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Post-Katrina Insurance Issues Surrounding Water Damage Exclusions in Homeowners' Insurance Policies

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Post-Katrina Insurance Issues Surrounding Water Damage Exclusions in Homeowners' Insurance Policies

Summary

In the aftermath of Hurricanes Katrina and Rita, homeowners in Louisiana, Mississippi, and Alabama have protested what they view as inappropriate obstacles to the payment of their property damage insurance claims. When insurance adjustors and damage experts assessed the properties damaged by the 2005 storms, they were faced with the issue of allocating damages between wind (a covered loss) and flood (an excluded loss). The delays and economic uncertainty that this activity has engendered have raised financial and legal issues for insurers, as well as homeowners and businesses along the Gulf Coast region.

The solution for some of the insureds has been to litigate with their insurers under a variety of legal theories with the objective of avoiding the standard "water damage" exclusion — a move that would arguably allow insureds to receive coverage for water damage under their homeowners' policies. Many of these theories rely on the principle that any ambiguity in the insurance policy should be construed in favor of the policyholder. In addition, even where the water damage exclusion is enforced, difficult factual and legal disputes have arisen relating to the allocation of damage between covered wind damage and excluded flood damage.

In the aftermath of the devastating 2005 hurricane season, three broad policy issues for the 110th Congress have emerged related to post-Katrina economic uncertainties: (1) the massive insured and uninsured property losses and their impact on Gulf Coast property insurance markets and rebuilding after Katrina, (2) assertions that insurers have shifted the cost of damages onto the federal flood program and U.S. taxpayers, and (3) unreliable government flood maps that are used in decision making by homeowners for purchasing insurance.

Post-Katrina insurance claims litigation and the economic uncertainty it generates for consumers and insurers raise concerns about the volatility in the legal environment in terms of post-event judicial interpretations in the scope of insurance coverage. Questions include What should be done to mitigate the economic consequences of future floods? Are the American people and policymakers ready to address perceived weakness in the U.S. floodplain management policy? Should the nation forgo development of its floodplains (a new policy initiative) or continue along the current path embodied in the NFIP?

Finally, insurance analysts have observed that a large percentage of those eligible to buy federally subsidized flood insurance do not. What could or should be done about this? These and other policy questions might be examined in the 110th Congress.

This report will be updated as events warrant.

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Introduction

Hurricane Katrina, the storm surges it produced, and the subsequent levee failures caused devastating flooding in communities located along the Gulf of Mexico Coast. Katrina's winds destroyed or substantially damaged many of the properties located on the Mississippi Gulf Coast, as well as property located further inland from the immediate coastal areas. Tens of thousands of homes and businesses in Louisiana, Mississippi, and Alabama were damaged as a direct result of Katrina's storm surge. Many thousands more homes were condemned and left empty due to exposure to days and even weeks of soaking in often-contaminated flood waters.

Modern homeowners' and business owners' policies are often issued on an "open perils" or "special causes of loss" basis which provides that all direct physical loss or damage to insured property is covered except as specifically excluded. Some policies are still issued on a "named perils" or "specified perils" basis by which the insurer promises to insure covered property only if damaged by listed perils and subject to certain exclusions. Under either approach, damage by wind is typically covered while water damage from flooding, wind driven water, storm surge, seepage or through openings in the building (not cause by other damage) is typically specifically excluded.

There are three main reasons that insurers utilize exclusions: (1) the excluded peril or property is more appropriately insured under a different insurance product or through an optional coverage (e.g., exclusion in property policies for earthquake and mobile equipment); (2) insurance is not an appropriate vehicle for transfer of a particular risk (e.g., exclusions in property policies for failure of appropriate maintenance); or (3) the peril or property presents an unacceptable hazard to the insurer (e.g., exclusions in property policies for nuclear or contamination event). The water damage exclusion is thought to be the result of the first and third reasons. For many homeowners and small businesses, the only explicit insurance coverage against flood damage is underwritten by the National Flood Insurance Program (NFIP), but homeowners have not participated in sufficient numbers for various reasons, as required by law.[1]

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[1] See Lloyd Dixon, Noreen Clancy, and Seth A. Seabury, "The National Flood Insurance Program's Market Penetration Rate: Estimates and Policy Implications," *Rand Corporation*, Mar. 13, 2006, at [http://www.rand.org/pubs/technical_reports/2006/RAND_TR300.pdf].

Because of water damage exclusions and underutilization of available NFIP coverage, a significant number of the thousands of properties damaged or lost through Hurricanes Katrina, Rita, and Wilma were uninsured. These storms have spawned numerous class actions and other litigation concerning insurance coverage for losses. Both uninsured and underinsured property owners have focused on the water damage exclusions in homeowners' policies, maintaining that they apparently should be made whole through government flood insurance, homeowners' insurance, some combination of both, or the government, depending on each person's particular insurance coverage.

For example, the Insurance Services Office (ISO) commercial policy wording (CP 10-30-04 02) with respect to the flood exclusion provides the following:

> *We will not pay for loss or damage caused directly or indirectly by any of the following. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss....*
>
> ***
>
> *(1) Flood, surface water, waves, tides, tidal waves, overflow of any body of water, or their spray, all whether driven by wind or not:*
>
> *(2) Mudslide or mudflow;*
>
> *(3) Water that backs up or overflows from a sewer, drain or sump; or*
>
> *(4) Water under the ground surface pressing on, or flowing or seeping through;*
>
> *(a) Foundations, walls, floors or paved surfaces;*
>
> *(b) Basements, whether paved or not; or*
>
> *(c) Doors, windows or other openings.*
>
> *But if water, as described in g(1) through g(4) above, results in fire, explosions or sprinkler leakage, we will pay for the loss or damage caused by that fire, explosion or sprinkler leakage.*

Insurers take the position that these policies do not provide coverage for water damage resulting from such events as levee breaches or storm surge because of the policy exclusion. For example, the standard homeowners' insurance policy language does not specifically identify "storm surge," but insurers insist that the breadth of the water damage exclusion encompasses such damage.

Insurance coverage disputes and litigation over the policy exclusions have ensued between policyholders and their insurers. The key coverage issue has been and will be whether damage or destruction to properties along the coastal regions was caused by winds (typically covered under homeowners' policies) or by the flooding accompanying the storm (typically excluded under homeowners' policies). With Katrina, the possibility exists that either wind or flood caused damage — either

separately or working in combination. Disputes over causation are inevitable. Hundreds of millions and perhaps billions of dollars in potential insurance coverage will rest on the outcome of decisions rendered in the courts.

On February 14, 2007, Mississippi's largest provider of homeowners' insurance, State Farm Fire and Casualty Company, announced plans to suspend sales of new policies in the state because of what the insurer claims is an increasingly unpredictable business and legal environment.[2] The decision is not expected to affect existing policyholders. A State Farm representative stated that the decision to curtail writing new policies was a business decision to protect corporate assets in response to an adverse legal and political environment in the state.[3]

State Attorney General Jim Hood responded to State Farm's announced plans by unveiling a legislative proposal to the state's Governor, insurance commissioner and the public that would compel insurers to continue writing policies in the state. The proposal, which is based on similar legislation enacted in Florida, would require insurers writing auto insurance in the state to provide homeowners' and commercial insurance if they sell those policies elsewhere in the United States.[4]

Following the State Farm announcement, the concern raised by insurance regulators and policymakers is what to do about other insurers who might decide to retreat further from the Gulf Coast region because of the uncertainty of pending legal battles. Consumer advocacy groups expect other insurers to follow State Farm's lead as a way to apply political pressure on the Mississippi courts and legislature to deal with the insurance coverage issue.[5]

This report provides an analysis of post-Katrina insurance issues in Louisiana, Mississippi, and Alabama, particularly as they have related to (1) the magnitude and impact of flooding, (2) the way private insurers settle claims, (3) the types and scope of policies and coverage, and (4) how courts have determined whether coverage exists under property policies when both covered and uncovered risks combine to cause a loss. The report does not provide legal advice, nor is it a definitive assessment of the applicable law in each jurisdiction.

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[2] Steve Tucker, "State Farm Halts New Mississippi Business," *National Underwriter Online News Service*, Feb. 14, 2007.

[3] Mark E. Ruquet, "Hood Calls State Farm on Bullying Tactics," *National Underwriter Online News Service*, Feb. 16, 2007.

[4] In addition to signing the new catastrophic insurance legislation, the Florida Governor signed an emergency order suspending the right of insurers to cancel and non-renew pending full implementation of the new law. The Florida Insurance Council, an insurance company trade group, initially challenged the validity of the Governor's order, but later withdrew the legal challenge. Events in Florida are not discussed in this report.

[5] Joseph B. Treaster, "State Farm Ends New Property Coverage in Mississippi," *New York Times*, Feb. 15, 2007, p. C2.

The Issues

Overview

Private insurers play a central role in the functioning of the U.S. economy not only because of their risk-transfer function, but also because of their ability to provide relatively easy access to sources of capital. Instability in the availability and price of coverage, interruptions in the payment of claims immediately after a disaster, and the large numbers of uninsured or underinsured Americans have led to pressure for government intervention in property insurance markets. In the wake of Katrina's massive flooding and uninsured property losses, specific concerns have been expressed in Congress not only about making sure that every insurance claim owed is paid, but also that there is a Gulf Coast insurance market after all the litigation is concluded.

In 1983, as a result of adverse court decisions in which insurers were forced to pay flood-related claims that insurers did not believe they were responsible to pay, the property and casualty insurance industry revised its policy language in the exclusions in homeowners' policies. Today, almost all homeowners' policies have a water damage exclusion with anti-concurrent causation language[6] which, according to insurers, should have eliminated coverage for flooding including from storm surge and levee breaches. Not all water is excluded, just the water damage described in the exclusion. There are still several instances in which water damage is covered, such as when the pipes in a home freeze and burst, when a roof is ripped off the home and rain water comes in, or the fire department hoses down the house.

Particular policy phrases and their interpretation frequently are at the center of insurance-based litigation. The central question is how the courts will interpret the water damage exclusion or whether they will rule in favor of the claimants, forcing insurers to pay billions of dollars to repair flood damage. Certain other insurance-related issues have arisen, such as concerns that some insurers inappropriately billed the federal flood insurance program for claims that should have been paid by the insurers' wind policies.[7]

Some Members of the 110th Congress support efforts to investigate the Katrina claims practices of insurance companies that contract with the National Flood Insurance Program.[8] Others support legislation creating a federal catastrophe fund backed by state funds to shore up the private insurance industry in the event of a mega-catastrophe. Still other Members support the repeal of the insurance industry's

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[6] The term "anti-concurrent causation language" refers to language that is typically inserted in an insurance policy to make it as clear and unambiguous as possible that a specific risk is not covered. Insurers use this type of language in contracts in an attempt to prevent policyholders from seeking coverage for losses they never intend to cover.

[7] Matt Brady, "U.S. Representative Taylor Seeks Probe of Insurers," *National Underwriter Online News Service*, Jan. 12, 2007.

[8] Arthur D. Postal, "Gulf Congressmen Attack Insurers on Many Fronts," *National Underwriter Online News Service*, Jan. 19, 2007.

limited federal antitrust exemption to address what they insist is an anti-competitive industry. The exemption from federal antitrust laws has allowed collaboration in the industry, such as development of standardized policy forms.[9]

The Louisiana, Mississippi, and Alabama Departments of Insurance, like those in other states, have a right of review and approve policy forms before use. As with all other states, Louisiana and Mississippi have for many years reviewed and approved flood and related water exclusions.

Departments of Insurance have also undertaken efforts to advise residents that most personal and commercial property insurance policies do not cover flood and that a national program (NFIP) is available to meet flood insurance needs. This frequent communication effort includes fact sheets and press releases (Louisiana — 2002, 2003, 2004, 2005; Mississippi — 2000, 2002; Alabama — 2002, 2004, 2005).

In addition, the federal government through the NFIP has for years undertaken a multi-media campaign to advise homeowners and business owners that most insurance policies do not cover flood — but that federal coverage is available. For homeowners' insurance, federal flood insurance is typically less than $1,000 per year (although pricing varies depending on the value insured and location of the property). For businesses, the federal flood insurance premium is typically a couple of thousand dollars, again depending on the amount of coverage and location of the property.

Litigation between policyholders and their insurers over the interpretation of "water damage" exclusion and the "anti-concurrent causation" clauses could continue for months and even years. The outcome of legal disputes will likely determine how losses are eventually apportioned among the National Flood Insurance Program (NFIP), private insurers, individuals, and businesses.[10]

Impact of Hurricane Katrina on Insurance Markets

In the aftermath of Hurricanes Katrina, Rita, and Wilma, three broad issues have emerged related to post-Katrina economic uncertainties:

- the massive insured and uninsured property losses and their impact on Gulf Coast property insurance markets and rebuilding after Katrina;

- assertions that insurers have shifted the cost for damage to the federal flood program and FEMA for U.S. taxpayers to pay the bill — i.e., potentially huge uninsured property losses and the denial of thousands of Katrina wind claims where insurers invoked the "water

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[9] For a brief discussion of what the McCarran-Ferguson Act does and does not cover, as well as some McCarran-related legislation in the 109th Congress, see CRS Report RL33683, *Courts Narrow McCarran-Ferguson Antitrust Exemption for 'Business of Insurance ...,"* by Janice E. Rubin.

[10] Bill Mellander, "Payouts Hinge on the Cause of Damage," *New York Time*s, Aug. 31, 2005, p. C5.

damage exclusion" and "anti-concurrent causation" clause in homeowners' policies;

- unreliable government flood maps that are used by homeowners, lenders, and realtors to determine whether flood insurance was needed.

First, Hurricanes Katrina, Rita and Wilma resulted in massive property losses for both private insurers and the National Flood Insurance Program (NFIP). In addition, the total value of uninsured property damage and business interruption caused by Katrina has been estimated at $135 billion.[11] Congress has already appropriated $109 billion for disaster relief and recovery aid to affected communities, plus more than $8 billion in tax relief.[12]

Table 1 shows that private insurers paid $58.4 billion in insured property damages caused by Hurricane Katrina, Rita, and Wilma. This amount does not include claims filed under the NFIP. Insurers are still assessing losses in terms of how they will affect ultimate claim payments for losses in 2005, including the total cost of litigating and settling "wind v. flood" cases.

Table 1. Ten Most Costly Catastrophes in the United States

Rank	Date	Peril	Insured Loss ($ millions)	
			Dollars When Occurred	In 2006 dollars
1	Aug. 2005	Hurricane Katrina	$40,600	$41,910
2	Aug. 1992	Hurricane Andrew	15,500	22,272
3	Sept. 2001	World Trade Center, Pentagon Terrorist Attacks	18,800	21,401
4	Jan. 1994	Northridge, CA earthquake	12,500	17,004
5	Oct. 2005	Hurricane Wilma	10,300	10,632
6	Aug. 2004	Hurricane Charley	7,475	7,978
7	Sept. 2004	Hurricane Ivan	7,110	7,588
8	Sept. 1989	Hurricane Hugo	4,195	6,820
9	Sept. 2005	Hurricane Rita	5,627	5,809
10	Sept. 2004	Hurricane Frances	4,595	4,904

Source: Insurance Services Office (ISO); Insurance Information Institute.

Table 2 shows Hurricanes Katrina and Rita caused a record 226,419 flood insurance claims of which 164,615 individual claims were paid. Some 62,849

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[11] Council of Economic Advisers, *Economic Report of the President*, Feb. 2007, p. 120.

[12] Matt Fellowes and Amy Liu, "Federal Allocations in Response to Katrina, Rita and Wilma: An Update," *The Brookings Institutions*, located at [http://www.brookings.edu/metro/pubs/20060712_katrinafactsheet.pdf#search=%22community%20development%20block%20grant%20and%20katrina%20flood%20relief%22].

damaged homes were not covered by flood insurance and 58,413 claims were closed without payment. According to the Federal Emergency Management Agency (FEMA), as of February 2007, the NFIP paid $18.8 billion in claims payments — an amount that far exceeds the aggregate amount of claims paid in the history of the program.

Table 2. National Flood Insurance Program Data for Hurricanes Katrina and Rita

(As of January 5, 2007)

State and Disaster Number	Number of Flood Insurance Claims Received	Number of Homes Damaged Without Flood Insurance[a]	Number of Household Individual Claims Fully Paid	Number of Flood Insurance Claims Closed Without Payment
Florida, DR-1602	9,021	733	5,814	3,070
Louisiana, DR - 1603	177,827	32,768[b]	127,330	47,942
Mississippi, DR 1604	19,006	26,716	17,159	1,519
Alabama, DR - 1605	5,725	1,743	5,123	557
Texas, DR-1606	3,930	889	1,721	2,111
Louisiana, DR-1607	10,910	[b]	7,468	3,214
Total	**226,419**	**62,849**	**164,615**	**58,413**

Source: FEMA Office of Federal Affairs

Notes:
a. Data are as of March 28, 2006;
b. Louisiana disaster numbers DR-1603 and 1607 combined.

Unprecedented losses in the NFIP have led to unprecedented borrowing from the U.S. Treasury. Most of the $18.8 billion was borrowed from the U.S. Treasury, and must be repaid with interest. The Congressional Budget Office calculates that FEMA is unlikely to repay the funds borrowed to pay 2005 hurricane-related claims withing the next 10 years.[13] Consequently, the 110th Congress might be called upon to overhaul the National Flood Insurance Program in order to address: (1) program's financial solvency; (2) indebtedness to the U.S. Treasury; (3) magnitude of uninsured flood damage due to the widespread noncompliance with the mandatory flood insurance purchase requirements; and (4) controversy surrounding the practice of contracting with private insurers for policy adjusting and servicing.

Second, Hurricane Katrina damaged or destroyed thousands of homes and businesses that were covered for wind damages, but not water damage. Insurers have

[13] See Letter from Donald B. Marron, Acting Director of Congressional Budget Office, to Honorable Judd Gregg, Chairman, Committee on the Budget, May 31, 2006, located at [http://www.cbo.gov/ftpdocs/72xx/doc7233/05-31-NFIPLetterGregg.pdf].

reportedly denied thousands of Katrina wind claims by assigning all Katrina damages to flooding covered by the NFIP and not to their own windstorm policies. Insurers say they are simply invoking the "water damage" exclusion and "anti-concurrent causation" clause in homeowners' policies. Policyholder advocates claim insurers have a conflict of interest because they are able to shift the cost for damage to the federal flood program rather than to themselves. Further, insureds doubt whether FEMA provides proper oversight of NFIP's Write Your Own (WYO)[14] insurers to ensure they are fulfilling their contractual obligations to fairly adjust flood claims, particularly those involving combined wind and water damage. Finally, critics charge that, while the states have a role in regulating the claims adjusting process, the "Unfair Claims Practices" statutes are not being adequately enforced by the states.

On the other side of this issue, many homeowners who were eligible for low cost NFIP flood coverage (including those required by law to purchase it) declined this available coverage despite state and federal educational efforts. Many insurers — and several recent editorials — assert that policyholders' claims of flood coverage under homeowners' policies with flood exclusions are post-event rationalizations for poor personal planning decisions.

Researchers have suggested that millions of families are now living in flood-prone areas without adequate insurance protection. This is despite that fact that structures in areas with at least a 1% chance of flooding in any given year — the so-called "100-year" flood or Special Flood Hazard Areas (SFHAs) — are required to have flood insurance if they have a loan from a federally insured or regulated lender. The insurance must be in an amount of at least equal to the outstanding principal balance of the loan or the maximum available under the NFIP, whichever is less.[15] This requirement is based on two federal laws: the Flood Disaster Protection Act of 1973[16] and the National Flood Insurance Reform Act of 1994.[17]

According to a Rand Corporation nationwide study, about 49% of single-family homes in SFHA are covered by flood insurance (the market penetration rate), with substantial variations across geographic regions.[18] In addition, about 1% of

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[14] WYO insurers are private insurers who have agreed to sell and service NFIP policies, and adjust flood insurance claims under a contractual agreement with FEMA.

[15] These property owners or loans include (1) loans from federally regulated lending institutions; (2) loans that are purchased by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac); and (3) property owners who receive federal financial assistance for acquisition or construction purposes in SFHAs in communities that participate in the NFIP.

[16] P.L. 93-234; 87 Stat. 975.

[17] P.L. 103-325; 108 Stat. 2255.

[18] See Lloyd Dixon, Noreen Clancy, Seth A. Seabury, "The National Flood Insurance Program's Market Penetration Rate: Estimates and Policy Implications," *Rand Corporation*, Mar. 13, 2006, located at [http://www.rand.org/pubs/technical_reports/2006/RAND_TR300.pdf]

homeowners in non-SFHAs purchase flood insurance coverage.[19] The purchase of flood insurance is voluntary outside SFHAs.

Researchers have explored factors influencing insurance purchase decisions.[20] They include the following:

- Millions of homeowners incorrectly believe that their standard homeowners' policies automatically provide coverage against flooding, when in fact an additional flood policy is needed.

- People have misperception of risk and tend to underestimate their chances of being disaster victims and do not purchase flood insurance. They have difficulty dealing with probabilistic information for small likelihood events because they need a context in which to evaluate the data.[21] Homeowners might think it is not a good investment when comparing the insurance price of coverage per dollar against their estimate of the probability of total loss, which they assume approaches zero.

- There are economic disincentives to buying flood insurance because of "free" federal and charitable disaster assistance and the tax-deductibility of flood losses.[22] Property owners often believe that disaster relief (i.e., Small Business Administration (SBA) low interest loans and grants) will compensate them for flood losses.

- The NFIP can undercompensate for losses given the high property (and land) values for coastal properties and the NFIP's maximum coverage of $250,000 for structure and $100,000 for contents.

- Property owners sometimes self-protect or self-insure — a substitute for formal insurance — by, for example, elevating their property above the base flood elevation (BFE), which serves to reduce both the probability of loss and the size of the potential costs.

- Homeowners might simply cancel their flood coverage without lenders taking action.

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[19] Ibid.

[20] Howard Kunreuther, "Has the Time Come for Comprehensive Natural Disaster Insurance?" in *On Risk and Disaster: Lessons from Hurricane Katrina*, Roland J. Daniels, Donald F. Kettle, eds. (Philadelphia: University of Pennsylvania Press, 2006), p. 175.

[21] Howard Kunreuther and M. Pauly, "Rules Rather than Discretion: Lessons from Hurricane Katrina," *Journal of Risk and Uncertainty*, 2006, vol. 33, pp. 101-116.

[22] Howard Kunreuther and M. Pauly, "Neglecting Disaster: Why Don't People Insure Against Large Losses?" *Journal of Risk and Uncertainty*, 2004, vol. 28, pp. 5-21.

- Homeowners with mortgages issued by non-federally regulated lenders are not subject to the mandatory flood purchase requirements.

In response to low levels of compliance with the mandatory purchase requirements and the financial challenges facing federal insurance program, some insurance market analysts have proposed an overhaul of the NFIP to address these and other programmatic issues.[23] Although FEMA does have an interest in ensuring high levels of compliance, the agency must rely on federally regulated lenders, government sponsored enterprises (GSEs), and federal agencies that provide financial assistance for construction and acquisition of property in SFHAs to implement and monitor compliance with the mandatory purchase requirement. Some propose requiring all U.S. homeowners to purchase flood insurance, possibly the way liability insurance is required for automobile owners.

Third, thousands of residents along the Gulf Coast who relied on government flood maps to determine who must buy flood insurance were arguably unaware of their actual flood risk and uninsured when Hurricanes Katrina, Rita, and Wilma struck. An issue for the 110th Congress, therefore, might be to decide what to do about flood maps that may be incorrectly measuring risk and, therefore, not capturing the nation's exposure to flood risk. Critics of FEMA's flood map modernization efforts say these activities have been underfunded and lack focus.

Many people in Hurricane Katrina's path did not have flood insurance because, according to government flood maps, they were not in a floodplain and did not need coverage. On October 18, 2005, the Department of Homeland Security's Inspector General released a report that raised concerns about the accuracy of flood maps.[24] The report concluded that outdated flood maps placed homeowners and residents at physical and financial risk because many people living in high-risk areas did not know of the dangers and, therefore, might not have chosen to participate in the NFIP.

Again, according to Rand Corporation, about one-third of all flood claims occur outside of SFHAs, yet only 1% of property owners residing in these areas purchase flood insurance from the NFIP. Communities in harm's way might not be adequately enforcing strong building codes or land use zoning ordinances, which would have reduced the amount of wind-related damage.

In the case of New Orleans — a city that experienced massive flooding and an historic 29-foot storm surge — FEMA flood maps incorrectly made the assumption that levees and flood walls would withstand the storm surge and protect the residents

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[23] For more information on flood insurance reform see CRS Report RL33689, *Flood Insurance Reform: Analysis and Comparison of 109th Congress Bills: (H.R. 4973 and S. 3589)*, by Rawle O. King.

[24] Office of Inspector General, Department of Homeland Security, "Challenges in FEMA's Flood Map Modernization Program," Report No. OIG-05-44, Sept. 2005, located at [http://oversight.house.gov/Documents/20051018124029-72925.pdf].

from flooding.[25] Many property owners in Katrina-impacted areas outside government-designated flood zones whose homes were destroyed were not subject to the mandatory purchase requirement and, therefore, did not have adequate coverage. Efforts are underway at FEMA under its flood map modernization program to develop accurate digital flood plain maps that are consistent in terms of data collection standards and analytical methods.

Post-Katrina Economic Uncertainty for Policyholders and Insurers

In the aftermath of Hurricanes Katrina and Rita, thousands of homeowners in Louisiana, Mississippi, and Alabama face significant obstacles in getting their property damage insurance claims paid. When insurance adjustors and damage experts assessed properties damaged by the 2005 hurricanes, they were faced with the issue of allocating damages between wind (a covered loss) and flood (an excluded loss). The ambiguity and economic uncertainty that this activity has engendered has raised financial and legal issues for insurers, as well as homeowners and businesses along the Gulf Coast region. The solution for some of the insureds has been to litigate with their insurers, seeking to declare the "water damage exclusion" clause in their policies unenforceable — a move that would arguably then allow insureds to receive coverage for flood damage under their homeowners' policies. Allocating damages between covered wind damages and excluded flood damages has become a question of fact to be decided by the courts.

Issues of Contention. Insurers attempt to separate the wind damage (covered) from the flood damage (excluded) through physical examination of the location. In many areas of New Orleans, for example, the house contains a clear water-line with no or minimal roof damage. Along the Mississippi coast, many homes are completely destroyed with only a slab remaining. In those cases, the factual investigation turns on an analysis of weather conditions and the construction of the home to determine the extent of wind damage that occurred prior to the destruction of the home by excluded storm surge. Policyholders and insurers can have different views on these facts which result in litigation.

From the industry's perspective, claims are settled in the same manner they always have been with regard to the water damage exclusion that they assert has been well known among homeowners and state regulators for years. Insurers have argued that they settle claims fairly and in accordance with policy language and the historical treatment in court cases of storm surge associated with flooding during a hurricane. This is why, insurers insist, the federal government offers flood insurance. In addition, insurers note that they did not cover, and therefore price, the flood risk in the homeowners' policies, and hence did not set aside appropriate loss reserves to pay such claims.[26] Further, insurers maintain that the uncertainty associated with the court's *ex post* re-interpretation of insurance policy terms and language substantially

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[25] Peter Whorisky, "Risk Estimates Led to Fewer Flood Policies," *Washington Post*, Oct. 17, 2005, p. A 1.

[26] Ibid.

increases their risk — i.e., paying flood insurance claims after the loss without actuarially accounting for this event before the loss could jeopardize their financial solvency. If they raise rates to reflect the increased risk, their customers will pay more for coverage that is now provided by the NFIP.

Policyholders and their advocates have charged that insurers rely upon the "flood exclusion" and anti-concurrent causation policy language to not pay claims on homes damaged by a combination of wind and flood. From their perspectives, insistence on the unenforceability of the "flood exclusion" and the anti-concurrent clause is consistent with "reasonable expectation" since they thought they had "full protection."

Post-Katrina insurance claims litigation and the economic uncertainty it generates for consumers and insurers have raised at least four interrelated policy issues for the 110th Congress: insurance coverage disputes; disaster and the law; flood plain policy; and insurance reforms.

Insurance Coverage Disputes. There may be congressional oversight and investigations into the handling of Katrina-related insurance claims, and possible legislative efforts to modify the industry's antitrust exemption under the McCarran-Ferguson Act of 1945[27] and state supervision and regulation of the business of insurance. Members of the 110th Congress have the option to address the volatility in the legal environment in terms of post-event judicial interpretations in the scope of insurance coverage and legislative or regulatory "lock-ins" of capacity in the months and even years after a storm. After Katrina and Rita, for example, in states like Florida and Louisiana, the insurance commissioners declared a state of emergency in the state's insurance market and suspended certain statutes and regulations regarding policy cancellations, non-renewals, reinstatements, and claim filings. These emergency declarations have had the effect of "locking in" the investor capital that stands behind the policies sold in the state. Some insurance experts have suggested that legal and regulatory volatility tends to discourage rather than encourage the retention and expansion of capital commitments in the affected states.

Disasters and the Law. Katrina demonstrates apparent gaps in the legal system and its ability to respond to events of this magnitude. This issue is important if communities are to be able to rebuild and recover in a timely manner after a major catastrophe. In the short term, Congress might consider oversight and investigation hearings into post-Katrina insurance claims issues and the regulatory impact this could have on the insurance market. In the long term, businesses, including the insurance industry, rely on a predictable legal regime that will operate efficiently in an emergency situation. In anticipation of another Katrina-sized natural disaster, Congress has the option to consider the enactment of a nationwide body of "disaster law"so the nation might be better prepared to rebuild and recover after a major catastrophe.[28]

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[27] P.L. 79-15; 59 Stat. 33

[28] See Daniel A. Farber, "Disasters and the Law: Katrina and Beyond" (Aspen Publishers: (continued...)

U.S. Floodplain Management Policy. What should be done and not done to recover from flood damage and mitigate the consequences of future floods? The aftermath of a disaster often presents the opportunity to address multiple long-standing problems. After Hurricane Katrina, the floodplain policy response seems to have been to build "bigger and better" flood protections systems — i.e., take a nationwide inventory of the structural flood controls (levees), reinforce and strengthen them, and expand requirements for insuring residual risks behind levees and dams. History (1920s-1960s and 1993 Midwest floods) has showed that relying on structural means of controlling floods, such as building levees and dams, is not always the best flood control policy. Two broad policy options have been suggested that would (1) surrender land to the water, a new idea that would require forgoing development of floodplains and property buyouts; or (2) continue along the current path embodied in the NFIP (i.e., risk assessment or mapping, floodplain management, and insurance protection), but strengthen zoning laws and construction standards, modernize flood maps, and enforce existing mandatory flood insurance purchase requirements.

Insurance Reforms. A large percentage of those eligible to buy federally subsidized flood insurance do not. The NFIP subsidizes insurance rates for about 26% of policies, generally high-risk buildings built before NFIP floodplain regulations were established in their community. As a long-standing public policy, the federal government forgoes significant premium income because of policy subsidies. Moreover, losses associated with subsidized properties account for 25% to 30% of all claims losses. What is the solvency and regulatory impact of massive Katrina-related flood losses on the NFIP? How effective has the program's mandatory flood insurance purchase requirement been in increasing market penetration and reducing future flood losses?

Insurance Policy Language and Coverage

Private insurers generally do not cover the flood hazard because of the problem of adverse selection,[29] and the perceived unprofitability and volatility of this line of insurance due to the absence of tools for technical risk rating or portfolio diversification. Since 1968, this gap in coverage has been filled by the purchase of federally subsidized flood insurance. Many homeowners incorrectly believe that their standard homeowners policies automatically provide coverage against flooding, when in fact an additional flood policy will be needed.

This section provides an analysis and comparison of both federal flood insurance and the NFIP's standard homeowners' insurance policy, and the nature and types of the insuring clauses, including the "water damage" exclusion provision.

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[28] (...continued)
2006.)

[29] Adverse selection is the tendency of people who have a greater perceived probability of loss than does the average person to seek insurance.

Federal Flood Insurance

Federal flood insurance is available to residents only in communities that agreed to institute floodplain management strategies designed to reduce future flood losses. The federal government established certain minimum building and development standards for floodplain construction that the communities have to adopt in order to participate in the NFIP. Under the National Flood Insurance Act of 1968,[30] the federal government is required to map the nation's floodplain. In order to do so, FEMA determines flood risk through various sources specific to each community. This flood risk information is then delineated by zones on Flood Insurance Rate Maps (FIRMs).[31] The area of flood hazards on these maps is the Special Flood Hazard Area (SFHA), which is defined as an area of land that experiences a 1% chance of being flooded in any given year (also known as the base flood or 100-year flood).

Standard Flood Insurance Policy (SFIP). The NFIP offers three Standard Flood Insurance Policy (SFIP) forms: Dwelling Policy; General Property Policy; and Residential Condominium Building Association Policy. The *Dwelling Policy* is used to insure residential structures and their contents and is issued to homeowners (including those in condominium units, manufactured mobile/trailer homes, townhouse structures, and timeshares), residential renters, or owners of residential buildings containing two to four units. The Dwelling Form offers coverage for building property, up to $250,000, and personal property (contents), up to $100,000. Contents coverage must be purchased separately.

The *General Property Policy* is issued to owners of residential buildings with five or more units, owners or lessees of nonresidential structures, such as hotels, apartment buildings, schools, commercial structures, cooperative associations, and their contents. Coverage is available up to $500,000 for non-residential buildings and their contents.

The *Residential Condominium Building Association Policy* (RCBAP) is issued to residential condominium building associations to cover the entire building under one policy. The policy covers all units, improvements within the units, and personal property owned in common. Eligible structures under the RCBAP include high-rise and low-rise condominium buildings and condominium associations.

The SFIP is not a *guaranteed replacement cost policy* that pays the to rebuild regardless of the limit of liability in the event of a total loss. Instead, the SFIP policies pay the replacement cost of actual damages, up to the policy limit. In other words, flood insurance does not pay more than the policy limit.

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[30] P.L. 90-448, 82 Stat 573.

[31] In order to assess a community's flood risk which is delineated on FIRMs, FEMA uses historical flood data, including the community's rainfall and river-flow, topography, wind velocity, tidal surge, flood-control measures, development, and other factors.

NFIP's Definition of a Flood. The NFIP defines a flood as

> general and temporary condition of partial or complete inundation of two or more acres of normally dry land area or of two or more properties from: overflow of inland or tidal waters, unusual and rapid accumulation or runoff of surface waters from any source, mudflow, or collapse or subsidence of land along the shore of a lake or similar body of water as a result of erosion or undermining caused by waves or currents of water exceeding anticipated cyclical levels.

The SFIP covers physical damage to the building or personal property "directly" caused by a flood. It does not cover: damage caused by moisture, mildew or mold; loss of currency and valuable papers such as stock certificates; living expenses such as temporary housing; and, financial losses caused by business interruption or loss of use of insured property.

Standard Homeowners' Insurance

The property insurance industry uses standardized policy language to provide uniformity in coverage and consistency in legal outcomes. The basic forms are developed and written by the Insurance Services Office Inc. (ISO).[32] The standard homeowners' insurance (HO) policy that ISO publishes combines various personal insurance protections which can include losses on the home, its contents, loss of its use (additional living expenses), as well as liability coverage in the event the homeowner is sued and found legally responsible for damages.

There are seven types of ISO standardized HO forms in general and consistent use. Of these, HO-3 is the most common policy, followed by HO-4 and HO-6. Others that are less used are HO-1, HO-2, HO-5, and HO-8. The HO-3 is a special homeowners policy — called *open- perils* — that covers all perils except those specifically excluded by the policy such as earthquakes, floods, *Acts of God*, or war. Special insurance can be purchased for these possibilities, including flood insurance and earthquake insurance. The HO policy might also contain options, called *riders*, *floaters*, or *endorsements*, that can provide additional coverages for such items as art or coin collections for an additional premium.

State insurance departments are responsible for reviewing and approving all insurance policy forms and rates before the policy can be lawfully used by an insurer. The approval process includes an examination of every word, sentence, and paragraph in the policy. Before the regulators are given the policy form for approval, however, it is standard practice in the industry for insurers to consult with actuaries and insurance underwriters to develop the policy language so that pricing is commensurate with the related coverage. Economic efficiencies are realized in this activity by utilizing certain industry organizations, like the ISO, to develop the specific provision in standard-form insurance policies and to file with the each state insurance department so that individual insurers can use them without expending

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[32] The Insurance Services Office, Inc. (ISO) is an insurance organization that provides statistical information, actuarial analyses and consulting, policy language, and technical services to insurers.

money and time that would be required to get the policy forms approved in every state in which they operate.

By standardizing the HO policy, insurers hope that court interpretations of standard coverage forms provide consistent treatment of claimants. Thus, when a court determines the meaning of a word, phrase, or clause in a standard coverage form, that interpretation triggers a rewrite or adjustment to the policy language.

Insuring Clauses. Property and casualty (p/c) insurance policies are classified by causation, and contain in their insuring clauses the words, "loss caused by..." or their equivalent. The insuring clause in the HO-3 policy is a statement of the promises the insurer makes to the insured as far as what perils and exposures are covered; it varies greatly from policy to policy. The problem is that when an insured cause (wind) joins with one or more additional causes (flood), which may be uninsured or may be insured under a separate contract, *concurrent causation* can be said to exist. It is this concurrent causation that has generated so much litigation surrounding the "wind v. flood" legal disputes. Litigation arises as to whether the damage was caused by an insured event or by an event which is either excluded from coverage or not within the scope of the policy.

Named-Perils v. Open-Perils Policies. Property policies come in several types, including commercial and homeowners. These policies are further divided by the type of risks insured: *named-peril risk* or *open-peril risk*. Named risk policies insure against physical loss or damage caused by various risks specified in the policy (e.g., fire, lightning, explosion, windstorm or hail, smoke, aircraft or vehicles, riot or civil commotion, vandalism, sprinkler leakage, sinkhole collapse and volcanic action).

Open-peril policies, on the other hand, insure against physical loss or damage caused by any risk that is not excluded or limited by the policy. The distinction between named-peril and open-peril policies becomes especially important in litigation. Under the named-peril policies, courts have held that a policyholder must first prove one or more of the named perils caused a loss. Insurers must then prove that the loss is excluded in the policy. Under an open-peril policy, the policyholder must prove damage occurred to the insured property. Insurers must establish that an excluded risk caused the loss.

In some litigation addressing the water damage exclusion, plaintiffs have contended that the water damage should be covered because it resulted from storm surge, which was not a specifically excluded peril. A recent federal court decision held that "storm surge" was within the policy definition of "flood" and the exclusion should apply.[33] In another case involving water damage but that specifically covered winds or hail, the court denied the insurer's motion to dismiss, hold that there was coverage for all damage caused by wind, and wind-driven rain, but that losses directly resulting from storm surge were excluded by the water damage exclusion.[34] Applying Mississippi law in the *Tuepker* case, the judge also held that the

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[33] Buente v. Allstate Prop. and Cas. Ins. Co., 2006 WL 980784 (S.D. Miss. 4/12/2006).

[34] Tuepker v. State Farm Fire and Cas., 2006 WL 1442489 (S.D. Miss. 5/24/2006).

exclusionary language in the policy was invalid to the extent that it did not allow for consideration of the proximate cause (covered wind or uncovered water) of the insured's damage;[35] and further that, at trial, if the insured could prove its damage was sustained as a result of covered perils, its claim would be paid.[36]

Open-perils policies cover many perils not covered by named-perils policies; consequently, the open-perils policy provides broader coverage than a named-perils policy, and carries a higher premium. Whether the policy is open-perils or named-perils, however, the coverage it provides will have exclusions. Exclusions are an integral part of every insurance policy. The flood peril, in particular, is excluded from HO policies because it is unusual and requires a separate rating.

Water Damage Exclusion. In the event of hurricane-related flooding, the question of the cause of damage, whether wind *or* water or wind *and* water is of considerable importance.[37] The reason is that flood exclusion language has been a standard feature of homeowners' insurance policies since around 1968, when the federal government's National Flood Insurance Program (NFIP) was established. Homeowners' policies generally exclude coverage for flood damage. Insurers have not priced and, therefore, not collected premiums to pay for flood coverage.

An insurance policy usually specifies what causes — called "hazards" or "perils" — are covered. It also specifies what effects — called "losses" or "damages" — are covered and which perils and losses are excluded from coverage. The insurance industry defines an "exclusion" as a provision in an insurance policy that eliminates coverage for certain risks, people, property, classes, or locations. The insurance policy language that specifically excludes flooding is found in the "Perils Insured Against" and "Exclusions" section of the standard homeowners' policy.

Claims Adjustment, Causation, and Policy Language Interpretation

Two broad sets of post-Katrina claims-adjustment issues may be relevant to the 110th Congress. *First* is the alleged adverse impact on insureds of computerized claims settlement systems and products. Public interest advocacy groups have alleged that the insurance industry uses computer programs, such as "Colossus" sold by Computer Sciences Corporation (CSC) or "Claims Outcome Advisor" sold by the Insurance Services Office (ISO), to systematically underpay homeowners claims.[38]

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[35] Ibid., at *4.

[36] Ibid., at *6.

[37] The controversial issue involving the allocation of damage between wind and water is not present in the commercial insurance marketplace because these policies do cover both flood and water damage. To the extent an issue might arise, it is with respect to sublimits for damage from flood. For example, a commercial building could be insured for $200 million but with a $30 million sublimit for flood.

[38] See J. Robert Hunter, *Property/Casualty Insurance in 2007: Overpriced Insurance,* (continued...)

Their argument is that these systems allow insurers to calibrate the amount of savings they want to generate to the detriment of their insureds.

Claims adjustment under the NFIP is different from that in the private homeowners' insurance market. The adjustment of federal flood insurance claims is conducted by property and casualty insurers who write and service NFIP policies and claims under a contractual agreement with the NFIP's Write Your Own (WYO) Program. Over 95% of NFIP's policies are written under this program. Private insurers enter into a "Financial Assistance Subsidy Arrangement" whereby they agree to issue flood policies in their own names and take responsibility for policy administration, claims processing, marketing, and sales. Private insurers handle all claims issued in their names, and adjust and settle flood loss claims consistent with their general claims practices. In adjusting flood insurance claims, which are binding upon the federal government, a WYO insurer is authorized to use staff adjusters or independent contractors selected and supervised by the company. The WYO insurer also determines when and how adjusters will be compensated for their work on flood claims.

WYO insurers typically receive an expense allowance for policies written and claims processed, and the federal government assumes total financial responsibility for underwriting losses. Insurers retain 15% of premiums written to cover commissions and salaries of agents and brokers. They are also reimbursed for marketing, operating, and administrative expenses. The expense ratio of the WYO appears to be about one-third of premiums.[39]

On January 18, 2006, the Collins Center for Public Policy issued a report that raised several specific concerns involving contracting with private insurance companies for NFIP policy claims adjusting and servicing. The issue paper indicated (1) WYO insurers had no financial incentive to adjust claims in the best interest of the NFIP because the federal government pays all claims, and (2) the existence of conflicts of interest for WYO insurers and their agents when they attempt to adjust possibly competing claims against flood insurance offered by NFIP, and claims against their own policies for wind or other coverage.[40]

Critics have charged that the NFIP appears to have few systemic checks and balances to ensure that it is being administered correctly. FEMA has responded to this charge by noting that WYO insurers are subject to certain standards and oversight as detailed in the NFIP's "Write Your Own Program Financial Control Plan Requirements and Procedures Manual." WYO insurers, for example, must comply with monthly financial and statistical transaction reporting requirements. They are subject to a review of operations — claims, underwriting, customer service,

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[38] (...continued)
Underpaid Claims, Declining Losses and Unjustified Profits, Jan. 8, 2007, located at [http://www.centerjd.org/free/mythbusters-free/CFA_070108.pdf].

[39] See Collins Center for Public Policy, *Issue Paper: National Flood Insurance Program*, located at [http://www.fldfs.com/PressOffice/Documents/RetrieveDocument.asp?DocumentID=%7B115A82E4-01B1-44C6-874D-6950E134524D%7D].

[40] Ibid.

marketing, and litigation activities — every three years to assure that each company is meeting its performance objectives and adhering to program standards and policies. In addition, WYO insurers are subject to a "Biennial Claims Audit" every two years, and a "Claims Reinspection Program" that randomly reviews a percentage of WYO insurers' claims settlement practices.

Congress may debate the WYO claims adjusting issue given that, under legislation passed in the 109th Congress, the Department of Homeland Security Inspector General is required to investigate and report to Congress by April 2007 on whether insurers under the WYO Program improperly attributed damages from Hurricane Katrina to flooding covered under the National Flood Insurance Program rather than to windstorms covered by such insurers.[41]

Second is the issue of *causation* in the homeowners' claims adjustment process — a major source of insurance-coverage disputes between policyholders and their insurers: i.e., whether a loss was caused by winds (typically covered under homeowners' policies) or flooding accompanying the storm (typically excluded under homeowners' policies). Causation is the key factor involved in the water damage exclusion and the "wind versus flood" legal disputes in Louisiana and Mississippi.[42]

Homeowners insurance claims are typically paid if the loss is caused by a covered peril or, in the case of "all risk" (open-perils) policies, a peril that is not expressly excluded. If the loss is caused by multiple factors (mixed cases), such as wind that is covered and flood that is not, claims adjustment becomes more challenging. Both wind and flood, for example, might have worked together to cause the loss; one may have followed directly from the other, or the two may have arisen independently. In either case, the causal nature of the relationship between the perils has resulted in legal disputes between policyholders and their insurers. In order to resolve these mixed cases, the courts have developed various tests for situations in which an excluded peril and a non-excluded peril contributed to the loss, with the most prominent being the "efficient proximate cause" doctrine and the "concurrent causation" doctrine.[43]

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[41] Department of Homeland Security Appropriations Act of 2007, P.L. 109-295; 120 Stat. 1357.

[42] Causation issues may extend beyond the question of windstorm versus flood. For example, damage to buildings may be linked to pre-existing structural deficiencies or to outside forces such as vandalism. Mold in buildings may have been there before any flooding. Yet another issue is damages resulting from the levee break. A key question is: What is the chain of causation? The breach of a levees built by government authorities would presumably involve two entirely independent causes that combine to result in loss or damage, but neither set the other in motion. In this case, "coverage under a policy is equally available to an insured whenever an insured risk constitutes simply a concurrent proximate cause of the injuries." Policyholders have been able to argue successfully that while a policy might exclude flooding, it did not exclude the independent concurrent cause of negligence in design or maintenance of levees. In other words, because the loss resulted from the occurrence of an excluded hazard *and* a covered hazard, it should be covered.

[43] Seth A. Tucker and Ann-Kelley Kemper, "Hurricane Katrina Insurance Coverage Issues," (continued...)

Causation Battles Over Hurricane Katrina Claims

The exact application of causation doctrines — "concurrent causation," "proximate cause," "efficient proximate cause," and "anti-concurrent causation" — in the context of Hurricane Katrina claims will depend on the type of insurance policy owned by the claimant, the facts of the claim, and the case law in the pertinent jurisdiction. Insurance lawyers have observed that every legally disputed case has unique features with different fact patterns and different levels and types of coverage that apply to each policyholder.

The next four sections examine causation doctrines or "rules of insurance policy interpretation" that could be used in understanding the tension between intended meaning in policy language and interpretation of certain provisions.

Concurrent Causation. Claimants' attorneys have focused considerable attention on finding ways to overcome decades of legal precedent supporting the flood exclusion. The principle of concurrent causation holds that if two causes combine to produce a loss or damage, and one of the two causes is excluded (e.g., flood) and the other is covered (e.g., windstorm), the loss will be covered absent policy wording to the contrary.[44] "Proximate cause" and "efficient proximate cause" are variations on "concurrent causation."

Proximate Cause. The proximate cause concept is particularly important in the "chain of causation" arguments involving wind versus flood claims following a major hurricane. Under the proximate cause concept, if a policy covers fire, not only is the direct damage by fire covered, but the collateral smoke damage — as well as damage from the water used by firefighters — is treated as a loss by fire. The key is that the damage must actually have been caused by the fire and any collateral damage that did not break the "chain of causation."

Proximate cause may impose limits on scope of legal liability because determining the cause of a loss can only be based on what is administratively possible and convenient, i.e., it may not be determinable with precision. For example, assuming that hurricane winds destroyed the roof or walls of a home or caused a levee to be overtopped or damaged. Whether the resulting flooding damage would be covered because it was considered due to the proximate cause of wind is not necessarily certain.

Efficient Proximate Cause. Given the uncertainty of determining actual "proximate cause," the efficient proximate doctrine is used by some courts to allocate losses when damage results from a combination of both covered and excluded

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[43] (...continued)
Covington & Burling, Oct.4, 2005, located at [http://www.cov.com/files/Publication/0a096d9d-4741-4cd3-bee7-7359422c2a3a/Presentation/PublicationAttachment/61063844-2886-44d8-bac4-7f5c3bbecafe/oid27267.pdf].

[44] See Doug Simpson's weblog, *Unintended Consequences: Flood Insurance and Exclusions, Proximate and Concurrent Causation*, located at [http://www.dougsimpson.com/blog/archives/000464.html].

causes. Thus, in the event of multiple causes for a loss, the efficient proximate cause doctrine allows payment under the policy if the non-excluded cause is the *dominant* cause of the loss (i.e., the one that sets the others in motion), notwithstanding that an excluded peril may have contributed to the loss.[45]

Attorneys and the courts frequently utilize the "but for" rule in determining how far back the chain of causation should go." The rule, as applied to the "wind-v.-flood" coverage dispute, says that "but for" the particular event (e.g., wind), the loss experienced by the plaintiff would not have occurred, even when the loss and the covered event are separated by a chain of events that include floods.

As in any insurance coverage litigation involving whether coverage should be available when both covered (wind) and excluded (flood) losses are part of a chain of events, there are differences of opinion on the proper scope of the efficient proximate cause doctrine, particularly whether the cause is considered a minor or major factor in producing the injury or damage.

Anti-Concurrent Causation Clauses. In response to the successful use of the concurrent causation arguments and the courts' reinterpretation of the flood exclusion language that has led to unanticipated exposures, insurers have sought to draft, file, and get state approval of policy language to make it as clear and unambiguous as possible that no damage due to flood is covered. Hoping to avoid the unexpected consequences of future adverse court decisions, insurers sought to implement industry-standard language designed to cover "all risks" not specifically excluded by the contract language. The "anti-concurrent causation" doctrine was designed to prevent the theory of concurrent causation from providing coverage for losses never intended to be covered by standard property insurance policies. Plaintiffs' attorneys, however, frequently argue that the exclusions are in violation of public policy.

Generally speaking, and notwithstanding some federal court decisions to the contrary, the efficient proximate cause doctrine has been adopted by the highest courts of Mississippi, Louisiana, and Alabama.[46] Courts in these three states have interpreted the doctrine to allow policyholders to recover for hurricane-related losses where their evidence showed that wind was the proximate cause of the damage, even if flooding contributed to the loss. To attempt to defend against the claim, insurers must counter the insured's evidence with evidence tending to prove that the proximate and efficient cause was one that falls outside of the coverage of the insurance policy.[47]

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[45] For expert commentary on causation in insurance contract interpretation, see *The Enigma of Causation in Insurance Contract Interpretation*, Kenneth S. Wollner, [http://www.irmi.com/Expert/Articles/2004/Wollmer01.aspx].

[46] Western Assurance Co. v. Hann, 78 So. 232 (Ala. 1971); Glens Falls Ins. Co. of Glens Falls, N.Y. v. Linwood Elevator, 130 So. 2d 262, 270 (Miss. 1961); Evans Plantation, Inc. V. Yorkshire Ins. Co, 58 So. 2d 797, 798 (Miss. 1952); Roach-Strayhan-Holland Post No. 20, American Legion Club, Inc. v. Continental Ins. Co. of N.Y., 112 So. 2d 680 (La. 1959).

[47] See, e.g., Broussard v. State Farm Fire and Casualty Company, Civil Action No. 1:06cv6-
(continued...)

And recently decided cases, specifically in Mississippi, suggest that the federal courts will enforce the flood exclusion to the extent the damage is caused by flood, not wind and rain, but will not enforce anti-concurrent causation language where it would eliminate coverage for otherwise covered damage.[48] In addition, because insurers bear the burden of proving allocation of loss between wind/rain (covered) and flood (excluded), insurers will likely be held liable for paying all Katrina damage for which the cause of loss cannot be definitely established.[49]

Unfair Claims Practices State Laws

In addition to the application of the efficient proximate cause doctrine to uphold or not uphold coverage in favor of policyholders, most states and jurisdictions have regulations and rules on claims handling that provide certain protection to policyholders. Most states have adopted a version of the National Association of Insurance Commissioners (NAIC) *Model Unfair Claims Practices Act* that governs how insurers must deal with claimants. These statutes require insurance companies to handle claims with good faith and fair dealing. Insurers, for example, must pay claims according to standards of practice, which is within 30 days after receipt of a "Proof of Loss" — i.e., a legal document that states the amount the policyholder is claiming under the policy. In the course of insurance litigation, the interpretation of specific insurance statutory and regulatory provisions comes into play. Lawsuits frequently arise alleging insurer violation of specific provisions (e.g., unfair claim settlement practices, delay in settling claims, etc.).

Summary of Katrina Litigation

Katrina spawned hundreds of lawsuits against insurance companies,[50] most challenging insurers' reliance on the water-damage exclusion and the anti-concurrent causation language in homeowners' policies to deny property damage claims. Among the issues is the extent to which the anti-concurrent causation language is consistent with or contrary to the settlement law in a given state. This section provides a brief, narrative summary of major legal activities related to Katrina insurance claims disputes.

"Valued Policy" Statutes and Related Litigation

Policyholders typically use the "valued policy" statutes to gain coverage in cases where both wind and water caused damage to the property. Valued Policy statutes

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[47] (...continued)
LTS-RHW (S.D. Miss. 1/11/2007) (on cross-motions for judgment as a matter of law).

[48] E.g., Leonard v. Nationwide Mutual Ins. Co., 438 F. Supp. 2d 684 (S.D. Miss. 2006).

[49] *Broussard, supra.*

[50] Daniel Hays and Susanne Sclafane, "Mississippi Negotiating Katrina Settlements: Deal With State Farm Reportedly Near," *National Underwriter: Property & Casualty*, Jan. 15, 2007.

require insurers to determine the value of the property being insured at the time a policy is written and to pay that full value to the insured when there is a total loss caused by a covered peril. The insured is not required to prove the value of the damaged property. A building is considered a total loss when the necessary repair costs are more than 50% of the value of the building.

Both Louisiana and Mississippi have enacted "valued policy" statutes:

The Louisiana Valued Policy statute provides that

> Under any fire insurance policy insuring inanimate, immovable property in this state, if the insurer places a valuation upon the covered property and uses such valuation for purposes of determining the premium charge to be made under the policy, in the case of total loss the insurer shall compute and indemnify or compensate any covered loss of, or damage to, such property which occurs during the term of the policy at such valuation without deduction or offset, unless a different method is to be used in the computation of loss, in which latter case, the policy, and any application therefore, shall set forth in type of equal size, the actual method of such loss computation by the insurer.

The Mississippi Valued Policy statute provides that

> No insurance company shall knowingly issue any fire insurance policy upon property within this state for an amount which, taken with any existing insurance thereon, exceeds a fair value of the property, nor for a longer term than five years. When buildings and structures are insured against loss by fire and, situated within the state, are totally destroyed by fire, the company shall not be permitted to deny that the building or structures insured were worth at the time of the issuance of the policy the full value upon which the insurance is calculated and the measure of damages shall be the amount for which the building and structures were insured.

Mississippi has an instructive precedent regarding the water damage exclusion. Under Mississippi common law, where there is damage caused by both wind and rain (covered loss) and flood (excluded loss), the amount due under the policy will generally depend on the proximate and efficient cause of the damage (i.e., hurricane wind), even if other "non" covered causes also contributed to the loss.[51]

A Florida case found that that state's Valued Policy statute did, in fact, require payment of the face amount of the wind-insurance policy because the insured property was damaged — at least in part — by a covered peril (wind).[52] The special concurrence in *Mierzwa* would have required that the "proximate cause" of the damage be the covered peril (wind) (and not merely, as the majority held, that it be *some part* of the cause of the damage), but agreed with the majority result because

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[51] See Grace v. Lititz Mutual Insurance Co. 257 So. 2d 217 (Miss. 1972).

[52] Mierzwa v. Florida Windstorm Underwriting Association, 877 So. 2d 774 (Fla. App. 2004).

the concurrer found such "proximate cause."[53] The Florida statute, however, was amended after the *Mierzwa* decision to specifically allow for the pro rating of damages caused by both a covered and a non-covered peril except "if the covered perils alone would have caused the total loss."[54]

Several cases from Louisiana have been filed, presumably seeking to rely on *Mierzwa*, attempting to get insurers to cover their damages — notwithstanding that the Louisiana valued policy statute is directed specifically at fire insurance policies.

Other Litigation

A suit filed in Mississippi Chancery Court by the Mississippi Attorney General in September 2005 against State Farm Fire and Casualty Company and other insurers sought to enforce the insurance policies issued by defendant insurers. Although the defendants, who maintained that the policies exclude coverage of damages caused by flooding, attempted to have the case removed to federal court on the ground that it involved litigation concerning a federal program (the insurers are WYO issuers of flood insurance policies pursuant to the NFIP), the United States District Court for the Southern District of Mississippi, on reconsideration of an earlier Order to remand the case to the state court, affirmed the Order, stating

> [Defendants] have attempted to create federal jurisdiction out of what is essentially ... 'the interpretation of the terms of private [homeowners'] insurance policies, tradition ally a function of state law.'[55]

State Farm agreed to a proposed settlement of the case, in conjunction with a pending, private, proposed, class-action suit,[56] and the settlement was concluded on January 23, 2007. Not only was the proposed class denied,[57] the court rejected the settlement on several grounds:

> The proposed settlement agreement establishes certain absolute limits on class members' potential recoveries that may be inconsistent with my prior rulings. ... The agreement [pursuant to which the insurer's liability is limited by the amount of recovery under separate flood-damage policies] does not provide for any exception for situations in which the fair market value or the actual cash value

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[53] 877 So. 2d at 781-2.

[54] See West's F.S.A. § 627.702(1)(b), effective 6/1/2005.

[55] Hood v. Mississippi Farm Bureau Insurance Company, 2006 WL 3802170 (S.D. Miss. 2006), *quoting* from the earlier Order issued by Judge Tom S. Lee.

[56] Woullard v. State Farm Fire and Casualty Co., Docket No. 1:06cv1057 (S.D. Miss.). Available at [http://www.mssd.uscourts.gov/Insurance%20Opinions/ch06cv1057order0126.pdf].

[57] "The plaintiffs have alleged that 'many hundreds, if not thousands, of individuals and/or entities have asserted claims or have potential claims' against State Farm. Neither the plaintiffs nor State Farm has given the Court any information from which the Court can determine with any reasonable degree of certainty how many policyholders are within the proposed class or how many policyholders have each of the eleven types of policies identified." *Id.*

> of the insured property is equal to or greater than the combined limits of flood coverage limits and the coverage limits in the State Farm policies.[58]

In addition, the court was bothered by State Farm's "indirect control" over the claims handling procedure because the appointment by State Farm of a Special Master to oversee the process would impinge on a function "that is exclusively within the prerogative of the Court."[59] Moreover, the complexity of the claims procedure, which would have prevented the effective participation of many claimants; the court's discomfort with "sending a large number of policyholders into the process of binding arbitration when none of these individuals have ever agreed to participate in that procedure"; and the fact that

> the resolution of the state court actions brought by the Mississippi Attorney General purports to incorporate or rely upon an arbitration program administered by this Court

were considerable obstacles that led to the court's rejection of the settlement.[60]

There are other, private, ongoing cases in both Mississippi and Louisiana challenging insurers' interpretations of policies relied upon for protection against hurricane-related damage. A list of the opinions or orders in those cases[61] is available on the website of the U.S. District Court for the Southern District of Mississippi, as the cases have been consolidated on the docket of that court.[62] All of the cases involve some permutation of the wind v. water/flood equation.

Criminal Investigation of Insurer's Claim Handling Practices

The Attorney General of Mississippi began a criminal investigation into State Farm's handling of Katrina claims. A grand jury was seated to hear the charges that focused on the wind v. water debate. Using documents provided by whistleblowers who worked for an insurer, and the state's Unfair Claims Practices statute, Hood alleged insurers defrauded policyholders by manipulating engineering reports to deny claims. On January 23, 2007, as part of the settlement with State Farm on the class action litigation, Hood ended the criminal investigation, opting instead to handle the matter in civil court and in Congress. He supports congressional oversight and investigation on this matter and national insurance reform.[63]

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[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] Descriptions of the litigation of those cases is contemplated in a forthcoming addendum to this report.

[62] See [http://www.mssd.uscourts.gov/insurance.htm].

[63] Michael Kunzelman, "Ex-State Farm Adjusters Tell Mississippi Grand Jury of Katrina Claims," *Associated Press*, Jan. 23, 2007, located at [http://www.insurancejournal.com/news/southeast/2007/01/23/76104.htm]

Legislative Response

Three sets of bills — H.R. 920; H.R. 1081/S. 618, and H.R. 537/S. 292 — have been introduced in the 110th Congress to address post-Katrina insurance coverage issues. These measures would:(1) enhance insurance reform of the NFIP (H.R. 920); (2) establish a bipartisan commission to study the Gulf states' insurance market in Katrina's aftermath and make recommendations to Congress regarding the availability of insurance for catastrophic risks (H.R. 537/S. 292); and (3) repeal the insurance industry's limited exemption from federal antitrust laws to make the industry more competitive (H.R. 1081/S. 618).

On February 8, 2007, Representative Gene Taylor introduced the *Multiple Peril Insurance Act of 2007* (H.R. 920), which would create an all-peril policy that covers both wind- and water-related damages for both homeowners and small businesses under the NFIP. The legislation seeks to expand coverage offered by the NFIP from flood only policies to include flood and wind perils. H.R. 920 is also designed to reduce complexity in claims adjusting associated with wind and flood loss segregation; and enhance wind insurance availability and reduce prices.

On February 16, 2007, Senator Patrick Leahy introduced the Insurance Industry Competition Act of 2007 (S. 618/H.R. 1081), which would amend the McCarran-Ferguson Act of 1945 to give the Federal Trade Commission and the Justice Department oversight over ensuring that insurers comply with federal antitrust laws. The McCarran Ferguson Act allows collaborative industry practices like the development of standardized policy language which makes it easy for consumers to compare policies and prices.

On January 12, 2007, Senator Bill Nelson introduced the Commission on Catastrophe Disaster Risk and Insurance Act of 2007 (S. 292/H.R. 537) to create a federal bipartisan commission to study catastrophe insurance markets in Katrina's aftermath and make recommendations to Congress regarding the availability of insurance for catastrophic risks. The commission would establish a forum for both the insurance and consumers to address post-Katrina insurance issues.

Finally, the 109th Congress enacted the Department of Homeland Security Appropriations Act of 2007 that included a provision that directed the DHS Inspector general to investigate and report to Congress on whether insurers under the NFIP's Write-your-Own program improperly attributed damages from Hurricane Katrina to flooding covered under the National Flood Insurance Program rather than to windstorms covered by such insurers.

The section of the DHS Appropriations Act reads as follows:

> ...the Department of Homeland Security Inspector General shall investigate whether, and to what extent, in adjusting and settling claims resulting from Hurricane Katrina, insurers making flood insurance coverage available under the Write-your-own program pursuant to section 1345 of the National Flood Insurance Act of 1968 (42 U.S.C. 4081) and subpart C of part 62 of title 44, Code of Federal Regulations, improperly attributed damages from such hurricane to flooding covered under the insurance coverage provided under the national

flood insurance program rather than to windstorms covered under coverage provide by such insurers or by windstorm insurance pools in which such insurers participated...the Department of Homeland Security Inspector General shall submit a report to Congress not later than April 1, 2007, setting forth the conclusions of such investigation.[64]

Concluding Observations

Several concluding observations could be made.

- One major problem that has been identified is that the NFIP flood coverage and the private market wind coverage are provided under separate coverage forms, many times by separate insurers and often through separate distribution mechanisms. Congress might choose to focus on the identified problem: flood and wind coverages do not intersect. The NFIP's WYO program (which places nearly all NFIP coverages) works today because the flood policy is typically sold by the same personal lines agent and through the same personal lines insurer that offer the basic property policy. The challenge for policymakers and insurers is to develop a better coordination between flood and wind coverage.

- A major problem with the current system of flood risk mapping is the incorporation of the latest information on risk. When there is evidence that risk levels are rising or that risk was previously underestimated, it can be difficult to get the appropriate adjustments approved. As an illustration, climatologists have observed that the nation is in a period of higher hurricane activity and rising sea levels. The NFIP's coastal storm surge flood zones at any return period may extend further inland than are shown on the official FEMA flood maps. As a result, the construction of buildings at dangerously low elevations will continue to be permitted. In 2006, FEMA announced it was in the process of issuing new flood maps for the City of New Orleans and areas of Mississippi. Until such time as these maps are available, FEMA has issued Advisory BFEs, which direct areas "protected by levees to elevate substantially damaged homes and businesses to 3 feet above the highest adjacent existing grade on site or the current BFE on the flood insurance rate map, whichever is higher."

- NFIP has a low level of market penetration. Despite a requirement that many policyholders purchase NFIP coverage, a much lower than expected number do. Many of those that claim "wind / flood" issues appear to be attacking the private insurance policy's flood exclusion because the policyholder did not purchase NFIP coverage. Congress faces relatively low levels of participation in the NFIP.

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[64] P.L. 109-295, 120 Stat. 1357.

- Is there a need for a national catastrophe insurance solution? The media has made references to affordability issues "from Texas to Massachusetts." One solution offered is to have the federal government assume the wind risk (H.R. 920) and displace private business in all 50 states. In Illinois, for example, wind cover is cheap and plentiful. Some question: Why does Illinois need to disband its well functioning system as part of a nationalization of wind insurance? The real problem seems localized, but consumer advocacy groups have proposed a solution that appears much bigger.

- Government insurance only appears cheaper than private insurance. Federal insurance programs like any of the state catastrophe funds or federal insurance programs appear cheaper up front than they really are. Because government can use taxpayer capital without compensating the taxpayer, government can provide an up-front cost of insurance that is "actuarially sound" for much less than private insurers. This is how the NFIP has functioned to date. Now, there is a call on the taxpayer's capital in the form of a $22 billion deficit. Analysts ask: How was the taxpayer compensated for taking that risk? If NFIP was a private company, then it would have had to acquire capital from investors and/or reinsurers — and pay them for that capital. Government can implicitly tax the taxpayer pre-event by shifting the risk to large future post-event expenditures, thereby denying taxpayers compensation for that risk. In this way, government can make insurance appear cheap on the front end but with enormous post-event costs.