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How Will Homeowners Insurance Litigation After Hurricane Katrina Play Out?

The Key Dynamics, the Mississippi Lawsuit, and the Courts' Likely Views

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Over a century ago, an insurance executive observed that, "the insurer proposes, but the court disposes." As the nation reels from Hurricane Katrina and its aftermath, insurance companies and policyholders now living in shelters would do well to reflect on this fundamental characteristic of insurance law.

Insurers have moved swiftly into storm-ravaged areas, setting up mobile claims units and dispatching adjusters to meet with policyholders. While prompt customer service is undoubtedly commendable, there is reason for skepticism here as insurers begin choosing which claims to pay, and which to decline.

In this column, I will discuss three key dynamics that are at play here. In addition, I will comment on how they will affect the lawsuit filed by the Mississippi Attorney General last Thursday, September 15, against a number of insurance companies.

Significantly, substantially similar issues have been raised in Louisiana, where the first lawsuits against insurers were filed last week and more are expected shortly.

The Key Dynamics Likely to Affect Insurance Coverage Issues

As insurers have begun to process the hundreds of thousands of property claims, their adjusters are making coverage determinations, often at the very ruins of the homes where still-shaken policyholders once lived. From published reports, it is clear that adjusters are cutting checks not just for short-term living expenses (to which homeowners are entitled) but for the underlying property damage claims as well. While literally hundreds of coverage issues are likely to arise, policyholders and insurers should consider three dynamics at work.

First, a homeowners insurance agreement is one of the most complicated contracts the average person will ever sign. This is partly due to the historical development of homeowners insurance -- which was stitched together in something like its present form just a few decades ago, from various strands of the law of insurance contracts, which developed over centuries.

Unsurprisingly, given the complexity of these contracts, individual policyholders do not bargain over the terms of their contracts; with rare exceptions, they have neither read their contracts, nor would understand them even if they did. Almost every word in a modern insurance policy has acquired meaning through a cycle of drafting, legal challenge, and redrafting. Indeed, these repeated cycles have often bestowed upon insurance terms not simply a single meaning, but multiple meanings.

Relatedly, courts have long treated insurance as a special sort of contract, recognizing both the complexity of such contracts, and the central importance of insurance in people's lives. For at least 150 years, courts have struggled to match the typically stark and restrictive language of insurance policies with the messy and wide-ranging needs of typical policyholders.

Two complementary doctrines have emerged: First, insurance contracts are construed, wherever possible, to provide coverage. If a word or clause is ambiguous, that doubt is resolved in the policyholder's favor, and against the insurer. This makes sense, as the insurer drafted the contract, and had every chance to make it clear.

Second, courts will honor the "reasonable expectations" of a policyholder even where a "painstaking" reading of the contract (a task invariably left until after a loss has occurred) would reveal the absence of coverage. This reflects the fact that insurers know a great deal about what people (perhaps subliminally) expect from their insurance contracts; it would be wrong to permit insurers to reap the benefit of those expectations (in the form of premiums), while subtly eliminating the very coverage the policyholder thinks he is buying.

Two caveats: These doctrines are not magic wands that point inexorably to coverage, though they do tend to favor the policyholder.

Moreover, as one might expect, courts differ in the zeal with which they apply these doctrines when interpreting insurance contracts. Judges do not like to appear to be rewriting the terms of contracts "freely" entered into. However, most courts do approach the task of interpretation with a pragmatic grasp on the profound limitations policyholders typically bring to the purchase of insurance. Judges generally understand the realities I mentioned above: policyholders who aren't lawyers (and even some who are) simply do not read or understand their contracts.

Whether courts mention them explicitly or not, the doctrines mentioned above exert a strong gravitational effect on the legal meaning of insurance terms - causing courts to bend words, wherever plausible, towards the maximization of coverage.

Third, once the meaning(s) of insurance terms are settled in accordance with the rules described above, it remains to apply them to the facts. But "facts" are rarely determined by judges alone. Rather, courts set wide parameters within which juries are empanelled to find the operative facts that will determine the outcome of a case.

Suppose that each afternoon, an office worker walks across the street to a café to get coffee, often taking requests from his co-workers. On the way back to the office one day, he is hit by a car. Is he covered by workers' compensation - even though he's not in the office, and was getting coffee for co-workers, not the boss? Probably.

Workers' compensation insures against injuries "arising out of, or in the course of, employment." This phrase has been given a broad meaning. A jury could find as a fact that the employee acted for the convenience of the employer (and his fellow employees), and therefore was covered.

The same process is at play whenever a homeowner contests an insurer's claim that damage to the home was caused by an excluded peril (such as flood), rather than an included peril, such as a windstorm. If the jury can find in favor of the policyholder, within the parameters of the judge's instructions, it typically will do so.

Mississippi's Allegations Against Homeowners Insurance Companies

With these observations in mind, consider the lawsuit filed by the Mississippi Attorney General last Thursday. The suit named as defendants insurance companies doing 70% of the homeowners business in that state.

In its complaint, Mississippi makes a number of allegations. It contends that insurers are ignoring

the interpretive rules applicable to insurance contracts and taking advantage of homeowners ignorant of their rights under the law. It also contends that the contracts are so complex and beyond the comprehension of the average person as to be "unconscionable," and thus void.

It also alleges that the standard exclusions for "water damage" and "flood" are ambiguous in the context of a homeowners policy. And it alleges that insurers have illegally engaged in unfair trade practices by representing that their homeowners insurance contracts provide "full and comprehensive hurricane coverage" when the policies, in fact, contain substantial exclusions limiting liability.

Mississippi claims that, as a result of such practices, vulnerable homeowners are being pressured into accepting partial payments and signing away their rights. Accordingly, Mississippi is asking a court to order the companies to stop paying less than full value on claims under the policies, and to hold that the water and flood exclusions are unenforceable.

Assessing the Mississippi Suit: Causation Issues Will Be Crucial

On its face, the Mississippi complaint is rather broad. In response to it, insurers suggest the suit is nothing less than an attempt to rewrite contracts after the fact. They note the irony that Mississippi regulators earlier approved the very agreements now claimed to be "unconscionable."

Although it is unlikely that all of its claims will be upheld, Mississippi has a strong chance to blunt the force of the flood exclusion. For at the core of this dispute is the legal doctrine of "proximate cause."

Proximate cause has long been the bane of law students required to learn it, and lawyers and judges required to apply it. Needless to say, it is an object of singular delight to law professors.

Proximate cause describes a relationship between events sufficient to trigger a legal consequence. So suppose a car accident leads to a rather unusual injury. The driver (and his insurer) may be liable if a court finds the injury to have been "proximately caused" by the driver's negligence. Or suppose the "proximate cause" of a loss is something firmly excluded from insurance coverage; then the insurer is not liable.

But what kind of causes count as "proximate"? Simplifying grossly, the damaging consequence must have a sort of thematic connection to the antecedent event that is claimed to be its "proximate" cause. Only then does the law speak of the consequence as having been "legally caused" by that event.

Why "Legal Causation" Will Play a Large Role In Mississippi and Louisiana

Centuries ago, insurance policies were very simple documents with few exclusions. But over time, as policyholders became more creative in their claims, insurers added ever more exclusions.

That caused an important wrinkle for courts: Many policy-excluded perils had some relationship to policy-included perils. But which was the "legal cause"?

Sometimes excluded and included perils act in tandem. For instance, suppose a house is destroyed by a combination of earthquake and flood, when there is a flood exclusion, but no earthquake exclusion.

Or, one peril might cause another, in a way that requires coverage. In the standard homeowners policy, which contains a flood exemption, an explosion that destroys a house is covered, *even if the explosion is caused by a flood* (imagine an explosion resulting, for instance, from a ruptured gas line).

In some cases, insurers redrafted their policies to preserve coverage, but in others, insurers have

tried to make certain exclusions more definite with respect to causation. These exclusions purport to deny coverage for losses "directly or indirectly" caused by, "contributed to" by, or otherwise linked with, an excluded peril.

The contours of the problem in Mississippi and Louisiana will differ, neighborhood by neighborhood. First, there are entire neighborhoods that are simply gone, leaving only a sludge of forensic questions behind. Whether these homes were destroyed by flood or wind is, at present, a matter of speculation.

In contrast, with respect to identifiable shards of former homes, event reconstruction is certainly possible. But few homeowners can evaluate the evidence without professional advice.

I am a great admirer of insurance companies, but all things being equal, they would rather pay less than pay more. With insured losses estimated to be as high as $60 billion (incredibly, this is merely a fraction of total direct losses), insurers have every incentive to construe what evidence there is in their own favor, rather than in policyholders' favor.

Arguments For a Literal Reading of Insurance Contracts Will Probably Fail

These facts alone would counsel caution, but there is a larger issue that implicates the observations above.

As noted above, it is common for excluded perils to play some role in an otherwise insured loss. What of the houses already weakened by flooding (or rain) and subsequently blown away by wind? Such losses are undeniably caused at least "indirectly" by flood, and thus excluded under the literal terms of policies that use the "directly or indirectly" language quoted above.

But the law is unlikely to accept any literal view of the policies. In Mississippi, and elsewhere, courts have frequently held that where a covered cause (in our example, wind) contributes in some significant way to the loss, then there is coverage even though an excluded cause also contributed to the loss. After all, it is in the nature of things for events to have multiple causes; certainly hurricanes can be expected to inflict both wind and water damage concurrently, or in sequence.

To the extent that insurers insist on a literal and restrictive reading of their policies, the core claim of the Mississippi lawsuit is sound.

Insurers should not be surprised by that, because this result is consistent with the interpretive doctrines described above. When courts hold that there is coverage for flood-related wind damage, or for a wind-damaged home that might have remained intact had its roof been perfectly maintained, they do no more than honor the reasonable expectations of the average policyholder.

Conversely, denying coverage under a flood exclusion where, for example, water was only minutely responsible for the loss would likewise frustrate the average person's understanding of his insurance contract.

It is for these reasons that a court is likely to find the terms "water damage" or "flood" ambiguous in the context of loss caused in conjunction with other, plainly covered causes - and thus to construe these terms in the policyholder's favor.

Finally, one must recall that these causal speculations are ultimately questions of fact to be resolved by the jurors. And Mississippi and Louisiana jurors are likely to have a keen appreciation for the effects of wind in these cases - as well as an intense sympathy for the policyholders who lost so much, and thought they were protected.

Of course, no juror or court should disregard the duty to faithfully apply the law, even where both natural sympathy for hurricane survivors and the regrettable antipathy towards insurance companies

are at their zenith. But no court or juror need do so, in many cases, in order to decide in favor of the policyholder. Where there exists genuine doubt regarding the cause of losses, the legal system allocates the burden of that doubt to the insurer. As insurers assess their costs and estimate their coverage in the wake of Katrina, they must take that reality into account.

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