

THE PENDULUM SWINGS: IS CALIFORNIA ENVIRONMENTAL INSURANCE LAW BECOMING MORE FAVORABLE TO POLICYHOLDERS?

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INTRODUCTION

A string of California decisions, culminating in the California Supreme Court's 2001 ruling in *Certain Underwriters at Lloyd's London v. Superior Ct.*, 24 Cal. 4th 945 (2001) (*Powerine I*) that the term "damages" as used in Comprehensive General Liability (CGL) policies does not include those costs incurred as a result of compliance with an administrative agency's environmental orders (and therefore such costs do not trigger a CGL insurer's duty to indemnify), has led to the perception that California courts are somehow hostile to policyholders seeking to recover from their insurers. However, two recent decisions indicate that the tide may be turning and California courts may be becoming somewhat less protective of insurers and more solicitous of insureds' expectations of coverage. The 2001 *Powerine I* decision and two recent significant decisions representing the possible countervailing trend, are discussed below.

POWERINE I

In 2001, the California Supreme Court reached a widely publicized anti-policyholder decision that has greatly impacted insurance coverage litigation in California. In *Powerine I*, the Supreme Court interpreted the indemnification language of the standard CGL policy, which provides that the insurer must indemnify the

insured for "all sums which the assured shall become legally obligated to pay as damages," to include only money ordered by a court. Thus, costs incurred to comply with an administrative agency's environmental orders are not covered "damage." Therefore, under *Powerine I*, if a policyholder received notice from an administrative agency, such as the EPA, and expended funds to comply with the agency's directives, it could not recover those funds from its insurers because the policyholder was not required to pay those costs "as damages."

Factual Background and Procedural History

Powerine Oil Company (Powerine Oil) had been engaged in the oil refining business for approximately 60 years. *Id.* at 951. Its predecessor, Rothschild Oil Company, started oil refining operations in Santa Fe Springs, California, in the 1930s. *Id.* Over the years Powerine Oil had expanded its operations and employed hundreds of people, while also engaging in "oil and petroleum-related exploration, production, terminaling and transportation operations throughout the western states." *Id.* Ultimately, after the market declined and resulted in Powerine's declaring bankruptcy, the company divested all of its operations except for the Santa Fe Springs refinery. *Id.* This refinery operated periodically from 1986 through 1995, and maintained only a small crew to deal with "environmental compliance and equipment maintenance" issues. *Id.*

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One of Powerine Oil's insurance carriers, Highlands Insurance Company, filed a declaratory relief action seeking a declaration that it owed Powerine Oil no duty to defend or indemnify in the pending administrative proceeding instituted by the United States Environmental Protection Agency (EPA) pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA or Superfund) (42 U.S.C. § 9601), for the cleanup of contamination and the abatement of its effects. *Id.* at 952. Powerine Oil filed a cross-complaint against Highlands and certain London Insurers, among others, alleging that the EPA and the California Regional Water Quality Control Boards had instituted various proceedings against it, and that its insurers owed Powerine Oil a duty to defend and indemnify it in connection with these proceedings. *Id.* at 952-953.

On the London Insurers' motion for summary adjudication, the superior court ruled that the London Insurers owed no duty to defend Powerine Oil for the pending Water Quality Control Board proceedings (the only proceedings at issue), but denied the motion as to the duty to indemnify, concluding that the "duty to indemnify was not limited to money ordered by a court, but could extend to expenses required by an administrative agency pursuant to an environmental statute." *Id.* at 954. The Court of Appeal reversed the latter part of the order, concluding that the duty to indemnify was limited to money ordered by a court. *Id.* at 954-955.

"Damages" and the Duty to Indemnify

The California Supreme Court affirmed the Court of Appeal's decision by holding that an insurer's duty to indemnify its insured for "all sums that the insured becomes legally obligated to pay as damages" is limited to money ordered by a court. *Id.* at 955-960. In *Powerine I* the Court relied in large part on its decision in *Foster-Gardner, Inc. v. National Union Fire Ins. Co.*, 18 Cal. 4th 857 (1998). In *Foster-Gardner*, the Court concluded that an insurer's duty to defend a "suit" seeking "damages" was limited to defense of a civil action prosecuted in court, and did not extend to proceedings instituted by

an administrative agency pursuant to an environmental statute. 24 Cal. 4th at 960. The *Powerine I* Court noted that the duty to defend is broader than the duty to indemnify, and since the duty to defend under CGL policies was not sufficiently broad to include anything beyond a civil action (under its holding in *Foster-Gardner*), the duty to indemnify could not include anything beyond court-ordered monetary "damages." *Id.* at 961.

POWERINE II

In 2002, a California Court of Appeal was faced with a similar situation, yet reached a noticeably different result in *Powerine Oil Co. v. Superior Ct.*, 128 Cal. Rptr. 2d 827 (2002) (*Powerine II*), based on policy language markedly different from the standard language at work in *Powerine I*.

Factual Background and Procedural History

During the pendency of *Powerine I*, Powerine Oil still faced the "governmentally-imposed environmental liabilities" resulting from its operations at various sites brought by the California Regional Water Control Board, among others. As noted above, Powerine Oil had cross-complained against many of its insurers to cover its defense of these proceedings, including the real party in interest in *Powerine II*, Central National Insurance Company of Omaha (Central National). At issue in *Powerine II* were the nine excess/umbrella liability policies that Central National had issued to Powerine Oil, starting in 1973, and the meaning of the policies' indemnification provision, which was different from the GGL policy language at issue in *Powerine I*. 128 Cal. Rptr. 2d at 831. After *Powerine I* was decided, Central National moved for and was granted summary adjudication that it owed no duty to indemnify Powerine Oil since none of the administrative orders involved "damages." *Id.* at 831-832.

Distinguishing Powerine I

After detailing the *Foster-Gardner* and *Powerine I* decisions, the *Powerine II* Court

concluded that the two cases stood for the following proposition:

the duty to defend a “suit” seeking “damages” under the standard CGL policies is restricted to civil actions prosecuted in a court, initiated by the filing of a complaint, and does not include *claims*, which can denote proceedings conducted by administrative agencies under environmental statutes. Likewise, the duty to indemnify “for all sums that the insured becomes legally obligated to pay as damages” (citation omitted) ... is limited to money ordered by a court, and does not include *expenses* such as may be incurred in responding to administrative agency orders.”

Id. at 835 (emphasis in original).

With these guidelines in mind, the *Powerine II* Court turned to the policy provisions in question.

In reviewing the relevant coverage provisions, the Court concluded that “coverage is unambiguous and *clearly* extends beyond money ordered by a court.” *Id.* (emphasis added.) In rendering its decision, the Court paid close attention to the differences between the coverage provisions of the CGL policies at issue in *Powerine I*, as opposed to the excess/umbrella policies issued by Central National. While the insuring clause of the standard CGL policy limited coverage to the insured’s liability to pay “damages,” the insuring clause in the excess/umbrella liability policy adds the term “expenses.” According to the Court: “The use of both terms raises the inference that they were not intended to be synonymous.” *Id.* (quoting *Reserve Ins. Co. v. Pisciotto*, 30 Cal. 3d 800, 811, 180 Cal. Rptr. 628, 640 (1982)). By adding the term “expenses,” the excess/umbrella policies created coverage for costs separate from those contained within the definition of

“damages,” thereby extending coverage beyond court-ordered monetary amounts. *Id.*

The Court of Appeal found further support for its holding in the policies’ definitions of “damages” and “expenses.” Both terms refer to “ultimate net loss,” which is defined as the sum which the insured becomes “obligated to pay by reason of ... property damage ... either through adjudication *or* compromise...” *Id.* (emphasis in original). While “adjudication” refers to a court proceeding, a “compromise” may refer to something completely different. “A compromise may be reached before a complaint is ever filed. Nor must a ‘compromise’ be judicially approved.” *Id.* This conclusion comported with at least one of the administrative orders against Powerine Oil, a cleanup and abatement order that resulted from extensive negotiations between attorneys for the Water Control Board and Powerine Oil. Given this consistency, the *Powerine II* Court concluded that its decision also comported with the reasonable expectations of the insured, Powerine Oil. *Id.* at 836-837.

The fact that the excess/umbrella policies also included both “suits” and “claims” within their “ultimate net loss” definitions only further bolstered the Court’s conclusion. While the terms “suit” and “action” are generally considered to include actions at law or equity, the *Foster-Gardner* Court concluded that a claim “can be any number of things, *none of which rise to the formal level of a suit...* While a claim may ultimately ripen into a suit, ‘*claim*’ and ‘*suit*’ are not synonymous.” *Id.* at 837 (quoting *Foster-Gardner, supra*, at 879) (emphasis in original). Instead, a “claim” can mean any number of proceedings, including administrative proceedings. *Id.*

Therefore, the *Powerine II* Court found that the term “expenses” under the excess/umbrella policies includes not only those sums determined by an adjudication but also those reached through compromise. *Id.* The only limit that the Court found was that the “expenses” be “paid as a consequence of any occurrence covered hereunder [under the policy]’ i.e., resolved by ‘adjudication *or* settlement.” *Id.* (emphasis in original). In addition, the ultimate net loss provision includes

a veritable laundry list of expenses that “looks very much like the site investigation and cleanup expenses which may be characterized as environmental response costs.” *Id.* at 838. The Court also noted other cases in which the same conclusions were reached, including *Powerine I. Id.*

The *Powerine II* Court therefore concluded that the policies’ language was clear and unambiguous in its meaning and coverage extended beyond “damages” to include those costs incurred to comply with orders issued by an administrative agency for environmental liability. *Id.* at 838-839. Unpersuaded by Central National’s arguments, *Id.* at 841-843, the Court found the notable differences in the coverage provisions of the excess/umbrella policies versus the CGL policies to be sufficient support for the conclusion that Central National’s policies provide coverage for the costs *Powerine Oil* incurred in its compliance with the administrative agencies’ cleanup and abatement orders. *Id.* at 843.

While a review of *Powerine II* has been granted, a decision by the California Supreme Court that follows the reasoning of the *Powerine II* Court could set the stage for policyholders to begin recovering such costs incurred from governmentally-imposed cleanup and abatement orders under excess and/or umbrella policies.

MACKINNON V. TRUCK INSURANCE EXCHANGE

The California Supreme Court recently issued another pro-policyholder decision that may further indicate that the pendulum is swinging in the right direction.

Factual Background and Procedural History

In *MacKinnon v. Truck Ins. Exch.*, 31 Cal.4th 635, 3 Cal. Rptr. 3d 228 (2003), a policyholder brought an action for declaratory relief, breach of contract and breach of the implied covenant of good faith and fair dealing against its insurance carrier for the carrier’s failure to defend and indemnify the policyholder against liability for a death allegedly caused by pesticide spraying. The dispute in *MacKinnon* involved

the scope and application of a pollution exclusion in a CGL policy that Truck Insurance Exchange (“Truck Insurance”) had issued to its insured, *MacKinnon*. A tenant in *MacKinnon*’s apartment building requested that *MacKinnon* spray to eliminate an infestation of yellow jackets. *MacKinnon* subsequently hired a pest control company to spray the building, which it did on several occasions in 1995 and 1996. On May 19, 1996, the tenant died and a wrongful death suit against *MacKinnon* was filed. *Id.* at 640.

After *MacKinnon* tendered the underlying wrongful death lawsuit to Truck Insurance, the carrier filed a responsive pleading on behalf of *MacKinnon* but informed him that it was still investigating the matter to determine if coverage existed. Approximately six months later, Truck Insurance advised *MacKinnon* that it had concluded the pollution exclusion precluded coverage for the underlying claim, and therefore it was withdrawing its defense. *Id.* *MacKinnon* subsequently hired independent counsel, settled the underlying claim, and filed the action against Truck Insurance. The trial court granted Truck Insurance’s motion for summary judgment, holding that the pollution exclusion was clear and unambiguous, and excluded coverage for the underlying action. The Court of Appeal affirmed, and the Supreme Court granted review. *Id.* at 640-641.

Interpreting the “Absolute” Pollution Exclusion

The Supreme Court initially recognized that California courts have not extensively adjudicated the most recent iteration of the standard pollution exclusion, but those that have interpreted the provision can be divided into two schools of thought. *Id.* at 641-642. One side finds ambiguity in the pollution exclusion and applies it only to “traditional environmental pollution into the air, water, and soil”; the other side, however, sees no such ambiguity and “maintains that the clause applies equally to negligence involving toxic substances and traditional environmental pollution.” *Id.*

To understand the meaning of this provision, the Supreme Court provided a fairly detailed account of the historical background of

the pollution exclusion. *Id.* at 643-645. While the full account will not be duplicated here, the details of the current pollution exclusion, dubbed by many as the “absolute” pollution exclusion, will be noted. In 1985, insurance companies drafted the so-called “absolute” pollution exclusion, which removed the “sudden and accidental” language present in the previous version and eliminated the requirement that the pollution be discharged “into or upon land, the atmosphere or any watercourse or body of water.” *Id.* at 644. Many believed that the 1985 “absolute” exclusion was designed to eliminate coverage for gradual environmental pollution and government-mandated cleanup. *Id.* at 645. Some cite to the exclusion’s history and the motivation behind its drafting (and re-drafting) as support for an argument that the exclusion should be narrowly interpreted. *Id.*

In determining the scope of the exclusion, the California Supreme Court first considered the coverage afforded by the policy. The insuring clause obligated Truck Insurance to pay “all sums for which [the insured] become[s] legally obligated to pay as damages caused by bodily injury, property damage or personal injury.” *Id.* at 649. The Court interpreted this language to establish a reasonable expectation by the insured that coverage will be afforded unless the pollution exclusion “conspicuously, plainly and clearly apprise[s] the insured that certain acts of ordinary negligence, such as the spraying of pesticides in this case, will not be covered.” *Id.* Truck Insurance contended that, read literally, the pollution exclusion clearly includes all negligent acts involving irritants or contaminating substances, including pesticides. The Court, however, dismissed this contention as erroneously relying upon a “fallacy ... that the meaning of policy language is to be discovered by citing one of the dictionary meanings of the key words, such as ‘irritant’ or ‘discharge.’” *Id.* Instead of relying heavily upon the dictionary, the Court decided that its holding should be based upon a more objective standard: how might a layperson reasonably interpret the policy’s language. *Id.* Under this objective standard, the Court found Truck

Insurance’s interpretation of the pollution exclusion to be too broad. *Id.* at 650-651.

To find the plain meaning of the pollution exclusion, the Court turned to the meaning of the term “pollutant.” Rather than using the definition of the term, which could include every conceivable irritant or contaminant, the Court instead chose to employ the “common connotative meaning of that term, i.e., environmental pollution.” *Id.* at 652-653. This use not only serves the dual purpose of reflecting the exclusion’s historical objective (to avoid liability for environmental crises connected with intentional industrial pollution), and comports with the exclusion’s purpose (to address the potential liability from anti-pollution laws enacted between 1966 and 1980), but it also is in line with the purpose of CGL policies as a whole (to provide the insured with the broadest possible coverage against unintentional and unexpected injury or damage from an insured’s business). *Id.* at 653-654. Based upon this interpretation, the Court held that it would be highly unlikely that the insured’s claim for injuries arising from the negligent application of pesticides would be considered pollution. “While pesticides may be pollutants under some circumstances, it is unlikely a reasonable policyholder would think of the act of spraying pesticides under these circumstances as an act of pollution.” *Id.* at 654. Therefore, the court held the so-called “absolute” pollution exclusion did not apply.

Conclusion

While it is still too early to tell, it appears that California may become a safe jurisdiction for policyholders seeking to enforce the terms of their insurance policies. Such a trend would bring California law closer to the law of states perceived to be much more “policyholder-friendly” such as New Jersey. *See e.g. Lansco, Inc. v. Dept of Environmental Protection*, 138 N.J. Super. 275 (Ch. Div. 1975) (holding that where administrative cleanup costs have been incurred pursuant to an order or directive sounding in strict liability, the policyholder is legally obligated to pay those cleanup costs “as damages”).

Six Steps Companies Should Take to Protect Their Environmental Claims:

- Educate appropriate company personnel regarding existence and scope of coverage
- Understand notice requirements and designate personnel responsible for reporting claims in a timely fashion
- Periodically review insurance portfolio to confirm company is adequately protected, especially for newly developing risks
- Regularly communicate with carriers regarding status of tendered claims to avoid failure to cooperate defenses
- Where carriers have acknowledged coverage or issued a reservation of rights without denying coverage, do not settle claims without first obtaining consent from insurers
- Preserve a historical record of corporate insurance coverage to avoid missing policy issues