



Pollution Exclusions in Insurance Contracts:

Avoiding Confusion and Litigation

by David Dybdahl

This article sheds light on pollution exclusions, limited coverage give-backs, and the resulting coverage gaps that far too often lead to unnecessary coverage litigation. It shares the history of pollution exclusions and exposes the inherent flaws with limited coverage give-backs for contamination losses. Readers will gain perspective on pollution exclusions that are often ignored, which needlessly harms policyholders, who should know that reliable coverage solutions are readily available in the environmental insurance marketplace.



Pollution exclusions have created historic levels of insurance litigation.

Coverage litigation usually occurs when the buyer and seller of an insurance policy have different ideas of how coverage should work in a claims situation. Accurate labeling of pollution exclusions in insurance contracts and the use of appropriate forms of environmental insurance policies in insurance program designs would likely avert a lot of coverage litigation for pollution and contamination losses.

Specifically, most such litigation could be avoided if insurance practitioners followed a two-step process when designing insurance programs.

First, practitioners must recognize and plan for the far-reaching effects of pollution and contamination exclusions in insurance coverage designs. Insurance buyers need to share in that vision. Second, the coverage design should employ genuine environmental insurance products to address pollution-related coverage gaps. Exceptions to pollution exclusions should never be relied on as the sole source of recovery for losses caused by pollution.

The most common environmental risks arise from water intrusion in the built environment

These two steps are rarely followed, which can lead to uninsured contamination events. Larger pollution losses often end up in litigation, which may take up to a decade to resolve.

Although pollution exclusions have existed in most property-casualty policies for many years, a recent trend is for insurers to expand them. They do so by removing coverage for specifically listed materials, such as mold, bacteria, lead, and silica, in addition to irritants or contaminants traditionally referenced in pollution exclusions.

Over the past thirty years, a broad range of environmental insurance products has evolved to fill the coverage gaps created by pollution exclusions in property and liability insurance policies. Environmental/pollution insurance is readily available for anything from the simple operations of a plumber to contamination risks as complex and severe as the containment operations at the Chernobyl nuclear disaster.

Virtually every type of commercial operation has had access to environmental insurance coverage in the United States market for at least the past 25 years. Today, dozens of insurers offer more than 150 different environmental insurance policy forms.

NEEDLESSLY UNINSURED RISKS

The most common environmental risks arise from water intrusion in the built environment, which leads to excluded losses involving fungi and bacteria. Despite continuous product availability for 30 years, today only about 1 in 100 commercial properties is adequately insured against common contamination hazards.

This extremely poor market penetration of the environmental insurance product line exists in the face of a hotly competitive, oversupplied environmental insurance market. Although the environmental insurance sector has experienced growth, that growth has not kept pace with expansions in pollution and contamination exclusions. The result is unprecedented levels of inadequately insured commercial insurance buyers today.

What explains negligible environmental insurance product use after thirty years of excess supply and during a time of growing need for this protection? The answer is confusion about how pollution exclusions eliminate coverage and a cycle of apathy among insurance agents, insurance brokers, and their customer base.

Customers' lack of interest in environmental insurance disincentivizes insurance agents and brokers from becoming knowledgeable about pollution exclusions and environmental risks and insurance. However, most customers are disinterested in environmental insurance only because agents and brokers generally avoid discussing the effects of pollution exclusions and the need for environmental coverage. This self-fulfilling pattern of apathy leads to significant uncovered losses, which triggers unexpectedly denied claims and may give rise to coverage lawsuits if the insured can afford to litigate post loss.

The confusion over pollution exclusions can be attributed to these major drivers:

- Insurance professionals often ignore pollution exclusions in insurance program designs. To make matters worse, because they lack expertise in the subject matter, insurance educators tend to gloss over this topic. Education in this area is often inaccurate; it does not consider the case law developed by

extensive pollution-exclusion litigation over decades. This results in a problematic status quo: most insurance brokers and agents avoid environmental risk discussions with their customers so they don't appear ignorant regarding what can be a complex topic and line of coverage.

- For unknown reasons, many people think pollution exclusions apply only to hazardous industrial waste. This belief, even held by some judges, is completely without foundation. When pollution exclusions were first introduced more than forty years ago, they specifically referenced contamination, not hazardous waste. That holds true to this day.

Many people think pollution exclusions apply only to hazardous industrial waste



- Insurers may perpetuate confusion within their customer base concerning pollution exclusions by creating false expectations of coverage. Rather than presenting actual pollution coverage, they offer what is essentially an exception to a pollution exclusion and call it pollution coverage. In some classes of business, pollution exclusion exceptions and exceptions to the exceptions are buried under multiple layers of language in a policy's exclusions and definitions sections.

The insurance industry would benefit from improved accuracy in labeling pollution exclusions and from clearly

revealing the way pollution and contamination exclusions operate, both of which would help avoid surprises in the face of a denied claim. Let's look at an example of this: "sudden and accidental pollution coverage."

SHAKY FOUNDATIONS

The introduction of the first industry-standard pollution exclusion came in 1971, at a time when people began to notice human-caused environmental damage and degradation on a wide scale. The insurance business responded to the growing public attitude of making polluters pay for damages and created a new exclusion endorsement for the General Liability (GL) insurance policy. Its intent was to minimize insurer loss exposure from contamination and pollution claims.

The original GL contamination and pollution exclusion endorsement contained an exception to the exclusion. The exception made the exclusion inapplicable if the polluting event was "sudden and accidental." This is the phrasing from the original pollution and contamination endorsement used in the 1971 GL policy:

It is agreed that the insurance does not apply 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 watercourse or body of water; but this exclusion does not apply if such discharge, release or escape is sudden and accidental.¹

In 1973, the newly formed Insurance Services Office, Inc. (ISO) used this wording for its pollution exclusion in the new Comprehensive General Liability (CGL) policy. Through the creative work of marketers, the new CGL *exclusion* became known as sudden and accidental pollution *coverage*—a characterization that served as a marketing triumph for insurers.

By calling a new exclusion a new coverage, insurers were able to get this coverage restriction approved with little or no regulatory pressure to reduce rates. The practice of marketing pollution exclusions as pollution coverage is to this day the root cause of many unintentionally uninsured contamination and pollution losses.

A GL policy with a pollution-exclusion exception is not genuine environmental/pollution insurance and should not be represented on insurance certificates as such. Insurance producers commonly make the mistake of representing pollution coverage buy-backs in GL policies as environmental insurance.

A genuine environmental/pollution insurance policy provides coverage for contamination- and pollution-caused losses in its insuring agreement, not solely through wording within an exclusions section. GL policies also lack specific coverage in the insuring agreement for clean-up expenses, which is an essential element in a genuine environmental insurance policy.



Labeling pollution coverage give-backs as an exception to the pollution exclusion instead of pollution coverage would go a long way. It would help set expectations with insurance buyers and producers and, in turn, help avoid unnecessary coverage litigation for pollution losses.

THE DEMISE OF THE "SUDDEN AND ACCIDENTAL" EXCEPTION

A major flaw in the 1970s vintage pollution exclusion was that the word "sudden" was not defined in the GL policy.

Superfund site clean-up claims in the 1980s led to an onslaught of litigation over the meaning of "sudden" within the exception to the CGL pollution exclusion. Policyholders sought to recover their hazardous waste site clean-up costs under legacy GL policies. Via litigation, courts in every state were asked to define "sudden" as used in the pollution exclusion exception.

Many courts, rather than finding a definition for "sudden," took the stance that accidental meant "unexpected and unintended." Consequently, insureds found coverage under CGL policies for decades-old and decades-long pollution incidents if the claim was unexpected and unintended.

In light of the ambiguity associated with the "sudden and accidental" exception and facing billions of dollars in environmental legacy claims, insurers needed a reliable way to exclude pollution losses from ongoing business activities in liability insurance policies. In 1986, the Comprehensive General Liability policy was replaced with the Commercial General Liability policy. The new CGL policy eliminated the use of "sudden and accidental" in the wording of its various pollution-exclusion exceptions.

By 1990, virtually all U.S. insurers abandoned the use of "sudden and accidental" as operative words in GL pollution exclusions. Instead, the pollution exclusion in the 1986 CGL policy took up a full page to make limited exceptions to the exclusion, making it significantly more complex and effective at eliminating unintended coverage than the six lines used in the 1973 version.

The 1986 exclusion is often called the "absolute pollution exclusion" even though "absolute" never appears in the policy and the exclusion does not absolutely exclude all contamination or pollution losses. Like "sudden and accidental pollution coverage," the term "absolute pollution exclusion" is simply insurance marketing slang.

The modern pollution exclusion in CGL policies basically precludes coverage for bodily injury or property damage "arising out of the actual, alleged or threatened discharge, dispersal, seepage, migration, release or escape of pollutants" in roughly six situations described

in the exclusion. Many of these specific exclusions contain double-negative wording, or exclusions to exclusions under narrowly defined parameters regarding the source or cause of the pollution.

The result is unpredictable coverage gaps for losses associated with unpredictable contamination events.

TIME-ELEMENT EXCEPTIONS TO POLLUTION EXCLUSIONS

It is common in some classes of business to purchase general liability coverage extensions that protect against losses involving specified pollution releases. About thirty years ago, these coverage extensions switched from the nebulous "sudden and accidental" language to time-element-based wording.

Under a time-element exception, the pollution exclusion does not apply if the pollution release begins, ends, and is discovered within a set period of time, often defined in hours. A second coverage hurdle associated with a time-element exception is that an otherwise-covered claim arising from pollution must be reported to the insurer within a set number of days.

Existing insurance marketing that refers to time-element exceptions to pollution exclusions as "sudden and accidental pollution coverage"

is as misleading as insurance marketers referring to a brand-new exclusion for pollution-caused losses as “pollution coverage” in the 1970s. Since when is a new exclusion new coverage?

Insurance buyers and sellers are often in different worlds concerning how a pollution exclusion functions in an actual loss. Much of the confusion could be avoided by accurately describing exclusions instead of labeling or referring to them as things they are not.

For example, true sudden and accidental exceptions to a pollution exclusion have not been available for purchase in the U.S. for the past twenty-five years. For this reason, anyone selling a policy referencing “sudden and accidental pollution” anywhere within the policy form would be well-advised to seek help from a qualified specialist in environmental risks and insurance to evaluate the insurance product for potentially material coverage flaws.

THE THRILLING GAME OF COVERAGE ROULETTE

Defined peril and time-element pollution-exclusion exceptions force insurance buyers to play insurance roulette. In this unfortunate game, available coverage can be determined only after a loss, based on a set of random, unpredictable facts. No other insurance product line provides such inherently flawed and unreliable coverage.

For example, one section of the modern CGL pollution exclusion (f.) permits possible coverage for pollution-caused losses resulting from hostile fire or lightning at an insured premises but does not provide the same exception to the pollution exclusion for losses caused by

windstorms. Windstorms have far greater potential to make pollution events more severe, as contaminants may be spread in their pure form over a wide area. On the other hand, a fire may act to reduce the contamination effects of a material. Yet windstorm-related pollution is excluded, and a pollution loss arising from a fire is covered. Few insurance practitioners notice the irrationality of that reality from an insurance program-design perspective.

Another common coverage issue is the separate exclusionary endorsement called a Total Pollution Exclusion (TPE) that is routinely added to the CGL policy. This endorsement removes a handful of defined peril exceptions to Exclusion (f.) Pollution. It also eliminates products and completed operations coverage for a loss caused by pollutants. The standard Exclusion (f.) Pollution in the CGL policy is silent on this hazard and by omission provides coverage for losses involving contamination arising from the products and completed operations of the insured.

Most insurance professionals greatly underestimate the effects of the TPE endorsement. For instance, plumbers are commonly covered by TPE-modified GL policies.

All water in a drainpipe is considered Category 3 water because of the bacteria it contains. If a plumber incurs a claim arising from a leaking drainpipe on a project completed three years ago, the TPE exclusion would eliminate the CGL coverage in a state with case law establishing bacteria as a pollutant. In addition to the TPE exclusion, if the plumber’s CGL policy contains a separate exclusion for fungi and bacteria, there is likely no coverage for Category 3 water losses for any of his or her work.

To close this unintended coverage gap, plumbing firms should carry a specially modified contractors pollution liability insurance policy, but very few do.

Commercial property and liability coverage sold to apartments and condos also illustrates the situation of flawed insurance-program designs relative to pollution exclusions. Apartment and condo complexes frequently file insurance claims involving non-flood-related water intrusion damages. Such incidents typically involve water that moistens drywall, triggering the growth of mold within seventy-two hours, or they involve Category 3 water from a drainpipe. Both causes of loss fall under the sublimit in the property policy for losses involving mold or bacteria.

To put mold coverage compared with mold losses into perspective, the average mold-related claim on a commercial property is \$250,000—and is much higher if loss of rent and extra expense are taken into account. A Category 3 water loss in a high-rise condominium building can easily reach eight figures. In contrast, property insurance policies often have low sublimits for mold- and bacteria-related losses, typically providing only \$10,000 of coverage for the entire loss event.

The result? Commonly sold property insurance sublimits for mold- or bacteria-related losses on commercial properties are extremely inadequate even on an average loss.

Let’s look at a common liability coverage shortfall. The typical GL policy sold for apartment complexes completely excludes losses involving mold or bacteria. These new exclusions were quietly slipped into the insurance market in 2005 without instructions to agents and

brokers as to their impact. One consequence is that no GL coverage exists for wrongful death claims involving Legionnaires’ disease.

Selling insurance with unaddressed gaps in coverage for fungi and bacteria to uninformed owners of apartment complexes does not make sense. But this mistake is duplicated millions of times each year by well-intentioned insurance practitioners insuring commercial buildings.

Environmental insurance products are available that can fill the property and liability insurance coverage gaps created by contamination and pollution exclusions and sublimits on commercial buildings. Property owners who are informed about coverage gaps and affordable coverage solutions are more likely to be concerned about the far-reaching effects of exclusions and to purchase environmental insurance to fill the gaps.

Similar insurance coverage design flaws for contamination- and pollution-related losses with correspondingly affordable environmental insurance options are common across all classes of business.

Confusion and litigation regarding pollution exclusions can be avoided by:

- Appreciating the effects of contamination and pollution exclusions in insurance program designs and explaining the coverage shortfalls to insurance buyers
- Not falling for insurance marketing that refers to pollution-exclusion exceptions as coverage
- Using the wide range of genuine environmental insurance products to fill coverage gaps created by contamination and pollution exclusions ■

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1. The National Underwriter Company, *FC&S Bulletins*, “Contamination or Pollution Exclusion,” 1972, p. 126.

