

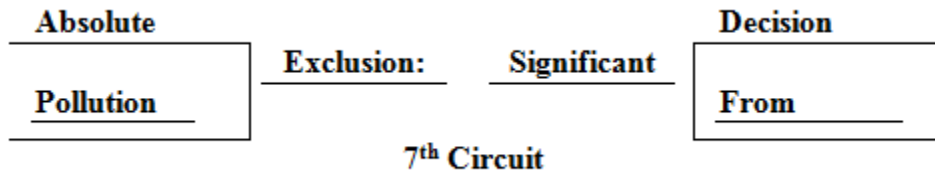
BINDING AUTHORITY

Insurance Coverage Decisions: Issued Today - Impact Tomorrow



Randy J. Maniloff
maniloffr@whiteandwilliams.com

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Posner On The Pollution Exclusion: Could It Have Been The Most Important Decision Ever?

Binding Authority Contest: Last year I did a few contests on *Binding Authority* and they were a lot of fun. Copies of [“General Liability Insurance Coverage – Key Issues in Every State”](#) were given out as prizes to the winners. Our editor at Oxford University Press has promised to supply plenty of copies of “*Key Issues*” to be used as prizes for more *Binding Authority* contests. Unfortunately, despite being a reasonably creative type, I have been unable to think of any contests with an insurance-related theme. It has been frustrating since I would love nothing more than to spend some of Oxford’s money. So here is the contest – Send me an idea for a *Binding Authority* contest. Anything – as long it has some relationship to insurance coverage. If I use it, you’ll get a complimentary copy of *Key Issues*. So it’s a contest about a contest. It’s like Kramer’s coffee table book about coffee tables.

I am convinced that, at any given moment of the day or night, I can find an episode of *Law & Order* somewhere on my television. Now don’t get me wrong, I enjoy the show, but in the end the episodes all blur together and they are hard to remember two days later. That is not unlike Pollution Exclusion case law. New decisions are constant, but

they too generally blur together and are hard to remember two days later. Bat guano cases are few and far between.

This week's Pollution Exclusion decision from the Seventh Circuit, in *Scottsdale Indemnity Co. v. Village of Crestwood*, could easily fit into this category. Indeed, the decision's unremarkability (not sure that's a word) is clearly demonstrated by this -- the court concluded that it could have affirmed the decision of the District Court, that the Pollution Exclusion applied, in one sentence.

Yet, if *Scottsdale Indemnity Co. v. Village of Crestwood* had been decided 20 years ago, it could have been one of the most important Pollution Exclusion decisions ever handed down. It could have changed how the next two decades of Pollution Exclusion litigation played out. But timing is everything. Look, I wish I would have discovered 20 years ago that I liked black licorice more than red.

Why is the decision so potentially important? *Scottsdale Indemnity Co. v. Village of Crestwood* was authored by Judge Posner of the Seventh Circuit. Posner is probably the famous judge in the country who is not on the U.S. Supreme Court. According to Wikipedia, citing the Journal of American Studies, Posner is the [most cited](#) legal scholar of the 20th century. While he is not without controversy, his decisions get noticed. That said, the formula that Posner advocated in *Village of Crestwood*, for interpreting the Pollution Exclusion, surely would not have gone unnoticed by other courts facing, for the first time, how to interpret the Pollution Exclusion.

Village of Crestwood involved coverage for tort suits brought against Village of Crestwood, by its residents, on account of the contamination of their water supply with perc (a common dry cleaning solvent). Posner concluded that there is no doubt that perc is a contaminant, within the pollution exclusion, and, as such, the District Court's decision, that the Pollution Exclusion applied, could have been affirmed in one sentence.

But Posner did not stop there. He stated: "The problem with stopping there and affirming the district court in one sentence is that a literal reading of the pollution exclusion would exclude coverage for acts remote from the ordinary understanding of pollution harms and unrelated to the concerns that gave rise to the exclusion." *Village of Crestwood* at 4.

Posner then went on to adopt a methodology for interpreting the Pollution Exclusion that differs from the one that has been widely adopted nationally, over the past two decades, for determining its scope. The divide between the courts regarding application of the pollution exclusion is frequently described as a difference over whether the exclusion applies only to what is historically regarded as a pollution claim, such as hazardous waste or industrial pollution, often referred to as "Traditional Environmental Pollution," or whether the exclusion, based on a broad linguistic reading, makes it applicable to claims involving any hazardous substance.

But Posner rejected the very popular "Traditional Environmental Pollution" test. Instead, as he is wont to do, he adopted a methodology based on economic considerations – tied to the underwriting of general liability policies. He stated that a "more perspicuous

formula that ‘traditional environmental pollution’ would be ‘pollution harms as originally understood.’” *Id.* at 6.

Posner’s theory is based on the underwriting issue of “adverse self-selection,” a situation where proposed insureds have a higher than normal likelihood of making a claim, but because of a consideration that is invisible to the insurer. As such, the insurer cannot price the policy in a manner that accounts for this additional risk. Because the inclusion of such people in the risk pool increases the losses, it drives up the premiums. Legitimate insurance purchases, unhappy with the higher premium, would shift their business to insurers that do not offer policies that allow for adverse selection. This would further raise the possibility of losses to the now shrunken insurance pool and raise premiums even higher, leading to a “death spiral.” *Id.* at 6-7.

Posner then turned his “adverse self-selection” theory to the Pollution Exclusion and its interpretation for purposes of determining coverage:

The main reason for the broad pollution exclusion is the adverse-selection problem of which we gave examples earlier. It is true that there is adverse selection only where the adverse factor, such as a pre-existing medical condition or the very low value placed by a property owner on his property, is invisible to the insurer, who therefore can’t adjust the insurance premium to the greater risk of loss from insuring those people—can’t in other words separate its high-risk customers from its low-risk ones and charge different premiums to the different groups. But invisibility is a problem with pollution insurance too, as this case illustrates dramatically: deliberate concealment by the insureds of the pollution is alleged. If insurers can’t determine how likely a would-be buyer of insurance is to pollute, coverage would force enterprises that have a slight risk of liability for causing pollution damage to subsidize the premiums of high-risk potential polluters.

Insurers could have excluded coverage just for knowing or deliberate polluting, which would have done the trick in this case but would not be a complete solution to the adverse-selection problem. A shopper for

pollution insurance who knows that he has a high risk of accidentally polluting and being sued for it would, if able to buy the insurance at the normal premium, contribute to the premium spiral that we've described. Forcing him to self-identify as a potential polluter by buying a pollution-coverage rider to his general liability policy (as otherwise he will fall within the pollution exclusion) separates high- and low-risk polluters.

Id. at 9-10

Applying this adverse selection theory, Posner's interpretation of the Pollution Exclusion is not based on whether the polluting substance is a "Traditional Environmental Pollutant," but, rather, whether it involves a "pollution harm as originally understood." He illustrated this as follows:

The concerns that animate the pollution exclusion were absent from the cases we discussed earlier, which were typical tort cases in the sense of involving a sudden occurrence the risks of which are well known and that injures one or a few persons. That the occurrence happens to be precipitated by a contaminant is incidental; its presence makes the risk or amount of loss no more uncertain than if, in our hypothetical case, the tanker truck had spilled milk rather than perc.

Id. at 10-11.

In other words, Posner's theory focuses on the cause or likelihood of the pollution, as it relates to the insured's business, and not the nature of the polluting substance. Based on his premium and underwriting/anti-selection theory, Judge Posner is unwilling to apply the Pollution Exclusion to cases that involve "injuries resulting from everyday activities gone slightly, but not surprisingly, awry." *Id.* at 5.

Given Posner's influence, one wonders what could have been if his theory for interpretation of the Pollution Exclusion had been available to courts 20 years ago – before the Traditional Environmental Pollutant methodology took hold.

A copy of the March 12 decision in *Scottsdale Indemnity Co. v. Village of Crestwood* can be accessed here:

<http://www.ca7.uscourts.gov/tmp/GG0DRU2O.pdf>

Please let me know if you have any questions.

Randy



Randy J. Maniloff

1650 Market Street | One Liberty Place, Suite 1800 | Philadelphia, PA 19103-7395

Direct 215.864.6311 | Fax 215.789.7608

maniloffr@whiteandwilliams.com | whiteandwilliams.com

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