

# Environmental Claims and Bad Faith: Contract Obligations That Mature into Extra-Contractual Lawsuits

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## I. INTRODUCTION

### A. *The Essence of the Environmental Insurance Contract*

Since the passage of the Comprehensive Environmental Response/Cleanup Liability Act (CERCLA), insureds are now responsible to the government for multi-million dollar environmental response costs and to private parties for bodily injuries or property damage resulting from the insureds' release of pollutants into the environment over past decades. Consequently, insureds have claimed that these expenses are covered losses and looked to their insurers for reimbursement. If the insurer mishandles such a claim in bad faith, it may be liable in tort for its conduct.

The question of an insurance company's liability for these losses will generally arise under one of two types of insurance policies: (1) a Comprehensive General Liability Policy (CGL policy), or (2) an Environmental Impairment Liability Policy (EIL policy).

#### 1. *Comprehensive General Liability Policy*

Usually, CGL policies exclude coverage for damages caused to property that is owned, rented, or used by the insured. Thus, the insured may be precluded from asserting a first party claim under the "owned property" exclusion.<sup>1</sup> An insured who is faced with a third party environmental damage

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<sup>1</sup> See *infra* note 149. The courts have avoided the application of the insured-owned property exclusion in actions initiated under CERCLA and other environmental statutes by holding that the government has a "quasi-sovereign" interest in all lands under its jurisdiction. *Continental Ins. Co. v. Northeastern Pharm. & Chem. Co. (NEPACCO I)*, 811 F.2d 1180, 1185 (8th Cir. 1986), *rev'd on other grounds*, *Continental Ins. Co. v. Northeastern Pharm. & Chem. Co. (NEPACCO II)*, 842 F.2d 977 (8th Cir.), *cert. denied*, 488 U.S. 821 (1988).

claim, however, is in a different situation. This third party environmental damage claim that the insured tenders under its CGL Policy is most often (1) an action compelling the insured to cleanup the contaminated waste site or reimburse the government for the cost incurred in cleaning up the contaminated site, or both, or (2) a private action for personal injury or property damage caused by the invasion of contaminants disposed by the insured onto neighboring property, or both.

Thus, for examples of third party claims, consider two recent California cases in which the courts ruled on important issues relating to environmental insurance coverage under CGL policies. In *Aerojet-General Corp. v. Superior Court*,<sup>2</sup> the appellate court held that CGL policies cover the costs of removing waste that spread to third party and government-owned property.

Perhaps more important is the recent decision in *AIU Ins. Co. v. Superior Court (FMC Corp.)*.<sup>3</sup> The California Supreme Court held that the terms "damages" or "ultimate net loss" as used in the general insuring provisions of the CGL policy required the insurer to pay those costs that the insured became obligated to pay in compliance with an injunctive order or as reimbursement in third party suits brought by the government, or both.<sup>4</sup> The costs at issue in *AIU* fell in two categories: first, those arising in compliance with the abatement and cleanup order of the insured's own property, and second, those incurred by governmental agencies for their cleanup efforts.<sup>5</sup>

While the court held that such costs were covered under the general insuring provisions, it declined to consider the application of any exclusions because they were not at issue. The holding of the court is summarized in the following statement from the *AIU* opinion:

[W]e conclude that the policies cover the costs of reimbursing government agencies and complying with injunctions ordering cleanup under CERCLA and similar statutes. Although many of the policies contain exclusions arguably relevant to whether environmental cleanup costs are covered, we do not consider the applicability of exclusions in the case . . . .<sup>6</sup>

## 2. *Environmental Impairment Liability Insurance*

The EIL policy is a recently fashioned separate coverage that specifically provides protection for environmental liability and expenses. Unlike the standard CGL policy, EIL policies provide coverage for personal injury, property damage, or interference with an environmental right caused by the

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<sup>2</sup> 211 Cal. App. 3d 216, 258 Cal. Rptr. 621 (1989).

<sup>3</sup> 51 Cal. 3d 807, 799 P.2d 1253, 274 Cal. Rptr. 820 (1990).

<sup>4</sup> *Id.* at 824-29, 799 P.2d at 1266-70, 274 Cal. Rptr. at 823-36.

<sup>5</sup> *Id.* at 838, 799 P.2d at 1276, 274 Cal. Rptr. at 843.

<sup>6</sup> *Id.* at 814, 799 P.2d at 1259, 274 Cal. Rptr. at 826.

discharge or disposal of pollutants that is not sudden and accidental<sup>7</sup> in the course of the insured's business.

Coverage under the EIL policy is triggered generally when a third party claim is involved. Similar to the CGL policies, EIL coverage does not extend to property that the insured owned, rented or occupied except in government initiated actions. Furthermore, EIL insurance contains an "other insurance" provision that renders it excess over all other insurance.

## B. *Bad Faith Actions Arising out of Environmental Claims*

### 1. *Basis for Liability*

The expansion of an insurer's liability to include what is now known as extra-contractual damages has developed from the concept that implicit in every insurance contract is a covenant of good faith and fair dealing. Insurance "bad faith" cases are of two types: first and third party. First party cases result from claims in which the obligation of the insurance company is to indemnify or reimburse directly its insured. Third party cases involve claims against the insured by parties who are strangers to the insurance relationship. In such cases, the obligation of the insurance company is to defend and cover the insured for personal liability.<sup>8</sup>

Liability policies are usually thought of as involving third party claims, such as third party "bad faith" suits. For example, a third party claimant may file suit to recover the amount of the excess judgment, provided that the insured assigns his or her claim against the insurer under a liability insurance policy to a third party claimant, who is a judgment creditor of the insured.<sup>9</sup> Statutory actions against insureds<sup>10</sup> and actions based upon traditional tort

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<sup>7</sup> See *infra* note 146 and accompanying text.

<sup>8</sup> See *Arizona Property & Casualty Ins. Guar. Fund v. Helme*, 153 Ariz. 129, 137, 735 P.2d 451, 459 (1987); *Garvey v. State Farm Fire & Casualty Co.*, 48 Cal. 3d 395, 407, 770 P.2d 704, 710, 257 Cal. Rptr. 292, 298 (1989); *S.G. v. St. Paul Fire & Marine Ins. Co.*, 460 N.W.2d 639, 643 (Minn. App. 1990); *Hartford Accident & Indem. Co. v. Aetna Life & Casualty Ins. Co.*, 198 N.J. 18, 23, 483 A.2d 402, 405 (1984); *Mowry v. Badger State Mut. Casualty Co.*, 129 Wis. 2d 496, 503, 385 N.W.2d 171, 185 (1986).

<sup>9</sup> In return, the third party claimant executes a covenant not to execute in favor of the insured defendant, so that the insured defendant is protected from execution on the judgment. See *Murphy v. Allstate Ins. Co.*, 17 Cal. 3d 937, 553 P.2d 584, 132 Cal. Rptr. 424 (1976); *Purcell v. Colonial Ins. Co.*, 20 Cal. App. 3d 807, 97 Cal. Rptr. 874 (1971).

<sup>10</sup> See, e.g., *Royal Globe Ins. Co. v. Superior Court*, 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979), *rev'd Moradi-Shalal v. Fireman's Fund Ins. Co.*, 46 Cal. 3d 287, 758 P.2d 58, 250 Cal. Rptr. 116 (1988).

theories of fraud or intentional infliction of emotional distress by the third party claimant<sup>11</sup> may also result in extra-contractual awards.

## 2. *Compensatory Damages*

If the insurer breaches the implied covenant of good faith and fair dealing by wrongfully handling an insurance claim under the applicable standard, a tort is committed. The compensatory damages recoverable for an insurer's tortious conduct in these cases not only includes what may be recovered under the contract but also, provided there is sufficient proof, other consequential damages as well.<sup>12</sup> The fact that the conduct of the insurer constitutes a tort enables the insured to recover damages for injuries proximately caused by the insurer's conduct, whether or not those injuries could have been anticipated at the time the contract was made. As a result, tort damages for emotional distress, economic losses suffered, and in some instances attorney's fees, may be recovered.

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<sup>11</sup> See, e.g., *Committee on Children's Television, Inc. v. General Foods Corp.*, 35 Cal. 3d 197, 673 P.2d 660, 197 Cal. Rptr. 783 (1983) (fraud); *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970) (intentional infliction of emotional distress).

<sup>12</sup> This distinction between the contract measure of damages and that measure applicable to tort actions is codified in the California Civil Code. Section 3300 states the contract rule:

For the breach of an obligation arising from contract, the measure of damages, except where otherwise expressly provided by this Code, is the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom.

CAL. CIV. CODE § 3300 (West 1970). Section 3333 states the tort rule:

BREACH OF OBLIGATION OTHER THAN CONTRACT. For the breach of an obligation not arising from contract, the measure of damages, except where otherwise expressly provided by this Code, is the amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not.

CAL. CIV. CODE § 3333 (West 1970).

It should be noted that when applied to insurance "bad faith" actions, the two approaches may not differ in the amount of compensatory damages awarded. There is, however, one significant distinction: although no punitive damages may attach to a contract action, if a tort is proven, punitive damages may be available. CAL. CIV. CODE § 3294(a) (West 1970 & Supp. 1991).

### 3. Punitive Damages

Once an underlying tort liability is established, punitive damages may also be awarded under certain circumstances.<sup>13</sup> Obviously, the greatest danger to an insurer defending against a bad faith claim is this potential for exposure to punitive damages, which are generally recognized as an appropriate deterrent to conduct that is malicious, fraudulent or oppressive, or conduct that evidences an "evil mind."<sup>14</sup> In essence, punitive damages are imposed to punish the defendant and to deter others from following suit. Such damages are usually not recoverable in an action for breach of contract unless the breach amounts to an independent tort. A point, however, needs to be stressed: an insurer's tortious conduct does not automatically entitle the insured to punitive damages.<sup>15</sup> As a general rule, there must be a showing that while tortiously handling the claim, the insurer acted with oppression, fraud, malice, or some form of the requisite evil conduct. Punitive damages are not recoverable in a bad faith tort case unless the evidence reflects "something more" than conduct necessary to establish the tort.<sup>16</sup> These points are discussed more fully later in this paper.

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<sup>13</sup> The rule in tort cases is that damages are determined at the time of the wrong, rather than at the time of the making of the contract. CAL. CIV. CODE §§ 3300, 3333 (West 1970). The tort rule thus focuses on what damages are foreseeable at the time the tort is committed, while the contract rule looks at the damages contemplated by the parties at the time of the making of the contract. Generally, the latter is a more limited rule of damages, so the conversion of a contract right under the insurance policy to a tort claim permits a broader damages claim. Conversion to a tort also permits the imposition of punitive damages, which are ordinarily not permitted for a simple breach of contract. CAL. CIV. CODE § 3294 (West 1970 & Supp. 1991).

<sup>14</sup> See *Linthicum v. Nationwide Ins. Co.*, 150 Ariz. 326, 723 P.2d 675 (1986).

<sup>15</sup> *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 462, 521 P.2d 1103, 1110, 113 Cal. Rptr. 711, 718 (1974). "It does not follow that because plaintiff is entitled to compensatory damages that he is also entitled to exemplary damages. . . . [The defendant] must act with the intent to vex, injure or annoy, or with a conscious disregard of the plaintiff's rights." *Id.*

<sup>16</sup> *Linthicum*, 150 Ariz. at 330-32, 723 P.2d at 679-81. Courts generally have applied one of two standards in determining whether punitive damages are awardable: the "preponderance of the evidence" standard or the "clear and convincing evidence" standard.

## II. INSURANCE CONTRACT ISSUES THAT CAN LEAD TO EXTRA-CONTRACTUAL CLAIMS

### A. *Interrelationship Between Contractual Duties and the Potential for Tort Liability*

#### 1. *Essential Duties Arising from the Contract*

The insurance contract defines both the insurer's expressed and implied contractual duties. The governing contract, however, is subject to some interpretation. If the policy language is interpreted adversely to the insurer, then the insurer may be subject to extra-contractual liability, particularly in cases in which the insurer's conduct in handling the claim has been especially wrongful.<sup>17</sup> Thus, it is important to look first at the company's contractual duties in order to determine the essential obligations of the insurer.

The contract defines those duties expected of the insurer that must be carried out for the benefit of its insured. If those contractual duties are carried out properly, then there is little opportunity for extra-contractual exposure.<sup>18</sup> If,

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<sup>17</sup> The rules governing the interpretation of contracts generally apply to insurance policies. *Atlas Assurance Co. v. McCombs Corp.*, 146 Cal. App. 3d 135, 143, 194 Cal. Rptr. 66, 69 (1983). Some courts, however, have adopted special rules for construing insurance policies so as to protect the reasonable expectations of the insured. *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 269, 419 P.2d 168, 172, 54 Cal. Rptr. 104, 108 (1966). In general, any ambiguity in the policy language will be strictly interpreted against the insurer. Reasonable doubts as to construing uncertain language must be resolved in favor of the insureds. *CNA Casualty v. Seaboard Sur. Co.*, 176 Cal. App. 3d 598, 614, 222 Cal. Rptr. 276, 285 (1986); *Crane v. State Farm Fire & Casualty Co.*, 5 Cal. 3d 112, 115, 485 P.2d 1129, 1130, 95 Cal. Rptr. 513, 514 (1971).

<sup>18</sup> A question that has loomed on the horizon is whether an insurer can be found to have committed a tort if there is no coverage. Of course, there must be a valid and enforceable policy in order for there to be the potential of a "bad faith" claim, since the tort depends on an underlying contractual relationship. *See Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 556, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973). However, while there may be a policy, there may not be coverage. If there is no coverage, can the insurer violate the covenant so as to create the potential for tort liability? This issue was addressed by the California Supreme Court in *Judah v. State Farm Fire & Casualty Co.*, 227 Cal. App. 3d 1133, 266 Cal. Rptr. 455 (1990), *reh'g granted*, April 19, 1990.

In *Judah*, the insured sought coverage under her all-risk policy issued by State Farm for property damage to her house. State Farm retained the services of civil engineers to determine the cause of the damage as well as represent to the insured that there was coverage. Almost one year after the insured had tendered her claim, State Farm denied coverage under the policy. The court held that despite the fact there was no coverage, the insured could pursue her action for breach of the implied covenant because of State Farm's improper claims handling.



however, the insurer acts unreasonably and without proper cause, there may be an action for breach of the implied covenant of good faith and fair dealing, which creates the potential for extra-contractual compensatory recovery and punitive damages,<sup>19</sup> or the potential of recovery for other tort claims.

## 2. Tort Liability Potential Arising Out of Contractual Obligations

### a. Essential Contractual Responsibilities

While it is the contract's terms and their interpretation which govern the contractual obligations of the insurer, it is the insurer's conduct in carrying out those obligations—both express and implied—which determines its extra-contractual liability. As stated by one court, “[c]onduct that is merely a breach of contract is not a tort. The contract, however, may establish a relationship demanding the exercise of proper care and acts and omissions which in performance may give rise to a tort liability.”<sup>20</sup> To assess extra-contractual liability, the insurer's conduct is superimposed on its contractual duties in order to determine if it has fulfilled the obligations under its policy reasonably and with cause or justification. If not, there is the potential for extra-contractual damages.

There are several essential duties typical of most first and third party coverages that arise out of the CGL and EIL policies. While the nature and scope of these duties may differ according to the type of coverage afforded and the varying policy language, their execution is critical to the correct handling of any environmental impairment claim. For liability coverages these duties include:

- (1) the duty to defend;
- (2) the duty to indemnify;
- (3) the duty to settle; and
- (4) the duty to investigate.

For first party coverages, these duties include:

- (1) the duty to investigate;
- (2) the duty to evaluate the claim objectively;<sup>21</sup>
- (3) the duty to not unreasonably withhold, deny, or underpay a claim.

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<sup>19</sup> See *infra* notes 74–86 and accompanying text.

<sup>20</sup> *Weeg v. Iowa Mut. Ins. Co.*, 82 S.D. 104, 109, 141 N.W.2d 913, 916 (1986).

<sup>21</sup> As has been stated in a number of cases, the insurer has a duty to treat the insured's interests equally with those of the insurer. This duty has been stated in first party cases, *Egan v. Mutual of Omaha Co.*, 24 Cal. 3d 809, 818-19, 598 P.2d 452, 456, 157 Cal. Rptr. 482, 486 (1979), *cert. denied*, 445 U.S. 912 (1980), and in liability cases, *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 659, 328 P.2d 198 (1958); see also *Shamblin v. Nationwide Mut. Ins. Co.*, 396 S.E.2d 766, 776 (W. Va. 1990).

b. *Liability Coverages: Duty to Defend Versus Duty to Indemnify*

i. *Potential for Coverage*

One of the areas of frequent confusion in handling claims under liability policies is the difference between the duty to defend and the duty to indemnify. An insurer may not refuse to defend merely because the insured has failed to prove coverage. While the question of indemnification depends on whether or not there is coverage, the duty to defend depends on whether there is potential coverage under all the circumstances.<sup>22</sup> Thus, the general rule is that if there is potential coverage under either (1) the complaint's allegations, or (2) the facts and circumstances as determined after the insurer complies with its duty to investigate, then there is a duty to defend.<sup>23</sup>

The duty to defend is broader than the duty to indemnify.<sup>24</sup> If the complaint's allegations suggest potential coverage but the facts do not, there is a duty to defend.<sup>25</sup> If the complaint's allegations do not suggest coverage, but the facts do, there is a duty to defend.<sup>26</sup> The duty to defend may exist even

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<sup>22</sup> See *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 276-77, 419 P.2d 168, 179, 54 Cal. Rptr. 104, 115 (1966); *CNA Casualty Seaboard Sur. Co.*, 176 Cal. App. 3d 598, 606-07, 222 Cal. Rptr. 276, 278 (1986); see also *Johnson v. Aid Ins. Co.*, 287 N.W.2d 663, 665 (Minn. 1980) (as a general rule, if any part of the cause of action against its insured is arguably within the scope of the policy's coverage, the insurer must provide a defense).

<sup>23</sup> Not all jurisdictions require the determination of "potentiality of coverage" to be based on both the complaint's allegations *and* the facts and circumstances discovered in the course of the insured's investigation. While some courts require both, *Gray*, 65 Cal. 2d at 275-77, 419 P.2d at 177, 54 Cal. Rptr. at 113; *Burns v. Underwriters Adjusting Co.*, 234 Mont. 508, 509, 765 P.2d 712, 713 (1988), other courts look only to the allegations contained in the complaint. *American Alliance Ins. Co. v. Frito-Lay Inc.*, 788 S.W.2d 152, 153 (Tex. Ct. App. 1990) ("Eight Corners" rule requires the examination only of "the allegations in the complaint and the insurance policy in determining whether a duty to defend exists."); *Reliance Ins. Co. v. Royal Motorcar Corp.*, 534 So. 2d 922, 923 (Fla. Dist. Ct. App. 1988) (an insurer's duty to defend is determined solely by the complaint's allegations, not by the actual facts or the insured's version of the facts); *Viking Ins. Co. v. Hill*, 57 Wash. App. 341, 347, 787 P.2d 1385, 1388 (1990) ("The duty to defend is determined by a review of the allegations on the face of the pleading which give rise to the covered action. Thus, the duty to defend hinges not on the insured's potential liability to the claimant, but rather on whether the complaint contains any factual allegations rendering the insurer liable to the insured under the policy.").

<sup>24</sup> See *Gray*, 65 Cal. 2d at 275-76, 419 P.2d at 175, 54 Cal. Rptr. at 111; *Lanoue v. Fireman's Fund Ins. Am. Co.*, 278 N.W. 2d 49, 53 n.1 (Minn. 1979); *Aetna Ins. Co. v. Lythgoe*, 618 P.2d 1057, 1061 (Wyo. 1980).

<sup>25</sup> See *supra* note 24 and accompanying text.

<sup>26</sup> *Id.*

though it is later determined that there is no duty to indemnify.<sup>27</sup> In most situations, then, an insurer would be prudent to defend under a properly worded reservation that reserves the right to further investigate the case and outlines the basis of noncoverage for the claim at issue.<sup>28</sup> This would permit an insurer to retain control of the defense, look at the opportunities to settle, and still preserve right to decline indemnification at a later date.<sup>29</sup>

### c. *Duty to Settle*

Of the many issues arising under the duty to settle, the most important deal with policy limits demands. When an insurer is faced with a policy limits demand, a conflict of interest arises between the insurer and insured. Faced with such a demand, the insurer may decide to try the case in order to obtain a judgment within the policy limits and save money. In choosing to litigate instead of settling for the limits, insurers risk the financial security of their insureds by potentially exposing them to adverse judgments in excess of the

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<sup>27</sup> *Aetna Ins. Co.*, 618 P.2d at 1061 (“[T]he decision as to the duty to defend is not made on the basis of the ultimate liability of the insurer to indemnify the insured or on the basis of whether the underlying action is groundless or unsuccessful.”).

<sup>28</sup> There is some question whether the insurer risks a waiver of a coverage defense if it does not set it out in the reservation of rights or declination letter. *See McLaughlin v. Connecticut Gen. Ins. Co.*, 565 F. Supp. 434, 451 (N.D. Cal. 1983) (“an insurance company which relies on specified grounds for denying a claim thereby waives the right to rely in subsequent litigation on any other grounds which a reasonable investigation would have uncovered.”). A leading authority on insurance cites at least fifteen jurisdictions which follow the rule set forth in *McLaughlin*. *See* 16C J. APPLEMAN, *INSURANCE LAW AND PRACTICE* § 9260 at 393 (1980); (Alabama, Delaware, Georgia, Indiana, Iowa, Kansas, Massachusetts, Michigan, Missouri, Nebraska, New York, New Mexico, Oregon, Pennsylvania, Texas, Vermont, Washington, and Wisconsin).

<sup>29</sup> In defending, it is critical that the claims personnel and attorneys appointed to defend the insured insulate themselves from any involvement in the investigation of, determination of, or litigation of, coverage, *i.e.*, a declaratory action. Those handling the liability claim must remain separate and apart from the coverage action because their duties are to the insured. Those handling the coverage matter are adverse to the insured since a determination of non-coverage is not in the interest of the insured. While the determination and technical analysis of coverage are not critical to the decision to defend, they are critical to the decision to indemnify. Only the potentiality of coverage triggers the duty to defend. Thus, in cases where a possible exclusion may negate coverage under the general insuring clause, the company should seriously consider defending under a reservation of rights since (1) exclusions are often found ambiguous, (2) they are applied narrowly, and (3) the burden is on the insurer to prove there is no coverage. *CNA Casualty v. Seaboard Sur. Co.*, 176 Cal. App. 3d 598, 614, 222 Cal. Rptr. 276, 285 (1986); *Clemmer v. Hartford Ins. Co.*, 22 Cal. 3d 865, 880, 587 P.2d 1098, 1105, 151 Cal. Rptr. 285, 292 (1978).

policy limits.<sup>30</sup> Therefore, when faced with a policy limits demand, the insurer has a duty to settle at or below the policy limits if there is a substantial likelihood of excess or personal exposure to the insured.<sup>31</sup> If the insurer chooses to try the case, and there is an excess judgment against the insured, a jury may hold the insurer liable for the excess judgment because it unreasonably refused to settle.<sup>32</sup> Furthermore, the jury may consider the

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<sup>30</sup> See *Merritt v. Reserve Ins. Co.*, 34 Cal. App. 3d 858, 875-76, 110 Cal. Rptr. 511, 521 (1973); see also *Dumas v. Hartford Accident & Indem. Co.*, 94 N.H. 484, 488, 56 A.2d 57, 60 (1947). (“[I]n deciding whether or not to settle . . . the insurer cannot be too venturesome and speculate with a trial of the issues in the accident case at the risk of the insured.”).

<sup>31</sup> *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967); *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958). In Wisconsin, the insurer must fulfill three obligations in order to meet its duty to settle. It must first exercise reasonable diligence in ascertaining facts to base a good faith decision to settle. Second, it must inform the insured of the likelihood of a judgment in excess of the policy limits. Third, it must keep the insured abreast of any offers and negotiations. *Mowry v. Badger State Mut. Casualty Co.*, 129 Wis. 2d 496, 510, 385 N.W.2d 171, 178 (1986).

In West Virginia, the insurer has the burden of proving by clear and convincing evidence that it

attempted in good faith to investigate a settlement, that any failure to enter into a settlement where the opportunity to do so existed [sic] was based on reasonable and substantial grounds, and that it accorded the interests and rights of the insured at least as great a respect as its own . . . . In assessing whether an insurer is liable to its insured for personal liability in excess of policy limits, the proper test to be applied is whether the reasonably prudent insurer would have refused to settle within policy limits under the facts and circumstances of the case, bearing in mind always its duty of good faith and fair dealing with its insured.

*Shamblin v. Nationwide Mut. Ins. Co.*, 396 S.E.2d 766, 776 (W. Va. 1990).

In Arizona, the insurer is held to the “equal consideration” rule: whether the insurer, if operating without policy limits, thus giving equal consideration to the insured’s interests, would have accepted the settlement offer. *Clearwater v. State Farm Mut. Auto Ins. Co.*, 164 Ariz. 256, 792 P.2d 719 (1990).

<sup>32</sup> For example, California BAJI jury instruction 12.95 provides:

**INSURANCE COMPANY’S OBLIGATIONS-DUTY TO ACCEPT REASONABLE SETTLEMENT OFFER TO SETTLE THIRD PARTY CLAIM**

The implied obligation of good faith and fair dealing in an insurance policy imposes a duty on an insurance company to accept a reasonable offer to settle a claim against the person insured if the offer is within the limits of the insurance coverage and if there is a substantial likelihood of recovery against the person insured for an amount in excess of the insurance coverage.

An insurance company that fails to fulfill such duty is liable for all damages proximately resulting from such failure.

amount of an excess judgment in deciding if the insurer acted unreasonably; this is called the "hindsight rule."<sup>33</sup> Generally after an excess judgment, the insured assigns the excess claim to the plaintiff (third party claimant), who in turn brings an action to recover the excess from the insurer.<sup>34</sup>

#### d. *Duty to Investigate*

The duty on the part of the insurer to *thoroughly* investigate claims is critical. The insured purchases insurance to obtain peace of mind and security. Thus, it is essential that the insurer fully inquire into the possible avenues

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California Jury Instructions: Civil (BAJI) No. 12.95 (7th ed. 1986).

<sup>33</sup> In California, the courts may instruct the jury as follows:

In considering whether defendant insurance company acted in good faith or in bad faith in rejecting an offer of settlement, you should consider all the evidence which tends to establish either good faith or bad faith, including, but not limited to, evidence on the following factors: . . . the extent of the financial risk to which the insurance company and the insured person were exposed in the event of a refusal to settle.

*Id.* at No. 12.98.

*See also* Betts v. Allstate Ins. Co., 154 Cal. App. 3d 688, 708, 201 Cal. Rptr. 528, 538 (1984) (In determining the reasonableness of the insurer's conduct the jury may rationally infer that the value of the claim against the insured is equivalent to the amount of the judgment against the insured. Thus, if the insurer failed to settle within the policy limits and the judgment against the insured exceeds the policy limits, then the jury can infer that the insurer acted unreasonably.).

*But see* Austero v. National Casualty Co., 84 Cal. App. 3d 1, 32, 148 Cal. Rptr. 653, 673 (1978) ("to see if there was any unreasonable conduct by the Company, it is essential that no hindsight test be applied. The reasonable or unreasonable action by the Company must be measured as of the time it was confronted with a factual situation to which it was called upon to respond.").

In Alabama, the Supreme Court stated that "whether an insurance company is justified in denying a claim under a policy must be judged by what was before it at the time the decision was made." In order for the insured to recover on a bad faith claim, the insured must prove that if the contract claim had been tried on the date of denial, without consideration of any facts discovered after the denial, it would have been entitled to a directed verdict. This is called the "Dutton" test. *National Sav. Life Ins. Co. v. Dutton*, 419 So. 2d 1357, 1362 (Ala. 1982).

<sup>34</sup> In this situation, the third party claimant is limited to the amount of the excess and cannot recover personal damages for emotional distress or punitive damages. *See* *Murphy v. Allstate*, 17 Cal. 3d 937, 553 P.2d 584, 132 Cal. Rptr. 424 (1976); *Purcell v. Colonial Ins. Co.*, 20 Cal. App. 3d 807, 97 Cal. Rptr. 874 (1971). Because the insured cannot assign his or her personal rights, the third party claimant has no action for personal damages without the insured as co-plaintiff. *See* *Cain v. Mutual Auto. Ins. Co.*, 47 Cal. App. 3d 783, 121 Cal. Rptr. 200 (1975).

which would support the insured's claim. Denial of benefits to an insured without thoroughly investigating the insured's claim amounts to breach of the implied covenant.<sup>35</sup> This aspect of an insurer's responsibility is discussed further below.<sup>36</sup>

### B. *Independent (Cumis) Counsel*

The insurer's duty to defend the insured may obligate it to furnish independent (*Cumis*)<sup>37</sup> counsel when a disqualifying conflict of interest arises between the insurer and the insured. A conflict of interest between jointly represented clients exists "whenever their common lawyer's representation of the one is rendered less effective by reason of his representation of the other."<sup>38</sup> The insurer's denial of coverage for a third party claim, however, does not always obligate it to provide independent counsel for the insured. The provision of independent counsel depends on the nature of the coverage dispute.<sup>39</sup> Nor is independent counsel required simply because coverage is denied on the allegations or facts in the third party action. The allegations or facts showing non-covered conduct do not by themselves constitute a conflict of interest requiring independent counsel. Independent counsel, however, may be required when the insurer elects to defend under a reservation of rights, because the outcome of the action may control the coverage issue. Under such circumstances, an existing conflict of interest may require the insurer to furnish independent counsel for the insured.

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<sup>35</sup> *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 817, 598 P.2d 452, 456, 157 Cal. Rptr. 482, 486 (1979), *cert. denied*, 445 U.S. 912 (an insurer may breach the covenant of good faith and fair dealing by failing to properly investigate its insured's claims); *Betts v. Allstate Ins. Co.*, 154 Cal. App. 3d 668, 201 Cal. Rptr. 528 (1984) (by equal parity of reasoning, a failure to investigate and fairly appraise the third party's claim against the insured would breach the covenant of good faith and fair dealing).

<sup>36</sup> See *infra* notes 64-73 and accompanying text.

<sup>37</sup> So named after *San Diego Navy Fed. Credit. Union v. Cumis Ins. Soc'y*, 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984); see also *Fireman's Fund Ins. Co. v. Waste Management Inc.*, 777 F.2d 366 (7th Cir. 1985); *Executive Aviation, Inc. v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971); CAL. CIV. CODE § 2860 (West 1987 & Supp. 1991).

<sup>38</sup> *Spindle v. Chubb/Pacific Indem. Group*, 89 Cal. App. 3d 706, 713, 152 Cal. Rptr. 776, 780-81 (1979).

<sup>39</sup> For instance, in *Prahn v. Rupp Constr. Co.*, 277 N.W.2d 389, 391 (Minn. 1979), defendant-insured interpleaded its insurer, Great American Insurance Company, as third party defendant after it refused to provide coverage under a policy exclusion. Because both the liability of the insured and the coverage issue would be determined at the same trial, the court held that a conflict of interest existed among the insured, Great American, and the attorney it appointed to defend the insured. The court required Great American to furnish independent counsel for its insured.

### III. GENERAL PRINCIPLES OF EXTRA-CONTRACTUAL LIABILITY APPLICABLE TO ENVIRONMENTAL COVERAGE

#### A. *Standard for Bad Faith*

The applicable standard used to determine if an insurer is liable for extra-contractual damages depends on both the particular legal theory of recovery (tort or statute) and the jurisdiction whose rules govern that theory.<sup>40</sup> Not all states agree on the standard used in assessing whether "bad faith" exists.<sup>41</sup> This section will give a sample of the various approaches among different states in applying the standards of the implied covenant of good faith and fair dealing.

#### 1. *Analytical Framework*

A bad faith action focuses on three tiers, which can be summarized as follows:<sup>42</sup>

Tier One: Contract liability. If an insurance company is found to have contractual liability, it will be assessed the benefits due under the policy. This does not necessarily mean that the insurer has liability for extra-contractual (*e.g.*, tort or statutory) damages.

Tier Two: Liability for "bad faith" leading to extra-contractual compensatory damages. Extra-contractual compensatory damages can be assessed only if there is a proven tort or statutory claim.<sup>43</sup> If so, extra-contractual compensatory damages will be assessed provided there are actual proven losses proximately resulting from the wrong committed.

Tier Three: Liability for punitive damages. Punitive damages may be assessed against the insurer if the second tier is met. Such damages are based not on proven losses but on the company's wealth and other factors. A tort or statutory violation constituting bad faith on the part of an insurer, however, is generally not enough to support a punitive award. A showing of something more than bad faith conduct is required; a stricter standard must be met to recover punitive damages.

#### 2. *Theories of Recovery*

It should be remembered that a breach of the implied covenant is not the only legal theory of recovery available in these cases; other theories are

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<sup>40</sup> See *supra* note 18 and accompanying text.

<sup>41</sup> See *infra* notes 46-54 and accompanying text.

<sup>42</sup> The principles stated in this summary are discussed in various sections of this paper. Because the citations for these general rules are found in those sections, they are not recited here.

<sup>43</sup> See *supra* note 21 and accompanying text.

available as well.<sup>44</sup> While the following discussion focuses on the standard for a breach of the covenant of good faith and fair dealing, which is the most

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<sup>44</sup> In addition to actions based upon breach of the covenant of good faith and fair dealing, extra-contractual actions against an insurer may also be brought on theories of intentional infliction of emotional distress, *e.g.*, *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970); fraud, *e.g.*, *Handel v. U.S. Fidelity & Guar. Ins. Co.*, 192 Cal. App. 3d 684, 237 Cal. Rptr. 667 (1987); conspiracy, *e.g.*, *Unruh v. Truck Ins. Exch.*, 7 Cal. App. 3d 616, 498 P.2d 1063, 102 Cal. Rptr. 815 (1972); and other tort theories, *e.g.*, *Fletcher*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78.

In some jurisdictions, the insured may state a cause of action against the insurer for statutorily defined unfair practices. California has recently held that the Unfair Practices Act does not provide a separate theory for recovery by a third party, *Moradi-Shalal v. Fireman's Fund Ins. Co.*, 46 Cal. 3d 287, 758 P.2d 58, 290 Cal. Rptr. 116 (1988), or by a first party claimant, *Tricor Calif. Inc. v. Superior Court*, 220 Cal. App. 3d 880, 269 Cal. Rptr. 642 (1990).

Recovery under consumer statutes is permitted in some states. For instance, private causes of action against insurers for unfair practices is permitted under the Washington Consumer Protection Act, WASH. REV. CODE ANN. § 19.86 (1972). However, there is no private cause of action against insurers for statutory unfair practices under Texas Unfair Claim Settlement Practices Act, TEX. INS. CODE ANN. § 21.21-2 (1973), or the Texas Deceptive Trade Practices Act/Consumer Protection Act, TEX. BUS. & COMM. CODE § 17.41 (1987); *see, e.g.*, *McKnight v. Ideal Mut. Ins. Co.*, 534 F. Supp. 362 (N.D. Tex. 1982). Similarly, there is no private right of action under the Arizona Unfair Claim Settlement Practices Act, ARIZ. REV. STAT. ANN. §20-461 (c) (1990 and West Supp. 1991).

Breach of fiduciary duty is another theory that has been advanced in bad faith actions against insurers. However, not all jurisdictions recognize this cause of action in the context of insurance bad faith. The California Supreme Court does not recognize that a true fiduciary relationship exists between an insured and an insurer. *See Henry v. Associated Indem. Corp.*, 217 Cal. App. 3d 1405, 1418, 266 Cal. Rptr. 578, 586 (1990). Likewise, the Utah Supreme Court has held that the nature of the relationship between an insurer and its insured is contractual rather than fiduciary. *See Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 801 (Utah 1985). However, the Louisiana Supreme Court held that "[i]n every case, the insurance company is held to a high fiduciary duty to discharge its policy obligations to its insured in good faith including the duty to defend the insured against covered claims and to consider the interests of the insured in every settlement." *Pareti v. Sentry Indem. Co.*, 536 So. 2d 417, 423 (La. 1988).

There have been cases dealing with ordinary negligence. However, it appears that this may not be a proper basis for recovery in some jurisdictions because of the redundancy of alleging both negligence and breach of the implied covenant of good faith and fair dealing. *See Kooyman v. Farm Bureau Mut. Ins. Co.*, 267 N.W.2d 403 (Iowa 1978); *see also Commercial Union Ins. Co. v. Liberty Mut. Ins. Co.*, 426 Mich. 127, 393 N.W.2d 161 (1986); *State Farm Mut. Auto. Ins. Co. v. Floyd*, 235 Va. 136, 366 S.E.2d 93 (1988) (allowing the insured to recover against the insurer for its arbitrary, reckless, indifferent, or intentional disregard of its insured's interest only by an action for bad faith).



popular avenue of recovery, the availability of other theories to a plaintiff must be kept in mind.

### 3. *First Party Cases*

#### a. *California Standard of Liability (Without Proper Cause)*

California has been a leader in developing law in first party cases. It is well-settled that an erroneous decision to not pay a claim for benefits due under a policy does not by itself justify an award of extra-contractual compensatory damages.<sup>45</sup> Such damages may be awarded only if there is a tort committed, such as a breach of the implied covenant of good faith and fair dealing.<sup>46</sup> Thus, the decision to decline payment of a claim must not only be wrong but must also be "unreasonable, and without proper cause."<sup>47</sup> Hence, the California Supreme Court has found that a party which declines to perform a contractual duty with proper cause does not breach the implied covenant.<sup>48</sup>

#### b. *Other States*

##### i. *Arizona*

The Arizona standard of liability in first party cases has a two-tier approach. The first tier requires a finding that the insurance company knew it

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Finally, negligent infliction of emotional distress might be available in a proper case. *See Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973) (recognizing extra-contractual liability for emotional distress as economic loss). Some cases reject recovery, however, by one other than the insured for negligent infliction of emotional distress. *Soto v. Royal Globe Ins. Co.*, 184 Cal. App. 3d 420, 432-34, 229 Cal. Rptr. 192, 199-200 (1986) (disallowing recovery for emotional distress by the estate or surviving family members suing on behalf of the deceased insured); *see also* *Murphy v. Allstate Ins. Co.*, 17 Cal. 3d 937, 553 P.2d 584, 132 Cal. Rptr. 424 (1976) (insureds cannot assign their claims for personal injury or emotional distress to third party claimants).

<sup>45</sup> *Hanson v. Prudential Ins. Co.*, 772 F.2d 580, 584, *superseded*, 783 F.2d 762 (9th Cir. 1985); *Austero v. National Casualty Co.*, 84 Cal. App. 3d 1, 31-32, 148 Cal. Rptr. 653, 672-73 (1978); *cf.* *Rawling v. Apodaca*, 151 Ariz. 149, 157, 726 P.2d 565, 573 (1986).

<sup>46</sup> *See supra* notes 20-21 and accompanying text.

<sup>47</sup> The term "bad faith" really has no meaning in this context since it does not accurately portray the standard to be applied to determine an insurer's extra-contractual compensatory liability. Rather, it is a generic term to describe a type of case in which extra-contractual damages from an insurer are sought on a variety of available theories of recovery.

<sup>48</sup> *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 36 Cal. 3d 752, 770, 686 P.2d 1158, 1167, 206 Cal. Rptr. 354, 363 (1984).

did not have a reasonable basis for denying the claim. The second tier requires a finding that the insurance company intentionally denied the claim when it knew it had no reasonable basis for doing so.<sup>49</sup>

## ii. *Indiana*

Indiana requires the insured to establish by a preponderance of the evidence that the insurer failed to settle a claim which in good faith cannot be disputed. While Indiana does not recognize bad faith as an independent tort, punitive damages for breach of contract are nonetheless recoverable under either of the following conditions: (1) the conduct at issue constitutes an independent tort, or (2) "elements of fraud, malice, gross negligence or oppression mingle in the controversy[,] . . . provided that the public interest is served by the deterrent effect of the punitive damages award."<sup>50</sup>

## iii. *Wisconsin*

Wisconsin recognizes a bad faith claim only if the insured can show that a reasonable insurer would not have denied or delayed payment of the claim. As the Wisconsin Supreme Court has observed: "It is apparent then, that the tort of bad faith is an intentional one."<sup>51</sup> Thus, an insurer in Wisconsin incurs no liability for denying a claim that is "fairly debatable."<sup>52</sup>

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<sup>49</sup> The insurer can overcome this two-level approach in first party cases by meeting the "fairly debatable" standard, *see infra* note 53 and accompanying text. However, the "equal consideration" standard applies to third parties. *Clearwater v. State Farm Mut. Auto. Ins. Co.*, 164 Ariz. 256, 92 P.2d 719 (1990). Arizona, like California, has adopted the "clear and convincing" standard for punitive damages. *Gurule v. Illinois Mut. Life & Casualty Co.*, 152 Ariz. 600, 734 P.2d 85 (1987).

<sup>50</sup> *Hoosier Ins. v. Mangino*, 419 N.E.2d 978, 981 (Ind. 1981).

<sup>51</sup> *Anderson v. Continental Ins. Co.*, 85 Wis. 2d 675, 691, 271 N.W.2d 368, 376 (1978).

<sup>52</sup> *Mowry v. Badger State Mut. Casualty Co.*, 129 Wis. 2d 496, 516, 385 N.W.2d 171, 180 (1986). The court in *Mowry* rejected the California standard, which it believed held the insurer strictly liable for failure to settle within the policy limits. Instead, the court stated that the "insurer will have committed the tort of bad faith only when it has denied a claim without a reasonable basis for doing so. . . ." *Id.* at 516, 385 N.W.2d at 180. Other jurisdictions adopting the "fairly debatable" standard: Alabama, *McLaughlin v. Alabama Farm Bureau Mut. Casualty Ins. Co.*, 437 So. 2d 86, 90 (Ala. 1983); Colorado, *Travelers Ins. Co. v. Savio*, 706 P.2d 1258, 1275 (Colo. 1985); Idaho, *White v. Unigard Mut. Ins. Co.*, 112 Idaho 94, 100, 730 P.2d 1014, 1020 (1986); Iowa, *Kiner v. Reliance Ins. Co.*, 463 N.W.2d 9, 12 (Iowa 1990); South Dakota, *Matter of Certification of a Question of Law from the U.S. Dist. Court, Dist. of South Dakota, Western Div.*, 399 N.W.2d 320, 324 (1987); and Utah, *Callioux v. Progressive Ins. Co.*, 745 P.2d 838, 842 (Utah 1987).

#### iv. *Other States*

Alabama recognizes that an insurer may be liable when there is either "(1) no lawful basis for the refusal coupled with actual knowledge of that fact, or (2) intentional failure to determine whether or not there was any lawful basis for such refusal."<sup>53</sup> In Arkansas, a finding of bad faith requires proof that the insurer engaged in misconduct that is dishonest, malicious, or oppressive in order to avoid a just obligation to its insured. In Kentucky, bad faith requires an intentional, willful, or reckless disregard by the insurer of the insured's rights. Some jurisdictions essentially combine the second and third tiers of the analytical framework described above in Section III by allowing the recovery of punitive damages if intentional or malicious conduct is an element of the tort of "bad faith."

#### 4. *Third Party Cases*

Actions by third parties, who are strangers to the insurance relationship, against insurers for extra-contractual damages are restricted to certain situations. They generally fall into two types of categories.<sup>54</sup> First, there is the so-called "excess case" that permits the third party, who receives an assignment of the excess judgment from the insured defendant, to recover the amount of that excess judgment from the insurer.<sup>55</sup> The third party may not recover more than this. That is, there is no recovery for any extra-contractual damages other than the excess (*e.g.*, emotional distress or punitive damages). This is because the insured cannot assign these damages to the third party and because the third party has no independent basis for recovery of these damages. In the second category, the third party has an independent right to recovery. This second category is limited to jurisdictions in which the third party has a right to

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<sup>53</sup> *Chavers v. National Sec. Fire & Casualty Co.*, 405 So. 2d 1, 7 (Ala. 1981). *But see Prudential Ins. Co. v. Coleman*, 428 So. 2d 593, 599 (Ala. 1983) (delay alone will not support a bad faith cause of action plaintiff must prove an "intentional refusal to pay the insured's claim").

<sup>54</sup> These two categories do not include direct actions by third parties to recover from an insurer the amount due under a liability insurance policy. California permits such actions only to the extent of the policy limits (*i.e.*, there is no extra-contractual recovery in such cases), and only after a judgment is obtained against the insured defendant. Recovery is limited to the amount of the judgment up to the limits of coverage. CAL. INS. CODE § 11580(b)(2) (West 1988).

<sup>55</sup> *Murphy v. Allstate Ins. Co.*, 17 Cal. 3d 937, 553 P.2d 584, 132 Cal. Rptr. 424 (1976).

enforce a statute or in which the recovery for some tort other than a breach of the covenant of good faith and fair dealing may be available.<sup>56</sup>

### 5. *Duty to Defend Cases*

#### a. *Choices for Insurer with Coverage Issue*

Since the duty to defend inures to the benefit of the insured and not the injured party, actions against an insured are really part of first party coverage. Essentially, an insurer has four alternatives when faced with a claim as to which there is a coverage question: the insurer may (1) refuse to furnish a defense; (2) defend under a reservation of rights;<sup>57</sup> (3) reserve its rights and furnish independent counsel to defend the insured action;<sup>58</sup> or (4) accept the defense of the third party suit and waive objections to the lack of coverage.

#### b. *Elements of the Breach of the Duty to Defend*

To maintain a bad faith action against the insurer for a wrongful refusal to defend, the insured must plead and prove the following: (1) the existence of a duty to defend; (2) notice and opportunity to defend; (3) the unreasonable refusal to defend; and (4) damages resulting from the "bad faith" refusal to defend.

#### c. *Damages for Refusal to Defend*

Without additional facts, an insurer's erroneous refusal to furnish a defense is simply a breach of contract. Extra-contractual damages may be awarded for breach of the implied covenant, however, when the refusal to defend is

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<sup>56</sup> Third party claimants who bring a bad faith action against the insurer may also bring an action for intentional and/or negligent infliction of emotional distress. In order to allege a cause of action for intentional infliction of emotional distress, the third party must allege facts showing that the insurer's conduct was outrageous and that the insurer acted outrageously with the intent to inflict emotional distress to the third party. *Schlauch v. Hartford Accident & Indem. Co.*, 146 Cal. App. 3d 926, 927, 194 Cal. Rptr. 658, 659 (1983). To bring an action for negligent infliction of emotional distress, the third party claimant must allege facts showing that the insurer owed a duty to the third party claimant and that the insurer's breach of such a duty caused emotional distress. *Beckham v. Safeco Ins. Co.*, 691 F.2d 898, 904 (9th Cir. 1982). In these scenarios, the third party claimant is seeking damages for his own emotional distress, which was allegedly caused by the insurer.

<sup>57</sup> See *Val's Painting & Dry Wall v. Allstate Ins. Co.*, 53 Cal. App. 3d 576, 126 Cal. Rptr. 267 (1975) (either a bilateral "nonwaiver" agreement or a unilateral notice to the insured may be utilized to serve as the insurer's right to raise coverage defenses).

<sup>58</sup> See *supra* notes 38-40 and accompanying text.

unreasonable or without proper cause.<sup>59</sup> “[D]eclining to perform a contractual duty under the policy with proper cause is not a breach of the implied covenant.”<sup>60</sup> The failure to live up to the obligations of express or implied provisions of the contract, such as the duty to defend, creates liability under contract and tort. For example, an insurer’s erroneous failure to accept a tender of defense of a claim against its insured may constitute a breach of the insurer’s duty to defend and thus a breach of contract. In that circumstance, the insured would be entitled to recover contract damages (including fees and costs incurred in defending the case, and possibly other economic and even emotional distress damages resulting from this breach of contract). No punitive damages can be recovered when there is only a breach of contract. If, in refusing to defend, the insurer acts unreasonably and without proper cause, then it commits not only a breach of contract but also a tort. In this situation, a breach of the implied covenant of good faith and fair dealing has occurred and the insured is entitled to recover not only contract damages but extra-contractual compensatory damages. In extreme cases in which the refusal to defend and denial of coverage are coupled with conduct constituting a severe form of misconduct, punitive damages may be awarded.<sup>61</sup>

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<sup>59</sup> *Bodenhamer v. Superior Court (St. Paul Fire & Marine Ins. Co.)*, 192 Cal. App. 3d 1472, 238 Cal. Rptr. 177 (1987).

<sup>60</sup> *California Shoppers, Inc. v. Royal Globe Ins. Co.*, 175 Cal. App. 3d 1, 54, 221 Cal. Rptr. 171, 200 (1985). “[I]t is our view that a *mistaken withholding* of policy benefits is consistent with observance of the implied covenant of good faith and fair dealing because the mistake supplies the ‘proper cause’.” *Id.* at 55, 221 Cal. Rptr. at 201.

<sup>61</sup> A breach of the insurer’s duty to defend the insured in a third party lawsuit subjects it to liability for whatever litigation expenses—attorney fees and other defense costs—the insured incurred in defending the lawsuit. *See Brandt v. Superior Court*, 37 Cal. 3d 813, 817, 693 P.2d 796, 798, 210 Cal. Rptr. 211, 213 (1985). The potential for extra-contractual recovery comes in the form of additional damages such as any excess judgment resulting from the failure of the insurer to pay its limits either because it refused to do so or simply did not defend the case. *See Samson v. Transamerica Ins. Co.*, 30 Cal. 3d 220, 636 P.2d 32, 178 Cal. Rptr. 343 (1981). California authorities have held further that the insurer will be liable for the amount of any excess judgment against the insured only where the refusal to defend is coupled with an unreasonable refusal to settle within the policy limits. *See California Shoppers, Inc. v. Royal Globe Ins.*, 175 Cal. App. 3d 1, 15, 221 Cal. Rptr. 171, 175 (1985). Once the insurer has unreasonably refused to defend the insured in a third party claim, the insured is entitled to make a reasonable settlement of the claim, and then seek reimbursement. A reasonable settlement is presumptive evidence of the insured’s liability in the underlying claim. *See Betts v. Allstate Ins. Co.*, 154 Cal. App. 3d 688, 201 Cal. Rptr. 528 (1984).

Of course, the insured might also sue the insurer that refuses to defend even where there is not excess judgment, and attempt to recoup defense fees and expenses, plus damages for emotional distress and other proximately related damages, and punitive damages which are proven by the applicable standard. *See Tibbs v. Great Am. Ins. Co.*, 755 F.2d 1370 (9th Cir. 1987).

## B. *Factors Showing Breach of Covenant*

While this list is not by far exhaustive, the following are indicia of conduct that might support the finding of bad faith:

- (1) Failure to investigate a claim thoroughly;
- (2) Failure to evaluate a claim objectively;
- (3) Unduly restrictive interpretation of policy language or claims forms;
- (4) Using improper standards to deny a claim;
- (5) Unjustified delay in payment of a claim;
- (6) Dilatory claims handling;
- (7) Deceptive practices to avoid payment of a claim;
- (8) Abusive or coercive practices to compel compromise of a claim;
- (9) Unreasonable conduct during litigation;
- (10) Arbitrary and unreasonable demands for proof of loss;
- (11) Absence of a reasonable basis for the denial of a claim or delay in payment;
- (12) Failure of surety to act in good faith;
- (13) Improper refusal to defend an insured;
- (14) Improper handling of defense of insured resulting in loss of goodwill; and
- (15) Deliberate misinterpretation of records or the policy to defeat coverage.

## C. *Duty to Investigate*

### 1. *Nature of the Duty*

An insurer's duty to investigate is an important part of any bad faith case arising from the handling of first party and third party claims. The investigation must be prompt, thorough, reasonable, and conducted in good faith.

One aspect of the duty to investigate is officially codified in some states' unfair practices statutes, which may proscribe the failure "to adopt and implement reasonable standards for the prompt investigation and processing of

claims arising under insurance policies.”<sup>62</sup> Although a separate cause of action rarely exists under these statutes,<sup>63</sup> the application of the duty to investigate remains important.<sup>64</sup> An erroneous and unreasonable denial of claims is frequently coupled with an insurer’s failure to investigate a claim, thus breaching the implied covenant of good faith and fair dealing. Hence, the threshold question in any action for breach of the implied covenant of good faith and fair dealing is: Did the insurer adhere to its duty to investigate the claim?

## 2. *When Coupled with a Withholding of Benefits or Denial of the Claim*

An erroneous withholding of policy benefits or a denial of the claim that results from the failure to investigate the claim thoroughly may constitute a breach of the implied covenant. In order to protect the insured’s peace of mind and security, “an insurer cannot reasonably and in good faith deny payments to its insured without thoroughly investigating the foundation for its denial.”<sup>65</sup> Furthermore, the insurer must fully inquire into possible bases that might support the insured’s claim.

## 3. *When Duty Arises*

The insurer’s duty to investigate arises when the insurer has sufficient notice of the insured’s claim. In order to maintain a tort action for breach of the implied covenant, however, the insurer must have had actual notice of the claim. Constructive notice of a claim is sufficient only for a breach of contract action by the insured. “While constructive notice has significance in determining contractual liabilities, it has no application [regarding tort liabilities]. More particularly, without actual presentation of a claim by the insured in compliance with claims procedures contained in the policy, there is no duty imposed on the insurer to investigate the claim.”<sup>66</sup> The insurer’s duty to investigate is triggered once the insured has made a good faith effort to comply with the notice of loss provisions in the insurance policy. Nonetheless, the insurer’s duty to investigate is independent of the insured’s duty to comply with the policy provisions. Thus, an insurer may be required to make independent inquiry when the insured failed to supply requested information regarding the claim.

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<sup>62</sup> IND. CODE § 27-4-1-4.5(3) (1981); CAL. INS. CODE § 790.03(h)(3) (West 1972).

<sup>63</sup> See *supra* note 36 and accompanying text.

<sup>64</sup> Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979), *cert. denied*, 445 U.S. 912 (1980).

<sup>65</sup> Egan, 24 Cal. 3d at 819, 598 P.2d at 457, 157 Cal. Rptr. at 487.

<sup>66</sup> California Shoppers, Inc. v. Royal Globe Ins. Co., 75 Cal. App. 3d. 1, 57, 221 Cal. Rptr. 171, 202 (1985).

#### 4. *Independent Inquiry Required*

The duty to investigate is described as an obligation of “thoroughly investigating the foundation for [a claims’s] denial,” and “full[y] inquir[ing] into the possible bases that might support the insured’s claim.”<sup>67</sup> The insurer must pursue all reasonable avenues in its investigation of a claim, including avenues that favor coverage to the insured. An insurer who fails to perform an even-handed investigation exposes itself to a sizable jury verdict for breach of the implied covenant of good faith and fair dealing.

The insurer’s obligation to investigate a claim arises when the insured has made a “good faith effort to comply with claims procedures.” If the policy requires written notice of claim or a written proof of loss, the insurer is under no duty to investigate until the insured has made a reasonable effort to comply with both requirements. “[A]ny responsibility to investigate on an insurer’s part would not arise unless and until the threshold issue as to whether a claim was filed, or a good faith effort to comply with claims procedure was made, has been determined.”<sup>68</sup> The insurer cannot delay its investigation by insisting on both a written notice of claim and a subsequent proof of claim if both essentially request the same information. An insurer is required to make its own independent inquiry into the facts of the claim even if the insured fails to supply those facts; the insured’s failure to provide requested information that is obtainable by reasonable investigation is no excuse for the insurer’s lack of further inquiry.<sup>69</sup>

#### 5. *Guidelines for Investigation*

Insurers should consider the following guidelines for investigating environmental claims:

(1) Gather material facts pertinent to the claim, including evidence supporting coverage.

(2) Develop accurate investigation reports. A report with obvious or frequent inaccuracies indicates that the investigation was not carefully conducted.

(3) Prepare the investigation reports in an objective fashion. Subjective impressions and conclusions that have no basis in fact indicate bias and an intent to slant the facts to justify a denial of the claim.

(4) Obtain significant information that is reasonably available by obtaining pertinent available records, contacting witnesses by letter, telephone, or

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<sup>67</sup> *Egan*, 24 Cal. 3d at 819, 598 P.2d at 457, 157 Cal. Rptr. at 486-87.

<sup>68</sup> *Paulfrey v. Blue Chip Stamps*, 150 Cal. App. 3d 187, 199, 197 Cal. Rptr. 501, 508 (1983).

<sup>69</sup> *See McCormick v. Sentinel Life Ins. Co.*, 153 Cal. App. 3d 1030, 1047-48, 200 Cal. Rptr. 732, 742 (1984).



personal interview, etc. Undeveloped or unresolved facts imply that the insurer conducted a minimal and inadequate inquiry into the claim.

(5) Follow up all leads developed during your inquiry to discover reasonably available additional information. Do not pursue only those leads that may produce a basis for denying the claim.

(6) Avoid relying solely on information provided by the insured. Develop information through other reasonably available sources.

(7) Conduct the investigation as promptly as possible so as to obtain available facts essential to a proper claims decision. Always explain substantial delays that occur before the commencement or completion of the investigation.

(8) Ensure that the investigation is conducted by competent personnel who have adequate training and experience.

(9) Promptly engage independent experts whose observations and opinions are essential to a proper resolution of the claim, and provide the experts with the records and resources to make a proper inquiry. Because environmental claims can be exceedingly complex, it is almost imperative that expert analyses and studies be conducted. In many instances, the insured will have such studies to support an environmental claim. The reputation, skill, and experience of the insured's experts, as well as the thoroughness and objectivity of the study, should be considered in determining whether additional studies are needed. While such expert studies can be exceedingly expensive, the failure to conduct such studies could yield even more costly results to the insurer.

(10) Conduct an adequate investigation into the present state of the law.

### *6. Reliance on Investigation of Official Agencies*

An insurance company may rely on the investigation by an official agency provided that the investigation meets the standard applicable to insurers and develops the required information to determine the existence or nonexistence of coverage. If the official agency's investigation meets the standard applicable to insurers, the insurer should then monitor the official agency's investigation and be prepared to conduct its own inquiry or supplement the official investigation if needed to comply with its own duties to the insured.

It is important to note, however, that most environmental liability statutes do not necessarily touch on coverage issues. Instead, demands and actions against the insured pursuant to those environmental statutes proceed on strict liability. Thus, the trend is moving towards requiring the insurer to fulfill its contractual obligations under the policy and conduct its own independent investigation into environmental claims.<sup>70</sup>

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<sup>70</sup> *Higgins Indus., Inc. v. Fireman's Fund Ins. Co.*, 730 F. Supp. 774, 777 (E.D. Mich. 1989).

An insurer may attempt to postpone its own investigation to avoid expenses and conserve time by waiting for the results of an official agency's investigation into the facts that serve as the basis for the claim. If the insurer relies on the investigation of official agencies and does not conduct its own investigation, then it takes several risks: (1) that the official agency's investigation will be incomplete; (2) that the additional facts which could have been developed had the investigation been promptly performed are now unavailable; and (3) that the official agency's investigation is delayed for an unreasonable period of time, which in turn, results in an unreasonably delayed claims decision.

### *7. Unreasonable Investigation as Tort*

There are limits on how far an insurer may go in investigating a claim. Unreasonable investigative efforts may be actionable as an invasion of privacy, trespass, or other tort. Thus, it would be unreasonable for an insurer to engage in investigative efforts that are tortious even if this is the only means by which information pertinent to the claim can be gathered (*e.g.*, intrusive surveillance that violates insured's right of privacy).<sup>71</sup>

## *D. Punitive Damage Claims*

### *1. In General*

Punitive damages are not recoverable in actions for breach of contract. Punitive damages are, however, recoverable in actions amounting to an independent tort if the plaintiff meets the standard established by the different jurisdictions for awarding such damages.

### *2. Standard for Awarding Punitive Damages*

A finding that an insurer acted in bad faith does not by itself justify an award for punitive damages. Generally, the insured must prove that the breach complained of was done in a malicious, fraudulent, or oppressive manner.<sup>72</sup>

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<sup>71</sup> See *Cain v. State Farm Mut. Auto. Ins. Co.*, 62 Cal. App. 3d 310, 132 Cal. Rptr. 860 (1976).

<sup>72</sup> See, *e.g.*, CAL. CIV. CODE § 3294(a) (West 1970 & Supp. 1991):

(a) In an action for the breach of an obligation not arising from contract, where it is proven by clear and convincing evidence that the defendant has been guilty of oppression, fraud, or malice, the plaintiff, in addition to the actual damages, may recover damages for the sake of example and by way of punishing the defendant.

Evidence of negligence or an honest mistake is insufficient to justify an award for punitive damages.<sup>73</sup>

The approach to awarding punitive damages varies among the states. In California, the plaintiff may recover punitive damages only in tort cases, and not for breach of contract, but an additional showing over and above tort liability must be shown. The defendant must have acted with "oppression, fraud, or malice."<sup>74</sup>

Because punitive damages are awarded "primarily to punish wrongdoers and deter the commission of wrongful acts,"<sup>75</sup> proof of a breach of the covenant alone does not meet the standard for awarding punitive damages.<sup>76</sup>

The Nevada Supreme Court recently held, for example, that its statute required evidence of intent to deliberately harm the plaintiff before awarding punitive damages.<sup>77</sup>

The Arizona Supreme Court has held that bad faith handling of an insurance claim alone is insufficient to sustain a punitive damage award.<sup>78</sup> In order to recover any punitive damage award, the insured must establish that the insurer intended to harm the insured or that the insurer consciously conducted himself in a manner he knew would create a substantial risk of harm. Evidence that the insurer acted out of spite, with actual malice, with intent to defraud, or with conscious and deliberate disregard to the rights of others will justify a punitive damages award.<sup>79</sup>

The Texas courts award punitive damages to plaintiffs only if the verdict is supported by evidence that establishes all the elements of the causes of action and that the defendant acted with malice, intent to defraud, or gross negligence.

Some states have adopted a less stringent standard for awarding punitive damages. For example, the Indiana courts have awarded punitive damages in

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<sup>73</sup> See, e.g., *Gurule v. Illinois Mut. Life & Casualty Co.*, 152 Ariz. 600, 602, 734 P.2d 85, 87 (1987); *National Mut. Ins. Co. v. Neville*, 434 N.E.2d 585, 596 (Ind. App. 1982).

<sup>74</sup> See statutes cited *supra* note 74.

<sup>75</sup> *Devlin v. Kearny Mesa AMC/Jeep/Renault, Inc.*, 155 Cal. App. 3d 381, 387, 202 Cal. Rptr. 204, 208 (1984).

<sup>76</sup> *McLaughlin v. Connecticut Gen. Life Ins. Co.*, 565 F. Supp. 434 (N.D. Cal. 1983); *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 462, 521 P.2d 1103, 1110, 113 Cal. Rptr. 711, 718 (1974).

<sup>77</sup> *Craig v. Circus-Circus Enters.*, 106 Nev. 1, 786 P.2d 22 (1990).

<sup>78</sup> *Gurule v. Illinois Mut. Life & Casualty Co.*, 152 Ariz. 600, 601, 734 P.2d 85, 86 (1987).

<sup>79</sup> Similarly, Idaho requires proof that the insurer acted with an extremely harmful state of mind, *i.e.*, malice, oppression, fraud, wantonness or gross negligence, *see* *Garnett v. Transamerica Ins. Servs.*, 118 Idaho 769, 800 P.2d 656 (1990), while West Virginia requires proof that the insurer actually knew that the claim was proper but willfully, maliciously, and intentionally denied the claim before punitives can be awarded to the insured, *see* *Shamblin v. Nationwide Mut. Ins. Co.*, 396 S.E.2d 766, 772 (W. Va. 1990).

the absence of any showing of malice, ill will, or intent to injure. Although the Indiana courts are reluctant to award punitive damages, such damages are permitted in cases in which the plaintiff establishes the elements of a common law tort independent of any breach. Thus, the insurer has a greater exposure to punitive damages if the insured's claim is denied or remains unsettled.<sup>80</sup>

### 3. *Clear and Convincing Evidence Versus Preponderance of the Evidence*

Some states such as Alabama, Alaska, Florida, Indiana, Kentucky, Montana, Oregon, and South Carolina statutorily require that the evidence supporting a punitive damage award must be clear and convincing.

Montana, which requires the punitive damage award standard to be proved by clear and convincing evidence, defines "clear and convincing" as "evidence in which there is no serious or substantial doubt about the correctness of the conclusions drawn from the evidence . . . but less than beyond a reasonable doubt."<sup>81</sup> Likewise, California, Kentucky, and North Dakota require proof by clear and convincing evidence that the defendant is guilty of oppression, fraud, or malice before awarding punitive damages.<sup>82</sup>

Only a handful of states require proof of evidence by a lesser standard. For example, Idaho and New Jersey require only proof by a preponderance of the evidence.<sup>83</sup> By contrast, Colorado requires proof beyond a reasonable doubt.<sup>84</sup>

## IV. ENVIRONMENTAL COVERAGE ISSUES THAT ARE POTENTIAL AVENUES FOR BAD FAITH CLAIMS

### A. *Exhaustion of Limits*

#### 1. *In General*

In actions involving environmental injury, the insured is often covered with layers of primary and excess insurance in each policy period. Before an excess carrier has the duty to provide coverage under its policy, the limits of the

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<sup>80</sup> *Vernon Fire & Casualty Ins. Co. v. Sharp*, 264 Ind. 599, 349 N.E.2d 173 (1976); Arthur, *Insurance*, 17 IND. L. REV. 223 (1984).

<sup>81</sup> MONT. CODE ANN. § 27-1-221(5) (1987).

<sup>82</sup> CAL. CIV. CODE § 3294(a) (West 1970 & Supp. 1991); KY. REV. STAT. ANN. § 411.184 (Michie/Bobbs-Merrill 1988); N.D. CENT. CODE § 32-03.2-11 (1987).

<sup>83</sup> IDAHO CODE § 6-1604(1) (1988); N.J. STAT. ANN. § 2A 58C-5(a) (1987).

<sup>84</sup> COLO. REV. STAT. § 13-25-127(2) (1963).

primary policy that the excess policy follows must be exhausted.<sup>85</sup> A problem may arise when two or more of the policies within a single layer contain an "other insurance" or escape clause, i.e., the pro rata provision or the excess provision.

The "other insurance" provision is a vehicle used by primary insurers to limit their liability. The excess provision serves to convert the primary policy into an excess policy when there is another primary policy covering the same risk.<sup>86</sup> The pro rata provision serves to prorate its share of the liability when there is other collectible insurance for the same risk.<sup>87</sup>

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<sup>85</sup> *New Castle v. Continental Casualty Co. (CNA)*, 725 F. Supp. 800, 817 (Del. 1989), *aff'd*, 933 F.2d 1162 (3d Cir. 1991); *Hartford Accident & Indem. Co. v. Sequoia Ins. Co.*, 211 Cal. App. 3d 1285, 1302, 260 Cal. Rptr. 190, 198 (1989).

<sup>86</sup> A standard "other insurance" provision reads:

The insurance afforded by this policy is primary insurance, except when stated to apply in excess of or contingent upon the absence of other insurance. When this insurance is primary and the insured has other insurance which is stated to be applicable to the loss on an excess or contingent basis, the amount of the company's liability under this policy shall not be reduced by the existence of such other insurance.

Thomas W. Johnson, *Standard Insurance Forms* 4 app. (1990).

<sup>87</sup> A standard pro rata provision reads:

If all of such other valid and collectible insurance provides for contribution of equal shares, the company shall not be liable for a greater proportion of such loss than would be payable if each insurer contributes an equal share until the share of each insurer equals the lowest applicable limit of liability under any one policy or the full amount of the loss is paid, and with respect to any amount of loss not so paid the remaining insurers then continue to contribute equal shares of the remaining amount of the loss until each such insurer has paid its limit in full or the full amount of the loss is paid.

If any such other insurance does not provide for contribution by equal shares, the company shall not be liable for a greater proportion of such loss than the applicable limit of liability under this policy for such loss bears to the total applicable limit of liability of all valid and collective insurance against such loss.

## 2. *Other Insurance as Excess*

Policies that do not contain the excess provision are the first tier of insurance. Policies with the excess provision create a second tier of insurance by converting their primary status to excess. However, policies containing excess provisions that cover the same risk cancel themselves out. Hence, in claims that have exhausted the first tier of insurance, the second tier insurers must share in the loss.<sup>88</sup>

Some jurisdictions prorate the total loss against the maximum limits of each policy.<sup>89</sup> Some jurisdictions that oppose the policy-limit method prorate the loss according to the amount of premiums paid.<sup>90</sup> A strong movement is emerging, however, that rejects both the policy-limit method and the premiums-paid method. Instead, an increasing number of jurisdictions find that prorating the loss equally among the insurers is a far more equitable and reasonable method.<sup>91</sup>

## 3. *Other Insurance Prorated Versus Excess*

Unlike policies with the excess provisions, policies with the pro rata provision that cover the same risk are not repugnant to each other, but are compatible. If two primary policies, one with a pro rata provision and the other with an excess provision, cover the same risk, then a conflict seemingly exists. In reality, however, no conflict exists. In fact, both the pro rata and the excess provisions are given full force and effect. The primary policy with the pro rata provision does not convert to an excess policy when there is other collectible primary insurance. It simply prorates the amount it is liable to pay for the loss. The primary policy with the excess provision does convert to an excess policy at the sight of other collectible primary insurance. Thus, there is no coverage under a primary policy that contains an excess provision until the limits of all other collectible primary insurance are exhausted.<sup>92</sup>

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<sup>88</sup> *Reliance Ins. Co. v. St. Paul Surplus Lines Ins. Co.*, 753 F.2d 1288, 1291-92 (4th Cir. 1985).

<sup>89</sup> *E.g.*, *St. Paul Mercury Ins. Co. v. Underwriters at Lloyds*, 365 F.2d 659 (10th Cir. 1966).

<sup>90</sup> *E.g.*, *Ruan Transp. Corp. v. Truck Rentals*, 278 F. Supp. 692 (D. Colo. 1968); *Insurance Co. v. Employers Liab. Assurance Corp.*, 163 F. Supp. 143 (S.D. Cal. 1958).

<sup>91</sup> *E.g.*, *St. Paul Mercury Ins. Co. v. Pennsylvania Casualty Co.*, 642 F. Supp. 180, 184 (D. Wyo. 1986); *Cosmopolitan Mutual Ins. Co. v. Continental Casualty Co.*, 28 N.J. 554, 147 A.2d 529 (1959).

<sup>92</sup> *St. Paul Mercury Ins. Co. v. Pennsylvania Casualty Co.*, 642 F. Supp. 180, 182-85 (D. Wyo. 1986); *Jones v. Medox, Inc.*, 430 A.2d 488 (D.C. 1981).

## B. *Conflicts Between Application, Declaration, and Insuring Agreements*

In general, an intent to incorporate the application, declaration, and other documents into the policy must be clear.<sup>93</sup> If the application, declaration, or other documents are attached to the policy, then they must be reasonably construed together with the policy as a whole.<sup>94</sup>

If a conflict exists among the application, the declaration, and the policy, the language of the policy governs.<sup>95</sup> Some courts, however, hold that the application controls over the policy when the language of the application affords better coverage. In such situations, the courts will construe the conflicting language of the application and the policy in the light most favorable to the insured.<sup>96</sup>

## C. *Definition of Environmental Impairment*

In addition to private third party actions, the federal and state environmental agencies, by statute, may compel the clean up of the contaminated waste sites or seek the reimbursement of costs they expended to remedy the impairment. Most of the environmental response statutes specifically address and define a particular type of environmental impairment and the remedial action available.<sup>97</sup>

In the standard CGL policy, "environmental impairment" is not mentioned. Instead, the CGL policy provides coverage for environmental impairment through its pollution exclusion clause. Under the pollution exclusion clause, the insurer will provide coverage for bodily injury or property damage arising out

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<sup>93</sup> See, e.g., *Taylor v. Kinsella*, 742 F.2d 709 (2d Cir. 1984); *Thompson v. Harold Thompson Trucking*, 12 Kan. App. 2d 449, 748 P.2d 430 (1987) (the declaration must be specifically included by reference to become part of a contract).

<sup>94</sup> *New England Mut. Life Ins. Co. v. Lauffer*, 215 F. Supp. 91 (S.D. Cal. 1963); *West v. Rudd*, 242 Ga. 393, 249 S.E.2d 76 (1978); *Lightner v. Centennial Life Ins. Co.*, 242 Kan. 29, 744 P.2d 840 (1987).

<sup>95</sup> See COUCH ON INSURANCE 2d § 15:32 (1985), citing *Mutual Life Ins. Co. v. Hill*, 193 U.S. 551 (1904); see also *Interstate Life & Acc. Ins. Co. v. Flanagan*, 284 So. 2d 33 (Miss. 1973) (language of policy supersedes that of insurance application).

<sup>96</sup> See *Mathews v. Ranger Ins. Co.*, 281 So. 2d 345 (Fla. 1973); COUCH ON INSURANCE 2d § 15:32 (1985).

<sup>97</sup> The environmental response statutes, both federal and state, are designed to protect public health and the environment. See, e.g., *Solid Waste Disposal Act*, 42 U.S.C.A. § 6901 (West 1983 & Supp. 1991); *Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)* 42 U.S.C.A. § 9602 (West 1983 & Supp. 1991); *Safe Drinking Water Act*, 42 U.S.C.A. § 300g-1 (West 1991); *Clean Air Act*, 42 U.S.C.A. § 7401 (West 1983 & Supp. 1991); and *Maguson Fishery Conservation and Management Act*, 16 U.S.C.A. § 1801 (West 1985 & Supp. 1991).

of the sudden and accidental release of chemical pollutants into the environment.<sup>98</sup> None of the terms in the pollution exclusion are defined.

The standard EIL policy specifically defines "environmental impairment" as the gradual and nonaccidental release of chemical pollutants or generation of sensory phenomena into the environment, which arises out of or occurs in the course of the insured's operations.<sup>99</sup> Although the policy generally sets forth the type of pollutants and sensory phenomena covered under it, the terms are not specifically defined.

The environmental response statutes provide extensive definitions for such terms as "release," "disposal," and "hazardous substance." Although the courts may look to the definitions provided in those statutes to assist in construing the policy, for purposes of determining coverage, the language of the policy dominates.<sup>100</sup> As a general rule of construction, if the policies fail to clearly and unambiguously define terms with specificity, their plain and ordinary meaning applies.<sup>101</sup> If the terms are capable of more than one meaning, they

<sup>98</sup> The standard comprehensive general liability policy reads:

This [insurance] does not apply . . .

(f) to 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 water course or body of water; but this exclusion does not apply if such discharge, dispersal, release or escape is sudden and accidental.

<sup>99</sup> A standard environmental impairment policy reads:

*Environmental impairment*, whenever used in this policy means any one or a combination of the following:

(a) Emission, discharge, dispersal, disposal, release, escape or seepage 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 water course or body of water;

(b) the generation of odor, noises, vibrations, light, electricity, radiation, changes in temperature or any other sensory phenomena;

arising out of or in the course of the Insured's operations, installations or premises, . . . provided (a) or (b) is not sudden and accidental.

<sup>100</sup> *Garriott Crop Dusting Co. v. Superior Court (Southern Ins. Co.)*, 221 Cal. App. 3d 783, 790-94, 270 Cal. Rptr. 678, 681-85 (1990); *Washington Pub. Util. Dists.' Utils. Sys. v. Public Util. Dist. 1*, 112 Wash. 2d 1, 10, 771 P.2d 701 (1989).

<sup>101</sup> *See, e.g., Ray v. Farmers Ins. Exch.*, 200 Cal. App. 3d 1411, 1416, 246 Cal. Rptr. 593, 595 (1988); *Woods v. Nationwide Mut. Ins. Co.*, 295 N.C. 500, 506, 246



must be resolved in favor of the insured's reasonable expectation of coverage.<sup>102</sup>

#### D. Continuous Losses/Appportionment of Liability

##### 1. In General

Both the CGL and EIL policies provide coverage to the insured when an occurrence arises during the policy period. A problem often arises in environmental injury actions because the discharge of, or exposure to, hazardous wastes has occurred over a period of time. The situation is further complicated when different insurers have provided insurance for different periods and with different aggregate limits and exclusions. Thus, a major issue arises as to which policy is triggered when an occurrence takes place.<sup>103</sup>

##### 2. Property Damage

Property damage is not determined at the time the wrongful act occurs; property damage is established when actual damage manifests itself. This is known as the manifestation rule.<sup>104</sup> Generally, the insurer on the risk at the time the damage manifests itself is liable to the insured for coverage.<sup>105</sup>

On the other hand, if the property damage progresses or continues over a substantial period of time, then successive insurers, commencing with the

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S.E.2d 773, 777 (1978); *Claussen v. Aetna Casualty & Sur. Co.*, 259 Ga. 333, 380 S.E.2d 686, *aff'd* 888 F.2d 747 (11th Cir. 1989).

<sup>102</sup> *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 267, 419 P.2d 168, 169, 54 Cal. Rptr. 104, 105 (1966); *Thomas J. Lipton, Inc. v. Liberty Mut. Ins. Co.*, 34 N.Y.2d 356, 361, 314 N.E.2d 37, 39, 357 N.Y.S.2d 705, 708 (1974); *State Capital Ins. Co. v. Nationwide Mut. Ins. Co.*, 318 N.C. 534, 538, 350 S.E.2d 66, 68 (1986); *Transcontinental Ins. Co. v. Washington Pub. Utils. Dists.' Util. Sys.*, 111 Wash. 2d 452, 456-57, 760 P.2d 337, 340 (1988).

<sup>103</sup> See *Birnbaum, Sullivan, & Wrubel, Hazardous Waste Litigation: CGL Coverage Issues, Hazardous Waste, Toxic Torts and Products Liability Insurance Problems*, PLI COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES, NO. 378 (1985).

<sup>104</sup> *Michigan Chem. Corp. v. American Home Assurance Co.*, 728 F.2d 374 (6th Cir. 1984); *State v. Glens Falls Ins. Co.*, 125 Ariz. 328, 609 P.2d 598 (Ariz. Ct. App. 1980); *California Union Ins. Co. v. Landmark Ins. Co.*, 145 Cal. App. 3d 462, 193 Cal. Rptr. 461 (1983); *Millers Mut. Fire Ins. Co. v. Ed Bailey, Inc.*, 103 Idaho 377, 647 P.2d 1249 (1982).

<sup>105</sup> See, e.g., *American Motorists Ins. Co. v. Trane Co.*, 544 F.Supp. 669 (W.D. Wis. 1982), *aff'd*. 718 F.2d 842 (7th Cir. 1983); *United States Fidelity & Guar. Co. v. American Ins. Co.*, 169 Ind. App. 1, 345 N.E.2d 267 (1976).

insurer on the risk at the time of the wrongful act, are liable for coverage.<sup>106</sup> A determination of when the wrongful act occurred, however, is often difficult. Some courts identify the triggering event as when the wastes were released into the environment; others identify the triggering event as when the wastes contaminated the property, or when the contamination was discovered.<sup>107</sup>

### 3. *Bodily Injury*

Private citizens may bring an action against the insured for bodily injury caused from exposure to hazardous waste released into the environment. There are at least four theories upon which coverage can be triggered: (1) the exposure theory, (2) the manifestation theory, (3) the injury-in-fact theory, and (4) the multiple trigger theory.<sup>108</sup>

Under the exposure theory, coverage is triggered when there is exposure to hazardous wastes. The injury need not be actual or apparent. Generally, each exposure is a separate injury causing multiple occurrences. If the injury is of a continuous nature, however, all insurers during the period of exposure are on the risk to provide coverage.<sup>109</sup>

The manifestation theory provides that coverage is triggered when the injury manifests itself. Thus, exposure may have occurred at an earlier point in time when coverage existed, but because there was no manifestation of injury the exposure triggered no coverage under the policy.<sup>110</sup>

The injury-in-fact theory provides that coverage is triggered when the actual injury arises. When the exposure to the hazardous wastes and the manifestation of the injury took place is irrelevant.<sup>111</sup> If it is difficult to pinpoint when the actual injury arose, all of the insurers during the period the injury came into existence are on the risk to provide coverage.<sup>112</sup>

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<sup>106</sup> *California Union Ins. Co. v. Landmark Ins. Co.*, 145 Cal. App. 3d 462, 193 Cal. Rptr. 461 (1983); *Gruol Constr. Co., Inc. v. Insurance Co.*, 11 Wash. App. 632, 524 P.2d 427 (1974).

<sup>107</sup> *Riehl v. Travelers Ins. Co.*, 772 F.2d 19, 23 (3d Cir. 1985).

<sup>108</sup> See S. BIRNBAUM, I. SULLIVAN, & B. WRUBEL, *HAZARDOUS WASTE LITIGATION: CGL INSURANCE COVERAGE ISSUES* (Practicing Law Institute, 1985).

<sup>109</sup> See *Insurance Co. v. Forty-Eight Insulators, Inc.*, 633 F.2d 1212 (6th Cir. 1980), *modified*, 657 F.2d 814 (6th Cir. 1981), *cert. denied*, 454 U.S. 1109 (1981); *Porter v. American Optical Corp.*, 641 F.2d 1128 (5th Cir. 1980), *cert. denied*, *Aetna Casualty & Sur. Co. v. Porter*, 454 U.S. 1109 (1981).

<sup>110</sup> *Eagle-Picher Indus. v. Liberty Mut. Ins. Co.*, 682 F.2d 12 (1st Cir. 1982), *cert. denied*, 460 U.S. 1028 (1983).

<sup>111</sup> See *American Home Prods. Corp. v. Liberty Mut. Ins. Co.*, 748 F.2d 760 (2d Cir. 1984).

<sup>112</sup> *Sandoz, Inc. v. Employer's Liab. Assurance Corp.*, 554 F. Supp. 257 (D. N.J. 1983).

The broadest coverage is afforded under the multiple trigger theory. The multiple trigger theory combines the exposure theory, the injury-in-fact theory, and the manifestation theory.<sup>113</sup> Thus, all insurers who provided coverage to the insured during the exposure of harm are on the risk because the progressive nature of the injury constitutes a single continuous harm.

## E. *Cleanup and Response Costs as "Damage"*

### 1. *Damages Generally*

The definition of damages has always been a thorn in insurance case law. Traditionally, "damages" were narrowly restricted to lawsuits for money damages. In general, "damages" refer to some type of pecuniary compensation determined by the courts for the person who has suffered a loss, detriment, or injury to his person or property because of the unlawful or tortious act of another.<sup>114</sup> Often in insurance actions, courts make the distinction between claims for equitable relief, such as injunctive or restitutive relief, and claims for legal damages.<sup>115</sup>

### 2. *Cleanup and Response Costs*

Some environmental actions involve private individuals who seek damages for bodily injury, personal injury, or property damage resulting from hazardous wastes deposited on adjoining or nearby properties. Most environmental actions, however, are pursued by the state and federal agencies against potentially responsible parties ("PRP") for depositing large amounts of hazardous wastes at various disposal sites over a long period of time.

Typically, the agencies file actions for injunctive relief or restitution based on the results of their investigation. In most cases, the agencies bring an action against the PRP for reimbursement of the cleanup and response costs they expended in the process of cleaning up the disposal sites. In other cases, the agencies seek an injunctive order to compel the PRP to clean up the site itself.

Since the 1950s, the courts have narrowly construed "legal damages" to monetary awards.<sup>116</sup> Prior to the enactment of CERCLA and other environmental statutes, courts held that the CGL policy did not afford coverage

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<sup>113</sup> See *Keene Corp. v. Insurance Co.*, 667 F.2d 1034 (D.C. Cir. 1981), *cert. denied*, 455 U.S. 1007 (1982).

<sup>114</sup> RESTATEMENT (SECOND) OF TORTS § 12A (1969).

<sup>115</sup> See *Maryland Casualty Co. v. Armco, Inc.*, 822 F.2d 1348, 1353 (4th Cir. 1987), *cert. denied*, 484 U.S. 1008 (1988); *Aetna Casualty & Sur. Co. v. Hanna*, 224 F.2d 499, 503 (5th Cir. 1955).

<sup>116</sup> *Aetna Casualty & Sur. Co. v. Hanna*, 224 F.2d 499 (5th Cir. 1955).

to costs incurred in complying with an injunctive order.<sup>117</sup> Since the enactment of CERCLA, the courts have adhered to the general rule that the costs and expenses of hazardous waste cleanups fall outside the ambit of "damages."<sup>118</sup>

Recent cases indicate a movement toward eliminating the distinction between equitable relief and legal damages claims in actions seeking coverage for environmental claims. In *Lansco, Inc. v. Department of Environmental Protection*,<sup>119</sup> the court found that the state had a sovereign interest in real property, and therefore, was entitled to recover damages for environmental harm to the real property.<sup>120</sup> Second, the state statute provided that the state could recover as damages the cost of cleaning up the contamination. For that reason, the court held that the insured had an expectation of coverage in the state's action to obtain damages for harm to public resources and the environment.<sup>121</sup>

Similarly, New York has also rejected the insurance industry's narrow interpretation of the term "legal damages."<sup>122</sup> In actions for coverage of environmental claims, it is important to know that New York legislatively mandates cleanup costs as a measure of damages for environmental injury.<sup>123</sup>

In Michigan, the narrow definition of "damages," which excluded noncompensatory awards, was rejected. The state has an interest in its natural resources. Thus, when there is injury to its natural resources, the state is entitled to recover damages. Damages are measured in terms of the cost to the state to restore the natural resource to its natural state.<sup>124</sup>

The California Supreme Court likewise rejected the exclusion of equitable damages from the term "damages."<sup>125</sup> The Court chose to apply the ordinary

<sup>117</sup> See *id.*; *Desrochers v. New York Casualty Co.*, 99 N.H. 129, 106 A.2d 196 (1954); *Ladd Constr. Co. v. Insurance Co.*, 73 Ill. App. 3d 43, 391 N.E.2d 568 (1979); *Garden Sanctuary, Inc. v. Insurance Co.*, 292 So. 2d 75 (Fla. Dist. Ct. App. 1974).

<sup>118</sup> *Continental Ins. Co. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO II)*, 842 F.2d 977 (8th Cir. 1988), *cert. denied*, 488 U.S. 821 (1988); *Maryland Casualty Co. v. Armco, Inc.*, 822 F.2d 1348, 1352 (4th Cir. 1987).

<sup>119</sup> 138 N.J. Super. 275, 350 A.2d 520 (1975), *aff'd*, 145 N.J. Super. 433, 368 A.2d 363 (1976), *cert. denied*, 73 N.J. 57, 372 A.2d 322 (1977).

<sup>120</sup> The U.S. Supreme Court has held that "the state has a sovereign's interest in the preservation of public resources and the environment enables it to maintain an action to prevent injury thereto." *Georgia v. Tennessee Copper Co.*, 206 U.S. 230, 237 (1907); *Missouri v. Illinois*, 180 U.S. 208, 241 (1901).

<sup>121</sup> *Lansco*, 138 N.J. Super. at 283-84, 350 A.2d at 524-25.

<sup>122</sup> *Kutscher's Country Club v. Lincoln Ins. Co.*, 119 Misc. 2d 889, 465 N.Y.S.2d 136 (1983).

<sup>123</sup> N.Y. NAV. LAW § 170 (McKinney 1979).

<sup>124</sup> *United States Aviex Co. v. Travelers Ins. Co.*, 125 Mich. App. 579, 336 N.W.2d 838 (1983).

<sup>125</sup> *AIU Ins. Co. v. Superior Court (FMC Corporation)*, 51 Cal.3d 807, 799 P.2d 1253, 274 Cal. Rptr. 820 (1990).

and popular dictionary definition of “damages” and found no distinction between monetary compensation and equitable remedies. Furthermore, California Civil Code section 3281 defines “damages” as monetary compensation for a party who has suffered a loss or detriment through the unlawful acts of another. Because the state has an interest in all lands within its jurisdiction, the contamination of real property is a loss for which the state can recover through the reimbursement of cleanup and response costs. Adhering to the rule that the policy provisions must be construed to protect the reasonable expectation of the insured, the court declined to exclude injunctive and restitutive relief from the definition of “damages.”<sup>126</sup>

The courts are not only divided on whether to include cleanup and response costs as “damages,” but also differ in their approach to defining “damages.” Some courts may look to the statutes to determine if cleanup and response costs are an appropriate measure of damages. Others may follow a general rule that excludes the reimbursement of cleanup and response costs as damages. Some may simply rely upon Webster’s dictionary to determine if cleanup and response costs are “damages” under the policy. It is essential that the insurer discover the current state of the law in the jurisdiction in which the action is brought.

## F. Trigger of Coverage

### 1. “Suit”

In the traditional sense, the duty to defend against any “suit” did not arise until the filing of a lawsuit. Some courts adhere to this rule and hold that the insurer’s duty to defend does not arise in the absence of a lawsuit.<sup>127</sup>

Insurers should be aware that some courts no longer limit the policy term “suit” to the filing of the lawsuit. As one court pointed out, the Environmental Protection Agency (“EPA”) has shifted away from the use of lawsuits. Instead, the EPA and similar state environmental agencies have resorted to the use of demand letters to PRP.<sup>128</sup>

The PRP letters inform the PRP that their voluntary participation in the cleanup of the waste sites is requested. If the PRP decline to voluntarily participate in the cleanup plan, criminal penalties can be imposed on the PRP. Because the “consequences of the receipt of the EPA letter [are] so substantially

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<sup>126</sup> *AIU Ins. Co.*, 51 Cal. 3d at 840-42, 274 Cal. Rptr. at 844-45.

<sup>127</sup> *Aetna Casualty & Sur. Co. v. Gulf Resources & Chem. Corp.*, 709 F. Supp. 958, 960 (D. Idaho 1989); *Technicon Elecs. Corp. v. American Home Assurance Co.*, 533 N.Y.S.2d 91, 141 A.D.2d 124 (1988), *aff’d*, 74 N.Y.2d 66, 544 N.Y.S.2d 531, 542 N.E.2d 1048 (1989).

<sup>128</sup> *Hazen Paper Co. v. United States Fidelity & Guar. Co.*, 407 Mass. 689, 697, 555 N.E.2d 576, 581 (1990).

equivalent to the commencement of a lawsuit[,] the duty to defend arose immediately.”<sup>129</sup>

Other courts have stated that to apply the policy term “suit” to the traditional lawsuit is merely an unreasonable argument of form over substance. The environmental agencies seek to impose liability upon the PRP, whether through PRP letters<sup>130</sup> or threats of legal action.<sup>131</sup> Thus, unless the policy language specifically limits the insurer’s duty to defend to actual lawsuits, demands for the cleanup of the waste sites, PRP letters requesting the reimbursements of cleanup costs, and threats of legal action are sufficient to trigger the duty to defend. Obviously in such situations, the failure to defend could give rise to a breach of the implied covenant of good faith and fair dealing and potentially expose the insurer to punitive damages.

## 2. “Sudden and Accidental” Requirement

The CGL policy provides coverage for environmental impairment which is *sudden and accidental*.<sup>132</sup> The EIL policy in contrast provides coverage for environmental impairment that is *not sudden and accidental*.<sup>133</sup>

The requirement that the triggering event either be or not be “sudden and accidental” is, in actuality, a policy exclusion. Generally, exclusions are construed narrowly against the insurer so as to ensure that the insured’s reasonable expectation of coverage is met. Typically, terms are given their popular and ordinary meaning. In many cases, the courts have resorted to the dictionary to discover the popular and ordinary definition of policy terms.

### a. Pollution Exclusion Under the CGL Policy

The terms “sudden” and “accidental” have been extensively dissected by the courts because a policy often embodies the two independent concepts as conditions contrary to the exclusion without defining the exclusion. In the past, most courts found “sudden” and “accidental” ambiguous and resolved the ambiguity in favor of coverage.<sup>134</sup> Because of the ambiguity, some courts held that the terms “sudden” and “accidental” were analogous to the definition of

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<sup>129</sup> *Id.* at 695, 555 N.E.2d at 581.

<sup>130</sup> *Fireman’s Fund Ins. Co. v. Ex-Cell-O Corp.*, 662 F. Supp. 71, 75 (E.D. Mich. 1987).

<sup>131</sup> *See, e.g., U.S. Aviex Co. v. Travelers Ins. Co.*, 125 Mich. App. 579, 586, 336 N.W.2d 838, 841 (1983).

<sup>132</sup> *See supra* note 100 for pollution exclusion clause.

<sup>133</sup> *See supra* note 101 for definition of environmental impairment in an EIL policy.

<sup>134</sup> *New Castle County v. Hartford Accident & Indem. Co.*, 673 F. Supp. 1359 (D. Del. 1987); *Farm Family Mut. Ins. Co. v. Bagley*, 64 A.D.2d 1014, 409 N.Y.S.2d 294 (N.Y. App. Div. 1979).

“occurrence” found in the CGL policy,<sup>135</sup> while other courts held that the terms “sudden” and “accidental” were synonymous with the term “unexpected and unintended.”<sup>136</sup>

A recent trend has emerged rejecting the notion that “sudden” and “accidental” are ambiguous.<sup>137</sup> Instead, “sudden” and “accidental” are afforded their plain and ordinary meaning.<sup>138</sup> Thus, the majority of the courts agree that the meaning of “sudden” and “accidental” is not limited to just “unexpected and unintended.”

There is a judicial consensus that “accidental,” in its plain and ordinary meaning, is equivalent to “unexpected and unintended.” In support of this view, some courts note in the history of the pollution exclusion clause that the insurance industry intended the exclusion to exclude only intentional polluters.<sup>139</sup>

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<sup>135</sup> Jackson Township Mun. Utils. Auth. v. Hartford Accident & Indem. Co., 186 N.J. Super. 156, 451 A.2d 990 (1982) (holding that the terms “sudden and accidental” were a restatement of the occurrence definition in the CGL policy); *see also* Buckeye Union Ins. Co. v. Liberty Solvents & Chem. Co., 17 Ohio App. 3d 127, 477 N.E.2d 1227 (1984).

The typical CGL policy defines “occurrence” as “an accident including continuous or repeated exposure to conditions which results in bodily injury or property damage neither expected nor intended from the standpoint of the insured.”

<sup>136</sup> United States Fidelity & Guar. Co. v. Specialty Coatings Co., 180 Ill. App. 3d 378, 535 N.E.2d 1071 (1989); Broadwell Realty Serv. Inc. v. Fidelity & Casualty Co., 218 N.J. Super. 516, 528 A.2d 76, 85-86 (N.J. Super. Ct. App. Div. 1987); *Just v. Land Reclamation, Ltd.*, 155 Wis. 2d 737, 157 Wis. 2d 507, 456 N.W.2d 570 (1990) (because “sudden and accidental” is undefined by the policy and thus ambiguous, “sudden and accidental” is given its ordinary and popular meaning: “unexpected and unintentional”).

<sup>137</sup> *E.g.*, Colonie Motors, Inc. v. Hartford Accident & Indem. Co., 145 A.D.2d 180, 538 N.Y.S.2d 630, 632 (1989); *see also* Technicon Elecs. v. American Homes Assurance Co., 141 A.D.2d 124, 136, 533 N.Y.S.2d 91, 96 (1988), *aff'd*, 544 N.Y.S.2d 531, 542 N.E.2d 1048 (1989) (“emerging nationwide judicial consensus that the ‘pollution exclusion’ is unambiguous and that an insured who was accused of causing injury or property damage by the intentional discharge of pollutants over an extended period of time is bound by the terms of the exclusion and is not entitled to be defended or indemnified by its insurer”).

<sup>138</sup> Great Lakes Container Corp. v. National Union Fire Ins. Co., 727 F.2d 30 (1st Cir. 1984) (the terms “sudden” and “accidental” have a plain and precise meaning).

<sup>139</sup> In *Just v. Land Reclamation, Ltd.*, 155 Wis. 2d 737, 456 N.W.2d 570 (1990), the Wisconsin Supreme Court noted that: the pollution exclusion clause “was designed to decrease claims for losses caused by expected or intended pollution by providing an incentive to industry to improve its manufacturing and disposal processes, and unintentional or unexpected damages would still be covered as an ‘occurrence’ under the policy.” *Id.* at 749, 456 N.W.2d at 574. *See also* Molten, Allen & Williams, Inc. v. St. Paul Fire & Marine Ins. Co., 347 So. 2d 95, 99 (Ala. 1977), in which the Alabama Supreme Court also recognized that the insurance industry’s purpose in drafting the pollution exclusion was to exclude coverage for intentional polluters:

The pollution exclusion clause provides, however, that the pollution must be both "sudden" and "accidental." Although "sudden" may incorporate some of the characteristics of "accidental," it also has temporal significance.<sup>140</sup> A discharge of hazardous waste must be limited to a specific time and place in order for the court to find the discharge "sudden."<sup>141</sup> Thus, the regular and systematic discharges of hazardous material in the course of the insured's business make them expected and non-sudden and are sufficient to trigger the exclusion and defeat coverage.<sup>142</sup>

It is important to note that some courts still prefer to utilize the occurrence/"unintended and unexpected" type analysis to interpret the pollution exclusion clause. In holding that the terms "sudden" and "accidental" are synonymous with "unintended and unexpected," those courts have stated that long term discharge of hazardous wastes could still be covered under the CGL policy.<sup>143</sup>

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It is believed that the intent of the "pollution exclusion" clause was to eliminate coverage for damages arising out of pollution or contamination by industry-related activities. The use of specific industry-related irritants, contaminants and pollutants seem to indicate this was the reason for the exclusion. We judicially know that during the last decade, much emphasis has been placed upon protecting the environment. The pollution exclusion was no doubt designed to decrease the risk where an insured was putting smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials or other irritants, contaminants or pollutants into the environment.

*Id.* at 99.

<sup>140</sup> *International Minerals & Chem. Corp. v. Liberty Mut. Ins. Co.*, 168 Ill. App. 3d 361, 522 N.E.2d 758 (1988) (the temporal definition of "sudden" limits the discharge to a brief definable period of time); *Technicon Elecs. Corp. v. American Home Assurance Co.*, 141 A.D.2d 124, 533 N.Y.S.2d 91 (N.Y. App. Div. 1988) (logical to construe "sudden" as having temporal significance); *Waste Management v. Peerless Ins. Co.*, 315 N.C. 688, 340 S.E.2d 374 (1986).

<sup>141</sup> *American States Ins. Co. v. Maryland Casualty Co.*, 587 F.Supp 1549 (E.D. Mich. 1984); *Transamerica Ins. Co. v. Sunnes*, 77 Ore. App. 136, 711 P.2d 212 (1985), *rev. denied*, 301 Ore. 76, 717 P.2d 631 (1986).

<sup>142</sup> *Borden, Inc. v. Affiliated F.M.Ins. Co.*, 865 F.2d 1267 (6th Cir. 1989) (the pollution exclusion is clear and unambiguous. It excludes coverage except in those cases where the discharge was sudden and accidental, identifiable as to time and place, and not anticipated by the insured); *Barnet of Indiana, Inc. v. Security Ins. Group*, 425 N.E.2d 201 (Ind. Ct. App. 1981); *City of Milwaukee v. Allied Smelting Corp.*, 117 Wis. 2d 377, 344 N.W.2d 523 (1983), *vacated*, *Just v. Land Reclamation Ltd.*, 155 Wis. 2d 737, 456 N.W.2d 570 (1990).

<sup>143</sup> *Claussen v. Aetna Casualty Co.*, 259 Ga. 333, 380 S.E.2d 686 (1989); *U.S. Fidelity & Guar. Co. v. Specialty Coatings*, 180 Ill. App. 3d 378, 535 N.E.2d 1071 (1989); *Weber v. IMT Ins. Co.*, 462 N.W.2d 283 (Iowa 1990); *Polkow v. Citizens Ins. Co.*, 180 Mich. App. 651, 447 N.W.2d 853 (1989); *Travelers Indem. Co. v. Dingwell*, 414 A.2d 220 (Me. 1980).



b. *Coverage Under the EIL Policy*

EIL policies provide coverage for those who may release or dispose of pollutants in the normal course of their business. Because the EIL policy is a rare breed of insurance, there is very little case law on the interpretation of the EIL policy.<sup>144</sup>

As stated above, the EIL policy provides coverage when the release or disposal of pollutants into the environment was not sudden and accidental. Applying the same rules of construction for the interpretation of “sudden and accidental,” “not sudden and accidental” ordinarily means expected, intended, and continuous. Thus, under the EIL policy, the insurer’s duty to defend arises if the release or disposal of pollutants is expected, intended, and gradual.

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<sup>144</sup> In *Masonite Corp. v. Great Am. Surplus Lines Ins. Co.*, 224 Cal. App. 3d 912, 274 Cal. Rptr. 206 (1990), the California appellate court was confronted with the task of interpreting an EIL policy. Unlike standard EIL policies, which provide coverage for the expected or intended gradual release or discharge of pollutants into the environment, the Great American EIL policy provided coverage for environmental damage caused by the gradual, fortuitous, unintended, and unexpected release or discharge of pollutants into the environment arising out of or in the course of the insured’s operations. The court found no ambiguity in the coverage provision; instead, it applied the ordinary meanings to “gradual, fortuitous, unintended and unexpected.”

### c. *Cause Versus Effect*

The courts are divided on whether “sudden and accidental” applies to the cause of the environmental damage, *i.e.*, the act of disposing or releasing contaminants into the environment, or to the damage resulting from the pollution. The majority view is that “sudden and accidental” applies to the act of disposing or releasing the contaminants into the environment.<sup>145</sup>

For those in the minority, the issue becomes whether the bodily injury or property damage was unexpected or unintended. The test is a subjective one and examines the intentions or expectations of the insured.<sup>146</sup>

### 3. *Insured-Owned Property Exclusion*

The CGL policy’s third party nature provides coverage to a private citizen, such as a neighbor, for property damage caused by the seepage of hazardous wastes from the insured’s own property. The standard CGL insurance policy, however, contains an insured-owned property exclusion that excludes coverage for damage to property owned by the insured.<sup>147</sup> An exception is carved out

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<sup>145</sup> See, *e.g.*, *City of Carter Lake v. Aetna Casualty & Sur. Co.*, 604 F.2d 1052, 1058 (8th Cir. 1979) (“if the damage was not intentionally caused, it was caused by accident. Whether the damage was expected is not considered.”); *Du-Wel Products v. U.S. Fire Ins. Co.*, 236 N.J. Super. 349, 565 A.2d 1113, *cert. denied*, 121 N.J. 617, 583 A.2d 316 (1990); *Lower Paxton Township v. United States Fidelity and Guar. Co.*, 383 Pa. Super. 558, 578, 557 A.2d 393 (1989) (insured has the burden of proving that there was an abrupt discharge of gas); *Technicon Elecs. Corp. v. American Home Assurance Co.*, 141 A.D.2d 124, 144, 533 N.Y.S.2d 91, 103 (N.Y. App. Div. 1988), *aff’d* 74 N.Y.2d 66, 544 N.Y.S.2d 531, 542 N.E.2d 1048 (1989) (“the logical and proper application of the pollution exclusion depends solely upon the method by which the pollutants entered the environment.” (citations omitted)).

<sup>146</sup> *Waste Management v. Peerless Ins. Co.*, 72 N.C. App. 80, 87, 323 S.E.2d 726, 731 (1984).

<sup>147</sup> The standard CGL insured-owned property exclusion provides as follows:

This insurance does not apply to:

- (k) *property damage to*
    - (1) property owned or occupied by or rented to the *insured*,
    - (2) property used by the *insured*, or
    - (3) property in the care, custody or control of the *insured* or as to which the *insured* is for any purpose exercising physical control;
- but parts (2) and (3) of this exclusion do not apply with respect to liability under a written sidetrack agreement and part (3) of this exclusion does not apply with respect to *property damage* (other than the *elevators*) arising out of the use of an *elevator* at premises owned by, rented to or controlled by the *named insured*.[.]

for actions or demands by the governmental agencies to remedy environmental injuries to the insured's own property.

In recent cases involving coverage for environmental liability under the CGL policy, the courts recognize that both the federal and the state governments have a proprietary or quasi-sovereign interest in all real property and natural resources.<sup>148</sup> Thus, actions or demands against the insured by governmental agencies for environmental injuries become third party actions or demands to remedy environmental injuries to the public's property.

## V. CONCLUSION

The advent of CERCLA and other environmental response statutes has brought a new wave of multi-million dollar claims for insurers to handle. Because of the complexity involved in handling environmental claims, the risk of exposure to bad faith liability is even greater. Such being the case, the insurer's only buttress against multi-million dollar bad faith actions and even greater punitive damage awards is proper claims handling.<sup>149</sup> The insurer must

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<sup>148</sup> *Continental Ins. Co. v. Northeastern Pharmaceutical & Chem. Co. (NEPACCO I)*, 811 F.2d 1180 (8th Cir. 1987), *on reh'g*, 842 F.2d 977 (8th Cir. 1988) (citing *Missouri v. Illinois*, 180 U.S. 208, 240-43 (1901)); *AIU Ins. Co. v. Superior Court (FMC Corp.)*, 51 Cal. 3d 807, 829, 274 Cal. Rptr. 820, 836 (1990).

<sup>149</sup> Claims administration requires attention to (1) file management; (2) good investigation techniques; (3) personal skills at dealing with the outside world, particularly the insured and its representatives; and (4) sound judgment based on well-gathered and accurate information. Sloppy, inattentive, and careless claims administration can lead to not only extra-contractual compensatory awards, but also punitive damages. *See, e.g.*, *Betts v. Allstate Ins. Co.*, 154 Cal. App. 3d 688, 201 Cal. Rptr. 528 (1984); *Fleming v. Safeco Ins. Co. of Am.*, 160 Cal. App. 3d 31, 206 Cal. Rptr. 313 (1984); *Gourley v. State Farm Mut. Auto. Ins. Co.*, 227 Cal. App. 3d 1099, 265 Cal. Rptr. 634 (1990), *rev'd on other grounds*, 53 Cal. 3d 121, 279 Cal. Rptr. 307, 806 P.2d 1342 (1991).

Those who testify in bad faith cases as representatives of the insurer must focus on (1) the impression created by the presentation in the courtroom and (2) the impression created by how the file was handled. Jurors will form perceptions about how the company does business, and how it treats its policyholders from the testimony of the company witnesses.

The jury must be persuaded that the claim was handled objectively, fairly, thoroughly, and in an unbiased fashion. A claims witness must be able to competently explain not only *what was done*, but *why—the rationale for claims decisions, and the methodology employed*. The inability to explain the claim's "methodology" was one of the points made by the Court of Appeal in *Gourley v. State Farm Mut. Auto. Ins. Co.*, 227 Cal. App. 3d 1099, 266 Cal. Rptr. 455 (1990), *modified*, 53 Cal. 3d 121, 806 P.2d 1342, 279 Cal. Rptr. 307 (1991), which led to that court affirming an award of \$1.5 million in punitive damages.

An investigation should be thorough, prompt, and fair, and devoid of biased or prejudiced comments. As a practical matter, facts must be tested to make sure they are accurate. Primary sources, if reasonably available, should be consulted when possible.

make a good faith attempt to fulfill its obligations, both expressed and implied, under the contract, while at the same time safeguarding its own interest through a properly worded reservation of rights and defenses.

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Claims decisions should not be made on assumptions. In some cases, logical conclusions can be reached from well-documented and accurate facts, but speculation must be avoided. Rumor also does not justify or support claims decisions. Verification of information is critical to the insurer's duty to investigate, and is a corollary to this duty.

Insurers should always follow up their communications with the insureds in writing. Following up in writing serves to protect the insurer. First, following up each communication with the insured creates a record showing that the insurer was actively handling the insured's claim. Furthermore, it produces a record of what was actually communicated, and reduces conflicting testimonies regarding what representations the insurer made upon which the insured relied.

The records on which the insurer bases its claims decision is the product of its investigation. It is important to obtain all the records reasonably necessary to do a thorough investigation and to make a fair decision regarding coverage.

Always avoid cutting corners. Often the insurer will know from gut instincts and experience at day one that the claim is not meritorious, but should obtain all the records anyway. There will be a problem if there is not enough information in the file to OBJECTIVELY justify the denial. Remember that the insurer needs to create the impression to a group of lay persons that there was sufficient, objective data to justify the denial. Without enough objective, verifiable *facts and information to back up its decision*, it will appear to the lay persons several years later that the insurer was looking for ways to deny the claim.

The insurer should always remember that it is creating an impression for a group of lay persons who will review the claims file some time in the future. Therefore, the insurer should always consider the use of experts.

For example, the insurer suspects that the corporation has been knowingly and intentionally disposing hazardous waste in defective containers. The insurer is probably right, but it is dangerous to deny the claim on that basis because the insurer is not a specialist. As part of the duty to evaluate the claim objectively, the insurer should protect itself by using experts.

A typically common basis for a bad faith suit is that the company took too long to process and decide the claim. Although the delay alone is not deadly, unexplained delay can be lethal. In addition to following up on the delay in writing, always let the insured know what is going on.

Although putting notes, observations, conclusions, etc., in writing means this written information can be used against the insurer later, reaching the incorrect claims decision is not the end of the world so long as the insurer has thoroughly and fairly investigated the claim. A well-documented claims file will subdue the jury's wrath.

Under no circumstances should the insurer delete from or alter the file. File alterations and deletions are not only unethical, but they are unbelievably dangerous.

A poorly maintained file will look even worse when the truth comes out. For instance, given the number of people involved on these files, alterations or deletions will create discrepancies. The discrepancies are not limited to the file itself; discrepancies between the file and the testimony of the claims handlers will arise and serve to discredit the company.