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By Thomas A. McCann*

5th Circuit Ruling: A Tough Pill to Swallow for Katrina Policyholders

Big insurance companies won a major victory this August, and Katrina-ravaged policy holders were handed a tough blow, when the United States Court of Appeals for the 5th Circuit ruled that the companies' "all-risk" insurance policies excluded the extensive water damage to residents' properties caused by Hurricane Katrina.¹

The federal appeal dealt with four of more than 40 pending cases related to the hurricane that had been consolidated for pre-trial purposes in the Eastern District of Louisiana.² Each plaintiff in the case was a policyholder with homeowners, renters, or commercial property insurance whose property was damaged during the Katrina-related flooding of New Orleans in August 2005.³

At stake is potentially \$1 billion in insurance payouts for flood damage throughout the Gulf Coast in the aftermath of Katrina.⁴ The appeal features more than 40 named plaintiffs, including Xavier University, and more than 15 insurance company defendants, including Allstate Insurance Co., Travelers Property Casualty Co. of Amer-

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¹ Becky Yerak, *Insurers Win Key Katrina Ruling*, CHI. TRIB., Aug. 3, 2007, at C1.

² *In re Katrina Canal Breaches Litig.*, 495 F.3d 191, 196 (5th Cir. 2007).

³ *Id.*

⁴ Yerak, *supra* note 1, at C1.

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ica, Liberty Mutual Fire Insurance Co., and Unitrin Preferred Insurance Co.⁵

The plaintiff policyholders had argued that even though their policies had specific exclusions for any damage from “flood,” the damage from Katrina was not the result of natural flooding.⁶ A negligently built canal system, they argued, actually caused the damage. Thus, the terms of the insurance policies were ambiguous, the policyholders argued, and should be interpreted in favor of coverage.⁷

Plaintiffs in all four cases of the appeal alleged that Hurricane Katrina was not the main cause of their water damage. One set of plaintiffs, the “Vanderbrook plaintiffs,” alleged that “sometime between 10:00 and 11:00 a.m., before the full force of [the hurricane] reached the City of New Orleans, a small section of the concrete out-fall canal wall known as the 17th Street Canal, suddenly broke, causing water to enter the streets of the city.”⁸ Another set of plaintiffs, the “Chehardy plaintiffs,” alleged that the city’s levee system was breached in at least eight places, causing approximately 80 percent of Orleans parish to become submerged.⁹

The Chehardy plaintiffs referred in their complaint to engineering reports which concluded that “the vast amounts of the water that entered the [c]ity. . .and the surrounding parishes came about as the result of levee failures caused by negligent design, negligent maintenance and/or inadequate materials and not by topping of the levees.”¹⁰ The plaintiffs also cited testimony of the chief of the Army Corps of Engineers, stating that “the Corps neglected to consider the possibility that the levee walls atop the 17th Street Canal levee would lurch away from their footings under significant water pressure and eat away at the earthen barriers below. . .[t]he levees simply failed to work the way they were supposed to work.”¹¹ The Chehardy plaintiffs further alleged that the levee breach was at least partially due to an inadequately moored barge that crashed into the levee wall, com-

⁵ *In re Katrina Canal Breaches Litig.*, 495 F.3d at 196-203.

⁶ *Id.* at 196.

⁷ *Id.*

⁸ *Id.* at 196-97.

⁹ *Id.* at 200.

¹⁰ *In re Katrina Canal Breaches Litig.*, 495 F.3d at 200.

¹¹ *Id.*

promising the levee's wall integrity. The remaining two sets of plaintiffs in the appeal alleged similar facts.¹²

Each plaintiff in the appeal had purchased what is called an "all-risk" insurance policy, "a special type of insurance extending to risks not usually contemplated, and generally allows recovery for all fortuitous losses, unless the policy expressly excludes the loss from coverage."¹³

Most of the insurance policies at issue in the case contained terms similar to those in the policy issued by defendant Hanover Insurance Company. As an example, the Hanover policy provided coverage for risk of direct physical loss to structures on the property as well as for certain risks of loss to personal property, as long as the loss was not an excluded peril.¹⁴ The Hanover policy contains this exclusion for flood:

We do not insure for loss caused directly or indirectly by any of the following. Such loss is excluded regardless of any other cause or event contributing concurrently or in any sequence to the loss. . .

Water Damage, meaning: . . . Flood, surface water, waves, tidal water, overflow of a body of water, or spray from any of these, whether or not driven by the wind. . .¹⁵

The plaintiffs brought various claims against the insurers, including breach of contract, breach of the implied covenant of good faith and fair dealing, and insurance bad faith under Louisiana state law.¹⁶ The Vanderbrook plaintiffs alleged that the policies were contracts of adhesion that were "unduly and unreasonably complex," and that the flood exclusions were oppressive to consumers and so unreasonably favorable to the insurance companies that the policies were unconscionable and void.¹⁷

¹² *Id.*

¹³ *In re Katrina Canal Breaches Consol. Litig.*, 466 F. Supp. 2d 729, 737 (E.D. La. 2006); *see also* Jane M. Draper, Annotation, *Coverage under All-Risk Insurance*, 30 A.L.R. 5th 170 (1995).

¹⁴ *In re Katrina Canal Breaches Litig.*, 495 F.3d at 197.

¹⁵ *Id.*

¹⁶ *Id.* at 197-203.

¹⁷ *Id.* at 197.

The Chehardy plaintiffs sought a declaratory judgment that the efficient proximate causes of their home damage were “windstorm, acts of negligence, and storm surge, all of which were covered perils,” that “the breaking or failure of boundaries of lakes, reservoirs, streams, or other bodies of water, was a peril not specifically excluded by any of the . . . policies;” and that “[t]he damage caused by water. . . due to the breaches in the levees. . . neither falls within the regular definition of flood, nor within any of the subject insurance policies’ exclusions for flood.”¹⁸

The U.S. District Court for the Eastern District of Louisiana agreed, holding that the water damage provisions and the word “flood” in most of the policies could reasonably be interpreted two ways: 1) to mean a “flood” caused only by natural events or 2) to mean a “flood” resulting from both natural causes and negligent or intentional acts.¹⁹ Thus, the terms of the policies were ambiguous and should be interpreted in favor of the policy holders.

The district court applied Louisiana canons of construction and rules of interpretation to the contracts at issue. The district court stated that insurance exclusions are to be strictly construed, and that ambiguous policy provisions are to be construed against the insurer.²⁰ Moreover, a contract of adhesion, executed in a standard form, must be interpreted in favor of the party that did not write the contract.²¹ The court cited the Louisiana rule that strict construction applies if the ambiguous policy provision is susceptible to two or more reasonable interpretations, and the court ruled that an insurance customer could have more than one reasonable interpretation of the term “flood.”²² The court ruled that strict construction should apply.

However, the district court did side with the insurance companies regarding one type of policy, typified by the terms of State Farm Fire and Casualty Co.’s policy with several of the plaintiffs.²³ The State Farm policy stated:

¹⁸ *In re Katrina Canal Breaches Litig.*, 495 F.3d at 201.

¹⁹ *Id.* at 198.

²⁰ *In re Katrina Canal Breaches Consol. Litig.*, 466 F. Supp. 2d at 738.

²¹ *Id.*

²² *Id.*

²³ *In re Katrina Canal Breaches Litig.*, 495 F.3d at 197.

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. We do not insure for such loss regardless of: (a) the cause of the excluded event; or (b) other causes of the loss; (c) whether other causes acted concurrently or in any sequence with the excluded event to produce the loss; or (d) whether the event occurs suddenly or gradually, involves isolated or widespread damage, *arises from natural or external forces*, or occurs as a result of any combination of these:

Water Damage, meaning: (1) 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. . .²⁴

Regarding the State Farm policy, the district court concluded that the policy's "lead-in clause," describing external forces, cured the ambiguity and clearly excluded coverage for all floods, whether natural or not.²⁵ The district court granted State Farm's motions and dismissed the case against it.²⁶ The district court reached the same conclusion as to a similar policy from Hartford Insurance Co. of the Midwest and dismissed that company from the case as well. However, the judge declined to dismiss the remaining insurers who did not have the lead-in clause, allowing the plaintiffs to attempt to prove that negligent design or maintenance of the levees indeed did cause their water damage.²⁷

The district court's opinion shocked many on both sides of the insurance coverage debate and injected new life into claims by property owners devastated by hurricanes Katrina and Rita.²⁸ Up to this point, insurance companies had "years of precedent" on their side.²⁹ According to legal experts in the Gulf Coast region, the public generally knew that insurers did not cover flood damage and that at-risk

²⁴ *Id.* at 197-98.

²⁵ *Id.* at 198.

²⁶ *Id.*

²⁷ *Id.*

²⁸ Molly McDonough, *Defining Flood: Federal Judge's Ruling Has Katrina Victims Hoping for Coverage Cash*, ABA J. EREPORT, Dec. 8, 2006, available at <http://www.abanet.org/journal/ereport/d8trina.html> (last visited Oct. 11, 2007).

²⁹ *Id.*

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consumers had to purchase flood protection separately from the U.S. government's National Flood Insurance Program.³⁰

Sensing the implications of his ruling, the district judge put the case on a fast track to a 5th Circuit appeal.³¹ On August 2, a three-judge panel of the 5th Circuit overturned the district court's ruling.³²

To determine the scope of the flood exclusions, both the district court and appellate court focused on dictionary definitions of the words "flood," "overflow," and other terms used in the policies. The district court determined that the word "flood" in standard dictionaries described a natural event caused by rain or tide, not an inundation of water due to negligence.³³ The district court compared the situation to cases upholding insurance coverage for flooding due to broken water mains or damage to property from "earth movements" caused by human error.³⁴ The district court also stated that many dictionaries used the word "overflow" to define the meaning of flood and indicated that "overflowing" should be read to mean "overtopping" a water barrier like a riverbank or levee. The court inferred that because the water did not "overtop" the levee walls in this case, the breaches did not create a "flood."³⁵

In its review, the appellate court examined definitions of flood in four different dictionaries, as well as an encyclopedia entry describing the Johnstown flood of 1899, and disagreed with the district court.³⁶ The appellate court determined that a flood in its essence was "an overflowing of water onto land that is normally dry."³⁷ The appellate court found that this simple definition of flood was met when the water from the canal overflowed onto the dry land of New Orleans.³⁸

³⁰ *Id.*

³¹ McDonough, *supra* note 28.

³² Victims of Katrina Lose an Insurance Appeal, ASS'D PRESS, Aug. 3, 2007.

³³ *In re Katrina Canal Breaches Litig.*, 495 F.3d at 198.

³⁴ *Id.*

³⁵ *Id.* at 214.

³⁶ *Id.* at 211.

³⁷ *Id.*

³⁸ *In re Katrina Canal Breaches Litig.*, 495 F.3d at 211.

The appellate court also disputed the district court interpretation of the term “overflow.” The appellate court determined the dictionary definition of “overflow” was “to flow over; to overspread or cover with water or other liquid; to flood or inundate.”³⁹ Thus, the definition was much broader than simply overtopping a levee wall. Further, the appellate court noted that a levee is a “flood-control structure; its very purpose is to prevent the headwaters of a watercourse from overflowing onto certain land areas.”⁴⁰ The court reasoned that even if the levee failure was due to negligent design, it “does not change the character of the water escaping through the levee’s breach; the waters are still floodwaters, and the result is a flood.”⁴¹

Thus, the court concluded the flood exclusions, even without specifically defining the term flood or expressly excluding man-made negligence, are “unambiguous in the context of this case and what occurred here fits squarely within the generally prevailing meaning of the term ‘flood.’”⁴²

Insurance industry leaders celebrated the 5th Circuit ruling. Robert Hartwig, chief economist for the Insurance Information Institute, called it “an extremely important decision” because of the billions of dollars at stake.⁴³ Hartwig said the ruling “sets a precedent . . . shuts down a line of litigation . . . removes a cloud of uncertainty hanging over the market and in the long run will provide better stability for insurers to operate. That will benefit people trying to rebuild.”⁴⁴

However, the ruling is a disappointment to the many homeowners left with the damage from Hurricane Katrina. More than 200,000 homes and thousands of businesses were damaged or destroyed, and the relatively small amounts insurers have paid out to homeowners and businesses for wind damage have been too small for most people to rebuild.⁴⁵ The U.S. government promised several bil-

³⁹ *Id.* at 214.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *In re Katrina Canal Breaches Litig.*, 495 F.3d at 221.

⁴³ Yerak, *supra* note 1, at C1.

⁴⁴ *Id.*

⁴⁵ Katrina Victims Win One in Court: Judge Rules Insurance Companies Liable for Flood-Caused Damage, CHI. TRIB., Nov. 29, 2006, at C1.

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lion dollars in aid to the homeowners, but little of the money has reached the people who need it.⁴⁶

The Fifth Circuit opinion will ensure, moreover, that more insurance providers will adopt State Farm's more explicit exclusions for "floods" due in part to man-made negligence when they write up their next round of insurance policies.⁴⁷

⁴⁶ *Id.*

⁴⁷ Yerak, *supra* note 1, at C1.

Illinois Appellate Court Puts Scare Into Corporations By Striking Down Arbitration Agreement

The Illinois 5th District Appellate Court set a high bar for major businesses and bestowed increased protection on Illinois consumers this summer when it ruled that a satellite broadcasting company could not enforce the mandatory arbitration provision of its standard customer service agreement because the agreement was procedurally unconscionable.⁴⁸

DirecTV is a national satellite television provider that works through hundreds of independent retailers around the country to sign up customers for its satellite service.⁴⁹ A potential customer usually first purchases the necessary television equipment from the independent retailer; then the customer calls DirecTV personally to sign up for one of the company's satellite packages.⁵⁰ DirecTV typically then waits until after service is activated to mail the customer for the first time a copy of the parties' proposed written contract, called the "Customer Agreement." The company typically sends the contract in the same envelope as the first bill.⁵¹

In November 1999, Charlotte Bess purchased the necessary equipment and signed up for a DirecTV service plan. Thereafter, she received a copy of DirecTV's October 1999 Customer Service Agreement, which specified that if the customer does not accept the terms of the agreement, she must notify DirecTV immediately to cancel her service. If she does not do this and continues to receive the service, the Customer Agreement states she accepts the terms of the contract.⁵² Among its terms, the contract stated that the customer incurs a "deactivation fee" if and when she cancels her service. The contract did not contain a provision, however, concerning any refund

⁴⁸ Bess v. DirecTV, Inc., 2007 WL 2013613 (Ill. App. 5 Dist. 2007).

⁴⁹ *Id.* at *1.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.* at *1.

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for the already purchased television equipment.⁵³ Also, the contract stated that Bess would receive a bill from DirecTV once every 30 days, and if DirecTV did not receive payment in full before issuing its next statement, it would charge Bess a \$5 administrative late fee.⁵⁴

Bess eventually sued DirecTV over this provision, arguing that the \$5 administrative late fee was improper because the company's true cost for the inconvenience of a late-paying customer amounted to far less than \$5.⁵⁵ Bess argued that the fee violates both Illinois common law regarding liquidated damages and the Illinois Consumer Fraud and Deceptive Business Practices Act.⁵⁶

However, Bess' contract with DirecTV also contained an arbitration agreement, whereby Bess waived her right to a jury trial.⁵⁷ The contract first included an informal dispute resolution clause, under which Bess must first notify DirecTV of her claim at least 60 days before starting any formal proceeding.⁵⁸ The contract also included a formal dispute resolution clause, under which both parties agreed that any legal claim "will be resolved only by binding arbitration."⁵⁹ The contract stated that Bess would pay a fee of \$125 if she initiated the arbitration and would pay certain other fees related to the arbitration.⁶⁰ The contract declared in bold print: "**ARBITRATION MEANS YOU WAIVE YOUR RIGHT TO A JURY TRIAL.**"⁶¹

DirecTV notified Bess in December 2000 that it intended to enforce the contract's provisions and then filed a motion in court to compel arbitration and stay Bess' action so the arbitration could move forward.⁶² However, the trial court declined DirecTV's motion, finding that the arbitration clause was both procedurally and

⁵³ *Bess*, 2007 WL 2013613 at *1.

⁵⁴ *Id.* at *1.

⁵⁵ *Id.* *2.

⁵⁶ *See* 815 ILCS 505/1 et seq.

⁵⁷ *Bess*, 2007 WL 2013613 at *1.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Bess*, 2007 WL 2013613 at *2.

substantively unconscionable.⁶³ A three-justice panel of the Appellate Court of Illinois for the 5th District affirmed the trial court in a 2-1 decision.

The court first affirmed the fundamental importance of enforcing valid arbitration agreements, but asserted that a party can be forced into arbitration “only if he or she has in fact entered into a valid, enforceable contract waiving his or her right to a judicial forum.”⁶⁴ The court here was most concerned with whether the Customer Agreement was procedurally unconscionable, i.e. whether it was “so difficult to find, read, or understand that the plaintiff cannot fairly be said to have been aware he was agreeing to it” and whether there is “disparity of bargaining power between the drafter . . . and the party claiming unconscionability.”⁶⁵ The court said it must analyze procedural unconscionability by looking at the totality of the circumstances.⁶⁶

The court noted that the DirecTV arbitration provision was printed on a 10-paneled, fold-up pamphlet in about an eight-point font, with each panel containing more than 700 words.⁶⁷ The court also noted the disparate bargaining position between DirecTV and Bess and that DirecTV issued the provision to Bess on a take-it-or-leave-it basis.⁶⁸ However, the court said all these facts were relevant, but more was required for a finding of procedural unconscionability—there must be “some impropriety during the process of forming the contract depriving a party of a meaningful choice.”⁶⁹

The court found such impropriety in the fact that Bess never saw the contract before she signed up for the DirecTV satellite service, and that if she cancelled the contract she would be charged a “deactivation fee” and be on the hook for her already-purchased satellite equipment.⁷⁰ The court applied an Illinois Supreme Court de-

⁶³ *Id.*

⁶⁴ *Id.* at *3.

⁶⁵ *Id.* at *5.

⁶⁶ *Id.* at *4.

⁶⁷ *Bess*, 2007 WL 2013613 at *5.

⁶⁸ *Id.*

⁶⁹ *Id.* at *6.

⁷⁰ *Id.* at *7.

cision, *Razor v. Hyundai Motor America*⁷¹, to the case. In *Razor*, the Supreme Court held that a consequential damages provision in a pre-printed limited warranty form was unenforceable because it was not conveyed to the consumer at or before the time of the purchase.⁷² The appellate court extended this line of reasoning to preprinted customer agreements like the one Bess entered into with DirecTV. Citing *Razor*, the court said “it simply does not matter how large the type was or how clearly . . . expressed if the consumer did not have the opportunity to *see* the language before entering into the contract.”⁷³ The court said that Bess never saw the arbitration clause before entering into her contract, and there was no way for her to have seen the provision until she received her first bill.⁷⁴ Moreover, the court said that by making Bess buy her equipment first, DirecTV “required Bess to contract to receive its service and substantially change her economic position *before* she was provided with the . . . [a]greement . . . [t]herefore, Bess was deprived of a meaningful choice.”⁷⁵

The appellate court found that the procedural unconscionability of Bess’ contract rose to such a level that it invalidated the arbitration provision, thereby allowing Bess to proceed with her action in court.⁷⁶ The appellate court declined to determine whether the contract also was substantively unconscionable because it was unnecessary to the outcome of the case.⁷⁷

However, one justice on the court forcefully dissented. Justice James K. Donovan agreed that Bess’ customer agreement was “unconscionable to a certain extent,” but argued that this by itself could not render the entire arbitration provision unenforceable.⁷⁸

Justice Donovan cited an Illinois Supreme Court case, *Kinkel v. Cingular Wireless, LLC*, that reviewed a cell phone service agreement similar to the DirecTV contract, and found that even though the

⁷¹ *Razor v. Hyundai Motor America*, 222 Ill.2d 75 (2006).

⁷² *Id.* at 102-03.

⁷³ *Bess*, 2007 WL 2013613 at *6.

⁷⁴ *Id.*

⁷⁵ *Id.* at *7.

⁷⁶ *Id.*

⁷⁷ *Id.* at *8.

⁷⁸ *Bess*, 2007 WL 2013613 at *8 (Donovan, J., dissenting).

contract did not inform the consumer of the costs of the arbitration process or that she would be required to pay some of the costs, this procedural unconscionability did not by itself render a class action waiver in the agreement unenforceable.⁷⁹ The court in that case said that such form contracts:

are a fact of modern life. Consumers routinely sign such agreements to obtain credit cards, rental cars, land and cellular telephone service, home furnishings and appliances, loans, and other products and services. It cannot reasonably be said that all such contracts are so procedurally unconscionable as to be unenforceable.⁸⁰

Justice Donovan said *Kinkel* should hold sway and reasoned that the *Razor* case was distinguishable, because a limited warranty like the one in *Razor* is entirely different from the standard customer service agreement at issue in the case at bar.⁸¹ He argued the strong public policy favoring arbitration agreements, unlike limited warranties. He also emphasized how customary such customer contracts are these days, and how typical it is to send the agreement after purchase is made or inside the product box, where the customer accepts or rejects to contract after purchase.⁸²

Further, Justice Donovan cited case law from the 7th Circuit which argued that consumers as a whole are better off “when vendors skip costly and ineffectual steps such as telephonic recitation, and use instead a simple approve-or-return device. Competent adults are bound by such agreements, read or unread.”⁸³

Justice Donovan found that the deactivation fee in Bess’ contract was somewhat procedurally unconscionable, but that such provisions are increasingly commonplace.⁸⁴ Also, he found no direct evidence that Bess would not get a refund for her purchased equip-

⁷⁹ *Id.* at *8 (citing *Kinkel v. Cingular Wireless, LLC*, 223 Ill.2d 1, 27 (2006)).

⁸⁰ *Kinkel*, 223 Ill.2d at 26.

⁸¹ *Bess*, 2007 WL 2013613 at *8.

⁸² *Id.* at *9.

⁸³ *Id.* at *8 (citing *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147, 1149 (7th Cir. 1997)).

⁸⁴ *Bess*, 2007 WL 2013613 at *9.

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ment.⁸⁵ Thus, he concluded that the arbitration agreement still should have been enforceable.⁸⁶

The Illinois decision comes at a time when mandatory arbitration agreements and the familiar small-type, pre-printed customer contracts typical of countless everyday consumer transactions are coming under increasing scrutiny in courts across the nation. In September 2007, the U.S. Court of Appeals for the 11th Circuit found a class action waiver unconscionable as written in the arbitration agreement of a customer contract issued by cable giant Comcast Corp.⁸⁷ The Washington Supreme Court reached a similar decision recently, ruling that cell phone provider Cingular Wireless could not enforce its arbitration agreement forcing consumers to waive their rights to a class action.⁸⁸

The decision in *Bess* should reverberate through corporate America because it attacks the arbitration agreements generally and strikes down as unconscionable procedures that have become standard across the country. The Illinois Supreme Court has yet to address the issue.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Gene Dale v. Comcast Corp.*, 2007 WL 2471222 (11th Cir. 2007).

⁸⁸ *Phuong Cat Le, State High Court Says Consumers Can't Sign Away Class Action Rights*, SEATTLE POST-INTELLIGENCER, July 13, 2007, at A1.