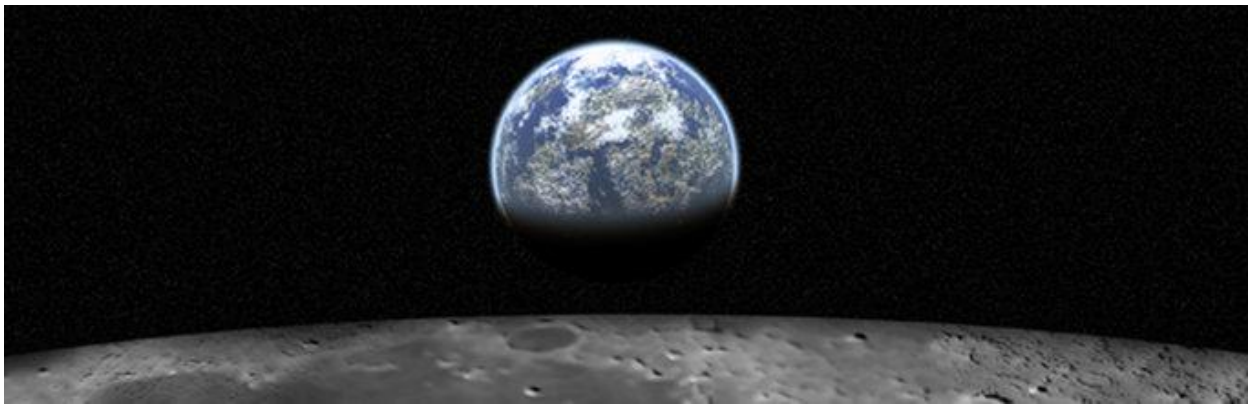
Swiss Re
Centre for Global Dialogue



US environmental law and its impact on the insurance industry

John C. Sullivan, Rick Perdian, 16 Oct 14

The United States of America underwent a period of rapid industrialisation and economic expansion in the late 19th century. The 20th century brought mobilisation for World War I from which the US emerged as the world's leading economic and industrial nation.

After having ground to a halt during the Great Depression, the US economy was revived by mobilisation for World War II. Nominal GDP in the US grew from about USD 102.9 billion in 1940 to $302 billion in 1950 to more than USD 543.3 billion in 19601. The growth did come with consequences however.

Science and technology drove this unprecedented era of economic expansion. The variety of chemicals that were manufactured and used across the manufacturing spectrum increased exponentially. What did not keep pace were disposal methods and practices to cope with the industrial wastes that were being created and an understanding of the impact these wastes were having on the environment.

Existing laws and regulations were inadequate to respond to the situation. Historically, matters of this type were dealt with at the state or local level. Nuisance law and other common law causes of action such as trespass, negligence, and strict liability for abnormally dangerous activities were suitable to deal with small, localised problems. As the scale of the environmental problems grew, it was becoming clear that the common law was inadequate to deal with the size and scope of 20th century environmental problems. The US Congress gradually began to act.

The first post-war environmental legislation was the 1948 Federal Water Pollution Control Act addressing water quality. The 1955 Air Pollution Control Act was the first piece of legislation to address air pollution. The laws would be periodically amended and additional ones would be passed, but a comprehensive, coordinated approach was lacking along with enforcement measures.

Environmental catastrophes raise public awareness

Rachel Carson's 1962 book, *Silent Spring* alarmed readers across the US and helped to set the stage for the environmental movement. As controversial now in some circles as it was then, the book focused on the hazards of the pesticide DDT and questioned humanity's faith in technological progress. Just three years later, a 1965 court ruling[2] gave the nascent environmental movement in the US legitimacy. In response to a proposal by Consolidated Edison, New York State's power company, to build a facility on the Hudson River, the Scenic Hudson Preservation Conference (SHPC) filed suit to prevent its construction. SHPC, a citizen's group with no economic interests at stake, argued the public interest relating to the beauty and historical significance of the landscape had not been considered in the proposal to build the power plant. SHPC was granted standing to sue over Consolidated Edison's arguments that it had no economic interest in the matter. The power plant was never built, and the courtroom became yet another avenue for the ever growing number of activists to use in their efforts to preserve and protect the environment.

Environmental catastrophes however were what captured the attention of the press, scared the public and ultimately prompted the Congress to act. In January 1969, an oil spill contaminated the beaches of Santa Barbara, California despoiling miles of coastline and killing birds and other wildlife. A few months later, the Cuyahoga River near Cleveland, Ohio caught fire with flames reaching five stories high. It was not the first time. *Time* magazine wrote that the river "oozes rather than flows", while using a more dramatic photograph of an earlier fire on its cover to achieve the desired impact. It all culminated in the first Earth Day on 22 April 1970. An estimated 20 million people across the country took part, still the largest demonstration ever in the US.

The following decade would bring sweeping federal legislation addressing many key elements essential to protecting the environment. The laws however were proactive in nature and did nothing to address the legacy of decades of industrial waste disposal that had been conducted with little to no regard for the environment. Two environmental disasters yet again caught the press and the public's attention and would force the lawmakers' hands.

Love Canal near Niagara Falls in New York was a former dump site that had been used for decades. Adding to the toxic mix deposited there, were wastes from the US Army's efforts to build a nuclear bomb during World War II. The site was later developed, and a school and housing project were built on it. In 1978, after the extent of the contamination at the site was established, Love Canal was declared to pose a federal health emergency by President Jimmy Carter. This was the first time such an emergency had ever been declared outside of the context of a natural catastrophe. The Valley of Drums in Kentucky made the news a year later. The 23-acre site contained more than 17 000 discarded, rusted, leaking barrels, many of them containing hazardous waste.

Love Canal posed the more immediate threat to human health. Moreover, the notion of suburbia as a safe haven was brought into question. Who knew what toxic hazards were lurking beneath homes, parks and schools? But it was the photographs of the Valley of Drums that highlighted the problem. These two environmental catastrophes are linked directly to sweeping and unprecedented federal legislation which would impact the insurance industry dramatically.

Superfund

The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), commonly known as Superfund was enacted by the US Congress on 11 December 1980. Unlike earlier pollution–related statutes which focused on preventing pollution, the principal aims of CERCLA were the prompt clean-up of hazardous waste sites and the imposition of all clean-up costs on responsible parties. The law created a tax on the chemical and petroleum industries and

provided broad federal authority to respond directly to releases or threatened releases of hazardous substances that may endanger public health or the environment. It also granted the Environmental Protection Agency (EPA) the authority to clean up uncontrolled or abandoned hazardous-waste sites and seek out those parties responsible and assure their cooperation in the clean-up.

CERCLA sought to balance the economic incentives and disincentives for environmental protection. The rule was simple and direct – the polluter pays. In practical terms however, CERCLA created a new liability for thousands of companies where little or more often none had previously existed. The breadth of the law was vast, and sweeping, new powers were given to the EPA. The Superfund statute made pollution liability excessively costly and unpredictable because companies whose conduct was not actionable at the time they acted, could now retroactively be held liable without fault (strict liability), jointly and severally liable (liability without regard to degree of fault) and liable without any limitation on the amount recoverable (unlimited liability). Unfortunately for the insurance industry, US corporations would turn to their insurers to help share the burden.

The introduction of the pollution exclusion

As environmental awareness was developing in the US, the insurance industry became aware that claims were inevitable. Insurance underwriting involves two basic elements: (1) risk transfer, which is the shifting of loss from the insured to the insurer and (2) risk spreading, which is the distribution of risk among similarly situated persons.[3] To be insurable, risks must also meet certain criteria. These include being definable, accidental in nature, and part of a group of similar risks large enough to make losses predictable. The clean-up costs and other potential damages for the ever increasing number of environmental catastrophes were unquantifiable. They were also the consequence of years of manufacturing and waste disposal practices that seldom took the environment into consideration. The rules of the game, however, had changed.

Prior to 1966, the standard liability policy utilised by the insurance industry protected insureds from liability for bodily injury or property damage that was caused by an “accident.” The term “accident” was undefined, which led to disputes as to whether an insurable accident was only a single identifiable event fixed in time and place or also encompassed gradual injury or damage. Prompted in part by policyholders' requests for coverage for gradual damage, the insurance industry adopted a standard occurrence-based policy in 1966. Under the occurrence-based policy, insureds were protected from liability for bodily injury or property damage that was caused by an "occurrence," which was defined as "an accident, including continuous or repeated exposure to conditions, which results, during the policy period, in bodily or property damage neither expected nor intended from the standpoint of the insured."[4]

There were valid arguments to be made that the occurrence-based comprehensive general liability (CGL) policies introduced in 1966 would operate to bar coverage for many, but not all pollution claims. In the late 1960s, however, because of increased awareness of the potential magnitude of pollution damage claims, an additional change in language was deemed necessary. First proposed by the Insurance Rating Board and Mutual Insurance Rating Board to state insurance regulators in 1970, the standard pollution exclusion[5] sought to carve out pollution losses except those resulting from the sudden and accidental discharge of contaminants. The "sudden and accidental" pollution exclusion (SAPE), as it became known, was standard in all CGL policies from 1973 to 1986.

Public policy considerations also came into play. There was a strong sentiment that the pollution exclusion would operate to create an economic disincentive to pollute by prohibiting insurance coverage for pollution damage. The costs associated with pollution should be borne by those best able to prevent the pollution and passed on to the consumers of the products and services, not

passed on to insurers. The passage of an amendment to New York's insurance law in 1971[6] was endorsed by then Governor Nelson Rockefeller, who linked the state's concern for environmental values with the need to make corporate polluters bear the costs of their own polluting activities and to prevent them from shifting the consequences of their actions to insurers. The bill passed with little opposition from the state's large business community. But pollution claims were virtually unheard of in early 1970s and silence did not mean acquiescence. Policyholders would challenge the exclusion in court in New York and every other jurisdiction.

The role of the courts - applying, rewriting or ignoring the policy language

The standard occurrence-based policy as written eliminated coverage only if the result — the bodily injury or property damage — was expected or intended; the pollution exclusion focused on the cause — whether the discharge or release of pollutants was sudden (ie quick) and accidental. The overwhelming majority of the claims post CERCLA dealt with historical contamination from manufacturing or waste disposal activities conducted over decades, and in the industry's view and pursuant to the wording of the policies were excluded from coverage. Language or no language, with billions of dollars at stake[7] US corporations turned to their insurers to foot the bill. Insurers, secure in the wording of the SAPE issued reservation of rights letters and investigated the claims, but there was little forthcoming in the way of indemnification. Policyholders responded by bringing coverage actions to force insurers to pay in courts across the country. Only five reported cases have been found concerning the SAPE prior to the passage of CERCLA. By the end of 2000, there were more than 750 reported cases addressing this exclusion.

Much of the initial focus of the litigation over the SAPE focused on the actual language of the exclusion. There were disputes over whether particular substances qualified as “irritants, contaminants or pollutants.” Other cases focused on whether the word “sudden” meant “quick,” thus eliminating gradual discharges, or meant unexpected, with the result that the pollution exclusion would eliminate coverage only for discharges that were expected or intentional. Still other cases addressed the question of whether the release of irritants, contaminants or pollutants within a building qualified as a release into the “atmosphere.” All of these cases examined the text of the SAPE and asked the courts to apply general principles of contract interpretation to determine whether the exclusion barred coverage under the circumstances of a particular claim. Although the court decisions were not entirely consistent, in a majority of the cases involving CERCLA liability, the courts found that the SAPE precluded coverage.

As a result, lawyers representing policyholders developed a new approach, one in which the focus was not the language of the exclusion, but rather the representations made to state insurance regulators at the time the SAPE was submitted for approval. Most states in the US require insurers to submit policy forms to the states’ insurance departments, which are authorised to prevent the use of insurance policy forms that are unfair or contrary to law or which result in premium rates that are excessive or discriminatory.[8] The policyholders claimed that insurers should be estopped from relying on the plain terms of the pollution exclusion because they alleged that insurance industry representatives had misled insurance regulators about the effect the pollution exclusion clause would have on existing coverage in an effort to obtain approval of the exclusion.

This “regulatory estoppel” theory was accepted by the Supreme Court of New Jersey[9], the state with the most contaminated sites on the Superfund National Priorities List, the list of the most serious uncontrolled or abandoned hazardous waste sites in the US. Insurers had urged that the New Jersey Supreme Court should not consider the regulatory history of the standard clause without holding a full factual hearing, but the court denied the request and issued a ruling that was based largely on articles written by lawyers representing insureds. In subsequent cases[10], the New Jersey Supreme Court has actually touted its approach to resolving issues concerning the applicability of insurance policies in the context of pollution claims. Rather than relying on

traditional rules of insurance policy construction, courts in New Jersey have based their decisions on a public policy designed to maximise insurance coverage for the clean-up of pollution.

The overwhelming majority of state and federal courts outside of New Jersey that have considered the issue have rejected the regulatory estoppel argument, primarily on the basis that extrinsic evidence is not permitted to vary clear and unambiguous policy language. Other courts have rejected the New Jersey approach on the grounds that the representations made to state insurance regulators in 1970 were not clearly misleading.

The insurance industry in crisis

By the middle of the 1980s, the US was undergoing an insurance availability/ affordability crisis in which insurance was unavailable or, where available, was extremely expensive. Among the factors identified as a cause of the crisis was that the Superfund statute had made pollution liability excessively costly and unpredictable because insureds whose prior conduct was neither illegal nor actionable under federal or state law in force at the time they acted could retroactively be held liable without any limitation on the amount recoverable. At the same time, the insurance industry was facing the continued and increasing impact of asbestos claims and the emergence of new types of toxic tort claims, such as lead exposure claims. These too found their way into the courts. Due to the expenses incurred in the process and conflicting court rulings, insurers began to lack confidence in the US court system. Insurers believed that courts were rewriting policies, rather than interpreting them, and, in the process unfairly imposing obligations to provide coverage in a manner contrary to the insurers' intent.

The insurance industry responded to this confluence of events by increasing premiums, withdrawing from certain markets and changing the language of the policies to avoid the impact of unfavourable court decisions. In the mid-1980s, the "absolute" pollution exclusion (APE)[11] was added to the standard general liability policy. Unlike the prior version of the pollution exclusion, the APE did not contain an exception for sudden and accidental discharges. The APE essentially eliminated coverage for Superfund liability. Insurers also moved away from occurrence-based policies, which were triggered by bodily injury or property damage that occurred during the policy period (claims could be filed years later) to claims-made" policies, which afford coverage only for those claims made while the policy is in force.

The introduction of new excess liability insurance forms in 1985 was also a direct response to the pollution and toxic tort coverage litigation explosion. The Bermuda Form, as these policies became known, addressed many of the coverage issues that were just starting to wind their way through the US courts. There are variations in the policy wording, but the general provisions are the same. To escape US jurisdiction, the form called for dispute resolution by means of binding arbitration in either London or Bermuda. New York law was to be applied if there was a coverage dispute, although the law of other jurisdictions was sometimes substituted. Absolute pollution and asbestos exclusions were standard. Punitive damages were also excluded to mitigate against the moral hazard of indemnifying corporations for egregious behaviour.

The Bermuda Form also addressed another issue brought to light by environmental and other long-tail claims. Once a pollution or toxic tort loss had been deemed covered under CGL or other policy forms, US courts addressed the issue of how the losses should be allocated across multiple years and layers of coverage. The result was once again conflicting rulings, at times running contrary to the policy language and often operating to increase insurers' ultimate exposures. The Bermuda Form addressed this in two ways. First, most policies were issued for annual policy periods and on an occurrence-reported basis, thus eliminating the question of which policy year would respond. Secondly, multiple losses were permitted to be batched together into a single claim called an "Integrated Occurrence"[12]. Policyholders were provided coverage for claims which would otherwise have been barred by either the policy deductible or other policy provisions when applied to individual claims. Insurers benefited by gaining certainty as to the ultimate exposure for

mass tort exposures by having just one annual policy limit at risk.

The lasting impact on the insurance industry

As environmental awareness began to grow and eventually become a national issue in the US in the 1960s, few envisioned the eventual impact on the global insurance industry. It is not due entirely to the nature of the laws and regulations. CERCLA's polluter pays rule is hardly unique to the US and is a feature of other countries' environmental regulatory schemes. The same holds true for strict liability. Retroactivity and the threat of unlimited liability without regard to fault clearly were factors. US corporations were faced with enormous environmental clean-up costs and predictably turned to their insurers for indemnification.

The insurance industry might have been able to envisage the surge in claims, but clearly did not anticipate the onslaught of coverage litigation and the disparate rulings on key policy provisions that emerged from the state courts. In the US, the insurance industry is regulated at the state level and disputed policy language is interpreted as a matter of state law. Accordingly, 50 states had the potential to and did take into account local and cultural biases for or against the insurance industry and protectionist attitudes towards manufacturing and other companies located within their borders. The claims often implicated policies which were written long before the unprecedented increase in environmental liability and which contained policy language that was never intended to address such claims. Insurers were not unified in their position on all issues. As a result, the application of these policies to complex and unforeseen loss scenarios was open to debate. In a system where policy language deemed ambiguous is generally construed in favour of the policyholder, the worst case scenario for the insurance industry played out in many states.

The impact of the environmental and mass tort lawsuits that began in the early 1980sstill reverberates throughout the insurance industry. US corporations continue to face liability for historical pollution under CERCLA. They in turn file insurance claims. It has become routine business, even though courts occasionally issue rulings that surprise either the policy holders or their insurers. It is however the changes in policy terms and conditions that are the lasting legacy. To the extent possible the insurance industry reacted by the best means available to them – policy language.

References

1. See, http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=1&isuri=1
2. See, eg Scenic Hudson Pres. Conference v. Fed. Power Comm'n, 354 F.2d 608, 615 (2d Cir. 1965).
3. 44 C.J.S. Insurance § 2(a).
4. See, George Clemon Freeman, Jr., *Tort Law Reform: Superfund/RCRA Liability as a Major Cause of the Insurance Crisis*, 21 Tort & Ins. L.J. 517 (1986).
5. The standard pollution exclusion bars coverage for bodily injury or property damage arising out of the discharge, dispersal, 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.
6. Eleven years later, the legislature repealed the 1971 amendment in order to address a different public policy -- preventing corporate polluters from avoiding clean-up liability by filing for bankruptcy.
7. In 1990, the EPA estimated that as many as 2 000 waste disposal sites in the US could pose a potential threat to public health or the environment. See, Mealey's Litigation Reports - Superfund, Vol. 3, No. 17 (12 Dec 1990), at 16-18.
8. See, eg N.J. Stat. § 17:29AA-11.
9. Morton Int'l, Inc. v. General Accident Ins. Co., 134 N.J. 1 (1993).

10. See, eg Spaulding Composites Co. v. Aetna Cas. & Sur. Co.,176 N.J. 25 (2003).
11. The APE bars coverage for bodily injury or property damage arising out of the actual, alleged, or threatened discharge, dispersal, release or escape of pollutants: (a) at or from premises the insured owns, rents or occupies; (b) at or from any location used for the handling, storage, disposal, processing or treatment of waste; (c) which are at any time transported, handled, stored, treated, disposed of, or processed as waste. It also eliminates coverage for any loss, cost, or expense arising out of any governmental direction or request that the insured test for, monitor, clean up, remove, contain, treat, detoxify or neutralise the pollutants.
12. Integrated Occurrence was defined as where personal injuries or property damage to two or more persons or properties have a common cause or there is a common defect, but they commence more than 30 days apart. Their treatment as a single occurrence depends upon whether the insured elects to give notice of an integrated occurrence.

John C. Sullivan is a Principal and Chair of the Post & Schell PC's Insurance Law Department. He has handled insurance coverage questions and coverage litigation for more than 30 years. Mr Sullivan has addressed complex insurance coverage problems, including pollution and toxic exposure claims. He provides opinions and counseling on contract drafting, interpretation, and application, and trends in the law. Mr Sullivan has also represented clients in cases filed throughout the United States, including cases with multi-million dollar exposures involving pollution and exposures to asbestos and other toxic substances.

Rick Perdian is a Senior Business Development Manager for Swiss Re’s Centre for Global Dialogue. Prior to joining the Centre's team in 2008, he worked for 25 years in law and insurance. Mr Perdian represented US insurance carriers in environmental and toxic tort insurance coverage law suits in jurisdictions across the US. He later went in house to The Home Insurance Company where he managed, resolved and was engaged in reinsurance recovery efforts for those same matters. Mr Perdian moved to Switzerland in 2003 to join the claims and legal management team of Swiss Re's Financial Services Business Group.

Find this article at:
http://cgd.swissre.com/global_dialogue/topics/Environmental_liability/US_environmental_law_and_its_impact_on_the_insurance_industry.html