losses	38.1	189.5	40.1	86.1

(Source: Yearbook of China Insurance [2008–2011])

Reinsurance is an important potential complement to expanding primary insurers' capacity to underwrite risks. However, reinsurance currently does not provide strong support for catastrophe insurance in China. At present, the China Reinsurance (Group) Corporation (its predecessor, the People's Insurance Company of China Reinsurance, was created in 1996) is the only domestic reinsurer in China, with consolidated total assets of around \$30 billion and net assets of \$8.6 billion.¹⁴² Its capital is much lower than the annual losses caused by natural disasters. Although China's reinsurance market has become open to foreign reinsurance companies after China's entry into the World Trade Organization, only a few reinsurance companies, such as Swiss Re and Munich Re, have established business operations in China, and they are only in the initial stages of reinsuring risks. By 2013, there were only eight foreign reinsurers who had registered branches in China.¹⁴³ When underwriting catastrophe risks, domestic reinsurers will strongly demand government sponsorship, which could provide the government with deep credit capacity.

¹⁴² China Re, *Annual Report 2014* (2014) <http://www.chinare.com.cn/zhjt/resource/cms/2015/08/2015082709085075513.pdf>.

¹⁴³ CPCRC, *Overview of Chinese Reinsurance Market* (May 20, 2013), https://www.casact.org/education/spring/2013/handouts%5CPaper_1680_handout_962_0.pdf.

B. EFFECTIVENESS OF REGULATION BY CATASTROPHE REINSURANCE

There is little doubt that the government should provide reinsurance capacity as a last resort to catastrophe risk management in China. What is less clear is how to apply the proper regulatory techniques, as discussed in sections III and V. Clearly, catastrophe reinsurance is closely associated with the operation of primary insurance. As mentioned above, in 2014, China launched its first catastrophe insurance pilot in Shenzhen (Shenzhen Model). Therefore, the possibility and feasibility of regulation by reinsurance in China will be explored through the examination of its regulatory techniques in the Shenzhen Model.

Shenzhen was selected for the pilot because it has both major exposure to catastrophe threats¹⁴⁴ and a large number of valuable assets.¹⁴⁵ The catastrophe insurance framework of the Shenzhen Model includes three different layers: the first layer is the government catastrophe insurance assistance, which is bought by the Shenzhen municipal government, with the beneficiaries being all residents of Shenzhen City; the second layer is a catastrophe fund mainly sponsored by the Shenzhen government and social donations; and the third layer is commercial catastrophe insurance.¹⁴⁶ The first two layers of the Shenzhen Model represent the social insurance protection. According to the arrangement in the first layer, the Shenzhen city government buys catastrophe insurance products from the People's Insurance Company of China (PICC), Shenzhen branch.¹⁴⁷ It has a cap of RMB 2.5 billion with individual claim payments

¹⁴⁴ Frequently occurring disasters in Shenzhen include, but are not limited to, heavy winds (extending to whole gale, strong gale, and fresh gale), rainstorms, lightning strikes, floods, waterlogging, tornados, typhoons, tsunamis, hail, landslides, mudslides, cliff fall, land subsidence, squall lines, and earthquakes of more than 4.5 magnitude. See ICC, *Catastrophe Insurance Framework of Shenzhen City* (2015), <http://wenku.baidu.com/link?url=oLT1RmQ3BXgfW49ETc-Drhv6S1pOb8dOA5E3YOVZgCAkJrTD-aiBaF1doiXOq9Xsb1rLoty4IP-b1dPBKzZY2eiNgZex52GfzpdheyZEIt>.

¹⁴⁵ Shenzhen is a megacity with approximately 15 million residents. It is China's first and one of the most successful Special Economic Zones with its GDP totaled \$260.48 billion in 2014. See Yisha Hou, *Promoting the Construction of Shenzhen Catastrophe Insurance System*, 25 *DISASTER REDUCTION IN CHINA* 42, 42-45 (2015).

¹⁴⁶ *China says testing catastrophe insurance system*, *supra* note 138.

¹⁴⁷ The individuals receiving coverage under the Shenzhen model do not pay upfront for any losses through deductibles. See Anastasia Telesetsky, *Climate Change Insurance and Disasters: Is the Shenzhen Parametric Social Insurance a*

of RMB 100,000, and the payments are only available for bodily injury and death, but not for property damage.¹⁴⁸ According to the arrangement in the second layer, the Shenzhen city government has committed to providing RMB 36 million of funds annually to support the first layer. The third layer is related to private insurance and policies that could cover property damages. In the conception of the Shenzhen Model, reinsurers like the China Re, Swiss Re, and Taiping Re were involved. Therefore, reinsurance could and should play its role to control moral hazard of primary insurers and mitigate losses through relevant regulatory techniques.

Loss-Sensitive Premiums. In the first layer of the Shenzhen Model, the government buys insurance products from insurance companies (e.g., PICC, Shenzhen branch) rather than acting as a reinsurer. PICC cedes a large portion of underwriting to Swiss Re, China Re, and Taiping Re, according to the quota share treaties.¹⁴⁹ These treaties provide loss-sensitive premiums for PICC. Following loss-sensitive premiums, primary insurers have incentives to control moral hazard and mitigate losses. PICC has worked in tandem with experts, insureds, and other stakeholders to identify the technical and economic parameters of catastrophe risks and develop system-wide technologies of loss prevention. For example, PICC extracts 5 percent of the premium to organize disaster research, disaster prevention, disaster emergency relief drills, and disaster emergency advertising; submits to the government a quarterly report of current disaster and claims payments and an annual report of disaster risk management; offers advice on risk prevention, emergency management, and disaster relief to the municipal government; and establishes and operates a disaster data base for disaster analysis and prevention.¹⁵⁰ Furthermore, loss-sensitive premiums also induce primary insurers to regulate policyholder's behavior for loss mitigation. PICC offers the Shenzhen government a discounted premium for taking cost-effective mitigation measures. For example, PICC provides that if the annual loss ratio (actual payment amount / total premium) is less than 10 percent, then the premium the following year will be discounted by 10 percent; if the loss

Model for Adaptation?, 43(2) B.C. ENVTL. AFF. L. REV. 485 (May 31, 2016).

¹⁴⁸ Martin Li & Yin Ran, *SZ launches 1st disaster insurance*, SHENZHEN DAILY (July 17, 2014), http://szdaily.sznews.com/html/2014-07/10/content_2936724.htm.

¹⁴⁹ *China Re, Swiss Re, and Taiping Re Underwrite the Shenzhen Catastrophe Reinsurance Policies*, 21ST CENTURY BUS. HERALD (July 6, 2014), http://xw.sinoins.com/2014-07/16/content_121575.htm.

¹⁵⁰ PICC, *Catastrophe Insurance Framework of Shenzhen City* (2015), <http://wenku.baidu.com/link?url=oLT1RmQ3BXgfW49ETc-Drhv6S1pOb8dOA5E3YOVZgCAkJrTD-aiBaF1doiXOq9Xsb1rLoty4IP-b1dPBKzZY2eiNgZex52GfzpdheyzEIt3>.

ratio is less than 10 percent in two consecutive years, the third year's premium will be discounted by 20 percent; if the loss ratio is less than 10 percent in three consecutive years, the fourth year's premium will be discounted by 30 percent.¹⁵¹

In the third layer of the Shenzhen Model, the PingAn Insurance Company starts to design and sell relative catastrophe insurance products to the residents of Shenzhen.¹⁵² There is no doubt that commercial primary insurers, like PingAn Insurance Company, also have strong incentives to transfer catastrophe risks to reinsurers. The form of government sponsorship has not yet been decided in the Shenzhen Model. From the perspective of control of moral hazard, the approach of TCIP might be a good choice: the government only provides contingent liquidity support when the payments of claims exceed insurers' capacity. If China follows the model of CCR or JERS, political pressure or other reasons would not prevent it from repeating their mistakes in subsidizing premiums.

The Duty of Utmost Good Faith. According to the quota share treaty between insurers and reinsurers, it could contribute to PICC's performance of the duty of utmost good faith, since PICC has to retain some portion of the risks itself. In contrast, the typical long-term relationship mechanism between insurers and reinsurers, which is closely associated with utmost good faith may not be workable in the Shenzhen Model. The current Shenzhen Model is a temporary trial project and lacks legislative provisions.¹⁵³ Without explicit legislative provisions, the prospect of the Shenzhen Model is quite uncertain. The Shenzhen municipal government may cease to buy catastrophe insurance policies in future years. If the government does not buy insurance, there is no opportunity for a long-term relationship between PICC and reinsurers.

Providing Risk Management Services. Like TCIP, reinsurers, especially international reinsurers like Swiss Re and Munich Re, play an important role as consultants to provide risk management services in the conception of the Shenzhen Model. For example, Swiss Re initiated a Parametric Insurance Solutions for Disaster Relief System Reform research program in 2013 as a sponsor for the China Development and Research Foundation.¹⁵⁴ This research program helps Swiss Re become a technical advisor and a leading reinsurer for the Shenzhen Model.¹⁵⁵

¹⁵¹ *Id.*

¹⁵² Yisha Hou, *supra* note 145.

¹⁵³ Shi Xing, *Inspirations of Shenzhen catastrophe insurance pilot revelation*, 21ST CENTURY BUS. HERALD (Oct. 11, 2014), <http://insurance.hexun.com/2014-10-11/169210867.html>.

¹⁵⁴ *Swiss Re Works with Government Bodies in Mitigating Natural Catastrophe Risks in China*, SWISS RE (Aug. 13, 2014), <http://www.swissre.com/>

VII. CONCLUSION

Government-sponsored reinsurance can not only support failing catastrophe insurance due to the deep credit capacity of the government. Considered the corollary of the regulation-by-insurance idea,¹⁵⁶ as the title of this Article suggests, government-sponsored reinsurance can also regulate primary insurers' behaviors in risk mitigation and risk management through reinsurers' regulatory techniques.

Currently, affected parties of natural disasters, especially the pilot catastrophe insurers, are demanding government sponsorship of their catastrophe losses in China. Considering the reform of the Whole-Nation System, there is a pressing need for the Chinese government to provide reinsurance capacity as the new government-intervention approach. Moreover, regardless of which type of government intervention the Chinese government adopts, it is necessary to exert the role of reinsurance in regulating primary insurers through reinsurance regulatory techniques.

china/Swiss_Re_works_with_government_bodies_in_mitigating_natural_catastrophe_risks_in_China.html.

¹⁵⁵ Liu Ailin, *Risks of the First Catastrophe Insurance Policy Are Ceded to China Re, Swiss Re and CPIC Re*, 21ST CENTURY BUS. HERALD (July 16, 2014), <http://finance.sina.com.cn/money/insurance/bxdt/20140716/025719714880.shtml>.

¹⁵⁶ Abramovsky, *supra* note 4 (“Just as insurance is often viewed as having a regulatory effect on insured industries, so too should reinsurance be considered as having a regulatory effect on its reinsureds.”).

REMEDIES FOR BREACH OF THE PRE-CONTRACT DUTY OF DISCLOSURE IN CHINESE INSURANCE LAW

ZHEN JING*

Chinese Insurance Law imposes on the insured a duty to disclose material information prior to the formation of the contract. This duty is limited to the scope and extent of the insurer's inquiry and to the insured's actual knowledge. The insurer may rescind the contract if the insured fails to disclose a material fact, either intentionally or by gross negligence. This article considers the remedies for breach of this duty, examines the way in which Chinese courts determine whether a breach occurs intentionally or by gross negligence, and discusses deficiencies of the available remedies. Finally, this article recommends adopting the doctrine of proportionality for insurers' liability for losses.

I. INTRODUCTION

An insurance contract is a contract based on the utmost good faith.¹ In the contract formation period, the principle of utmost good faith creates a well-established duty owed by the insured to the insurer to disclose material facts and to refrain from making untrue statements when negotiating the contract.² Typically, the insurer is not knowledgeable about the specific thing being insured, while on the other hand, the insured often knows everything. Thus, it is the duty of the insured to make a full disclosure to the insurer of all the material facts of the subject to be insured. Based on the information provided by the insured, the insurer can decide whether to accept the risk and, if so, on what terms.

Generally speaking, the insured is obliged to disclose to the insurer all material information prior to the formation of the contract.³ In China,

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¹ Marine Insurance Act 1906, 6 Edw. 7 c. 41 §17. For more on history and development of the doctrine of disclosure in English law, *see generally* ROBERT MERKIN, COLINVAUX'S LAW OF INSURANCE (11th ed., Sweet & Maxwell, 2016).

² *See* J. BIRDS, B. LYNCH & S. MILNES, MACGILLIVRAY ON INSURANCE LAW (12th ed. Sweet & Maxwell, 2012).

³ *See*, Marine Insurance Act 1906, 6 Edw. 7 c. 41 § 18; (UK), *Insurance Contracts Act 1984* s 21 No. 80, 1984 as amended in 2008 (Austl.), *Insurance Contract Act of 23 November 2007* Federal Law Gazette I, at page 2631, No. as

the current law relating to the insured's duty of disclosure or representations is provided in Art. 16 of the Insurance Law 2009 (Insurance Law),⁴ which states, "[w]hen concluding an insurance contract, the insurer may raise questions concerning relevant details of the insured subject matter or of the insured. The proposer shall truthfully disclose such details to the insurer."⁵ Where the proposer (the insured)⁶ fails to comply with the duty of disclosure, the insurer's remedies depend on the degree of the insured's fault and resulting consequences of the breach.⁷

This paper considers the remedies available to insurers when an insured breaches the duty of disclosure in both Chinese Insurance Law and English law. It examines the way in which Chinese courts determine whether a breach occurs intentionally or by gross negligence. Additionally, it considers deficiencies of the law in respect to the available remedies, and makes recommendations regarding the doctrine of proportionality. Specifically, as the doctrine relates to the definitions of intentional and grossly negligent non-disclosure, and how it affects the insurer's exposure in the case of a grossly negligent non-disclosure.

last amended by Article 2 (79) of the Act of 22 December 2011 (Federal Law Gazette I, at page 3044) § 19 (Ger.); Insurance Law of the People's Republic of China, promulgated by Order No. 51 of the President of the People's Republic of China, effective 2009 (China) [hereinafter Insurance Law of the People's Republic of China].

⁴ Insurance Law of the People's Republic of China was enacted by the National People's Congress in 1995, which was the first comprehensive legislation on insurance in China that consists of insurance contract law and insurance regulation. To meet the commitment to the WTO, the Insurance Law 1995 was amended in 2002 mainly on insurance regulation, and insurance contract law was essentially not changed in 2002 version. The Law was again amended in 2009. Both contract law and regulation were amended substantially. Insurance Law of the People's Republic of China, *supra* note 3.

⁵ *Id.*

⁶ The person who makes an application for insurance is called the proposer. When the insurer has agreed to underwrite the risk, the proposer is now called the insured or the policyholder. This article uses the term "the insured" for the proposer or the insured.

⁷ Insurance Law of the People's Republic of China, *supra* note 3, at Art. 16(4) and (5).

II. A BRIEF OVERVIEW OF THE DUTY OF DISCLOSURE

A. INQUIRY DISCLOSURE

Chinese Insurance Law uses inquiry disclosure, i.e. “asking and answering” questions in the proposal form.⁸ According to Art. 16(1) of the Insurance Law, the insured is required to disclose only the information asked by the insurer on the proposal form. Even if the insured fails to disclose material information, the insurer may not rescind the contract when such information is beyond the scope of the questions raised in the proposal form.⁹

When the Supreme People’s Court of China (the SPC) enacted its Second Interpretation on Certain Questions Concerning the Application of the Insurance Law of the Peoples’ Republic of China (the SPC Interpretation II),¹⁰ the SPC made it clear that “[t]he insured’s duty of disclosure is limited to the scope and content of the insurer’s inquiry; where the insurer and the insured dispute on the scope and content of the inquiry, the onus of proof rests upon the insurer.”¹¹ Accordingly, the insured has fulfilled the duty of disclosure if he has truthfully answered the questions in the proposal form. He has no duty to volunteer information to the insurer, even if the information is material.

⁸ *But see* Maritime Code of the People’s Republic of China (promulgated by Order No. 64 of the President of the People’s Republic of China, November 7, 1992, effective July 1, 1993 (“...before the contract is concluded, the insured shall disclose to the insurer material circumstances which the insured has knowledge of or ought to have knowledge of in his ordinary business practice and which would influence the insurer in deciding the premium or whether he agrees to insure or not.”)).

⁹ *See* Z. Jing, *Insured’s duty of disclosure and test of materiality in marine and non-marine insurance laws in China*, JBL 681, 686-687 (2006).

¹⁰ *See* Interpretations of the Supreme People’s Court on Several Issues Concerning the Application of the Insurance Law of the People’s Republic of China (promulgated by Sup. People’s Ct., May 6, 2013, effective June 8, 2013) Document No. fa shi [2013] No. 14, Art. 5 & 6, <http://www.sglaw.cn/en/news.php?id=361> (last visited Feb. 4, 2017) (China) (clarifying ambiguities of the Insurance Law and puts forth detailed rules for the Insurance Law) [hereinafter SPC Interpretations]. The Supreme People’s Court stipulation, judicial explanation or decision has legal force. This means that the Supreme People’s Court stipulation, judicial explanation or decision is one of the legal sources in China.

¹¹ *Id.* at Art. 6(1),

Sometimes a situation may occur where the insured has voluntarily disclosed some information without being inquired by the insurer, but the information is untrue and misleading. Neither the Insurance Law nor the SPC Interpretation II provides any rule for handling this situation. However, the High People's Court (HPC) of Beijing City has stated that if an insured has voluntarily written down information on the proposal form which was not requested by the insurer, it is deemed that the insurer has made inquiry as to that information. Therefore, the insured owes a duty to disclose that information truthfully.¹² This issue has yet to be addressed by the SPC.

Under English law, the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA)¹³ does not require consumers to volunteer material facts. Instead, consumers are required to take reasonable care not to make a misrepresentation.¹⁴ This means that the consumers must take reasonable care to answer insurers' questions fully and accurately. If consumers do volunteer information, they must take reasonable care to ensure that the information is not misleading. For non-consumer insurance,¹⁵ the duty of fair presentation is now provided in s.3 of the Insurance Act 2015 (UK).¹⁶ The general effect of fair presentation is that it creates a duty of disclosure. Sections 3(4)(a)-(b) provide two statutory ways of satisfying this duty of (voluntary) disclosure. Section 3(4)(a) effectively replicates the disclosure duty in § 18(1) of the Marine Insurance Act 1906 (UK), its key features are that the insured must disclose "every

¹² Art. 8 of the Guidance of the High People's Court of Beijing City Concerning Questions of How to Deal with Insurance Disputes 2005. It must be noted the guidance enacted by the High People's Court is only to guide the lower courts rather than to bind them. These guiding rules have no legal force.

¹³ Consumer Insurance (Disclosure and Representations) Act 2012 c. 6 (U.K.), <http://www.legislation.gov.uk/ukpga/2012/6/contents/enacted> ("Consumer insurance contract means a contract of insurance between (a) an individual who enters into the contract wholly or mainly for purposes unrelated to the individual's trade, business or profession, and (b) a person who carries on business of insurance and who becomes a party to the contract by way of that business[;] "consumer" means the individual who enters into a consumer insurance contract, or proposes to do so.").

¹⁴ *Id.* at 2(2).

¹⁵ A non-consumer insurance contract means any insurance contract that is not used for consumer purposes. This includes insurance for charities, micro-businesses and small or medium enterprises, as well as large risks, marine insurance and reinsurance.

¹⁶ Insurance Act 2015, c. 4, § 3 (U.K.), <http://www.legislation.gov.uk/ukpga/2015/4/contents/enacted>.

material circumstance” that the insured “knows or ought to know.”¹⁷ If the insured has failed to satisfy the strict duty in § 3(4)(a), it may still satisfy the disclosure duty under § 3(4)(b). Specifically, § 3 (4)(b) is satisfied by disclosing sufficient information to put a prudent insurer on notice that the insurer must make further inquiries that, when answered, would reveal material circumstances that the insured knows or ought to know. Section 3(4)(b) represents the key change to the duty of disclosure. It reflects the trend in case law of accepting the fact that it may not be possible or necessary for every material circumstance to be disclosed.¹⁸

In summary, under English law with respect to consumer insurance, inquiry-based disclosure (i.e. representation) is adopted under CIDRA. In the context of non-consumer insurance, voluntary disclosure has been preserved by the Insurance Act 2015 (U.K.), but the strictness of the duty of voluntary disclosure has been mitigated by § 3(4)(b) of the Insurance Act 2015 (U.K.).

B. INSURED’S ACTUAL KNOWLEDGE

Art. 16(1) of the Chinese Insurance Law requires the insured to disclose material information to the insurer at the time of the contract, but does not give any provision about the insured’s knowledge. The SPC has provided a clear rule with respect to the insured’s knowledge, stating that “[w]hen entering into an insurance contract, circumstances about the subject matter of insurance or of the insured which are to be truthfully disclosed by the insured as required by Art. 16(1) of the Insurance Law are those that the insured actually knows.”¹⁹ The insured is obligated to disclose only what he actually knows, not what he ought to know. Therefore, constructive knowledge is irrelevant.

C. TEST OF MATERIALITY

By virtue of Art. 16(2) of the Insurance Law,²⁰ a material fact is a fact that “shall sufficiently influence the insurer’s decision on whether or

¹⁷ *Id.*

¹⁸ See *CTI v. Oceanus* [1984] 1 Lloyd’s Rep. 476 (U.K.); *Garnat Trading and Shipping v. Baominh Insurance Corporation* [2011] EWCA (Civ) 773 (U.K.).

¹⁹ SPC Interpretations, *supra* note 10, at Art. 5.

²⁰ Insurance Law of the People’s Republic of China, *supra* note 3, at Art. 16(2) (“The insurer shall have the right to rescind the insurance contract where the

not he will accept the insurance or raise the premium rate.”²¹ The term “sufficient influence” can also mean “decisive influence.”²² The term “insurer” mentioned in Art. 16(2) denotes a “prudent insurer” or “reasonable insurer.”²³ The test of materiality under Chinese Insurance Law can be described as a “prudent insurer decisive influence” test, where an insurer would not have entered into the contract or would have raised the premium rate had he known of the fact undisclosed or misrepresented by the insured.²⁴

In contrast, under English law, CIDRA abolishes “the mere influence prudent insurer” test of materiality, but the concept of “inducement”²⁵ has been preserved. Under this standard, the insurer must show that without the misrepresentation he would not have entered into the contract, or would have done so on different terms.²⁶ The inducement approach has also been preserved in § 8(1) of the Insurance Act 2015 (U.K.) for non-consumer insurance.

III. TYPES OF NON-DISCLOSURE AND REMEDIES

A. RESCISSION OF THE CONTRACT

Non-disclosure or misrepresentation can be made intentionally, by gross negligence, negligently or innocently. Chinese Insurance Law provides different remedies for breach of the duty of disclosure depending on the type of breach. The insurer is entitled to rescind the contract where the insured breaches the duty to disclose intentionally or through gross negligence if the insured’s misrepresentation or failure to disclose sufficiently influenced the insurer’s decision to accept the insurance or raise

proposer fails to fulfil the obligation of truthful disclosure ... intentionally or by gross negligence so that the failure of disclosure or misrepresentation shall sufficiently influence the insurer’s decision on whether he will accept the insurance or raise the premium rate.”).

²¹ *Id.*

²² Jing, *supra* note 9, at 695.

²³ *Id.* See also Z.Y. Liu, *Life Insurance Law and Practice*, LAW PRESS CHINA 230 (2012).

²⁴ *Id.*

²⁵ *Pan Atlantic Ins. Co. Ltd v. Pine Top Ins. Co. Ltd* [1995] 1 A.C. 501, [1994] 3 W.L.R. 677; [1994] 3 All E.R. 581 (U.K.).

²⁶ Consumer Insurance (Disclosure and Representations) Act, 2012, c. 6 § 4.1(b) (U.K.), <http://www.legislation.gov.uk/ukpga/2012/6/contents/enacted> [hereinafter *CIDRA*].

the premium rate.²⁷ Art. 16 of the Insurance Law implies that the insurer is not entitled to rescind a contract resulting from the innocent or mere negligent non-disclosure or misrepresentation, even if the undisclosed information is material. The insured's right of rescission shall lapse when the insurer does not exercise it thirty days after learning of the insured's breach, or past two years from the date of formation of the contract.²⁸

Under Chinese law, an insurer is not allowed to rescind the contract, unless the following conditions are met: (i) the insured must have made inquiries about the relevant facts in questions raised in the proposal form prior to the formation of the contract;²⁹ (ii) the insured must actually know the relevant facts;³⁰ (iii) the insured breached this duty intentionally or by gross negligence;³¹ (iv) the undisclosed information is material in that it sufficiently influences a prudent insurer's decision on whether or not he will accept the insurance or raise the premium rate;³² (v) when concluding the contract, the insurer did not know that the insured had failed to provide truthful information;³³ and (vi) the insurer's right of rescission of the

²⁷ Insurance Law of the People's Republic of China, *supra* note 3, at Art. 16(2).

²⁸ *Id.* at Art.16(3) ("The right of rescission provided in the preceding paragraph shall lapse where the insurer does not exercise it thirty days after he knows that there is the cause for rescission. Where over two years have passed from the date of formation of the contract, the insurer may not rescind the contract; where an insured event occurs, the insurer shall be liable for making indemnity payment or paying insurance benefits."). See Z. Jing, *Incontestability provisions in insurance law and policies*, J. OF BUS. L. 253-288 (2016) (discussing the time limits for the insurer's right of rescission of the contract).

²⁹ Insurance Law of the People's Republic of China, *supra* note 3, at Art. 16(1). See also Art. 6.1, Interpretations of the Supreme People's Court on Several Issues Concerning the Application of the Insurance Law of the People's Republic of China (promulgated by Sup. People's Ct., May 6th, 2013, effective June 8th, 2013) Document No. fa shi [2013] No.14, <http://www.sglaw.cn/en/news.php?id=361> (last visited Feb. 4th, 2017)(China).

³⁰ SPC Interpretations, *supra* note 10, at Art. 5.

³¹ Insurance Law of the People's Republic of China, *supra* note 3, at Art.16(2).

³² *Id.*

³³ Insurance Law of the People's Republic of China, *supra* note 3, at Art.16(6) ("Where the insurer knows that the proposer fails to make a truthful disclosure at the time of entering into a contract, the insurer may not rescind the contract; where an insured event occurs, the insurer shall be liable for making indemnity payment or paying insurance benefits.").

contract must be exercised within thirty days after learning of the insured's breach of the duty, or within two years from the date of formation of the contract.³⁴

Similarly, under English law, CIDRA provides that if a consumer breaches the duty to take reasonable care not to make a misrepresentation,³⁵ and this misrepresentation induces the insurer to enter into the contract, the insurer will have a remedy. The nature of the insurer's remedy depends on the nature of the consumer's misrepresentation and, in particular, the consumer's state of mind.

For a deliberate or reckless misrepresentation,³⁶ the insurer is entitled to void the contract, refuse all claims, and treat the contract as if it never existed. The insurer may also retain the premium unless it would be unfair to do so.³⁷ In contrast, for an honest and reasonable misrepresentation, the insurer is not entitled to rescind the contract and must pay the claim.

For a careless misrepresentation,³⁸ the insurer's remedies are based on what he would have done if the consumer had complied with the duty to take reasonable care not to make a misrepresentation. If the insurer would not have entered into the contract on any terms, the insurer may void the contract and refuse all claims, but must return the premium paid. If the insurer would have entered into the contract on different terms, the contract may be read to include those different terms. If the premium would have been higher, the insurer must proportionately reduce the amount to be paid on a claim.³⁹ In situations where the insurer would have contracted on different terms or for a higher premium (or both), available remedies will be determined by the specific line of insurance. For example, in non-life insurance, either side is entitled to terminate future coverage with reasonable notice. Whereas, in life insurance, the insurer is not allowed to

³⁴ Insurance Law of the People's Republic of China, *supra* note 3, at Art.16(3).

³⁵ *CIDRA*, *supra* note 26, at c. 6 § 2.2.

³⁶ *Id.* at § 5.2 ("A misrepresentation is deliberate or reckless if the consumer (a) knew that it was untrue or misleading, or did not care whether or not it was untrue or misleading, and (b) knew that the matter to which the misrepresentation related was relevant to the insurer, or did not care whether or not it was relevant to the insurer.").

³⁷ *CIDRA*, *supra* note 26, at sch 1.

³⁸ *Id.* at § 5.3 ("A qualifying misrepresentation is careless if it is not deliberate or reckless.").

³⁹ *Id.* at 7.

terminate the contract and must continue the policy either on the existing terms or on amended terms.⁴⁰

Under the Insurance Act 2015 (U.K.), for non-consumer insurance, the insurer has a remedy for a breach of fair presentation if the insurer can show that but for the breach, it would not have entered into the contract at all, or would have done so only on different terms.⁴¹ The insurer may void the contract for deliberate, reckless, or even innocent breach of this duty if the insurer can show inducement.

B. REMEDIES IN RELATION TO PRE-RESCISSION LOSSES AND PREMIUM PAID

The legal consequences with respect to losses that occurred prior to the rescission of the contract and with respect to the premium paid by the insured depend on whether the breach occurred intentionally or through gross negligence.

For intentional non-disclosure or misrepresentation, the insurer is not liable for losses that occurred prior to the rescission of the contract whether or not the loss is caused by the undisclosed facts, and shall not refund the premium.⁴² The insurer may rescind the contract *ab initio*, as if the insurer had never been at risk under the policy. The retroactive effect of a rescinded contract seems to be unilateral to the insurer in the sense that only the insurer is entitled to demand restoration of *status quo ante*, but the insured is not entitled to a recovery of premium paid. The retention of the premium by the insurer can be regarded as a penalty to the insured for his intentional breach of the duty of disclosure.

In the case of non-disclosure or misrepresentation by gross negligence, depending on whether or not the fact undisclosed or misrepresented has a material impact on the occurrence of the insured events, there are two possible remedies. The insurer is not liable for losses that occurred prior to the rescission of the contract if the fact undisclosed or misrepresented has a material impact on the occurrence of the insured events, but the insurer must refund the premium.⁴³ In this case, the rescission of the

⁴⁰ J. BIRDS, B. LYNCH & S. MILNES, *supra* note 2, at 582.

⁴¹ Insurance Act, 2015, c. 4, § 8(1) (U.K.).

⁴² Insurance Law of the People's Republic of China, *supra* note 3, at Art. 16(4).

⁴³ Insurance Law of the People's Republic of China, *supra* note 3, at Art. 16(5).

contract is retroactive. If there is no causal connection between the occurrence of the insured event and the undisclosed fact, the insurer is liable for losses that occurred prior to the rescission of the contract. In this case, the rescission of the contract is not retroactive, but prospective, i.e. from the moment of rescission.

The question of whether or not the rescission of the contract is retroactive is important in some circumstances. If, for example, the insured is paid for a loss under a health policy, and then, on the occasion of a second loss, the insurer discovers that there has been an intentional or a grossly negligent non-disclosure or misrepresentation by the insured, it is material to know the moment in time from which the policy is deemed to be rescinded. If the contract is rescinded only from the moment of rescission, the insured would keep the money paid to him for his earlier claim. This is so in the case of a grossly negligent non-disclosure which has no material impact on the occurrence of the insured events. If the contract is rescinded *ab initio*, and not merely for the future, the insurer should be deemed to have never been at risk, the insured should repay the money to the insurer. This is so for the case of an intentional non-disclosure, and also for the case of a grossly negligent non-disclosure which has a material impact on the occurrence of the insured event.

C. DETERMINATION OF INTENTIONAL OR GROSSLY NEGLIGENT BREACH OF THE DUTY

The legal consequences for an intentional or grossly negligent breach of the duty of disclosure are different with respect to liability for losses which occurred prior to rescission of the contract and for return of premium paid by the insured. There is a continuum that runs from simple negligence through gross negligence to intentional misconduct. Recklessness, or reckless disregard, lies between gross negligence and intentional harm.⁴⁴ It is not easy to clearly draw a line between mere negligence and gross negligence, but it is necessary and important to distinguish intentional acts from grossly negligent acts, and mere negligent acts from grossly negligent acts, since different remedies are available depending on the type of breach.

The Chinese Insurance Law does not define the term “intentional.” The definition of the term “intentional” is provided by the Criminal Law of

⁴⁴ *Saba v. Compagnie Nationale Air Fr.*, 78 F.3d 664, 667 (D.C. Cir. 1996).

China.⁴⁵ There, an intentional crime refers to an act committed by a person who clearly knows that his act will entail harmful consequences to society but who wishes or allows such consequences to occur.⁴⁶ By analogy, a non-disclosure or misrepresentation can be deemed intentional if the insured has knowledge of a fact or information but does not disclose it to the insurer. The same would be true if an insured provides an untrue answer to the insurer's question, knowing that the insurer would act on the fact or information and enter into the contract which the insured would otherwise not have been able to enter into.

Intention is subjective, and unless the insured admits his intent, his culpability can only be reflected and judged by the facts of the case. Courts usually treat a breach of the duty of disclosure as an intentional breach if the insured: (i) knew the existence of the fact in question;⁴⁷ (ii) knew that the fact was relevant to the insurer;⁴⁸ and (iii) knew that his answer to the question was untrue or misleading, with the purpose of inducing the insurer to enter into the proposed contract. For example, in *Mr. Guo v. the Life Insurance Company Beijing Branch*,⁴⁹ Mr. Guo purchased a critical illness policy in his name on November 16, 2008. Mr. Guo was diagnosed with acute myocardial infarction on May 24, 2009, and incurred related medical costs of ¥80,000. Upon investigation, the insurer discovered that the insured was diagnosed with coronary heart disease and treated at the same hospital before the formation of the insurance contract, but the insured gave a negative answer to the question in the proposal form which asked "Have the life insured been diagnosed with any heart disease?" The court held that the insured knew the fact that he suffered from heart disease and concealed that fact, so the failure to comply with the duty of disclosure was

⁴⁵ Criminal Law of the People's Republic of China was adopted by the Second Session of the Fifth National People's Congress on July 1, 1979, amended by the Fifth Session of the Eighth National People's Congress on March 14, 1997, promulgated by Order No. 83 of the President of the People's Republic of China on March 14, 1997, and effective on October 1, 1997 [hereinafter *Criminal Law*].

⁴⁶ *Id.* at Art. 14.

⁴⁷ SPC Interpretations, *supra* note 10, at Art. 5 (The insured's knowledge refers to actual knowledge. The insured's constructive knowledge is irrelevant).

⁴⁸ *Id.*; Insurance Law of the People's Republic of China, *supra* note 3, at Art. 16.

⁴⁹ *Mr. Guo v. The Life Ins. Co. Beijing Branch*, (Interm. People's Ct. 2012) (China), reported in 5 Annual Report of the Typical Insurance Cases, LAW PRESS CHINA, 2013; see also, ZHEN JING, CHINESE INSURANCE CONTRACTS: LAW AND PRACTICE, n. 433 (2016).

intentional. The insurer would not have entered into the contract had the insurer known of the undisclosed fact, thus the insurer was not liable for the medical costs.

The Chinese Insurance Law provides no definition of “gross negligence.” The definition of “negligent crime” is provided under Chinese Criminal Law. There, a negligent crime refers to an act committed by a person who should have foreseen that his actions would possibly entail harmful consequences to society.⁵⁰ The standard of negligence is what conduct one expects from the proverbial “reasonable person.” Gross negligence connotes a significantly higher degree of culpability. Gross negligence is a severe degree of negligence taken as reckless disregard. Blatant indifference to one’s legal duty, other’s safety, or their rights are examples.⁵¹ It is also described as a lack of care that even a careless person would use.⁵²

In *Conway v. O’Brien*,⁵³ the United States Supreme Court described gross negligence as being, “substantially and appreciably higher in magnitude and more culpable than ordinary negligence. Gross negligence is equivalent to the failure to exercise even a slight degree of care.... It is very great negligence, or the absence of slight diligence, or the want of even scant care.”⁵⁴ Similarly, in *Grill v. General Iron Screw Collier Co.*,⁵⁵ Justice Willes famously observed that gross negligence is ordinary negligence with a “vituperative epithet.”⁵⁶

Though the Chinese Insurance Law provides no definition of “gross negligence,” Chinese courts have found non-disclosure of material facts to be grossly negligent in the following situations.⁵⁷

⁵⁰ *Criminal Law*, *supra* note 45, at Art. 15.

⁵¹ *Gross Negligence*, BLACK’S LAW DICTIONARY (10th ed. 2014).

⁵² ZHAN HAO, THE NEW INSURANCE LAW: INTERPRETATION ON PRACTICE HIGHLIGHTS AND CASE ANALYSIS 83 (2009).

⁵³ *Conway v. O’Brien*, 312 U.S. 492, 495 (1941).

⁵⁴ *Id.* at 495. The definition was the accepted Vermont definition of gross negligence found in *Shaw v. Moore*, 104 Vt 529, 529 (1932).

⁵⁵ *Grill v. Gen. Iron Screw Collier Co.*, L.R. 1 C. P. 600 (1866).

⁵⁶ *Id.* at 612.

⁵⁷ X.M. XI, UNDERSTANDING AND APPLICATION OF THE SUPREME PEOPLE’S COURT SECOND INTERPRETATION ON CERTAIN QUESTIONS CONCERNING THE APPLICATION OF THE INSURANCE LAW OF THE PEOPLES’ REPUBLIC OF CHINA 156 (2014), *cited in* Jing, *supra* note 49.

- (1) The insured failed to know the materiality of the relevant facts due to his gross negligence. The Insurance Law adopts inquiry-based disclosure; the insured is obliged to disclose only the facts which are inquired by the insurer in questions in proposal form. The insured has no duty to volunteer information to the insurer.⁵⁸ Sometimes, even if the insurer puts questions in the proposal form, the insured failed to understand the meaning of the question due to his gross negligence, and therefore failed to disclose the material facts to the insurer, this constitutes gross negligent non-disclosure.

- (2) In some situations, although the insured knew the relevant facts and also knew that the facts are material, he failed to disclose the material facts to the insurer due to his gross negligence. Sometimes the insurer's agents sell insurance products in an inappropriate manner. The agent fills in the proposal form and answers the questions raised in the proposal form, and then, asks the insured to sign the completed proposal. According to Art. 3 of the SPC Interpretation II, in the situation where the insurer or his agent completes the proposal form, the insured then signs the proposal, the content provided by the insured or the agent is treated as the real representations by the insured himself. If the insured does not read the completed proposal form but simply signs it, he may not be able to find any inconsistency between what was put in the form and what was true in reality. Thus, the insured is deemed to fail by gross negligence to disclose the true facts which he knew, but not intentionally, as the insured has no subjective intention to mislead the insurer to make a wrong judgement and decision regarding the proposed contract.

The following cases explain how courts find gross negligence. In *Mrs. Zhang v. the Life Insurance Company Beijing Branch*,⁵⁹ Mrs. Zhang

⁵⁸ Insurance Law of the People's Republic of China, *supra* note 3, at Art. 16(1).

⁵⁹ *Mrs. Zhang v. The Life Ins. Co. Beijing Branch*, cited in J.X LIU, TYPICAL CASES AND ADJUDGEMENT CONSIDERATION OF INSURANCE LAW 269 (2012); J.X

effected a life insurance policy on the life of her uncle in September 2010.⁶⁰ In the proposal form, a number of questions about the state of the life insured's health were raised. Specifically the insurer asked: (1) "In the last three years, has the life insured been found to have any physical abnormality by medical examination?" and (2) "In the last year, has the life insured visited any hospital for medical tests, received any treatments and taken any medicine?"⁶¹ The insured answered the questions in the negative. The life insured died from carbon monoxide poisoning in March 2011. After the life insured's death and upon inquiry by the insurer, Mrs. Zhang told the insurer that she took the life insured for a medical examination in July 2010 and there was no abnormality of the life insured's health. Based on the information provided by Mrs. Zhang, the insurer further investigated the case and found in the medical examination report from the hospital that the life insured's blood cells number decreased and the doctor advised him to have a further test. The insurer refused the claim by reason of the insured's failure to disclose the material fact. According to the normal practice of underwriting, the insurer would not issue a life insurance policy if the life insured was found to have any abnormalities in a blood test. Mrs. Zhang said that the proposal form was filled by the insurer's agent. She was asked by the agent to sign the proposal. She did not read the proposal but signed it. The court noted that the insurer would not have discovered the insured's blood test abnormality had Mrs. Zhang not told the insurer after the death of the life insured the fact that the life insured had taken a medical examination and the details of the hospital where the medical examination was carried out.⁶²

This led the Court to believe that Mrs. Zhang did not intend to conceal the material fact in order to mislead the insurer intentionally, and her statement that the insurer's agent filled the proposal form and that she did not read the proposal form should be accepted as true. Thus, the court held that the insured's failure to disclose the material fact was not intentional, but grossly negligent.⁶³ The "gross" negligence in this case is reflected by the fact that if the insured had taken a little care to read the

LIU, TYPICAL CASES AND ADJUDGEMENT CONSIDERATION OF INSURANCE LAW (2012).

⁶⁰ She had an insurable interest on her uncle. For more on insurable interest, see Z. Jing, *Insurable Interest in Life Insurance: a Chinese Perspective*, J. OF BUS. L. 337 (2014).

⁶¹ Mrs. Zhang v. The Life Ins. Co. Beijing Branch, *supra* note 59.

⁶² *Id.*

⁶³ *Id.*

proposal, she should have found the misrepresentation made by the agent. The court also held that according to Art. 16(5) of the Insurance Law, in the case of gross negligence, if the undisclosed fact has a material impact on the occurrence of the insured events, the insurer is not liable for paying insurance benefits related to the insured events occurring prior to the rescission of the contract. In this case, the life insured died of gas poisoning and there was no causal connection between the undisclosed fact (decrease of blood cell number) and the death of the life insured, so the insurer was liable for paying the insurance proceeds.

In *Mrs. Zhou v. the Insurance Company*,⁶⁴ Mrs. Zhou effected a life policy with coverage of hospital expenses on the life of her husband in January 2005. In the proposal form the insurer asked: (1) “[h]ave you had any blood tests within the last two years?” and (2) “[h]ave you had any blood disease, or suspected blood disease?”⁶⁵ The answers to the questions were negative. In March 2005, the life insured visited a hospital. He was suspected to have blood disease which was not confirmed. The insured paid for the hospital expenses. On another occasion in May 2005, the life insured visited the hospital again for treatment and was diagnosed with myelodysplastic syndrome. The insured paid for the costs of treatment. In August 2005, the life insured died of leukaemia. It was discovered after the death of the life insured that before the contract was entered into, the life insured visited hospital in March 2003 and was diagnosed with pneumonia and suspected aplastic anaemia.

The court held that the insured must have been aware of the blood disease but failed to disclose it to the insurer. As to the question of whether the non-disclosure was intentional or grossly negligent, the court found that on the proposal form, in the box regarding how to contact the life insured’s son and/or daughter, it said, “the same as the proposer.” The term “proposer” is a technical term. Mrs. Zhou lacked insurance knowledge and she should not have known how to use the term “proposer.” Moreover, some details about the life insured, such as his height and weight, were incorrect. The evidence showed that the proposal form was completed by the insurer’s agent not the insured. The insured failed to read the proposal form before signing it. Therefore, her failure to disclose was held to be grossly negligent. The court considered whether there was any causal connection between the undisclosed fact and the occurrence of the insured event. In this case, the insured died of leukaemia and the undisclosed

⁶⁴ XI, *supra* note 57, at 157.

⁶⁵ *Id.*

disease was suspected aplastic anaemia. There was an apparent causal connection between the death of the life insured and the undisclosed disease. Thus, the court found that the insurer was not liable but should return the premium to the insured.

In a more recent case,⁶⁶ the insured purchased life insurance with coverage of critical illness on her aunt's life in June 2013. The proposal form asked: "[d]oes the life insured drink alcohol? If yes, how much do you drink daily?" The insured gave a negative response to both questions. In August 2013, the life insured was diagnosed with cirrhosis and chronic liver failure. While being treated, she told the doctor that she drank alcohol for 20 years with a daily volume of about 500ml (equivalent to half a litre of whisky every day), but about 50ml in the last two months. The insured filed a claim for critical illness. The insurer denied the claim on the ground that the insured intentionally failed to disclose her heavy alcohol consumption. The insured provided evidence of a recorded telephone conversation with the insurer's agent who sold the life policy to the insured. In this conversation the agent said that "you told me that the life insured has a habit of drinking but you did not tell me she drank 500ml every day, I passed your message to the Insurance Company."

The main issue before the court was whether the non-disclosure was intentional, grossly negligent or merely negligent. Although the insured gave a negative response to the question about the life insured's drinking habit on the proposal form, she told the agent that the life insured had a habit of drinking, so she did not intentionally conceal this material fact. The life insured is the insured's aunt, not mother, the insured should not be expected to know the amount of alcohol consumed by her aunt every day, so it would be reasonable to hold that the insured did not intentionally withhold the material fact in respect of the amount of alcohol consumed by her aunt. On the other hand, if the insured had asked her aunt about the fact of her drinking habit and amount of alcohol consumed daily, she would easily know that fact. The court held that the insured's non-compliance with her duty of disclosure of the material fact was grossly negligent. The insurer was not liable for critical illness payment as there was a causal connection between the life insured's heavy drinking habit and her liver failure. However, the insurer returned the premium to the insured.

⁶⁶ Feng v. the Life Ins. Co. Beijing Branch, reported in Wan Jun Yuan, *The Insured Does Not Truthfully Inform the Insurance Company Has the Right to Terminate the Insurance Contract*, CHINA INS. NEWS (Mar. 15, 2016), http://chsh.sinoins.com/2016-03/15/content_188025.htm.

The aforementioned cases demonstrate how Chinese courts analyze the insured's duty to disclose. First, courts consider whether the insured has intentionally concealed a material fact. If a court fails to find the insured's non-disclosure was intentional, it will then examine the extent of the insured's negligence. Differentiating between gross negligence and mere negligence requires a fact specific inquiry. Courts have great discretionary power, as there is no clear definition of gross negligence under Chinese Insurance Law.

D. CAUSATION

Liability for an intentional non-disclosure does not require proof of any connection between the insurer's loss and the undisclosed fact.⁶⁷ However, in the context of a grossly negligent non-disclosure, a causal link must be established before the insurer can be discharged from liability for pre-rescission loss.⁶⁸

As discussed earlier, Chinese courts interpret the term "material impact" to mean "causal connection." The People's Courts will not uphold an insurer's repudiation of liability for pre-rescission loss if there is no causal connection between the undisclosed fact and the occurrence of an insured event.⁶⁹ However, the extent of the causal connection varies

⁶⁷ Insurance Law of the People's Republic of China, *supra* note 3, at Art. 16(4) (The insurer is allowed to rescind the contract where there is an intentional breach of the duty).

⁶⁸ *Id.* at Art. 16(5).

⁶⁹ Guiding Opinions of the Higher People's Court of Guangdong Province on Several Issues Concerning the Trial of Insurance Contract Disputes (promulgated by Guangdong Province Higher People's Court, effective Sept. 2, 2011) at Art. 6(2) (China), http://blog.sina.com.cn/s/blog_9fad4650101fbnt.html; Notice of the Higher People's Court of Shandong Province on Printing and Distribution of the Opinions on Several Issues Concerning the Trial of Insurance Contract Disputes (Trial) (promulgated by Shandong Province Higher People's Court, effective Mar. 17, 2011) at Art. 7 (China) [hereinafter *Notice of the Higher People's Court of Shandong Province*], <https://wenku.baidu.com/view/41faa4b9453610661fd9f475.html>; Higher People's Court of Zhejiang Province on Trial of Property Insurance Contract Disputes Guiding Opinions on Several Issues in Dispute Cases (promulgated by Zhejiang Province Higher People's Court, effective Sept. 8, 2009) at Art. 7 (China), <http://wenku.baidu.com/view/e6c9c806cc1755270722083c.html?re=view>. It must be noted the guidance enacted by the High People's Courts is only to guide the lower courts rather than to bind them. These guiding rules have no legal force.

according to the guiding rules for handling insurance disputes provided by different courts. For example, the High People's Court (HPC) of Shandong Province seeks a "causal connection";⁷⁰ the HPC of Guangdong Province demands a "direct causal connection";⁷¹ while the HPC of Zhejiang Province looks for "the proximate causal connection."⁷² It is submitted that, "direct causal connection" and "proximate causal connection" have the same meaning, that is, the loss is caused by the event. As for "simple causal connection," some commentators argue correlation is sufficient and does not require strict causality. For example, a "simple causal connection" could be made between smoking and lung cancer, hypertension and heart-attack, anaemia and leukaemia, and hepatitis and liver cancer.⁷³ The issue of causal connection is complex and needs further clarification by the SPC.

IV. DEFICIENCIES OF THE LAW WITH RESPECT TO GROSSLY NEGLIGENT NON-DISCLOSURE

Under the current framework, the insurer's refusal of liability for loss by reason of a grossly negligent non-disclosure requires a causal connection between the loss and the undisclosed fact. The law seems reasonable, but there is a major flaw. In some situations, the insurer would

⁷⁰ Notice of the Higher People's Court of Shandong Province, *supra* note 69 ("People's Courts shall not uphold the insurer's repudiation of liability for losses which occurred prior to rescission of the contract on the ground of non-disclosure or misrepresentation where there is no causal connection between the fact undisclosed by the insured's gross negligence and the occurrence of the insured event").

⁷¹ Guiding Opinions of the Higher People's Court of Guangdong Province on Several Issues Concerning the Trial of Insurance Contract Disputes, Art. 6(2) ("Where the insured failed to comply with the duty of disclosure by gross negligence as stipulated in Art. 16(5) of the Insurance Law, and there is no direct causal connection between the undisclosed fact and the occurrence of the insured event, People's Courts shall not uphold the insurer's repudiation of liability on the ground of the insured's failure to disclose the fact.").

⁷² See The Guidance of Zhejiang Province High People's Court Concerning Questions of How to Deal with Property Insurance Disputes 2011, Art. 7 ("Where the fact undisclosed by the insured's gross negligence was not the proximate cause to the occurrence of the insured event, and there was not decisive causal connection to the insurer's liability, the insurer's refusal of liability on the ground of non-disclosure will not be upheld.").

⁷³ X.M. XI, UNDERSTANDING AND APPLICATION OF THE INSURANCE LAW OF THE PEOPLES' REPUBLIC OF CHINA 90 (2010); Liu, *supra* note 59, at 274.

not have entered into the contract, or would have entered into the contract with a higher premium, had he known of the undisclosed fact at the time of the contract. However, the insurer is nevertheless liable for the loss if there is no causal connection between the undisclosed fact and the occurrence of the insured event. Thus, the insurer may receive a lower premium but bear a higher risk.

For example, an insured pays a £1000 annual premium for a death policy in the amount of £40,000. The insured did not inform the insurer of the fact that he had high blood pressure at the time of the contract. Had the insurer known of the insured's hypertension, the insurer would still have issued the policy but would have charged a higher premium of £1,300. The insured then dies of liver cancer. The insurer is liable for the loss, as no causal connection can be established between the death and hypertension. In this situation, the insurer received £1000 premium and paid £40,000 for the loss. The insurer would have received £1300 premium and paid £40,000 for the loss had the insured disclosed his hypertension.

This unfair and unreasonable outcome demonstrates why the doctrine of proportionality should be adopted. The insurer should be able to reduce the amount of benefit paid proportionately to the ratio of premium he received and the premium he should have received had he known of the undisclosed fact. Accordingly, if the doctrine of proportionality applied, the insurer would pay £30,769⁷⁴ instead of £40,000.

England and Australia have adopted the doctrine of proportionality. Under CIDRA, for careless misrepresentations, if the insurer would have entered into the consumer insurance contract, but would have charged a higher premium, the insurer may proportionately reduce the amount to be paid on a claim.⁷⁵ This is also the approach for neither deliberate nor reckless non-disclosures for non-consumer insurance in the Insurance Act 2015 (U.K.).⁷⁶

Under the Insurance Contracts Act 1984 (Australia), if an insured fails to comply with its duty of disclosure before the contract is entered into, the insurer's claim-based liability is reduced to the amount that would place the insurer in the position in which it would have been if the failure to disclose had not occurred or the misrepresentation had not been made (as

⁷⁴ (£40,000 × £1000/£1300 = £30,769)

⁷⁵ Consumer Insurance Disclosure and Representations Act 2012, *supra* note 13, at ¶ 7(1).

⁷⁶ Insurance Act 2015, *supra* note 16, at ¶ 6(1).

long as the insurer is not entitled to avoid the contract or being entitled to avoid the contract has not done so).⁷⁷

V. RECOMMENDATIONS FOR AMENDMENT OF THE LAW

This article has discussed the shortcomings of the current law with respect to remedies for grossly negligent breach of the duty of disclosure at the time of the contract. Recommendations for the definitions of the terms below have been put forward with reference to the judicial practice in China and to the English approach under CIDRA and the Insurance Act 2015 (U.K.).

The following recommendations address these shortcomings, specifically:

- (1) For a grossly negligent breach of the duty of disclosure by the insured:
 - a. Where the insurer can show a causal connection between the occurrence of the insured event and the material fact undisclosed or misrepresented, the insurer shall not be liable for the insured events which occurred prior to the rescission of the contract, but shall refund the premium paid.
 - b. Where there is no causal connection between the occurrence of the insured event and the material fact undisclosed or misrepresented,
 - i. if the insurer would not have entered into the contract had he been informed by the insured of the material fact, the insurer shall not be liable for the insured events which occurred prior to the rescission of the contract, but shall refund the premium paid;
 - ii. if the insurer would have entered into the contract, but would have charged a higher premium had he been informed by the insured of the material fact, the insurer may reduce the amount to be paid proportionately to the ratio of

⁷⁷ Insurance Contracts Act 1984, s. 28 (Austl.).

premium he received and the premium he should have received.

- (2) It is also suggested that Chinese Insurance Law provide definitions for the terms of intentional and grossly negligent non-disclosure or misrepresentation. Recommendations for these definitions are as follows:
- a. A non-disclosure or misrepresentation is intentional if the insured: (a) knew the existence of the fact in question,⁷⁸ (b) knew that the fact was relevant to the insurer, and (c) knew that his answer to the question was untrue or misleading, with the intention that the insurer act on it in the sense that it would induce the insurer to enter into the proposed contract.
 - b. A non-disclosure or misrepresentation is grossly negligent⁷⁹ if the insured: (a) did not care whether or not it was untrue or misleading, (b) did not care whether or not it was relevant to the insurer, but (c) had no intention that the insurer act on it in the sense that it would induce the insurer to enter into the proposed contract.⁸⁰

VI. CONCLUSION

This article has considered the insured's duty of disclosure and the remedies for the breach of this duty under Chinese Insurance Law as compared to other jurisdictions. By comparing Chinese law and English law with respect to remedies for breach of the duty of disclosure or representation, we find the same approach has been applied, specifically with regard to intentional breach. This approach allows both Chinese and English insurers to rescind the contract and retain the premium paid. CIDRA and the Insurance Act 2015 (U.K.) further entitles the insurer to avoid the contract and retain premium paid for a reckless breach of the duty, while Chinese law provides milder remedies for the same grossly negligent breach. the insurer is entitled to rescind the contract but must refund the

⁷⁸ SPC Interpretations, *supra* note 10, at Art. 5.

⁷⁹ This refers to the definition of reckless misrepresentation in section 5(2) of the CIDRA.

⁸⁰ Liu, *supra* note 59, at 274.

premium paid, and he is liable for losses which occurred prior to the rescission of the contract if there is no causal connection between the occurrence of the insured event and the undisclosed fact. Remedies under Chinese law appear to be more protective of the insured who has less bargaining power in an insurance negotiation. However, there are shortcomings and omissions with respect to remedies for breach of the duty under Chinese law.

As discussed earlier, the remedies for pre-rescission losses in the case of a grossly negligent non-disclosure, which has no material impact on the occurrence of the insured event, are flawed. In this situation, the insurer may receive a lower premium, but bears a higher risk, if the insurer would not have entered into the contract or would have done so but charged a higher premium. In order to strike a balance between protecting the insured and being fair to the insurer, the doctrine of proportionality should be applied.

Lastly, Chinese law is flawed in that it does not provide definitions for the terms “intentional” or “grossly negligent” non-disclosure or misrepresentation. This has created uncertainty and judicial difficulties. Courts give different decisions for similar factual cases. It is necessary to introduce a provision into the Insurance Law to define the terms “intentional” and “grossly negligent” non-disclosures.

AGREEING IN THE SHADOW OF THE POLICY: HOW CORPORATE INSURANCE POLICIES IMPACT THE RESOLUTION OF GOVERNMENTAL INVESTIGATIONS INTO CORPORATE CRIME

BETH OLSEN*

Since 1999, prosecutors have increasingly utilized deferred prosecution agreements (DPAs) and non-prosecution agreements (NPAs) to resolve investigations into corporate criminal conduct. Corporations are often eager to enter into such agreements in order to avoid indictment, believing that the consequences set forth in the terms of the DPA or NPA are less harmful than are the consequences of a corporate indictment. However, the impact that a DPA or NPA may have on a corporation's insurance coverage may not be readily apparent or even contemplated when the corporation elects to enter into the agreement.

This Note analyzes the ways in which corporate insurance coverage interacts with and is impacted by white-collar criminal investigations and the resolution of such investigations through the use of NPAs and DPAs. Specifically, this Note discusses situations in which corporations have lost insurance coverage as a result of entrance into a DPA or NPA and identifies ways in which such consequences could be avoided. Finally, this Note anticipates the impact that the Department of Justice's (DOJ) new emphasis on individual prosecution for white-collar crimes will have on corporate insurance availability and policies.

I. INTRODUCTION

When a corporation finds itself under criminal investigation by federal prosecutors, it will likely attempt to resolve the investigation by entering into a DPA or NPA.¹ From a risk aversion perspective, it makes

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¹ NPAs and DPAs are agreements between the government and a corporate entity (or, less commonly, an individual) that is alleged to have engaged in some kind of wrongdoing. The agreement may impose upon the corporation a range of sanctions such as fines, restitution, institutional changes, and additional reporting

sense that a corporation would prefer to accept the known costs associated with entering into a DPA or NPA rather than face the uncertain, and potentially devastating consequences of a corporate indictment, trial or even conviction.² This fear of indictment gives prosecutors enormous leverage in any negotiation with a corporation relating to the corporation's allegedly criminal conduct. Although some critics maintain that DPAs and NPAs exploit the appreciably unequal bargaining power between prosecutors and corporations,³ corporations appear rational in seeking to enter into DPAs or NPAs, despite their burdensome conduct requirements, sizeable penalties and often-unfavorable admissions. This risk aversion rationale is premised on the expectation that a corporation understands and can compare the relative costs of a DPA or NPA, on the one hand, and of the consequences of non-cooperation (such as an indictment, trial or conviction), on the other. Thus, corporate counsel should be well aware of the collateral consequences that can flow from a DPA or NPA in determining how valuable such an agreement is and what concessions a corporation should be willing to make within the agreement, so as to ensure that entering into a DPA or NPA will produce a better outcome for the corporation than would non-cooperation.

or cooperation duties. In exchange for the corporation's acceptance of the sanctions, the government agrees not to prosecute in a non-prosecution agreement, or the government agrees to dismiss filed charges in a deferred prosecution agreement. The government's agreement to refrain from prosecuting or dismiss charges is contingent upon the corporation's adherence to the terms of the agreement, which can be quite onerous. *See generally* Roma W. Theus II, *What Cooperating with the Government Really Means for a Company*, 48 No. 1 DRI FOR DEF. 32 (Jan. 2006).

² A person or entity is risk averse where the certainty equivalent, meaning the amount they are willing to pay or accept to avoid a high risk gamble, is greater than the expected value of taking the risk.

³ *See, e.g.*, James R. Copland, *The Shadow Regulatory State: The Rise of Deferred Prosecution Agreements*, CIV. JUST. REP., May 2012, at 1, http://www.manhattan-institute.org/html/cjr_14.htm (discussing how prosecutors have ample bargaining power to force companies to "implement onerous training and reporting programs, hire senior officials to oversee companies' compliance' with prosecutors' legal interpretations, modify sales-force practices and compensation plans, contract with independent 'monitors' empowered to dictate modifications to business practices, and even fire and replace directors or chief executives"); Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 853 (2007) (identifying and discussing "some indications of [prosecutorial] overreaching, if perhaps not abuse of prosecutorial discretion").

This paper will discuss the subtle, but significant, impact that DPAs and NPAs can have on a corporation's access to the benefits of its insurance coverage. Part II will discuss the functions of insurance in society, and provide a breakdown of the different types of corporate insurance coverage that is available, both for individuals and for corporate entities. Part III lays out the evolution of the guidelines that have been promulgated for prosecutors concerning how to make charging decisions in the corporate context. Part IV will present a discussion of the impact that corporate insurance has had on corporate cooperation and prosecutorial discretion, as demonstrated through an analysis of DPAs and NPAs. Part IV provides specific examples of past DPAs or NPAs that have jeopardized or eliminated a corporation's insurance coverage and lays out new insurance concerns for corporate counsel to consider when entering into DPAs and NPAs in light of the DOJ's recent shift towards increasing individual accountability for corporate crimes.

II. THE PURPOSE OF INSURANCE GENERALLY AND INSURANCE IN THE CORPORATE SETTING

A. THE GENERAL GOALS OF INSURANCE

One of the primary purposes of insurance is to take risks that would otherwise be borne entirely by an individual or a corporate entity and distribute the costs of such risks efficiently throughout a larger population.⁴ In considering the extent to which a prosecutor might contemplate a corporate defendant's insurance coverage in making charging decisions and entering into agreements, it is important to be thinking about what types of corporate conduct we want to be insurable, and the potential impact of such insurability on the deterrent goals of the criminal justice system. At the same time, the interest in deterrence should be balanced against the restitutionary interest of compensating the victims of corporate malfeasance.⁵

⁴ For an interesting discussion of how the economic justifications for insurance in a corporate setting differs from those that are applicable to individuals see Kenneth A. Froot, David S. Scharfstein & Jeremy Stein, *Risk Management: Coordinating Corporate Investment and Financing Policies*, 40 J. FIN., 1629, 1639-1658 (1993).

⁵ The extent to which the criminal justice system's interest in deterrence should yield to, or even consider, the restitutionary interests of victims in being

Where a corporation may face other liabilities or losses related to the conduct covered by a NPA or DPA, should such losses or liabilities be uninsurable as a matter of public policy or be cast outside the scope of a policy's coverage because of the contents of a contract between the government and the corporation?⁶ In situations when a corporate entity is itself subjected to criminal charges, the prosecuting governmental entity will consider whether a charging decision is likely to result in rendering the corporation insolvent, potentially jeopardizing thousands of jobs.⁷

In much the same way that individuals pay premiums to secure health insurance coverage in the event that they experience a costly medical expense in the future, corporations purchase a range of insurance products to protect against potential astronomical liabilities that could threaten their

compensated when making charging decisions is not something that has been clearly established. This is in part because restitution or victim compensation may be considered a goal of both the civil and criminal justice systems, and there is debate as to the system to which it most appropriately belongs. *See* Bridgett N. Shephard, *Classifying Crime Victim Restitution: The Theoretical Arguments and Practical Consequences of Labeling Restitution as Either a Criminal or Civil Law Concept*, 18 LEWIS & CLARK L. REV. 801, 808 (2014) (“Victim restitution has commonly been cited as an example of the blurring between civil and criminal law. Some commentators argue that restitution is clearly a civil idea, and others argue that it is clearly criminal. Other commentators believe that restitution is a hybrid criminal-civil concept, while still others see restitution as neither criminal nor civil, but rather, as a concept that is sui generis, something entirely of its own likeness that cannot be based on existing legal frameworks.”). Restitution to victims of corporate crime may be accomplished through civil suits, through the award of damages, but DPAs and NPAs may provide for the establishment of trusts for compensation of victims and will consider the extent to which the corporation has made efforts to make full restitution in determining a suitable penalty. *See e.g.*, Press Release, DOJ, SunTrust Mortgage Agrees to \$320 Million Settlement (July 3, 2014), <http://www.justice.gov/opa/pr/suntrust-mortgage-agrees-320-million-settlement> (explaining that SunTrust's Agreement with the DOJ required SunTrust to pay \$179 million in restitution to compensate borrowers for damage caused by its conduct, and further, that if more than \$179 million was needed to sufficiently compensate the victims, the bank would guarantee an additional \$95 million for additional restitution).

⁶ Whether, as a policy matter insurance coverage should be available to cover the penalties agreed upon in a DPA or NPA is outside the scope of this paper. As a practical matter, such coverage is usually precluded based on state public policy or insurance policy exclusions. N.Y. Ins. Law § 1101(a)(1) (McKinney 2000).

⁷ This consideration has been particularly compelling in the wake of Arthur Anderson's collapse following its indictment related to providing accounting services to Enron, which will be discussed more extensively later on in this paper.

solvency. These types of general corporate liability insurance policies function as cover for the corporate entity itself. Although they may operate indirectly to protect the interests of a corporation's executives, by helping to maintain share prices in the face of litigation or preventing a corporation from becoming insolvent due to the owing of a massive claim, the policies themselves do not provide coverage for the individual executives. Thus, in addition to purchasing insurance coverage for liabilities incurred by the corporate entity, most corporations also secure coverage for the directors and officers of their corporation through D&O Policies.

B. COVERAGE FOR THE CORPORATE ENTITY

Corporations have a range of different insurance products available to protect the corporate entity both from potential liabilities to third parties, risks inherent in their business, and a host of other hazards. For instance, car manufacturers have commercial liability policies protecting them from potential tort claims related to their cars, energy companies have property insurance protecting their power plants. Generally, these policies have provisions which cover actual settlements or liabilities resulting from litigation, provide for a legal defense (or the costs of one), and losses incurred by the corporation as a result of property damage or some other event.

C. COVERAGE FOR INDIVIDUALS: INDEMNIFICATION AND D&O POLICIES

When an individual serves as a director or officer of a corporation, he is subjected to the risk of being sued as an individual when his decisions or conduct in running the corporation results in some sort of litigation. Additionally, serving as an officer of a corporation may expose an individual to an array of expenses associated with defending governmental agency investigations for actions that he has taken in his official capacity.⁸

⁸ Indeed, the Delaware Supreme Court has acknowledged that a corporation's capacity to indemnify its officers serves the dual policies of "(a) allowing corporate officials to resist unjustified lawsuits, secure in the knowledge that, if vindicated, the corporation will bear the expense of litigation; and (b) encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the cost of defending their honesty and integrity." *See VonFeldt v. Stifel Fin. Corp.*, 714 A.2d 79, 84 (Del. 1998).

Given these risks, it makes sense that a corporation seeking to recruit the best and the brightest individuals to serve as its officers would want to protect them against the aforementioned risks to the extent that is allowable by law.⁹ One way in which corporations “insure” their executive officers against these risks is by providing for the indemnification of such officers. In addition to indemnification, corporations are explicitly permitted to purchase D&O liability insurance policies for the protection of corporate directors and officers, even when the corporation could not itself indemnify the individual.¹⁰

Indemnification refers to the reimbursement by the corporation of liabilities, including judgments, amounts paid in settlement expenses, and attorneys' fees incurred by directors, officers, employees, and sometimes agents in the course of their service to the corporation. Such indemnification is vital in that it “encourages corporate service by capable individuals by protecting their personal financial resources from depletion by the expenses they incur during an investigation or litigation that results

⁹ As will be discussed more extensively in the below section regarding uninsurable and unindemnifiable risks, state law and public policy objections sometimes prohibit the purchasing of insurance for certain types of risks and losses. *See e.g.*, *Level 3 Comm., Inc. v. Fed. Ins. Co.*, 272 F.3d 908 (7th Cir. 2001) (disgorgement of unlawfully obtained funds was uninsurable as a matter of state public policy); *State Farm Fire & Cas. Co. v. Superior Court*, 191 Cal. App. 3d 74, 77-78 (1987); *Wausau Ins. Co. v. Valspar Corp.*, 594 F. Supp. 269, 273 (N.D. Ill. 1984); *Grant v. North River Ins. Co.*, 453 F. Supp. 1361, 1370 (N.D. Ind. 1978) (punitive damage awards uninsurable as matter of public policy); *see also Checkley v. Ill. Cent. R.R. Co.*, 100 N.E 942, 944 (Ill. 1913) (“A fire insurance policy issued to anyone, which purported to insure his property against his own willful and intentional burning of the same, would manifestly be condemned by all courts as contrary to a sound public policy...”).

¹⁰ State laws expressly permit corporations to purchase D&O insurance. *See e.g.*, 8 DEL. LAWS § 145(g) (1953) (“A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the corporation would have the power to indemnify such person against such liability under this section.”); 32 ILL. COMP. STAT. 5 § 8.75(g) (2012) (authorizing Illinois corporations to purchase D&O insurance).

by reason of that service.”¹¹ Corporate indemnification can be voluntarily assumed by a corporation through the corporation’s bylaws or other founding documents (permissive indemnification), or may also be mandatory in certain situations under state law (mandatory indemnification).¹²

Under Delaware law,¹³ a corporation has broad discretion to enter into indemnification agreements with its officers or draft provisions of its bylaws providing indemnification beyond that which is explicitly contemplated by the state statute (§145).¹⁴ Section 145 applies to any person involved in actual or threatened litigation or an investigation by reason of his status as an officer, director, employee, or agent of the corporation or of another entity he or she served at the request of the indemnifying corporation.¹⁵ Specifically, §145(a) permits indemnification of officers, directors, employees, or agents for attorneys’ fees and other expenses, as well as judgments or amounts paid in settlements in civil cases brought by third parties.¹⁶

Although the advancement of fees is a distinct concept from indemnification, the Delaware Supreme Court has acknowledged, “advancement is an especially important corollary to indemnification as an inducement for attracting capable individuals into corporate service.”¹⁷ Section 145(e) permits the advancement of attorneys’ fees and other legal expenses to officers and directors in connection with defending any civil,

¹¹ *Homestore, Inc. v. Tafeen*, 888 A.2d 204 (Del. 2005).

¹² See generally Stacy Kalberman, *Director and Officer Liability: An Overview of Corporate and Insurance Indemnification*, 7 No. 4 ANDREWS SEC. LITIG. & REG. REP. 17 (2001) (corporations are typically required by statute to indemnify directors and officers for the cost of their defense where the officer or director has prevailed in litigation or other proceedings).

¹³ Delaware law is a good place to look for the general provisions concerning corporate indemnification. This is because Delaware is the most favored state of incorporation for U.S. businesses and home to more than half of the corporations that make up the Fortune 500. See L.S. Black, *Why Corporations Choose Delaware*, DEL. DEP’T OF STATE (2007), http://corp.delaware.gov/pdfs/whycorporations_english.pdf.

¹⁴ DEL. CODE ANN. tit. 8, § 145 (1953) [hereinafter *Section 145*].

¹⁵ *Id.*

¹⁶ See *Cochran v. Stifel Fin. Corp.*, C.A. No. 17350 (Del. Ch. Mar. 8, 2000), slip op. at 26-29; *In re Massey Energy Co. Derivative & Class Action Litig.*, C.A. No. 5430-VCS (Del. Ch. May 31, 2011), slip op. at 38 n.123.

¹⁷ *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 211 (Del. 2005).

criminal, administrative, or investigative proceeding. These expenses may be paid “in advance of the final disposition” of the proceeding. Corporations generally have fairly wide latitude in determining the conditions under which they will advance defense costs to a director or officer, subject to Section 145(e)’s requirement that such advancement be conditioned “upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the corporation.”¹⁸ When a corporation adopts charter provisions or otherwise provides for broad, mandatory advancement to the fullest extent allowable under the law, a corporation must advance such funds upon receipt of an undertaking, and may not stop such advancement until the conclusion of the proceeding if it is determined that the individual did not meet the standard of conduct for indemnification under Delaware law.¹⁹

There are several limitations on the circumstances in which a corporation may indemnify an officer. First, a corporation may not indemnify an officer who has not “acted in good faith and in a manner he [] reasonably believed to be in, or not opposed to, the best interests of the corporation.”²⁰ Second, in criminal matters, a corporation may only indemnify when, in addition to acting in good faith, the officer did not have reasonable cause to believe his conduct was unlawful.²¹ Third, in actions brought by or in the right of the corporation (such as derivative actions), a corporation may indemnify only for expenses and attorneys fees, and cannot indemnify at all “in respect of any claim, issue or matter as to which [an officer] shall have been adjudged to be liable to the corporation.”²² These limitations on the extent of corporate indemnification do not apply to the scope of D&O coverage.²³ When a corporation is unable to indemnify

¹⁸ Del. C. § 145; *But see* *Homestore*, 888 A.2d at 211 (explaining that § 145(e) of Delaware’s statute “provides corporations with the flexibility to advance funds to former corporate officials...without an express undertaking.”).

¹⁹ *See* *Blankenship v. Alpha Appalachia Holdings, Inc.*, C.A. No. 10610-CB (Del. Ch. May 28, 2015) (holding that where corporation agreed to advance defense costs to fullest extent allowed under law, the corporation could not later condition the advancement upon the individual’s statements regarding his belief that he believed he had acted lawfully).

²⁰ *Section 145.*

²¹ *Id.*

²² *Id.*

²³ *See id.* § 145(g) (providing that a corporation can buy D&O insurance even when it would not have the power to personally indemnify directors or officers).

its officer, the officer may still be covered under his D&O policy.²⁴ Thus, D&O policies can function as an important safety net for an officer in situations where, for whatever reason, the corporation cannot or will not indemnify him.²⁵

A typical D&O policy contains three different types of coverage; “Side A” coverage, which protects individual managers directly from the risk of shareholder litigation (so reimbursement for claims is paid directly to the officers), “Side B” coverage, which reimburses the corporation for its indemnification payments to officers and directors, and “Side C” coverage, which protects the corporation from the risk of shareholder litigation to which the corporate entity itself is a party. A standard insuring clause within a D&O policy provides:

(For Side A) This policy shall pay the Loss of each and every Director or Officer of the Company arising from a Claim first made against the Directors or Officers during the Policy Period ... for any actual or alleged Wrongful Act occurring on or prior to the Effective Time in their respective capacities as Directors or Officers of the Company, except when and to the extent that the Company ... has indemnified the Directors or Officers. The Insurer shall ... advance Defense Costs of such Claim prior to its final disposition.²⁶

(For Side B) The Insurer shall reimburse the Company for Loss arising from any claim first made against the Insureds and reported to the Insurer during the Policy Period by reason of any Wrongful Act but only when and to the extent the Company has indemnified the Insureds for such Loss pursuant to law, statutory or common, or pursuant to

See also Stacy Kalberman, *Director and Officer Liability: An Overview of Corporate and Insurance Indemnification*, 11 ANDREWS' PROF. LIAB. LITIG. REP. 18 (2001).

²⁴ However, as will be discussed further below, D&O policies contain a number of exclusions, so it is possible that a corporation will be unable to indemnify an officer and the officer's conduct will fall within an exclusion under the D&O policy and thus the officer will have no coverage either through indemnification or his D&O insurance.

²⁵ Kalberman, *supra* note 23, at 3.

²⁶ See, e.g., *In re Allied Digital Techs Corp.*, 306 B.R. 505, 510 (Bankr. D. Del. 2004).

the Charter or By-Laws of the Company.²⁷

These policies will often contain a number of exclusions, some of which are relevant in the context of a corporate criminal investigation or the ensuing civil litigation. “Conduct” exclusions eliminate coverage for particular conduct that is considered so self-serving or egregious that insurance coverage is deemed inappropriate. These “conduct” exclusions preclude coverage for dishonest or fraudulent acts²⁸; claims alleging that directors engaged in conduct detrimental to the corporation for their own personal gain; willful violation of the law; and illegal remuneration.²⁹ “Prior Claims” exclusions eliminate coverage under the policy in situations where the insured corporation or officer was on notice of a claim or a claim was actually pending prior to the commencement of the policy period.³⁰ Additionally, many D&O policies will exclude coverage for claims “made against the Insureds...based upon or arising out of any deliberate...act or omission by such Insureds.”³¹

²⁷ See Jennifer M. Schwartz, *Insurance Defense Costs in a Mixed Action: Scope of Duty: D&O Insurers*, 28 CBA REC. 28, at 29 (2014) (citing *Art Bookbinders of Am., Inc. v. Tudor Ins. Co.*, 409 Ill. App. 3d 1144, *11-12 (1st Dist. June 7, 2011)).

²⁸ See e.g., AIG, *D&O Policy* at 17, http://www.aig.com/public-company-do_295_391889.html (last visited Dec. 5, 2015) (excluding coverage for claims “arising out of, based upon or attributable to the committing in fact of any deliberate criminal or deliberate fraudulent act by the Insured.”).

²⁹ See e.g., *id.* at 6 (excluding coverage for claims “arising out of, based upon or attributable to payments to an Insured of any remuneration without the previous approval of the stockholders or members of an Organization, which payment without such previous approval shall be held to have been illegal.”).

³⁰ See e.g., *id.* at 5 (excluding coverage for claims, “[a]lleging, arising out of, based upon or attributable to the facts alleged, or to the same or related Wrongful Acts alleged or contained in any Claim which has been reported, or in any circumstances of which notice has been given, under any policy of which this policy is a renewal or replacement or which it may succeed in time...[and] any pending or prior: (1) litigation; or (2) administrative or regulatory proceeding or investigation of which an Insured had notice, or alleging or derived from the same or essentially the same facts as alleged in such pending or prior litigation or administrative or regulatory proceeding or investigation...[and] if any Insured, as of such Continuity Date, knew or could have reasonably foreseen that such Wrongful Act could lead to a Claim under this policy.”).

³¹ See *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 42 Misc. 3d 1230(A), 988 N.Y.S.2d 523 (N.Y. Sup. 2014).

D. RISK THAT IS UNINSURABLE AS A MATTER OF PUBLIC POLICY

Even when insurers would like to provide coverage, certain losses or risks are deemed uninsurable as a matter of public policy. One common example is punitive damage awards, which a number of states consider uninsurable based on public policy grounds.³² Not surprisingly, most states also prohibit insurance coverage for conduct that is intended to cause injury.³³ Recently, D&O insurers have attempted to use the intentional harm public policy exception to preclude coverage for SEC settlements, though the efficacy of this argument remains to be seen.³⁴ The issue of whether restitutionary or disgorgement payments may be considered an insurable loss has not been conclusively established by each state, but a number of cases suggest that such insurance coverage may not be allowed.³⁵

³² See generally McCullough, Campbell & Lane LLP, *Chart of Punitive Damages by State*, http://www.mcandl.com/puni_chart.html (last visited Dec. 5, 2015); See also *Nw. Nat'l Cas. Co. v. McNulty*, 307 F.2d 432, 433 (5th Cir. 1962) (excluding coverage for punitive damages and comparing insurance coverage for punitive damages to insurance coverage for criminal liability.).

³³ Debates exist as to how subjective the intent must be in order to be considered an intentional act that cannot be covered. See *City of Carter Lake v. Aetna Cas. & Ins. Co.*, 604 F.2d 1052, 1058-1059 (8th Cir. 1979) (an act is intentional and uninsurable if actor knew or should have known that there was a substantial probability that his conduct would produce such a result); See also *Physicians Ins. Co. of Ohio v. Swanson*, 58 Ohio St. 3d 189, 193 (1991) (act is intentional where the insured subjectively intended to produce the particular result).

³⁴ See *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 126 A.D.3d 76, 88 (N.Y. App. Div. 2015).

³⁵ See generally Katherine C. Skilling, *Coverage for Ill-Gotten Gains?: Discussing the Uninsurability of Restitution and Disgorgement*, 72 WASH. & LEE L. REV. 1077 (2015) (surveying recent case law addressing the insurability of disgorgement payments); See e.g. *Level 3 Commc'ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908, 910 (7th Cir. 2001) (excluding coverage for a restitutionary payment based on the language of the policy and finding that a "loss" within the meaning of the policy could not include the restoration of an ill-gotten gain); *Conseco, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 2002 WL 31961447, at *16 (Ind. Cir. Ct. Dec. 31, 2002) (where portion of settlement of securities class action and derivative litigation constituted ill-gotten gains, coverage was unavailable because settlement was not a loss under the policy); *Dobson v. Twin City Fire Ins. Co.*, 2012 WL 2708392, at *9-10 (C.D. Cal. July 5, 2012) (excluding from coverage

III. CORPORATE ACCOUNTABILITY: CHARGING DECISION GUIDELINES

The criminal justice system in the United States is intended to further the goals of deterrence, retribution, incapacitation, rehabilitation, and restitution. These goals endure whether the subject of a criminal investigation is an individual or a corporation, and irrespective of the nature of the purportedly illegal conduct at issue. Nonetheless, distinctions between so-called “white collar crimes” and other forms of crime have resulted in debates as to whether and to what extent subjecting corporations to criminal liability furthers the underlying goals of our criminal justice system.³⁶ In the 1990’s, as the number of corporations facing criminal charges increased, it appeared to many as though decisions as to whether to charge corporations were unpredictable. In response to complaints that there were no uniform rules in deciding whether to bring charges in corporate cases,³⁷ then-Deputy Attorney General Eric Holder, Jr. released the first set of guidelines on indicting corporations, in a memorandum titled “Bringing Charges Against Corporations,” (Holder Memorandum).³⁸ These

claims seeking restitution for fraud in the underlying action, and also breach of fiduciary duty claim to the extent that it was based on the same restitution allegations). *But see* U.S. Bank Nat’l Ass’n et al. v. Indian Harbor Ins. Co., 2014 WL 3012969 at *3 (D. Minn. July 3, 2014) (finding that a restitutionary “settlement is not uninsurable under Delaware law because no Delaware authority has held that restitution is uninsurable as a matter of law” and distinguishing the case from *Level 3* based on the policy language).

³⁶ Compare Sara S. Beale, *A Response to the Critics of Corporate Criminal Liability*, 46 AM. CRIM. L. REV. 1481, 1482 (2009) (arguing that corporate criminal liability continues to make sense and is preferable to a system in which corporations are not subject to criminal liability) with Albert W. Alschuler, *Two Ways to Think About the Punishment of Corporations*, 46 AM. CRIM. L. REV. 1359, 1369-1370, 1372, 1376 (2009) (arguing that subjecting corporations to criminal liability unnecessarily punishes innocent shareholders and creates irresolvable conflicts of interest, while not substantially furthering the goals of our criminal justice system).

³⁷ In a 2006 interview with the Wall Street Journal, Holder explained that “back in 1999 there were a group of private practitioners complaining that there was no uniformity in the way in which prosecutors decided to indict corporations” and that the Holder memorandum was a response to these complaints. See Peter Lattman, *The Holder Memo and its Progeny*, WALL STREET J. LAW BLOG (Dec. 13, 2006), <http://blogs.wsj.com/law/2006/12/13/the-holder-memo/>.

³⁸ Memorandum from Eric Holder, Deputy Att’y Gen., U.S. Dep’t of Justice to Component Heads and U.S. Attorneys on Bringing Criminal Charges Against

guidelines have subsequently been amended and updated a number of times to reflect perceived inadequacies or new developments in corporate crime.

A. THE GUIDELINES UP UNTIL 2015

In 1999, the Holder Memorandum memorialized Chapter Eight of the U.S. Sentencing Guidelines’³⁹ consideration of a corporation’s cooperation as a factor in making charging decisions⁴⁰ and combined the U.S. Sentencing Guidelines with the U.S. Attorneys’ Manual to create a directive for prosecutors to make charging decisions in the corporate context.⁴¹ The Holder Memorandum emphasized the “substantial federal interest in indicting the corporation,” and laid out non-mandatory guidelines that a prosecutor could, but was not obligated to consider in deciding how to charge a corporation.⁴² However, the Holder Memorandum also suggested that prosecutors should utilize NPAs or DPAs as a mechanism of pre-trial diversion that would reward cooperation. Specifically, the Holder Memorandum set forth eight factors for prosecutors to consider:

1. The nature and seriousness of the offense, including the risk of harm to the public, and applicable policies and priorities, if any, governing the prosecution of corporations for particular categories of crime;
2. The pervasiveness of wrongdoing within the corporation, including the complicity in, or condonation of, the wrongdoing by corporate management;

Corps. (June 16, 1999), <http://www.justice.gov/sites/default/files/criminal-fraud/legacy/2010/04/11/charging-corps.PDF> [hereinafter Holder Memorandum].

³⁹ Chapter Eight was incorporated into the Federal Sentencing Guidelines in response to the increase of corporate criminal prosecutions that occurred during the 1990s. Specifically, Chapter Eight sought to ensure that the sanctions imposed upon corporations provided adequate deterrence and incentivized the adoption and maintenance of effective mechanisms for discovering, reporting, and preventing criminal conduct within the corporation. See U.S. SENTENCING COMMISSION ANNUAL REPORT (1991), <http://www.uscc.gov/guidelines-manual/1991/1991-federal-sentencing-guidelines-manual>.

⁴⁰ Holder Memorandum, *supra* note 38.

⁴¹ *Id.*

⁴² *Id.* at Part II (internal citations omitted).

3. The corporation's history of similar conduct, including prior criminal, civil, and regulatory enforcement actions against it;
4. The corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product privileges;
5. The existence and adequacy of the corporation's compliance program;
6. The corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies;
7. Collateral consequences, including disproportionate harm to shareholders and employees not proven personally culpable; and
8. The adequacy of non-criminal remedies, such as civil or regulatory enforcement actions.⁴³

The Holder Memorandum was replaced in 2003 when then-Deputy Attorney General Larry Thompson released the "Principles of Federal Prosecution of Business Organizations" (Thompson Memorandum).⁴⁴ The Thompson Memorandum included the same eight factors that had been enumerated in the Holder Memorandum, but added the additional factor of "the adequacy of the prosecution of individuals responsible for the

⁴³ *Id.*

⁴⁴ See generally Memorandum from Larry D. Thompson, Deputy Att'y Gen., on Principles of Federal Prosecution of Business Organizations to to Heads of Dep't Components and U.S. Att'ys (Jan. 20, 2003), http://www.americanbar.org/content/dam/aba/migrated/poladv/priorities/privilegewaiver/2003jan20_privwaiv_dojthomp.authcheckdam.pdf [hereinafter Thompson Memorandum].

corporation's malfeasance."⁴⁵ While the Holder Memorandum's factors had merely been advisory, consideration of the Thompson Memorandum's factors, in charging decisions, was mandatory.⁴⁶ In another significant departure from the Holder Memorandum, the Thompson Memorandum underscored that only rarely should individuals not be pursued, irrespective of whether the corporation offers to plead guilty.⁴⁷ The Thompson Memorandum further emphasized the value of pre-trial diversion strategies (such as NPAs or DPAs) and "permit[ted] a non prosecution agreement in exchange for cooperation when a corporation's timely cooperation appears to be necessary to the public interest and other means of obtaining the desired cooperation are unavailable or would not be effective."⁴⁸

In December of 2006, the DOJ overhauled its guidelines for charging decisions in corporate criminal investigations with "The Principles of Federal Prosecution of Business Organizations" (McNulty Memorandum).⁴⁹ The McNulty Memorandum sought to "expand[] upon the [DOJ's] long-standing policies concerning how [it] evaluate[s] the authenticity of a corporation's cooperation with a government investigation."⁵⁰ Specifically, the McNulty Memorandum was primarily intended to address public concern regarding a cooperating corporation's waiving of attorney-client privilege and the potential for prosecutors to consider a corporation's advancement of attorney's fees in making charging decisions.⁵¹ In a public statement concerning the guidelines, then-

⁴⁵ *Id.* at 3.

⁴⁶ *See* United States v. Stein, 435 F. Supp. 2d 330, 338 (S.D.N.Y. 2006) ("The Thompson Memorandum sets forth nine factors that federal prosecutors *must* consider in determining whether to charge a corporation or other business organization.") (emphasis added).

⁴⁷ Thompson Memorandum, *supra* note 44, at 2. Notably, the Memorandum specifically stated that "only rarely should *provable* individual culpability not be pursued." (emphasis added). Thus, it is within the prosecutor's discretion to determine what constitutes "provable" culpability.

⁴⁸ Thompson Memorandum, *supra* note 44, at 6.

⁴⁹ *See generally* Memorandum from Paul J. McNulty, Deputy Att'y Gen., U.S. Dep't of Justice, to Heads of Dep't Components, U.S. Att'ys, regarding Principles of Fed. Prosecution of Bus. Orgs., http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf [hereinafter McNulty Memorandum].

⁵⁰ *Id.* at 2.

⁵¹ Thompson Memorandum, *supra* note 44; *See also* Wulf A. Kaal & Timothy A. Lacine, *The Effect of Deferred and Non-Prosecution Agreements on Corporate*

Deputy Attorney General Paul McNulty stated that they were intended to “further promote public confidence in the [DOJ], encourage corporate fraud prevention efforts, and clarify [the DOJ’s] goals without sacrificing [its] ability to prosecute these important cases effectively.”⁵²

The Holder, Thompson and McNulty Memoranda’s emphasis on the value of pre-trial diversion methods resulted in a proliferation of the use of DPAs and NPAs to resolve corporate criminal investigations. Indeed, between 2001 and 2014, prosecutors entered into 306 DPAs and NPAs with corporations.⁵³ In the majority of situations in which a corporation entered into a DPA or NPA, officers or employees of the corporation were not charged.⁵⁴ When individual employees were prosecuted, the individuals were typically not high-level executives and, if convicted, received short terms of imprisonment (if any) and paid on average a fine of \$382,000.⁵⁵ Despite statements in prior iterations of the guidelines that individuals should be pursued even when a corporation cooperates,⁵⁶ the general public consensus has been that the individuals responsible for corporate crimes rarely face criminal responsibility for their conduct.⁵⁷

Governance: Evidence From 1993-2013, 70 BUS. L. 61, 77 (2014) (discussing how the McNulty Memorandum differed from prior guidelines).

⁵² Paul J. McNulty, Deputy Att’y Gen., U.S. Dep’t of Justice, Prepared Remarks at the Lawyers for Civil Justice Membership Conference Regarding the Dep’ts Charging Guidelines in Corporate Fraud Prosecutions (Dec. 12, 2006), http://www.usdoj.gov/archive/dag/speeches/2006/dag_speech_061212.htm.

⁵³ Brandon L. Garret, *The Corporate Criminal as Scapegoat*, 101 VA. L. REV. 1789, 1791 (2015).

⁵⁴ *See id.* (noting that of the 306 DPAs or NPAs, “only 34%, or 104 companies, had officers or employees prosecuted, with 414 total individuals prosecuted.”).

⁵⁵ *See id.* (explaining that “of the individuals prosecuted in these cases, thirteen were presidents, twenty-six were CEOs, twenty-eight were CFOs, and fifty-nine were vice-presidents” and that only 42% of those individuals who were convicted received any jail time, with “the average sentence, including those who received probation but no jail time, [being] eighteen months.”).

⁵⁶ *See* Thompson Memorandum, *supra* note 44, at 2 (explaining that, “because a corporation can act only through individuals, imposition of individual criminal liability may provide the strongest deterrent against future corporate wrongdoing. Only rarely should provable individual culpability not be pursued, even in the face of offers of corporate guilty pleas.”).

⁵⁷ *See e.g.*, James B. Stewart, *In Corporate Crimes, Individual Accountability is Elusive*, N.Y. TIMES (Feb. 19, 2015), http://www.nytimes.com/2015/02/20/business/in-corporate-crimes-individual-accountability-is-elusive.html?_r=0.

B. A FUTURE OF INDIVIDUAL ACCOUNTABILITY: THE YATES MEMORANDUM

On September 9, 2015, Deputy Attorney General Sally Quillian Yates released a memorandum to the DOJ's prosecutors titled "Individual Accountability for Corporate Wrongdoing" (hereinafter Yates Memorandum).⁵⁸ Like the Holder, Thompson, and McNulty Memoranda that preceded it, the Yates Memorandum set forth guidelines as to how to make charging decisions in the corporate context. Unlike its predecessors, however, the Yates Memorandum encouraged prosecutors to "seek accountability from the individuals who perpetrated the wrongdoing."⁵⁹ Previously, corporations typically settled claims and the DOJ had generally opted not to pursue cases against individuals except in the most egregious instances involving fraud. Specifically, the Yates Memorandum outlined six "key steps" that were intended to bolster the government's pursuit of individual wrongdoing:

1. In order to qualify for any cooperation credit, the corporation must provide investigators with all relevant facts related to the individuals responsible for the misconduct.
2. Both criminal and civil corporate investigations should focus on individuals from the inception of the investigation.
3. Criminal and civil attorneys handling corporate investigations should be in routine communication with one another.
4. Absent extraordinary circumstances or approved departmental policy, the government will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation.

⁵⁸ See generally Memorandum from Sally Quillian Yates, Deputy Att'y Gen., U.S. Dep't of Justice, to Heads of Dep't Components, U.S. Att'ys regarding Individual Accountability for Corp. Wrongdoing, <http://www.justice.gov/dag/file/769036/download> [hereinafter Yates Memorandum].

⁵⁹ *Id.* at 2.

5. Government attorneys should not resolve matters with a corporation without a clear plan to resolve related individual cases and memorialize any declination as to individuals in such cases.

6. Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.⁶⁰

IV. THE RELATIONSHIP BETWEEN DPAS/NPAS AND CORPORATE INSURANCE COVERAGE

Prosecutors are aware of the presence of corporate insurance coverage when they negotiate and enter into NPAs and DPAs. This awareness is demonstrated through the inclusion of provisions in some NPAs or DPAs specifically concerning the potential availability of insurer funds to cover, either in part or in its entirety, the penalty that the corporation has agreed to pay. The 2005 DPA between KPMG and the USAO, for the Southern District of New York,⁶¹ serves as a particularly illustrative example of the extent to which the prosecutor may consider a corporation's insurance coverage in setting the terms of an agreement. The KPMG Agreement provided in relevant part that,

KPMG has represented to the United States that no portion of the \$456,000,000 that it has agreed to pay to the United States under the terms of this Agreement will be covered by any insurance policy in existence at the time of the conduct alleged in the Information or at the time any notice of claim was made to its insurer(s), *which representation was material to the United States in determining KPMG's ability to make full restitution and pay penalties to the United States*, which amounts, in the Government's view, were far in excess of the \$456,000,000 agreed to herein.

⁶⁰ *Id.*

⁶¹ Letter from David N. Kelley, U.S. Att'y for S.D.N.Y., to Robert S. Bennett, KPMG Counsel (Aug. 26, 2005), <http://www.corporatecrimereporter.com/documents/kpmgdeferred.pdf> (last visited Nov. 29, 2015) [hereinafter KPMG Agreement].

KPMG agrees that, in the event that any portion of KPMG's \$456,000,000 obligation to the United States is ultimately covered by insurance, 50 percent of any insurance funds received by KPMG shall be remitted to the United States. The payment to the United States of a portion of the amounts received from insurance shall be over and above the \$456,000,000 that KPMG has agreed to pay, but in no event shall the total payments made by KPMG to the United States (which total payments include both the underlying \$456,000,000 and insurance proceeds) exceeds \$600,000,000. In addition, KPMG agrees that it will not enter into any agreement or understanding with its insurance carrier(s) to receive insurance coverage for any portion of that \$456,000,000 in exchange for increased insurance premium payments made by KPMG in the future.⁶² (emphasis added)

This provision is noteworthy in several respects. First, it indicates that the USAO may take into account the extent to which a payment will come directly out of the company coffers (meaning that there is no insurance coverage for it) in deciding the amount of the penalty. The USAO here considered the availability of insurance funds "material" in agreeing to a \$456,000,000 penalty, and implied that a larger amount would have been preferable but considerations of KPMG's solvency and capacity to pay militated against a higher figure. In requiring that, should KPMG be entitled to insurance coverage for any portion of the \$456,000,000 payment, KPMG was obligated to remit fifty percent of all funds resulting from such coverage up to a total payment of \$600,000,000, but only requiring KPMG to pay \$456,000,000 in the event that no insurance coverage was available, the agreement suggests that the USAO would have preferred a penalty of \$600,000,000, but recognized that such a sum might jeopardize the solvency of KPMG⁶³ or reduce the likelihood that

⁶² *Id.* at 3-4.

⁶³ It is worth noting that this agreement was entered into just a few years after the collapse of the accounting firm Arthur Andersen, which many attribute directly to the firm's 2002 indictment by the DOJ for obstruction of justice charges resulting from their accounting work for Enron. *See generally* Kathleen F. Brickey, *Anderson's Fall From Grace*, 81 WASH. U. L. Q. 917 (2003) (discussing the collapse of Arthur Andersen and noting that the DOJ should have known that an

KPMG would be willing to enter into the agreement. Second, by forbidding KPMG from entering into future insurance arrangements that would provide coverage for the \$456,000,000 penalty, the agreement explicitly contemplates that the conduct admitted to by KPMG⁶⁴ is the type of conduct which may be insurable and is not necessarily uninsurable due to public policy or state law. One possible implication of provisions like that in the KPMG Agreement is that the governmental agency entering into the agreement with the defendant corporation may attempt to structure the terms of the agreement and the statement of facts in such a way as to avoid completely precluding insurance coverage for the conduct at issue. This would make sense if the governmental agency's goal is to optimize the amount of money that is recoverable from the defendant corporation.

Where the prosecuting agency is less interested in merely recovering funds (restitution), irrespective of whether they come directly from the corporation or are recouped from an insurer, an NPA or DPA may explicitly prohibit the stipulated penalty from being paid by the corporation's insurer. For instance, the 2004 DPA between Computer Associates International and the USAO for the Eastern District of New York stipulated that Computer Associates International "will not, in connection with the monies it pays into the Restitution Fund, seek, obtain or accept any reimbursement or other payments or credits from any insurer of [Computer Associates International] or of any of its divisions or subsidiaries" in order to satisfy the terms of the agreement.⁶⁵ In January of 2015, the SEC entered into a DPA with PBSJ Corporation resolving their FCPA violations and requiring PBSJ to pay a \$3,407,875 penalty and

indictment would deal the firm a fatal blow); Peter Lattman, *SAC Capital is Indicted, and Called a Magnet for Cheating*, N.Y. TIMES (July 25, 2015), http://dealbook.nytimes.com/2013/07/25/sac-capital-is-indicted/?_r=0 (explaining that the justice department's indictment of Arthur Andersen "lead[] the firm to collapse and terminate 28,000 jobs.").

⁶⁴ See Press Release, DOJ, KPMG to Pay \$456 Million for Criminal Violations in Relation to Largest-Ever Tax Shelter Fraud Case (Aug. 29, 2005), http://www.justice.gov/archive/opa/pr/2005/August/05_ag_433.html (noting that KPMG admitted that it had "design[ed], market[ed] and implement[ed] illegal tax shelters" by concocting "tax shelter transactions-together with false and fraudulent factual scenarios to support them-and targeted them to wealthy individuals who needed a minimum of \$10 or \$20 million in tax losses so that they would pay fees that were a percentage of the desired tax loss to KPMG, certain law firms, and others instead of paying billions of dollars in taxes owed to the government.").

⁶⁵ *United States v. Computer Assoc. Int'l, Inc.*, No. 04-837 (ILG) (E.D.N.Y. Sept. 22, 2004).

prohibiting PBSJ from “seeking or accepting reimbursement or indemnification from any source, including, but not limited to, payment made pursuant to an insurance policy or employment contract, with regard to any civil monetary penalty paid pursuant to this Agreement.”⁶⁶ Almost identical prohibitions exist in a number of other DPAs.⁶⁷ As is outlined above, there is direct evidence that the prosecuting agency may take into consideration the potential existence of insurance coverage when determining the appropriate dollar amount for a penalty. To what extent a prosecuting agency may be willing to consider the availability of insurance coverage when determining the actual terms of the agreement is a more complicated question.

V. WHEN EXPECTED COVERAGE VANISHES: LEARNING FROM THE PAST AND ANTICIPATING THE IMPACT OF THE YATES MEMORANDUM ON COVERAGE

DPAs and NPAs between a corporation and governmental agency do not exist in a vacuum. The corporate conduct that gave rise to the criminal investigation will in almost all cases result in some form of civil litigation in which the corporation could face massive additional monetary liabilities. The availability of insurance funds to cover the costs (attorney’s fees, lost business and the like) as well as any potential findings of liability associated with these civil litigations can be essential to maintaining the solvency of the defendant corporation. There are a number of ways in which the contents of an NPA or DPA can impact civil proceedings⁶⁸

⁶⁶ *Id.*

⁶⁷ *See e.g.*, Regions Deferred Prosecution Agreement, U.S. SEC. AND EXCH. COMM’N, http://www.gibsondunn.com/publications/Documents/Regions_DPA.pdf (Requiring Regions “to refrain from seeking or accepting reimbursement or indemnification from any source, including, but not limited to, payment made pursuant to an insurance policy or employment contract, with regard to any civil penalties paid pursuant to this Agreement or to the Federal Reserve Board related to or in connection with the conduct described in Paragraph 6.”).

⁶⁸ NPAs and DPAs can also have unanticipated collateral impacts on a corporation’s capacity to enter into contracts for work with the government and may even indirectly preclude a corporation from entering into a contract with another corporation if that corporation is functioning as a government contractor. *See* Stephanie Martz, *Trends in Deferred Prosecution Agreements*, 29 THE CHAMPION 43 (2005) (explaining that “the Federal Acquisition Regulations state that only ‘adequate’ evidence of fraud need be present to result in a suspension

arising from the same or intimately related conduct. On a basic level, the admissions of guilt and narrative contained in a statement of facts can be used as evidence against the corporation in a later civil proceeding,⁶⁹ increasing the likelihood that it will be found civilly liable as well as the amount it will be required to pay.⁷⁰ Additionally, most NPAs and DPAs prohibit the corporate defendant from publicly contesting or disputing its admission of wrongdoing, so-called “muzzle clauses”.⁷¹ In addition to directly affecting civil litigation, admissions contained in the statement of facts, particularly coupled with the prohibitions on conduct (such as “muzzle clauses”), may even jeopardize a corporate defendant’s claims for non-third-party/liability insurance coverage.⁷²

from government contracting” and how “certain flow-down provisions can prevent other government contractors from doing business with a debarred entity.”).

⁶⁹ See Sarah Kelly-Kilgore & Emily M. Smith, *Corporate Criminal Liability*, 48 AM. CRIM. L. REV. 421, 453 (2011) (noting that a corporate defendant’s admission of wrongdoing “will be admissible in subsequent civil litigation and disclosures will likely be discoverable”); Michael R. Sklaire & Joshua G. Berman, *Deferred Prosecution Agreements: What is the Cost of Staying in Business?*, WASH. LEGAL FOUND. (June 3, 2005), at 2 (“While a company is not required to admit guilt as part of the agreement, the company very often will be required to stipulate to the Government’s presentation of facts—a stipulation that a plaintiff will seek to use against the corporation in a later civil proceeding.”).

⁷⁰ See Martz, *supra* note 68 (“for corporations, the ripple effect of these admissions could be devastating. To the extent outstanding shareholder suits are not resolved in the agreement, public disclosures of wrongdoing could operate as admissions, and the information pertaining to these admissions could very well be discoverable.... There would seem to be only one avenue left once companies have agreed to extensive factual admissions—to settle.”).

⁷¹ These provisions have been called “muzzle clauses” by some commentators. See generally Michael Koehler, *The ‘Muzzle’ Clause*, FCPA PROFESSOR (Mar. 26, 2013), <http://www.fcpaprofessor.com/the-muzzle-clause>; see also Cort E. Golumbic & Albert D. Lichy, *The “Too Big to Jail” Effect and the Impact on the Justice Department’s Corporate Charging Policy*, 65 HASTINGS L.J. 1293 (2014) (discussing the standard provisions contained in modern DPAs and NPAs).

⁷² Third-Party/Liability insurance provides coverage to the insured for the costs of the harms that happen to others as a result of the insured’s conduct, whereas first-party insurance is coverage for harms that can happen to the individual or corporate entity itself. On a basic level, Third Party/Liability Insurance shifts the risk of liability for potential tort claims away from the insured and onto the insurer.

A. PRE-YATES INSURANCE ISSUES CREATED BY DPAS AND NPAS

Beyond the potential that a DPA will jeopardize insurance coverage for the costs of related civil litigation, there is also the possibility that the admissions contained within a DPA, which cannot be contested due to the non-contradiction “muzzle clauses”, will be used directly by an insurer to preclude a corporation from receiving coverage under a non-liability or first-party policy. The circumstances that followed the DPA between FirstEnergy Nuclear Operating Company (FEOC) and the DOJ⁷³ provide a perfect example of this type of unanticipated consequences to an unrelated insurance policy.

On January 20, 2006, FEOC entered into a DPA regarding false statements that it had allegedly made to the Nuclear Regulatory Commission, concerning the safety of the Davis-Besse Nuclear Power Station located in northwest Ohio.⁷⁴ Specifically, FEOC admitted that its employees, acting on its behalf, knowingly made false statements to the Nuclear Regulatory Commission in an attempt to mislead them into believing that the power station at Davis-Besse was safe to operate beyond December 31, 2001.⁷⁵ Notably, in the DPA’s statement of facts, FEOC admitted that it had failed for years to properly maintain its corrosion program.⁷⁶ In addition to these admissions, the FEOC DPA included a non-contradiction clause that stated, “FirstEnergy agrees that it shall not, through its attorneys, agents, or employees, make any statement, including in litigation, contradicting the statements of facts, or its representations in this agreement.”⁷⁷ In the event that the DOJ determined that the FEOC had materially breached the terms of the agreement, the DOJ “may prosecute FEOC for any violations known to it at that time, including the conduct described in the Statement of Facts...and in any such proceeding the

⁷³ FirstEnergy News Release, U.S. Dep’t of Just., Nuclear Operating Company to Pay \$28 Million Relating to Operation of Davis-Besse Nuclear Power Station (Jan. 20, 2006), http://www.justice.gov/archive/opa/pr/2006/January/06_enrd_029.html.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ See Memorandum from U.S. Att’y’s Off., DOJ, on Deferred Prosecution Agreement Between the United States and FirstEnergy Nuclear Operation Company (Jan. 20, 2006), <http://www.corporatecrimereporter.com/documents/fenco.pdf>. [hereinafter FEOC DPA].

⁷⁷ *Id.* at 3.

Statement of Facts shall be admissible in evidence.”⁷⁸

In March of 2002, FEOC discovered that the plant’s reactor head had been eroded by leaking acid and would need to be shut down for two years.⁷⁹ As was customary, FEOC had purchased insurance coverage⁸⁰ for business losses owing to having to shut down one of their reactors for repairs from Nuclear Electric Insurance Limited (NEIL).⁸¹ Accordingly, after FEOC had entered into the DPA, it filed a claim with NEIL seeking coverage for the hundreds of millions of dollars in losses that it incurred while the damaged reactor was shut down for repairs.⁸² NEIL denied FEOC’s claim, and the parties ended up in arbitration over whether the losses FEOC incurred during the time the reactor had to be shut down for repairs were covered under the policy. FEOC’s policy excluded coverage for losses incurred as a result of the intentional acts of the insured.⁸³ In the NEIL arbitration, FEOC argued that it had done nothing to intentionally cause the corrosion damage to the reactor head at Davis-Besse, and thus was entitled to coverage under the policy.⁸⁴ On December 18, 2006, in support of this position, the FEOC submitted an analysis, prepared by

⁷⁸ *Id.* at 2-4.

⁷⁹ See Tom Henry, *Regulators Skeptical of Davis-Besse Report*, THE TOLEDO BLADE (May 19, 2007), <http://www.toledoblade.com/frontpage/2007/05/19/Regulators-skeptical-of-Davis-Besse-report.html>.

⁸⁰ For an in-depth discussion of the insurance system for nuclear energy, see Taylor Meehan, *Lessons From the Price-Anderson Nuclear Industry Indemnity Act for Future Clean Energy Compensatory Models*, 18 CONN. INS. L.J. 339 (2011).

⁸¹ See Tom Henry, *FirstEnergy Drops Insurance Claim*, THE TOLEDO BLADE (Dec. 8, 2007), <http://www.toledoblade.com/Energy/2007/12/08/FirstEnergy-drops-insurance-claim.html>.

⁸² See Joseph G. Block & David L. Feinberg, *Look Before You Leap: DPAs, NPAs and the Environmental Criminal Case*, A.L.I.-A.B.A. BUS. L. COURSE MATERIALS J. 5 (Feb. 2010), https://www.venable.com/files/publication/4307e686-a055-41ca-9150-b2ccfd550365/presentation/publicationattachment/83ca143f-8819-4478-8422-b820340fa10d/cmj1002-block_feinberg.pdf.

⁸³ *Id.* This is based largely on concerns for moral hazard, as excluding recovery for intentional losses discourages insureds from purposefully causing losses for which they know they will be able to recover. See generally RESTATEMENT OF THE LAW: LIABILITY INSURANCE § 34 (AM. LAW INST., Tentative Draft No. 1 Apr. 11, 2016) (noting that insurance for intentional acts may “insulat[e] the insured from the financial consequences of such liability [which] would contravene the public purpose of the liability.”).

⁸⁴ See *FirstEnergy and Davis-Besse*, OHIO CITIZEN ACTION (Dec. 6, 2015), <http://www.ohiocitizen.org/campaigns/electric/nucfront.html>.

Exponent Failure Analysis Associates and Altran Solutions Corporation, (Exponent Report) of the root cause of the erosion that had resulted in the closing of the reactor at Davis-Besse as expert testimony in the NEIL arbitration.⁸⁵ The Exponent Report maintained that most of Davis-Besse's old head had deteriorated from leaky reactor acid in the final three weeks before the February shut down.⁸⁶ FEOC's posture in the NEIL arbitration that it had done nothing to intentionally cause the corrosion which necessitated a shut down, was irreconcilable with its admissions in the DPA that it had failed to properly maintain a corrosion program for the Davis-Besse reactor.⁸⁷ Thus, if FEOC continued to dispute the denial of coverage in the NEIL arbitration, it was in danger of breaching the terms of its DPA and being prosecuted for the underlying false statements to the NRC. When the NRC learned of FEOC's position in the NEIL arbitration, it demanded that FEOC reconcile the Exponent Report with the admitted statement of facts in the DPA, and threatened to refer the matter over to the DOJ if the FEOC continued to take a position contrary to that admitted to in the DPA.⁸⁸ Not surprisingly, FEOC promptly dropped its insurance

⁸⁵ NUCLEAR REGULATORY COMMISSION, FirstEnergy Nuclear Operating Co.; Davis-Besse Nuclear Power Station, 72. Fed. Reg. 161 (Notice Aug. 21, 2007), https://www.justice.gov/archive/opa/pr/2006/January/06_enrd_029.html.

⁸⁶ *Id.*; see also *supra* note 78.

⁸⁷ *Supra* note 76, at 8 (statement from the FEOC) ("For several years prior to the summer of 2001, Davis-Besse employees had failed to properly implement the plant's Boric acid Corrosion Control and CORrecitve Action programs. These programs were designed to ensure that Davis-Besse employees discovered boric acid leaks, identified their sources, documented their extent, and dealt with any corrosion properly. Since 1996, some Davis-Besse employees knew that boric acid deposits were left on the reactor pressure vessel head from outage to outage. Some employees also knew that the service structure surrounding the reactor pressure vessel head impeded inspection of some of the nozzles. Inspection and cleaning steps under the Boric Acid Corrosion Control program were not performed properly during the refueling outages in 1996, 1998, and 200. Instead, Davis-Besse engineers prepared analyses without removing all of the boric acid. See FEOC DPA at B-2.").

⁸⁸ See JONATHON S. SACK & ELIZABETH HAINES, MORVILLO, ABRAMOWITZ, GRAND, IASON, ANELLO & BOHRER, P.C., *Be Careful What You Wish For: How Deferred and Non-Prosecution Agreements Can Be Used in Civil Litigation*, BLOOMBERG BNA (Dec. 6, 2015), <http://www.bna.com/deferred-and-non-prosecution-agreements/>.

coverage claim.⁸⁹

At the time the DOJ and FEOC entered into the DPA, it seems as though neither party specifically contemplated the impact that such an agreement would have on FEOC's first-party insurance coverage from NEIL. FEOC filed its claim with NEIL only shortly after entering into the DPA.⁹⁰ Given that FEOC dropped its claim for reimbursement from NEIL as soon as it was made aware that it may have been in breach of the DPA, FEOC would likely not have filed or argued its claim with NEIL as it did if it believed that such acts would constitute violations of the DPA. This is not to say that FEOC would have refused to enter into the DPA if it had considered this consequence, but it may have impacted the way in which it negotiated the DPA and how it chose to pursue its claim with NEIL.

B. SPECIFIC ISSUES ARISING POST-YATES MEMORANDUM

NPAs and DPA's capacity to impact insurance coverage, and the attendant implications for prosecutorial discretion in drafting and entering into agreements, will persist under the new guidelines emphasizing individual accountability. However, the Yates Memorandum also introduces a host of other potential insurance issues for corporations. Unlike the prior memoranda, the Yates Memorandum does not underscore the necessity for prosecutors to continue to consider the collateral consequences of criminal conviction when making charging decisions. But, it specifically states that a decision not to charge a potentially culpable individual should not be dependent upon that individual's capacity to pay.⁹¹ It remains to be seen whether, and to what extent, charging decisions for individuals will take into consideration the potential collateral consequences for the corporation. Thus, the discussion below regarding potential collateral insurance implications for corporate entities may also prove useful to counsel for individuals facing potential criminal charges for their corporate conduct.

In requiring that corporations "identify all individuals involved in or responsible for the misconduct at issue, regardless of their position, status or seniority, and provide to the Department all facts relating to that

⁸⁹ See Tom Henry, *FirstEnergy accepts blame for Davis-Besse oversight*, THE TOLEDO BLADE (JUNE 15, 2007), <http://www.toledoblade.com/frontpage/2007/06/15/-accepts-blame-for-Davis-Besse-oversight.html>.

⁹⁰ See *supra* note 84.

⁹¹ Yates Memorandum, *supra* note 58, at 6.

misconduct” and cannot “decline[] to learn of such facts” in order to receive any cooperation credit,⁹² the Yates Memorandum could give rise to several new forms of liability for the corporate entity. First, individual employees may attempt to pursue claims against the corporate entity arising out of the corporation’s actions in turning over information to the government. Second, the prohibition on a corporation “declining to learn of such facts” may create a new breed of derivative shareholder suit, based on the theory that a corporation who fails to receive cooperation credit had inadequate internal mechanisms for gathering and retaining “all facts relating to [the misconduct at issue].” Presently, corporate general liability insurance policies may not be drafted so as to provide coverage for such types of liability. Thus, corporations should consult with their insurers in order to ensure that they obtain a policy that would be inclusive of such risks.

A corporation’s capacity to be reimbursed by its Side B D&O policy may be jeopardized in situations where the corporation has caused its director or officer to face the criminal investigation or proceeding for which he is entitled to receive, at the very least, the advancement of attorney’s fees. Thus, corporations may find themselves in a position where they turn over documents or information supporting an investigation or indictment of one of their executives, all the while knowing that they will have to, at least initially, pay the legal fees for such executive in the proceeding. Furthermore, depending on the language of their Side B D&O policy, in the event that the executive is convicted of a crime based on the information that they turned over (and they are thus unable to indemnify him as a matter of law), their D&O insurer could decline to reimburse their indemnification⁹³ if the policy excludes coverage for losses that are unindemnifiable as a result of the corporation’s own actions. Where the corporate entity and the executive officer are both deemed “insureds” under

⁹² *Id.*

⁹³ The defense costs for individuals in white-collar cases can be enormous. Even for a large corporation, the capacity to recover advanced defense costs from its D&O insurer can be important. *See e.g.*, Walter Pavlo, *The High Cost of Mounting a White-Collar Criminal Defense*, FORBES (May 30, 2015), <http://www.forbes.com/sites/walterpavlo/2013/05/30/the-high-cost-of-mounting-a-white-collar-criminal-defense/>; Peter Lattman, Dealbook, *Goldman Stuck with Defense Tab, Awaiting Payback*, N.Y. TIMES (June 18, 2013), <http://dealbook.nytimes.com/2012/06/18/gupta-legal-bills/> (discussing the over \$30 million in defense costs associated with the insider trading case against former Goldman Board member Rajat Gupta.).

the Policy's definition, the corporation's deliberate act of turning over information related to that executive officer could be sufficient to trigger the "deliberate act" of an insured exclusion.⁹⁴ Again, corporate counsel should look closely at the current D&O policies and discuss with their insurers the extent to which this may create a gap in coverage.⁹⁵

Another potential hazard that could create coverage gaps for an executive under his D&O policy stems from the standard policy language excluding coverage for claims about which an insured had "known or should have known." If corporations generally comply with the guideline's requirements regarding turning over information regarding individuals, then it is not unreasonable to assume that an executive who was involved in the misconduct for which a corporation is being investigated "know[s] or should [] know" of the likelihood of an impending claim being brought against him once he becomes aware that the corporation is cooperating. In practice, it seems unlikely that this would eliminate coverage for the executive here, but it would likely create disputes about which period of time, and thus which policy, the claim falls into, which could impact the available limits of liability, particularly where the policies at issue are from different insurers. Yet another concern is the potential for situations in which an insurer could deny coverage based on the contention that the insured gave late notice of the claim to the insurer, so long as the insurer can demonstrate that it was prejudiced by the late notice.⁹⁶ Although it might not be good business practice on the part of D&O insurers, there is at

⁹⁴ See *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 42 Misc. 3d 1230(A), 988 N.Y.S.2d 523 (N.Y. Sup. 2014) (regarding exclusions that typically preclude coverage for claims) ("The Policy "shall not apply to any Claim(s) made against the Insured(s) ... based upon or arising out of any deliberate...act or omission by such Insured(s).").

⁹⁵ Beyond the explicit exclusions identified within a D&O policy, a corporation may find itself unable to recover the money it advanced to its executive for attorney's fees if the executive is charged and is convicted or enters into a settlement agreement in which he provides a detailed admission of his conduct based on public policy grounds. See *supra* notes 32-34 and accompanying text. If the Yates Memorandum has its intended impact, and more individuals are charged, then it is likely that there will be a commensurate increase in D&O insurers willingness to dispute claims.

⁹⁶ See *Arrowood Indemnity Co. v. King*, 304 Conn. 179, 201-203 (2012) (expressing the view of the vast majority of jurisdictions that where an insurer denies coverage due to late notice, the insurer bears the burden of proving that it was prejudiced by the late notice.).

least some potential for a late notice argument from an insurer, particularly because most D&O policies require that notice be given to the insurer “as soon as practicable...after the Named Entity’s Risk Manager or General Counsel (or equivalent position) first becomes aware of the Claim.”⁹⁷

In order to best avoid some of these coverage issues, corporate counsel should consult the relevant D&O policies that could be implicated in any action against an executive or officer that may result from corporate cooperation, and be cognizant of the points at time in which an executive may be deemed to have known or should have known that a claim would be forthcoming. In particular, in cooperating with the government and negotiating NPAs or DPAs, corporate counsel should pay close attention to how the term “Claim” is defined in the potentially relevant D&O policies. For instance, where claim means “a civil, criminal, administrative or regulatory investigation of an Insured Person [meaning executive] once such Insured Person is identified in writing by such investigating authority as a person against whom a proceeding may be commenced,”⁹⁸ the insurer must be put on notice as soon as the named entity (meaning the corporate entity for whom the director works) becomes aware of such an investigation. Thus, in situations where the corporate entity knows that the executive is likely going to be the subject to a proceeding because it is cooperating and has turned over information on him, a Claim may have arisen within the meaning of the policy even if the executive himself is completely unaware of it. In an age of increased emphasis on individual accountability in corporate crime, acting quickly to alert the insurer as soon as the corporation begins to cooperate (perhaps even earlier) could go a long way towards ensuring that D&O coverage will be available, or is less likely to be contested.

VI. CONCLUSION

Both prosecutors and corporations engage in a balancing equation throughout the course of a corporate criminal investigation. For prosecutors, charging decisions are supposed to be based on the consideration of a variety of factors, and the terms of a DPA or NPA will be impacted by both the corporation’s purportedly wrongful conduct and its remedial or cooperative steps. For corporate entities, cooperating with a

⁹⁷ See AIG, *D&O Policy*, http://www.aig.com/public-company-do_295_391889.html (last visited Dec. 5, 2015).

⁹⁸ *Id.*

government investigation, or deciding to enter into a NPA or DPA necessitates an understanding of all the consequences that ensue from such actions. Insurance coverage considerations are not always at the forefront of a corporate counsel's mind when he learns of an investigation into the company. By addressing the potential insurance problems that may ensue from a governmental investigation early on, and being familiar with the particular policies likely to be implicated, a corporation can avoid unexpected coverage pitfalls and be best situated to make decisions about cooperation that reflect the corporation's long-term best interests.

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