

The Flood After the Storm:

THE HURRICANE KATRINA

HOMEOWNERS' INSURANCE LITIGATION

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On August 23, 2005, the National Hurricane Center in Miami, Florida issued its first advisory about a tropical storm system 350 miles east of Miami.¹ The storm over the next six days would develop into one of the most infamous hurricanes in American history: Hurricane Katrina. By the time the storm surge subsided, Katrina left more than 1,500 people dead,² an estimated \$81 billion in damages,³ and the city of New Orleans in ruins. Yet, while the water subsided and the Gulf Coast attempted to put itself back together, another flood was surging through the Gulf Region. This flood was a flood of litigation, brought by various insurance policy holders claiming that their insurance companies were leaving them high and dry. Now, two years removed from Hurricane Katrina, courthouses across the Gulf Region are still knee deep in the litigation caused by this catastrophic storm. While Hurricane Katrina has seemingly caused litigation over every type of insurance policy imaginable,⁴ this article discusses the homeowners' insurance litigation caused by Hurricane Katrina and explains what impact the Hurricane Katrina litigation may have on the insurance industry overall.

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Homeowners' Insurance and the Insurance Industry

Homeowners Policies are generally considered “all-risks” insurance policies.⁵ All-risks insurance covers all fortuitous losses, unless the policy explicitly excludes a specific loss from coverage.⁶ When presented in court, the burden is both on the insured to demonstrate that the incident is within the policy's terms and on the insurer to demonstrate the applicability of the relevant exclusionary clause.⁷ Exclusionary clauses are “exceptions to insurance coverage upon which the insurer and insured have agreed prior to the execution of the policy.”⁸ Due to perceived differences in bargaining power, courts strictly construe

exclusionary clauses against insurers, interpreting any ambiguity in favor of coverage.⁹

Insurance companies (“insurers”) generate income in two ways.¹⁰ Insurers make money underwriting risks by receiving payments (“premiums”) for coverage.¹¹ Insurers also make money by investing the premiums, placing the money in investment vehicles which offer both high rates of return and provide the liquidity necessary to meet any potential liabilities.¹² To make such investments, insurers need to anticipate losses, in order to set competitive premium rates and ensure that enough money is available at a given time to cover anticipated exposures.¹³ Such predictions are possible due to the mathematical principle known as the law of large numbers.¹⁴

“According to the law of large numbers, as the number of similar but independent exposure units increases, the relative accuracy of predictions about future outcomes (losses) based on these exposure units also increases.”¹⁵ An exposure unit is defined as “a measure of loss exposure assumed by the insurer.”¹⁶ If the definition of an exposure unit is changed by the judicial interpretation of a policy clause, then insurers' calculations made in reliance on the principle may be incorrect. This could lead to insurers suffering revenue loss, insolvency, or, in extreme cases, bankruptcy. If insurers suffered substantial losses, the impact on both the insurance industry and those that purchase insurance would be tremendous.

Leonard v. Nationwide Mutual Insurance Co.

Within one year of Hurricane Katrina making landfall, nearly ninety-five percent of all homeowner claims were settled by insurance companies.¹⁷ However, the five percent of cases which have not settled may impact the insurance industry for years to come. One such case is *Leonard v. Nationwide Mutual Insurance Co.*, the first of the Hurricane Katrina cases to go to trial.¹⁸ In *Leonard*, the plaintiffs sought coverage from defendant, Nationwide, for damages caused by Hurricane Katrina.¹⁹ At issue in the trial was the Nationwide adjustor's assessment of damages and the validity of the anti-concurrent causation clause contained in the policy.²⁰ The validity of the anti-concurrent causation clause²¹ was an important issue in the litigation because

the clause stated that if two causes of loss damaged the property—one an insured cause and the other not—then the damage to the property would not be covered.²²

At the peak of the storm, the first floor of the Leonard's home was submerged in five feet of water.²³ Despite the damages to the first floor, the second floor of the Leonard's property was not damaged and the roof suffered only a few broken shingles.²⁴

With such findings, the adjuster authorized payment for the wind damages suffered to the second floor only, tendering a check to the Leonards in the amount of \$1,661.17.²⁵ According to the Leonard's experts, there were \$47,365.41 in damages that could be attributed to wind and \$130,253.49 in damages from both the wind and the floodwater.²⁶



Read literally, this provision [the anti-concurrent causation clause] would exclude any otherwise covered loss, e.g. windstorm damage, in any circumstance where “weather conditions,” i.e., the windstorm, combined with an excluded cause of loss, e.g. flooding, to damage the insured property. This reading of the policy would mean that an insured whose dwelling lost its roof in high winds

and at the same time suffered an incursion of even an inch of water could recover nothing under his Nationwide policy. Read literally, this provision would exclude all coverage when a windstorm did damage to both an insured dwelling (a covered loss) and adjacent “screens, including their supports, around a pool, patio, or other areas.” (an excluded loss). I do not believe this is a reasonable interpretation of the policy.

....

This reading of the policy would make the windstorm protection illusory for those who live in areas where the risk of flooding is greatest.³¹

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The adjuster only covered the damages caused by the wind and not the flooding because the policy excluded damages from “water and water-borne material,” which encompassed flooding.²⁷ In doing so, the adjuster did not compensate the Leonards for the damage to their ground-floor window or any damage that occurred above the high-water line on their first-floor wall.²⁸ The anti-concurrent causation clause stated that: “[w]e do not cover loss to any property resulting directly or indirectly from the following if another excluded peril contributes to the loss: ... (c) Weather conditions, if contributing in any way with an exclusion listed in paragraph 1. of this Section.”²⁹ It was within “paragraph 1” that water and water-borne materials were excluded.³⁰ Thus even though there was detectable wind damage on the first floor, because there was also flood damage on that floor, none of the wind damage was covered.

Finding the Anti-concurrent causation clause ambiguous, Judge Senter stated that:

Despite this important legal victory for the Leonards, Judge Senter found that nearly all of the damage to the house was caused by the flooding.³² Since the damage to the house was caused by flood, it constituted an uninsured loss.³³ Thus Judge Senter only awarded the Leonards an additional \$1,228.16 for their broken first-floor window and the damage to the first floor that occurred above the high water mark of the flood.³⁴

In response to the decision, the United States Court of Appeals for the Fifth Circuit agreed to hear oral arguments on August 6, 2007, only a few weeks before the second anniversary of Hurricane Katrina.³⁵ Since Judge Senter found that Nationwide was not obligated to cover the Leonards' claims for water damage, Nationwide technically defeated the lawsuit.³⁶ However, due to Judge Senter finding the policy language ambiguous, Nationwide appealed due to the effect the ruling could have in other cases.³⁷ The Fifth Circuit ultimately reversed Judge Senter, finding that the policy language was unambiguous.³⁸ A lawyer representing the Leonards stated that they planned to appeal the decision.³⁹

The Effect on Current and Future Insurance Policies

While there are no other anti-concurrent causation clause cases pending in state or federal court in Mississippi, the *Leonard* opinion still may have a far-reaching impact.⁴⁰ Prior to the *Leonard* case, neither Louisiana nor Mississippi has reported cases addressing anti-concurrent causation clause enforcement, and there is no consensus in other jurisdictions as to the enforceability of the clauses.⁴¹ Since many insurance companies still use these anti-concurrent causation clauses, the *Leonard* court's approval of the clause leaves the definition of an exposure unit intact. If overturned on appeal or found ambiguous by another court, shockwaves would be through the insurance industry, forcing insurers both small and large to re-evaluate their exposure liabilities across the United States.

The Effect on Corporate Goodwill

The *Leonard* case is the type of case that makes insurance company public-relations departments lose sleep at night. On one side, there is a family like the Leonards who has lost their home in a catastrophic disaster. On the other side is an insurance company with very deep pockets whose purpose is to insure people for their losses.⁴² While this is a relatively simple breakdown of the public-perception problem insurance companies are facing, the actual problem is much more severe.

State Farm Mutual Automobile Insurance Company, the largest homeowners' insurer in Mississippi,⁴³ moved United States District Court for the Southern District of Mississippi⁴⁴ for a change of venue "for lawsuits filed in southern Mississippi by individuals who claim insurance carriers failed to pay insured losses to those affected by the destruction of Hurricane Katrina."⁴⁵ In support of its motion, State Farm provided a survey showing that forty-nine "percent of people in southern Mississippi believe that insurance executives are on the same level as child molesters."⁴⁶ While State Farm has embarked on a campaign to revive its image in the Gulf Region, only time will tell if its effort will be successful.⁴⁷

As State Farm and other insurance companies attempt to rebuild both the Gulf Region and their reputations, those publicly traded insurance companies⁴⁸ also have to worry about the value of their corporate goodwill. Goodwill is an intangible asset used to represent "[t]he value of brand names, patents, customer base loyalty, competitive position, R&D and other hard-to-price

"As State Farm and other insurance companies attempt to rebuild both the Gulf Region and their reputations, those publicly traded insurance companies also have to worry about the value of their corporate goodwill."

assets a company might own."⁴⁹ If a company loses too much goodwill, its stock price may suffer. One needs to look no further than the AOL Time-Warner merger, in which AOL Time Warner "had to take a \$100 billion charge against its goodwill account, and in a stroke, the share value of the company collapsed by 75%."⁵⁰

Corporate "Gut Checks"

In a case involving the breaches of the New Orleans levees, *In re Katrina Canal Breaches Litigation*,⁵¹ both insurers and the insured saw firsthand how long the road to adjudication is. The *In re Katrina Canal Breaches* involved litigation over the definition of the word "flood," which was undefined in the plaintiffs' policies.⁵² The plaintiffs asserted that the term "flood" was ambiguous and did not distinguish between naturally and artificially caused floods.⁵³ As ambiguous, the plaintiffs wanted to limit the term to natural flooding⁵⁴ because such a limitation would allow the plaintiffs to argue that breaking of the floodwalls was due to third-party negligence.⁵⁵ If

the flood was due to third-party negligence, the "flood" would be man-made and covered under a homeowners' insurance policy, much like a pipe break.⁵⁶ The defendants contended that all of the water damage caused by the canal breach constituted a flood and was excluded from coverage.⁵⁷

After a District Court ruling in favor of the insured, the much anticipated Fifth Circuit opinion overturned the lower court's decision.⁵⁸ The Court of Appeals noted that "a levee is a *flood-control* structure; [whose] very purpose is to prevent ... floods from becoming more widespread."⁵⁹ Thus, "[b]y definition, whenever a levee ruptures and fails to hold back floodwaters, the result is a more widespread flood."⁶⁰ When a levee fails due to negligence or other factors, "the waters are still floodwaters, and the result is a flood."⁶¹



With the Fifth Circuit's ruling, the insurance companies emerged victorious, and with their exposure units left intact.⁶² Yet this victory did not come cheap for the insurance companies. Whether insurance companies in the Gulf Region will continue to pursue these legal battles in the future remains unseen. Some companies have already withdrawn from the region, citing risk management as the cause.⁶³ Depending on the ultimate resolution of the Katrina Cases, insurance companies may become more hesitant to issue homeowners' insurance in areas susceptible to hurricanes and flooding.

For instance, the Allstate Corporation took a \$3.7 billion pre-tax loss as a result of Hurricane Katrina.⁶⁴ State Farm, in comparison, lost between \$8 to \$9 billion.⁶⁵ These figures, from 2005, do not take into account attorneys fees the Hurricane Katrina cases are generating or the post-Katrina settlements and damage awards.⁶⁶ When these costs start to add up for insurance companies, business decisions will need to be made about the viability of insuring the Gulf Region. Allstate has already made this decision, cutting back its homeowners' insurance coverage along the coast from Connecticut to Texas in order to minimize its exposure.⁶⁷ As more insurers seek to minimize their exposures, the face of insurance in the Gulf Region will change, creating both business opportunities and business perils.

The Doomsday Scenario

While the Hurricane Katrina cases are beginning to reach trial, it is difficult to predict what the outcomes will be and what changes will occur in insurance law as a result. However, as the first Katrina opinions illustrate, courts are willing to look at precedent in similar disaster cases for guidance. Throughout both the *In re Katrina Canal Breaches* opinions, the courts relied heavily on persuasive precedent, including the Colorado Supreme Court opinion involving the failure of the Lawn Lake Dam in Colorado.⁶⁸ When other courts address Katrina related cases, they will certainly look to the other Katrina cases for guidance. Thus, as time marches on, the precedent set in the Katrina litigation may have an exponentially greater impact.

Perhaps one of the most feared natural disasters today is a catastrophic hurricane striking New York City. While many wish to believe this scenario is impossible, it is not only possible but also probable. In fact it happened in 1938, when a category three hurricane dubbed the "Long Island Express" ravaged Long Island, New York.⁶⁹ The hurricane struck the relatively undeveloped island (compared to its state of development today) and caused millions of dollars in damage.⁷⁰ Adjusting for inflation, the "Long Island Express" was the twelfth most costly hurricane ever recorded, inflicting a total of \$6 billion in damages along the Northeast.⁷¹ While researchers claim an "epic" hurricane is unlikely to hit New York, category three hurricanes have a return frequency of eighty years (compared to 200 years for a strong category three—low category four hurricane).⁷² If another cat-

egory three hurricane were to hit New York City, 130 mph winds and a thirty-foot storm surge could cause both the Hudson and East Rivers to overflow.⁷³ The storm could inflict more than \$100 billion.⁷⁴ in economic losses while forcing the evacuation of three million people—six times the population of pre-Katrina New Orleans.⁷⁵

As Judge Duval noted in his opinion *In re Katrina Canal Breach*, insurance companies have chosen not to fix areas of their policies that have been previously challenged as ambiguous.⁷⁶ While optimists hope that insurance companies will learn from the Katrina litigation, only time will tell if they actually will. If the same legal issues were to arise in the setting of another hurricane disaster, such as one striking New York City, courts in New York may look to the Katrina cases for guidance in unsettled areas of the law. While the New York City hypothetical is likely the last thing on judges' minds as they rule in the Katrina homeowners' cases before them, the hypothetical does serve as a reminder of how many more homeowners may ultimately be affected by this litigation. **BLB**

ENDNOTES: Eugene Benick

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³ RICHARD D. KNABB, JAMIE R. RHOME, & DANIEL P. BROWN, NAT'L HURRICANE CTR., TROPICAL CYCLONE REPORT HURRICANE KATRINA, 12 (Aug. 10, 2006), available at http://www.nhc.noaa.gov/pdf/TCR-AL122005_Katrina.pdf (\$81 million is a "preliminary estimate" from 2005).

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⁵ *In re Katrina Canal Breaches Consol. Litig.*, 466 F.Supp.2d 729, 737 (E.D.La. 2006).

⁶ *Id.* (citing Jane Massey Draper, Annotation, *Coverage Under All-Risk Ins.*, 30 A.L.R. 5th 170 (1995)).

⁷ See e.g. *In re Katrina Canal Breaches Consol. Litig.*, 466 F.Supp.2d at 738 (citing *Doerr v. Mobil Oil Corp.*, 774 So.2d 119, 124 (La. 2000)) (explaining the burden of proof in Louisiana).

⁸ *Exclusionary Clause*, WEST'S ENCYCLOPEDIA OF AMERICAN LAW, (Jeffrey Lehman and Shirelle Phelps eds., Gale Group, Inc. 2d ed. 2005) (2006), <http://www.enotes.com/wests-law-encyclopedia/exclusionary-clause> (last visited October 20, 2007).

⁹ See e.g. *In re Katrina Canal Breaches Consol. Litig.*, 466 F.Supp.2d at 738 (citing *Louisiana Ins. Guar. Ass'n v. Interstate Fire & Cas. Co.*, 630 So.2d 759, 764 (La. 1994)).

¹⁰ CONSTANCE M. LUTHARDT & ERIC A. WIENING, PROPERTY AND LIABILITY INSURANCE PRINCIPLES, § 3.3 (4th ed., American Institute for Chartered Property Casualty Underwriters/Insurance Institute of American 2005).

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- 12 *Id.*
- 13 *Id.*
- 14 *Id.* at §1.5.
- 15 *Id.*
- 16 *Id.*
- 17 CityBusiness Staff Report, *Insurance Industry: 95 Percent of Katrina Claims Settled*, NEW ORLEANS CITYBUSINESS, Aug. 22, 2006, http://findarticles.com/pl/articles/mi_qn4200/is_20060822/ai_n16688687.
- 18 438 F.Supp.2d 684 (S.D.Miss. 2006).
- 19 *Id.*
- 20 *Id.*
- 21 Mark D. Mese, Wind Versus Flood Coverage and Hurricane Katrina, 6 CLASS ACTION LITIG. REPORT 21, 795–97 (2005), available at <http://www.louisiana-lawblog.com/Wind%20Versus%20Flood%20Coverage%20and%20Hurricane%20Katrina.pdf> (last visited Oct. 20, 2007) (explaining that anti-concurrent causation clauses are clauses that “attempt to exclude coverage when there are multiple causes of a loss and any one of the causes are non-covered causes.”)
- 22 See Leonard, 438 F.Supp.2d at 694 (explaining the effect the anti-concurrent causation clause would have if it were enforced as written).
- 23 *Id.* at 689 (stating that at the highest point of the storm, “water inundated the Leonard residence to a depth of approximately five feet.”).
- 24 *Id.*
- 25 *Id.* at 690.
- 26 *Id.*
- 27 *Id.* at 689.
- 28 See *id.* at 696 (granting the Leonards damages for the window and the cleaning of the wall above the water line).
- 29 *Id.* at 689.
- 30 *Id.* at 693–94.
- 31 *Id.* at 694.
- 32 *Id.* at 696.
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- 34 *Id.*
- 35 Associated Press, *Federal Appeals Court to Hear Pascagoula Couple’s Katrina Insurance Claims*, WLOX ABC 13, July 2, 2007, <http://www.wlox.com/Global/story.asp?S=6734920>.
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- 50 *Id.*
- 51 495 F.3d 191 (5th Cir. 2007).
- 52 *Id.* at 196.
- 53 *Id.* at 208.
- 54 *Id.* at 218.
- 55 *Id.* at 215–16.
- 56 *Id.* at 215–16.
- 57 *Id.* at 220–21.
- 58 See e.g., Randy J. Maniloff, *The Thrilla In MaNOLA: Court Resolves Heavy-weight Insurance Battle In Louisiana*, Washington Legal Foundation, Oct. 19, 2007, <http://www.insurancecoverageblog.com/10-19-07/maniloff.pdf> (describing the case as having “all the trappings of a heavyweight title fight”).
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- 75 *N.Y. City Urged to Prepare*, *supra* note 73.
- 76 See *In re Katrina Canal Breaches Consol. Litig.*, 466 F.Supp.2d at 759 (stating that insurers have known about this ambiguity for years but, for reasons known only to them, chose not to fix the ambiguity).