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Are You Getting What You Expected (And Paid For)? The Reasonable Expectations of Insurance Policyholders, and the Need for Courts to Enforce Them, Including After Hurricane Katrina.

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I. Introduction

Policyholders pay substantial premium dollars every day to purchase insurance coverage to protect their homes and their businesses. That much is certain. What is tragically (but commonly) uncertain is whether those same policyholders receive the proper benefit of their insurance coverage when they need it most — when disaster strikes. Far too often, policyholders experience a loss that involves their normal day-to-day business operations, seek coverage for that loss, and receive a less than expected or satisfactory response from their insurance company. Indeed, that response often comes in the form of resistance, stalling or a flat denial of insurance coverage. Even when any business or person that purchased the insurance would have thought a claim involving their normal functions would be within the scope of coverage purchased, often times they are told otherwise by their insurance companies. In sum, policyholders' reasonable expectations of coverage often remain unmet.

"A review of the language of the applicable insurance policy is critical to determining whether coverage exists. The language of an insurance policy, however, is not the only factor. Critical to determining whether insurance coverage exists, and whether the insurance company has acted appropriately, are the policyholder's reasonable expectations surrounding the purchase of insurance coverage."

A number of factors must be considered when determining whether the insurance company's hesitance or refusal to pay a claim is proper. Naturally, a review of the language of the applicable insurance policy is critical to determining whether coverage exists. The language of an insurance policy, however, is not the only factor. Critical to determining whether insurance coverage exists, and whether the insurance company has acted appropriately, are the policyholder's reasonable expectations surrounding the purchase of insurance coverage. In short, is the policyholder seeking coverage for the type of claim or loss that any reasonable business or person would expect to be protected against by insurance purchased for their normal operations?

Courts throughout the country recognize the importance of the Reasonable Expectations Doctrine (the "Doctrine"), and apply it when making determinations of insurance coverage. In this article, we will discuss the law as it relates to the Doctrine in four states — Pennsylvania, New Jersey, New York and Louisiana — and discuss a recent decision in which the Doctrine played an important role in the finding of insurance coverage for potentially thousands of policyholders devastated by Hurricane Katrina.

II. The Reasonable Expectations Doctrine

Most jurisdictions recognize some form of the Doctrine. One court applying the Doctrine explained its underlying rationale as follows:

> The doctrine of protecting the reasonable expectations of the insured is closely related to the doctrine of contracts of adhesion. Where there is unequal bargaining power between the parties so that one party controls all of the terms and offers the contract on a take-it-or-leave-it basis, the contract will be strictly construed against the party who drafted it. Most courts recognize the great disparity in bargaining power between insurance companies and those who seek insurance. Further, they recognize that, in the majority of cases, a lay person lacks the necessary skills to read and understand insurance policies, which are typically long, set out in very small type and written from a legalistic or insurance expert's perspective. Finally, courts recognize that people purchase insurance relying on others, the agent or company, to provide a policy that meets their needs. The result of the lack of insurance expertise on the part of [policyholders] and the recognized marketing techniques of insurance companies is that "the objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."[1]

"Courts throughout the country — including Pennsylvania, New Jersey, New York and Louisiana — recognize the importance of the Reasonable Expectations Doctrine, and apply it when making determinations of insurance coverage. In Louisiana, the Doctrine played an important role in the finding of insurance coverage for potentially thousands of policyholders devastated by Hurricane Katrina."

Among the many jurisdictions that recognize the Doctrine are Pennsylvania, New Jersey, New York and Louisiana. We will briefly discuss an overview of the relevant law in these states to illustrate the purpose and importance of the doctrine, and then discuss a recent decision from Louisiana to demonstrate how application of the Doctrine serves to resolve properly a coverage dispute.

A. Pennsylvania

Pennsylvania courts have clearly and consistently ruled that "the proper focus for determining issues of insurance coverage is the reasonable expectations of the insured."[2] While "the language of the insurance policy will provide the best indication of the content of the parties' reasonable expectations,"[3] courts must examine "the totality of the insurance transaction involved to ascertain the reasonable expectations of the insured."[4]

Pennsylvania's courts base this principle on their long-held recognition that "insurance contracts are not freely negotiated agreements entered into by parties of equal status."[5] In fact, the Pennsylvania Supreme Court has noted that the reasonable expectations doctrine compensates for the fact that "the conditions of an insurance contract are for the most part dictated by the insurance companies."[6] While the insurance companies consistently seek to avoid

paying their policyholders based on nearly (or actually) unintelligible provisions buried in insurance policies, Pennsylvania courts have long recognized that Pennsylvania policyholders are at a distinct disadvantage in such a situation, and acknowledge that such language does not necessarily preclude coverage.

The Pennsylvania Supreme Court has adopted the Doctrine, and has explained it in the following way:

> The reasonable expectation of the insured is the focal point of the insurance transaction involved here. [] Courts should be concerned with assuring that the insurance purchasing public's reasonable expectations are fulfilled. Thus, regardless of the ambiguity, or lack thereof, inherent in a given set of insurance documents (whether they be applications, conditional receipts, riders, policies, or whatever), the public has a right to expect that they will receive something of comparable value in return for the premium paid. Courts should also keep alert to the fact that the expectations of the insured are in large measure created by the insurance industry itself. Through the use of lengthy, complex, and cumbersomely written applications, conditional receipts, riders, and policies, to name just a few, the insurance industry forces the insurance consumer to rely upon the oral representations of the insurance agent. Such representations may or may not accurately reflect the contents of the written document and therefore the insurer is often in a position to reap the benefit of the insured's lack of understanding of the transaction.
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> Courts must examine the dynamics of the insurance transaction to ascertain what are the reasonable expectations of the consumer. [] Courts must also keep in mind the obvious advantages gained by the insurer when the premium is paid at the time of application. An insurer should not be permitted to enjoy such benefits without giving comparable benefit in return to the insured.[7]

Even the most clearly written exclusion will not foreclose coverage in circumstances in which the policyholder has a reasonable expectation of coverage.[8] One Pennsylvania federal court, relying on the Doctrine, stated "where unambiguous terms do not support the reasonable expectations of the insured, that expectation prevails over the language of the policy."[9] The U.S. Court of Appeals for the Third Circuit has repeatedly expressed this maxim of insurance law:

> [T]he insurer is bound not only by the expectations that it creates, but also by any other reasonable expectations of the insured. The insured's reasonable expectations control, even if they are contrary to the explicit terms of the policy.[10]

Importantly, and unlike in some jurisdictions, examination of a policyholder's "reasonable expectations" of coverage is not predicated upon an initial finding of ambiguity in the policy language in Pennsylvania.[11] This is due, at least in part, to the principle that an insurance policy must always be interpreted in light of the nature of the policyholder's business and the insurance purchased to protect that business:

> We believe that any manufacturer who is operating with liability coverage has a reasonable expectation that any liability, reasonably encompassed within the policy, which is tied to that manufacturing and distributing process will be covered. After all, that is the primary reason the policy was purchased in the first place.[12]

B. New Jersey

The fundamental principle of New Jersey insurance law is to fulfill the reasonable expectations of the policyholder.[13] The reasonable expectations of policyholders will be honored "even though painstaking study of the policy provisions would have negated those expectations."[14] So strong is the policy behind the Doctrine that the New Jersey Supreme Court has "recognized the importance of construing contracts of insurance to reflect the reasonable expectations of the insured in the face of ambiguous language and phrasing,"[15] and that an *unambiguous* contract may be "interpreted contrary to its plain meaning so as to fulfill the reasonable expectations of the insured."[16]

New Jersey law on this subject is driven, at least in part, by the differences between policyholders and insurance companies. "[W]hile insurance policies are contractual in nature, they are not ordinary contracts but contracts of adhesion between parties who are not equally situated."[17] Even the most sophisticated policyholder finds his or her "bargaining power is necessarily limited."[18] Insurance policies are often unilaterally "prepared by the company's experts, [persons] learned in the law of insurance who serve its interest in exercising their draftsmanship art. The result of their effort is given to the insured in printed form upon the payment of his premium."[19] Because insurance policies "are contracts of adhesion, prepared 'unilaterally by the insurer, and have always been subjected to careful judicial scrutiny to avoid injury to the public."[20] Because of the unique nature

of contracts of insurance, New Jersey courts assume "a particularly vigilant role in ensuring their conformity to public policy and principles of fairness."[21]

"[O]ur courts have endorsed the principle of giving effect to the 'reasonable expectations' of the insured for the purpose of rendering a 'fair interpretation' of the boundaries of insurance coverage."[22] The policyholder's "reasonable expectations in the transaction may not justly be frustrated and courts have properly molded their governing interpretative principles with that uppermost in mind."[23]

Policyholders "are entitled to the broad measure of protection necessary to fulfill their reasonable expectations. They should not be subjected to technical encumbrances or to hidden pitfalls and their policies should be *construed liberally* in their favor to the end that coverage is afforded 'to the full extent that any fair interpretation will allow."[24] Indeed, where the literal reading of policy provisions would largely nullify the insurance coverage, "they will be severely restricted so as to enable fair fulfillment of the stated policy objective."[25] Insurance companies cannot "seek refuge in the literal language of their policies when the company's conduct and actions, or that of their agents, causes the insured to act or to fail to act based on that conduct."[26]

As the New Jersey Supreme Court has observed:

> We examine the actions of the parties, necessarily considering as well whether alternative conduct or more precise language by the insurer, if chosen, "would have put the matter beyond reasonable question." [] Moreover, we consider not only the actions of the parties at the time of formation of the policy, but the conduct both before and after. [][27]

Furthermore, because the reasonable expectations of the policyholder is fundamental it is "appropriate to explore factually what insurance was purchased, the circumstances surrounding procurement of coverage, the extent to which the [insurance] carrier or its agent may have been made aware of the [policyholder's purpose in acquiring the insurance], and any other evidence of the insured's understanding when it bought its policy."[28]

C. New York

New York law recognizes the Doctrine in interpreting insurance policies.[29] In New York, "[a]ny interpretation of an insurance contract implicates as a standard 'the reasonable expectation and purpose of the ordinary businessman when making an ordinary business contract.' "[30] New York courts, however, tend to require the existence of an ambiguity in the insurance policy before applying the Doctrine. These courts have explained that if an ambiguity arises in an insurance contract that "cannot be resolved by examining the parties' intentions, then the ambiguous language should be construed in accordance with the reasonable expectations of the insured *when he entered into the contract*."[31] Other courts have similarly emphasized that the reasonable expectations of the insured should be considered at the time the contract was entered into.[32]

In New York, the Doctrine is seen as a corollary to the "*contra-proferentem* rule," also favoring policyholders in insurance contract interpretation.[33] According to the *contra-proferentem* rule, "where a policy of insurance is so framed as to leave room for two constructions, the words used should be interpreted most strongly against the insurer."[34] Courts have adopted this doctrine because insurers generally prepare policies, therefore, "when the meaning is doubtful, it should be construed most favorably to the insured, who had nothing to do with the preparation thereof."[35] Similarly, the Doctrine interprets ambiguities in favor of coverage and against the insurance company.

D. Louisiana

Under well-established Louisiana jurisprudence, when absurd results will occur from a reading of a contract's terms, the contract is ambiguous and "the courts *must* construe the provision in a manner consistent with the 'nature of the contract, equity, usages, the conduct of the parties before and after the formation of the contract, and of other contracts of a like nature between the same parties.' "[36] Moreover, Louisiana courts must construe insurance policies "to effect, not deny coverage, and any ambiguity should be interpreted in favor of the [policyholder.]"[37] More specifically, "equivocal provisions seeking to narrow an insurer's obligation are strictly construed against the insurer" if a provision is susceptible to two or more reasonable interpretations.[38]

Furthermore, if a policy or its provisions are ambiguous, Louisiana courts apply the Reasonable Expectations Doctrine.[39] Under the Doctrine, " 'courts will protect the [policyholders'] reasonable expectations . . . regarding the coverage afforded by insurance contracts even though a careful examination of the policy provisions indicates that such expectations are contrary to the expressed intention of the insurer.' "[40] As explained below, a court's proper application of the Doctrine can be the difference between a finding of coverage that is needed, paid for and expected, and a finding that coverage that a policyholder pays for and expects does not exist.

III. Recent Application of the Reasonable Expectations Doctrine: The Hurricane Katrina Case Study

In a ruling that will have unprecedented impact on hundreds of thousands of Greater New Orleans Metropolitan Area residents whose homes were damaged or lost in the wake of Hurricane Katrina, a federal court in Louisiana recently ruled that homeowners insurance companies cannot deny claims for losses caused by water released from the failed New Orleans Levees System unless their policies expressly exclude coverage for water-related losses caused by negligent acts or man-made causes of the water's release. In its Opinion, the court recognized the Doctrine, and applied it to resolve the issue of coverage in light of its determination that the term "flood" was ambiguous, and the insurance polices involved were All-Risk homeowners policies.

The opinion was issued in the consolidated matter of *In Re: Katrina Canal Breaches Consolidated Litigation*, Civil Action No, 05-4182, which is currently pending in the United States District Court for the Eastern District of Louisiana and encompasses all cases related to damages caused by water released from the New Orleans levees. Included among the four matters which are the subject of the Honorable Stanwood R. Duval's opinion is *Chehardy, et al. v. State Farm, et al.,* the most comprehensive class action lawsuit filed on behalf of New Orleans area homeowners. The *Chehardy* action was brought against fifteen insurance companies that sold All-Risk homeowners insurance policies to Louisiana residents.

"The Court's decision in Louisiana is a major defeat for the insurance industry, which, despite collecting premiums from New Orleans-area policyholders for years, attempted to exclude losses caused by Hurricane Katrina's windstorms, the storm surge created by the winds, as well as the negligent acts of third-parties with regard to the New Orleans-area levees."

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The Court noted that the insurance companies "wrote every word of their respective policies" but failed to draft a clear exclusion for water damage caused by negligent acts, something the insurance companies could have done "with very little effort." Consequently, the Court refused to accept the insurance companies' overbroad interpretation of "flood" and held the term to be ambiguous which, under Louisiana law, requires an interpretation providing coverage to the homeowners. The Court also explained that given the ambiguity, it was required to:

> ascertain how a reasonable insurance policy purchaser would construe the clause at the time the insurance contract was entered to fulfill the reasonable expectations of the insured even though a carful [sic] examination of the policy provisions indicate that such expectations are contrary to the expressed intention of the insurer.[41]

Accordingly, given the applicable law and the facts, the Court properly applied the Doctrine in determining that coverage existed for policyholders in this most critical dispute.

IV. Conclusion

"With the odds stacked in favor of the insurance company and against the policyholder, a policyholder in a coverage dispute with its insurance company must utilize any and all tools that it can to ensure that its reasonable expectations of coverage are met — especially if it becomes necessary for a court to compel the insurance company to satisfy that obligation."

This recent example in Louisiana is only one of many examples that demonstrates the importance of the Reasonable Expectations Doctrine for policyholders. Regardless of where a coverage dispute is being litigated, a policyholder must research and consider the applicable law of that jurisdiction to determine if and how the Doctrine may be used to establish coverage, depending, of course, on the facts unique to that particular case. With the odds stacked

in favor of the insurance company and against the policyholder, a policyholder in a coverage dispute with its insurance company must utilize any and all tools that it can to ensure that its reasonable expectations of coverage are met — especially if it becomes necessary for a court to compel the insurance company to satisfy that obligation.

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[1] *Atwater Creamery Co. v. Western Nat'l Mut. Ins. Co.,* 366 N.W.2d 271 (Minn. 1985) (quoting Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961 (1970)).

[2] *Reliance Ins. Co. v. Moessner,* 121 F.3d 895, 903 (3d Cir. 1997) (applying Pennsylvania law).

[3] *Bensalem Twp. v. International Surplus Lines Ins. Co.,* 38 F.3d 1303, 1309 (3d Cir. 1994).

[4] *Dibble v. Security of Am. Life Ins. Co.,* 404 Pa. Super. 205, 210, 590 A.2d 352, 354 (1991) (quoted in *Bensalem Twp.,* 38 F.3d at 1309).

[5] *Collister v. Nationwide Life Ins. Co.,* 479 Pa. 579, 388 A.2d 1346 (1978), *cert. denied,* 439 U.S. 1089 (1979).

[6] *Collister,* 479 Pa. 579, 388 A.2d 1346

[7] *Tonkovic v. State Farm Mut. Auto. Ins. Co.,* 513 Pa. 445, 456–57, 521 A.2d 920, 926 (1987) (citations omitted).

[8] *See Bensalem Twp.,* 38 F.3d at 1309, 1311 (applying Pennsylvania law).

[9] *Island Assocs., Inc. v. Erie Group, Inc.,* 894 F. Supp. 200, 203 (W.D. Pa. 1995) (citing *Bensalem Twp.*, 38 F.3d at 1311).

[10] *Medical Protective Co. v. Watkins,* 198 F.3d 100, 106 (3d Cir. 1999) (quoting *West American Ins. Co. v. Park,* 933 F.2d 1236, 1239 (3d Cir. 1991) and citing *State Farm Mut. Auto. Ins. Co. v. Williams,* 481 Pa. 130, 142, 392 A.2d 281, 286–87 (1978)).

[11] *See; UPMC Health Sys. v. Metro. Life Ins.,* 391 F.3d 497, 504 (3d Cir. 2004) (stating that "[n]either any lack of ambiguity in the policy language nor UPMC's status as a sophisticated purchaser of insurance prevents application of the doctrine of reasonable expectations.") (applying Pennsylvania law).

[12] *J.H. France Refractories Co. v. Allstate Ins. Co.,* 396 Pa. Super. 185, 200–01, 578 A.2d 468, 476 (1990), *aff'd in part, rev'd in part on other grounds*, 534 Pa. 29, 626 A.2d 502 (1993).

[13] *See, e.g., Salem Group v. Oliver,* 128 N.J. 1, 4, 607 A.2d 138, 139 (1992); *DiOrio v. New Jersey Mfrs. Ins. Co.,* 79 N.J. 257, 269, 398 A.2d 1274, 1280 (1979); *Allen v. Metropolitan Life Ins. Co.,* 44 N.J. 294, 305, 208 A.2d 638, 644 (1965); *Merchants Indem. Corp. v. Eggleston,* 37 N.J. 114, 121–22, 179 A.2d 505, 508–509 (1962).

[14] *Sparks v. St. Paul Ins. Co.,* 100 N.J. 325, 338–339, 495 A.2d 406, 414 (1985) (quoting R. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970)).

[15] *Nav-Its, Inc. v. Selective Ins. Co. of Am.,* 183 N.J. 110, 119, 869 A.2d 929, 934 (2005).

[16] *Werner Indus., Inc. v. First State Ins. Co.,* 112 N.J. 30, 35–36, 548 A.2d 188, 191 (1988); *Liebling v. Garden State Indem.,* 337 N.J. Super. 447, 462, 767 A.2d 515, 524 (App. Div. 2001), *cert. denied*, 169 N.J. 606, 782 A.2d 424 (2001) (quoting *Werner*, 112 N.J. at 35–36, 548 *A.*2d 188).

[17] *Meier v. New Jersey Life Ins. Co.,* 101 N.J. 597, 611, 503 A.2d 862, 869 (1986).

[18] *Zuckerman v. National Union Fire Ins. Co.,* 100 N.J. 304, 320, 495 A.2d 395, 404 (1985).

[19] *Mazzilli v. Accident & Cas. Ins. Co.,* 35 N.J. 1, 7–8, 170 A.2d 800, 803 (1961).

[20] *Sparks*, 100 N.J. at 334, 495 A.2d at 412.

[21] *Voorhees v. Preferred Mut. Ins. Co.,* 128 N.J. 165, 175, 607 A.2d 1255, 1260 (1992).

[22] *DiOrio,* 79 N.J. at 269, 398 A.2d at 1280 (1979).

[23] *Allen*, 44 N.J. at 305, 208 A.2d at 644.

[24] *Kievit v. Loyal Protective Life Ins. Co.,* 34 N.J. 475, 482, 170 A.2d 22, 26 (1961) (citing *Danek v. Hommer,* 28 N.J. Super. 68, 76, 100 A.2d 198, 202 (App. Div. 1953), *aff'd*,15 N.J. 573, 15 N.J. 573, 105 A.2d 667 (1954)) (emphasis added).

[25] *Kievit*, 34 N.J. at 483, 170 A.2d at 26 (citation omitted).

[26] *Harr v. Allstate Ins. Co.,* 54 N.J. 287, 304, 255 A.2d 208, 217–218 (1969).

[27] *Doto v. Russo,* 140 N.J. 544, 557, 659 A.2d 1371, 1377 (1995) (citations omitted).

[28] *Gottlieb v. Newark Ins. Co.,* 238 N.J. Super. 531, 545, 570 A.2d 443, 450 (App. Div. 1990).

[29] *Haber v. St. Paul Guardian Ins. Co.,* 137 F.3d 691, 697 (2d Cir. 1998).

[30] *In re; Liquidation of Midland Ins. Co.,* 269 A.D.2d 50, 59, 709 N.Y.S.2d 24, 31 (1st Dep't 2000) (citation omitted). *See also Atlantic Cement Co. v. Fidelity & Cas. Co. of N.Y.,* 91 A.D.2d 412, 418, 459 N.Y.S.2d 425, 429 (1st Dep't 1983); *Belt Painting Corp. v. TIG Ins. Co.,* 100 N.Y.2d 377, 383, 795 N.E.2d 15, 17 (2003) (court read insurance policy in light of "common speech" and the "reasonable expectations of a businessperson"); *United States Underwriters Ins. Co. v. Affordable Hous. Found., Inc.,* 256 F. Supp. 2d 176, 181 (S.D.N.Y. 2003) (court must construe insurance policy language "in accordance with the reasonable expectations of the average insured individual, reading the policy and employing common language skills.").

[31] *Haber*, 137 F.3d at 697 (emphasis added).

[32] *See Cetta v. Robinson,* 145 A.D.2d 820, 822, 535 N.Y.S.2d 805, 807 (3d Dep't 1988) (insurance policy must be read "with a view towards common speech and to what was reasonably intended by the parties when the policy was written and accepted"); *Herbert Rosenthal Jewelry Corp. v. St. Paul Fire & Marine Ins. Co.,* 21 A.D.2d 160, 167, 249 N.Y.S.2d 208, 216 (1st Dep't 1964)

("contracts are made by people about real transactions and they should be interpreted in accordance with their reasonable intentions at the time.").

[33] *Haber*, 137 F.3d at 697.

[34] *Haber*, 137 F.3d at 697.

[35] *Haber*, 137 F.3d at 698.

[36] *Doerr v. Mobil Oil Corp.,* 774 So.2d 119, 124 (La. 2000) (citing La. Civ. Code. Art. 2053) (emphasis added).

[37] *Doerr*, 774 So.2d at 124 (citing *Yount v. Maisano,* 627 So.2d 148, 151 (La. 1993)); *Garcia v. St. Bernard Parish Sch. Bd.,* 576 So.2d 975, 976 (La. 1991); *Breland v. Schilling,* 550 So.2d 609, 610 (La. 1989).

[38] *Cadwallader v. Allstate Ins. Co.,* 848 So.2d 577, 580 (La. 2003).

[39] *Holden v. Connex — Metalna,* Civ. A. No. 98-3326 (E.D. La Feb. 2, 2001); *Louisiana Ins. Guar. Ass'n v. Interstate Fire & Cas. Co.,* 630 So.2d 759, 764 (La. 1994); *Breland*, 550 So.2d at 610–11.

[40] *Louisiana Ins. Guar. Ass'n*, 630 So.2d at 764, n.9 (quoting R. Keeton and A. Widiss, Insurance Law § 6.13 (1988)).

[41] *In re Katrina Canal Breaches Consolidated Litigation*, Civil Action No, 05-4182, at 40 (citing *Louisiana Ins. Guar. Ass'n*, 630 So.2d at 764, n.19).