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Ameron International: The California Supreme Court Breathes New Life Into Environmental Coverage Claims for California Policyholders

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Introduction

Prudent policyholders facing environmental liabilities typically take steps to minimize their liabilities by exercising control over the investigation and remediation of their legacy sites. Absent extraordinary circumstances, they do not intentionally violate administrative orders or cede control over the cleanup of their sites to state and federal regulators, forcing those regulators to sue them to recover cleanup costs. Paradoxically, this laudable behavior has been discouraged by California's highest court, which has held that policyholders are not entitled to defense or indemnification for their environmental liabilities unless they are sued in a court of law and ordered to pay money damages. But a recently decided California Supreme Court case, *Ameron International Corp. v. Insurance Company of the State of Pennsylvania*, marks a departure from the court's narrow construction of the duty to defend and indemnify under general liability policies. There, the court held that an administrative proceeding triggered the insurer's duty to defend because, while not a proceeding in a court of law, the administrative proceeding was sufficiently similar to a lawsuit. This new "functional equivalent" exception to California's old bright-line rule strictly construing the duty to defend is likely to be only the first in a series of exceptions that may ultimately swallow the rule altogether.

At least until the late 1990's, California coverage law was regarded as highly favorable for policyholders with environmental claims. However, things took an unexpected turn in the summer of 1998, when the Supreme Court of California sided with a distinct minority of state courts, holding that an administrative agency letter identifying an insured as a potentially responsible party ("PRP") does not trigger an insurer's duty to defend. In reaching this conclusion, the court interpreted the term "suit" narrowly to mean only an actual court proceeding initiated by the filing of a complaint. This restrictive reading of the duty to defend led to another blow to policyholders in 2001, when the California Supreme Court held that environmental response costs do not constitute "damages" within the coverage of a comprehensive general liability policy. The court interpreted the term "damages" restrictively to mean "money ordered by a court." The court reasoned that because the duty to defend is broader than the duty to indemnify, if the duty to defend is limited to an actual court proceeding, then the duty to indemnify cannot extend beyond money awarded in those court proceedings. Stated otherwise, the court reasoned that the duty to indemnify cannot include amounts arising out of a proceeding that would not have triggered the duty to defend.

Taken together, these two decisions drastically limited coverage available to California policyholders with environmental claims. In *Ameron*, however, the California Supreme Court recently revisited the meaning of the term "suit." That case involved an administrative appeal before the United States Department of the Interior Board of Contract Appeals (IBCA).

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There, the court found that, although the policyholder was not sued in an actual court proceeding (rather, the policyholder was the appellant in an administrative proceeding), the proceeding bore enough similarities to an actual court proceeding to trigger the duty to defend. In so holding, the California Supreme Court appears to have abandoned its literal reading of the term "suit" and adopted a "functional equivalent" test that it previously had rejected.

Background

In the seminal case, *Foster-Gardner, Inc. v. National Union Fire Insurance Co.*, 959 P.2d 265 (Cal. 1998), the California Supreme Court held that an administrative proceeding under an environmental statute does not constitute a "suit" triggering the duty to defend. In that case, plaintiff Foster-Gardner received an "Imminent and Substantial Endangerment Order and Remedial Action Order" from the Department of Toxic Substances Control (DTSC) of the California Environmental Protection Agency. The letter asserted that Foster-Gardner was a "responsible party" or "liable person" under California's Superfund Law and ordered Foster-Gardner to comply with monitoring, cleanup and other requirements, including a Remedial Investigation and Feasibility Study Workplan. Foster-Gardner tendered the defense of the DTSC Order to four of its insurers, all of whom had issued materially identical CGL policies agreeing to defend any "suit"—a term that none of the policies defined. The trial court entered summary judgment in favor of the insurers in part on the ground that the insurers had no duty to defend because the DTSC Order was not a "suit." The Court of Appeal reversed.

The California Supreme Court chose to hear the case because there was a conflict between two California Courts of Appeal on the issue. The Court explained that other state courts had taken varying approaches in determining whether environmental agency activity prior to the filing of a complaint is a "suit" within the meaning of a CGL policy. It referred to these three approaches as the literal, functional and hybrid approaches.

The "Literal Meaning" Approach: The *Foster-Gardner* court explained that "[u]nder the 'literal meaning' approach, the term 'suit' is deemed unambiguous, referring to actual court proceedings initiated by the filing of a complaint. When no complaint has been filed, there is no 'suit' the insurer has a duty to defend." 959 P.2d at 273. The court also noted that some courts find support for the "literal meaning" approach in the connection between the filing of a complaint and the duty to defend, as the issue of whether an insurer's duty to defend has arisen and is generally determined by comparing the allegations in the underlying complaint with the policy provisions. *Id.* at 274. Many courts also feel compelled to maintain the distinction between the policy terms "suit" and "claim," which distinction they contend cannot be maintained if the word "suit" is broadened to include "claims." *Id.* These courts typically view a PRP letter or other administrative action short of a lawsuit as a "claim," which therefore cannot be a "suit."

The "Functional" Approach: Under the "functional" approach, any PRP letter or other pre-complaint environmental agency activity constitutes a "suit." Under this approach, the term "suit" is viewed as ambiguous and is reasonably understood by policyholders to include administrative proceedings, not just those in a court of law initiated by the filing of a complaint. Because of this ambiguity and the general rule of interpreting ambiguous terms in favor of the insured, courts using the "functional" approach have determined that an insured would reasonably expect the insurer to defend an administrative agency order or other administrative activity.

The "Hybrid" Approach: Some courts have refined the functional approach by holding that a PRP letter or other pre-complaint environmental agency action is only a "suit" if it is sufficiently coercive and threatening. Under this "hybrid" approach, a preliminary notification alone does not constitute a "suit," nor does a mere request for voluntary action. Like the "functional" approach, however, courts using the hybrid approach view the term "suit" as ambiguous and therefore interpret it in favor of the insured, but only if the administrative action is sufficiently serious.

Foster-Gardner. In *Foster-Gardner*, the insurers asserted that the word "suit" means "a civil action commenced by filing a complaint," and that "[a]nything short of this is a 'claim.'" 959 P.2d at 279. *Foster-Gardner*, on the other hand, asserted that a "suit" is any "attempt to gain an end by legal process before a trial judge or some other dispute resolution authority, as opposed to a threat to do so" (which *Foster-Gardner* asserted would be a "claim"). *Id.* The California Supreme Court sided with the insurers, adopting the "literal meaning" approach, holding that "the unambiguous language of the policies obligated the insurers to defend a 'suit,'" not, as *Foster-Gardener* asserted, the "substantive equivalent" of a "suit." *Id.* at 280. The court also rejected the "hybrid" approach, noting that it would "introduce a significant element of uncertainty into an insurer's ascertainment of its duty to defend" and asserting that "courts would have to rewrite unambiguous policy language on a case-by-case basis under the guise of interpretation." *Id.* at 281.

The *Foster-Gardner* court concluded that its "bright-line rule" that a "suit" is a court proceeding initiated by the filing of a complaint will reduce the need for future litigation by clearly delineating the scope of risk. The court opined that the functional or hybrid approaches, in contrast, would "open the flood gates of litigation by inviting, and requiring, a case-by-case determination" as to whether an administrative action is the functional equivalent of a suit brought in a court of law. *Id.* at 286.

Powerine I. Not surprisingly, shortly after deciding *Foster-Gardner*, the California Supreme Court faced a similar issue in the context of the duty to indemnify in *Certain Underwriters at Lloyd's of London v. Superior Court (Powerine Oil Co.)*, 16 P.3d 94 (Cal. 2001). In this case, known as *Powerine I*, the California Supreme Court held that an insurer's duty, under a standard CGL insurance policy, to indemnify the insured for all sums that the insured becomes legally obligated to pay "as damages" is limited to money ordered by a court. *Id.* at 103. Accordingly, the court held that an insurer does not have a duty to indemnify an insured for expenses assessed in an administrative proceeding brought pursuant to a state environmental statute in connection with cleanup and abatement of environmental contamination.

Like in *Foster-Gardner*, the focus in *Powerine I* was interpretation of policy language. In *Powerine I*, the Lloyd's policy promised to indemnify Powerine for "all sums" which Powerine "shall become legally obligated to pay as damages." The *Powerine I* court applied *Foster-Gardner*'s "literal meaning" approach to conclude that the phrase "as damages" is unambiguous and can only be understood to mean those sums ordered by a court of law. The *Powerine I* court relied upon what it called "*Foster-Gardner*'s syllogism," reasoning that:

> The duty to defend is broader than the duty to indemnify. The duty to defend is not broad enough to extend beyond a "suit," i.e., a civil action prosecuted in a court, but rather is limited thereto. A fortiori, the duty to indemnify is not broad enough to extend beyond "damages," i.e., money ordered by a court, but rather is limited thereto. 16 P.3d at 103-104.

As a result, *Powerine I* changed the legal landscape in California by holding that the damages clause in a standard CGL policy does not require that the insurer pay for costs arising out of pollution cleanup orders (or any other administrative order). With this ruling, the California Supreme Court distanced itself still further from the rule adopted in the vast majority of other states.[1] Indeed, one of the two state Supreme Courts that *Foster-Gardner* relied upon in support of its narrow interpretation of "suit" has since overruled itself, only further widening the chasm between California law and the majority rule on this issue. *Johnson Controls, Inc. v. Employers Insurance of Wausau*, 665 N.W.2d 257 (Wis. 2003), *overruling City of Edgerton v. General Casualty Co. of Wisconsin*, 517 N.W.2d 463 (Wis. 1994).[2]

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After *Foster-Gardner* and *Powerine I*, the meaning of "suit" and "as damages" seemed firmly established under California law, and it appeared well settled that a policyholder could not recover costs arising out of administrative proceedings, at least unless its policies contained unique language not ordinarily found in CGL policies. However, the foundation for these settled expectations recently was substantially weakened.

In November 2010, the California Supreme Court revisited the meaning of "suit" in *Ameron International Corp. v. Insurance Company of the State of Pennsylvania*, 242 P.3d 1020 (Cal. 2010). Specifically, the court addressed whether a federal administrative adjudicative proceeding before an administrative law judge of the former United States Department of the Interior Board of Contract Appeals (IBCA) is a "suit" for purposes of the duty to defend. In framing the issue, the court expressly noted that the IBCA proceeding was commenced by the filing of a notice and complaint, involved 22 days of trial, numerous witnesses and substantial evidence, and was governed by the Federal Rules of Evidence. 242 P.3d at 1022. The policy language at issue was substantially the same as the *Foster-Gardner* and *Powerine I* policy language. The Court of Appeal held that although the insured would reasonably expect the IBCA litigation to be considered a "suit" seeking damages, *Foster-Gardner*'s bright-line rule compelled the court to interpret the word "suit" as limited to a proceeding in a court of law. *Id.* at 1024.

In an unexpected move, the California Supreme Court reversed the Court of Appeal judgment, holding instead that the IBCA administrative adjudicative proceeding was a "suit" triggering the duty to defend. *Id.* at 1030. Its analysis focused on whether the

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[1] A major question left unanswered in *Powerine I* was whether standard excess/umbrella liability policies are broad enough to cover the costs of complying with administrative orders. In 2005, the California Supreme Court answered this question in the affirmative in *Powerine Oil Company v. Superior Court*, 118 P.3d 589 (Cal. 2005) (*Powerine II*). Although seemingly in tension with *Powerine I*, the court based its decision on the specific language used in the policies, holding that policies including the word "expenses" in addition to "damages" require insurers to indemnify the insured for cleanup of contaminated sites.

[2] In *Johnson Controls*, the Wisconsin Supreme Court observed that California and Maine were the only two Supreme Courts holding that environmental response costs are not "damages" under CGL policies. 665 N.W.2d at 288. The court referred to *Powerine I* as a "somewhat unique" decision that "apparently encourages insureds to wait to be sued before remediating property, if they wish to receive liability insurance coverage." *Id.*

concerns that led the *Foster-Gardner* court to find that the issuance of a PRP letter is not a "suit" are also applicable to hearings before a federal administrative adjudicative body. The court relied on the following points in distinguishing the facts in *Ameron* from *Foster-Gardner*:

- The ICBA procedure at issue requires a complaint "setting forth simple, concise, and direct statements of each claim, alleging the basis with appropriate reference to contract provisions for each claim, and the dollar amount claimed." This complaint, together with the government's answer, serve to inform the insurer of the nature of the dispute so that it can determine its defense duties under the insurance policy. *Id.* at 1028.

- The ICBA pleading requirements meet the standards for a complaint under the California Code of Civil Procedure. *Id.* at 1029.

- The legislative history shows that Congress intended the IBCA to serve as an alternative means to resolve contract disputes in an informal, expeditious and inexpensive way. Congress even stated that "the contractor should feel that he is able to obtain his 'day in court'…through the agency board process." *Id.*

- The insured has a reasonable expectation of coverage for an administrative adjudicative proceeding that involves lengthy hearings, testimony and cross-examination of witnesses. *Id.* at 1030.

The *Ameron* court emphasized that the *Foster-Gardner* rule will continue to apply to actions involving pollution remediation orders or any matters that involve threats to take legal action only, rather than "suits." *Id.*

However, while preserving the holding of *Foster-Gardner* as applied to its facts, it is clear that *Ameron* creates an exception to the *Foster-Gardner* rule. *Foster-Gardner* created a bright-line rule that only actions in a court of law count as "suits" under CGL policies. *Ameron* blurs this bright line significantly. And it does so by utilizing the very "functional" approach that *Foster-Gardner* rejected. After *Ameron*, both traditional lawsuits as well as proceedings that are very similar to a lawsuit are sufficient to invoke a duty to defend.

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In creating this loophole of indeterminate size, the *Ameron* opinion clearly weakens the foundation of *Foster-Gardner*. Further, because the *Powerine I* Court relied so strongly on the *Foster-Gardner* syllogism and on *Foster-Gardner*'s "literal meaning" approach, *Ameron* undermines the *Powerine I* decision as well.

Perhaps most significant is the *Ameron* court's departure from *Foster-Gardner*'s holding that the word "suit" is unambiguous. Without acknowledging its earlier holding, the *Ameron* court relied on the principle of construction that "any ambiguity in the policy terms will be construed against the insurer to protect the insured's reasonable expectation of coverage," and concluded that "a reasonable policyholder would believe that a policy providing coverage for a 'suit' would provide coverage for the IBCA proceedings." 242 P.3d at 1030. California courts only look to the reasonable expectations of the insured if a term is ambiguous. Accordingly, like the courts adopting the functional approach, the *Ameron* court necessarily found the term "suit" to be ambiguous and looked to the reasonable expectations of the insured to determine its meaning.

The question that remains to be answered is how this new exception will affect environmental coverage claims (or other claims involving administrative proceedings) in California. A wide range of different types of administrative actions exists, from the least adjudicative PRP letter (such as that at issue in *Foster-Gardner*) to the most adjudicative administrative quasi-adjudicative proceeding (like the one in *Ameron*). As to everything in between, policyholders seeking coverage after *Ameron* can now ask courts to make the case-by-case determination that previously was thought to be foreclosed by *Foster-Gardner*. In each case, the question will be whether the particular administrative proceeding resembles an action in a court of law closely enough to be considered a "suit" triggering the duty to defend. In examining this question, California courts will have to consider the reasonable expectations of the insured.

In addition to asking whether a wide range of administrative actions may qualify as "suits," policyholders have a good faith basis to ask California courts to revisit the meaning of "damages" under a CGL policy. *Powerine I*'s holding that "damages" are limited to money ordered by a court rested on the *Foster-Gardner* syllogism, which, in turn, rested on a narrow interpretation of the term "suit." Now that the meaning of the term "suit" has been broadened, so must the meaning of the term "damages." Thus, *Ameron* represents an opportunity for policyholders with environmental claims in California to move California environmental coverage law back in line with the vast majority of the state courts. Just how far California courts will go remains to be seen.

In a concurring opinion in *Ameron*, California Supreme Court Justice Kennard noted that since *Foster-Gardner* was decided in 1998, no other state court has adopted its "literal meaning approach," while nine other state courts and federal courts applying the law of two other states all have adopted the "functional" or "hybrid" approaches that *Foster-Gardner* rejected. Justice Kennard wrote that he "would prefer that *Foster-Gardner* be overruled," but the *Ameron* decision is "at least a step in the right direction." 242 P.3d at 1031.

Wisconsin law on this very issue may provide a road map for the California courts. As noted above, in *City of Edgerton v. General Casualty Co. of Wisconsin*, 517 N.W.2d 463 (Wis. 1994), the Wisconsin Supreme Court ruled that a PRP letter did not constitute a "suit" triggering the duty to defend, and environmental remediation pursuant to a government directive or order did not constitute covered "damages." Three years later, the Wisconsin Supreme Court created an exception to the *Edgerton* rule, holding that monetary relief sought from the insured by private third parties for losses they incurred as a result of administrative clean-up orders for past contamination caused by the insured was covered "damages." *General Casualty Co. of Wisconsin v. Hills*, 561 N.W.2d 718 (Wis. 1997). This led to an even more complicated set of exceptions to the *Edgerton* rule, which ultimately led to the Wisconsin Supreme Court's decision in *Johnson Controls*, overruling *Edgerton*. Given the concurring opinion in *Ameron* expressing a preference that *Foster-Gardner* be overruled, it would not be surprising to see the California Supreme Court follow a path similar to that followed by the Wisconsin Supreme Court.

Finally, *Ameron*'s focus on the degree to which an adjudicative proceeding looks like a lawsuit may also influence policyholder behavior. As the Wisconsin Supreme Court observed in *Johnson Controls*, the California Supreme Court's narrow interpretation of "suit" and "damages" under CGL policies "encourages insureds to wait to be sued before remediating property, if they wish to receive liability insurance coverage." Of course, policyholders have other reasons to avoid being sued, so the *Foster-Gardner* and *Powerine I* rules are more likely to simply penalize policyholders for engaging in productive behavior than to actually prompt them to engage in unproductive behavior. But the *Ameron* rule encourages more subtle changes in behavior. Without intentionally violating orders or forcing regulators to sue them, policyholders may well opt for more "adjudicative" regulatory proceedings, if doing so will not increase their ultimate exposure while better positioning them for coverage.