



A Real Insurance Fraud

By James Q. Wilson

When Hurricane Katrina hit our southern coast, it was the worst natural disaster in American history, killing 1,800 people, forcing more than a million to evacuate the area, and putting four-fifths of New Orleans under water. In the struggle to recover from this event, people turned to their insurance companies for help. Thousands of claims were handled, but for some people there was no coverage. The problem was that they were not insured against flooding.

Insurance companies' policies are quite clear on this, and state insurance departments, including the ones in Mississippi and New Orleans, have approved these rules. The homeowners' policy issued by State Farm, for example, says that water damage from a flood, waves, tidal waves, or a tsunami are not covered. (Full disclosure: for several years I was a director of State Farm.)

The reason for the exclusion of water damage is quite clear: hardly any insurance company wants to encourage people to build or occupy structures in places where such damage is likely. If they did allow this, either the company would go bankrupt from losses it could not pay or it would have to charge a premium so high that hardly anyone could afford the insurance. Even without water-damage coverage, insurance companies paid out around \$40 billion to Katrina victims.

You can buy a hurricane deductible endorsement from insurance companies, but it does not protect you against flooding. It simply alters the amount of the deductible you must pay under a regular policy.

You can get flood insurance under a federal National Flood Insurance Policy (NFIP) that will cover up to \$250,000 for home damage, provided the flood area in which you live has met certain

federal standards. These require that buildings have floors that are higher than what a flood is likely to produce. In parts of New Orleans, that would mean the floors would have to be put on stilts fifteen feet above the ground.

Not content with these policies and rules, trial lawyers and politicians in Mississippi demanded that insurance companies should be required to pay for flood losses even though they were not covered by the policies. Richard "Dickie" Scruggs, a veteran of class-action suits, and Mississippi attorney general Jim Hood worked together to create a lawsuit that would retrospectively ban the flood exclusion rule. (Scruggs was a major source of campaign money for Hood.) At the same time, Representative Gene Taylor (D-Miss.) urged Congress to require a retroactive payment of flood insurance. Never mind what the homeowners' insurance policies said or what their coverage was, demanding money to which they were not entitled became "good public policy."

Soon thereafter, Senator Trent Lott (R-Miss.), Scruggs's brother-in-law and the owner of a waterfront home damaged by Katrina, filed suit against State Farm. He had already been paid by NFIP, but he wanted private insurance money as well. The next year both a Mississippi and a federal grand jury subpoenaed State Farm on the basis of allegations that employees of a private adjusting firm had damaging information about State Farm.

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These may strike you as routine political and legal maneuvers. But what insurance companies—not just State Farm, but all of them—did after Katrina was anything but routine. State Farm sent four thousand claims adjusters and their support staff into the area. Most of them had nowhere to live and little to eat. Some had to stay in Birmingham, Jackson, Mobile, and other towns and move in and out of the Katrina area every day. The company built two trailer cities, each with a hundred trailers. GI food, or Meals Ready to Eat (MREs), were shipped in by willing truckers. These emergency homes and MREs lasted not for a day or two but for up to ten weeks.

The claims adjusters worked twelve-hour days. They struggled to find the homes of policyholders because street signs were down, and even when they were not, many people had left town for unknown addresses. To get money into the hands of policyholders quickly, the adjusters were authorized to pass out \$2,500 as an advance to cover additional living expenses to everyone who had a homeowner's policy, with the full payment to come in days. Hundreds of adjusters were struggling to exercise their judgment about complicated losses in ways that would help people living in what was close to a war zone.

Through his actions, Hood sent a message that said these adjusters were not exercising judgment—they were committing a crime. One wonders how any insurance company will recruit and motivate adjusters who will go into the field under these difficult conditions if politicians say they are part of a criminal enterprise.

In time, some measure of sanity was restored. A federal district court judge upheld the flood exclusion in insurance policies, a view that was affirmed by the Court of Appeals for the Fifth Circuit. More recently, the Fifth Circuit has affirmed that there is no coverage when an excluded peril (such as flooding) and a covered one (such as windstorms) both contribute to the same damage. A Louisiana state judge agreed that policies not written to provide flood insurance did not, in fact, provide it. State Farm reached a settlement with Hood and Scruggs, and Hood concluded his grand jury investigation. Lott settled his suit with State Farm.

But the return of sanity was of short duration. In June, Scruggs filed a lawsuit against State Farm saying that it engaged in racketeering, and Hood filed a new civil lawsuit—and then followed up with another grand

jury investigation contrary to his prior agreement with State Farm. One wonders how claims adjusters feel when they are told that they are no better than members of the Mafia.

In light of all this, State Farm announced earlier this year that it would no longer sell new homeowners' policies in Mississippi—not to punish people there but because politicians had made it impossible to do business in an orderly way. In response, Hood demanded that the governor order State Farm to write new policies. Governor Haley Barbour replied, quite reasonably, that he does not have the authority to tell a private company that it must do business in his state. There will no doubt be

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congressional investigations of the insurance business because it did what it told people it was doing.

To be sure, there are things that could be done better. It would be nice if the federal government enforced a flood insurance program based on buildings conforming to flood-resistant standards. (Before Katrina, it had said that these standards did not affect much of New Orleans because it believed the levees would hold.) It might be helpful if an arbitration procedure was created outside the court system to resolve differences between insurance companies and policyholders about all matters, including arguments over whether what an insurance company believes was flood damage (and thus not insurable) was in fact wind damage (and thus insurable). Insurance companies could also do a better job of educating their customers about what they are buying.

Still, most of the problems down in Mississippi would have been resolved if the people of the Magnolia State had elected a new attorney general (instead, they threw out of office the insurance commissioner who had disagreed with Hood). In Mississippi, remarkably, the attorney general has succeeded in making it seem like settling insurance claims is a crime.