

Public Policy Considerations of Water Damage Exclusions in Hurricane Insurance Policies

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Many Mississippi homeowners who suffered property damage in Hurricane Katrina had insurance policies containing exclusions that denied recovery for damage caused by water. The Attorney General of Mississippi filed suit in response, attempting to declare these water damage exclusions void as against public policy. This paper examines the merits of the suit, addressing the central legal and economic reasons why the suit will likely be unsuccessful. The paper then proposes prescriptive measures, including changes to the National Flood Insurance Program and possible implementation of a federal comprehensive natural disaster insurance program, which may facilitate more efficient and widespread flood insurance coverage in the future.

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I. INTRODUCTION

On August 29, 2005, Hurricane Katrina wreaked havoc on the Gulf of Mexico coast. High velocity winds, heavy rain, flooding, coastal erosion, hail, and tornadoes caused deaths, injuries, property and infrastructure damage, economic loss, and human suffering in Louisiana, Mississippi, and Alabama.¹ Early estimates of private insurer loss for damaged, destroyed, or flooded homes and businesses, and for offshore oil and gas platforms were estimated at \$40-\$60 billion.² As estimates were revised, it was shown that flood and storm surge caused \$44 billion in damage, much of it uninsured.³

After natural disasters of this magnitude, fights about the scope of insurance coverage are almost inevitable. Those who have insurance are attempting to rebuild their lives and homes, turning first to their homeowners' insurance contracts as a source of recovery. These homeowners may have been surprised to learn that their hurricane policies had specific exclusions for flood or other types of water damage, whether or not such damage was caused by wind. A large percentage of homes suffered this type of damage, which posted a large problem not only in New Orleans but also in Mississippi.

The response of the Mississippi Attorney General, Jim Hood, was to file suit in state court on behalf of the state against five named and additional unnamed insurance companies that issued homeowners' hurricane insurance policies to policyholders.⁴ The suit alleges five counts

¹ Rawle O. King, *Hurricane Katrina: Insurance Losses and National Capacities for Financing Disaster Risk*, CRS Report for Congress (September 15, 2005).

² *Id.*

³ Insurance Information Institute, *AIR Worldwide* (September 29, 2005), referenced by First American Flood Data Services, *Hurricane Katrina: Road to Recovery Fact Sheet*.

⁴ The insurance companies filed a motion to remove the case to federal court which is pending as of this paper's publication.

and seeks a temporary restraining order.⁵ Its counts are: (1) violation of the public policy of the State of Mississippi; (2) unconscionability of the insurance contracts;⁶ (3) “water damage” and/or “flood” exclusions in the subject policies are ambiguous; (4) violation of the Mississippi Consumer Protection Act; and (5) irreparable injury. It seeks injunctive relief to prevent the companies from denying coverage based on the exclusions. This paper focuses specifically on the suit’s public policy justification for voiding the exclusionary clauses.

While several individuals, including Senator Trent Lott, have also filed suit against the insurance companies that carried their policies, the Attorney General’s suit casts a wider net and hopes to invalidate the water damage exclusions on a statewide basis. Though the arguments of the Attorney General—and those of the policyholders he represents—are truly sympathetic, they are unlikely to prevail in court.

This paper addresses four central reasons that Attorney General Hood’s effort to invalidate the policies on public policy grounds will not be successful, drawing on legal, economic, and sociological analyses and touching on several of the other counts in the lawsuit:

1. The Attorney General’s argument that the policies should be enforced based on the reasonable expectations of the policyholders will not be accepted because Mississippi courts only interpret insurance contracts in this way if contract language is ambiguous.

Prior case law and approval of the contract language by the Department of Insurance demonstrate that the language of these exclusions is not facially ambiguous.

⁵ *Hood v. Mississippi Farm Bureau Insurance*, Complaint, Chancery Court of Hinds County, First Judicial District, Civil Action No. G2005-1642R11 (September 2005).

⁶ This paper argues that the exclusionary clauses will not be void on public policy grounds, but similar reasoning applies to the unconscionability claim. Since the policy language is not ambiguous, the court is unlikely to find the clauses unconscionable. Similarly, because the clauses were approved by the Mississippi Department of Insurance, the court is unlikely to second-guess agency authority. A final reason that the clauses will not be voided as unconscionable is that nearly identical clauses were upheld after Hurricane Camille in 1972. For these reasons, the unconscionability claim—like the public policy claim—is likely to fail.

2. Mississippi has adopted the efficient proximate cause doctrine in interpreting insurance contracts, allowing policyholders to recover for hurricane-related losses where they can prove that wind was the efficient cause of the damage, even if an excluded clause such as flooding contributed to the loss. When confronted with similar clauses in the past, Mississippi courts did not void the clauses, but allowed the policyholders to recover for those damages they can prove were efficiently caused by a covered peril.
3. In considering the practical realities of voiding the exclusions, the potential implications on the homeowners' insurance market in Mississippi could be disastrous if the companies are forced to pay for damage they neither collected premiums for nor have the accumulated capital to cover. Companies will likely become insolvent and may retreat from the market altogether, thereby leaving the state with a looming crisis: a scarcity of companies willing to provide homeowners' insurance. The court will likely try to avoid such a problem by upholding the exclusionary clauses.
4. Even though private insurance companies do not coverage water damage, homeowners in Mississippi had the option of purchasing flood insurance from the National Flood Insurance Program (NFIP) administered by the Federal Emergency Management Administration (FEMA). The program was created in 1968 to provide flood insurance where private insurers refused to do so and covers flood and storm surge. Since homeowners had and will continue to have at least one available option for purchasing water damage insurance, invalidating the exclusions on public policy grounds is unnecessary. However, there are several problems with NFIP implementation. The paper then concludes with several prescriptive measures that can be taken by homeowners, insurance companies, and the government to avoid these problems in the future

without invalidating the water damage exclusions on public policy grounds. Both small-scale and large-scale solutions are discussed, including revamping the NFIP to increase participation rates and the possible implementation of a federal comprehensive natural disaster insurance program. These prescriptive measures can help to ensure that citizens are more fully aware of what their policies cover and can help avoid insurance problems like those caused by Hurricane Katrina for future natural disasters.

II. DOCTRINE OF REASONABLE EXPECTATIONS

The Mississippi Attorney General's suit asserts that the policies "purport[ed] to insure against property loss and damage from wind storms and hurricanes, but contain...provisions to exclude coverage for hurricane loss and damage if the loss and/or damage included, directly or indirectly, loss or damage resulting from water, whether or not driven by wind."⁷ The complaint further asserts that, based on these "purported policy coverages, the property owners on the Mississippi Gulf Coast purchased these policies for the primary purpose of insuring against any and all hurricane damage with the *reasonable expectation* that these policies would provide such coverage" (emphasis added).⁸

The insurance companies maintain that the water damage exclusion in the policies limits their liability and that homeowners will need to pay for remedying the water damage on their own. They argue that the policy language clearly excludes such damage and, as a result, the contracts should be interpreted as written. Building on that argument, they claim that any perceptions policyholders held that such damage was covered are not reasonable because of the explicit policy language.

⁷ Hood Compl. ¶ 17.

⁸ Hood Compl. ¶ 19.

The Mississippi lawsuit invokes a longstanding doctrine of insurance contract interpretation: the doctrine of reasonable expectations, which generally provides that the “objectively reasonable expectations of...intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provision would have negated those expectations.”⁹

A. General Contours of the Doctrine

The reasonable expectations doctrine represents a judicial effort against insurance companies who have long leveraged their superior information reserves, financial resources, and litigation experience against policyholders who often have little or no bargaining power when seeking property insurance coverage. Based on the understanding that most policyholders do not draft, negotiate, or assent to the specific provisions in standard-form insurance policies, and may not either read or understand those provisions, courts have used the doctrine to broaden insurance coverage where policies’ exclusions attempt to limit it.¹⁰ Reasonable expectations doctrine has been used by courts along with other doctrines in favor of the insured, such as unconscionability, estoppel, public policy, and *contra proferentem*, which means that ambiguities are to be construed against the drafter.¹¹ By utilizing these legal doctrines, courts have attempted to balance the asymmetries of information and experience that exist between the insurance companies and the policyholders. The Mississippi Attorney General’s lawsuit draws on several of these theories to form its counts, including unconscionability, public policy, and

⁹ Robert Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 Harv. L. Rev. 961, 967 (1970).

¹⁰ See Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholders’ Objectively Reasonable Expectations of Insurance Coverage*, 5 Conn. Ins. L.J. 335, 363 (Fall 1998).

¹¹ See Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. Chi. L. Rev. 1461, 1465 (Fall 1989).

ambiguous policy language. The counts together argue that the policies should be interpreted by the policyholders' reasonable expectations of what was and was not covered.

The reasonable expectations doctrine is an objective standard that protects the reasonable expectations of insurance coverage that most policyholders would hold and does not protect subjective beliefs of idiosyncratic policyholders.¹² The standard takes into account *ex ante* reasonable expectations of policyholders at the time of signing the contract that are considered, rather than *ex post* judgments, which would give the policyholders seeking broader interpretation of the contracts the benefit of hindsight. The applicable inquiry for the present case under this framework, then, is what the Gulf region residents purchasing homeowners' assurance reasonably believed their hurricane insurance policies would cover at that time. The Attorney General will argue that policyholders reasonably believed that water damage was included in their hurricane policy, but the court may not reach this issue because of the limited circumstances in which reasonable expectations doctrine is triggered.

Courts typically take one of three general approaches to applying the reasonable expectations doctrine to insurance policy disputes: (1) restricting the doctrine of reasonable expectations to ambiguous terms only; (2) refusing to enforce the "fine print" of an insurance contract because it limits a more prominent part of the contract upon which policyholder's reasonable expectations were formed; and (3) looking to the "whole transaction" to determine whether the insurance company's behavior outside of the contract has negated the policyholder's reasonable expectations.¹³ The Gulf region states choose the first method and invoke reasonable expectations doctrine only where the contract language is facially ambiguous; if no ambiguity exists, courts are reluctant to apply the doctrine. Thus, in the case of the Hurricane Katrina

¹²*Id.* at 339.

¹³ See Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, *supra* note 10.

insurance policies, the court may not even reach the question of what expectations the policyholders held before the hurricane struck.

B. Reasonable Expectations Doctrine in Gulf States' Courts

The Gulf region states, including Mississippi, choose to invoke the reasonable expectations doctrine only when contract language is ambiguous. The Mississippi Supreme Court has held that although disputes about coverage are very common after incidents occur, the mere fact that parties disagree about the meaning of a provision of a contract does not make the contract ambiguous as a matter of law.¹⁴ The only time an insurance contract is not given its plain meaning occurs when the policy is ambiguous, at which time the policy will be interpreted in the light most favorable to the insured.¹⁵ However, Mississippi law prohibits courts from rewriting unambiguous insurance policy exclusions.¹⁶ Generally, for exclusions in flood insurance policies administered by private insurance companies are binding on the policyholder, “regardless of the actual knowledge of what is in the policy or of the hardship resulting from innocent ignorance.”¹⁷

Though this rule may seem harsh to policyholders who are left without insurance coverage after a natural disaster like Hurricane Katrina, Mississippi is not alone in enforcing it. Texas and Louisiana courts follow the same principle. In Texas, where contract language is not itself ambiguous, conflicting expectations about what was covered do not create ambiguity.¹⁸ Similarly, in Louisiana, if the policy wording at issue is clear and unambiguously expresses the parties' intent, the insurance contract must be enforced as written and courts lack the authority to

¹⁴ *Cherry v. Anthony, Gibbs, & Sage*, 501 So. 2d 416 (Miss. 1987), citing *Union Planters Leasing v. Woods*, 687 F.2d 117, 119 (5th Cir. 1982).

¹⁵ *Eaker v. State Farm Fire & Cas. Ins. Co.*, 216 F. Supp. 2d 606, 621 (S.D.Miss. 2001) (interpreting an identical water damage exclusion as is contested in Attorney General Hood's suit).

¹⁶ See, e.g., *American States Insurance Company v. Nethery*, 79 F.3d 473 (5th Cir. 1996); *Maryland Cas. Co. v. Southern Farm Bureau Cas. Ins. Co.*, 235 F.2d 679, 683 (5th Cir. 1956).

¹⁷ *Id.* at 617.

¹⁸ See *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132 (Tex. 1994).

change or alter the terms under the guise of interpretation.¹⁹ Louisiana courts recognize the ability of insurers, just like other contracting parties, to limit their liability and enforce reasonable conditions upon the policy obligations they contractually assume.²⁰

Given these interpretations of reasonable expectations doctrine by both state and federal courts in the Gulf region, the doctrine can only be invoked in the present case if the wording of the water damage exclusions in the policies is ambiguous.

C. The Water Damage Exclusions in Hurricane Katrina Insurance Policies

The relevant wording of the water damage exclusions is:

“We do not insure under any coverage for any loss which would not have occurred in the absence of one or more of the following excluded events...water damage, meaning flood, surface water, waves, tidal water, tsunami, seiche, overflow of a body of water, or spray from any of these, all whether driven by wind or not.”²¹

Interpreting an extremely similar water damage exclusion²² in *Eaker v. State Farm Fire & Casualty Insurance*, a Mississippi federal court found that the exclusion was sufficiently unambiguous to be interpreted based strictly on the contract language without invoking the reasonable expectations doctrine. The court held that the language was “clear and unequivocal,” and plainly excluded the damages claimed by the plaintiffs.²³ In another type of exclusion case, the Mississippi Court of Appeals held that the insurance company’s formulation of an earth

¹⁹ See *Leblanc v. Babin*, 786 So.2d 850 (La. Ct. App. 2001).

²⁰ *Id.* at 855.

²¹ Defendant’s Motion to Dismiss Plaintiff’s Complaint, *Lott v. State Farm Fire & Cas. Co.*, No. 1:05-CV-671-LG-RHW (S.D.Miss. 2006). This water damage exclusion is representative of those subject to suit after Hurricane Katrina in Mississippi.

²² “Water damage, meaning: flood, surface water, waves, tidal water, overflow of a body of water, or spray from any of these, all whether driven by wind or not.” *Eaker*, 216 F. Supp. 2d at 622.

²³ *Id.*

movement exclusion in a homeowners' policy contained "unambiguous language" and that although ambiguities in insurance contracts are read to favor the insured, "that principle does not permit the creation of ambiguity where there is none."²⁴

These two cases show Mississippi courts' hesitation to rewrite or otherwise find ambiguous insurance contracts that have been deemed clear to finders of fact. Other Gulf region states' cases echo the same sentiment.²⁵ In order to win the case that such water damage exclusions should be void against public policy, the Attorney General's arguments will have to surmount considerable authority to the contrary. The strongest argument to avoid the water damage exclusion is that the water damage caused by Hurricane Katrina was prompted by a "storm surge," defined by the National Weather Service as a "a maximum rise above the normal water level of 10-30 feet along a shore caused by strong onshore winds and/or reduced atmospheric pressure."²⁶ The policy language does not specifically exclude "storm surge," but the insurance companies argue that by definition, it falls squarely within the excluded categories. However, while no Mississippi case is directly on point, other states' courts have implicitly accepted the idea that storm surge is excluded by insurance policies with typical water damage exclusions.²⁷ Moreover, despite that Hurricane Camille was termed a "Historic Storm Surge Event" by the National Hurricane Center, resulting water damage was consistently excluded

²⁴ *Boteler v. State Farm Cas. Ins. Co.* 876 So. 2d 1067, 1069 (Miss. Ct. App. 2004).

²⁵ In another strikingly similar, but older, Texas case following a hurricane, the court rejected plaintiffs' argument that the insuring clauses of the policies purported to cover hurricane damage, and an interpretation of the water exclusion clause so as to exclude water damage caused by a hurricane would create an ambiguity that should invoke the rule that insurance contracts should in cases of doubt or ambiguity be construed favorably to the insured. Finding that no ambiguity or uncertainty arose from the policy language, the court held that to allow recovery for water damage would be to give the words of the policy a different meaning from that which the parties intended. *Hardware Dealers Mutual Ins. Co. v. Berglund*, 393 S.W.2d 309 (Tex. 1965).

²⁶ National Weather Service Jetstream Online Weather School. < http://www.srh.weather.gov/srh/jetstream/append/glossary_s.htm>.

²⁷ See, e.g., *Lower Chesapeake Associates v. Valley Forge Insurance Co.*, 532 S.E.2d 325 (Va. 2000) (holding that a marina owner was not entitled to coverage under a policy with a water damage exclusion when Hurricane Fran affected the Norfolk area with wind, rain, and storm surge).

from coverage because of water damage exclusions.²⁸ Based on these arguments, the court will likely find that the excluded terms implicitly encompassed “storm surge,” thus exculpating the insurance companies from liability. Finally, the suit will attempt to distinguish *Eaker*, but it is unlikely that these arguments will succeed because the *Eaker* court directly addressed the clarity of a water damage exclusion that is identical in all relevant parts to that in the Hurricane Katrina case.

Finally, the language in these specific hurricane insurance policies was approved by the Mississippi Department of Insurance. Under Miss. Code Ann. § 83-2-7, the Mississippi Department of Insurance must review and approve all insurance policy forms and rates at least thirty days prior to the proposed effective date of the policy.²⁹ In order for the insurance companies to lawfully issue the policies in question, then, they must have been pre-approved by a government agency tasked with regulating the insurance industry in the state. Indeed, as required by law, the policy language and rates did undergo the approval process and were accepted by the Mississippi Commissioner of Insurance.³⁰ Though courts have the power to overrule an agency’s decision if there has been some sort of regulatory failure, that is not likely to be the case here because several Mississippi courts have enforced these types of exclusions in the past and have not categorically found them to be against public policy. Finding the exclusions to be void against public policy would contradict both judicial precedent and agency discretion. It is unlikely that the court will choose that route, despite the seeming unfairness to the policyholders who will be left without coverage.

²⁸ See National Hurricane Center, “Hurricane Preparedness: Storm Surge, Historic Storm Surge Events,” available at <http://www.nhc.noaa.gov/HAW2/english/storm_surge.shtml>; see *Lunday v. Lititz Mutual Insurance Co.*, 276 So. 2d 696 (Miss. 1973); *Grace v. Lititz Mutual Insurance Co.*, 257 So. 2d 217 (Miss. 1972).

²⁹ Miss. Code Ann. § 83-2-7.

³⁰ See Doug Simpson, *Unintended Consequences Blog*.

<<http://www.dougsimpson.com/blog/archives/000464.html>>; Defendant’s Motion to Dismiss Plaintiff’s Complaint, *Lott v. State Farm Fire & Cas. Co.*, No. 1:05-CV-671-LG-RHW (S.D.Miss. 2006), Statement of Facts.

III. EFFICIENT PROXIMATE CAUSE DOCTRINE

A. General Contours of the Doctrine

Insurance companies will argue that damages to homes during Hurricane Katrina resulted from flooding rather than wind, and therefore fall outside the coverage of the policies. Many courts have adopted the efficient proximate cause doctrine to deal with this situation.³¹

Generally speaking, where multiple causes contribute to create a loss, the efficient proximate cause doctrine allows recovery under an insurance policy if a non-excluded cause is the efficient and proximate cause of the damage, even if the other cause is specifically excluded in the policy.³² In the context of insurance policies, the proximate and efficient cause refers to the “nearest cause to the damage of loss sustained to the insured without which the loss would not have occurred.”³³ For example, in a policy with a water damage exclusion, coverage would be granted under the efficient proximate cause doctrine for damages that resulted because “water had entered through the house through the openings made by the wind from the roof and from the windows.”³⁴

B. Mississippi’s Approach to the Efficient Proximate Cause Doctrine

The Supreme Court of Mississippi has adopted the efficient proximate cause doctrine.³⁵

In *Glen Falls Ins. Co. v. Linwood Elevator*, the court embraced the position that “only the

³¹ Seth Tucker & Ann-Kelley Kemper, *Wind: Selected Insurance Issues After Hurricane Katrina*, Insurance Coverage Issues, 2 (2005), <http://www.cov.com/publications/download/oid27267/570.pdf>.

³² *Id.*

³³ Michelle Evans, *Recovery Under Property Insurance for Loss Due to Surface Water, Sewer Backup, and Flood*, 48 Am. Jur. Proof of Facts 3d 419, 31 (2005).

³⁴ *Commercial Union Ins. Co. v. Byrne*, 248 So. 2d 777, 781 (1971).

³⁵ See e.g. *Glen Falls Ins. Co. v. Linwood Elevator*, 130 So.2d 262, 271 (Miss. 1961), *Lititz Mutual Ins. Co. v. Boatner*, 254 So.2d 765,766 (Miss. 1971), *Grace v. Lititz Mutual Ins. Co.*, 257 So.2d 217 (Miss. 1972). Recently, the District Court for the Southern District of Mississippi, in *Rhoden v. State Farm Fire and Casualty Co.*, claimed that Mississippi courts have not adopted the efficient proximate cause doctrine. 32 F. Supp. 2d 907, 912 (S.D. Miss. 1998). However, this is widely regarded as a faulty decision by the District Court, as well as an explicit contradiction to the cases mentioned above. Furthermore, in 1968, the Fifth Circuit also said in order to recover under a windstorm policy “it is sufficient to who that wind was the proximate or efficient cause of the loss or damage notwithstanding other factors contributed to loss.” *Kemp v. Am. Universal Ins. Co.*, 391 F.2d 533, 535 (5th Cir. 1968).

proximate cause of loss, and not the remote cause, is to be regarded in determining whether recovery may be had under a policy of insurance.”³⁶ While that case involved recovery under a fire insurance policy, the efficient proximate cause doctrine has been embraced in the context of weather phenomena and homeowners’ insurance. In *Kemp v. American Universal Ins. Co.*, the Fifth Circuit recognized the substantive law of Mississippi would permit coverage under the “windstorm” provision of an insurance policy where the wind was the efficient cause.³⁷ Similarly, in *Lititz v. Boatner*, a case to recover under an insurance policy for damages as a result of Hurricane Camille, the court was confronted with a similar exclusion for damages caused by water.³⁸ Citing the *Kemp* opinion, the Mississippi Supreme Court agreed that it was “sufficient to show that wind was the proximate or efficient cause of loss or damage notwithstanding other factors contributed to the loss.”³⁹

Although Mississippi has adopted the efficient proximate cause doctrine, it does not ensure an automatic recovery for the insured because the application of the doctrine occurs on a case-by-case basis with both parties carrying some burden of proof. In *Boatner*, the court held that in order to recover under the efficient proximate cause doctrine, the plaintiffs must establish, by a preponderance of the evidence, that the damages sustained were caused by a risk covered under their insurance policy.⁴⁰ Evidence presented to the court to show that wind was the proximate and efficient cause of the damage may include witness testimony, pictures and maps.⁴¹ On the other hand, where an insurance company pleads an affirmative defense it has the burden of proving that defense.⁴² In *Commercial Union Ins. Co. v. Byrne*, the insurer denied an

³⁶ *Glen Falls Ins. Co.*, 130 So.2d at 271.

³⁷ *Kemp*, 391 F.2d at 535.

³⁸ *Boatner*, 254 So.2d at 765.

³⁹ *Id.* at 767.

⁴⁰ *Id.* at 766.

⁴¹ *Id.*

⁴² *Commercial Union Ins. Co. v. Byrne*, 248 So.2d 777, 782 (Miss. 1971).

insurance claim for damages to plaintiff's home resulting from Hurricane Camille.⁴³ The insurer claimed the damage was caused by flooding and therefore excluded under the terms of the insurance policy, which specifically excluded damages resulting from "flood... whether driven by wind or not."⁴⁴ The court recognized the insurers' contention as an affirmative defense, placing upon the insurer the burden of proving the defense.⁴⁵ Thus, while the insured has the burden of proving the damage was caused by a covered cause, the insurer often has the burden of proving the damage was caused by an excluded cause.

Ultimately, it is the jury who decides whether or not the insured will recover. The Mississippi Supreme Court has repeatedly held that determining the efficient and proximate cause is within the province of the jury.⁴⁶ Furthermore, in *Grace v. Lititz Mutual Insurance Co.*, the Mississippi Supreme Court asserted "the rule is well established in this state that where the question presented to the jury was whether the loss was due to windstorm or to water, the entire question of proximate cause is treated as one of fact independent of the explicit application of any rule of law."⁴⁷ The characterization of the role of the jury in such an ambiguous way can make it difficult to overturn the findings of the jury. In past cases of this nature where material facts are in dispute, Mississippi courts have been reluctant to overturn the findings of the jury with regards to the proximate and efficient cause.⁴⁸ Thus, in order to recover under an insurance policy, the insured must provide sufficient evidence to convince the jury that the proximate and efficient cause of the damage was one that was insured against. The insurance company must

⁴³ *Id.* at 777.

⁴⁴ *Id.*

⁴⁵ *Id.* at 782.

⁴⁶ See e.g. *Grace v. Lititz Mutual Ins. Co.*, 257 So.2d 217, 224 (1972); *Boatner*, 254 So.2d at 767; and *Firemen's Ins. Co. v. Shulte*, 200 So.2d 440,442 (Miss. 1967).

⁴⁷ *Grace*, 257 So.2d at 224, Mississippi Supreme Court upholding jury verdict for plaintiff against their insurance company for damages resulting during Hurricane Camille.

⁴⁸ See *Id.*

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.

C. Implications for the Mississippi Attorney General's Lawsuit

The approach that Mississippi courts have taken with regards to the efficient proximate cause doctrine provides important implications for the present suit filed by the Attorney General of Mississippi. Count One of the Attorney General's complaint claims that the water damage exclusions are void "because they violate and/or expressly contradict Mississippi common law, which mandates that full coverage be provided if the proximate and efficient cause of the damage is covered under the subject policy."⁴⁹ It is important to note that nearly all of the cases discussed above involved almost identical exclusions as the one contained in the homeowners' insurance policies at the center of this lawsuit.⁵⁰ However, although the Mississippi courts have been confronted with these clauses numerous times in the past, they have never seen fit to void the clause.

This lawsuit claims these clauses should be voided as against the public policy because they contradict the common law of Mississippi.⁵¹ Although Mississippi courts have never addressed this specific argument before, the Alabama Supreme Court addressed this very issue in the case of *State Farm Fire & Casualty Co. v. Slade*. That case involved an insurance policy

⁴⁹ *Hood supra* note 4. Count One of the Complaint asserts violation of the public policy of the state of Mississippi. According to the Complaint, "such exclusion provisions are void and unenforceable as violations of the public policy of the state of Mississippi in that such exclusion provisions attempt to alter, abrogate or invalidate longstanding Mississippi law and judicial precedents governing the issue of proximate causation and attempts to immunize the Defendants from contractual liability on insured perils which may be a proximate or contributing cause of loss, all in contravention of Mississippi law." As of now, the public policy claim focuses on violation of the efficient proximate cause doctrine and discusses only issues of proximate causation.

⁵⁰ The exclusions in *Grace*, *Boatner*, and *Byrne* all contained the following exclusion "flood, surface water, waves, tidal water, or tidal wave, overflow of streams or other bodies of water, or spray from any of the foregoing, all whether driven by wind or not."

⁵¹ *Hood supra*, note 4.

containing an earth movement exclusion.⁵² The plaintiff's home suffered damage after being struck by lightning but the insurer denied coverage because engineering reports concluded that both lightning and earth movement caused the damage.⁵³ The plaintiffs in this case argued that the earth movement exclusion should be void because it violated the efficient proximate cause doctrine, which had already been adopted by Alabama.⁵⁴ The court asserted that insurance company could draft an insurance policy as they wanted, as long as the terms did not "offend some rule of law or contravene public policy."⁵⁵

The *Slade* court concluded that the efficient proximate cause doctrine was not a principle of public policy and thus this exclusion was not void.⁵⁶ The court explained "to elevate the efficient-proximate causation rule to a principle of public policy today would invade the province of the Legislature, because it has delegated to the Commissioner of the Department of Insurance the responsibility of supervising insurance policies."⁵⁷ In other words, the legislature, through statute or regulation, should determine public policy.⁵⁸

The Attorney General of Mississippi is making a very similar argument to that of the plaintiffs in *Slade*. This lawsuit argues these exclusions be deemed void in part because they violate the efficient proximate cause doctrine, which is a principle of public policy.⁵⁹ However, in Mississippi, the legislature has explicitly made it the role of the insurance commissioner to regulate the language of insurance policies.⁶⁰ As discussed above, all insurers in Mississippi are

⁵² *State Farm Fire & Casualty Co v. Slade*, 747 So.2d 293, 298 (1999).

⁵³ *Id.*

⁵⁴ *Id.* at 313. The efficient proximate cause doctrine was adopted by the Alabama Supreme Court in *Western Assurance Co. v. Hann*, 201 Ala. 376, 387 (1917).

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.* at 314.

⁵⁸ Bill Wilson, *Insurance Implications of Hurricane Katrina Lawsuits*, Independent Insurance Agent (2005), <http://www.independentagent.com/VU/NonMember/LawsuitImplications.htm>.

⁵⁹ Hood *supra*, note 4.

⁶⁰ Miss. Code Ann. § 83-2-7 (2005).

required to file all policy forms with the insurance commissioner, who has the authority to disapprove any language.⁶¹ No insurance company can issue a policy unless and until the policy forms have been filed and approved by the insurance commissioner.⁶² The insurance commissioner approved the policy language in the present case. With such legislatively enforced regulations already in place, the Mississippi courts are unlikely to elevate the efficient proximate cause doctrine to a principle of public policy.

Nevertheless, while the efficient proximate cause doctrine will not be used to preemptively void the policy exclusions, victims of Hurricane Katrina will have the opportunity to bring individual suits pursuant to the efficient proximate cause doctrine. Under this doctrine, only where they can convince a jury that a covered cause, such as wind, was the efficient and proximate cause of the damage sustained will they be able to recover from insurance companies. However, if the jury determines water to be the efficient cause, courts will let the exclusions stand and refuse recovery. Because the efficient proximate cause doctrine is fact-specific, its applicability is determined on a case-by-case basis. An example of the type of situation that would trigger application of the efficient proximate cause doctrine would be where the wind caused windows of a home to break, which subsequently allowed flood waters to rush into the home and destroy the contents. In such a situation, the jury would likely conclude that wind was the efficient proximate cause and allow coverage for the resulting damages to the home. Where the efficient proximate cause doctrine is applied, the courts do not treat the exclusions as void. Rather, the efficient proximate doctrine is used by courts to allocate losses when damage results from a combination of causes, some of which are excluded by the terms of the policy.

⁶¹ *Id.*

⁶² *Id.*

IV. POTENTIAL EFFECT ON THE HOMEOWNERS' INSURANCE MARKET

When courts make decisions based on public policy grounds, they go beyond the legal arguments involved in the particular case and consider various external realities about the impact of the decision on the surrounding community and interested parties. In the present case, it is especially important to do so because of the lessons of history: many of the insurance-related problems provoked by Hurricane Katrina are reminiscent of those that occurred after other American natural disasters. The shock to insurance markets caused by the sheer magnitude of a natural disaster has serious economic consequences; this impact is exacerbated when uncertainty exists about what those consequences will be, as it will here until the Attorney General's suit is completed. Therefore, one of the most significant practical realities the court must take into consideration when it weighs the benefits of voiding the clauses against the costs are the effects on the short-term and long-term homeowners' insurance markets in the state. These economic ramifications are likely to play a central role in the court's decision to void the clauses on public policy grounds, so it is important to consider them here in light of historical trends.

After natural disasters such as Hurricane Andrew in Florida and the Northridge earthquake in California, insurance companies suffered tremendous losses, forcing many of them to become insolvent and leave the market altogether. When they do so, consumers are the ultimate losers because the few remaining companies issuing policies can increase their rates since there is lower supply and constant or increased demand. In deciding whether to rule the water damage exclusions void against public policy after the fact in the present case, then, the court should consider the potential impact on insurance companies of having to cover damage they did not collect premiums to cover. If forced to provide unanticipated coverage to the thousands affected

by water damage from Hurricane Katrina, insurance companies will likely become insolvent and leave the market.

A. Problems in the Catastrophe Insurance Market

Insurance companies are hesitant to provide catastrophe insurance for a number of reasons: uncertainty of the risk, rising disaster costs, and the nature of the insurance market. Risk uncertainty plays a large role on both the supplier and consumer sides of natural disaster insurance for different reasons. Insurance companies are fairly apt at predicting the occurrence and likely cost of frequently occurring disasters, such as fires. But for low probability-high consequence events, such as hurricanes, floods, and earthquakes, risk estimates are less precise. Companies must rely on meteorologists and seismologists, many of whom disagree about the probability of a natural disaster occurring within a specific time frame. Empirical surveys of insurance underwriters show that they will charge higher premiums for these unpredictable disasters than for those with more specified risks.⁶³ Technological advances have allowed for more sophisticated probabilistic modeling, but the risks remain unpredictable.

While insurance underwriters may be overestimating the risk of natural disasters for financial reasons, homeowners tend to underestimate such risk in the face of high premiums. Homeowners engage in cost-benefit analyses, whereby the cost of premiums is weighed against the perceived risk, which is often based on intuition and the time lapse since the last major natural disaster. For example, before the Loma Prieta earthquake in northern California in 1989, about 34% of the uninsured respondents felt that earthquake insurance was unnecessary, whereas a year following the disaster, that number was reduced to 5%.⁶⁴ Yet potential victims of disaster

⁶³ Howard Kunreuther, Jacqueline Meszaros, Robin Hogarth, and Mark Spranca, *Ambiguity and Underwriter Decision Processes*, *Journal of Economic Behavior and Organization* 26, 337-52 (1995).

⁶⁴ Howard Kunreuther, *Mitigating Disaster Losses through Insurance*, *Journal of Risk and Uncertainty*, 12:171-187 (1996).

consider the costs of protection so high relative to the expected benefits that they do not purchase natural disaster insurance, and many believe that the government will bail them out in the event of a disaster. Even those who do purchase insurance are likely to cancel their policies if a disaster has not struck after a few years.⁶⁵ The uncertainty of the risk for both insurance suppliers and consumers presents a problem in obtaining the adequate amount of natural disaster insurance.

A second issue for insurance companies is the rising costs of natural disasters. As of 1996, census data shows that over one-half of the U.S. population lived along one of the ocean or inland coastlines.⁶⁶ By 2010, approximately 72 million people will reside in the most hurricane-prone counties in the country.⁶⁷ As the population of coastal areas has increased, property values have also risen, significantly increasing the total monetary value of property threatened by hurricanes and other severe storms.⁶⁸ A hurricane in a small coastal area that may have caused \$100 million in damages a decade ago could cause many times that amount of damages today because of increased population density, development, and inflation.⁶⁹

Finally, the nature of the insurance market contributes to the problems of natural disaster insurance. Because the insurance market is highly regulated, premiums are not necessarily set at efficient levels; instead, government regulation puts a ceiling on policy premiums to make them affordable to more people. The nature of the catastrophe insurance market is such that there is little national risk pooling: companies are hesitant to use one state's premiums to pay for a

⁶⁵ Howard Kunreuther, *Has the Time Come for Comprehensive Natural Disaster Insurance?*, On Risk and Disaster: Lessons from Hurricane Katrina, University of Pennsylvania Press (2006).

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ Catherine England and Jeffrey R. Yousey, *Insuring Against Natural Disasters: Possibilities for Market-Based Reform*. Insurance Reform Project, Competitive Enterprise Institute (1998).

⁶⁹ Academic Task Force on Hurricane Catastrophe Insurance, *Restoring Florida's Paradise: Final Report*, The Collins Center for Public Policy, Tallahassee, Florida. September 30, 1995, p. 34, cited by England & Yousey, *Insuring Against Natural Disasters*.

disaster in another state because cross-payments easily become cross-subsidies. Also, companies see no real benefit in issuing policies in multiple disaster-prone areas because doing so simply means increased risk with marginal increased profit. Moreover, several institutional features of the insurance market work against the accumulation of capital from which to pay future catastrophe losses.⁷⁰ Accounting practices, for example, preclude insurance companies from earmarking capital surplus to pay for a future catastrophe loss, even though the occurrence of that loss is highly likely.⁷¹ The companies are also taxed on any income they try to hold over in a reserve fund to pay for a large catastrophe. If publicly traded insurance companies do keep a large reserve for that purpose, they are at risk for unfriendly takeovers by companies eyeing the cash reserve or anger from stockholders whose myopic behavior typically abhors large sums of cash being set aside with no present use.⁷²

These features of the catastrophe insurance market demonstrate the complicated issues that disaster insurance presents to both consumers and insurance companies. It is also critical to consider the implications of governments forcing insurance companies to provide disaster insurance when doing so is unprofitable.

B. Case Studies from Past Natural Disasters

Following natural disasters, state governments have in the past imposed restrictions on insurance companies that have essentially forced the companies to provide homeowners' insurance at rates that do not accurately reflect the risk of such policies. Doing so may be highly detrimental to insurance markets, as demonstrated by the examples of Florida after Hurricane Andrew in 1992 and California following the Northridge earthquake in 1994.

⁷⁰ Dwight M. Jaffee and Thomas Russell, *Catastrophe Insurance, Capital Markets, and Uninsurable Risks*, *The Journal of Risk and Insurance*, Vol. 64, No. 2, p. 205-230 (June 1997).

⁷¹ *Id.* at 209.

⁷² *Id.* at 213.

1. *Hurricane Andrew*

Hurricane Andrew hit the Florida coastline in August 1992, causing twenty-three deaths in the United States and \$26.5 billion in damage.⁷³ Following the 600,000 insurance claims that were filed, eleven smaller property-casualty insurance companies with significant business in Florida became insolvent and thirty others lost up to 20% or more of their surplus.⁷⁴ This was the largest number of hurricane-related insolvencies in U.S. history.⁷⁵ Property insurance became much more difficult to obtain after the hurricane, as many insurers limited their concentrations of insured property in coastal areas to reduce the likelihood of future catastrophic losses from hurricanes. About 930,000 policyholders were left with no coverage options.⁷⁶

The Florida legislature intervened to put a moratorium on cancellation and non-renewal of residential property policies, forcing insurers to stay in the market. It also created the Joint Underwriting Association (JUA) as an insurer of last resort for those who could not obtain homeowners insurance coverage in the private insurance market. Although originally created as a temporary mechanism, the program grew to 937,000 policies by 1996 but was down to 339,000 policyholders by 1998.⁷⁷ These large numbers became a problem because, as the Congressional Budget Office observes, the ability of state-sponsored programs to offer low-cost insurance is more illusory than real, for several reasons.⁷⁸ Most of the programs are undercapitalized, and as a result, a major catastrophic event would probably result in deficit for the program. Since states back the insurance pools due to political considerations, a catastrophe could substantially

⁷³ National Oceanic & Atmospheric Administration, *Hurricane Andrew: Ten Years Later*, < <http://www.noaa.gov/hurricaneandrew.html>>.

⁷⁴ Adrian Sainz, *Ten years after Hurricane Andrew, effects are still felt*, South Florida Sun-Sentinel < <http://www.sun-sentinel.com/news/weather/hurricane/sfl-1992-ap-mainstory,0,913282.story>> (2002).

⁷⁵ Kunreuther, *Has the Time Come for Comprehensive Natural Disaster Insurance?*, *supra* note 65.

⁷⁶ *Id.*

⁷⁷ Testimony of Donald A. Dowdell, Deputy General Counsel, Florida Department of Insurance, before House Subcommittee on Housing and Community Opportunity. (April 23, 1998).

⁷⁸ Congressional Budget Office, *Federal Reinsurance for Disasters*, Appendix A (September 2002).

increase a state's debt.⁷⁹ Moreover, the state government generally subsidizes rates, though not explicitly.⁸⁰ The legislature also created the Florida Hurricane Catastrophe Fund (FHCH) in 1993 as a mandatory reinsurance program.⁸¹ These two mechanisms artificially inflated the supply of insurance following the hurricane but years later, the Florida insurance market was still attempting to stabilize.⁸²

2. *Northridge Earthquake*

Since 1985, the California legislature has required all insurers selling residential property insurance in California to offer earthquake coverage. The damage amount from Northridge earthquake, which struck in 1994, was \$13 billion, exceeded in the United States only by Hurricane Andrew.⁸³ After the quake, the California Insurance Commissioner limited insurers' ability to cancel policies and deny renewals in designated areas, just as was done in Florida in 1992.⁸⁴ Companies tried to exit the earthquake insurance market after the moratorium ended but could not because of the legislative mandate to provide earthquake insurance. Finding it impossible to offer earthquake coverage, 97% of companies severely limited coverage, stopped

⁷⁹ *Id.*

⁸⁰ *Id.* The report notes that the problem of adverse selection leads to indirect subsidies for policies issued by state-run insurance funds, explaining that any property owner who could find cheaper coverage in the private market would do so, so the association's rates are likely to be below market rates because it must cater to those who cannot afford market rates.

⁸¹ Kunreuther, *Has the Time Come for Comprehensive Natural Disaster Insurance?*, *supra* note 65. Reinsurance programs serve as insurance for insurance companies, covering losses past a certain amount that the companies pay themselves, akin to a deductible paid by homeowners' policyholders. For the FHCH, each insurer has an individual deductible, which is its proportionate share of the \$4.5 billion industry aggregate. Insurers can choose from three reimbursement options for their losses (45%, 75%, or 90%) depending on how much they want to pay for reinsurance to the FHCH. *Id.*, citing Rawle King, *Hurricanes and Disaster Risk Financing Through Insurance: Challenges and Policy Options*, Washington, D.C: Congressional Research Service, (March 25, 2005).

⁸² See Donald Dowdell testimony, *supra* note 77.

⁸³ Kathleen Scalise, *Damage claims skyrocket from Northridge earthquake, finds new UC Berkeley report*, University of California-Berkeley Department of Public Affairs (October 1, 1996).

⁸⁴ Insurance Services Office, *Catastrophes: Insurance Issues Surrounding the Northridge Earthquake and Other Natural Disasters*, Executive Summary (December 1994).

writing homeowners' policies, or pulled out of California altogether.⁸⁵ Mortgage companies, however, still required new home purchasers to provide proof of insurance before financing a home purchase even though such policies were scarce and often prohibitively expensive. Creditworthy potential homebuyers were thus priced out of the market and the real estate market in California suffered greatly.⁸⁶ The legislature stepped in with a solution: the California Earthquake Authority (CEA).

The CEA, established in 1996, is a privately financed, publicly managed organization that offers basic earthquake insurance. In lieu of offering earthquake insurance themselves, insurance companies can pay into the fund and thereby meet their requirement to "offer" earthquake insurance in order to write homeowners' policies in the state. No public funds are used to cover losses, and private companies sell the CEA policies, which cover substantially less than what private earthquake insurance was covering prior to Northridge.⁸⁷

The CEA has met with strong consumer resistance since it was formed. Possibly as many as 50% of the homeowners who previously had private earthquake insurance policies were foregoing their earthquake coverage rather than purchasing the CEA contract.⁸⁸ The resistance is based on the common view that the premiums are much too high given the limited coverage and high deductible of 15%.⁸⁹ Due to consumer protest, premiums have been lowered below the level of actuarially expected losses, reducing the quality of CEA insurance and lowering the perceived costs of living in highly risky areas, meaning that the CEA is providing perverse

⁸⁵ George Raine, *Insurance firms tighten up coverage in California*, The Examiner (August 1, 1996); History of the California Earthquake Authority, <<http://www.earthquakeauthority.com>>.

⁸⁶ Testimony of Catherine Whatley for National Association of Realtors to House Banking and Financial Services Committee (April 23, 1998).

⁸⁷ Dwight M. Jaffee and Thomas Russell, *Catastrophe Insurance when Capital is Limited: A Comparison of Public and Private Approaches*, prepared for Pacific Rim Insurance Conference (1997).

⁸⁸ *Id.* at 21.

⁸⁹ *Id.*

incentives for people to build in the most vulnerable areas of the state.⁹⁰ Moreover, it is unlikely that consumers understand fully that even though they are buying insurance provided by a government entity, the state of California has no liability for loss and the government will not back them up if the damage exceeds the CEA's available capital pool.⁹¹

These case examples have demonstrated the flaws that result when insurance companies cannot operate at their market efficient levels, which unfortunately may be to provide no coverage in a specific region. Understandably, governments must step in with creative mechanisms to protect citizens from having no disaster insurance coverage, but none of the systems works perfectly. Both the Florida and California systems have yet to be tested because a catastrophe the size of that which prompted their creation has not yet struck either state. If and when one does, it will be critical to examine whether policyholders, insurance companies, or the state governments bear the loss and revise the current public schemes accordingly.

If the court chooses to void the Hurricane Katrina water damage exclusions on public policy grounds, it is likely to set off a chain reaction of events. First, the insurance companies who provided coverage will be forced to pay for risks they did not collect premiums for since they assumed their contract language clearly excluded water damage. Second, if they do not have enough stored capital or reinsurance to cover these additional losses, they may become insolvent. Third, once they become insolvent, they will exit the Mississippi homeowners' insurance market altogether, leaving the state government to put in place a temporary moratorium on market exit as was done in both California and Florida. It will then have to devise a public or public-private partnership scheme of insurance similar to either the Florida Joint Underwriting Association or the California Earthquake Authority to provide comprehensive

⁹⁰ Dwight M. Jaffee and Thomas Russell, *Behavioral Models of Insurance: The Case of the California Earthquake Authority*, prepared for the NBER Insurance Conference (Revision of February 19, 2000).

⁹¹ Jaffee & Russell, *Catastrophe Insurance when Capital is Limited*, *supra* note 83 at 19.

hurricane insurance to its citizens. The success of such programs in the long run is murky at best.

Voiding the clauses and establishing a resulting public scheme makes even less sense because the National Flood Insurance Program already exists since private companies have not covered water damage for decades. Under the NFIP, if consumers in flood-prone areas adhere to building codes and other regulations, they can obtain water damage insurance from the government for under-market rates. This insurance was available before Hurricane Katrina struck and could have prevented altogether disputes over whether water damage was covered by hurricane insurance policies if consumers had just bought it, if insurance companies had promulgated it, and if the state had recommended or even required it.

V. NATIONAL FLOOD INSURANCE PROGRAM

The NFIP was created in 1968 in response to the massive costs of disaster relief for flood victims and the tremendous damage caused by floods.⁹² It is managed by FEMA and was founded to advance two major goals. The first was to provide affordable flood insurance for people living in flood-prone areas like Mississippi.⁹³ It was thought the availability of insurance would shift the large costs of flooding away from the general public because less taxpayer-funded federal assistance would be needed after flooding if more homeowners could rely on insurance.⁹⁴ The second major goal of the NFIP was to help guide future development and construction in flood-prone areas.⁹⁵

⁹² *About Flood Insurance* (2006), <http://www.fema.gov/nfip/whonfip.shtm>.

⁹³ John Herke, *Teething Pains at Age 25: Developing Meaningful Enforcement of the National Flood Insurance Program*, 7 *Tul. Envtl. L.J.* 165 (1993).

⁹⁴ *Id.*

⁹⁵ *Id.*

A. Community Requirements of the NFIP

In order for residents of a community to be eligible to purchase flood insurance from the NFIP, their community must be a participant in the NFIP.⁹⁶ To become a participant, a community must agree to adopt measures designed by the NFIP to mitigate future flood hazards in future construction and development within their community.⁹⁷ Some of these measures include regulations regarding zoning, subdivisions, and building codes.⁹⁸ For example, the NFIP regulations mandate that new construction or extensively damaged buildings in special flood hazard areas have the lowest floor of their home elevated at least up to the predetermined base flood elevation.⁹⁹ As a result of this, and other similar regulations, it is estimated that buildings constructed in compliance with NFIP building standards suffer approximately 80 percent less damage annually than those not built in compliance.¹⁰⁰ This is estimated to lead to a savings of almost \$1 billion in reduced flood losses every year.¹⁰¹

B. Flood Insurance Through the NFIP

Once a community becomes a participant, the NFIP makes flood insurance available for purchase to business owners, renters and homeowners in that community.¹⁰² The flood insurance can be bought at any time, but there is a 30-day waiting period before the policy goes into effect.¹⁰³ Therefore, in a year where forecasters are expecting an extraordinarily harsh hurricane season, it is possible for homeowners to buy flood insurance a month before hurricane season is expected to begin. The cost will range from about \$300-\$400 a year for about \$100,000 worth of

⁹⁶ *About Flood Insurance*, *supra* note 92.

⁹⁷ *Id.*

⁹⁸ *Mitigation* (2006), <http://www.fema.gov/nfip/whonfip.shtm>.

⁹⁹ *National Flood Insurance Program, Mitigation Division: Frequently Asked Questions*, (2005) http://www.fema.gov/txt/press/katrina_after/floodplain_management_faq.txt.

¹⁰⁰ *About Flood Insurance*, *supra* note 92.

¹⁰¹ *National Flood Insurance Program*, *supra* note 99.

¹⁰² *About Flood Insurance*, *supra* note 92.

¹⁰³ *Flood Insurance, Insuring Your Home*, (2006), http://homebuying.about.com/cs/floodsflooding/a/flood_insurance.htm.

coverage.¹⁰⁴ Under the NFIP, individuals can purchase up to \$250,000 worth of coverage.¹⁰⁵ A flood insurance policy issued by the NFIP covers direct physical loss to property by flooding, where flooding is defined as a “temporary condition during which the surface of normally dry land is partially or completely inundated.”¹⁰⁶

C. Problems with the NFIP

1. *Low Participation Rates*

The NFIP has a strong presence in Mississippi, where 273 communities are official participants.¹⁰⁷ However, even with the large number of participant communities, convincing individuals in Mississippi to buy flood insurance still remains a challenge. Of the areas hit by Hurricane Katrina, more homeowners in Louisiana possessed NFIP coverage than in Mississippi.¹⁰⁸ It is worrisome that the coastal areas of Mississippi damaged by Hurricane Katrina had extremely low participation rates: in Harrison County, where the cities of Biloxi and Gulfport are located, and in Jackson County, about 10 percent of citizens participated. In Hancock County, participation only reached roughly 23 percent.¹⁰⁹ However, this problem extends far beyond Mississippi; the NFIP has historically been plagued with low national participation rates.¹¹⁰

The problem of low participation is often attributed to the fact that purchasing individual flood insurance through the NFIP is advised rather than mandated for most individuals.¹¹¹ Generally, insurance companies aim to have a large base of subscribers, assuming that only a

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *About Flood Insurance, supra* note 92.

¹⁰⁷ *National Flood Insurance Program*, Mississippi Emergency Management Agency
<http://www.msema.org/nfip/nfip.htm>.

¹⁰⁸ David John, *Providing Flood Insurance Coverage After the Disaster is a Mistake*, (October 19, 2005),
<http://www.heritage.org/Research/Regulation/wm888.cfm>.

¹⁰⁹ *Id.*

¹¹⁰ Herke *supra* note 93.

¹¹¹ *Id.*

percentage of them will have to file a claim in a given year, and they anticipate those claims will be paid through the premiums collected from all subscribers.¹¹² However, if they do not have enough subscribers, it would be difficult for the insurer to break even. Because of low participation, the NFIP has trouble bringing in enough revenue from premiums to offset its payouts in a given year.¹¹³ Furthermore, because the NFIP offers subsidized insurance rates, the premiums they do receive are often too low to exceed costs.¹¹⁴ Consequently, the NFIP is unable to build a fund and financially prepare for future major disasters.¹¹⁵ In fact, when the major hurricanes of 2004 hit, the NFIP was overwhelmed by the almost \$1.8 billion of flood insurance claims, and needed to borrow \$300 million from the U.S. Treasury.¹¹⁶ With Hurricane Katrina hitting soon thereafter, new legislation was passed which increased the amount the NFIP could borrow to \$3.5 billion.¹¹⁷

The Riegle Community Development and Regulatory Improvement Act of 1994 attempted to make flood insurance mandatory for many homes. The act mandated that all federally-regulated lending institutions require homeowners located in special flood hazard areas to purchase flood insurance before allowing them to take out a mortgage.¹¹⁸ However, it has been estimated that almost one-third of coastal homes were purchased for cash many years ago and therefore required no mortgages.¹¹⁹ Furthermore, this act only applies to lending institutions under federal regulation, so homeowners who apply for mortgages through lenders that are not

¹¹² *Id.* at 181.

¹¹³ *Id.*

¹¹⁴ *Oversight and Management of the National Flood Insurance Program, Statement of William Jenkins, Jr.*, (October 2005), Federal Emergency Management Agency.

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Riegle Community Development and Regulatory Improvement Act of 1994*, Pub. L. No. 103-325, section 522, 108 Stat. 2255, 2257 (2004).

¹¹⁹ *Federal Flood Insurance After Katrina*, Center on Federal Financial Institutions, p. 5, (October 16, 2005), <http://www.coffi.org/pubs/Federal%20Flood%20Insurance%20After%20Katrina%20v6.pdf>.

under federal regulation have no requirement to purchase flood insurance.¹²⁰ Most alarmingly, even of those homeowners that fall under this act, many are managing to remain uninsured.¹²¹ For example, some homeowners cancel their flood insurance after securing their mortgage.¹²² Overall, it also seems the NFIP has been lax in regulating compliance with this Act.¹²³

2. *Financial Problems Due to Policy Subsidies, Repetitive Loss Properties, and Inaccurate Flood Maps*

As mentioned earlier, part of the financial problem facing the NFIP is attributable to subsidized insurance rates. The National Flood Insurance Act of 1968, which created the NFIP, contained a provision that buildings constructed prior to 1974 would be eligible for subsidized premiums.¹²⁴ This special subsidy was put in place because these structures were constructed prior to the identification of a flood risk and therefore should have been eligible to purchase affordable insurance. With these subsidies, these policyholders are paying less than half of the true risk premium they should be paying.¹²⁵ Overall, almost one-third of all policies under the NFIP are subsidized.¹²⁶ The problem is aggravated by the fact that some of these subsidized policies cover properties that repeatedly suffer flood damages. In other words, it is often true that the people who pay discounted premiums for coverage are also the people that tend to file the most claims under their NFIP policies.

While subsidized premiums are a major cause of financial strain on the NFIP, unsubsidized premium rates are also often set too low. The NFIP determines premium rates based on Flood Insurance Rate Maps (FIRMs). FIRMs identify Special Flood Hazard Areas

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ Jenkins *supra* note 114 at 15.

¹²⁴ *Challenges Facing the National Flood Insurance Program, Statement of William Jenkins, Jr.*, p. 6 (October 2005), Federal Emergency Management Agency.

¹²⁵ *Id.* at 4.

¹²⁶ *Id.*

(SFHAs), which are land areas subject to inundation by flood with a 1% probability or more in any given year.¹²⁷ FIRMs categorically separate these SFHAs into different zones according to the severity of the flood hazard.¹²⁸ In addition to setting premium rates, FIRMs are also used to regulate new construction, and to determine the communities where flood insurance should be mandated pursuant to the Riegle Act mentioned earlier.¹²⁹ Communities with higher flood hazards, as reflected by FIRMs, are subject to stricter regulations than those with a lower flood hazard. However, since FIRMs are rarely updated, they often do not reflect changes, such as increased development, which would change the flood hazard as well as the regulatory measures a community would need to adopt under the NFIP.¹³⁰ In fact, a recent study found that 70% of FIRMs hadn't been updated in over 10 years.¹³¹ For example, for Jackson County, an area in Mississippi ravaged by Hurricane Katrina, the most recent FIRM available is dated April 16, 1993.¹³² These outdated and often inaccurate FIRMs are widely used, thereby “allowing development to proceed on the basis of these maps without proper safeguards and without insurance rates that reflect the true risk.”¹³³

VI. PRESCRIPTIVE MEASURES

Having identified the reasons why the Mississippi court should not void the water damage exclusions and the problems doing so might cause, we now turn to prescriptive measures

¹²⁷ *Using a Flood Insurance Rate Map*, Federal Emergency Management Agency, (2005), http://www.fema.gov/fima/mat/pdfs/fema499/hgcc_fact03.pdf.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Infrastructure, Local Development, and Housing Programs*, The Impact of Federal Programs on Wetlands, ch. 5, p. 7, (1994), <http://www.doi.gov/oepc/wetlands2/v2ch5.html>.

¹³¹ *Flood Map Modernization, Federal Emergency Management Agency's Implementation of a National Strategy*, p. 3, (July 2005), <http://www.gao.gov/new.items/d05894t.pdf>.

¹³² *Communities Participating in the National Flood Insurance Program*, Federal Emergency Management Agency, p. 3, (2006), <http://www.fema.gov/cis/MS.pdf>.

¹³³ *Infrastructure, Local Development, and Housing Programs*, *supra* note 130.

to facilitate more efficient insurance coverage for citizens in natural-disaster prone areas. These policy ideas address changes to the regulation of NFIP and the possible implementation of a federal comprehensive disaster insurance scheme. By considering both the small, easily implemented solutions as well as the large-scale innovations discussed below, perhaps the insurance-related problems that confronted Mississippi after Hurricane Katrina can be avoided in the future.

A. National Flood Insurance Program

1. *Increasing Premiums for Subsidized Policies*

In order to combat the problems caused by properties that repeatedly suffer flood damage, the 2004 Flood Insurance Reform Act was enacted. These properties, termed repetitive loss properties, are a major drain on the NFIP. From 1978 until 2004, these repetitive loss properties accounted for \$4.6 billion of the claims payments made by the NFIP.¹³⁴ They account for about 25-30% of the claims paid by the NFIP annually, although they constitute only 1% of the total number of policies issued by the NFIP.¹³⁵ The Flood Insurance Reform Act defines a repetitive loss property as one that has incurred flood-related damage

“for which 4 or more separate claims payments have been made under flood insurance coverage under this title, with the amount of each such claim exceeding \$ 5,000... or for which at least 2 separate claims payments have been made under such coverage, with the cumulative amount of such claims exceeding the value of the property.”¹³⁶

¹³⁴ *Challenges For the National Flood Insurance Program, Statement of David M. Walker*, p. 8, (January 2006), Federal Emergency Management Agency, <http://www.gao.gov/new.items/d06335t.pdf>.

¹³⁵ Jenkins *supra* note 124.

¹³⁶ *Flood Insurance Reform Act of 2004*, Pub. L. No. 108-264, section 102(b), 118 Stat. 712, 714 (2004).

Under this Act, once a repetitive loss property has been identified, the community may carry out mitigation activities or purchase the property.¹³⁷ If property owners refuse to comply with the mitigation activities or refuse to sell the property, they will be required to face a 150% increase in their premium rates.¹³⁸ Since this program was only recently enacted, its effectiveness has yet to be analyzed.

The Flood Insurance Act of 2004, while attempting to reduce the drain that repetitive loss properties create in the NFIP, may also provide implications for reducing the financial strain on the NFIP caused by subsidized insurance policies. A plausible solution to the subsidized insurance rates would be to start increasing the premiums for the subsidized policies. The National Flood Insurance Act guaranteed these structures would be eligible for subsidized rates, and they still can be, but perhaps to a lesser extent. Currently, the NFIP has issued nearly 4.8 million policies,¹³⁹ but since one-third of these policies are subsidized, even a minimal increase in premiums would generate considerable revenue for the NFIP. Given the current national attention on natural disasters, consumers may be more inclined to pay the minimal increase than lose their insurance, especially considering that many of the subsidized policies cover properties in flood-risk areas. However, the increases should be kept minimal, since large increases in premium rates may serve to drive too many consumers out of the NFIP altogether. Thus, increasing premiums is necessary, but should not be taken as a sufficient solution to the financial woes of the NFIP.

¹³⁷ *Id.* at section 102(c). The act specifically authorizes the community or state “to carry out mitigation activities that reduce flood damages to severe repetitive loss properties, including elevation, relocation, demolition, and floodproofing of structures, and minor physical localized flood control projects, and the demolition and rebuilding of properties to at least Base Flood Elevation or greater, if required by any local ordinance.”

¹³⁸ Jenkins *supra*, note 124 at 7.

¹³⁹ *Flood Insurance: Policies in Force*, (2006), <http://www.fema.gov/nfip/pol200512.shtml>.

2. *Creating Accurate Flood Insurance Rate Maps*

In an effort to produce more accurate FIRMs, there is currently a national flood map modernization program under way.¹⁴⁰ The goals of this six-year, \$1.5 billion program are to update the flood maps and make them widely accessible over the Internet.¹⁴¹ However, this program is off to a rough start. One of the most widely recognized problems with this program is the lack of clear and developed standards with regards to data and level of analysis to be used in developing these maps.¹⁴² The program currently maintains different standards in mapping, dependent upon the flood risk of the area to be mapped.¹⁴³ Since many different entities will participate in developing these maps including FEMA, contractors, and state and local governments, the creation of uniformity across these maps requires the establishment of data standards.¹⁴⁴

Additionally, better management and oversight over the program are necessary. While the program was initiated in 2003, it was not until 2004 that a contractor was hired, at a cost of \$750 million, to execute the map modernization program.¹⁴⁵ However, even after the contract was awarded, progress has been slow because poor management has “enabled the contractor hired to execute the program to incur significant cost overruns and to repeatedly delay implementation schedules.”¹⁴⁶ Tighter control and oversight over the contractor and expenditures is necessary to the viability and success of this program.¹⁴⁷ Otherwise, the entire

¹⁴⁰ *Flood Map Modernization, Federal Emergency Management Agency’s Implementation of a National Strategy*, p. 3, (July 2005), <http://www.gao.gov/new.items/d05894t.pdf>.

¹⁴¹ *DHS Inspector General Finds That FEMA’s Flood Map Program is Underfunded and Inadequate*, p. 2, (October 2005), <http://www.democrats.reform.house.gov/Documents/20051018124108-44306.pdf>.

¹⁴² *Flood Map Modernization*, *supra* note 140 at 10.

¹⁴³ Walker *supra* note 134 at 16.

¹⁴⁴ *Flood Map Modernization*, *supra* note 140 at 10.

¹⁴⁵ See *DHS Inspector General Find that FEMA’s Flood Map Program is Underfunded and Inadequate*, *supra* note 141 at 3.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

map modernization program is in danger of running out of funding before completion of its goals. In order for the NFIP to successfully guide development in floodplains and collect accurate premiums, the flood map modernization program must strengthen oversight and create uniform standards in mapping.

3. *Strengthening Oversight and Enforcement Mechanisms of the Riegle Community Development and Regulatory Improvement Act*

While the Riegle Community Development and Regulatory Improvement Act of 1994 attempts to make flood insurance mandatory for many homes, this act does not mandate flood insurance for homeowners with no mortgages or those who received their mortgages from lenders that are not under federal regulation.¹⁴⁸ Additionally, it seems the NFIP has been lax in regulating compliance with this act.¹⁴⁹ In fact, the NFIP keeps no statistically sound data to assess lender compliance on a national level.¹⁵⁰ Lenders are subject to reviews; however, noncompliance estimates have shown that “insurance was not always in place where required.”¹⁵¹ Therefore, even with the implementation of this Act, it is still possible, as exemplified by the low numbers of flood insured homes in Mississippi areas hit by Hurricane Katrina, for many homes in high flood risk areas to continue without insurance. Strengthening the enforcement and regulatory scheme of the NFIP with regards to the Reigle Act is a necessary step. The NFIP may need to mandate more frequent reviews of lending institutions. Lenders need to be held responsible for ensuring that their customers retain their flood insurance after they receive their mortgages. Perhaps exerting more pressure on lenders, through more intense regulation, will in turn force them to step up their own monitoring systems. While initially this

¹⁴⁸ Jenkins *supra* note 114 at 14.

¹⁴⁹ *Id.* at 15.

¹⁵⁰ Walker *supra* note 134 at 14.

¹⁵¹ Jenkins *supra*, note 124 at 9.

may lead to increased administrative costs, it will also lead to increased revenue from monetary fines on lending institutions found not to be in compliance with the Act.

4. *Informing Consumers About the Realities of Federal Disaster Relief*

Filling the information gap between consumers and insurers may help the NFIP increase participation. Consumers often fail to purchase flood insurance, assuming they can rely on federal disaster relief after a flood.¹⁵² The Robert T. Stafford Disaster Relief and Emergency Assistance Act (Stafford Act) provides federal assistance to State and local governments in areas where the President declares a disaster.¹⁵³ Disaster relief under the Stafford Act has become more frequent in recent times because the government has decreased the criteria necessary to declare a disaster, thereby increasing the number of Presidential declarations.¹⁵⁴ The Stafford Act authorizes individual disaster relief such as temporary housing, repair, replacement, and housing construction.¹⁵⁵ However, under the Stafford Act, the primary form of disaster assistance given to many individuals is the Small Business Administration (SBA) disaster loan.¹⁵⁶ These loans are meant to provide individuals with the means to repair or replace damaged homes and personal property.¹⁵⁷ Individuals may borrow up to \$40,000 to repair and replace personal property and up to \$200,000 to repair or restore their home.¹⁵⁸ While they are federally subsidized, these loans must still be paid back.

¹⁵² Charles T. Griffith, *The National Flood Insurance Program: Unattained Purposes, Liability in Contract and Takings*, 35 Wm and Mary L. Rev. 727, 737 (1994).

¹⁵³ *Id.*

¹⁵⁴ Daniel D. Barnhizer, *Givings Recapture: Funding Public Acquisition of Private Property Interests on the Coasts*, 27 Harv. Envtl. L. Rev. 295, 331 (2003).

¹⁵⁵ 42 U.S.C. § 5174

¹⁵⁶ *A Guide To The Disaster Declaration Process and Federal Disaster Assistance*, (2004),

http://www.fema.gov/rrr/dec_guid.shtm.

¹⁵⁷ *Id.*

¹⁵⁸ *Hurricane Disaster Assistance*, (2006), http://www.sba.gov/disaster_recov/disasterrecovery.pdf.

In the aftermath of Hurricane Katrina, the SBA has approved over 73,000 disaster loans totaling over \$5.2 billion.¹⁵⁹ Many homeowners view federal disaster relief as a safety net and are therefore more prone to ignoring flood risks and the importance of insurance.¹⁶⁰ In fact, “the annual premium for an NFIP policy, averaging about \$300 per year, is less expensive than interest on federal disaster loans.”¹⁶¹ In flood-prone areas, such as Mississippi, the NFIP must take a more proactive approach aimed at informing individuals about the realities of federal disaster relief and reducing their dependence on this assistance. To begin, lenders should comprehensively address this issue when consulting with their clients. The NFIP also needs to be more persistent in reaching out to the public. A simple solution such as mailing out brochures detailing disaster relief would be a good way of stimulating discourse on the subject. Federal disaster relief is not an automatic entitlement free of restrictions, and it is time to start dispelling that myth. Otherwise, it is not until after a disaster, like Hurricane Katrina, that individuals realize the importance of purchasing flood insurance.

B. Federal Comprehensive Natural Disaster Insurance

A second, more nascent possible solution to the insurance problems caused by natural disasters is implementation of a federal comprehensive natural disaster insurance program, where all natural disasters are covered by a single policy. Some academics who study insurance markets have advocated such a program, but the idea is still in its formation stages.¹⁶² While there seems to be agreement that the private insurance market should administer the policies, the extent of government involvement in the program is still under discussion. Scholars and

¹⁵⁹ *Emergencies & Disasters*, (February 28, 2006), <http://www.dhs.gov/interweb/assetlibrary/katrina.htm>

¹⁶⁰ Barnhizer *supra* note 154 at 331.

¹⁶¹ *Myths and Facts About the National Flood Insurance Program*, (2000), <http://www.ces.ncsu.edu/disaster/factsheets/pdf/23.pdf>.

¹⁶² Kunreuther, *Has the Time Come for Comprehensive Natural Disaster Insurance?*, *supra* note 65; Dwight Jaffee and Thomas Russell, *Should Governments Provide Catastrophe Insurance?* (September 1, 2005). Fisher Center for Real Estate & Urban Economics. Fisher Center Working Papers: Paper 296. <<http://repositories.cdlib.org/iber/fcreue/fcwp/296>>

insurance company executives should investigate this option as a means of preventing post-disaster insurance disputes in the future.

Currently, insurance programs for residents in hazard-prone areas are segmented across perils.¹⁶³ Companies issue earthquake policies in California, hurricane policies in the southeastern states, and the NFIP issues flood insurance nationwide. Under a comprehensive system, companies would issue a uniform policy to cover earthquake, hurricane, flood, and other natural disasters no matter where a resident lived.¹⁶⁴ Premiums would be risk-based and would be calculated based on the probability of each specific natural disaster occurring. For example, a policyholder in Mississippi would be protected against flood, hurricanes, and earthquakes, even though the risk of an earthquake occurring in Mississippi is minimal. The premium this customer would pay would be adjusted so that the price accurately reflects the risk of each possible natural disaster; where the risk of a particular type of disaster occurring in the area is extremely low, the customer would theoretically pay nothing for the additional coverage.

1. *Benefits of a Comprehensive Scheme*

Both private insurers and consumers could potentially benefit from a comprehensive natural disaster insurance program. One of the problems of private natural disaster insurance detailed above is that companies are hesitant to pool their risk nationally design a profitable business model because disasters of this magnitude strike regionally and usually cause extensive damage. An insurance company thus stands to lose a significant amount of capital if it insures a large number of people against hurricanes in, for example, the Gulf region. If the insurer is

¹⁶³ Kunreuther, *Has the Time Come?*, *supra* note 65.

¹⁶⁴ It is unclear in academic proposals whether the provision of flood insurance under a comprehensive system would imply that the NFIP would be abolished. For the purposes of this discussion, it is assumed that either (1) the government would discontinue its flood insurance and allow the private insurance companies to provide all flood insurance or (2) the government would still be able to issue flood insurance policies under NFIP but consumers could choose between purchasing such insurance from the government or purchasing comprehensive natural disaster insurance from a private insurer.

concerned about the variability of profits, the ideal risk is one where the potential loss from each insured individual is relatively small and independent of the losses from other policyholders.¹⁶⁵ A comprehensive program would allow the companies to collect premiums nationwide to build up capital. Moreover, by diversifying its risk across various regions with differing probabilities of natural disasters, an insurance company has a lower chance of becoming insolvent after any one natural disaster because the losses will be relatively small in comparison to its national capital pool and will be independent of the losses from other regions' natural disasters. In the Hurricane Katrina case, companies would have to pay out much more if they were covering both wind and water damage as they would under a comprehensive program, but if premiums are set based on risk, the market should be capable of recovery.

Consumers would benefit from such a program because it is simpler and avoids the costly and laborious process of determining what damage was caused by wind and what by water, as the efficient proximate cause doctrine discussed above mandates. The problem of separating wind damage from water damage after Hurricane Katrina is particularly difficult because for buildings that are no longer standing, there is little evidence on which to base a conclusion about the cause of the damage. In an effort to minimize their losses, insurance companies may choose to litigate these disputes, and the imbalance of resources and expertise between companies and consumers puts policyholders at a significant disadvantage. A comprehensive program would eliminate this legal battle. Furthermore, a comprehensive program would arguably be simpler for homeowners to understand. The problem of homeowners not realizing that their policies do not cover water damage, as happened after Hurricane Katrina, would be eliminated because all risks would be covered. At least some of the ambiguity surrounding complicated insurance contracts would be reduced. A study done in 1979 showed that 80% of homeowners preferred

¹⁶⁵ Kunreuther, *Has The Time Come*, *supra* note 65.

comprehensive coverage to “probabilistic” insurance where there was a chance that some loss was not covered.¹⁶⁶ Perhaps more people would choose to buy natural disaster coverage if they knew its coverage was comprehensive.

2. *Challenges of Comprehensive Coverage*

There are also substantial challenges that a comprehensive program would entail for consumers, insurance companies, and the government. The most important ramification for consumers is that since the policies would be all-inclusive, they would be more expensive than current policies that come with in-built limitations on coverage. This raises a social justice issue: lower-income homeowners may only be able to afford the limited coverage, leaving those who are the most vulnerable to face the daunting task of proving the exact cause of damage. These are also the people who are the least likely to fight insurance companies for coverage. Thus, if this program is to be implemented, policymakers must decide what role, if any, the government should play in subsidizing these policies for low-income citizens.

Policymakers must also consider the extent to which the government should be involved in the system as a whole. While several bills have been considered in Congress regarding post-catastrophe insurance, none have passed.¹⁶⁷ Economists have noted that extensive government involvement can crowd out private insurers.¹⁶⁸ These academics argue that if the government should be involved in the program at all, it should mimic the private market’s function as closely

¹⁶⁶ D. Kahneman, and Amos Tversky, *Prospect theory: An analysis of decision under risk*. *Econometrica* Volume 47, Issue 2, Pages 263-291 (1979).

¹⁶⁷ Rawle O. King, *Hurricane Katrina: Insurance Losses and National Capacities for Financing Disaster Risk*, CRS Report for Congress at CRS-10, *supra* note 1 (September 15, 2005). The report describes H.R. 21 in the 106th Congress and H.R. 1552 in the 108th Congress, which proposed an “all-hazard” approach to covering most natural disasters by establishing a federal program to provide reinsurance to improve the availability of homeowners’ insurance. Neither bill was made into law.

¹⁶⁸ Dwight Jaffee and Thomas Russell, *Should Governments Provide Catastrophe Insurance?* (September 1, 2005). Fisher Center for Real Estate & Urban Economics. Fisher Center Working Papers: Paper 296, *supra* note 162.

as possible.¹⁶⁹ A related argument is that the government should support—but not replace—a private comprehensive insurance market. For example, in the event of a large private loss, the government could function as a lender of last resort (as opposed to an insurer of last resort), giving temporary loans to private insurers until they have time to replenish their capital.¹⁷⁰ The Federal Reserve System already does this for the banking industry, and it could be extended to the insurance industry.¹⁷¹ Alternatively, a private-public partnership could be developed where the government shares more responsibility.¹⁷² Government regulation may actually be necessary to guarantee that premiums are being set at their actuarially fair rates, given that the massive capital accumulation necessary for a successful comprehensive system may lead insurers to increase premiums when the system is first implemented.

A third challenge is that facing insurance companies as they attempt to set premiums based on risk. To begin, state Departments of Insurance must give the companies leeway to set actuarially fair premiums rather than setting premium ceilings. The system can only function properly if premiums are not held at artificially low levels. Admittedly, this prompts the social justice concerns described above, but the government could step in to subsidize this insurance protection for low-income citizens.¹⁷³ The problem of low participation rates that plagues the NFIP is also major concern for a federal comprehensive system, especially if such insurance is prohibitively expensive. For the system to work, insurance companies must be able to spread their risk among a large number of people in different areas of the country; without enough participation, the program will fail.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 4.

¹⁷¹ *Id.*

¹⁷² For a more complete discussion of a private-public partnership, see Kunreuther, *Has The Time Come for Comprehensive Natural Disaster Insurance?*, *supra* note 65.

¹⁷³ *Id.*

Insurance companies must also develop accurate models that help them assess the risk on which to base the premiums. This problem is complicated in a comprehensive program because risks for different natural disasters must be calculated for each region of the country. Academic literature discusses the use of exceedance probability curves to specify catastrophe models that combine sets of events to predict resulting probabilities of exceeding losses of different magnitudes in any given area.¹⁷⁴ Moreover, companies should adjust their premiums based on mitigation methods taken by consumers in order to incentivize adherence to stricter building codes, for example. It is clear that setting these premiums will be an incredibly complex process.

3. *International Comprehensive Coverage Models*

American insurance companies can look to the comprehensive coverage models in France and Spain as examples of this type of system in practice. Spain established a public corporation, the Consorcio de Compensation de Seguros (CCS) in 1954 that provides mandatory insurance for so-called “extraordinary risks” that include natural disasters and political and social events such as terrorism, riots, and civil commotion.¹⁷⁵ The coverage is in addition to private property insurance policies, and CCS pays claims only if the loss is not covered by private insurance, if low-income families do not have private insurance, or if insurance companies become insolvent.¹⁷⁶ The government collects the premiums and private insurers market the policies and handle claims settlements.¹⁷⁷

In France, property insurance covers natural disasters and terrorism risks. Through a public-private partnership, the Caisse Centrale de Reinsurance (CCR) bears the risk for

¹⁷⁴ Kunreuther, *Has The Time Come for Comprehensive Natural Disaster Insurance?*, *supra* note 65.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ Paul Freeman and Kathryn Scott, “Comparative Analysis of Large Scale Catastrophe Compensation Schemes’ in *Catastrophic Risks and Insurance*, Paris: Organization for Economic Cooperation and Development (OECD) (2005).

“uninsurable” disasters such as earthquake, flood, drought, or landslide.¹⁷⁸ CCR functions as a reinsurance mechanism to keep private insurers from bankruptcy.

The utility of examining the French and Spanish models of comprehensive coverage may be limited because those countries face different probabilities of natural disasters than the United States due to their small size and geographic location. Comparison with the Japanese insurance market may be more fruitful because it faces similar risks of earthquakes and typhoons. Japan does not have a comprehensive national insurance program but participation in private natural disaster insurance has been significantly higher than in the United States.¹⁷⁹ A detailed study of those models and their respective success could help the American insurance market develop a plan for a comprehensive federal natural disaster insurance program.

4. *Further Analysis is Necessary*

Designing and implementing an effective federal comprehensive disaster insurance program will be quite difficult, but if it would remedy some of the insurance-related problems spurred by Hurricane Katrina, it is at least deserving of academic, government, and private sector attention. A federal comprehensive disaster insurance program would increase the risk exposure of the federal government, leaving taxpayers to foot the bill for disasters if revenues fail to cover costs or if returns are lower than expected.¹⁸⁰ However, there are no easy solutions to the complex insurance problems caused by natural disasters. The scope of the problem is national, and the country as a whole suffers when insurance companies cannot handle payouts after a catastrophic event, so a federal program may be justified. Emulating other nations’ plans and

¹⁷⁸ Erwann Michel-Kerjan, *Insurance Against Natural Disasters: Do the French have the answer? Strengths and Limitations*, Working Paper, Cahier n°2001-007, Laboratoire d’économetrie, Ecole Polytechnique, Paris (2001).

¹⁷⁹ Patricia Rossi, Risk Management Solutions. Discussant at Berkeley Symposium on Real Estate, Catastrophic Risk and Public Policy. (March 23, 2006).

¹⁸⁰ Rawle O. King, *Hurricane Katrina: Insurance Losses and National Capacities for Financing Disaster Risk*, CRS Report for Congress at CRS-13, *supra* note 1 (September 15, 2005).

investing serious effort to study the viability of a federal comprehensive disaster insurance plan in the United States is necessary if we hope to avoid insurance problems like this in the future.

VII. CONCLUSION

Although the floodwaters have receded in Mississippi, homeowners are still struggling to rebuild their lives and homes. Complications hinder the rebuilding process, since many of these homeowners were without flood insurance and are now left to rely on homeowners' insurance policies that contained water damage exclusions. In an effort to help these homeowners, the Attorney General of Mississippi has attempted to declare these water damage exclusions void as against public policy, but it seems likely he will fail.

His attempt to invoke the reasonable expectations doctrine is complicated by the fact that Mississippi courts only invoke this doctrine when faced with ambiguous contract language. In this case, however, prior case law in addition to the fact that the exclusions at issue were approved by the Department of Insurance demonstrates that the language of the exclusions is not facially ambiguous. Courts are also unlikely to void these exclusions as against public policy because of Mississippi's application of the efficient proximate cause doctrine. When confronted with similar exclusions in the past, Mississippi courts did not void the clauses, but instead used the efficient proximate cause doctrine to allow individual policyholders to recover for those damages they could prove were efficiently caused by a covered peril. Because legislative regulation mechanisms already exist for homeowners' insurance, the court will be wary to invade the province of the legislature. Declaring these exclusions void against public policy carries with it the possibility of broad consequences extending far beyond the suit at issue. If insurance companies are forced to pay for damage they neither collected premiums for nor have the

accumulated capital to cover, they will often face insolvency and may retreat from the market altogether. Finally, homeowners in Mississippi currently have flood insurance available for purchase through the NFIP. Since a provider of flood insurance already exists, and voiding the clauses would have far-reaching consequences, the court will likely uphold the exclusionary clauses.

While there are numerous reasons that will likely prevent the Mississippi courts from voiding the water damage exclusions, there are prescriptive measures that can be taken to facilitate more efficient and widespread insurance coverage in the future. Two of these forward-looking prescriptive measures include changes to the regulation of NFIP and the possible implementation of a federal comprehensive disaster insurance scheme. These prescriptive measures are designed to address and avoid insurance-related problems when the next major hurricane occurs. Hopefully, they will help mitigate the disastrous consequences that Hurricane Katrina has highlighted as tremendous problems within the American catastrophe insurance system.