California Real Property Journal
OFFICIAL PUBLICATION OF THE REAL PROPERTY LAW SECTION STATE BAR OF CALIFORNIA
Vol. 16, No. 4 Fall, 1998

California Supreme Court Sets Rules for Determining Insurance Coverage for Environmental Claims

By Jon Enscoe* and Paul M. Zieff**

"This...draws us deep into the catacombs of insurance policy English, a dimly lit underworld where many have lost their way."[1]

I. INTRODUCTION

For as long as there has been insurance, there have been disputes over the scope of coverage. This, of course, is to be expected. Few insurance policies are free of ambiguity. Yet while coverage litigation has always been part of the insurance landscape, nowhere has it been more prevalent or intense than in the context of environmental claims. The reasons are not difficult to understand.

Estimates for the cost of cleaning up existing contamination are staggering. Some analysts have predicted that enforcement of the federal Superfund law—a statute adopted in 1980 to

Special Issue: Insurance

Whether you are negotiating a lease, drafting loan documents, or advising a client about how to proceed with its contaminated site, it is increasingly important that you understand insurance coverage and how it may affect your client. Environmental insurance allows some owners and lenders to quantify their risk of damages for clean-up of a contaminated property, and appropriate planning of insurance coverage for owners, contractors, and subcontractors can provide a source of recovery or can reduce liability in the event of a construction defect claim. These and other insurance coverage issues are discussed in this special issue of the *California Real Property Journal.*

INSIDE THIS ISSUE...

Letter from the Chair 3
Obtaining Insurance Coverage for Construction Defect Claims 12
"Environmentally Challenged" Property: Is Environmental Insurance the Answer? 20
New CLTA Extended Coverage Homeowner's Policy 25

DISTRIBUTED AT NO CHARGE TO MEMBERS OF
THE REAL PROPERTY LAW SECTION OF THE STATE BAR OF CALIFORNIA

clean up the nation's hazardous waste sites—may involve as much as $1 trillion.

From the perspective of the individual policyholder, the need for coverage is obvious and compelling. The cost of remediating environmental contamination can often exceed the value of the affected property. Moreover, environmental statutes cast a net wide enough to make even an innocent and passive landowner potentially responsible for contamination left behind by others.[2] These statutes embrace the concept of "joint and several liability," which provides that a single party can be saddled with the entire cost of a massive cleanup, even though others have caused or substantially contributed to the problem.[3] Although the law affords a defendant the right to seek contribution from other parties and—under certain limited circumstances—a complete defense, asserting these rights and defenses entails substantial expense.

At the same time, the specter of coverage for environmental claims is alarming to the insurance industry. The financial exposure of the industry as a result of environmental claims has been estimated to be as high as $400 billion. In testimony before the House Banking, Finance and Urban Affairs Subcommittee, an analyst from Salomon Brothers warned that the cash reserves of the commercial insurance industry could be "wiped out" by environmental cleanup claims.

Considering what is at stake, it is not surprising that insurers and policyholders are squaring off in courtrooms across the country, engaged in a pitched battle over the contours of coverage for environmental claims. These cases—like most other lawsuits over insurance coverage—call upon courts to resolve issues of fact that are often vigorously disputed. Coverage may turn, for example, on precisely when contamination occurred, how it occurred, or whether the insured expected or intended the damage in controversy. But before reaching these factual issues, the courts must decide what the relevant provisions in the insurance policy mean. These threshold questions of interpretation figure more prominently in environmental coverage litigation than in any other area of insurance law.

One might think that after more than a decade of environmental coverage litigation, most of the difficult interpretation issues raised by environmental claims would have been resolved. This is not the case. In most states, many of the key coverage issues raised by environmental claims have yet to be resolved. Moreover, because the meaning to be given a particular policy provision is a matter of state law, court decisions in one state—while perhaps persuasive—are not controlling in the courts of another. In fact, on many important coverage issues, state courts have reached wildly divergent results, despite the fact that the courts are construing the same standardized policy language.[4] As a result of this kaleidoscopic variation in state court decisions—a condition aptly described by one commentator as the "Balkanization" of American environmental insurance law—coverage may well depend on which state's law is applied in interpreting the insurance policy.

In California, the battle over coverage for environmental claims is far from over. Although the law in California is more developed than it is in many other states, there are still a number of significant issues that have yet to be resolved.

Just as courts in different states have not seen eye to eye on the meaning of standardized policy terms, so too, trial and appellate judges sitting in California have sometimes reached discrepant results. The fact that the inquiry in California is guided by rules of policy interpretation that have been well settled for many years has not always guaranteed either predictability or consistency in the decisions reached.

Continued on page 4

California Supreme Court Sets Rules for Determining Insurance Coverage for Environmental Claims

Continued from page 2

The potential for conflict and uncertainty is well illustrated by the recent appellate decisions considering whether a carrier's contractual obligation to defend a "suit" against its insured extends to administrative proceedings or, instead, is limited to formal lawsuits. Last year, in *Foster-Gardner, Inc. v. National Union Fire Insurance Co.*,[5] a panel of the second appellate district concluded that a carrier's duty to defend does embrace administrative proceedings. One month later, a different panel of the same appellate district reached precisely the opposite result in *Fireman's Fund Insurance Co. v. Superior Court*.[6] The California Supreme Court settled the issue this past August, reversing the court of appeal decision in *Foster-Gardner* and concluding that the term "suit" should not be read to include administrative proceedings.[7] The supreme court decision came as a surprise to the many lawyers on both sides of the coverage bar who were predicting that the supreme court would adopt a more expansive construction of the term "suit."

Although the California Supreme Court has issued relatively few decisions that specifically address coverage for environmental claims, three such decisions have been issued within the past twelve months. In the handful of environmental coverage cases that the California Supreme Court has decided since 1990, many of the most important and vigorously contested coverage issues presented by environmental claims have been resolved.

If, as *Foster-Gardner* illustrates, "it ain't over until the [California Supreme Court] sings," the spate of recent decisions suggests that now may be an opportune time to take stock of what has been decided with finality in California, and what has not, as it relates to coverage for environmental claims. What follows is a discussion of the issues that have been resolved by the California Supreme Court, followed by a brief discussion of important environmental coverage issues that the high court has not yet addressed.

II. ISSUES RELATING TO THE DUTY TO DEFEND

A. The Insurers' Broad Duty to Defend Environmental Claims

The function of a liability policy is to protect the insured against claims asserted by third parties. Protection is afforded by imposing on an insurer two principal duties—first, a duty to defend lawsuits, and second, a duty to indemnify or pay the claim in the event that the insured's liability is established. Both duties are set forth in the same portion of the insurance policy—the so-called "insuring agreement," which typically states:

> The Company *will pay* on behalf of the Insured all sums which the Insured shall become legally obligated to pay as damages because of bodily injury or property damage, to which this insurance applies, caused by an occurrence, and *the Company shall have the right and duty to defend any suit* against the insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent.... (emphasis added)

California courts have long held that the duty to defend is much broader than the duty to indemnify, and that a liability insurer has a duty to defend if there is any "possibility" of coverage under the facts alleged in the complaint.[8] The duty to defend operates as a form of "litigation insurance" protecting the insured from having to fund its own defense when sued by a third party on potentially covered claims.

The California Supreme Court considered the scope of an insurer's duty to defend an environmental claim in *Montrose Chemical Corporation v. Superior Court* ("*Montrose I*").[9] The policyholder in *Montrose I*, a defunct chemical company, was alleged to have released hazardous substances in the course of manufacturing DDT at a facility in Torrance, California, between 1947 and 1982. The United States and the State of California filed suit against Montrose under CERCLA, seeking to recover response costs and natural resource damages.

When Montrose's carriers refused to honor their obligation to defend the government claims, Montrose filed a declaratory judgment action and moved for summary adjudication on the insurers' duty to defend. The trial court denied Montrose's motion on two grounds. First, the trial court reasoned that because the complaint in the underlying action was silent or "neutral" with respect to certain coverage issues—for example, whether the insured's conduct was intentional or merely negligent—the complaint could not be relied on to establish a potential for coverage. Second, the trial court concluded that evidence presented by the insurers in opposition to the motion created doubt—and thus, a triable issue of fact—as to whether there would ultimately be a duty to indemnify.

The trial court's grudging analysis was repudiated—both by the court of appeal and the supreme court—in an historic reaffirmation of the duty to defend under California law. The supreme court stated:

> Travelers criticizes the Court of Appeal's...references to "possibility" of coverage as the test for whether the insurer owes a duty to defend its insured in the underlying suit. The correct test, Travelers insists, is whether there exists a "*reasonable* potential for coverage;" this permits the insurer to engage in...a "factual balancing," taking into account disputed and undisputed facts, before making its determination whether to provide its insured with a defense.... Traveler's argument betrays a fundamental misunderstanding of *Gray* [*v. Zurich*], and of what is at issue in an adjudication of the defense duty.[10]

The California Supreme Court in *Montrose I* once again approved the fundamental precept of California insurance law that "a bare potential or possibility of coverage" is sufficient to trigger a duty to defend.[11] Most important, the court also embraced the appellate court's conclusion that to defeat an insured's motion for summary adjudication on the duty to defend, the insurer must demonstrate that "undisputed facts...conclusively eliminate" any possibility of coverage.[12]

The significance of *Montrose I* for insurance policyholders cannot be overstated. Prior to *Montrose I*, many carriers would routinely refuse to defend environmental lawsuits based on preliminary, but inconclusive, evidence that the claims asserted *might* not be covered—for example, because contamination *might* not have been sudden or accidental (thus implicating the pollution exclusion), because damage *might* have been expected or intended (thus implicating the "occurrence" requirement), or because the damage *might* have

occurred outside the policy period. *Montrose I* confirms that a carrier's belief that there may be no coverage—even assuming the belief is based upon some actual evidence—does not justify withholding a defense:

> Facts merely tending to show that the claim is not covered, or may not be covered, but are insufficient to eliminate the possibility that resultant damages (or the nature of the action) will fall within the scope of coverage, therefore add no weight to the scales.[13]

In short, whatever evidence a carrier may have that "suggests but does not conclusively establish" an absence of coverage is evidence that, in the words of the *Montrose I* court, "add[s] no weight to the scales."[14] Under *Montrose I*, unless and until a carrier can prove that "undisputed facts" completely "eliminate the possibility" that "at least some" of the alleged property damage may be within the scope of coverage, the carrier necessarily owes a defense.[15]

The importance of a broad duty to defend in the context of environmental lawsuits is readily apparent. More often than not, the defense of such lawsuits will require a substantial commitment of financial resources. Because the duty to defend is so broad, an insurer may be required to defend claims asserted in a lawsuit for which there is no obligation to indemnify—either because the claims prove to be unfounded or because the evidence ultimately demonstrates a basis for exclusion from coverage. Significantly, if it turns out that there is coverage, the expense of defending a lawsuit will generally not count against, or reduce, the policy limits that are available under an insurance policy to pay a settlement or judgment.

B. Insurer's Obligation to Defend the Entire Action and Limitations on Its Right to Seek Reimbursement

When insurers agree to provide a defense for environmental claims, generally they expressly reserve the right to deny coverage on various stated grounds and to seek reimbursement of defense costs in the event coverage is not established. The scope of a carrier's right to seek reimbursement of defense costs was addressed by the California Supreme Court in a recent non-environmental coverage case.

In *Buss v. Superior Court*,[16] the insurer provided the insured with a full defense to a lawsuit that included one potentially covered claim (defamation) and twenty-six claims that were not potentially covered (breach of contract and various other claims for economic loss). At the outset of the litigation, the insurer expressly reserved the right to seek reimbursement from the insured for amounts it paid to defend claims for which there was no potential for coverage.

The supreme court held that an insurer is required prophylactically to defend all claims brought against the insured in a "mixed action"—that is, a lawsuit that includes both claims that are potentially covered and claims that are not. The supreme court also held, however, that an insurer that has properly reserved the right to do so may later seek reimbursement from its insured of those costs that are allocable "solely" to defend claims for which there was never a potential for coverage.[17] To establish a right to reimbursement, the insurer must carry the burden of proving that the costs to be reimbursed are properly allocated solely to the defense of claims for which there was never a potential for coverage.[18]

As a practical matter, the burden of proving that certain defense costs are allocable solely to claims for which there was never a potential for coverage will be difficult if not insurmountable in most environmental contamination cases. The various causes of action asserted in an environmental lawsuit typically arise out of the same conduct. Insurers are much more likely to seek reimbursement in a case such as *Buss*, where the conduct giving rise to the potentially covered claim (defamatory statements) is readily distinguished from the conduct on which the other claims are based.

C. Insurer's Duty to Defend Includes the Obligation to Pay for Investigative Costs

The defense of a claim involving environmental contamination takes more than competent legal counsel. It also generally requires technical advice and services provided by environmental consultants. In *Aerojet General Corporation v. Transport Indemnity Co.*,[19] the California Supreme Court considered whether the costs of investigating the extent of environmental damage and studying the feasibility of various clean-up alternatives are included within the scope of an insurer's duty to defend.

The court rejected the insurers' argument that because the costs of environmental investigations and feasibility studies assist the insured in cleaning up the environment, they should not be considered defense costs. The court held as a general matter that site investigation costs constitute defense costs if three criteria are satisfied: (1) the site investigations must be conducted after the action is tendered to the insurer and before the action is concluded; (2) the site investigation costs must amount to a reasonable and necessary effort to avoid or at least minimize liability; and (3) the site investigation expense must be reasonable and necessary for that purpose.[20]

The *Aerojet* decision specifically considered whether the expense of preparing a Remedial Investigation/Feasibility Study ("RI/FS") should be recoverable as a defense cost. The court concluded that an insured's site investigation in the context of an RI/FS does constitute a defense cost if the investigation represents a "reasonable and necessary effort to avoid *or at least minimize* liability."[21]

Policyholders benefit greatly to the extent that they can characterize and recover the expense of investigating site contamination and evaluating remediation alternatives as defense costs for several reasons: (1) the insurer's duty to defend is much broader, and easier to establish, than the duty to indemnify, (2) the expense of site investigation and feasibility studies can be very substantial, sometimes exceeding the expense of the remediation itself, and (3) typically, defense costs do not exhaust policy limits, but instead must be paid in addition to policy limits.

D. Insurers Have No Obligation to Defend Against Administrative Proceedings

In *Foster-Gardner, Inc. v. National Union Fire Insurance Co.*,[22] a sharply divided California Supreme Court handed California policyholders a major and unexpected defeat in the ongoing battle over coverage for environmental claims. The issue before the court in *Foster-Gardner* was whether or not an insurance carrier's obligation to provide its insured with a defense to a "suit"—a term that is left undefined in a CGL policy—requires the insurer to provide a defense to an administrative proceeding, such as those brought by state and federal environ-

mental regulators. Insurers insisted that the term "suit" should be narrowly read to exclude such administrative proceedings, arguing that the term "suit" embraces only a formal lawsuit in a court of law. Policyholders, on the other hand, argued that because an administrative proceeding is the functional equivalent of a lawsuit in the context of environmental claims, insurers should be required to provide a defense.

Courts outside California have divided on the issue. Until last year, there was no California appellate authority directly on point. In 1997, two California intermediate appellate courts reached diametrically opposite conclusions on the "suit" issue. In the *Foster-Gardner* case, the Second District appellate court held that an administrative proceeding by the California Environmental Protection Agency is the "functional equivalent" of a lawsuit and that the insurer must therefore provide a defense.[23] A month later, however, another panel of the same appellate district applied a "literal" contract interpretation approach in *Fireman's Fund Insurance Co. v. Superior Court*.[24] The *Fireman's Fund* court concluded that the term "suit" can only mean a formal "lawsuit," and therefore an insurer need not defend administrative proceedings.

The California Supreme Court accepted review of both decisions, and in *Foster-Gardner* resolved the "suit" issue decisively in favor of insurance carriers. In *Foster-Gardner*, the insured had received an "Imminent and Substantial Endangerment Order and Remedial Action Order" from the Department of Toxic Substance Control of the California Environmental Protection Agency. The order required Foster-Gardner to conduct an investigation and remediation at the site and stated that Foster-Gardner could be liable for up to $25,000 per day in penalties if it refused to do so. Although the supreme court expressly acknowledged "the seriousness of such an Order," it nonetheless concluded that the order was not a "suit" and the insurer therefore had no duty to provide a defense. Adopting a strict literal interpretation, the court's opinion, authored by Justice Brown, held that the term "suit" in a standard liability policy is unambiguous and embraces only a formal lawsuit in a court of law. The high court relied heavily on the fact that while the standard form insurance policy states that a carrier "may" investigate or settle any "claim or suit," the language imposing a duty to defend makes reference only to "suits."[25] In a vigorous dissent, Justice Kennard argued that the undefined term "suit" is ambiguous and should be interpreted to include an agency notice that directs the recipient to assume responsibility for remediation of pollution.[26]

The *Foster-Gardner* decision is likely to have a significant and unfortunate effect on existing and future environmental claims. When the government acts to compel environmental remediation, it almost always does so by initiating an administrative proceeding rather than a traditional lawsuit. In recent years, many insurers have agreed to provide their policyholders with a defense to administrative proceedings— presumably with the expectation that the California Supreme Court would eventually rule that insurers have a duty to defend. Now insurers may seek to abandon their insureds in the same proceedings that they previously agreed to defend.

Looking ahead, insureds now face the reality that they will have no insurance coverage for defense costs in an environmental matter unless a formal lawsuit is filed. It is not difficult to imagine how the *Foster-Gardner* decision will impact the willingness of policyholders to cooperate with governmental agencies in response to an administrative notice or order. If the penalty for such cooperation is a loss of insurance protection, many policyholders will be more likely to test the resolve of enforcement officials, refusing to pursue cooperative remediation in the absence of a lawsuit that will trigger the carrier's duty to defend. This, of course, will further strain already overburdened governmental agencies, to the benefit of no one. While the *Foster-Gardner* case will be hailed as a great victory by insurance companies, it undoubtedly will prove to be a harmful decision from a public policy perspective.

III. ISSUES RELATING TO DUTY TO INDEMNIFY

A. Environmental Injury As Damages

The policy language establishing an insurer's duty to indemnify typically requires that the insurer pay "all sums which the insured shall become legally obligated to pay as damages because of *property damage*." The standard CGL policy defines "property damage" to include both "physical injury to or the destruction of tangible property" and "loss of use of tangible property." In the early days of environmental coverage litigation, some insurers argued that environmental injury should not be considered "property damage." In *AIU Insurance Co. v. Superior Court*, the California Supreme Court rejected this argument, holding that environmental injury from a discharge or release of a harmful substance constitutes "property damage" within the meaning of a CGL policy.[27]

B. Coverage for Response Costs

To establish coverage under a CGL policy, however, it is not enough that environmental injury is "property damage." The policy language expressly limits coverage to sums that the insured is obligated to pay "*as damages* because of...property damage." Early on, insurers often attempted to avoid coverage by arguing that the phrase "as damages" should be narrowly construed. Specifically, the insurers argued that unless an insured is called upon to pay compensatory damages—that is, damages to an injured third party in the context of a conventional lawsuit—there should be no coverage. Such a reading of the phrase "as damages" would, of course, preclude coverage for environmental cleanup in most cases. When the government acts to address environmental contamination it often does so by seeking an injunction that compels the policyholder to undertake a cleanup. Compliance with such a mandate requires payment by the policyholder to contractors, consultants, and suppliers, rather than payment of a compensatory damage award to an injured claimant.

Whether such response costs satisfy the "as damages" requirement in a CGL policy was vigorously litigated. The California Supreme Court resolved the issue in the *AIU* case, squarely holding that a CGL policy provides coverage for the cost of complying with injunctions as well as the cost of reimbursing agencies for their out-of-pocket expenses.[28] The court concluded that a reasonable insured would expect such claims to be covered, and therefore, for the court to hold otherwise "would exalt form over substance."[29] Finding the word "damages" to be ambiguous in the special context of environmental claims, the *AIU* court construed it in favor of coverage.[30]

IV. THE COURT ADOPTS A CONTINUOUS TRIGGER OF COVERAGE

Under a standard CGL policy, coverage is triggered by "bodily injury" or "property damage" that takes place "during the policy

period." In the case of environmental contamination, the property damage that is caused by a release may be continuous and progressive, spanning a number of successive policy periods, and often the contamination is not discovered until years after the release occurred.

The choice of a "trigger of coverage" rule will determine which among successive policies must respond to a liability claim. The focus of the inquiry is on what must happen—what event or events must occur—during the policy period to require the insurer to respond to a claim.

Courts considering the appropriate trigger of coverage for progressive or continuous injury have adopted a variety of alternative approaches. The various trigger rules first evolved in the context of cases involving claims for latent bodily injuries, many of which involved injuries resulting from exposure to asbestos.[31]

In *Montrose Chemical Corporation v. Admiral Insurance Co.* (*"Montrose II"*),[32] the California Supreme Court addressed and resolved the trigger of coverage issue in the context of environmental claims. As explained by the court in *Montrose II*, the word "trigger" is not found in CGL policies or in the Insurance Code. Instead, it is a term of convenience "used to describe that which...must happen in the policy period in order for the *potential* of coverage to arise."[33]

The *Montrose II* case involved an effort by Montrose Chemical Corporation, the same company that was the plaintiff in *Montrose I*, to obtain insurance coverage for a number of underlying lawsuits, including two arising out of Montrose's disposal of toxic wastes at the Stringfellow Acid Pits in Riverside County. Montrose had been sued both by the United States and the State of California under CERCLA for generating toxic wastes shipped to the Stringfellow site and by various individuals asserting bodily injury and property damage claims resulting from the release of contaminants at the Stringfellow site. All of the lawsuits involved allegations of damage or injuries that began in the 1950s and continued until the 1980s.

Montrose tendered the defense of the Stringfellow lawsuits to the various carriers that issued policies between 1960 and 1986. Admiral Insurance Company refused to defend or indemnify Montrose on the grounds that the alleged damage had already occurred, and was known to Montrose, prior to 1982 when Admiral first issued a policy to Montrose.

The court in *Montrose II* concluded that the express language of the CGL policies unambiguously requires the adoption of a "continuous injury" trigger of coverage—the rule favored by policyholders. The court held that where "successive CGL policy periods are implicated, bodily injury and property damage which is continuous or progressively deteriorating throughout several policy periods is potentially covered by all policies in effect during those policy periods."[34]

The *Montrose II* court expressly rejected the "manifestation trigger of coverage" rule favored by most insurers and previously adopted by certain intermediate California appellate courts. Under a manifestation rule, coverage is limited to the policy in effect when the damage or injury is discovered, or manifests. Many insurers favored the manifestation rule because it generally limits coverage to a single year and to more recent policies under which there may be pollution exclusions limiting coverage for environmental claims.

V. NARROWING OF THE KNOWN LOSS RULE

Montrose II also addressed the "loss in progress" or "known loss" rule. The rule derives from the general concept that insurance only covers contingent or unknown losses.[35] The insurer in *Montrose II* argued that the known loss rule barred coverage under all of its policies because the insured knew of contamination, and had already received a potentially responsible party ("PRP") notice, *before* the policies were issued. The supreme court rejected the carrier's argument, finding that there remained a contingent or insurable risk *even after the PRP notice was issued.* The *Montrose II* court reasoned as follows:

> The PRP notice is just what its name suggests—notice that the EPA considered Montrose a "potentially" responsible party. While it may be true that an action to recover clean-up costs was inevitable as of that date, Montrose's liability in that action was not a certainty. There was still a contingency, and the fact that Montrose knew it was more probable than not that it would be sued (successfully or otherwise) is not enough to defeat the potential of coverage (and consequently, the duty to defend)....
>
> We therefore hold that, in the context of continuous or progressively deteriorating property damage or bodily injury insurable under a third party CGL policy, as long as there remains uncertainty about damage or injury that may occur during the policy period and the imposition of liability upon the insured, and no legal obligation to pay third party claims has been established, there is a potentially insurable risk within the meaning of sections 22 and 250 [of the Insurance Code] for which coverage may be sought.[36]

The holdings in *Montrose II*—adopting a continuous trigger and restricting the scope of the known loss rule—mean that policyholders can seek coverage under policies issued in all years from the time damage first began until the insured's liability is ultimately established. These rulings dramatically increase the potential for coverage of environmental claims. The *Montrose II* rulings also thrust to the forefront questions relating to the allocation of liability between successive insurers providing coverage during a period of continuous injury.

VI. EACH TRIGGERED POLICY OWES AN INDEPENDENT OBLIGATION TO RESPOND IN FULL

As discussed in the preceding section, under *Montrose II*, every liability policy in effect from the time that bodily injury or property damage begins until the policyholder's liability is established is "triggered" and may be called upon to respond to a claim, subject to applicable policy terms and exclusions. After *Montrose II*, insureds and insurers turned their focus to the question of allocation: how should responsibility for defense and indemnity be allocated when the property damage or bodily injury in question is continuous and extends beyond a single carrier's policy period? Should the policyholder be allowed to collect the full amount of defense costs and indemnity from a single insurer whose coverage has been triggered (leaving it to that insurer to seek contribution from the other insurers who issued triggered policies), or should an insurer's obligation instead be limited to only a *pro rata* share of the liability?

Insurers have always insisted that because coverage is not triggered unless injury or damage "occurs during the policy period," they should only be responsible for a *pro rata* share of the defense or indemnity obligation—that is, an amount that

corresponds to the length of time during which they provided coverage relative to the entire duration of the continuous injury or damage. For example, if damage occurred over a twenty-year period and an insurer provided coverage for only one year, the insurer could be expected to argue that it should be responsible for only one-twentieth of the defense or indemnity costs. Under such a *pro rata* approach, the insured would bear responsibility for the share allocable to any year or years for which the insured did not have, or could not establish, coverage. This would include years during which the policyholder was self-insured as well as years for which the policyholder could not establish coverage—for example, because of an applicable exclusion, because the policy could not be found or proved by secondary evidence, or because the carrier was no longer solvent.

In *Aerojet General Corporation v. Transport Indemnity Co.*,[37] the California Supreme Court specifically addressed such allocation issues in the context of environmental claims and rejected the insurers' *pro rata* argument. The court held that an insurer has a duty to defend an entire claim for continuous progressive damage that occurred over many years, even if only a portion of the damage occurred during the insurer's policy period. The court explained:

> [T]he insurers each had a duty to defend all the governmental and private actions in their entirety—to be precise, *each* had such a duty *separate and independent from the others*....
>
> If specified harm may possibly have been caused by an included occurrence and may possibly have resulted, at least in part, within the policy period, the duty to defend perdures to all points of time at which such harm may possibly have resulted thereafter....In a word, although the *trigger* of the duty to defend is limited to the policy period, the *extent* of the duty to defend is not.[38]

The California Supreme Court further held that an insurer who must respond under a triggered policy cannot obtain contribution from the policyholder even if the policyholder was self-insured for some period of time or is unable to establish coverage under other triggered policies. Under the holding in *Aerojet*—and assuming standard policy language—contribution may be sought only from other insurers.[39] Consistent with the holding in *Buss*, the *Aerojet* court held that an insurer can allocate a portion of the defense costs to the insured only if the insurer can prove by a preponderance of the evidence that the costs were incurred "solely" to defend against liability for damages that were not even potentially covered by the insurer's policy. Because environmental claims typically involve continuous and progressive damages, an insurer will rarely, if ever, be able to meet such a burden. Thus, in most cases a carrier who issued a triggered policy will be required to pay 100 percent of the defense costs, subject to a right to seek contribution from other insurers, but not from the insured.

Although the facts of the *Aerojet* case required resolution of the allocation issue only as it relates to a carrier's duty to defend, the supreme court made clear that the same allocation rule would apply to the insurer's indemnity obligation:

> [The duty to indemnify] is triggered if specified harm is caused by an included occurrence, so long as at least some such harm results within the policy period. It extends to all specified harm caused by an included occurrence, even if some such harm results beyond the policy period. In other words, if specified harm is caused by an included occurrence and results, at least in part, within the policy period, [the duty to indemnify] perdures to all points of time at which some such harm results thereafter.[40]

VII. THE INSURED HAS THE BURDEN OF PROVING THE SUDDEN AND ACCIDENTAL EXCEPTION TO THE QUALIFIED POLLUTION EXCLUSION

Until 1973, the standard CGL policy did not contain a pollution exclusion. In 1970, many carriers began to exclude coverage for some, but not all, pollution damage through the use of an endorsement to the standard form policy. The language of this qualified pollution exclusion was made part of the CGL policy itself when the policy was revised in 1973. The qualified pollution exclusion—Exclusion (f)—provides as follows:

> This insurance does not apply...to bodily injury or property damage arising out of the discharge, disposal, release or escape of smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials or other irritants contaminants or pollutants into or upon land, the atmosphere or any watercourse or body of water; but *this exclusion does not apply if such discharge, dispersal, release or escape is sudden and accidental.* (emphasis added)

When the standard general liability policy was revised in 1985, the pollution exclusion was modified to eliminate the exception for "sudden and accidental" pollution. Such exclusions, commonly referred to as "absolute" pollution exclusions, are generally interpreted to preclude coverage for all environmental damage and injury, although some courts have recognized exceptions to the general rule of non-coverage.[41]

Although the California Supreme Court has yet to say what "sudden and accidental" means, it did recently decide which party has the burden of proof on the issue for purposes of determining whether a duty to indemnify is owed. Allocation of the burden of proof is particularly important in environmental claims because it is often unknown exactly how and when the pollution occurred. It will therefore often be difficult for either party to sustain the burden of proving whether some particular contamination was, or was not, "sudden and accidental."

In *Aydin Corporation v. First State Insurance Co.*,[42] the same four-justice majority that issued the *Foster-Gardner* decision[43] held that the insured bears the burden of proving that contamination was sudden and accidental to establish coverage. Justice Brown again authored the majority opinion. And again, there were vigorous dissenting opinions, one authored by Justice Mosk and another by Justice Kennard.

All of the justices in *Aydin* acknowledged the well-settled principle that an insured bears the burden of showing that an occurrence is within the basic scope of insurance coverage, and that once an insured has made such a showing, the burden shifts to the insurer to prove that the claim is specifically excluded. The justices disagreed, however, about whether the "sudden and accidental" language in the pollution exclusion should be considered a coverage-affording provision or, instead, an exclusionary provision for purposes of allocating the burden of proof. The majority concluded that the burden of proof is properly placed upon the insured because the "sudden and accidental"

exception essentially reinstates coverage and therefore is within the rule imposing on an insured the burden of establishing coverage.[44] In his dissenting opinion, Justice Mosk takes issue with the majority's approach of subdividing a one-sentence exclusion into an exclusion and a separate grant of coverage. Justice Mosk wrote:

> [I]t is the insurer that bears the burden of proving that the insured's claim comes within an exclusionary clause of a liability insurance policy, and hence it is the insurer that bears the burden of proving that every fact essential thereto either exists or does not exist, as the case may be.[45]

The *Aydin* court made clear that it was *not* deciding who bears the burden on "sudden and accidental" when the issue is whether an insurer owes a duty to defend.[46] The court made the following observation, without in any way suggesting disapproval:

> [S]ome Courts of Appeal have held that regardless of which party bears the burden of proof when indemnification is at issue, when the defense duty is implicated, the insurer is obligated to defend its insured in an underlying action if there is any *potential* that the release or escape of at least some of the pollutants was "sudden and accidental."[47]

VIII. ISSUES NOT YET CONSIDERED BY THE SUPREME COURT

Although the California Supreme Court has resolved many significant coverage issues presented by environmental claims under general liability policies, there are others that have yet to be addressed by the high court. The following are among the issues often presented by environmental claims that have yet to be addressed by the supreme court.

A. Legal Obligation

The insuring agreement in a general liability policy limits the duty to indemnify to sums that the insured is "legally obligated" to pay. Courts in some states have held that if statutory law obligates an insured to clean up a site, the "legal obligation" requirement is satisfied, even in the absence of a lawsuit, and whether or not agency personnel actually become involved and direct that remediation take place.[48] Some courts in other states have applied the "legal obligation" requirement more strictly and found payments incurred in the absence of a formal order to be "voluntary" and, therefore, not covered.[49] The California Supreme Court has yet to articulate what is required to satisfy the "legal obligation" requirement in the context of indemnity for environmental claims. In fact, there is no reported California state court appellate decision that squarely addresses the issue.

B. Occurrence Requirement

To establish coverage under a general liability policy, the insured must generally establish that there has been an "occurrence." Most policies define "occurrence" to include "an accident...which results...in...[bodily injury or property damage] neither expected nor intended from the standpoint of the insured." This language has given rise to several issues of interpretation that have yet to be addressed by the California Supreme Court:

1. Subjective or Objective Standard

Courts across the country are divided on whether the "expected or intended" issue should be resolved by reference to an objective or a subjective standard. Under an objective standard—generally favored by insurers—the issue of expectation and intent is determined by reference to a hypothetical reasonable person. Would such a person, in the position of the insured, expect or intend that damage would result from the insured's course of conduct? In contrast, under a subjective standard—preferred by policyholders—the focus of the inquiry is limited to the individual policyholder's actual state of mind. In other words, did the policyholder intend the environmental damage in controversy? A California Court of Appeal adopted a subjective standard in *Shell Oil Company v. Winterthur Swiss Insurance Company*.[50] The *Shell* case was cited with approval by the California Supreme Court in *Montrose I*, so there seems little reason to expect a different result in the event that the matter receives further attention from the supreme court in the future.

2. Burden of Proof

As explained above, as a general matter the policyholder must carry the burden of proving that a claim falls within the coverage-affording provisions of an insurance policy, and the burden of proving that a claim falls within an exclusion rests on the insurer. Carriers argue that the burden of proving that damage was neither expected nor intended should be placed on the policyholder because the language appears in the definition of "occurrence"—a term which appears in the coverage-affording insuring agreement. This argument ignores the practical reality that the phrase "neither expected nor intended" effectively operates as an exclusion from coverage.

Earlier this year, a California Court of Appeal held in *FMC Corporation v. Plaisted and Cos.*[51] that the insured bears the burden of proving that damage was unexpected. The *FMC* decision was issued, however, before the supreme court held in *Aydin* that allocation of the burden should not depend on the physical location of language in a policy, but rather on its operative effect.[52] The analysis in *Aydin* provides good reason to believe that the California Supreme Court may allocate the burden of proof on the expected/intended issue to insurers when the court eventually considers the issue.

3. Corporate Knowledge

When the insured is a corporation, the question arises as to who must intend or expect damage for there to be a loss of coverage. The *FMC* court held that knowledge of even low-level employees can be imputed to a corporation for purposes of assessing expectation and intent so long as the knowledge concerns a matter within the scope of the employee's duties.[53] Credible arguments can be made, however, that the expected/intended language should preclude coverage only if a director, officer, or corporate manager expected or intended damage. Courts elsewhere are divided.

C. Pollution Exclusion

As noted above, the California Supreme Court has yet to decide on the meaning of "sudden and accidental" in the context of the qualified pollution exclusion. Because the issue was not presented on appeal in *Aydin*, the supreme court found "no

occasion to address the proper meaning of the term."[54] Some state supreme courts have held that the term "sudden" necessarily has a temporal dimension such that only pollution that is abrupt or instantaneous is covered.[55] Other courts have held that the language limiting coverage to contamination that is "sudden and accidental" is ambiguous or simply restates the general requirement that damage be "unexpected and unintended"—a requirement set forth in the definition of "occurrence."[56] Under such an interpretation, coverage for gradual contamination is not necessarily precluded. Although intermediate appellate courts in California have consistently held that "sudden" has a temporal element,[57] it is not possible to predict with certainty how the issue will be resolved by the California Supreme Court.

D. Exhaustion

Environmental claims often involve damage that continues over a period of many years. Insurance policies typically provide coverage for only a one-year period. As a result, during a period of continuing environmental damage, a policyholder will have been insured under many different primary policies—each providing first-layer coverage for a one-year period—as well as a series of one-year excess policies that provide coverage only after the limits of the corresponding underlying primary policy have been paid and thereby "exhausted." A significant allocation issue that the California Supreme Court has not yet addressed, and on which intermediate appellate decisions are in conflict, is whether a "horizontal" or "vertical" method of exhaustion is appropriate. Under the horizontal approach, all triggered primary policies that provide coverage during a period of continuous injury must be exhausted before any excess policy is required to respond. Under such an approach, the primary policies can be aggregated or "stacked" so that their combined policy limits will be available to the insured. Under a vertical exhaustion approach, the insured can select the policy year to respond to the claim in the first instance and can tap excess coverage without exhausting the primary policies that provided coverage during other years. The selected primary and excess insurers may seek contribution from carriers who issued policies providing coverage at other times during the period of continuous injury that are also triggered.

Although the insured can more readily reach excess coverage under a vertical exhaustion approach, some courts have held that such an approach does not permit stacking of policy limits from multiple policy years. For example, the *FMC* court recently adopted a vertical approach, expressly prohibiting stacking of policy limits.[58] Other intermediate appellate courts have adopted a horizontal exhaustion approach that allows stacking of policy limits.[59] The supreme court has not yet specifically addressed these issues.

IX. CONCLUSION

The scope of coverage for environmental claims in California is far clearer today than it was in 1990 when the California Supreme Court issued the first of its decisions addressing issues unique to environmental claims. The supreme court decisions discussed in this article, though relatively few in number, go a long way towards defining the scope of coverage. Both carriers and policyholders have had cause for celebration as well as reason for disappointment.

There remain a number of important coverage issues that have yet to be addressed by the supreme court. Given the prevalence of these issues in coverage litigation, it is reasonable to expect that some will be considered by the California Supreme Court within the next few years. Others may take longer to reach the high court, or they may remain unaddressed—for example, due to a developing consensus in the courts of appeal.

Even as the contours of coverage become more clear, there is no reason to expect that the incidence or intensity of coverage battles will greatly diminish. The standards for establishing coverage require resolution on a case-by-case basis of difficult, and often vigorously contested, questions of fact. Although greater certainty as to what the policy language means in the context of environmental claims will narrow the scope of what must be litigated, and may facilitate settlement in some cases, these factual issues will necessarily remain.

Endnotes

1. *Insurance Co. of North America v. Home & Auto Ins.*, 628 N.E.2d 643, 644 (Ill.App.1 Dist. 1993).
2. For example, CERCLA—the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. § 9601 *et seq.*—imposes strict liability on a current landowner even if the contamination was caused by a prior owner or lessee. *See* 42 U.S.C. § 9607; *State of New York v. Shore Realty Corp.*, 759 F.2d 1032, 1044 (2d Cir. 1985) (current owner strictly liable without regard to causation).
3. *See, e.g., United States v. Stringfellow*, 661 F. Supp. 1053 (C.D. Cal. 1987) (joint and several liability under CERCLA).
4. To date, most environmental claims activity and litigation has involved the Comprehensive General Liability ("CGL") policy. The CGL policy is the basic coverage agreement used in the United States for protection against third-party claims. The policy provides protection against liability arising from "property damage" or "bodily injury" caused by an "occurrence." First introduced in 1940, the standard form of the CGL policy was revised in 1943, 1955, 1966, 1973, and 1985. The 1985 revision changed the name of the policy from Comprehensive General Liability to *Commercial* General Liability Policy. The suggestion has been made that the insurance industry did so to keep courts from relying on the term "Comprehensive" to support expansive policy interpretations. 3 *Cal. Ins. Law & Prac.*, § 49.01[2] (Matthew Bender 1989).

   Most environmental insurance coverage disputes today involve the 1966, 1973, and 1985 versions of the CGL. However, because of the long "tail" or latency period for some environmental claims, earlier versions may have a role to play in some coverage claims.
5. 56 Cal.App.4th 204 (1997), *rev'd* 18 Cal.4th 857 (1998).
6. 57 Cal.App.4th 1252 (1997).
7. 18 Cal.4th 857 (1998). *See* discussion *infra* at Section II.D.
8. *E.g., Gray v. Zurich Ins. Co.*, 65 Cal.2d 263 (1966).
9. 6 Cal.4th 287 (1993).
10. *Id.* at 299 (emphasis in original).
11. *Id.* at 300.
12. *Id.* at 298–99.

13. *Id.* at 300.
14. *Id.* at 299, 300.
15. *Id.* at 301, 305.
16. 16 Cal.4th 35 (1997).
17. *Id.* at 50–52.
18. *Id.* at 53.
19. 17 Cal.4th 38 (1997).
20. *Id.* at 60–61.
21. *Id.* at 65 (emphasis added).
22. 18 Cal.4th 857 (1998).
23. 56 Cal.App.4th 204 (1997), *rev'd* 18 Cal.4th 857 (1998).
24. 57 Cal.App.4th 1252 (1997).
25. 18 Cal.4th 857, 878–82 (1998). Some policy forms provide that a duty to defend is triggered by "claims" as well as "suits." *Foster-Gardner* does not undermine the right to a defense of administrative proceedings under such policies.
26. *Id.* at 892–93.
27. 51 Cal.3d 807, 842 (1990).
28. *Id.* at 828–42.
29. *Id.* at 840.
30. *Id.* at 841, n.18.
31. At least four principal trigger of coverage rules were identified and applied in progressive injury cases: the "Exposure Rule" under which all policies in effect while the claimant is exposed to the injury-causing agent are triggered; the "Manifestation Rule" under which the policy in place when the damage or injury first manifests is triggered; the "Continuous Trigger Rule" under which all policies in effect from the date of first exposure until the date liability is established are triggered; and the "Injury-in-Fact Rule" under which a policy is triggered if actual injury occurred during the policy period, without regard to when the first exposure occurred or when the injury became manifest.
32. 10 Cal.4th 645 (1995).
33. *Id.* at 655, n. 2 (emphasis in original).
34. *Id.* at 689.
35. *See* Cal. Ins. Code §§ 22 and 250.
36. *Id.* at 690–93.
37. 17 Cal.4th 38 (1997).
38. *Id.* at 70–75 (emphasis in original).
39. *Id.* at 72.
40. *Id.* at 56–57 (citations omitted).
41. *See, e.g.*, M. Miller, *Lead Based Paint Insurance Coverage: Courts Mandate Coverage Despite Insurance Industry Opposition*, Environmental Claims Journal, Vol. 9, No. 4 (1997); T. Bick, *The Absolute Pollution Exclusion: It Was Never Meant to Apply to the Indoor Environment*, Environmental Claims Journal, Vol. 10, No. 4 (1998).
42. 18 Cal.4th 1183 (1998).
43. *See* Section II.D., *infra.*
44. *Id.* at 1205–06.
45. *Id.* at 1196.
46. *Id.* at 1194, n. 6.
47. *Id.*
48. *See, e.g., Weyerhaeuser Co. v. Aetna Cas. & Surety Co.*, 874 P.2d 142 (Wash. 1994); *Compass Ins. Co. v. Cravens Dargon & Co.*, 748 P.2d 724 (Wyo. 1988).
49. *See, e.g., Augat, Inc. v. Liberty Mut. Ins. Co.*, 410 Mass. 117, 571 N.E. 2d. 357 (Mass. 1991).
50. 12 Cal.App.4th 715, 743–48 (1993).
51. 61 Cal.App.4th 1132, 1156–57 (1998).
52. 18 Cal.4th at 1191–93.
53. *FMC Corp. v. Plaisted and Cos.*, 61 Cal.App.4th 1132, 1212 (1998).
54. 18 Cal.4th 1183, 1187 at n. 1.
55. *See, e.g., Hybud Equipment Corp. v. Sphere Drake Ins. Co. Ltd.*, 64 Ohio St. 3d 657, 597 N.E. 2d 1096, 1103 (1992).
56. *See, e.g., Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1092 (Colo. 1991). The decisions that hold the term "sudden" to be ambiguous find support in common usage and dictionary definitions, which confirm that "sudden" need not have a temporal element. For example, one might say, "I was strolling leisurely through the woods and came to a sudden fork in the path." In this instance, "sudden" is used to mean unexpected, not temporally abrupt. The fork in the path was there before, and will remain after, the speaker reaches it, and there is nothing temporallly sudden about a leisurely stroll.
57. *See, e.g., ACL Technologies, Inc. v. Northbrook Property and Casualty Ins. Co.*, 17 Cal.App.4th 1773 (1993); *Shell Oil Company v. Winterthur Swiss Ins. Co.*, 12 Cal.App.4th 715 (1993).
58. 61 Cal.App.4th at 1190.
59. *See Stonewall Ins. Co. v. City of Palos Verdes Estates*, 46 Cal.App.4th 1810, 1852–53 (1996); *Community Redevelopment Agency v. Aetna Casualty & Surety Co.*, 50 Cal.App.4th 329, 341–42 (1996).