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COMMENTARIES ON THE RECENT AMENDMENT OF THE INSURANCE LAW OF THE PEOPLE'S REPUBLIC OF CHINA REGARDING INSURANCE CONTRACTS FROM THE PERSPECTIVE OF COMPARATIVE LAW

KUAN-CHUN CHANG*

ABSTRACT

This Article, which begins with a brief history of the insurance industry and insurance law, discusses the recent amendments to the Insurance Law of the People's Republic of China. In particular, this Article focuses on the amendments relating to insurable interest, the insured's duty of disclosure, interpretation of contractual clauses, double insurance, and insurance fraud. The Article concludes by considering areas with which the amendments have not dealt and by suggesting ways in which the legislation could improve.

I. INTRODUCTION

In February 2009, the Insurance Law of the People's Republic of China ("PRC") was amended, resulting in major changes to both substantive insurance contract law and insurance company regulations.¹ At least 80% of the original articles were amended, and the total number of articles increased from 159 to 187.² Compared to the last change in insurance law, which focused on regulations pertaining to China's World Trade Organization ("WTO") commitments, this amendment placed more emphasis on settling insurance contract issues arising prior to the amendment and on the prudential regulation of insurance companies. The

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1. ZHONG HUA REN MIN GONG HE BAO XIAN FA [Insurance Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., 2009) (China) [hereinafter Insurance Law of the PRC], available at <http://www.circ.gov.cn/web/site0/tab68/i94860.htm>.

2. *Id.*

2009 amendment has improved various aspects of the original insurance law by enhancing the protection for consumers under an adhesion contract (incontestability clause), clarifying the insurer's right to rescind the contract due to the insured's misrepresentation, and the addition of a requirement specifying the insurer's duty to explain the contract.³ Despite the improvements, issues and unanswered questions associated with this amendment still exist. At a minimum, the 2009 amendment fails to address the following: (1) the "real" holder of an insurable interest remains confusing, (2) the time when an insurable interest must exist, (3) the period in which the insured owes the duty of disclosure to the insurer, (4) potential obstacles in implementing the incontestability provision, (5) possible unfairness associated with the rule regarding the construction and governance of contractual terms, and (6) the moral hazard issue embedded in rules relating to double insurance. Several perplexities and insufficiencies in the old law were not tackled.⁴

The primary sources of reference for this amendment were American and British law.⁵ This research not only examines most of the newly enacted articles in light of American and British common law, but also provides critiques in accordance with the general principles of both insurance theory and law, including principles of indemnity, consideration, and utmost good faith. More importantly, due to the civil law nature of the Chinese legal system,⁶ this Article examines representative insurance legislation recently enacted in the civil law legal systems of Germany⁷ and Japan,⁸ which also deeply influence the legal system of another Chinese

3. Hwabo Yang, *Woguo Xin Baoxian Fa De Zhuyao Bianhua* [Primary Changes of the New Insurance Law] 1 INS. L. REV. 3, 5 (2010).

4. For example, the old law and the 2009 Amendment both impose on the insured a duty of notification where the double insurance takes place; yet both of which did not provide the consequence of violating the duty of notification. Such omission impedes the insured's incentive to perform such duty. For details, see Insurance Law of the PRC, art. 56 (2009).

5. For example, the incontestability clause and rules regarding waiver and estoppel have been introduced into the 2009 Amendment. See, e.g., Insurance Law of PRC, art. 61 (2009); see also XU CHONGMIAO & LI LI, *ZUI XIN BAO XIAN FA SHI YONG YU AN LI* [NEWLY AMENDED INSURANCE LAW—APPLICATION & CASES] 14 (2009).

6. A series of statutory laws and regulations constitute the body of law in China. These written provisions "include laws (*fa*), regulatory provisions (*tiaoli*), rules (*guize*), detailed rules (*xize*), methods or measures (*banfa*), resolutions (*jueyi*), and orders (*mingling*).". For details, see JAMES M. ZIMMERMAN, *CHINA LAW DESK BOOK 60* (American Bar Ass'n, 2d ed. 2005). Given that the accepted theory of sources of law in the civil law tradition recognizes only statutes, regulations, and customs as sources of law, it is more appropriate to categorize the Chinese legal system as a civil law system. JOHN H. MERRYMAN & ROGELIO PEREZ-PERDOMO, *THE CIVIL LAW TRADITION* 24 (3d ed. 2006).

7. See generally *Vertragsversicherungsgesetz [VVG]* [Insurance Contract Act], Nov. 23, 2007, BANZ at 2631, last amended July 17, 2009, BANZ at 1990, art. 13a (Ger.) [hereinafter VVG], available at JURIS.

8. See generally *HOKENHOU* [Insurance Law], Law No. 56 of 2008 (Japan) [hereinafter Japan

society, Taiwan, to corroborate some of the viewpoints expressed about the 2009 PRC Law. Part II provides a brief history of modern Chinese insurance law. Part III examines the sections of the 2009 amendment relating to insurable interest, the insured's duty of disclosure, the interpretation of contractual clauses, double insurance, and insurance fraud. Part IV explores potential issues and problems not clarified in the 2009 amendment and proposes suggestions for further amendments. Part V will conclude the discussion with a brief remark.

II. BRIEF HISTORY OF CHINESE INSURANCE LEGISLATION

China's insurance legislation dates back to 1904 in the Qing Dynasty.⁹ The Qing government drafted the Qing Commercial Law, which consisted of two chapters concerning loss and life insurance.¹⁰ The Qing Dynasty, however, collapsed before implementation of this law.¹¹ The Kuomintang [Goumindang] ("KMT") government drafted the Insurance Law in 1929 and revised it in 1937. In 1931, KMT also promulgated the Maritime Law, which covered marine insurance.¹² After the foundation of the PRC in 1949, the State Council promulgated a series of insurance acts and regulations consisting of rules, administrative decisions, ordinances, methods, and notices.¹³ Most of these acts and regulations focused on compulsory insurance, especially for the property of state institutions and for the property of ship, train, and airplane passengers.¹⁴

China successfully legislated insurance in the Insurance Law of 1995, the first national legislation to also provide a framework for understanding China's insurance regulations.¹⁵ This legislation consisted of 152 articles in eight chapters.¹⁶ Chapter 1 covers the purpose of the law, definition of insurance, scope of the law, and principles of the insurance industry.¹⁷

Insurance Law)].

9. The Legislation on Insurance Law in Mainland China can be traced back to 1904 in "Da Qing Shang Lu Caoan" [Draft of the Qing Commercial Rule]. *See, e.g.*, Yu-Xiang Liang et al. *Shang Xi Fa Jing Lun* [Essence of Commercial Law] 524 (2007); QING DAI FALU CAOAN HUIBIAN (II) [The Collection of Drafted Laws of the Qing Dynasty (II)] 21-30 (1973).

10. GUANGHUA YU & MINKANG GU, *LAW AFFECTING BUSINESS TRANSACTIONS IN THE PRC* 126 (Kluwer Law Int'l 2001).

11. *Id.*

12. *Id.*

13. Linbo Fan, *The Insurance Market System*, FINANCIAL REGULATION IN THE GREAT CHINA AREA MAINLAND CHINA, TAIWAN AND HONG KONG 158 (Joseph J. Norton et al. eds., 2000).

14. *Id.*

15. *Id.*

16. YU & GU, *supra* note 10, at 126-27.

17. Insurance Law of the PRC (1995) (China), available at <http://www.lehmanlaw.com/resource->

Chapter 2 pertains to insurance contracts and consists of three sections: (1) the general rules of the formation, amendment, and performance of the insurance contract; (2) property insurance; and, (3) life insurance contract.¹⁸ Chapters 3 through 5 set forth the rules and requirements of insurance company administration and supervision, including licensing, scope of business, management of premiums, liquidation, and continuous supervision.¹⁹ Chapter 6 provides rules for the oversight of insurance and industry-related members, such as insurance agents and brokers.²⁰ Finally, Chapters 7 and 8 include provisions regarding legal liabilities and sanctions.²¹

As articles pertaining to the supervision and administration of insurance companies were still in the early stages of development, the China Insurance Regulatory Commission (“CIRC”) promulgated the Regulation Regarding the Administration of Insurance Companies (“Regulation”) in 2000 and subsequently amended it in 2005.²² The Regulation now has seven chapters with 105 articles, which provide more detailed rules for supervising and administering insurance companies.²³

China’s insurance industry changed drastically between 1995 and its first amendment in 2002. The number of insurance companies reached fifty-three by the end of 2002, and the total annual premium income had risen from ¥ 460 million RMB in 1995 to ¥ 226.3 billion RMB after the first three quarters of 2002.²⁴ This growth reflected the increasing number of insurance consumers and products, thereby generating demand for higher quality service and upgraded regulatory systems. With these changed objectives, several parts of the Insurance Law of 1995 ceased to be applicable to the market.²⁵ Some original provisions even became obstacles to reasonable operation in the altered environment.²⁶ Soon after

centre/laws-and-regulations/insurance/insurance-law-of-the-peoples-republic-of-china-1995.html (translating law in unofficial English version).

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. Regulation Administration of Insurance Companies, China Insurance Regulatory Commission (Dec. 22, 2005), <http://www.circ.gov.cn/web/site45/tab2746/i21575.htm> (translating regulation in English).

23. *Id.*

24. *Statistical Information Regarding the Operation of Insurance Industry*, CHINA INSURANCE REGULATORY COMMISSION, <http://www.circ.gov.cn/web/site0/tab454/> (last visited May 31, 2011).

25. Xu Guojian & Richard L. Mertl, *Amending the Insurance Law: Long-Term Policy or Expedient Measures?*, 16 CHINA L. & PRACTICE, no. 10, Dec. 2002/Jan. 2003, 21, 21–22.

26. *Id.*

its establishment, CIRC prioritized amending the Insurance Law of 1995.²⁷ Eventually, the National People's Congress granted legislative approval to CIRC's amendment on October 28, 2002.²⁸ The 2002 amendment was expected to accomplish four objectives: (1) to sustain the reform and development of China's insurance industry, (2) to strengthen supervision and regulation of the industry, (3) to standardize the regulation of insurance enterprises and business operations, and (4) to fulfill pledges to adopt international practices made during the WTO accession negotiations.²⁹

To balance the rights and interests of both the insured and the insurer as well as facilitate prudential supervision of insurance companies, the Standing Committee of the National People's Congress adopted the long-awaited amendments to the Insurance Law on February 28, 2009 with an effective date of October 1, 2009.³⁰ The 2009 amendment includes both a number of new provisions and extensive changes to existing provisions. Compared to the Insurance Law of the PRC in 2002, the newly amended version expands the rights of policyholders while imposing heavier duties on insurance companies.³¹

Significant changes resulting from the 2009 Amendment affected issues related to the insurance contract, the regulation of insurance companies, and the conduct of business. The first category includes articles pertaining to the (1) insurable interest, (2) applicants' duty to disclose misrepresentations, (3) interpretation of the policy, (4) timely notice of increased risks, (5) insurance fraud, and (6) double insurance.³² In terms of the regulations pertaining to insurance companies, the 2009 Amendment created additional licensing criteria for the establishment of a new insurance company as well as processes concerning the approval, fitness, and requirements of directors.³³ With respect to continuous supervision, the 2009 Amendment expands the list of permissible investment objects, but it also authorizes the CIRC to take prompt corrective action against insurance companies when necessary.³⁴

27. Kuan-Chun Chang, *Necessary Reform of Insurance Law in China after its WTO Accession*, 31 No. 1 SYRACUSE J. OF INT'L & COMP. L. 25, 40 (2004).

28. CHONGMIAO & LI, *supra* note 5, at 17, 21.

29. *Id.*

30. Insurance Law of the PRC (2009); *see also* XU & LI, *supra* note 5, at 22–23.

31. CHONGMIAO & LI, *supra* note 5, at 24.

32. Insurance Law of the PRC, arts. 12, 16, 27, 30, 52 (2009). *See also* BROAD & BLIGHT ATTORNEY AT LAW, *THE 2ND AMENDMENT TO CHINA'S INSURANCE LAW*, available at [http://www.broadbright.com/nl/\(No.11\)The%202nd%20Amendment%20to%20China's%20Insurance%20Law.pdf](http://www.broadbright.com/nl/(No.11)The%202nd%20Amendment%20to%20China's%20Insurance%20Law.pdf).

33. CHONGMIAO & LI, *supra* note 5, at 31–33.

34. Insurance Law of the PRC, arts. 106, 139–141 (2009). *See also* YUJING SHU, JOHN M.

Furthermore, Provisions on the Administration of Insurance Companies were deliberated and adopted at CIRC's executive meeting on September 18, 2009 to conform with and implement the newly enacted Insurance Law.³⁵

III. PRIMARY CHANGES TO INSURANCE CONTRACTS IN THE 2009 AMENDMENT

Although the 2009 Amendment retains the structure and organization of the old law in the Insurance Law of 2002 and Insurance Law of 1995, the number of articles has increased from 158 to 187 and several chapters have been renamed.³⁶ The latest legislation retained the eight chapters from the old law that Part II discusses.³⁷ This Part reviews the law as it pertains to insurance contracts.

A. *The Insurable Interest*

1. *The Insurable Interest Requirement*

The Insurance Law of 2002 required an applicant to have an insurable interest in the insured subject matter as the prerequisite for an effective insurance contract.³⁸ Under the old law, therefore, if the applicant holds no insurable interest in the subject matter, the corresponding insurance contract is deemed invalid.³⁹ Given that the old law did not distinguish insurable interest in property insurance from insurable interest in life insurance, Article 12 of the 2009 Amendment specifies that the applicant for "personal insurance" shall have an insurable interest in the insured person when entering into an insurance contract.⁴⁰ The insured person with

SYLVESTER, & IRIS HE, K&L GATES INSURANCE COVERAGE ALERT, NEWLY AMENDED CHINESE INSURANCE LAW, available at [http://www.klgates.com/files/Publication/3f725310-92b8-4066-b90b-04a0241b2a48/Presentation/PublicationAttachment/6c49e082-3a53-429d-899f-0e20e0a68103/12.17.09_Inscov Amended Chinese Insurance Law_Alert.pdf](http://www.klgates.com/files/Publication/3f725310-92b8-4066-b90b-04a0241b2a48/Presentation/PublicationAttachment/6c49e082-3a53-429d-899f-0e20e0a68103/12.17.09_Inscov%20Amended%20Chinese%20Insurance%20Law_Alert.pdf).

35. Press Release, CIRC, The CIRC Amended and Promulgated Provisions on the Administration of Insurance Companies, <http://www.circ.gov.cn/web/site0/tab456/i112034.htm> (last visited Jan. 20, 2010) (on file with Washington University School of Law's *Global Studies Law Review*).

36. DINGFU WU, ZHONGHUA RENMINGONHEGUO BAOXIANFA SHIYI [THE EXPLANATION OF THE INSURANCE LAW OF THE PEOPLE'S REPUBLIC OF CHINA] 399 (2009).

37. Insurance Law of the PRC (2009); see *supra* text accompanying note 30.

38. Insurance Law of the PRC, art. 12(1) (2002) (China), available at <http://www.lawinfochina.com/Law/list.asp>.

39. Insurance Law of the PRC, art. 12(2) (2002).

40. The term "personal insurance" is defined as "[a] type of insurance which takes the life and body of human beings as the subject matter insured." See Insurance Law of the PRC, art. 12(3) (2009).

respect to property insurance shall have an insurable interest in the subject matter insured when the insured event occurs.⁴¹ This change has eliminated confusion created by the old law when “the party paying the premium and the party insured were not one and the same,” only the contractual party who pays the premium is entitled to claim the proceeds.⁴² This argument tells only half of the story, as the original confusion should be traced back to the fundamental question—who should have the insurable interest?

The purpose of property insurance is to reimburse the insured; any net gain in excess of reimbursement to the insured is against public policy.⁴³ This “principle of indemnity” is inseparable from the doctrine of insurable interest.⁴⁴ In property insurance, the level of the insured’s loss determines the amount of payment recoverable under the policy, so that the insured is required to have an insurable interest to prove and calculate his loss.⁴⁵ The old law requiring an applicant to have an insurable interest in the subject matter of the insurance appeared to presume that the applicant bears the loss on occurrence of the insured risk.

According to the Insurance Law of 2002, the “applicant” is a person who signs the insurance contract with the insurer and pays the premiums.⁴⁶ The old law also regarded insurance as the payment of premiums by the applicant to the insurer with the insurer bearing responsibility to indemnify the applicant in case of loss. These two definitions created an illusion that the person who signs the contract and pays the premium shall have a legitimate right to the insurance claim. Under the old law, however, the applicant’s role was similar to that of the “insured” because the applicant’s entitlement to the claim depended on the applicant’s possession of the insurable interest rather than the duty to pay premiums. This insurable interest requirement made it possible for the applicant to suffer the loss without paying premiums. In the 2009 Amendment, the legislators attempted to solve this problem by clarifying the role of the applicant and the insured in property and life insurance respectively and by specifying who shall carry the insurable interest in both types of insurance.

41. Insurance Law of the PRC, art. 12(2) (2009).

42. MONICA DANG, LOCKTON, INC., CHINA’S NEW INSURANCE LAW 1 (2009), available at http://www.lockton.com/Resource_/InsightPublication/976/China%20news_revised2.pdf.

43. ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW 135 (1988).

44. *Id.*

45. JOHN LOWRY & PHILLIP RAWLINGS, INSURANCE LAW: DOCTRINES AND PRINCIPLES 39 (2000).

46. Insurance Law of the PRC, art. 12(1) (2002).

Article 12 of the 2009 Amendment is similar to British and American common law. The insurable interest in property insurance refers to the insured's economic relationship to the property, including at least property rights,⁴⁷ contract rights,⁴⁸ and legal liabilities. The insurable interest in life insurance is founded upon "the relations of parties to each other, either pecuniary or of blood or affinity, to expect some benefit or advantage from the continuance of the life of the assured."⁴⁹

Although the 2009 Amendment's definition of insurable interest in both property and life insurance appeared to supplant the common law definition, more problems are created by Section 5 of Article 12. This section defines "the insured" as a person whose property, life, or body is covered by an insurance contract and who is entitled to claim the insurance proceeds.⁵⁰ One issue with this definition is that the scope of an insurable interest in property insurance is not sufficiently inclusive. "Property" is anything that is owned by a person or entity: (1) real property refers to any interest in land, real estate, growing plants, or the improvements on it; and (2) personal property is everything else.⁵¹

The term "property" in the 2009 Amendment does not cover property rights other than ownership; nor does it mention contractual rights or legal liabilities.⁵² Scholarly writings acknowledge a broader variety of types of insurable interest in property insurance, for example, various contractual rights and legal liabilities, and thereby interpret Article 12 as inclusive.⁵³ Given that courts in China, unlike those in common law countries, carry no law-making function, statutory laws and administrative rules serve as the source of law.⁵⁴ The narrowly defined insurable interest in property insurance leads to the possibility of questioning the legitimacy of using

47. *See, e.g.*, *Brewster v. Michigan Millers Mut. Ins. Co.*, 274 So. 2d 213 (La. Ct. App. 1993) (stating that ownership qualifies an insurable interest).

48. *See, e.g.*, *Reid v. Hardware Mutual Ins. Co.*, 166 S.E.2d 317 (S.C. 1969) (indicating that a mortgagor has an insurable interest on the property insured).

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

50. Insurance Law of the PRC, art. 12 (5) (2009).

51. BLACK'S LAW DICTIONARY 1337 (9th ed. 2009) (defining personal property and real property).

52. Section 5 of Article 12 of the 2009 Amendment provides that "[a]n insured means a person whose property, life or body is covered by an insurance contract and who is entitled to claim the insurance money. An insurance applicant may be an insured." Insurance Law of the PRC, art. 12(5) (2009). Such design of insurable interest also contradicts with Article 50 and 65 of the 2009 Amendment, which provide basis for the sale of carrier insurance and liability insurance. For details, see *id.* arts. 50, 65.

53. *See, e.g.*, Kevin X. Li, Tingzhong Fu, Ling Zhu & Yunlong Lin, *Maritime Insurance Law in China*, 32 TUL. MAR. L.J. 425, 446 (2008) (discussing the various types of property interest).

54. CHONGMIAO & LI, *supra* note 5, at 8–9.

other property interests, contractual rights, or liabilities, although no one has yet done so.

Another issue with the definition of “property” in the 2009 Amendment is that the subject matter of life insurance is unclear. Life insurance is purchased with the intent to protect the interest derived from the continuity of the life of the insured. The insured in life insurance, therefore, functions similarly to the subject matter in property insurance in that the property is the object to which the insurable interest attaches.⁵⁵ Under the 2009 Amendment, for the reason that it is the applicant who is required to hold the insurable interest, it is the applicant who seeks insurance coverage against the loss of the insured’s life. As such, under the 2009 Amendment, it is the applicant who seems to be the person truly covered by the life insurance policy. Also, in theory, “[n]o one expects to suffer pecuniary loss as a result of one’s own death.”⁵⁶ Thus, Section 5 of Article 12 is problematic in two respects: (1) the insured, having no insurable interest, should not be the person “actually” covered under a life insurance policy; and (2) if the death of the insured is the risk covered by a life insurance policy, leaving the lingering question as to when a decedent who sustains no loss by the statutory definition is entitled to insurance proceeds.

In practice, at least in life insurance, the insured cannot and should not be the person to make the claim. Modern life insurance policies endow a policyholder, who could be the applicant, the right to name and change the beneficiary regardless of the identity of the primary beneficiary or the contingent beneficiary.⁵⁷ In the absence of a qualified designated beneficiary, the estate of the insured receives the proceeds.⁵⁸ Although Articles 40 to 42 of the Insurance Law of 2009 explain that the applicant or the insured has the right to designate the beneficiary and the entitlement of the insured’s heirs to the insurance proceeds, there is undoubted conflict between Article 12 and these two articles.⁵⁹

The Japanese Insurance Law, however, defines “insured” under different circumstances. In indemnity insurance, the insured refers to the person whose loss will be indemnified under the contract.⁶⁰ In life

55. KEETON & WIDISS, *supra* note 43, at 296.

56. ROBERT JERRY II, UNDERSTANDING INSURANCE LAW § 43 (2d ed. 1996).

57. *Id.* at 284.

58. *Id.*

59. *See* Insurance Law of the PRC, art. 40 (2009) (“The insured or insurance applicant may designate one or more beneficiaries . . .”); *see also id.* art. 42 (2009) (“After the death of the insured, under any of the following circumstances, the insurance money shall be deemed as the legacy of the insured, and the insurer shall perform the obligation of paying insurance money according to the Inheritance Law of the People’s Republic of China.”).

60. *See* Japan Insurance Law (2008).

insurance, the insured is the person whose death triggers the insured's duty to pay proceeds.⁶¹ In health insurance, the insured is the person whose illness obligates the insurer to compensate his medical expenses.⁶² The Japanese commentators' unanimous agreement that the existence of the insurable interest is to identify and measure losses, supports the notion that the insured is the holder of the insurable interest under a property or liability insurance policy.⁶³ The Japanese law also clearly addresses the status of the insured under life or health insurance policies.⁶⁴ Such legislation provides a possible solution for eliminating the present Article 12 confusion in the PRC's 2009 Amendment.

2. *The Time When an Insurable Interest Must Exist*

While the old law was not explicit on this matter, the 2009 Amendment stipulates the timing of when an insurable interest must exist. In property insurance, the insured must have an insurable interest at the time of loss, while in life insurance, the applicant should have an insurable interest at the time of the contract formation.⁶⁵

The language added in the 2009 Amendment is consistent with the majority opinion in common law courts, such as the American courts. The opinions from the majority of the American courts hold that insurance on property is valid when an insurable interest in the property exists at the time of the loss. The rationale is that if the loss only occurs to the insured with an insurable interest in the damaged property, then no loss can exist when the property lacks the prerequisite insurable interest at the time of loss.⁶⁶ An incentive for the property's destruction is also less likely to exist

61. *Id.*

62. Japan Insurance Law, art. 2(4) (2008).

63. KUNEO FUKUDA & EKO FURUTEKI, KASEI BAKENHOU [Amended Insurance Law] 20 (2009); TOMONOHU YAMASHITA ET AL., BAKENHOU [Insurance Law] 83 (3d ed. 2010).

64. *See* Japan Insurance Law (2008).

65. Insurance Law of the PRC, art. 12(1)-(2) (2009).

66. *E.g.*, Dairyland Ins. Co. v. Hawkins, 292 F. Supp. 947, 951 (S.D. Iowa 1968) (finding insurers could not deny coverage on grounds that insured, who was listed as owner, had no insurable interest because, even though the insured's son-in-law possessed the car and the insured intended to transfer ownership to son-in-law when insured received payment, a bona fide sale had not occurred at time of loss); Ins. Co. of N. Am. v. Seaboard Homes, Inc., 273 N.Y.S.2d 470, 472 (N.Y. Sup. Ct. 1965) ("[W]here builder agreed with lessor that title to building which builder had constructed on lessor's land would vest in lessor if building was not removed by certain date and building was not removed by such date, title to property was in lessor and builder had no 'insurable interest' in house when house was destroyed by fire after agreed date for removal."); Stauder v. Associated Gen. Fire Ins. Co., 151 N.E.2d 583, 585 (Ohio Ct. App. 1957) ("[A] father of minor children charged by court order with payment of money for their support subject to the further order of the court had an 'insurable interest' in the children's clothing as well as the furniture and household goods used by his

if the person has an insurable interest at the time of loss.⁶⁷ For life insurance, however, the general rule for most American courts declares that an insurable interest for all types of life insurance must exist only at the time the life insurance contract was formed, and the lack of any insurable interest at the time of the insured's death is irrelevant and immaterial in the absence of a contrary contractual provision or state statute.⁶⁸ This American common law rule also takes into consideration the possibility of the termination of the insurable interest in life insurance based either on the dissolution of the pecuniary interest, such as partnership, or family relationship, such as marriage.⁶⁹

Although the 2009 Amendment follows the majority rule of common law courts, neither section regarding the timing of the existence of the insurable interest is flawless. With respect to property insurance, the insurance interest must exist at the time of loss, but common law courts have never reached a consensus on whether the insurable interest must exist at the time of contract formation. Indeed, numerous cases, including the historic English case *Sadlers Co. v. Badcock*,⁷⁰ have held that the insured must have an insurable interest in property both at the time of contract formation and at the time of loss. Some argue against the ruling in *Sadlers Co.*:

[I]n most cases where the *Sadlers Co.* rule is applied, an insurable interest either exists both at the time of insuring and the time of loss, or at neither time. Thus, the confusion about the rule normally makes no practical difference in outcomes. In those cases where the rule matters, most courts have examined the rule carefully and decided only to require an insurable interest at the time of loss.⁷¹

divorced wife in the care, custody and control of the children so as to be entitled to maintain an action on a fire policy for the loss.”).

67. JERRY, *supra* note 56, at 255.

68. See, e.g., *Conn. Mut. Life Ins. Co. v. Shaefer*, 94 U.S. 457, 461 (1876) (“[A] life insurance policy taken out in good faith and valid at its inception, is not avoided by the cessation of the insurable interest, unless such be the necessary effect of the provisions of the policy itself.”); *Speroni v. Speroni*, 92 N.E.2d 63, 66 (Ill. 1950) (“Where the insurer recognizes the policy as valid and pays into court the proceeds thereof, a third person, such as the personal representative of the insured, cannot take advantage of the want of insurable interest.”); *Secor v. Pioneer Foundry Co.*, 173 N.W.2d 780, 782 (Mich. Ct. App. 1969) (“Public policy against speculation on life of another did not prohibit husband’s former employer, which had been applicant for, and owner and beneficiary of, ordinary life policy on husband, and which had paid premiums on such policy, from retaining insurance on husband after termination of employment or beyond date that first premium became due after such termination.”).

69. JERRY, *supra* note 56, at 256.

70. *Sadlers Co. v. Badcock*, 2 Atk. 544, 26 ER 733 (1743).

71. JERRY, *supra* note 56, at 255.

The rationale is that the requirement of an insurable interest in property insurance provides disincentives to using insurance as a method of wagering, specifically, incurring losses in the expectation of an insurance recovery.⁷² It makes more sense, however, for the court to deny recovery to someone who has taken out a policy without interest or expectation of interest as well as those who subsequently obtained an interest for the purpose of wagering.⁷³ The majority rule fails to counter the danger generated by gambling and provides no additional protection for legitimate interests.⁷⁴

In addition, the premium is recognized as an insurer's consideration for assuming the insured's risk in exchange for the insurer's obligation to pay proceeds.⁷⁵ Typically, policyholders must pay premiums before coverage begins.⁷⁶ The consideration may fail, however, if the insurer assumes no risk at the time premiums are paid because, even though the insurer promises to insure against the risk of loss, the insured risk does not exist until the insured actually obtains the insurable interest. Thus, during the period that the insured holds no insurable interest in the property, the insurer does not seem to have legitimate grounds to retain the premium because its promise is contingent upon the insured's acquisition of an insurable interest, which may not happen during the effective period of the contract.⁷⁷ Given that the insurable interest is an essential element for the valuable consideration of an insured's payment of premium, requiring its existence only at the time of loss materially therefore conflicts with the general principle of contract law.

As for life insurance, advocates of the majority rule present four primary arguments. First, substantial amounts of life insurance have been marketed as investment contracts rather than as contracts of indemnity. The majority rule requiring an insurable interest for life insurance only at the formation of the contract facilitates the liquidity of such investments.⁷⁸ Second, "there apparently was, and perhaps continues to be, a strong sense of protecting the integrity of the life insurance transaction in terms of both preserving the contractual freedom of the parties and assuring the stability

72. MALCOLM CLARKE, POLICIES AND PERCEPTIONS OF INSURANCE LAW IN THE TWENTY-FIRST CENTURY 36 (2007); KEETON & WIDISS, *supra* note 43, at 136.

73. KEETON & WIDISS, *supra* note 43, at 155 (quoting EDWIN PATTERSON, ESSENTIALS OF INSURANCE LAW 133 (Ralph H. Blanchard ed., 2d ed. 1957)).

74. *Id.*

75. AVERY W. KATZ, FOUNDATIONS OF THE ECONOMIC APPROACH TO LAW 210 (1998). *See also* JERRY, *supra* note 56, at 16.

76. CLARKE, *supra* note 72, at 132; JERRY, *supra* note 56, at 510.

77. CLARKE, *supra* note 72, at 133.

78. KEETON & WIDISS, *supra* note 43, at 152.

of the contractual commitment.”⁷⁹ Third, life insurance is often purchased for the benefit of relatives and spouses. Some familial relationships, such as those between parents and children, do not change with the passage of time.⁸⁰ Even though the spousal relationship may terminate in divorce, a pecuniary relationship usually survives the dissolution of the marriage. This pecuniary relationship is sufficient to satisfy the insurable interest requirement.⁸¹ Fourth, insurers continue to pay the full amount of the policy even when the interest had extinguished.⁸² “In short, life insurance ‘[c]ustom conquered the law,’ and the underlying reason for not requiring an insurable interest at the time of the insured’s death was actually founded on a life insurance marketing scheme.”⁸³

Several responses to these arguments have been presented by commentators who assert that an insurable interest in the life of another must exist both at the inception of the life insurance contract and at the time of the insured’s death. First, various forms of life insurance, including partnership life insurance policies, key employee life insurance policies, creditor-debtor life insurance policies, and other business-related life insurance policies, also possess important indemnity aspects.⁸⁴ Second, “a court generally does have the right, and the obligation, to review an insurance contract to determine whether or not such a contract is unconscionable or violates state public policy, including whether or not it constitutes an illegal wagering contract.”⁸⁵ Third, “an absolute divorce generally terminates this love and affection insurable interest between ex-spouses absent other valid economic interests such as spousal support and child support obligations.”⁸⁶ In this case, the moral hazard significantly increases as the ex-spouse, who is the primary beneficiary in a pre-existing life insurance policy, may murder a former spouse in order to recover the insurance proceeds.⁸⁷ This rationale, however, is an apparent wagering contract issue.⁸⁸

79. *Id.*

80. *Id.* at 151.

81. JERRY, *supra* note 56, at 256.

82. Peter N. Swisher, *Insurance Law Annual: Article: The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 DRAKE L. REV. 477, 526 (2005) (quoting PATTERSON, *supra* note 73, at 163).

83. *Id.*

84. *Id.* at 525.

85. *Id.* at 526.

86. *Id.* at 524–25.

87. *Id.* at 525.

88. *Id.*

Indeed, where life insurance involves the function of indemnity, the insured can only be “put back to the position he or she would have been in had the loss not occurred. . . .”⁸⁹ Since the insurable interest in indemnity insurance determines whether the insured has the expectation of loss,⁹⁰ it is required to exist at the time of loss, and, in the present case, at the death of the insured.

Insurance with no indemnity function, however, raises unique issues. Studies have revealed that being insured against the risk of being considered high risk reduces the incentive to exert preventive efforts to decrease the probability of greater risk.⁹¹ Similarly, a wagering contract is unquestionably riskier than a contract with an insurable interest, which discourages the use of insurance as a device of wagering and removes the incentive for the procurer of the insurance to destroy the insured person or property.⁹² Allowing an insurance policy’s effect to continue after the extinction of the insurable interest is inconsistent with the doctrine of insurable interests. In addition, insurance of any type functions as financing risk through the application of the law of large numbers to achieve the goal of risk distribution.⁹³ Arguments that emphasize investment through life insurance while ignoring the basic risk distribution function of insurance are confusing and may ultimately prove unsound.

Both German and Japanese legislators endorsed the principle that the insurable interest must exist through the entire duration of the insurance contract. Article 80 of the German Insurance Contract Act provides that “[t]he policyholder shall not be obligated to pay the insurance premium if no insured interest exists when the insurance cover[age] commences.”⁹⁴ “If the insured interest ceases to exist once the insurance cover[age] commences, the insurer shall be entitled to the premium to which he would have been entitled if the insurance had only been applied up until the time when the insurer learned of the cessation of the interest.”⁹⁵ “If the policyholder has insured a non-existent interest with the intention of thereby gaining an illegal pecuniary benefit, the contract shall be void; the insurer shall be entitled to the premium paid up until the time when he

89. LOWRY & RAWLINGS, *supra* note 45, at 179.

90. CLARKE, *supra* note 72, at 32.

91. Renaud Bourles, *Moral Hazard in Dynamic Insurance, Classification and Prepayment 2*, INSTITUT D’ECONOMIE PUBLIQUE (Mar. 12, 2009), <http://www.idep-fr.org/IMG/pdf/Bourles.pdf>.

92. JERRY, *supra* note 56, at 236.

93. EMMETT J. VAUGHAN & THERSE VAUGHAN, *FUNDAMENTALS OF RISK AND INSURANCE* 39 (9th ed. 2003).

94. VVG, *supra* note 7, § 80(1) (2008).

95. *Id.* § 80(2).

learns of the circumstances establishing the nullity.”⁹⁶ With respect to Japan, the insurable interest is required both at the time of the contract formation and the occurrence of the insured event.⁹⁷

Unless the moral hazard prevention mechanism is inlaid in the Chinese Insurance Law, the *Sadlers Co.* rule and similar rules applied by German and Japanese law appear to better facilitate the function of the insurable interest.

B. The Duty of Disclosure

Article 16 of the 2009 Amendment governs an insured’s duty of disclosure and introduced several significant changes to the old law: (1) the scope of the duty, (2) elements of breach of the duty, (3) the incontestability provision, and (4) the return of premium after the rescission of contract.⁹⁸

1. The Scope of the Duty of Disclosure

With regard to the scope of the insured’s duty to disclose, the old law provided that the insurer may raise inquiries on matters concerning the insured or the subject matter of insurance, and the insured was obliged to make true representations.⁹⁹ The 2009 Amendment, however, limited the scope of the insured’s duty: “where the insurer makes any inquiry about the subject matter or about the insured when entering into an insurance contract, the insurance applicant shall tell the truth.”¹⁰⁰ The 2009 Amendment unequivocally confines the insured’s duty of making true representations to the inquiries posed by the insurer. Moreover, the insured bores the duty only until the formation of the contract.¹⁰¹

The Insurance Law after the 2009 Amendment, imposing only the duty of true representation per the insurer’s questions, omits the insured’s duty to disclose facts material to the determination of the insurability and the risk. British and American common law, however, distinguish the terms “non-disclosure” and “misrepresentation.” While non-disclosure usually refers to a situation “where no answer has been volunteered to the insurer because no specific question was asked,” misrepresentation “describe[s]

96. VVG, *supra* note 7, § 80(3) (2008).

97. YAMASHITA ET AL., *supra* note 63, at 105–06.

98. WU, *supra* note 36, at 402–03.

99. Insurance Law of the PRC, art. 17(1) (2002).

100. Insurance Law of the PRC, art. 16(1) (2009).

101. WU, *supra* note 36, at 44.

situations where the wrong or misleading answer has been given to questions posed of the applicant for insurance.”¹⁰²

The purpose of the duty of disclosure, based on the implied duty of utmost good faith, is to assist the insurer in its risk assessment. Considering its underlying purpose, the duty of disclosure should continue throughout the negotiation and at least until the contract has been completed.¹⁰³

Holding both non-disclosure and misrepresentations as violations of the duty of good faith increases the clarity of British and American common law in hopes to accomplish the underlying purpose of the duty. Under British and American common law, the duty of disclosure applies to negotiations preceding the conclusion of the contract, and full disclosure of any material fact affecting the risk in question should be made up to the time when a binding contract is concluded.¹⁰⁴ Thus, an insured is required “to advise the insurer of such matters that he knows might influence the insurer in accepting or declining the risk, at least where such facts are not a matter of record and not discoverable by the insurer.”¹⁰⁵ Beyond making a true representation in an application, the insured must maintain his truthfulness until the delivery of the policy, and he must therefore use due diligence to communicate to the insurer facts materially affecting the risks that arise after the application has been made but before the contract is formed.¹⁰⁶ Otherwise, the insurer is likely to bear the increased risk during the underwriting period.

German law addresses the duty of disclosure somewhat similarly. German law provides that if, between receipt of the policyholder’s application and acceptance of the contract, the insurer asks such questions relevant to the insurer’s decision to conclude the contract, the policyholder shall also fulfill the duty of disclosure as it applies to these questions.¹⁰⁷

The 2009 Amendment, which lightened an insured’s duty of disclosure, may result in difficulty classifying risk, ultimately leading to adverse selection.¹⁰⁸ It also creates the possibility that an applicant might conceal or misrepresent material risks at the time of application and contend that

102. RAY HODGIN, *INSURANCE LAW* 173 (1998).

103. SEMIN PARK, *THE DUTY OF DISCLOSURE IN INSURANCE CONTRACT LAW* 59 (1996).

104. *Id.*

105. *Id.*

106. *E.g.*, *United Sav. Life Ins. Co. v. Coulson*, 560 S.W. 2d 211, 215 (Tex. Civ. App. 1977); *MacKenzie v. Prudential Ins. Co. of Am.* 411 F.2d 781 (6th Cir. 1969).

107. VVG, § 19(1) (2008).

108. For details, see SCOTT E. HARRINGTON & GREGORY R. NIEHAUS, *RISK MANAGEMENT AND INSURANCE* 115–19 (1999).

such risks arose only after the application. Such a scenario is inconsistent with the principle of utmost good faith.¹⁰⁹

The principle of utmost good faith is intended to correct a lack of equity in knowledge and sources of information available between the parties.¹¹⁰ Therefore, the duty of disclosure should remain intact for both parties until the contract is agreed upon to put the insurer on an equitable footing with the insured.¹¹¹

2. *Elements of the Breach of the Duty of Disclosure*

The old law was clear on the elements of the breach of the duty of disclosure. The old law noted three situations that constituted breach: (1) the insured intentionally concealing facts, (2) the insured refusing to perform the duty of true representations, or (3) the insured failing to fulfill the duty of true representations due to negligence.¹¹² Additionally, the Insurance Law of 2002 specified that a breach could only be sustained where the violation was sufficient to affect the insurer's decision to provide insurance or increase the premium.¹¹³

Although the 2009 Amendment retains most parts of this section, it further restricts breaches to those in which the insured failed to make true representations "intentionally or [through] gross negligence."¹¹⁴ It also explicitly restricts the insurer's right to rescind the contract when the insurer is aware of the truth of the insured's misrepresentation.¹¹⁵

Compared to the 2009 Amendment, except for the similarity in defining materiality, the U.S. does not regard the insured's intention as irrelevant in sustaining the misrepresentation.¹¹⁶ In the U.S., three

109. The rationale of the application of the doctrine of utmost good faith is that [i]nsurance is a contract of speculation. The special facts upon which the contingent chance is to be computed lie most commonly in the knowledge of the assured only; the underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge to mislead the underwriter into a belief that the circumstance does not exist. . . . Good faith forbids either party, by concealing what he privately knows, to draw the other into a bargain from his ignorance of the fact, and his believing the contrary.

LAWRY & RAWLINGS, *supra* note 45, at 73–74 (quoting *Carter v. Boehm*, (1766) 3 Burr 1905, 1909).

110. *Id.*

111. PETER M. EGGERS & PATRICK FOSS, *GOOD FAITH AND INSURANCE CONTRACTS* 43, 45–46 (1998) (citing *Looker v. Law Union and Rock Ins. Co.*, [1928] 1 K.B. 554, 559–60 (per Acton, J.)).

112. Insurance Law of the PRC, art. 17(2) (2002).

113. *Id.*

114. Insurance Law of the PRC, art. 16(2) (2009).

115. *Id.* art. 16(6).

116. *Clafin v. Commonwealth Ins. Co.*, 110 U.S. 81, 83 (1884) ("All fraud or [attempt at fraud by] false swearing shall cause a forfeiture of all claims on the insurers, and shall be a full bar to all remedies against the insurer on the policy.").

conditions must be met to constitute misrepresentation: (1) the representation is untrue, (2) the information is material either to the insurer's decision to insure or to the terms of the insurance contract, and (3) the insurer actually relies on the incorrect information.¹¹⁷ To reduce the insured's burden of disclosure, the 2009 Amendment excludes the untrue statement made due to negligence from the scope of "misrepresentation" regardless of the materiality of the statement to the risk assessment.¹¹⁸ Such an arrangement is not entirely without grounds. In the U.S., a few courts have ruled that an applicant for insurance cannot willfully intend to deceive a potential insurer unless the applicant has actual knowledge that the misrepresentation is untrue; proving constructive knowledge will not suffice in such courts.¹¹⁹

Most courts, however, still approve insurers' defense to coverage if the misrepresentation is material, regardless of the intention of the insured or the applicant.¹²⁰ The objective of the duty of disclosure is to ensure the accuracy of a prudent insurer's decision in computing the risk to be undertaken, so information pertaining to a proposed risk must be disclosed by an insured to allow an insurer to assess the risk properly.¹²¹ Therefore,

117. *See, e.g.*, Crawford v. Standard Ins. Co., 621 P.2d 583, 586 (Or. App. 1980) ("An insurer may show it approved the policy in the ordinary course of business which, when coupled with proof that the application contains false representations but for which the insurer would not have issued the policy and the insurer's legal right to rely on the application information, is sufficient to make out prima facie the element of reasonable reliance."); *see also* JERRY, *supra* note 56, at 682–88.

118. WU, *supra* note 36, at 45. Article 16 of the 2009 amendment provides that "Where the insurance applicant fails to perform the obligation of truthful representation . . . intentionally or for gross negligence . . . the insurer shall have the right to rescind the insurance contract." Insurance Law of the PRC, art. 16 (2009). Accordingly, first, the violation of the obligation of "truthful representation" includes both the non-disclosure and misrepresentation; second, only "intentional" and "gross negligence" are elements of constituting misrepresentation. *See id.* General negligence was excluded.

119. *See, e.g.*, Parsaie v. United Olympic Life Ins. Co., 29 F.3d 219, 221 (5th Cir. 1994) ("[A] cause of action for breach of the duty of good faith and fair dealing exists when the insurer wrongfully cancels an insurance policy without a reasonable basis." (quoting Union Bankers Ins. Co. v. Shelton, 889 S.W.2d 278, 283 (Tex. 1994))); Kuhns v. N.Y. Life Ins. Co. 147 A. 76, 77 (Pa. 1929) ("[A] forfeiture [of an insurance contract] does not follow where there has been no deliberate intent to deceive, and the known falsity of the answer is not affirmatively shown."); KEETON & WIDISS, *supra* note 43, at 573.

120. *See, e.g.*, Bankers Life & Cas. Co. v. Long, 266 So. 2d 780, 783 (Ala. Civ. App. 1972) ("Insurance companies are entitled to candid and truthful answers, and when such candor is withheld and involves matters material to the risk, no just complaint can be raised, when, in after investigations, the falsity is discovered and the policies issued in reliance upon the truthfulness of the statements, are avoided."); Elfstrom v. N.Y. Life. Ins. Co., 432 P.2d 731, 739 (Cal. 1967) (en banc) (finding that an insurer of a group insurance, despite the knowledge of the employer, may avoid a policy where the employee misrepresents material facts in the application to the employer acting as the agent of the insurer).

121. POH CHU CHAI, GENERAL INSURANCE LAW 68 (2009).

so long as the information is sufficient to affect the insurer's decision on the applicant's insurability, risk classification, and the premium associated with the level of risk, the falsity of such information will result in adverse selection and subsidization. Such subsidization may ultimately discourage ordinary people from using insurance as a tool of risk management.¹²² Whether the misrepresentation is intentional makes no difference. As far as insurance contracts are concerned, most courts hold that "the making of any material misrepresentation, whether innocent or not, violates the utmost good faith and constitutes a breach of duty at law."¹²³

If the central philosophy of the 2009 Amendment on the insured's duty of disclosure is to mitigate the insured's responsibility in misrepresentation, it makes sense that the 2009 Amendment includes a section regarding the insurer's waiver of the right to rescind the contract. For the insurer to avoid the coverage, U.S. courts require the insurer to prove that its reliance was reasonable.¹²⁴ Where an insurer investigates and learns the truth of the facts submitted before issuing the policy, there will obviously be no reliance on the original information in issuing the policy.¹²⁵ Oftentimes, insurers may urge the applicant to submit to medical examination by a physician designated by the insurer. The medical examination permits the insured to identify health conditions inconsistent with the insured's disclosure before approval of the application.¹²⁶ The addition of the "reliance" element eliminates the possibility of an insurer relying on the misrepresentation if he knows the truth of the misrepresented statement.¹²⁷ The 2009 Amendment includes the equivalent of the admirable reliance element in Section 6 of Article 16. The German Insurance Contract Act and the Japanese Insurance Law also carry similar provisions.¹²⁸

122. HARRINGTON & NIEHAUS, *supra* note 108, at 118.

123. EGGERS & FOSS, *supra* note 111, § 4.28.

124. *See, e.g.*, State Farm Mut. Auto. Ins. Co. v. Price, 396 N.E.2d 134, 137 (Ind. Ct. App. 1979) ("[Insurer] had no notice that the information obtained from [the insured] was false; therefore it was entitled to rely on this information in issuing its policy and had no duty to investigate the truthfulness of the application. Only where the insurer has sufficient information to give rise to a reason to doubt the representations made is there an obligation to investigate or make further inquiry.").

125. JERRY, *supra* note 56, at 689.

126. JOHN F. DOBBYN, INSURANCE LAW 196-96 (3d ed. 1996).

127. *Id.*

128. *See* VVG, § 19(4) (2008) ("The insurer's right to withdraw from the contract on account of grossly negligent breach of the duty of disclosure and his right to terminate the contract . . . shall be ruled out if he would also have concluded the contract in the knowledge of the facts which were not disclosed, albeit with other conditions."); Japan Insurance Law, arts. 28(II), 59(II), 84(II) ("Where the insurer is aware of the undisclosed or misrepresented facts or unaware due to its negligence, the insurer forfeits its right of contract rescission.").

3. *The Incontestability Provision*

The third change the 2009 Amendment made to the duty of disclosure was the addition of the incontestability provision. The new Section 3 of Article 16 provides that the insurer's right to rescind the contract upon an insured's misrepresentation shall be cancelled at the first of (1) at least thirty days from the day when the insurer knows the cause of rescission, or (2) at least two years from the date of contract formation.¹²⁹ The United States acknowledges the incontestability clause:

[The incontestability clause gives] the insurance company . . . an adequate window of time in which to investigate an application for life insurance so as to discover any material misrepresentation on the part of the applicant. Second, it protects the insured from having to defend against a possibly specious challenge long after acquisition of the policy. Thus, by requiring prompt investigation of statements made in an insurance application, the clause furthers the public policy of denying protection to those who make fraudulent claims. The "during the lifetime" wording is part of that public policy. If the insured dies of a serious illness a short time after obtaining a life insurance policy, the insurance company should be permitted to investigate in contemplation of a challenge.¹³⁰

The 2009 Amendment prevents the insurer from lulling the insured into a false sense of security for the purpose of receiving premiums and postponing the issue, possibly until after the death of the insured.

4. *Return of Premiums After Contract Rescission*

Both the 2009 Amendment and the Insurance Law of 2002 endowed the insurer with the right to rescind the contract when the applicant makes an untrue misrepresentation, either intentionally or as a result of gross negligence.¹³¹ Sections 3 and 4 of Article 16 of the 2009 Amendment set out the insurer's right to retain insurance premiums after rescission. The new law mandates that the insurer shall not refund the insurance premiums where the insurance applicant intentionally failed to make true

129. Insurance Law of the PRC, art. 16(3) (2009).

130. *Crow v. Capitol Bankers Life Ins. Co.*, 891 P.2d 1206, 1212 (N.M. 1995) (citing *Maxwell v. Cumberland Life Ins. Co.*, 748 P.2d 392, 395 (Idaho 1987)).

131. Insurance Law of the PRC, art. 16 (2009); Insurance Law of the PRC, art. 17 (2002). *See also* WU, *supra* note 36, at 402–03 (2009).

representations, but the insurer shall refund the insurance premiums where the applicant violated his obligation due to gross negligence.¹³²

As for the rationale of not returning the premiums, commentators in China explain that the purpose of withholding the refund is to punish the dishonest applicant, similar to punitive damages.¹³³ This argument is unpersuasive for several reasons.

First, punitive damages are “money damages awarded to a plaintiff in a private civil action, in addition to and apart from compensatory damages, assessed against a defendant guilty of flagrantly violating the plaintiff’s rights.”¹³⁴ They are commonly awarded in tort litigation, particularly corporate litigation such as product liability litigation or antitrust litigation.¹³⁵ In practice, punitive damages are “quasi-criminal”¹³⁶ and are remedies common in statutes regulating enterprises because imprisonment of corporations is impossible.¹³⁷ The rationale for punitive damages is less applicable to non-corporate defendants. Thus, it is a false analogy to argue that a “confiscated premium” is a punitive damage resulting from the insured’s misrepresentation to an insurer’s single inquiry.

Second, the rationalization that intentional misrepresentations adversely impact the insurer’s risk assessment applies to unintentional misrepresentations as well. If the insured’s misrepresentation of material facts, either intentionally or through gross negligence, has an equally adverse impact on the insurer’s risk assessment, then what is the rationale

132. Insurance Law of the PRC, arts. 16(3)–(4) (2009).

133. CHONGMIAO & LI, *supra* note 5, at 103.

134. David G. Owen, *Punitive Damages Overview: Functions, Problems and Reform*, 39 VILL. L. REV. 363, 364 (1994).

135. *Id.* at 371.

136. *Id.* at 365.

137. The Restrictive Rule manifested in Section 909 of the Second Restatement of Torts provides bases for courts to award punitive damages against corporations. See Christopher R. Green, *Punishing Corporations: The Food-Chain Schizophrenia in Punitive Damages and Criminal Law*, 87 NEB. L. REV. 197, 205–08 (2008). The Restatement states

[p]unitive damages can properly be awarded against a master or other principal because of an act by an agent if, but only if, (a) the principal or the managerial agent authorized the doing and the manner of the act, or (b) the agent was unfit and the principal or managerial agent was reckless in employing him, or (c) the agent was employed in a managerial capacity and was acting in the scope of employment, or (d) [the employer or a manager of the employer] ratified or approved the act.

RESTATEMENT (SECOND) OF TORTS § 909 (1979). In an analysis of the twenty-four jurisdictions that have adopted verbatim or variations of the law in Section 909, Professor Christopher Green argued that “[t]here is no good reason for criminal law and punitive damages to punish corporations using different rules Courts assessing either corporate criminal liability or the assessment of punitive damages against a corporation would be well-served to consider both fields at once.” Chris Green, *Punishing Corporations: The Food-Chain Schizophrenia in Punitive Damages and Criminal Law*, 87 NEB. L. REV. 197, 206–08, 269 (2008).

for permitting the refund under the gross-negligence circumstance?¹³⁸ The argument praising this provision has failed to answer this question.¹³⁹

Third, denying refunds of premiums ignores the dual character of savings and insurance in life insurance policies. Under a whole life insurance policy, a large portion of the premium payments in the early years are accumulated as savings of the policyholder.¹⁴⁰ Where the policyholder surrenders the policy, he is entitled to receive most of his prepayments back in the form of the policy's cash surrender value.¹⁴¹ Since Section 3 of Article 16 of the 2009 Amendment does not rule out its application to life insurance, it is unjustifiable to allow the insurer to seize the policyholder's savings because such seizure is inconsistent with how life insurance operates.

Likewise, under traditional contract principles, “[a]n insured is basically entitled to a return of premium where there has been a total failure of consideration”¹⁴² The common law rule required a refund of the insurance premium in the event of prospective cancellation and of the entire policy in the event of rescission.¹⁴³ As rescinding a contract renders a contract void,¹⁴⁴ the insurer would assume no insured risk and obligation for paying the proceeds as if the contract was never formed. Pursuant to the “no risk no premium” principle, the insurer suffers no detriment for retaining the premiums¹⁴⁵ and the consideration, therefore, fails. In particular, rescission is retroactive and puts parties in status quo ante and restores things so that the insurer is not liable for claims incurred between the formation of the contract and the moment of avoidance and, therefore,

138. Compare Insurance Law of the PRC, art. 16(3) (2009) (permitting the insurance company to retain the premiums if the insured intentionally fails to perform her obligation of telling the truth), with Insurance Law of the PRC, art. 16(4) (2009) (requiring the insurance company to refund the premiums if the applicant fails to perform her obligation of telling the truth due to gross negligence).

139. See generally CHONGMIAO & LI, *supra* note 5, at 103–05; JIANG AN, ZHONGHUA RENMINGONGHEGUO BAOXIANFA SHIYI [Explanation of Insurance Law of the PRC] 44 (2009) (providing no analysis as to the different refund policies for intentional misrepresentations and grossly negligent misrepresentations).

140. HARRINGTON & NIEHAUS, *supra* note 108, at 598.

141. *Id.*

142. JOHN BIRDS, MODERN INSURANCE LAW 179 (7th ed. 2007) (citing *Tyrie v. Fletcher*, (1777) 2 Cowp. 666).

143. See, e.g., *Dairyland Ins. Co. v. Kammerer*, 327 N.W.2d 618, 620–21 (Neb. 1982) (“Insurer is precluded from asserting a forfeiture where, after acquiring knowledge of the facts constituting a breach of condition, it has retained the unearned portion of the premium or has failed to return or tender it back with reasonable promptness, especially where the nature of the breach or ground for forfeiture is of such character as to render the policy void from its inception . . .”).

144. BLACK’S LAW DICTIONARY 1420 (9th ed. 2009) (defining “rescind” as “1. To abrogate or cancel (a contract) unilaterally or by agreement.”).

145. MALCOLM A. CLARKE, THE LAW OF INSURANCE CONTRACTS 314 (2d ed. 1994).

must return the premium.¹⁴⁶ Such rule was effectuated in the British Marine Insurance Act of 1906, which provides that “[w]here the consideration for the payment of the premium totally fails, and there has been no fraud or illegality on the part of the assured or his agents, the premium is thereupon returnable to the assured.”¹⁴⁷ The permission for the insurer to “confiscate” the premiums after the rescission of the contract in the 2009 Amendment violates the general rule of contract law.

C. *The Interpretation of Contract*

1. *Interpretation in Favor of the Insured*

Article 31 of the Insurance Law of 2002 provided that disputes as to the meaning of terms or clauses should be construed in favor of the insured and beneficiary.¹⁴⁸ Although Article 31 appears to conform to the principles of the ambiguity doctrine in spirit, the legislation proves problematic.¹⁴⁹ Article 31, sweeping in scope, grants a uniformly favorable interpretation to insured persons or beneficiaries without recognizing that ambiguity exists. As a result, a clause or term is automatically construed against the insurer in situations where no ambiguity exists. Certainly, Article 31 is to the advantage of the insured or the beneficiary. Where the insured or beneficiary is obviously in the wrong, however, application of this law appears unfair to the insurer while granting a windfall to the insured. Having noticed such a loophole, legislators drafting the 2009 Amendment attempted to seal it by imposing the conditions under which it could be applied to ambiguous terms. Article 30 of the new law states that in disputes over any clause of an insurance contract using the insurer’s standard clauses, the clause shall be interpreted as its commonly understood meaning.¹⁵⁰ Similar to the old law, however, the new law further states that where two parties attach different interpretations to a

146. *Id.* at 609–10.

147. Marine Insurance Act, 1906 6 Edw., c. 41 § 84, sched. 1.

148. Insurance Law of the PRC, art. 31 (2002).

149. When a contract is deemed “adhesive,” courts are more active in policing the bargain to counterbalance the potential detriment to the weaker parties so that all ambiguities should be construed against the insurer. Insurers who tailor sophisticated wordings in the policy must bear the burden of any resulting confusion. *See Gaunt v. John Hancock Mut. Life Ins. Co.*, 160 F.2d 599, 602 (2d Cir. 1947); *see also KEETON & WIDISS*, *supra* note 43, at 628; *BIRDS*, *supra* note 142, at 228 (citing *English v. Western*, [1940] 2 K.B. 156).

150. Insurance Law of the PRC, art. 30(1) (2009). *Zhengyi*, the Chinese term for ambiguity, does not explicitly appear in the law, however, the description in the law is clearly the definition of ambiguity. *See id.*

clause, it should be interpreted in favor of the insured and the beneficiary.¹⁵¹

Although the 2009 Amendment balanced some inequities, it did not cure all of the issues in the old law. Both limiting the application of the ambiguity rule to the standardized policy form, like adhesion contracts, and stating how to interpret ambiguous terms by providing a literal description undoubtedly made the interpretation rule in the Insurance Law of 2009 more reasonable and consistent with the international standards.¹⁵² The 2009 Amendment, however, fails to address the insured's reasonable expectation.

The reasonable expectation doctrine is multi-functional and can serve to increase predictable interpretations in insurance contracts. In some cases, the reasonable expectation doctrine applies when an ambiguity exists.¹⁵³ The doctrine also functions as a rule of interpretation where the principle of resolving ambiguities in a contract against the drafter is not an adequate explanation for the coverage issues in which no ambiguity exists.¹⁵⁴ Insurance contracts should provide the coverage that either the insured reasonably believed she purchased or that a reasonable person in the place of the insured would expect after reading the policy.¹⁵⁵ Once the doctrine is applied, two results occur: (1) an insurer will be denied any unconscionable advantage in an insurance transaction, and (2) "[t]he objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."¹⁵⁶

151. *Id.* art. 30(2).

152. WU, *supra* note 36, at 80–81. The term “ambiguity” in contract law is generally defined as “[a]n uncertainty of meaning or intention, as in a contractual term or statutory provision.” BLACK’S LAW DICTIONARY 93 (9th ed. 2009) (“In ordinary language this term is often confined to situation in which the same word is capable of meaning two different things . . .”). This general definition of “ambiguity” aligns with the definition in Insurance Law of the PRC (2009). *See supra* note 150 and accompanying text.

153. *See, e.g.*, *Allstate Ins. Co. v. Ellison*, 757 F.2d 1042, 1044 (9th Cir. 1985) (“The court will not artificially create ambiguity where none exists. If a reasonable interpretation favors the insurer and any other interpretation would be strained, no compulsion exists to torture or twist the language of the policy. . . . Coverage will also be found if the insured can demonstrate through extrinsic evidence that its expectation of coverage was based on specific facts which make its expectations reasonable.” (citing *Jarvis v. Aetna Cas. & Sur. Co.* 633 P.2d 1359, 1363 (Alaska 1981) (applying California law); *O’Neill Investigations, Inc. v. Illinois Employers Ins. of Wausau*, 636 P.2d 1170, 1177 (Alaska 1985)); *Auto-Owners Ins. Co. v. Jensen*, 667 F.2d 714, 721 (8th Cir. 1981) (“[T]he doctrine [of reasonable expectation] only applies to situations where an ambiguity exists in the insurance policy.”).

154. KEETON & WIDISS, *supra* note 43, at 630–31.

155. JERRY, *supra* note 56, at 141–42.

156. Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L.

In some situations, the application of the reasonable expectation doctrine is crucial to protecting the insured. Commentators have provided three solid bases in support of the application of reasonable expectation:

First, insurance contracts are set forth in insurance policies that typically are long, complicated documents which insurers know policyholders ordinarily will not even read and certainly will not carefully study. Second, the marketing approaches employed for most kinds of insurance ordinarily do not even allow a purchaser to examine a copy of an insurance policy until after the contract has been completed. In life insurance transactions, for example, the purchaser usually does not see the insurance policy terms until after the application has been submitted, the first premium has been paid, the insurance company has decided to approve the application, and the company has issued the policy. . . . [I]t is appropriate to protect expectations which result from the marketing practices of the insurer—that is, actual or reasonable expectations which differ from the coverage provisions—that are derived from events or acts which were attributable either to the actions of persons in the field representing the insurer in the marketing transaction or persons at a management center that directs the operations of the insurance company. Third, there are many situations in which protection is viewed as appropriate because it would be unconscionable or unfair to allow an insurer to enforce the limitations and restrictions in the insurance policy.¹⁵⁷

Therefore, to correct the unequal bargaining power between the insurer and the individual insured, it is suggested that the doctrine of reasonable expectation should be introduced.

Furthermore, the improvements in the new law may still result in confusion in how to interpret insurance contracts. As indicated in Article 30 of the 2009 Amendment, when disputes not involving ambiguity occur, the clause shall be interpreted as “commonly understood.”¹⁵⁸ What exactly is “common understanding”? Whose common understanding is it—the insurer’s or the insured’s? If it refers to the insured’s common understanding, is it based on the particular insured’s subjective standard or the reasonable insured’s objective standard? If it means the insurer’s common understanding, how can its contradiction with the ambiguity rule

REV. 961, 967 (1970).

157. KEETON & WIDISS, *supra* note 43, at 634–35.

158. Insurance Law of the PRC, art. 30(1) (2009).

be reconciled? All of these questions remain unanswered even by commentators in China.¹⁵⁹

Incorporating commonly used rules of contract interpretation in addition to the interpretation of ambiguous terms incorporated in the 2009 Amendment may further improve the Insurance Law of the PRC. Outside of China, the following rules typically apply to the interpretation of an insurance contract:

Rule 1: Words are to be understood in their ordinary sense as they would be understood by ordinary people. . . . Rule 2: In the event of inconsistency in the ordinary meaning of words in different parts of the contract, the court prefers the meaning that best reflects the intention of the parties. . . . Rule 3: If it appears that the words have been used in a special sense . . . the words will be interpreted in that special sense. Rule 4: If, in spite of the application of Rules 1 and 2, the meaning of the words is not clear, and Rule 3 is of no assistance . . . the words will be construed *contra proferentem*, that is, against the insurer and liberally in favour of policyholders.”¹⁶⁰

Besides the ambiguity rule, incorporating these rules into Article 30 of the current Insurance Law would establish a more unequivocal, systematic, and complete interpretation of the insurance contract in comparison to the present “common understanding” rule.

2. The “Control of Content” Rule

The 2009 Amendment also incorporated the rule commonly applied in civil law countries called “the control of the contractual content.”¹⁶¹ The newly promulgated Article 19 provides:

The following clauses in an insurance contract using the standard clauses of the insurer shall be null and void: (1) a clause exempting the insurer from any legal obligation or aggravating the liability of the insurance applicant or insurant; and (2) a clause excluding any legal right of the insurance applicant, insurant or beneficiary.¹⁶²

159. JIANG AN, ZHONGHWA RENMINGONGHEGUO BAOXIANFA SHIYI [EXPLANATION OF THE INSURANCE LAW OF THE PRC] 63 (2009). *See also* WU, *supra* note 36, at 79; CHONGMIAO & LI, *supra* note 5, at 103.

160. CLARKE, *supra* note 72, at 140.

161. CHAO-GUO JIANG, BAOXIANFA JICHU LILUN [THE FUNDAMENTAL THEORIES OF INSURANCE LAW] 39 (1996).

162. Insurance Law of the PRC, art. 19 (2009).

This article resembles Germany's *Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen*, *AGB-Gesetz* (Standard Contract Terms Act), Section 9 of which provides:

(1) Provisions in standard contract terms are void if they unreasonably disadvantage the contractual partner of the user contrary to the requirements of good faith. (2) In case of doubt, a provision is unreasonably disadvantageous if (1) this provision is irreconcilable with essential basic principles of the statutory provisions from which the terms deviate, or (2) essential rights or duties arising from the nature of the contract are restricted to a degree which jeopardizes the purpose of the contract being attained.¹⁶³

While this Article is not a critique of German law, the issue associated with the addition of Article 19 in the Insurance Law of 2009 is the harmonization between the civil law codified in Article 19 and the common law codified in Article 30. It is possible that a term may be deemed ambiguous and simultaneously places the insured in an unreasonably disadvantageous position. In that case, if the court follows the ambiguity rule, it is the court's duty to interpret the contractual terms in favor of the insured. If, however, the court simply applies the "control of the contractual content rule," then no further interpretation seems necessary. This trick suggests the possibility of regulatory arbitrage within the court system. Thus, rules further clarifying the conditions under which an article applies are needed.

Moreover, despite the similarities of Article 19 to German law, legislators did not actually duplicate the core spirit of the *AGB-Gesetz*, which adopts the "reasonableness" and "jeopardizing the purpose of the contract" as the court's standard of review.¹⁶⁴ In that case, once the situation triggers Article 19, such as a clause exempting the insurer from any legal obligation, then that contract clause automatically becomes void without consideration as to whether releasing the insurer's liability reasonably serves the purpose and practice of insurance. For instance, reasonable policies may require the insured to give the notice of loss immediately and failure to give notice within a reasonable time may provide the insurer with a defense to coverage. Such a provision appears to

163. *Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen*, [AGB-Gesetz] [Standard Contract Terms Act], 1978 § 9, (F.R.G.), available at <http://www.iuscomp.org/gla/statutes/AGBG.htm> [hereinafter German Standard Contract Terms].

164. *Id.*

exempt the insurer from its responsibility if the insured fails to give notice within a reasonable time. Accordingly, the provision may be deemed invalid under Article 19 of the 2009 Amendment. The primary purpose of the notice of loss provision, however, is to enable the insurer to investigate the circumstances of the loss or claim before information becomes stale or disappears.¹⁶⁵ Therefore, the exemption provision is unreasonable only where the insurer's investigation is not prejudiced by the delay.¹⁶⁶

Since Article 19 lacks the standard of review available in German law, various exemption clauses in an insurance policy will be declared void through the mechanical application of Article 19, regardless of their reasonableness and necessity in conducting the business of insurance. The inflexible "control of content" rule is likely to undermine the development of the insurance industry.

3. *The Insurer's Duty to Explain the Contract*

The 2009 Amendment also included the insurer's duty to explain the contract. The new law requires the insurer to explain the contents of the contract to the applicant when using standard clauses.¹⁶⁷ For those clauses exempting the insurer from liability in the insurance contract, the insurer shall sufficiently warn the applicant of clauses relieving the insurer's obligations set forth in the application form, the insurance policy, or any other insurance certificate and expressly explain the contents of such clauses to the applicant in writing or verbally.¹⁶⁸ The insurer's failure to provide such warning or explanation will invalidate those clauses.¹⁶⁹

In the United States, the majority of courts have ruled that the insurer bears no affirmative duty to explain the policy or its exclusions to the insured if the terms in an insurance policy are clear, unambiguous, and

165. JERRY, *supra* note 56, at 524.

166. Majority views in the United States hold that an unexcused failure to give notice will not result in a loss of benefits unless the insurer can show that it was prejudiced by the late notice. *See, e.g., Travelers Ins. Co. v. Feld Car & Truck Leasing Corp.*, 517 F. Supp. 1132, 1134–35 (D. Kan. 1981) (holding that (1) a notice of claim filed four and a half years after the accident was not timely; however (2) the insurer was required to show that it was prejudiced by the untimely notice of claim before it could avoid liability under the policy.); *see also* Charles C. Marvel, Annotation, *Modern Status of Rules Requiring Liability Insurer to Show Prejudice to Escape Liability Because of Insured's Failure or Delay in Giving Notice of Accident or Claim, or in Forwarding Suit Papers*, 32 A.L.R. 4th 141, 145 (1984) (discussing trends of courts requiring insurers demonstrate prejudice in addition to untimely notice and, in so holding, courts frequently discussed the insured's "reasonable expectations").

167. Insurance Law of the PRC, art. 17(1) (2009).

168. *Id.* art. 17(2).

169. *Id.*

explicit.¹⁷⁰ Arguments affirming the insurer's duty to explain the policy reason that "the doctrine of reasonable expectations can operate to impose *de facto* a duty on the insurer to explain the policy's coverage to the insured."¹⁷¹ In *Bowler v. Fidelity & Casualty Co. of New York*,¹⁷² the court ruled:

Insurance policies are contracts of the utmost good faith and must be administered and performed as such by the insurer. Good faith "demands that the insurer deal with laymen as laymen and not as experts in the subtleties of law and underwriting." In all insurance contracts, particularly where the language expressing the extent of the coverage may be deceptive to the ordinary layman, there is an implied covenant of good faith and fair dealing that the insurer will not do anything to injure the right of its policyholder to receive the benefits of his contract. This covenant goes deeper than the mere surface of the writing. When a loss occurs which because of its expertise the insurer knows or should know is within the coverage, and the dealings between the parties reasonably put the company on notice that the insured relies upon its integrity, fairness and honesty of purpose, and expects his right to payment to be considered, the obligation to deal with him takes on the highest burden of good faith. In situations where a layman might give the controlling language of the policy a more restrictive interpretation than the insurer knows the courts have given it and as a result the uninformed insured might be inclined to be quiescent about the disregard or non-payment of his claim and not to press it in timely fashion, the company cannot ignore its obligation. It cannot hide behind the insured's ignorance of the law; it cannot conceal its liability. In these circumstances it has the duty to speak and disclose, and to act in accordance with its contractual undertaking. The slightest evidence of deception or overreaching will bar reliance upon time limitations for prosecution of the claim.¹⁷³

170. See, e.g., *Standard Venetian Blind Co. v. Am. Empire Ins. Co.*, 469 A.2d 563, 567 (Pa. 1983) ("[W]here, as here, the policy limitation relied upon by the insurer to deny coverage is clearly worded and conspicuously displayed, the insured could may not avoid the consequences of that limitation by proof that it he failed to read the limitation or that it he did not understand it."); *Realin v. State Farm Fire and Cas. Co.*, 418 So.2d 431, 432 (Fla. Dist. Ct. App. 1982) ("[A]n insurer has no duty to explain uninsured motorist coverage to an insurance applicant unless asked . . .").

171. JERRY, *supra* note 56, at 185.

172. 250 A.2d 580 (1969).

173. *Id.* at 587-88 (citations omitted).

Observing the practice, insurance policies are typically long and complicated documents that insurers realize most policyholders will not even read, much less study.¹⁷⁴ In addition, numerous insurance policies “cannot be understood without detailed analysis, and often not even an extended consideration of the terms would fully [reveal to] an insured of the precise scope of coverage and the meaning of the limitations or restrictions [embedded] in a particular policy.”¹⁷⁵ Even in the case where the insured does attempt to analyze the policy and has only limited expertise of law and insurance theory, it is very likely that the insured will become frustrated. For these reasons, in China’s relatively young insurance market, where insurance purchasers do not have extensive experience in this matter, it is better to retain the insurer’s duty to explain the policy in its insurance law.

Mature insurance markets like Germany also impose on an insurer the duty to advise and provide necessary information to the policyholder. Pursuant to the German Insurance Contract Act, “[b]efore the contract is concluded, the insurer shall provide the policyholder with the advice in writing [without undue delay], clearly and comprehensibly stating reasons.”¹⁷⁶ The insurer is also under the duty to “inform the policyholder in writing of his terms of contract, including the general terms and conditions of insurance, as well as the information [mandated in statutory laws], . . . in good time before the policyholder submits his contractual acceptance.”¹⁷⁷

The 2009 Amendment is a step in the right direction.

D. Double Insurance

Double insurance was previously governed by Article 41 of the Insurance Law of 2002. The insured is carrying double insurance when the insured has two or more insurers to insure the same subject matter with the same insurable interest and the same risks.¹⁷⁸ The insured is obligated to notify each insurer of the other insurance policies.¹⁷⁹ If the sum of the amount insured under all contracts exceeds the value of the subject matter, the sum of proceeds paid by all insurers shall not exceed such value.¹⁸⁰

174. KEETON & WIDISS, *supra* note 43, § 6.3(4).

175. *Id.*

176. VVG § 6(2) (2008).

177. *Id.* § 7(1).

178. Insurance Law of the PRC, art. 41(3) (2002).

179. *Id.* art. 41(1).

180. *Id.* art. 41(2).

Unless otherwise provided, each insurer shall only share the loss on a pro-rata basis.¹⁸¹

The new law incorporates slight changes to the treatment of double insurance. The 2009 Amendment has two additions: (1) it limits the application of the double insurance provision only to the situation where the sum of the amount insured exceeds the insurable value of the subject matter; and (2) on the basis of the pro-rata contribution provision, the insured is entitled to the refund of premiums paid claim from each insurer in exchange for the protection exceeding the insurable value of the subject matter.¹⁸² While the second change meets the doctrine of consideration, the first change is inconsistent with the principle of indemnity.

The principle of indemnity indicates that “the amount recovered be commensurate with the amount lost.”¹⁸³ Even in the case of underinsurance, when the insured suffers only a partial loss, unjust enrichment may still occur. For example, suppose that insurance companies A, B, and C insure Mr. X’s sedan, valued at \$10,000, for \$3,000, \$2,000, and \$1,000, respectively. If the car is damaged in an accident and the repairs cost \$1,000, without Mr. X notifying all the insurers, he might successfully claim \$1,000 in compensation from each insurer because insurers A, B, and C have no knowledge of existence of the other policies insuring the same car, not to mention the fact that Mr. X might have intentionally damaged the car.

If, pursuant to the new law, the insured still bores the duty to notify insurers of double insurance, what would be the consequence of violation? Requiring this duty would deter people who over-insure their property in order to destroy or damage it and then collect on each of the insurance policies.¹⁸⁴ Under British law, courts tend to approve the forfeiture clause, which requires the insured to notify the insurer if he is carrying double insurance during the life of a policy. The sanction for non-disclosure is the forfeiture or cancellation of the policy.¹⁸⁵ In the United States, courts generally agree with insurers that when additional insurance is purchased for an insured property without permission from the insurer who has already insured the property (“first insurer”), it increases the likelihood

181. *Id.*

182. Insurance Law of the PRC, arts. 56(3)–(4) (2009).

183. HODGIN, *supra* note 102, at 28.

184. KEETON & WIDISS, *supra* note 43, at 259.

185. *E.g.*, Steadfast Ins. Co. Ltd. v. F & B Trading Co. Pty. Ltd., (1972) 46 A.L.R. 10; *see also* BIRDS, *supra* note 142, at 345–46.

that such property might be intentionally destroyed to recover the proceeds, especially when the property is over-insured.¹⁸⁶

The drafters of insurance policies have designed an “escape clause” with the goal of eliminating all liability under the insurance policy when the insured has purchased additional insurance policies without the permission of the first insurer.¹⁸⁷ “[E]scape clauses in property insurance policies . . . [are] often upheld.”¹⁸⁸ Without the legal consequence imposed on the person breaching his duty to notify, however, it seems unlikely that the new law’s Article 56 will effectively implement the principle of indemnity and, therefore, may enable an insured’s unjust enrichment.

To prevent this type of unjust enrichment, the legislature may consider amending Article 56 to include the insured’s right to forfeit the insurance policy, like in Germany’s insurance law. The German Insurance Contract Act provides a worthwhile model on this matter. It mandates that “[a]nyone who insures the same interest against the same risk with several insurers . . . inform each insurer about the other insurances without undue delay.”¹⁸⁹ Furthermore, each contract made “with the intention of thereby gaining an illegal pecuniary benefit . . . shall be void; the insurer shall be entitled to the insurance premium up until such time as he learned of the circumstances establishing the nullity.”¹⁹⁰

E. Insurance Fraud

The 2009 Amendment retained most of the old law’s provisions related to insurance fraud. The 2009 Amendment retained the section regulating the insurer’s immunity from paying the proceeds when, after the occurrence of an insured incident, the applicant, the insured, or the beneficiary, fabricated the cause of the incident or overstated the amount of losses by forging or altering the certificates, materials, or other

186. KEETON & WIDISS, *supra* note 43, at 259–60.

187. *Id.* at 259.

188. *Id.* at 260. *See, e.g.*, O’Leary v. Merchants’ & Bankers Mut. Ins. Co., 66 N.W. 175, 176 (Iowa 1896) (holding that an insurance company has the right to write in the contract the escape clause that its liability consequent upon a change in the contract shall be in writing); Zimmerman v. Home Ins. Co. of New York, N.Y., 42 N.W. 462 (Iowa 1889); Kirkman v. Farmers’ Ins. Co., 57 N.W. 952 (Iowa 1894); Hankins v. Rockford Ins. Co., 35 N.W. 34, 36 (Wis. 1887) (“[W]hen the assured has accepted a policy containing a clause prohibiting the waiver of any of its provisions [including the escape clause] by the local agent, he is bound by such inhibition, and that any subsequently attempted waiver, merely by virtue of such agency, is a nullity.”); Cleaver v. Traders’ Ins. Co. 32 N.W. 660, 663 (Mich. 1887) (“[T]he holder of the policy is estopped, by accepting the policy, from setting up or relying upon powers in the agent in opposition to limitations and restrictions in the policy.”).

189. VVG, § 77(1) (2008).

190. *Id.* § 78(3).

evidence.¹⁹¹ It also elaborated on the fraud provision by providing that where the insured or the beneficiary files a claim while intentionally deceiving the insurer about the occurrence, the insurer shall have the right to rescind the contract and keep the premiums.¹⁹²

Despite the objective of fraud deterrence in Article 27, to penalize the insured or the beneficiaries who have used deception to claim for payments from the insurer,¹⁹³ it is flawed in two related respects. First, in the case of a life insurance claim where only one of the several designated primary beneficiaries committed fraud, conferring upon the insurer the right to rescind the contract violates the rule that where the beneficiary intentionally caused the death of the insured, regardless of his disqualification, “the proceeds go to any remaining primary beneficiaries, or, if there are none, to designated contingent beneficiaries.”¹⁹⁴

Likewise, the second flaw is that legislators failed to consider the divisibility of the insurance coverage. Under the general rule of contract law,

[i]f the performances to be exchanged under an exchange of promises can be apportioned into corresponding pairs of part performances so that the parts of each pair are properly regarded as agreed equivalents, a party’s performance of his part of such a pair has the same effect on the other’s duties to render performance of the agreed equivalent as it would have if only that pair of performances had been promised.¹⁹⁵

Here, “the insured’s breach of one portion of an insurance contract will not deprive the insured of the full measure of the insurer’s promised performance,” unless the contract is indivisible.¹⁹⁶ For example, if a policy covers three perils and collects three premiums, such as an automobile policy that has collision, comprehensive loss, and liability coverage, the insured is considered to own three different policies for three different perils even though the coverage is stated within the parameters of one written contract.¹⁹⁷

Therefore, under the premise that multiple perils contained in the single contract at issue are divisible, the insurer’s right to rescind the contract in

191. Insurance Law of the PRC, art. 27(3) (2009); Insurance Law of the PRC, art. 28(3) (2002).

192. Insurance Law of the PRC, art. 27(1) (2009).

193. WU, *supra* note 36, at 70–71.

194. JERRY, *supra* note 56, at 297 (citing *Lee v. Aylward*, 790 S.W.2d 462 (Mo. 1990) (en banc)).

195. RESTATEMENT (SECOND) OF CONTRACTS § 240 (1981).

196. JERRY, *supra* note 56, at 714.

197. *Id.* at 714–15.

Article 27, thereby voiding the entire contract, is inconsistent with general contract principles. Article 27 would more properly align with general contract principles if the insurer's rescission were restricted only to the part of the coverage directly related to the fraud; otherwise, Article 27 permits the invalidation of the untainted part of the contract without grounds.

IV. UNFINISHED BUSINESS: WHAT STILL REMAINS TO BE DONE?

The 2009 Amendment has addressed many issues that the Insurance Law of 2002 ignored, especially the efforts to achieve a higher level of consumer protection and a more solid corporate governance mechanism for insurance companies. Nevertheless, some problems associated with the Insurance Law of 2002 were not dealt with in the 2009 Amendment. The discussion in the next section reveals these shortcomings.

A. *The Structure of Legislation*

The Insurance Law of 2002 and the 2009 Amendment mistakenly combine two types of law: (1) insurance contract law, which is civil legislation; and (2) the laws regarding insurance supervision and administration, or administrative law. "In societies that pledge adherence to notions of the rule of law, it is theoretically and conceptually necessary to maintain a distinct separation between civil and administrative legislation."¹⁹⁸ In fact, many of the world's leading insurance markets, such as Germany and Japan, utilize dual statutes: one regulates contractual transactions and the other regulates government administration in the marketplace.¹⁹⁹ Under insurance law, the issue is to clearly and carefully separate matters better dealt with through contractual agreements of mutual consensus from matters appropriately governed by administrative mediation.²⁰⁰ Separate legislation will serve to "protect insurance participants' rights from being arbitrarily subjected to inappropriate administrative power."²⁰¹ Furthermore, the use of separate statutes to address contractual and administrative aspects functions such that an amendment made to one part may not affect the other. "This practice maintains the continuity and stability of the law as a whole, and minimizes

198. Guojian & Mertl, *supra* note 25, at 23.

199. See FINANCIAL SERVICE AGENCY, <http://www.fsa.go.jp/common/about/syosyou.pdf> (last visited Jan. 25, 2010).

200. Guojian & Mertl, *supra* note 25, at 23.

201. *Id.*

disruption to the balance between flexibility and consistency built into the overall regulatory system.”²⁰²

B. Insurance Contract

Three issues concerning the insurance contract need further revisions. First, there is a mismatch between the principle of indemnity and the approach of categorizing the insurance contract in the 2009 Amendment. Second, the scope of the insurer’s right to subrogate is excessively broad. Third, virtually no article in the 2009 Amendment provides for various types of insurance contract.

1. Classification of Insurance Contracts

The 2009 Amendment retains the structure of the old law, which categorized insurance contracts into property insurance and personal insurance. While such a classification is not technically wrong, it is inaccurate under the principle of indemnity. Generally, in an insurance contract in which the principle of indemnity applies, the insurer agrees to indemnify the insured for the actual loss suffered if a particular incident occurs. This type of insurance contract is recognized as a “contract of indemnity.”²⁰³ Conversely, a contingency policy refers to an insurance contract in which the insurer, on the occurrence of a particular incident, promises to pay a fixed sum determined not by an estimate of the loss suffered, but rather by the amount of coverage agreed upon in the insurance contract.²⁰⁴ An indemnity policy that also includes the insurer’s promise to pay hospital bills in a personal accident policy or a health insurance policy is still considered personal insurance according to the Insurance Law of the PRC.²⁰⁵

Pursuant to the present Insurance Law, rules derived from the principle of indemnity, namely the rule regulating double insurance, the insurer’s right of subrogation, and the rule banning over-insurance, are all applicable only to “property insurance policies.”²⁰⁶ The confusion arises when determining whether such rules apply to policies of personal insurance that are in fact indemnity contracts, such as health insurance or

202. *Id.* at 24.

203. LOWRY & RAWLINGS, *supra* note 45, at 14–15.

204. Malcolm Clarke, *Policies and Perceptions of Insurance Law in the Twenty-First Century* 27 (Oxford Univ. Press 2005), available at <http://fds.oup.com/www.oup.co.uk/pdf/0-19-927330-8.pdf>.

205. Insurance Law of the PRC, art. 46 (2009).

206. *See id.* arts. 55, 56, 60.

credit life insurance. If the answer is negative, the principle of indemnity does not seem to have been completely executed, and such a problem could lead to cases of an insured's unjust enrichment by taking advantage of this loophole.

In order to extinguish the insured's incentive to take advantage of such a legislative flaw, insurance contracts must be re-categorized as indemnity contracts and contingency contracts in a timely manner. Such a change would be consistent with the German Insurance Contract Act and the Japanese Insurance Law, which also conform to the indemnity-contingency categorization.²⁰⁷

2. *The Insurer's Right of Subrogation*

Both the Insurance Law of 2002 and the 2009 Amendment grant the insurer a right, after having indemnified the insured, to subrogate the insured's claim for indemnity against the third party who incurred the loss up to the amount of proceeds paid.²⁰⁸ Furthermore, the Insurance Law provides that the insurer's right of subrogation shall not prejudice the insured's claim against the third party for the portion of losses not indemnified by the insurer.²⁰⁹

Compared to the British or American common law, Chinese law should be supplemented in at least three respects. First, because subrogation rights are not independent rights that insurers can exercise against the wrongdoer, the indemnifying insurer is entitled only to use the means by which the insured might have protected himself against or reimbursed himself for the loss.²¹⁰ Thus, the insurer who steps into the shoes of the insured has no more rights than the insured and cannot take actions that the insured could not have undertaken.²¹¹ Therefore, subrogation comes into operation when the insured has a legally enforceable right against a party who caused the loss, including any tortfeasors and the party breaching the contract, and the law gives the insured rights of compensation.²¹² The "insurer generally is not entitled to be subrogated to rights that may exist as a consequence of a liability claim against its own

207. See VVG, §§ 74-208 (2008); Japan Insurance Law, art. 3-94 (2008).

208. Japan Insurance Law, art. 60(1); Insurance Law of the PRC, art. 45 (1) (2002).

209. Insurance Law of the PRC, art. 60(3) (2009); Insurance Law of the PRC, art. 45(3) (2002).

210. *Simpson v. Thomson, Birrell* (1877), 3 App. Cas. (H.L.) 279, at 284 (appeal taken from Scot.).

211. HODGIN, *supra* note 102, at 563-64.

212. *Id.* at 564.

insured” person.²¹³ Article 59 has expanded the scope of insurer’s right of subrogation to every “third party who incurred the loss” regardless of whether those third parties are liable for the insured’s damage or are involved due to their relationship with the insured, such as an employer or spouse of the insured. Confusion may arise because of its overly broad reach.

Second, it remains unclear whether the insurer’s right of subrogation can only be activated after the insured’s indemnification is completed. The current law prohibits the insurer, in executing his right of subrogation, from interfering with the insured’s claim against the third party for the portion of losses not indemnified. The law, however, is silent as to when the insurer may invoke its right to subrogation. In the United States, if the insurer has paid only a portion of the amount that it is required to pay in accordance with the policy, the insured has not been indemnified in full for the loss and the insurer is not entitled to be subrogated to the insurer’s rights.²¹⁴ Even when the insurer pays the insured the full amount under the insurance contract, if the sum paid is insufficient to indemnify the insured for his losses, the insurer may still have no right of subrogation.²¹⁵ The rationale for such rules is simple: a subrogation right before the insured’s receipt of full indemnification would make the insurer a competitor with the insured for the remainder of the tortfeasor’s payment.²¹⁶ To promote organized and fair distribution of third party payments, it is necessary to clarify the wording of the Insurance Law.

Finally, nothing in the current law deals with the insured’s interference with an insurer’s right of subrogation, especially when a settlement between the third party and the insured has prejudiced that right.²¹⁷ Common law rules indicate that the insured’s act of releasing the third party after a loss without the insurer’s consent, though effective to the insurer, is an interference with the insurer’s right of subrogation.²¹⁸ Therefore, any compromise between the insured and the tortfeasor will discharge the insured’s obligations to the insurer under the contract, and the insurer is entitled to the return of any payments already made to the insured.²¹⁹ A rule similar to the common law rules regarding settlements

213. KEETON & WIDISS, *supra* note 43, at 221; BIRDS, *supra* note 142, at 321.

214. *E.g.*, Baillio v. Western Cas. & Sur. Co., 189 So. 2d 605 (La. Ct. App. 1966).

215. *E.g.*, Capps v. Klebs, 382 N.E. 2d 947 (Ind. Ct. App. 1978).

216. JERRY, *supra* note 56, at 606.

217. POH, *supra* note 215, at 580.

218. BIRDS, *supra* note 142, at 319.

219. *Compare e.g.*, Ankney v. Franch, 652 A.2d 1138, 1146 (Md. App. 1995).

and interference with the insurer's right of subrogation should also be added to the subrogation clause.

3. *Issues Associated with Various Types of Insurance*

The 2009 Amendment concerning the insurance contract concentrates only on general principles. Except for two simple articles dealing specifically with issues in liability insurance contracts—the third party's right to file a direct claim against the liability insurer and insurer's duty to defend—no other parts of the current law arose from a particular type of contract, such as accident policies, auto insurance, various liability insurances, annuities, surety bonds, fidelity bonds, or group insurance.

The present use of general principles in the Insurance Law, as opposed to articulating specific laws by contract type is odd for civil law countries like China, where the primary source of law is the legal code.²²⁰ The fact that most laws are codified in statutory form is considered the most significant distinction between a civil law and a common law system, in which judge-made law established in court decisions predominates.²²¹ Germany's civil law statutes reflect such specific regulations: the German Insurance Contract Act regulates property insurance,²²² liability insurance,²²³ legal expense insurance,²²⁴ transport insurance,²²⁵ fire insurance,²²⁶ life insurance,²²⁷ disability insurance,²²⁸ accident insurance,²²⁹ and health insurance,²³⁰ in respective chapters. Even in common law countries, however, regulating various types of insurance contracts through statutory laws is not uncommon. The California Insurance Code resembles the civil law statutes of Germany because it contains specific chapters governing fire insurance,²³¹ marine insurance,²³² life and disability insurance,²³³ group life insurance,²³⁴ and insurance covering

220. B. SHARON BYRD, *INTRODUCTION TO ANGLO-AMERICAN LAW AND LANGUAGE* 3 (1997).

221. For details, see ALAN B. MORRISON ET AL., *FUNDAMENTALS OF AMERICAN LAW* 10–14 (Oxford Univ. Press 1996).

222. *See* VVG, §§ 88–99 (2008).

223. *See id.* §§ 100–12.

224. *See id.* §§ 125–29.

225. *See id.* §§ 130–41.

226. *See id.* §§ 142–49.

227. *See id.* §§ 150–71.

228. *See* VVG, §§ 172–77.

229. *See id.* §§ 178–91.

230. *See id.* §§ 192–208.

231. *See* CA Ins. Code §§ 2030–84 (2009).

232. *See id.* §§ 1880–2010.

233. *See id.* §§ 10110–98.

land.²³⁵ Hence, incorporating issues associated with different types of insurance contracts into the statutory law is another essential step toward a better insurance code in China.

V. CONCLUSION

With respect to the portion related to insurance contracts, the 2009 Amendment has improved the protection of policyholders while stressing the obligations of both parties derived from the duty of utmost good faith.²³⁶ Through changes to almost every article in the Insurance Law of 2002, the new law has clarified several questions associated with insurance contracts under the old law, such as issues related to insurable interests, the insured's duty of disclosure, and double insurance. Regrettably, some problems found in the 2002 Insurance Law remain, and some new issues arise as a result of the 2009 Amendment. Because the modern insurance law regime of PRC was not established until 1995, expecting the Insurance Law of the PRC and related regulations to be perfected through the addition of two amendments in 2002 and 2009 is unrealistic.

This Article suggests ways in which the Insurance Law of the PRC could further improve by offering critiques of the present law and proposing future amendments with respect to insurance contracts and insurance regulations. The current Insurance Law of the PRC still needs to address several issues related to insurance contracts, including the definition and status of the insured in life insurance contracts, the time when an insurable interest must exist, the scope of the insured's duty of disclosure, the return of a premium associated with the rescission of the contract, the divisibility issue in the case of insurance fraud, the categorization of insurance contracts in accordance with the principle of indemnity, and the "full indemnity" standard in an insurer's right of subrogation.

While this Article covers only the first half of the 2009 Amendment that relates to insurance contracts, the second half of the 2009 Amendment

234. *See id.* §§ 10200–14.

235. *See id.* §§ 12340–661.

236. WU, *supra* note 36, at 2.

addressing various issues concerning the regulation and supervision of insurance companies needs the same level of attention. Further studies are essential to satisfy the demand for a comprehensive and clear Insurance Law of the PRC.