CPCU SOCIETY INSURING YOUR SUCCESS

Risk Management Quarterly

RMQ

Volume 25 Number 3 October 2008

Is It a Vase or Are There Two Faces?

Policyholders See One Thing; Insurers Another

by Rhonda D. Orin, J.D.

Rhonda D. Orin, J.D., is the managing partner of the Washington, D.C., office of Anderson Kill & Olick LLP. She has secured insurance coverage for policyholders in connection with hurricane losses, environmental clean-ups, asbestos actions, the administration of ERISA plans and other circumstances. As trial counsel in 2002, Orin won one of the 10 largest jury verdicts of the year. She is the author of numerous articles and one book, *Making Them Pay: How To Get the Most from Health Insurance and Managed Care* (St. Martin's Press 2000).

Editor's note: This article originally appeared in the November/December 2007 issue of *Contingencies,* a publication of the American Academy of Actuaries. It is reprinted with permission. Copyright © 2007 *Contingencies.* Orin gratefully acknowledges the invaluable assistance of Legal Assistant Brenda Bonazelli in the preparation of this article.

A Danish psychologist named Edgar Rubin became famous around the turn of the past century for designing a "vase/profile illusion," namely a picture that can be perceived as either a white vase against a black background or as two black faces against a white background. Since the picture's been around since 1915, you've probably seen it by now.

With apologies to Dr. Rubin, an analogy can be drawn between the vase/profile illusion and certain modern-day conflicts between policyholders and insurance companies. In short, these disparate groups can look at the same circumstance and come to completely opposite conclusions.

One of the clearest examples of these differing viewpoints can be seen in the 2005 hurricane season. To policyholders, when Hurricanes Katrina and Rita swept along the Gulf Coast, each one looked on television news like a cohesive whole. The swirling shape, with an eye in the center, was a single event — what most policyholders recognized as simply a hurricane.

But not so for the insurance industry. Insurance companies saw each hurricane as a series of wholly separate and unrelated events. One event was wind. Another was rain. Still others were high water, waves, storm surges, and so on.

The same is true for the consequences. To the "untrained" eye, the flooding of New Orleans, the power failures that rendered businesses inoperative, the evacuation orders that closed down entire communities, and the looting and thefts that followed the physical devastation all arose from single events: the hurricanes.

Here again, the insurance industry disagreed. It viewed each of the above as a separate event, rather than a collective consequence of the hurricanes.

There is a reason for the insurance industry to draw such distinctions. By parsing the hurricanes into separate parts, and especially by including "anti-concurrent causation" provisions that purport to justify the complete denial of coverage whenever there is a single uncovered part, insurance companies increase the likelihood of denying coverage for claims.

This entire system is confusing to policyholders. Often, when policyholders buy insurance policies that cover property damage and other losses that might follow in the wake of hurricanes, they think that they have purchased all the coverage that they need. They think that if a hurricane roars through their area and leaves physical and economic devastation in its wake, the damages that result from that hurricane will be covered.

Another problem is that the insurance policies are drafted by the insurance companies. The insurance companies define the key terms, such as "flood." The insurance companies draft the exclusions, even including draconian language that purports to exclude coverage whenever an excluded peril is among many causes of alleged harm. Finally, the insurance companies interpret the provisions that they drafted, leaving the policyholders with the relatively undesirable option of arguing against a *fait accompli*.

Continued on page 2

Is It a Vase or Are There Two Faces?

Continued from page 1

Certainly, there are checks and balances in this system. One of them is the role played by state insurance departments, which typically are empowered to review and approve the policy forms that the insurance companies propose to sell in their states. Another is the role played by state attorney generals and the courts in reviewing the insurance company denials. Still another is the role of the courts in reviewing policyholder challenges to denials of coverage, and in using state bad faith law to deter insurance companies from wrongful and bad faith denials.

Substantial activity in the courts following Hurricane Katrina should be immediately apparent to even the most casual observer. A brief review of Westlaw shows that in Louisiana alone, approximately seventy decisions regarding Hurricane Katrina were handed down by the end of 2006. Mississippi ran a close second, with approximately 50 such decisions.

It should be no surprise that many of these early decisions have addressed the threshold issue of jurisdiction. To the extent that a pattern can be generalized, policyholders tend to file suit in the state courts, insurance companies tend to remove these actions to federal courts, and policyholders tend to respond with motions for remand. Whether or not those motions are granted often reflects a careful analysis of the specific allegations in the complaints. Policyholders who sue for insurance coverage under policies issued as part of the National Flood Insurance Program ("NFIP") should expect an uphill battle in seeking remand. Policyholders seeking recovery under state statutes, such as state Valued Policy Laws, or under state common law, such as negligence actions against the insurance agents who sold them their policies, should not expect the struggle to be as hard.

Only one post-Katrina case had been tried to completion by the end of 2006: *Leonard v Nationwide*, in the Southern District of Mississippi. That outcome, which is discussed in more detail below, clearly illustrates that Katrina litigation is proving to be fact-intensive, with policyholders facing a high burden of proof with regard to the cause of their damages and insurance companies facing a serious challenge to the enforceability of their coverage provisions.

State governments, state insurance departments and state attorney generals have been notably active in Katrina-related activities. In Louisiana, for example, Governor Blanco issued several Executive Orders that extended various legal deadlines that were deemed impossible to meet under the twin circumstances of physical devastation of property and displacement of citizens. Also, the Louisiana Legislature enacted Act Nos. 739 and 802, which extend the prescriptive period within which citizens may file certain claims under their insurance policies. The Louisiana Attorney General filed suit on behalf of the state on July 10, 2006, seeking a declaratory judgment as to the constitutionality of these acts. The action was removed to federal court and then remanded back to state court, where the attorney general filed a writ of certiorari with the Louisiana Supreme Court. Ultimately, that court found that the legislative acts at issue are constitutional.

The Texas Department of Insurance ("TDI") and the Texas attorney general have taken affirmative actions to prevent insurance companies from denying insurance coverage to Texas residents who have been deprived of access to their property due to power failures. They have sought and obtained a court order against Allstate Insurance Company, providing such relief.

The Mississippi Attorney General's office has been particularly aggressive in challenging anti-concurrent causation provisions as unenforceable. On September 15, 2005, Attorney General Jim Hood filed a lawsuit in Hinds County, Mississippi, First Judicial District, alleging that insurance companies are interpreting their policies in an overly restrictive manner; that they are taking advantage of policyholders who do not understand their rights; and also that they are selling insurance policies that are so difficult to understand as to be unconscionable and therefore void.

The insurance companies filed a Notice of Removal the very next day, removing the case to the Southern District of Mississippi on grounds that the complaint interprets not only private homeowners' policies, but also Standard Flood Insurance Policies (SFIPs) that are relegated to the administration and supervision of the Federal Emergency Management Agency (FEMA). Attorney General Hood responded with a Motion to Remand, which was granted on March 8, 2006. The federal court granted that motion, ruling that the Attorney General's complaint does not pertain to the SFIPs.

On December 19, 2006, the case was transferred to Judge L.T. Senter, Jr., who then remanded the action back to the Chancery Court of Hinds County, Mississippi, First Judicial District, on December 26, 2006. Ultimately, the case was resolved by settlement, yet there is an ongoing issue now regarding enforcement of the settlement's terms.

Anti-concurrent causation provisions have come under attack — albeit unsuccessfully, thus far — in the Louisiana legislature as well. In 2005, and again in 2006, State Sen. Julie Quinn (R-Metairie) and State Rep. Tim Burns (R-Mandeville) have proposed legislation precluding the enforcement of these clauses. Both times, the proposed legislation died during the session.

Policyholders and others, often acting through the vehicle of class actions, have turned to the courts for relief in a wide variety of situations. For example, in Louisiana on September 15, 2005, some 160,000 property and business owners filed a class action lawsuit against the Commissioner of Insurance, Robert Wooley, and a number of insurance companies, captioned *Gladys Chehardy*,

et al. v Louisiana Insurance Commissioner J. Robert Wooley, et al. That lawsuit was one of the first class actions against the insurance industry as a result of Hurricane Katrina.

There, the plaintiffs were asking the court for an order requiring the insurance commissioner to nullify the exclusions for damage caused by rising water. They took the position that the flooding in New Orleans was caused by negligence in the construction and maintenance of the levees, rather than an excluded "Act of God." Accordingly, they alleged that the high water exclusions were not intended to apply to the flooding.

As with Attorney General Hood's lawsuit in Mississippi, the insurance companies immediately filed a Notice of Removal in Chehardy, removing the case to the U.S. District Court for the Middle District of Louisiana. The grounds were that the plaintiffs based their claims on "a construction of the National Flood Insurance Act (NFIA) and National Flood Insurance Program (NFIP)", and on the recently enacted Class Action Fairness Act (CAFA). In that case, the plaintiffs' remand motion was unsuccessful. That case was transferred to the Eastern District of Louisiana, where it has been consolidated with a class action, *In re Katrina Canal Breaches Consolidated Litigation, C.A. 05-4182,* which includes claims against the Orleans Levee District and its insurer for negligence in design, construction and maintenance of levees.

Against this backdrop of events, the following is a brief review of the standard policy language on wind, water and hurricanes, and the legal issues about causation under these policies.

Standard-Form Policy Language

Insurance for losses caused by hurricanes typically is provided under property policies, which are available to businesses as part of comprehensive or package policies, and to residents in such forms as homeowners' policies and renters' policies.

Commercial property insurance policies generally fall into two types. The first type covers losses caused by "all risks of direct physical loss or damage," except risks that are specifically excluded in the policy. In these broad policies, known as "all risk" policies, once an insured proves that it has suffered a loss, the insurance company has the burden of proving that the loss is not covered.

The other type of commercial property policy takes the opposite approach. It covers property damage or loss caused by listed perils, such as: fire, wind, hail or vandalism. Known as a "named perils" policy, it typically contains a wide variety of exclusions, including exclusions for many different types of weather conditions. The policyholder typically is found to have the burden of overcoming these exclusions, in accordance with basic principles of insurance law.

Both types of property insurance policies contain provisions insuring personal property. This coverage usually provides coverage for specified types of personal property contained within the covered premises. Often the coverage extends to property found within a certain distance from the covered premises.

Useful examples of this policy language can be found in the standard commercial policy of the Texas Windstorm Insurance Association ("T.W.I.A."). With regard to buildings, labeled "Coverage A," the policy expressly states that it covers:

> Building or structure, meaning everything which is legally part of the building or structure described in the Declarations. However, we do not cover machinery which is not used solely in the service of the building.
>
> Personal property owned by you that is used for the service of and located on the described location
> . . . .

Next, with regard to personal property, labeled "Coverage B," the policy expressly states that it covers:

> Business personal property located in or on the building described in the Declarations, or in the open on the described location, or in a vehicle or railroad car located within 100 feet of the described building.
> . . . .

These coverage agreements are followed by sections that delineate what types of personal property are and are not covered. Then comes a section called "Covered Causes of Loss," in which the policy specifies:

> We insure for direct physical loss to the covered property caused by windstorm or hail unless the loss is excluded in the Exclusions.

The next section – and the most important one, for purposes of this article – includes, but is not limited to, the following exclusions:

> The following exclusions apply to loss to covered property:
>
> Flood.
>
> We will not pay for loss or damage caused by or resulting from flood, surface water, waves, tidal water of tidal waves, overflow of streams or other bodies of water or spray from any of these whether or not driven by wind.
>
> Power Failure.
>
> We will not pay for loss or damage resulting from the failure of power or other utility service supplied to the described premises, if the failure occurs away from the described premises. However, we will pay for loss resulting from physical damage to power, heating or cooling equipment located on the described premises if caused by windstorm or hail.

Continued on page 3

Is It a Vase or Are There Two Faces?

Continued from page 19

Rain.

We will not pay for loss or damage caused by or resulting from rain, whether driven by wind or not unless wind or hail first makes an opening in the walls or roof of the described building. Then we will only pay for loss to the interior of the building, or the insured property within, caused immediately by rain entering through such openings.

The structure of this policy places causation directly into question. The problem is that, while some events are covered and others are not, damages often arise after a series of events take place. Hurricane Katrina is a perfect example. It involved a wide variety of perils, including wind, wind-driven water, flooding, levee breaches, sewage overflows, power failures, court-ordered evacuations, fire, looting, pollution and mold.

The courts have developed various tests for determining whether there is coverage when a covered peril and an excluded peril combine in some proportion to cause a loss. Most prominent among them is the doctrine of "efficient proximate cause." This doctrine provides for coverage if the covered cause is the efficient and dominant cause: the one that sets the loss into motion.

The highest courts of two of the states most affected by Hurricanes Katrina and Rita — Louisiana and Mississippi — have adopted the doctrine of efficient proximate cause. The Texas Supreme Court has no clear authority on this question.

The "efficient proximate cause" generally is defined as the "dominant" cause. If the dominant cause of the loss is a covered peril, there is coverage; if the dominant cause of the loss is an excluded peril, there is no coverage or, in some instances, reduced coverage. Although the "efficient proximate cause" doctrine most commonly has been applied where a loss was caused in part by a covered peril and in part by an excluded or non-covered peril, it is equally applicable where, as here, different limits of liability and may apply depending on what is determined to be the cause of the loss.

The "efficient proximate cause" doctrine sounds simple on paper. In practice, though, it is complicated to apply. One helpful explanation of "efficient proximate cause" offered in a respected treatise on insurance, and followed by many courts, is that it is the "risk [that] set[s] the other causes in motion which, in an unbroken sequence, produced the result for which recovery is sought."

This definition of "efficient proximate cause" may be helpful in arguing that the damages at issue with respect to Hurricanes Katrina and Rita were caused by wind, and not by flood, since it was the hurricanes that set in motion all the other events that led to the property damage at issue. Policyholders will argue (and insurance companies no doubt will disagree) that all subsequent events, including the breaches of the levees in New Orleans, were set in motion, in an unbroken sequence, by the hurricanes.

The insurance company's response to this coverage-friendly doctrine seems to be the addition of language designed to defeat coverage. Although not used by the T.W.I.A. in the sample policy highlighted above, many insurance policies contain a prefatory clause to the exclusions section, generally known as the "anti-concurrent causation" provision.

As published by the Insurance Services Offices ("ISO"), a typical anti-concurrent causation lead-in provision states as follows: "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."

This provision is significant because, if enforceable, it has the capacity to alter substantially the scope of coverage under a policy. Accordingly, many challenges have been raised to its enforceability. The lawsuit filed on September 15, 2005 by Mississippi's Attorney General is one example.

The most recent decisions in this area should be greatly encouraging to Mississippi business owners and homeowners (if they are not otherwise discouraged by certain holdings regarding the facts). In Leonard, Judge Senter found anti-concurrent causation clauses to be ambiguous and unenforceable as a matter of law in the context of hurricane damage. He ruled that enforcement of such language: "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."

Notably, there is no state law yet in Texas, Louisiana and Mississippi as to the enforceability of this provision, as the highest courts of these states have not had occasion to examine it. However, were the Mississippi Supreme Court to adopt Judge Senter's reasoning, if and when this important issue ultimately comes before it, that court would be in accord with the precedent of the highest courts of a number of other states.

The highest court in Washington State, for example, has held that as a matter of public policy, insurance companies may not use so-called anti-concurrent causation provisions to avoid the efficient proximate cause doctrine. West Virginia's highest court similarly has held that anti-concurrent causation clauses are ambiguous and that it offends the reasonable expectations of a policyholder to read them as precluding coverage for damage proximately caused by a covered peril.

On the other hand, this favorable response has not been universal. The highest court of Utah held that provisions like the anti-concurrent causation provision are enforceable, as insurance companies are entitled to contract around any applicable causation rule.

Applicable Doctrines and Statutes

Historically, the courts have considered a number of additional matters when called upon to decide insurance coverage disputes.

Principal among these is the doctrine of *contra proferentem*. This doctrine requires ambiguities in insurance policies to be interpreted against the insurance companies that drafted the policies, and in favor of coverage.

Courts typically agree that ambiguities are proved when courts adopt different interpretations of the same provision. Thus, the mere existence of a dispute over the meaning of the flood, rain and water exclusions, and the citation of supportive — yet contrary — authority by both policyholder and insurance company, should be sufficient to prove ambiguity, and tip the scales in favor of coverage.

Another important resource for the courts has been state statutes, which often are policyholder-friendly. For example, all three of the states being studied here — Texas, Louisiana and Mississippi — have statutes designed to protect policyholders against bad faith practices by insurance companies, particularly including unfair settlement practices and late payment practices. Also relevant are the Valued Policy Laws found in many states, which can lead to 100% recovery by policyholders in certain circumstances. Such statutes are likely to be studied carefully by both sides in the battlefields over hurricane coverage.

Conclusion

The principle of "buyer beware" extends all the way through the claims process for policyholders. As shown above, there are many possible reasons why policyholders may not receive the coverage they may believe that they purchased. But the inverse principle of "seller beware" applies to insurance companies. The developing precedent of Hurricane Katrina appears to be that ambiguous language in insurance policies will be "outed" by courts deciding hurricane cases. Insurance companies who sell ambiguous provisions may find themselves with serious legal problems, extending far beyond the particular framework of Katrina-related liabilities. ■