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PUNITIVE DAMAGES REJECTED WHEN INSURER MAKES “EXTREMELY CLOSE CALL”

by

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Not long after the winds and rains subsided, the water receded, and before the clean-up began in earnest, it was apparent to the insurance industry, if not the nation, that many insureds whose lives were devastated by Katrina would look to the insurance industry to bail them out. Many insureds knowingly built homes in this hurricane-prone region where water damage is a known, uncovered risk. Wind damage, on the other hand, may be covered under certain policy provisions. As a result, since Katrina slammed the Gulf Coast in August 2005, Mississippi state and federal courts have been center stage in the water vs. wind debate and have weighed in on this significant issue plaguing many insurers.

Most recently the U.S. Court of Appeals for the Fifth Circuit, in *Broussard v. State Farm Fire & Casualty Co.*, realizing that whether the damage to a particular building was caused by wind or water is a factual determination, and many times a very close call, found that a jury, and not the judge, must make the determination regarding causation. Further, the Fifth Circuit held that, based upon the difficult, factually dependent decision made by State Farm in this case, without the benefit of instant replay, its decision to deny coverage was not without a reasonable basis under the circumstances and that punitive damages were not warranted. As the Fifth Circuit reasoned: “Even after extensive investigation by both parties, the question of whether the Broussards’ property was first destroyed by wind or water remains an *extremely close one*.” (Emphasis added.) Accordingly, the court reversed (1) the District Court’s grant of judgment on behalf of the insured, (2) the finding of bad faith and (3) the jury’s award of \$2.5 Million (which had been reduced to \$1 Million by the trial court). The Fifth Circuit remanded the case back to the District Court for a factual finding by the jury on the causation issue only.

The underlying facts in *Broussard* are not unlike other Katrina cases. When the Broussards lost their home and personal belongings to Katrina, they turned to their insurer, State Farm, for rescue. State Farm’s insurance policy provided two types of coverage: (1) “named peril” personal property coverage which covered losses caused by wind and (2) “open peril” coverage for the dwelling which covered any “accidental direct loss” to the dwelling. The policy did not cover damage to personal property or the dwelling caused by water.

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From the outset, the Broussards and State Farm disagreed as to the cause of the damage. The Broussards argued that Katrina's wind caused the loss of their home and belongings whereas State Farm asserted that no coverage was available because the storm surge caused the damage.

At the trial court level, the District Court bifurcated the matter for a determination *first* as to causation and *second* as to damages. Although bifurcation of the trial, in and of itself, is not shocking, the conclusions reached by the trial court at both stages were unsupported. First, the court granted a judgment as a matter of law to the Broussards as to the coverage available under the "named peril" and "open peril" provisions. Then, addressing damages, the court referred the question of punitive damages to the jury which imposed on State Farm \$2.5 Million in punitive damages. State Farm appealed, among other things, the entry of judgment as a matter of law and the award of punitive damages. State Farm was victorious on both issues.

Under Mississippi law, a court may instruct the jury on punitive damages only when the trial court has determined that there is clear and convincing evidence that the insurer acted in bad faith. Further, bad faith damages may not be awarded if the insurer had reasonable justification, whether in fact or in law, to deny payment unless the insurer's behavior in writing the insurance policy or handling the insurance claim violated the implied covenant of good faith and fair dealing and constituted an independent tort. Under the facts of the case, the Fifth Circuit found that the standard was not met.

The Fifth Circuit evaluated State Farm's reasonable basis for the decision to deny coverage. The bases for the denial were: (a) the inspection of the Broussards' property including the debris line and the condition of the trees on the Broussards' property; (b) the determination that the damage to the surrounding trees was consistent with flooding; and (c) the conclusion that "tidal surge and flooding" caused the damage to the Broussards' home as well as the damage to the surrounding neighborhood. Based on these findings, the Fifth Circuit held that State Farm reasonably could find that no coverage was available because water – not wind – caused the Broussards' losses. The depth of the investigation not only provided a reasonable basis for its decision but also demonstrated that State Farm did not engage in a "grossly negligent" claim evaluation.

The Fifth Circuit also found that State Farm's continued withholding of payment after its expert conceded that some *de minimus* damages were caused by windstorm did not support an award of punitives. The Appeals Court's decision in this regard was again fact specific and premised on State Farm's advance of certain expenses and the applicability of a 2% deductible. Arguably, State Farm could have concluded that the advance payment and 2% deductible covered the wind losses. The Fifth Circuit found that State Farm did its job and that the District Court had no basis to submit the issue of punitive damages to the jury. Finally, the court found that a punitive damages award could not be premised upon an anti-concurrent clause when (1) the clause was consistent with Mississippi law and (2) State Farm argued that it did not rely upon the clause in reaching its decision.

Although the catastrophe left in the wake of Hurricane Katrina is horrific, the substantial damage does not automatically permit coverage or punitive damages under insurance policies. Insureds must still carry their burden of proving that the damage is within the risk covered by the policy. When causation is a close call, such as in *Broussard*, an insurer should not be *de facto* exposed to punitives. Rather, when, as here, there is a reasonable, arguable basis for the denial and the insurer has not conducted a grossly negligent investigation or engaged in abhorrent behavior in drafting the policy, a punitive damage award, much less a \$2.5 Million punitive award, will not be upheld.