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Special Bulletin

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California Supreme Court Limits Application of Pollution Exclusion

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On March 9, 2009, the California Supreme Court issued its opinion in *State of California v. Allstate Insurance Company*, Case No. S149988, which addressed the application of pollution exclusions in liability policies issued to the State of California for property damage claims resulting from discharges of pollutants. In a unanimous decision, the Supreme Court concluded:

- The relevant discharges for purposes of applying a pollution exclusion with a "sudden and accidental" exception were discharges *from* the site, rather than the initial deposits *to* the site; and

- Where indivisible property damage is caused by multiple releases of pollutants, some "sudden and accidental" (covered), and others gradual or non-accidental (not covered), an insured is not required to apportion damages between the covered and non-covered causes in order to obtain coverage if the covered releases were substantial factors contributing to contamination.

It also held that triable issues of fact exist as to whether coverage would be barred for a 1969 overflow event under pollution exclusions which apply to discharges of pollutants "into or upon any watercourse" and for 1978 releases on the grounds that they were not "accidental."

BACKGROUND

In the mid-1950s, the State designed and built an industrial waste disposal facility (now called the Stringfellow Superfund Site) at a former rock quarry in a canyon in Riverside County, California. More than 30 million gallons of industrial waste were deposited into unlined ponds at the Site, contaminating the underlying groundwater through an underground stream channel. In 1969, a rainstorm caused a concrete barrier dam to overflow and send polluted water down the canyon. In 1972, the State closed the facility after discovering evidence of groundwater contamination.

In 1974, the State's chief geologist inspected the site and prepared a report which concluded that there was a danger that the ponds would again flood in the event of heavy rains. The report suggested that the State implement several measures to prevent flooding. The State did not implement any of the recommended measures. After unusually heavy rains in 1978, the ponds were on the brink of overflowing and the retention dam at the site began to fail. As a preventive measure, the State made a series of controlled discharges from the ponds, releasing about one million gallons of polluted waste down the canyon.

The State and the U.S. government subsequently filed suit in federal court against companies that had disposed of waste at the site. The companies counterclaimed against the State. In 1998, a district court found the State liable for past and future costs of remediating soil and groundwater contamination. The court further determined that the 1978 releases would not have occurred if the State had followed the recommendations in the 1974 report.

The State sued its primary and excess liability insurers after they denied coverage for the State's claim. Certain insurers moved for summary judgment on the grounds that pollution exclusions in their policies barred coverage.[1] The trial court granted the motions and the State appealed. The Court of Appeal reversed, presenting the Supreme Court with the following issues:

- In applying the "sudden and accidental" exception to the pollution exclusions, whether the proper focus is on the initial deposit of wastes at the site or on the release of pollutants from the site into the environment;

- Whether the State was required to prove what part of its property damage liability resulted from "sudden and accidental" discharges;

- Whether pollution exclusions containing an absolute exclusion for discharges

1 Three of the four policies at issued contained a pollution exclusion that stated in relevant part: "This policy does not apply: [¶] . . . [¶] H. To . . . Property Damage arising out of the discharge, dispersal, release or escape of . . . pollutants into or upon land or the atmosphere, but this exclusion does not apply if such discharge, dispersal, release or escape is sudden and accidental. [¶] It is further agreed that the Policy does not apply to . . . Property Damage arising out of the discharge, dispersal, release or escape of . . . pollutants into or upon any watercourse or body of water." The fourth policy applied a "sudden and accidental" exception to all releases, including into or upon any watercourse or body of water.

- "into or upon any watercourse" applied to bar coverage for damage resulting from the 1969 overflow; and
- Whether the State's release of polluted runoff in 1978 was "accidental."

SUPREME COURT RULINGS

Relevant Discharge for Application of the Pollution Exclusion

The Supreme Court affirmed the Court of Appeal ruling that the relevant discharge for determining whether the State's discharge of pollutants was "sudden and accidental" was the release of the wastes from the site after they had been deposited there by other entities as opposed to the initial disposal of waste into the ponds, as the insurers had contended. In so ruling, it reasoned:

> [T]he focus of the analysis must be on the particular discharge or discharges that gave rise to that property damage. Here the State's liability was based on its having sited, designed, built, and operated the…facility in such a negligent manner as to allow hazardous chemicals to escape from the evaporation ponds (by both seepage and overflow) into the surrounding environment. The State was *not* held liable for polluting *the evaporation ponds*, but for polluting the land and groundwater *outside the ponds* . . .

The Supreme Court rejected the insurers' argument that a contrary result was required under *Standun, Inc. v. Fireman's Fund Ins. Co.*, 62 Cal.App.4th 882 (1998) and devoted substantial effort to reconciling its result with the holding in *Standun*, in which the Court of Appeal had concluded that for purposes of applying the pollution exclusion "[t]he relevant discharge as to [the insured] is the discharge of its wastes into the landfill," not the subsequent migration of wastes from the landfill to other property.[2] The Supreme Court explained that in *Standun*, the pollutants were deposited directly onto the land and without any attempt at containment. In contrast, the initial deposit of wastes at the Stringfellow site were put into confinement and only later escaped into the environment due to negligent design. As such, the subsequent escape of pollutants at the Stringfellow site was the liability-producing event which was the proper focus for purposes of applying the pollution exclusion.

Whether the State Must Prove the Amount of Damages Caused by "Sudden and Accidental" Discharges and Non-Covered Events

The trial court ruled that the State could recover nothing from its insurers because it could not differentiate between: (1) the property damage caused by the 1969 and 1978 releases which arguably fell within the "sudden and accidental" exception to the pollution exclusion; and (2) the property damage caused by gradual leakage of pollutants from the evaporation ponds.[3] The trial court agreed with the insurers that *Golden Eagle Refinery Co. v. Associated Int'l Ins. Co.*, 85 Cal.App.4th 1300 (2001) applied to bar coverage unless the insured could differentiate, quantify and allocate as between the property damage caused by "sudden and accidental" releases and non-covered causes.

The Court of Appeal reversed, accepting the State's position that the policies at issue covered the State's liability for indivisible damage caused partly by covered causes and partly by excluded causes. It relied upon *State Farm Mut. Auto. Ins. Co. v. Partridge*, 10 Cal.3d 94 (1973) to find that liability coverage exists "whenever an insured risk constitutes a proximate cause of an accident, even if an excluded risk is a concurrent proximate cause." The Supreme Court agreed. It stated that its application of *Partridge* was premised on the indivisibility of the remediation costs, and the fact that under tort liability theories, a tortfeasor whose acts have been a substantial factor in causing the damages is legally responsible for the whole.

The Supreme Court rejected the insurers' position that while *Partridge* involved a single injury, here each source of contamination caused damage of its own. It admitted that while in theory, one can differentiate between the pollutants that caused contamination, the summary judgment record failed to establish that the cost of remediation can be divided in that manner. Consequently, the damages resulting from the contamination were indivisible. Under California law, injuries for which the damages are indivisible are treated the same as a single injury, with the tortfeasor being liable for the entirety of damages. The Supreme Court adopted the "concurrent proximate cause" coverage analysis of *Partridge* and concluded that summary judgment was inappropriate because a triable issue of fact remained as to whether the 1969 and 1978 releases were substantial factors in causing the contamination upon which the alleged damages were based. The Supreme Court stated:

> [I]f the insured proves that multiple acts or events have concurred in causing a single injury…or an indivisible amount of property damage (as may be shown at trial here), such that one or more of the covered causes would have rendered the insured liable in tort for the entirety of the damages, the insured's inability to allocate the damages by cause does not excuse the insurer from its duty to indemnify. The insurer, of course, may counter the insured's evidence of indivisibility with its own evidence that the damages are divisible and that only a limited portion of them resulted from covered events.

The Supreme Court further stated that to the extent the State can show "sudden and accidental" releases proximately caused the damage for which it was held liable, the State was contractually entitled to indemnity for that liability.

Although the Supreme Court disapproved of *Golden Eagle's* requirement that the insured must show how much of an indivisible amount of damages resulted from covered causes and found that the State was not required to prove the amount of property damage caused by "sudden and accidental" discharges, it was careful to state multiple times that such discharges needed to be "substantial factors" in causing contamination of soils and groundwater. It further recognized California authority that required that the insured must show an "appreciable amount" of the damage for which it was held liable resulted from accidental discharges.

Application of the "Sudden and Accidental" Exception to the 1978 Discharges

The insurers argued that the 1978 discharges could not be deemed "accidental" because the State had been advised on, but had not taken, measures to avoid a repeat overflow from heavy rains. The Court of Appeal agreed, and rejected the State's contention that at most, the evidence shows that the State was negligent, not that it expected or intended the 1978 releases.[4] The Supreme Court reversed.

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2 In *Standun*, the Court of Appeal held that the pollution exclusion applied based on facts which established that the "relevant discharge . . . is the discharge of wastes into the landfill [which] was purposeful and regular [and therefore] neither sudden nor accidental." Specifically, in *Standun*, liquid waste was discharged directly into the landfill and mixed with dirt or refuse or in other words, "directly onto the land." The *Standun* court observed that none of liquid waste at issue was stored in underground tanks.

3 In discovery responses, the State had admitted that it could not differentiate this damage.

4 The parties had agreed that an "accidental" discharge, within the meaning of the "sudden and ac-

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The Supreme Court also rejected the insurers' argument that the "sudden and accidental" exception was inapplicable because the State intentionally released hazardous waste as part of a controlled discharge when a crack appeared in the dam. In doing so, it concluded that the pollution exclusion does not bar coverage for liability arising from the State's intentional releases performed to prevent such a greater accidental release. It indicated that California courts have recognized that liability policies may cover damages resulting from an act undertaken to prevent a covered source of injury from occurring, even if the act would otherwise not be covered. Moreover, the Supreme Court stated that the insurers would not be harmed by a finding of coverage because they would otherwise be responsible for greater liability were the measures not taken to prevent harm resulting from a break of the dam and greater overflow. It noted that the releases were ordered only to prevent a larger, uncontrolled discharge of wastes if the dam had broken, which the State contended would have been an accidental discharge.

Finally, in determining whether the threatened dam break and overflow would have been "accidental," the Supreme Court stated that the insurers were entitled to summary judgment only if they could prove, as an undisputed fact, that the State knew or believed a discharge was highly likely to occur because of flooding. In considering that the rainfalls preceding the 1978 releases were an "extraordinary, unpredictable phenomena," and that the ultimate release was caused in part by mechanical failure of a pump and structural failure of a dam, the Supreme Court concluded that the insurers had not met their burden on summary judgment to show that the State expected this set of events.

<u>"Into or Upon Any Watercourse" Language</u>

The Supreme Court addressed the insurers' argument that the "into or upon any watercourse" wording in the pollution exclusions at issue barred coverage for liability arising out of the 1969 overflow. It found that the insurers had not met their burden of proof to show that the overflow was confined to the regular channel of the stream draining the canyon, rather than onto the adjacent land that did not constitute a "watercourse." Accordingly, summary judgment was inappropriate under any of the pollution exclusions because triable issues of fact remained.

cidental" exception, is one the insured neither intended nor expected to happen pursuant to *Shell Oil Co. v. Winterthur Swiss Ins. Co.*, 12 Cal.App.4th 755 (1993).

OBSERVATIONS AND CONCLUSIONS

An initial read of the *State of California* decision suggests that application of pollution exclusions containing "sudden and accidental" exceptions has been significantly impaired under California law. Although the *State of California* decision does create additional challenges to the application of the exclusion, the scope of its rulings can be limited in many ways. The following are our observations and views concerning the issues addressed by the Supreme Court and the potential impact of its opinion:

- This decision may make it more difficult to advance the position that routine, purposeful waste disposal practices by an insured are the relevant discharges for purposes of applying the "sudden and accidental" pollution exclusion if there is some effort at containment. The holding of the Court of Appeal in *Standun* now appears to be limited to discharges directly into the environment (*e.g.*, unlined earthen pits).

- The Supreme Court expressly stated that its holding did not extend indemnity to situations where an insured can do no more than speculate that some polluting events may have occurred suddenly and accidentally, or where "sudden and accidental" events have contributed only trivially to property damage. It recognized California authority that has held against indemnity where the insured can make only "unsubstantiated claims of sudden and accidental discharges in the face of repeated, continuous discharges in the course of business."

- If a provably distinct amount of remediation costs were attributable to "sudden and accidental" discharges of pollutants, only that amount would be covered by insurance. It would be the insured's burden to show that its damages were indivisible in order to secure coverage under *Partridge*. The insurers could offer evidence that the damages were not indivisible. The Supreme Court expressed no opinion as to whether it would be possible to approximately allocate damages according to the amounts and types of pollutants released at various times.

- Although the Supreme Court found that the pollution exclusions did not bar coverage for the intentional 1978 controlled discharges to prevent failure of the dam, its conclusions were not so broad as to suggest that all preventive measures would be covered. The controlled discharges were performed to prevent a greater accidental release, which is a narrow exception to the general prohibition on coverage for preventive measures.[5]

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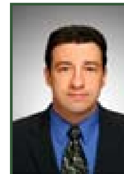

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5 In support of its position, the Supreme Court to cited to *AIU v. Superior Court*, 51 Cal.3d 807 (1990), which involved suits alleging past and present damage to land and water on and surrounding hazardous waste sites. The *AIU* court concluded that the costs at issue "concern reimbursement not for prophylactic purposes, but rather for remedial and mitigative actions." *Id.* at 833. While finding coverage for response costs to mitigate existing damage, the *AIU* court reaffirmed that "prophylactic measures" are an "uninsurable cost of doing business." *Id.* In order to reconcile the holdings of *State of California and AIU*, it is possible that the holding in *State of California* may be limited to truly exigent circumstances.

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