

RECENT DEVELOPMENTS IN INSURANCE  
COVERAGE

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## I. INTRODUCTION

This article highlights significant insurance coverage cases from October 1, 2016, to September 30, 2017. This past year, insurance coverage law saw many developments addressing a wide variety of issues. While state and federal courts are frequently divided on their approach to coverage issues, this article attempts to identify regional trends with the aim of assisting practitioners nationwide. The following sections are a review of particularly important decisions in insurance coverage law, including cyber insurance, the efficient proximate cause doctrine, declaratory judgment actions, and recent developments in the application of the pollution exclusion in general liability policies.

## II. DIVIDED FEDERAL COURTS HIGHLIGHT CYBER INSURANCE COVERAGE DISPUTES IN 2017

Facebook. Instagram. Twitter. LinkedIn. Each boasting hundreds of millions of users, these are just a handful of companies leading the way into the Digital Age, a period characterized by a high-tech global economy and a changing of the way in which people and companies share and process information. Through a simple internet search, a person's name, job title, email address, interests, and other personally identifiable information are readily available. It should perhaps come as no surprise, therefore, that the Digital Age has also seen a marked increase in the existence and complexity of cybersecurity issues and social engineering schemes.

The term "social engineering" is applied to schemes that use technology to manipulate people into performing certain actions, such as transferring assets or divulging confidential information.<sup>1</sup> In the business context, a common example of a social engineering scheme involves an employee who is tricked into wiring funds to an imposter's account based on a fraudulent email or forged documentation. From October 2013 to May 2016, the Federal Bureau of Investigation (FBI) Internet Crime Complaint Center estimates that over \$1 billion has been stolen through such schemes globally.<sup>2</sup> With the continued open sharing of information, this number is expected to rise as scammers leverage available information to bolster their credibility and take advantage of innocent and unsuspecting employees.

Although broad cyber insurance is available to protect against some of these risks, social engineering attacks may fall outside the scope of cover-

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1. *In re Toys "R" Us - Delaware, Inc.-Fair & Accurate Credit Transactions Act (FACTA) Litig.*, No. CV 06-08163 MMM FMOX, 2010 WL 5071073, at \*12 (C.D. Cal. Aug. 17, 2010).

2. Press Release, Federal Bureau of Investigation, Business E-mail Compromise: The 3.1 Billion Dollar Scam, June 14, 2016, <https://www.ic3.gov/media/2016/160614.aspx>.

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age afforded by certain policies. In particular, questions regarding direct causation and whether there has been a voluntary transfer of funds often arise. This has caused a deep divide in how the nation's courts approach social engineering coverage cases, and, if 2017 is any indication, state and federal courts may increasingly face litigation dealing with these issues.

For example, in *Taylor & Lieberman v. Federal Insurance Co.*, the U.S. Court of Appeals for the Ninth Circuit held that there was no coverage available under a crime policy where a perpetrator had fraudulently taken hold of a client's email account and duped an employee into transferring money overseas.<sup>3</sup> The plaintiff in this case, Taylor & Lieberman, was an accounting firm that performed services such as business management, account oversight, and tax planning and preparation for various clients.<sup>4</sup> The dispute arose from a series of emails that an employee received from a person claiming to be one of the firm's clients.<sup>5</sup> The emails requested wire transfers to overseas accounts, appeared to be from a client, and were signed with the client's name at the end.<sup>6</sup> It was only after the first two wire transfers were made, totaling \$192,765.90, that the fraudulent scheme was discovered.<sup>7</sup>

Taylor & Lieberman subsequently tendered the loss under the crime coverage part of its insurance policy, which provided forgery coverage, computer fraud coverage, and funds transfer fraud coverage.<sup>8</sup> After its insurer denied coverage, Taylor & Lieberman filed suit.

On appeal to the Ninth Circuit, the court held that there was no forgery coverage—which was provided for an insured's direct loss “resulting from Forgery or alteration of a Financial Instrument by a Third Party”—because the emails instructing the employee to wire money were not financial instruments, such as checks or drafts.<sup>9</sup> The court also held that there was no computer fraud coverage because (1) sending an email, without more, did not constitute an unauthorized entry into the recipient's computer system; and (2) the emails were not an unauthorized introduction of instructions that propagated themselves through Taylor & Lieberman's computer system (i.e., these were not the type of instructions that the policy was designed to cover, such as the introduction of malicious computer code).<sup>10</sup> Last, the court held that there was no funds transfer fraud coverage because

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3. 681 F. App'x 627 (9th Cir. 2017).

4. *Taylor & Lieberman v. Fed. Ins. Co.*, No. CV 14-3608 RSWL SHX, 2015 WL 3824130, at \*1 (C.D. Cal. June 18, 2015), *aff'd*, 681 F. App'x 627 (9th Cir. 2017).

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.* at \*2–3.

9. *Taylor & Lieberman*, 681 F. App'x at 628–29.

10. *Id.* at 629.

the employee requested and knew about the wire transfers.<sup>11</sup> In other words, although the employee did not know that the instructions were fraudulent, it was the employee who voluntarily directed its client's bank to wire the funds.<sup>12</sup> Accordingly, the court concluded that there was no coverage available under the policy.

Similarly, in *American Tooling Center, Inc. v. Travelers Casualty and Surety Co. of America*, the plaintiff, American Tooling Company, sought to recover under an insurance policy issued by the defendant-insurer after authorizing payments to a bank account it believed belonged to its vendor.<sup>13</sup> In this case, the plaintiff's vice president/treasurer sent an email to his contact at the vendor, requesting copies of all invoices.<sup>14</sup> In response, he received an email purportedly from the vendor that turned out to have been sent fraudulently by a third party.<sup>15</sup> The third party instructed the plaintiff to send payment for several legitimate outstanding invoices to a new bank account.<sup>16</sup> Without verifying the new banking instructions, the plaintiff wire-transferred approximately \$800,000 to a bank account that was not actually controlled by its vendor.<sup>17</sup>

After the fraud was detected, the plaintiff claimed that it suffered a loss covered under the "computer fraud" provision of its insurance policy.<sup>18</sup> The defendant-insurer denied the plaintiff's claim, however, maintaining that the loss was not "directly caused by the use of a computer," as required under the policy.<sup>19</sup> The plaintiff in turn filed suit. On cross-motions for summary judgment, the court concluded that the plaintiff did not suffer a "direct" loss "directly caused" by the use of any computer due to the intervening events between the receipt of the fraudulent emails and the authorized transfer of funds.<sup>20</sup>

Specifically, after receiving the fraudulent emails, the plaintiff verified that its vendor's production milestones had been met, authorized payment to the bank account specified in the emails, and initiated the transfers without verifying the bank account information.<sup>21</sup> The court noted that, under Michigan law, "direct" is defined as "immediate" and without any intervening events.<sup>22</sup> The court further noted cases in other jurisdictions where

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11. *Id.*

12. *Id.*

13. No. 16-12108, 2017 WL 3263356, at \*1 (E.D. Mich. Aug. 1, 2017).

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.* at \*2.

21. *Id.*

22. *Id.*

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courts found no coverage for similar instances of “computer fraud.”<sup>23</sup> Based on the foregoing, the court concluded that the emails themselves did not directly cause the transfers because there was no infiltration or hacking of the plaintiff’s computer system. Instead, the plaintiff authorized the transfers based on the information received in the emails.<sup>24</sup> Therefore, there was no coverage available for the loss.<sup>25</sup>

As shown in *Taylor & Lieberman* and *American Tooling Center*, coverage for social engineering losses routinely turns on questions of causation. Although each of these courts found that losses arising from social engineering schemes were not covered by the insurance policies at issue, other federal courts have reached the opposite conclusion.

For example, in *Medidata Solutions, Inc. v. Federal Insurance Co.*, the U.S. District Court for the Southern District of New York granted a policyholder’s motion for summary judgment on the issue of insurance coverage for “computer fraud” and “funds transfer fraud.”<sup>26</sup> The plaintiff in that case, Medidata Solutions, Inc., had notified its finance department of the company’s short-term business plans that included a possible acquisition.<sup>27</sup> Thereafter, an employee within the finance department received an email purportedly from the plaintiff’s president, stating that an attorney would contact her regarding the acquisition.<sup>28</sup> The employee then received a phone call from the “attorney” demanding that she process a wire transfer.<sup>29</sup> Upon indicating that she needed approval, the employee, vice president, and director of revenue received a group email, purportedly from the plaintiff’s president, approving the wire transfer.<sup>30</sup>

After it was discovered that the emails were fraudulent, the plaintiff submitted a claim under three different clauses in its insurance policy.<sup>31</sup> In turn, the carrier denied coverage, for many of the same reasons the *Taylor & Lieberman* and *American Tooling Center* courts found no coverage in those cases.<sup>32</sup>

Nevertheless, with regard to the computer fraud coverage claim, the court found that the plaintiff was correct in asserting coverage under the policy.<sup>33</sup> The court observed that the fraud on the plaintiff fell within the kind of “deceitful and dishonest access” imagined by the New York

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23. *Id.* at \*3 (citing *Apache Corp. v. Great Am. Ins. Co.*, 662 F. App’x 252 (5th Cir. 2016)).

24. *Id.*

25. *Id.*

26. No. 15-CV-907 (ALC), 2017 WL 3268529, at \*1 (S.D.N.Y. July 21, 2017).

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.* at \*1–2.

31. *Id.* at \*3.

32. *Id.*

33. *Id.* at \*4.

Court of Appeals in the matter of *Universal American Corp. v. National Union Fire Insurance Co. of Pittsburgh, Pa.*, which involved a health insurance company that was defrauded by health care providers who entered claims for reimbursement of services that were never rendered.<sup>34</sup> The court interpreted the decision in *Universal* as finding coverage for fraud where the perpetrator violates the integrity of a computer system through unauthorized access.<sup>35</sup> To this end, the court distinguished prior cases on the “direct cause” issue, finding that the fraud was achieved by entry into the plaintiff’s email system with spoofed emails armed with a computer code that masked the thief’s true identity.<sup>36</sup> Accordingly, the court concluded that the plaintiff’s losses were directly caused by a computer violation.<sup>37</sup>

As for the funds transfer fraud coverage claim, the court similarly found that the unambiguous policy language covered the plaintiff’s theft.<sup>38</sup> It was undisputed that a third party masked itself as an authorized representative and directed the plaintiff’s employee to initiate a wire transfer.<sup>39</sup> The validity of the transfer depended on several high-level employees’ knowledge and consent, which was obtained by trick, a form of larceny.<sup>40</sup> Accordingly, the court concluded that the “funds transfer fraud” clause also covered the theft.<sup>41</sup>

The decisions highlighted above represent only a fraction of the numerous insurance coverage cases for social engineering schemes currently making their way through courts around the country. Nevertheless, these decisions show the growing divide among courts as to the scope of computer crime and other cyber insurance coverage. Insurers will often claim that there is no coverage for multi-faceted social engineering schemes insofar as such schemes do not comport with the phrase “direct loss,” which often appears in these types of policies. As evidenced in the cases discussed above, insurers find support for this argument where policyholders had an opportunity to prevent a loss by, for example, verifying wire transfer details, but failed to take such action. On the other hand, policyholders will likely rely on the position taken by the *Medidata* court, which arguably reflects an approach that is more consistent with their reasonable expectations as to what should be covered under their policies.

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34. *Id.* at \*4–5 (citing *Universal Am. Corp. v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa.*, 37 N.E.3d 78 (N.Y. 2015)).

35. *Id.* at \*4–5.

36. *Id.* at \*6 (citing *Pestmaster Servs., Inc. v. Travelers Cas. & Sur. Co. of Am.*, No. CV 13-5039-JFW MRWX, 2014 WL 3844627 (C.D. Cal. July 17, 2014), *aff’d in part, vacated in part*, 656 F. App’x 332 (9th Cir. 2016)).

37. *Id.* at \*7.

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

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Although the ramifications of these recent decisions remain to be seen, it is clear that many courts recognize that there are limits to the scope of computer crime coverage. It is, therefore, imperative for both insurance carriers and policyholders to negotiate the clearest policy language possible. Insurers also can seek to avoid litigation by developing specialty coverage forms addressing cyber liability risks. To this end, however, many insurers have cut back on offering cyber coverage due to the increase in the number and types of breaches and attendant risk and potential liability.<sup>42</sup> Further, insurers are likely to refuse to provide coverage to companies if there are concerns about internal security controls.<sup>43</sup>

Even so, policyholders can take preventative actions to avoid social engineering losses in the first place. Perhaps most significantly, policyholders should recognize that even though nearly everyone knows about phishing and social engineering schemes, many companies are still sustaining millions of dollars in losses because of the actions of unsuspecting employees, often through the opening of a malicious email or the authorization of wire transfers without verification. In order to prevent these losses and minimize the risk of social engineering attacks, policyholders should, among other things, (1) provide anti-phishing training to employees; (2) provide training on safe practices when using Facebook, Instagram, Twitter, LinkedIn, and other social media services; (3) require multi-step authorization, authentication, and verification for any wire transfer; and (4) require sign-off by multiple employees. Through the implementation of such cybersecurity procedures by policyholders, both policyholders and insurance carriers can be in the best position to mitigate risk in the event of a social engineering attack.

Looking ahead, there are several potentially significant insurance coverage cases concerning social engineering losses that may be decided in the near term. For example, the Ninth Circuit is considering whether Aqua Star (USA) Corporation is entitled to computer fraud coverage for losses it allegedly suffered when it was spoofed into wiring funds to a scammer.<sup>44</sup> Similarly, the U.S. District Court for the Western District of Kentucky is considering whether Phoenix Process Equipment Company is entitled to computer crime coverage for a wire transfer to what it thought was the bank account of a vendor but was instead a scammer who had intercepted legitimate emails, impersonated the vendor's employees, and mocked up an invoice with fraudulent and incorrect bank ac-

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42. Jim Finkle, *U.S. utilities worry about cyber coverage after Ukraine grid attack*, REUTERS, Jan. 28, 2016, <https://www.reuters.com/article/us-cyber-insurance-utilities/u-s-utilities-worry-about-cyber-cover-after-ukraine-grid-attack-idUSKCN0V628N>.

43. *Id.*

44. Aqua Star (USA) Corp. v. Travelers Cas. & Sur. Co. of Am., Case No. 16-35614 (9th Cir.).

count information.<sup>45</sup> Further, appeals have been filed in the *American Tooling Center* and *Medidata* cases.<sup>46</sup>

Although these cases and others may be decided by the time this article is published, the decisions should be monitored because they may have important ramifications on the deepening divide amongst the nation's courts. In the interim, it is critical that insurers and policyholders alike continue to educate themselves on social engineering attacks, how to prevent them, and how to avoid litigation over insurance coverage in the event that they occur. Cyber insurance has the potential to greatly enhance risk management related to cybersecurity; however, it is a developing area of insurance that will likely see continued growth and change as cybersecurity becomes increasingly important to companies and organizations worldwide.

### III. THE EFFICIENT PROXIMATE CAUSE DOCTRINE: HISTORICAL UNDERPINNINGS AND FUTURE APPLICABILITY BEYOND FIRST-PARTY PROPERTY POLICIES

Insurance policies generally approach establishing the scope of covered risks in two ways. While some policies provide coverage for all causes of loss that result in covered injury or damage, unless the cause of the loss is specifically excluded, other policies specifically define those perils that are covered and excluded. The former policies, which we will refer to as "broad risk" policies, are common for third-party liability coverage. The latter policies, which we will refer to as "limited risk" policies, are traditionally used for first-party property coverage.

Whether a particular loss is covered can vary greatly depending on whether the policy provides broad or limited risk coverage. For broad risk policies, there is generally coverage if covered damage occurs unless the cause of the damage is specifically excluded. For limited risk policies, the analysis differs somewhat because insurers may be faced with claims for covered damage caused by both covered and excluded causes of loss. Such analysis requires determining coverage for claims involving an initial cause of loss that is a named risk in the policy (e.g., a severe storm) but also involving another contributing and potentially supervening cause of the loss that is excluded from coverage (e.g., earth movement). The proper determination will depend largely on the applicable law. This section will discuss the emergence of the efficient proximate cause doctrine and its historical application in limited risk first-party insurance policies,

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45. *Phoenix Processing Equip. Co. v. Fed. Ins. Co.*, Case No. 3:16-cv-00004 (W.D. Ky.).

46. *Am. Tooling Ctr., Inc. v. Travelers Cas. & Sur. Co. of America*, Case No. 17-2014 (6th Cir.); and *Medidata Solutions, Inc. v. Fed. Ins. Co.*, Case No. 17-2492 (2d Cir.).



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as well as a recent expansion of this doctrine to broad risk third-party liability policies.

A. *The General Rule Regarding the Efficient Proximate Cause Doctrine*

Courts employ the efficient proximate cause doctrine to resolve coverage disputes when a claim involves damage caused by both covered and excluded causes of loss. Under this doctrine, the focus of the inquiry is on establishing the “efficient proximate cause” of the loss, which in essence is the initial event that “sets into motion the chain of events” that, “in an unbroken sequence,” produced the loss for which coverage is sought.<sup>47</sup> In other words, if a covered cause of loss subsequently triggers other excluded causes of loss within the causative chain, the claimed damage still would be covered by the policy, despite the fact that these other causes are also causes-in-fact of the loss.<sup>48</sup> On the other hand, if an excluded cause of loss triggers a series of events that includes a covered cause of loss, the resulting damage would be excluded from coverage. While the application of this doctrine varies by state, a majority of states have adopted some form of the efficient proximate cause doctrine.

B. *Historical Background of the Efficient Proximate Cause Doctrine*

“The origin of the efficient proximate cause doctrine is rooted in the Latin maxim *causa proxima, non remota spectatur*. This maxim has been widely interpreted to mean ‘the immediate not the remote cause is considered.’”<sup>49</sup> This doctrine was historically applied in maritime and property insurance cases involving property damage. “[C]ourts seeking to determine the cause of [the alleged property] damage [would] assign greater weight to the ultimate, efficient causes than to the temporally remote causes.”<sup>50</sup> The logical underpinning of this doctrine is that, if the loss was “‘trace[d]’” backed to its “‘remote causes’” instead of the efficient causes, it “would violate the parties’ reasonable understandings as to the scope of coverage.”<sup>51</sup>

One of the “leading English case[s]” of the application of the efficient proximate cause doctrine came in the case of *Cory v. Burr*,<sup>52</sup> where “a captain committed barratry [fraud by a master or a crew at the expense of the

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47. *Safeco Ins. Co. of Am. v. Hirschmann*, 773 P.2d 413, 416 (Wash. 1989).

48. *Id.*

49. Julie A. Passa, Case Comment: *Insurance Law—Property Insurance: Adopting the Efficient Proximate Cause Doctrine, but Saying No to Contracting Out of It*, Western National Insurance Co. v. University of North Dakota, 79 N.D. L. REV. 561, 564 (2003) (quoting *Tillery v. Hull & Co., Inc.*, 876 F.2d 1517, 1519 (11th Cir. 1989)).

50. *Tillery*, 876 F.2d at 1519.

51. *Id.* (quoting and citing *Blaine Richards & Co. v. Marine Indem. Ins. Co.*, 635 F.2d 1051, 1054 (2d Cir. 1980)).

52. 8 App. Cas. 393 (1883) (*cited in Tillery*, 876 F.2d at 1519).

owners of a ship<sup>53</sup>) by attempting to pick up and smuggle a consignment of tobacco.”<sup>54</sup> “The [ship] was captured by Spanish authorities” and confiscated while the captain and crew were charged with smuggling.<sup>55</sup> “The [ship] was damaged incident to its capture, and the insurance contract contained standard barratry and FCS [Free of Capture and Seizure] clauses.”<sup>56</sup> After its owners were compelled to pay a large sum of money to get back their ship, they sought coverage for the damage.

Speaking for the House of Lords, Lord Blackburn stated that recovery could not be based on the remote cause of barratry:

If it had not been that the Spanish revenue officers doing their duty . . . had come and seized the ship, the barratry of the captain in coasting along there . . . would have done the assured no harm at all. The underwriters do undertake to indemnify against barratry; they do not undertake to indemnify against any loss which is directly sustained in consequence of the barratry.<sup>57</sup>

Another seminal decision came in the case of *Leyland Shipping Co. v. Norwich Union Fire Insurance Society*,<sup>58</sup> where “an insurance policy for a ship-covered loss [attributable to] perils of the sea, but excluded coverage for loss caused by hostilities or warlike operations.”<sup>59</sup> After the ship was sunk by a torpedo during World War I, “[t]he insured argued that the . . . water [entering] into the hole [of the ship] left from the torpedo was a peril of the sea” and, thus, should be covered.<sup>60</sup> However, “Lord Shaw noted that while the entry of seawater was indeed a peril of the sea and proximate in time, it was not . . . proximate in efficiency”; this “rule[d] out” the logic that proximate cause necessarily meant the cause “nearest in time.”<sup>61</sup> Instead, the court held that the efficient proximate cause was the “torpedo blast, which was an excluded cause [of loss].”<sup>62</sup>

Turning to the United States, one of the leading cases on the doctrine of efficient proximate cause is the U.S. Supreme Court case of *Insurance Company v. Boon*.<sup>63</sup> In *Boon*, the insured argued that it was entitled to coverage for certain goods stored in a building that was damaged during the Civil War when Confederate forces surrounded and attacked a city, which was defended by Union forces.<sup>64</sup> During the battle, the Union forces set

53. MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 100 (11th ed. 2003).

54. *Tillery*, 876 F.2d at 1519 (citing *Cory*, 8 App. Cas. 393).

55. *Id.*

56. *Id.*

57. *Tillery*, 876 F.2d at 1519–20 (quoting *Cory*, 8 App. Cas. 400–01).

58. [1918] A.C. 350 (HL).

59. *Passa*, *supra* note 49, at 564 (citing *Leyland*, [1918] A.C. at 350–51).

60. *Id.* (citing *Leyland*, [1918] A.C. at 350, 353–54).

61. *Id.* (citing *Leyland*, [1918] A.C. at 369–70).

62. *Id.* at 565 (citing *Leyland*, [1918] A.C. at 370).

63. 95 U.S. 117 (1877).

64. *Id.* at 129.

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fire to the City Hall to prevent it from falling into the hands of the enemy.<sup>65</sup> The fire spread to adjacent buildings, including the insured's building and destroyed the insured goods.<sup>66</sup>

The Court held "the burning of the city hall and the spread of the fire afterwards was not a new and independent cause of loss. [Rather], it was an incident, a necessary incident and consequence, of the hostile rebel attack on the town,—a military necessity caused by the attack."<sup>67</sup> In discussing the principle of proximate cause, the Court stated:

The proximate cause, as we have seen, is the dominant cause, not the one which is incidental to that cause, its mere instrument, though the latter may be nearest in place and time to the loss. . . . [I]n considering what is the proximate and what is the remote cause of an injury, "The inquiry must always be whether there was any intermediate cause disconnected from the primary fault, and self-operating, which produced the injury."<sup>68</sup>

The Supreme Court revisited the concept of efficient proximate cause in *Standard Oil Co. v. United States*,<sup>69</sup> where a ship owner sought to recover under a policy of war risk insurance that insured its vessel against "all consequences of hostilities or warlike operations."<sup>70</sup> The loss occurred when the vessel collided with a Navy mine sweeper that was clearing a channel to New York Harbor during World War II.<sup>71</sup> "Both vessels were [found to be] at fault in failing 'to comply with the . . . rules' of good seamanship 'under the circumstances.'"<sup>72</sup> The ship owner claimed that a collision with the moving warship was sufficient to establish liability under the policy.<sup>73</sup> While the Navy "conceded that mine sweeping is a 'warlike operation,'" it argued "that the collision was [not] a 'consequence' of the mine sweeping within the meaning of the insurance contract."<sup>74</sup> Writing for the majority, Justice Black cited to *Boon* and noted the state of the law regarding proximate cause under insurance law as follows:

Proximate cause in the insurance field has been variously defined. It has been said that proximate cause referred to the "cause nearest to the loss." Again, courts have properly stated that proximate cause "does not necessarily refer to the cause nearest in point of time to the loss. But the true meaning of

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65. *Id.*

66. *Id.* at 129–30.

67. *Id.* at 133.

68. *Id.* (quoting *Milwaukee & Saint Paul Ry. Co. v. Kellogg*, 94 U.S. 469 (1876)).

69. 340 U.S. 54 (1950).

70. *Id.* at 55.

71. *Id.*

72. *Id.* at 56.

73. *Id.*

74. *Id.*

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that maxim is, that it refers to that cause which is most nearly and essentially connected with the loss as its efficient cause.”<sup>75</sup>

The *Standard Oil* Court held that because “the facts of the case [were] susceptible both of the inference that the mine-sweeping activity . . . had some relation to the collision and that it did not.”<sup>76</sup> The ship owner had failed to establish that the warlike activity was the proximate cause of the collision as a matter of law, so the resolution of the case was “properly” the province of the lower courts because it was a factual dispute.<sup>77</sup>

### C. *Evolution of the Efficient Proximate Cause Doctrine to More Modern Insurance Policies*

As noted above, the efficient proximate cause doctrine was traditionally applied by looking behind the next, nearest, or immediate cause, to locate the real and efficient cause of the loss. In a more recent example, the court in *Bowers v. Farmers Insurance Exchange*<sup>78</sup> applied this doctrine to a homeowner’s claim for property damage arising from mold after tenants vandalized the insured home. Prior to renting her home, the homeowner (Bowers) had kept the home in good condition “without [any] problems of mold or excess vapor condensation.”<sup>79</sup> “The tenants converted [the] basement . . . into a hothouse for growing marijuana,” which included using halide lights, covering the basement windows, placing foil on the walls, and venting fumes from the marijuana operation “directly into the chimney.”<sup>80</sup> As a result of the hothouse operation, mold grew throughout the house because of “the lack of heat throughout the house, together with excessive water condensation from the . . . lights.”<sup>81</sup> After Bowers filed a claim for mold damage, her homeowner’s insurer (Farmers) “denied the claim . . . as not being covered under the policy.”<sup>82</sup> While the policy excluded mold as a cause of loss, it included vandalism as a covered cause of loss unless the property had been vacant for thirty consecutive days immediately prior to the loss.<sup>83</sup> Bowers argued, and the court agreed, that the tenants engaged in vandalism because they “acted in conscious . . . disregard for her property rights” from which malice can be inferred.<sup>84</sup> The court ultimately held that while the “mold growth was the immediate cause of her

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75. *Id.* at 58 (quoting *Queen Ins. Co. v. Globe & Rutgers Fire Ins. Co.*, 263 U.S. 487, 492 (1924)); *Dole v. New Eng. Mut. Ins. Co.*, 7 Fed. Cas. 837, 853 (C.C. Mass. 1864).

76. *Id.*

77. *See id.* at 58–59.

78. 991 P.2d 734 (Wash. Ct. App. 2000).

79. *Id.* at 736.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.* at 736–37.

84. *Id.* at 737.

loss,” the “tenants’ vandalism was the efficient proximate cause [for] the loss.”<sup>85</sup> As a result, the *Bowers* court found that the claim was covered under the homeowner’s policy.<sup>86</sup>

Another decision out of California further illustrates the traditional approach toward applying the efficient proximate cause doctrine. In *Sabella v. Wisler*,<sup>87</sup> a builder and ultimate seller of a home (Wisler) negligently built a home on unsuitable land. Shortly after Wisler sold the home to the Sabelas, “the sewer pipe . . . began to leak . . . near the house, causing the sewer outflow from the house to infiltrate the unstable earth near and below the foundation.”<sup>88</sup> As a result, the house allegedly sustained damage from settling, but did not collapse. Sabella’s insurer denied coverage because the policy excluded loss caused by “settling, cracking, shrinkage, or expansion of pavements, foundation, walls . . . unless loss by . . . collapse of buildings ensues.”<sup>89</sup> The court however, found that the alleged loss was covered “because the rupture of the sewer line attributable to the negligence of a third party, rather than [the] settling [of the house], was the efficient proximate cause of the loss.”<sup>90</sup> The court analyzed California Insurance Code Section 530, which provides that:

[a]n insurer is liable for a loss of which a peril insured against was the proximate cause, although a peril not contemplated by the contract may have been a remote cause of the loss; but he is not liable for a loss of which the peril insured against was only a remote cause.<sup>91</sup>

As a result, the *Sabella* court concluded that the policy covered the loss attributable to the sewer line, and since that was the proximate cause of the loss, there was coverage under the policy.

Further, in *Garvey v. State Farm Fire & Casualty Co.*,<sup>92</sup> the California Supreme Court held that the efficient proximate cause doctrine, instead of the concurrent cause doctrine, should have been applied to the homeowner’s first-party property insurance claim. In *Garvey*, the homeowners’ addition to their home “had begun to pull away,” and “[t]hey also discovered damage to a deck and garden wall.”<sup>93</sup> The homeowners made a claim to State Farm, which denied coverage by attributing the loss to an excluded cause of loss—the earth movement. The homeowners argued that it was negligence attributable to the contractor that was the cause of loss—not the earth movement.

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85. *Id.* at 738.

86. *See id.*

87. 377 P.2d 889 (Cal. 1963).

88. *Id.* at 892.

89. *Id.* at 891–92.

90. *See id.* at 895.

91. *Id.* at 896.

92. 770 P.2d 704 (Cal. 1989).

93. *Id.* at 705.

The California Supreme Court held the efficient proximate cause doctrine applied to the homeowners' first-party property insurance claim and rejected the homeowners' contention that the concurrent cause doctrine should apply.<sup>94</sup> Specifically, the court held that the concurrent cause doctrine applies only to third-party liability insurance policies, not first-party property insurance policies.<sup>95</sup> In discussing the differences in coverage between first-party and third-party insurance policies, the court stated:

[I]t is important to separate the causation analysis necessary in a first party property loss case from that which must be undertaken in a third party tort liability case. . . . "Property insurance . . . is an agreement, a contract, in which the insurer agrees to indemnify the insured in the event that the insured property suffers a covered loss. Coverage, in turn, is commonly provided by reference to causation, e.g., 'loss caused by . . .' certain enumerated perils. The term 'perils' in traditional property insurance parlance refers to fortuitous, active, physical forces such as lightning, wind, and explosion, which bring about the loss. *Thus, the 'cause' of loss in the context of a property insurance contract is totally different from that in a liability policy.* This distinction is critical to the resolution of losses involving multiple causes. Frequently property losses occur which involve more than one peril that might be considered legally significant. . . . The task becomes one of identifying the most important cause of the loss and attributing the loss to that cause."

On the other hand, the right to coverage in the third party liability insurance context draws on traditional tort concepts of fault, proximate cause and duty. This liability analysis differs substantially from the coverage analysis in the property insurance context, which draws on the relationship between perils that are either covered or excluded in the contract.<sup>96</sup>

Thus, the court held the two kinds of policies (first- and third-party policies) were starkly different in purpose and effect and required different causation analysis.

#### D. *New Application of the Efficient Proximate Cause Doctrine to Third-Party Liability Insurance Policies*

As shown above, various courts have adopted and implemented the efficient proximate cause doctrine to first-party property insurance policies, which are traditionally limited risk policies. On the other hand, broad risk policies, which are typically used for third-party liability insurance policies, are designed to cover all liabilities except those specifically excluded.<sup>97</sup>

94. *See id.*

95. *Id.* at 712–13.

96. *Id.* at 710 (quoting Michael E. Bragg, *Concurrent Causation and the Art of Policy Drafting: New Perils for Property Insurers*, 20 FORUM 385, 386–87 (1985)).

97. *See* Susan J. Field & Rina Carmel, *Evaluating First-Party Property Claims with Multiple Causes Under the Efficient Proximate Cause Doctrine*, American Bar Association (Jan. 30, 2012),

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When the efficient proximate cause doctrine is applied to broad risk policies, it is easy to imagine how a claim could effectively render the policy exclusions unenforceable as long as a claimant can point to *any* liability not excluded under this doctrine.<sup>98</sup> Unlike first-party property insurance policies, third-party insurance policies usually do not have covered causes of loss or perils. Thus, applying the efficient proximate cause doctrine to third-party policies could effectively open the floodgates to claims not intended to be covered by such policies.

With this in mind, we turn to a recent decision in *Xia v. ProBuilders Specialty Insurance Co. RRG*,<sup>99</sup> where the Washington Supreme Court applied the efficient proximate cause doctrine to a third-party liability policy.<sup>100</sup> In *Xia*, Ms. Xia purchased a home that was new construction, but “[s]oon after moving into her home, Xia began to feel ill.”<sup>101</sup> She “discovered that an exhaust vent attached to the hot water heater had not been installed correctly and was discharging carbon monoxide directly into the [home].”<sup>102</sup> “Xia notified [the builder] of her injuries” and the builder tendered the claim to ProBuilders, which told Xia “that coverage was not available” because the policy contained a pollution exclusion.<sup>103</sup> Xia subsequently filed suit against the builder, which carried a commercial general liability policy through ProBuilders, and ProBuilders refused to provide defense or indemnity coverage. Xia settled with the builder for \$2 million, which included a stipulated judgment and a covenant not to execute or enforce the judgment against the builder, along with an assignment of rights by the builder to Xia against ProBuilders.<sup>104</sup> “Xia filed suit against ProBuilders, seeking declaratory judgment with regard to coverage and alleging [various extra-contractual claims].”<sup>105</sup>

While ProBuilders prevailed at the trial court and appellate level, the Washington Supreme Court reversed and held that the efficient proximate cause rule applied to this third-party claim.<sup>106</sup> The court noted that it “ha[d] never . . . suggested that the . . . efficient proximate cause [rule] is limited to

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<http://apps.americanbar.org/litigation/committees/insurance/articles/novdec2011-evaluating-first-party-property-claims.html>.

98. Seth Row, Michael Fandel & Vanessa Wheeler, *In Extraordinary Ruling, Washington Supreme Court Applies “Efficient Proximate Cause” Rule to Liability Coverage Dispute*, MILLER NASH GRAHAM DUNN (May 5, 2017), <http://www.nwpolicyholder.com/2017/05/in-extraordinary-ruling-washington-supreme-court-applies-efficient-proximate-cause-rule-to-liability-coverage-dispute/>.

99. 400 P.3d 1234 (Wash. 2017).

100. Row et al., *supra* note 98.

101. *Xia*, 400 P.3d at 1237.

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

106. *See id.* at 1243–44.

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any one particular type of insurance policy,” but found that it “has broad application whenever a covered occurrence under the policy—whatever that may be—is determined to be the efficient proximate cause of the loss.”<sup>107</sup> Applying the efficient proximate cause rule to this case, the *Xia* court found that an act of negligence by the builder—an apparent covered cause of loss—may be the efficient proximate cause of the loss.<sup>108</sup> The *Xia* court explained its decision as follows:

[T]he efficient proximate clause [sic] rule applies only “when two or more perils combine in sequence to cause a loss and a covered peril is the predominant or efficient cause of the loss.” It is perfectly acceptable for insurers to write exclusions that deny coverage when an excluded occurrence initiates the causal chain and is itself either the sole proximate cause or the efficient proximate cause of the loss.

This court has repeatedly rejected attempts by insurers to draft language into the exclusion that expressly circumvents the rule.

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The exclusion cannot eviscerate a covered occurrence merely because an uncovered peril appeared later in the causal chain. The efficient proximate cause rule exists to avoid just such a result, ensuring that an insurance policy offering indemnity for a covered peril will provide coverage when a loss is proximately caused by that covered peril. Inasmuch as the causation language in the pollution exclusion here conflicts with established Washington law, it cannot defeat *Xia*’s recovery as assignee of rights under the policy.<sup>109</sup>

Prior to *Xia*, Washington courts had never previously applied the efficient proximate cause rule beyond first-party claims.<sup>110</sup> In fact, it appears that no court in the country had applied the efficient proximate cause beyond first-party claims prior to the *Xia* decision.

While the potential impact of this decision on both insurers and policyholders in Washington is still being determined, it has the potential to create uncertainty in the insurance market since insurers potentially must plan and prepare to cover third-party claims that were previously believed to be excluded under prior case law.<sup>111</sup>

Regarding the impact of *Xia* on other jurisdictions, it is likely only a matter of time before policyholders raise this issue of whether the efficient proximate cause rule applies to third-party claims. It will be interesting to see if other jurisdictions follow Washington or if Washington will remain an out-

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107. *Id.* at 1240.

108. *Id.* at 1243.

109. *Id.* at 1240–41 (quoting *Vision One, LLC v. Phila. Indem. Ins. Co.*, 174 Wash. 2d 501, 519, 276 P.3d 300 (2012)) (citations omitted).

110. Row et al., *supra* note 98.

111. *Id.*



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lier on this issue. Regardless, the potential that the efficient proximate cause rule may apply to broad risk policies should be considered and analyzed by anyone in the insurance industry because it could have a dramatic effect on how insurance policies are written and priced going forward.

#### IV. RECENT DEVELOPMENTS IN POLLUTION EXCLUSION CASE LAW

Three decades have passed since the absolute pollution exclusion, and later the total pollution exclusion, became standard in general liability policies. Yet each year, there are a new handful of cases decided that address novel issues, whether in terms of what constitutes a pollutant or what factual scenarios fall within the scope of the exclusion. While the dichotomy between traditional harm (i.e., impacts to the environment at large) and non-traditional environmental harm (which would encompass harms on a smaller scale such indoor releases of toxic fumes) remains a useful distinction, case law continues to evolve such that there are nuanced distinctions from state to state as to when and under what circumstances the exclusion will apply.<sup>112</sup> The last year has seen a number of significant and even surprising decisions that demonstrate the further balkanization of pollution exclusion case law throughout the country.

The first, and perhaps most notable decision, was *Xia v. ProBuilders Specialty Insurance Co. RRG*, decided by the Supreme Court of Washington.<sup>113</sup> As discussed above, *Xia* involved a question of coverage for an underlying bodily injury lawsuit in which the claimant alleged injury resulting from exposure to carbon monoxide fumes emanating from a hot water heater that was defectively installed by the insured. The insurer argued that the pollution exclusion in its policy applied to the claim given that carbon monoxide—a pollutant—was the cause of the plaintiff's injuries.

While the court initially addressed the issue of whether the incident resulted from traditional or non-traditional pollution, it ultimately concluded that the pollution exclusion was inapplicable because pollution was not the efficient proximate cause of the underlying loss.<sup>114</sup> Rather, the efficient proximate cause was the insured's negligent installation of the hot water heater, which eventually resulted in the carbon monoxide pollution. The court explained that this negligent installation would qualify as a covered event under the policy. As such, the court reasoned that the pollution exclusion should not apply to harms resulting from what otherwise would be considered a covered occurrence.

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112. See, e.g., *Quadrant Corp. v. Am. States Ins. Co.*, 110 P.3d 733 (Wash. 2015) (collecting cases); *Apana v. TIG Ins. Co.*, 574 F.3d 679 (9th Cir. 2009) (collecting cases).

113. 400 P.3d 1234 (Wash. 2017).

114. *Id.* at 1239, 1244.

In arguing against the application of the efficient proximate cause standard to the pollution exclusion, the insurer contended that any instance of pollution can be tied back to some accident or incident that might otherwise qualify as a covered occurrence.<sup>115</sup> Thus, the insurer contended that the pollution exclusion essentially would be rendered moot by application of an efficient proximate cause test. The court rejected this argument, stating that there may be instances where a pollution event is the first step in a chain of causation.<sup>116</sup> One example the court gave is where an insured applies flooring sealant that releases fumes causing injuries to third-parties, as the first step in the chain in this loss scenario is the pollution event itself. This is distinguished from the situation in *Xia*, where the first step in the chain of causation was the insured's faulty construction activities, which eventually allowed for a pollution event to happen later.

The *Xia* court suggested that it would be impermissible under Washington law for an insurer to draft a pollution exclusion applicable to harms regardless of whether the pollution event is the efficient proximate cause.<sup>117</sup> It did, however, suggest that insurers could draft exclusions for specific occurrences, such as an exclusion for any injuries or damages resulting in any way from faulty installation of hot water heaters. Because it is virtually impossible to predict the various ways in which a discharge, dispersal, release, etc. of a pollutant can happen, it is unlikely that insurers writing risks in Washington can effectively work around the *Xia* decision. Therefore, it is likely that the pollution exclusion will apply only to very limited circumstances under Washington law, keeping in mind that Washington courts had already limited application of the exclusion to matters involving traditional environmental harms. It is also possible, if not likely, that policyholders will raise similar arguments in other jurisdictions, which could prompt a new round of pollution-exclusion case law across the country addressing whether efficient proximate cause should be a relevant factor when considering the application of the exclusion.

The decision in *Xia* was put to the test by the U.S. District Court for the Eastern District of Washington in *Dolsen Cos. v. Bedivere Insurance Co.*<sup>118</sup> There, the court considered the application of the pollution exclusion to environmental harms caused by the failure of the insured's holding ponds at its farming facilities, allowing some 1.6 million gallons of untreated manure to be released.<sup>119</sup> After concluding that the manure was a pollutant and that the release caused soil and groundwater contamination, the court then turned to the efficient proximate cause test articulated

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115. *Id.* at 1243.

116. *Id.*

117. *Id.*

118. 2017 WL 3996440 (E.D. Wash. Sept. 11, 2017).

119. *Id.* at \*1.

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in the *Xia* decision. It concluded that the exclusion applied because the initial peril—the release of manure from a retaining pond—was the polluting act as opposed to situations such as in *Xia*, where the initial peril is the act that incidentally leads to a later pollution event.<sup>120</sup>

The U.S. District Court for the District of New Jersey decided another notable pair of cases. For over a decade, New Jersey courts have limited the pollution exclusion to matters involving traditional environmental harm. The federal court, however, added a wrinkle to this analysis, beginning with its decision in *Castoro & Co. v. Hartford Accident & Indemnity Co.*,<sup>121</sup> which it later upheld on motion for reconsideration in April 2017. The *Castoro* court, relying on a line in the New Jersey Supreme Court's 2005 decision in *Nav-Its, Inc. v. Selective Insurance Co. of America*,<sup>122</sup> concluded that the pollution exclusion applies only to intentional industrial pollution. Therefore, the pollution exclusion did not apply to a claim involving unintentional pollution caused by a “mom and pop” contracting business where the contamination was not expected or intended from the standpoint of the insured, even if the event giving rise to the contamination was expected.<sup>123</sup>

The New Jersey district court relied on the *Castoro* decision in *Benjamin v. State Farm Insurance Co.*,<sup>124</sup> where the court addressed the application of a pollution exclusion contained in a homeowner's policy. The court held that in the absence of any proof demonstrating that the insured policyholder expected or intended a leak from an underground storage tank, it was inappropriate to grant summary judgment in favor of the insurer, despite clear evidence of what ordinarily would be considered traditional environmental harms.

Also revisiting the pollution exclusion over the last year was an Indiana federal district court. In *Atlantic Casualty Insurance Co. v. Garcia*,<sup>125</sup> the court considered coverage under general liability policies for Stoddard solvents, PCE solvents, and heating oil that leaked from underground storage tanks at an auto repair shop and day spa. The pollution exclusions at issue, modified for an Indiana insured, defined “pollutant” as:

[A] “solid, liquid, gaseous, or thermal irritant or contaminant or all material for which a Material Safety Data Sheet is required pursuant to federal, state, or local laws, where ever discharged, dispersed, seeping, migrating or released, including but not limited to petroleum, oil, heating oil, gasoline, fuel oil, carbon monoxide, industrial waste, acid, alkalis, chemicals, waste,

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120. *Id.* at \*8.

121. 2016 WL 5660438 (D.N.J. Sept. 29, 2016).

122. 869 A.2d 929 (N.J. 2005).

123. *Castoro*, 2016 WL 5660438 at \*7.

124. 2017 WL 3535023 (D.N.J. Aug. 17, 2017).

125. 227 F. Supp. 3d 990 (N.D. Ind. 2017).

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treated sewage; and associated smoke, vapor, soot and fumes from said substance. . . .”<sup>126</sup>

The *Garcia* court acknowledged the long line of cases, from *American States Insurance Co. v. Kiger*,<sup>127</sup> to *Visteon Corp. v. National Union Fire Insurance Co. of Pittsburgh, PA*,<sup>128</sup> in which Indiana courts have found the exclusion to be ambiguous and unenforceable. The court acknowledged that these cases did not involve pollution exclusions comparable to the one before it containing such a specific definition of what substances qualified as pollutants, and that Indiana’s Supreme Court has compelled insurers to employ carefully drafted wordings of what substances qualify as “pollutants” in order to avoid an ambiguity. The *Garcia* court nevertheless questioned the propriety of defining “pollutants” generally by reference to federal or state law, noting that the Southern District of Indiana has held that a definition of “pollutants” by reference to federal law is not adequate.<sup>129</sup> Acknowledging the question to be close, the court avoided it altogether by ruling on a different coverage issue. In passing, however, the *Garcia* court quoted an observation by an Indiana Supreme Court justice that if the pollution exclusion is always unenforceable under Indiana law, then insurers will respond by raising premiums across the board.<sup>130</sup>

While the preceding cases dealt with more theoretical questions of the scope and purpose of the absolute and total pollution exclusions, the past year saw its share of decisions addressing more practical questions of whether particular substances qualify as pollutants for the purpose of the exclusion.

Notable among these cases was *Restaurant Recycling, LLC v. New Fashion Pork, LLP*, a case addressing the pollution exclusion in the context of a product defect case.<sup>131</sup> The policyholder sought coverage for a claim involving its shipment of contaminated fat product that was incorporated into the claimant’s feed product and ultimately caused harm to the claimant’s swine. The policyholder’s fat product had been contaminated with lasalocid (a medicine regulated by the FDA and used in feed for fowl) and lascadoil (a byproduct of lasalocid that is approved only for use as a biofuel).

In considering the application of the exclusion, the U.S. District Court for the District of Minnesota agreed that lasalocid and lascadoil qualified as pollutants for the purpose of the exclusion, despite the fact that these substances can be safely used under the right circumstances.<sup>132</sup> More complicated was the court’s consideration as to whether there had been

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126. *Id.* at 994.

127. 662 N.E.2d 945 (Ind. 1996).

128. 777 F.3d 415 (7th Cir. 2015).

129. *Garcia*, 227 F. Supp. 3d at 996–97.

130. *Id.* at 997.

131. 2017 WL 3016763 (D. Minn. July 14, 2017).

132. *Id.* at \*3.

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a discharge, dispersal, or release of these substances, as required by the exclusion. The policyholder argued that there was no dispersal of the two substances because they were never separated from its fat product. The policyholder also argued that the injury caused to the claimant's swine was not caused by a "dispersal" of the substances, but instead the "presence" of these substances in the feed. Finally, much like the policyholders in the New Jersey cases discussed above, the policyholder argued that the exclusion should apply only to intentional pollution.<sup>133</sup>

The court rejected each of these arguments, observing that intent is irrelevant, as was the insured's attempt to draw a distinction between the presence and the dispersal of a contaminant. The court instead concluded that the introduction of the two substances into the insured's fat product, and the blending of that product into the claimant's feed product, constituted two separate acts of dispersal for the purpose of the exclusion.<sup>134</sup> The court held, therefore, that the insurer had no coverage obligations for the underlying suit. In one sense, the *Restaurant Recycling* decision is unsurprising because Minnesota courts historically have not limited the pollution exclusion to matters involving traditional environmental harm. The *Restaurant Recycling* decision suggests, however, that the exclusion can apply to product defects cases, which could have the effect of an even broader application of the exclusion in Minnesota.

*Xia* was not the only court over the last year to address the application of the pollution exclusion to carbon monoxide claims. In *Travelers Property Casualty Co. of America v. Klick*, the Eighth Circuit, applying Minnesota law, found the exclusion applicable to carbon monoxide poisoning resulting from a broken exhaust pipe in a fishing boat.<sup>135</sup> The court agreed that carbon monoxide was a pollutant and that its release from the engine compartment to the boat's wheelhouse was sufficient movement into the "atmosphere" for the purpose of the exclusion. Similarly, in *Colony Insurance Co. v. Victory Construction LLC*,<sup>136</sup> the U.S. District Court for the District of Oregon, predicting Oregon law on the issue, found the exclusion applicable to a carbon monoxide poisoning claim resulting from the insured's negligent installation and ventilation of a natural gas swimming pool heater.

Just as carbon monoxide continues to be a topic generating a large body of case law in the pollution exclusion context, so too is sewage, and the last year was no exception. In *Cincinnati Insurance Co. v. Roy's Plumbing, Inc.*,<sup>137</sup> for example, the Second Circuit, applying New York

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133. *Id.* at \*4.

134. *Id.*

135. 867 F.3d 989 (8th Cir. 2017).

136. 239 F. Supp. 3d 1279 (D. Or. 2017).

137. 692 F. App'x 37 (2d Cir. 2017).

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law, held the exclusion applicable to widespread release of raw sewage from the sewage system in the Love Canal area. In reaching its conclusion, the court considered the insured plumber's argument that the coverage afforded under its policy essentially would be negated for most damages resulting from its plumbing work. The court observed that because under New York law the pollution exclusion applies only to traditional environmental harm, there would still be significant coverage for claims involving non-traditional environmental harms, such as indoor releases of sewage.<sup>138</sup>

The cases discussed in this section are primarily from jurisdictions with large and established bodies of case law addressing the pollution exclusion, such as New York, New Jersey, Washington, and Indiana. Decisions such as *Roy's Plumbing* and *Restaurant Recycling* are instances of courts further fleshing out the scope of the pollution exclusion in jurisdictions where the courts have long since held that the exclusion is either limited to traditional environmental harm or applied more broadly. More significant are the decisions in *Xia* and those issued by the New Jersey federal district court in *Castoro* and *Benjamin*, where the courts fundamentally affected the manner in which the exclusion is applied. The *Xia* decision in particular is a wholesale departure from prior Washington jurisprudence and represents an entirely new line of judicial limitation on the exclusion. While one cannot predict whether the upcoming year will see a decision as significant as *Xia*, one can safely assume that the upcoming year will see its share of pollution exclusion cases that at least incrementally affect the manner in which courts apply the exclusion.

#### V. THE "CAUTIOUS APPROACH": THE ILLINOIS APPELLATE COURT EMBRACES A MORE EXPANSIVE APPLICATION OF THE PEPPERS DOCTRINE

The Illinois Supreme Court's 1976 decision in *Maryland Casualty Co. v. Peppers*<sup>139</sup> has enjoyed nearly iconic status in Illinois for decades. It has become the namesake for what is commonly referred to as "*Peppers* counsel," the notion that insurers must provide independent counsel to their insureds when a conflict of interest arises. It has also played an important role in the development of the estoppel doctrine in Illinois, which recognizes that insurers can be precluded from raising coverage defenses if they do not defend under a reservation of rights or timely file a declaratory judgment action. What the *Peppers* decision is arguably best known for, however, is its pronouncement of the "*Peppers* doctrine"—a prematurity

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138. *Id.* at 39.

139. 355 N.E.2d 24 (Ill. 1976).

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concept that allows a circuit court to postpone the adjudication of coverage issues when resolving those issues would result in the premature determination of factual issues in the underlying litigation. For more than forty years, the *Peppers* doctrine has served as an important bulwark between the domains of the trial court and the coverage court. At its core, the *Peppers* doctrine recognizes the primacy of the trial court in resolving liability. If the resolution of coverage issues would require the court to decide matters that could bear upon the insured's liability, the *Peppers* doctrine commands that the coverage court yield from deciding those issues until the trial court has had an opportunity to address them. Although the *Peppers* doctrine has been firmly rooted in Illinois jurisprudence for decades, the precise contours of the doctrine have not been static; they have continued to progress and develop over time.

A recent decision by the Illinois Appellate Court takes an important step forward in the evolution of the *Peppers* doctrine and signals the court's acceptance of a more expansive application of the doctrine. In *Sentry Insurance v. Continental Casualty Co.*,<sup>140</sup> the Illinois Appellate Court recognized that the *Peppers* doctrine is not an inflexible rule to be rigidly applied, but a framework that should guide—not dictate—the sequence in which liability and coverage issues are decided. At least when invoked in the context of a stay of the proceedings, *Sentry* suggests that judges should be given significant leeway when taking a “cautious approach” toward navigating the often hazy intersection between coverage and liability issues.<sup>141</sup>

The *Sentry* case arose out of a series of lawsuits by oncology patients who, in order to address the risk of infertility associated with cancer treatment, chose to store semen samples cryogenically for possible future use in connection with assisted reproduction. After the patients underwent treatment, the tank in which the samples were stored malfunctioned, causing the samples to thaw and become unusable for procreative purposes.<sup>142</sup> The patients filed claims for negligence and bailment against the hospital and the physicians group for destroying their frozen sperm samples. The hospital and the physicians group filed third-party claims for indemnity and contribution against the manufacturers of the tank and its component parts whose negligence and defective design they alleged caused the tank to fail.

While the underlying actions were still pending, the primary and excess carriers for the physicians group filed declaratory judgment claims contesting their obligations to provide defense and indemnity coverage.<sup>143</sup> The in-

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140. 74 N.E.3d 1110 (Ill. App. Ct. 2017).

141. *Id.* at 1130.

142. *Id.* at 1114.

143. *Id.* at 1113.

urers relied primarily on two policy exclusions in each of their respective policies: (1) the care, custody or control exclusion; and (2) the professional services exclusion. The physicians group moved to dismiss or stay the declaratory judgment action as premature based on the *Peppers* doctrine, arguing that the declaratory relief requested by the insurers would require the coverage court to consider extrinsic evidence and decide factual issues bearing on its liability in the underlying actions. The court granted the motion in substantial part and stayed the insurers' request to offer extrinsic evidence to terminate their coverage obligations based on the two policy exclusions at issue, but allowed the rest of the coverage action to go forward to determine whether the patients' lawsuits triggered a duty to defend based on the allegations of the pleadings alone. The insurers filed an interlocutory appeal under Rule 307(a) challenging the stay order and the application of the *Peppers* doctrine.

In a unanimous opinion affirming the lower court's ruling, the appellate court held that the lower court acted within its discretion by staying the matter regarding the two policy exclusions at issue. The appellate court agreed that adjudicating the care, custody, or control and the professional services exclusions with extrinsic evidence could lead to the premature adjudication of factual issues bearing on the physicians' group's liability in the underlying actions. Refusing to fault the lower court for taking "the more cautious approach and choosing not to decide [issues] that it believed had the potential to affect the underlying lawsuit[,]” the appellate court concluded that the lower court acted properly when choosing to invoke the *Peppers* doctrine as a basis to stay the insurers' declaratory judgment claims.<sup>144</sup>

The *Sentry* court began its analysis by examining the origins of the *Peppers* doctrine.<sup>145</sup> In *Peppers*, the insured defendant was sued in a personal injury action by a plaintiff asserting alternative theories of intentional and negligent misconduct.<sup>146</sup> The insurer denied coverage and filed a declaratory judgment action seeking a finding that there was no coverage based on the intentional acts exclusion in its policy.<sup>147</sup> The circuit court agreed that the insured had acted intentionally when he injured the plaintiff and, therefore, concluded that the intentional acts exclusion precluded coverage, which decision was affirmed on appeal.<sup>148</sup> However, the Illinois Supreme Court reversed, holding that “[b]y virtue of the interrelation” of the various issues in the underlying and declaratory judgment actions, litigating the coverage issues was premature.<sup>149</sup> The supreme court reasoned that the ap-

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144. *Id.*

145. *Id.* at 1122–25.

146. *Md. Cas. Co. v. Peppers*, 355 N.E.2d 24 (Ill. 1976).

147. *Id.* at 27.

148. *Id.* at 26–27.

149. *Id.* at 29.



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plication of the intentional acts exclusion raised “one of the ultimate facts upon which recovery is predicated in the [underlying] personal injury action against Peppers.”<sup>150</sup> Therefore, “[u]nder the principle of collateral estoppel, the finding in the declaratory judgment action . . . ‘could possibly establish the allegations of the assault count in the complaint and might preclude [the underlying plaintiff’s] right to recover under the other theories alleged.’”<sup>151</sup> Thus, the *Peppers* doctrine was born.

In the decades that followed, the *Peppers* doctrine has come to stand for the proposition that “it is generally inappropriate for a court considering a declaratory judgment action to decide issues of ultimate fact that could bind the parties to the underlying litigation.”<sup>152</sup> The rationale for this rule stems from the recognition that “[i]n a declaratory judgment action, injured claimants are proper and necessary parties and the judgment in such an action is binding under the doctrine of collateral estoppel as to the facts determined by the judgment and would preclude parties to the action from relitigating them.”<sup>153</sup> Accordingly, where the resolution of an issue in the declaratory judgment action would require the court to decide facts that should be left to the trial court in the liability case, the declaratory judgment action should be dismissed or stayed as premature.

Yet it is not always clear whether something is an “ultimate fact.” As the *Sentry* court noted, “the Supreme Court in *Peppers* did not define the term ‘ultimate fact’ and has subsequently used other terms to stand for the same proposition.”<sup>154</sup> Most courts have adhered to the definition of “ultimate facts” set forth by the Illinois Appellate Court in *Envirodyne Engineers*, in which the court found that “ultimate facts” are facts “which would estop the plaintiff in the underlying case from pursuing one of his theories of recovery” or facts that pertain to “an issue crucial to the insured’s liability in the underlying case.”<sup>155</sup>

Relying on the *Envirodyne* definition, the insurers in *Sentry* argued that application of the *Peppers* doctrine is a question that is “purely legal” and should be limited to situations where a particular coverage issue directly overlaps with an element of a particular claim or defense.<sup>156</sup> Under this narrow construction of the *Peppers* doctrine, the *Peppers* case itself serves as the archetypal example—the plaintiff asserted mutually exclusive theo-

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150. *Id.* at 197.

151. *Sentry*, 73 N.E.3d at 1123 (quoting *Peppers*, 335 N.E.2d at 30).

152. *Landmark Am. Ins. Co. v. NIP Grp., Inc.*, 962 N.E. 2d 562, 579 (Ill. App. Ct. 2011) (quoting *Allstate Ins. Co. v. Kovar*, 842 N.E.2d 1268, 1275 (Ill. App. Ct. 2006)).

153. *Thornton v. Paul*, 384 N.E.2d 335, 345 (Ill. 1978) (overruled on other grounds by *Am. Family Mut. Ins. Co. v. Savickas*, 739 N.E.2d 378 (Ill. 2000)).

154. *Sentry*, 74 N.E. 3d at 1124.

155. *Fid. & Cas. Co. v. Envirodyne Eng’rs, Inc.*, 461 N.E. 2d 471, 473 (Ill. App. Ct. 1983).

156. *Sentry*, 74 N.E.2d at 1119.

ries of intentional and negligent misconduct. A finding by the coverage court that the defendant acted intentionally so as to trigger the intentional acts exclusion would directly cut off the plaintiff's claim for negligence (since, by definition, one who acts intentionally cannot have acted negligently). The insurers in *Sentry* argued that the *Peppers* doctrine should be confined only to these particular types of situations. However, the *Sentry* court rejected this myopic view of the *Peppers* doctrine, finding that judges should be permitted to "take the more cautious route and wait until the resolution of all of the underlying lawsuits" when faced with overlapping coverage and liability issues.<sup>157</sup>

Turning to the merits of the appeal, the court first addressed a stay of the care, custody, or control exclusion.<sup>158</sup> Under Illinois law, a "care, custody, or control" exclusion applies only if the insurer can show that the underlying claim involves damage to personal property that was in the exclusive possessory control of the insured at the time of the loss.<sup>159</sup> The court agreed that "in order for the trial court in the declaratory judgment action to determine that the 'care, custody, or control' exclusion applied in the instant case, it would need to determine that the [physicians group] exercised exclusive control over the specimens at the time they were damaged."<sup>160</sup> In holding that the lower court correctly applied the *Peppers* doctrine to the care, custody, or control exclusion, the Illinois Appellate Court pointed out that the underlying actions named both the physicians group and the hospital as defendants and alleged causes of action for bailment and negligence against each.<sup>161</sup> The court reasoned that a finding that the physicians group had exclusive control over the samples would "contradict the allegations in the underlying complaint that allege that the hospital exercised control over the specimens at the same time and would effectively preclude the underlying plaintiffs from proving their claims against the Hospital."<sup>162</sup>

The appellate court reached a similar result with respect to the professional services exclusion. In applying the *Peppers* doctrine, the lower court relied primarily on the language in the primary insurer's policy, which equated "professional services" with "health care malpractice."<sup>163</sup> The lower court reasoned that the *Peppers* doctrine precluded consideration of the professional services exclusion because the "trial court presiding over an insurance coverage declaratory judgment action should not decide whether an underlying defendant committed malpractice when that deci-

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157. *Id.* at 1133.

158. *Id.* at 1125–28.

159. *See, e.g.*, *Bołanowski v. McKinney*, 581 N.E.2d 345, 348 (Ill. App. Ct. 1991).

160. *Sentry*, 74 N.E.3d at 1126.

161. *Id.* at 1125–26.

162. *Id.* at 1126.

163. *Id.* at 1117.

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sion would bind the parties in the underlying litigation.”<sup>164</sup> However, while the appeal was pending, the physicians group settled with its primary insurer, leaving the umbrella insurer as the only party to the appeal. Unlike the primary insurer, the umbrella insurer’s policy did not define “professional services,” other than obtusely referring to them as “professional healthcare services.”<sup>165</sup>

In the appellate proceedings, the umbrella insurer attempted to seize on this difference in the language of the two policies and argued that the *Peppers* doctrine could not apply where professional services were not defined to mean “malpractice.” In the absence of a controlling definition in the policy, Illinois courts look to whether the conduct at issue involves “specialized knowledge, labor, or skill, and is predominantly mental or intellectual as opposed to physical or manual.”<sup>166</sup> The umbrella insurer argued that this inquiry did not require the court to decide any “ultimate fact” because whether the cryogenic program required specialized knowledge or skill would not impact any theory of recovery or defense in the underlying action.

Once again, the court disagreed. The court reasoned that although the nature of the services the physicians group provided was not strictly an element of a claim or defense, it was inextricably tied to the facts bearing on the insured’s liability.<sup>167</sup> The court found that the underlying complaints did not contain any description or detail as to how the sperm samples were cryogenically preserved. Therefore, the only way to resolve the professional services exclusion was to consider extrinsic evidence on that issue.<sup>168</sup> The court decided that examining such extrinsic evidence might tread too closely to the liability matters being litigated in the underlying cases. Justice Gordon illustrated this point with an insightful hypothetical example during the oral argument in the appeal:

You have a machine here. The machine is plugged into the wall. And it keeps these things, basically, in a frozen condition, correct? So, a cleaning lady comes in at night. She has her vacuum cleaner with her. She doesn’t speak any English and doesn’t understand what that machine is. She needs to plug in her vacuum cleaner. So she pulls out this thing—and I don’t know that it happened that way—but she’s vacuuming and the product loses its viability. In doing that, in getting that type of testimony, aren’t you deciding negligence issues? So isn’t the court correct to do that later?<sup>169</sup>

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164. *Id.* at 1117–18.

165. *Id.* at 1115.

166. *Pekin Ins. v. L.J. Shaw & Co.*, 684 N.E.2d 853, 855 (Ill. App. Ct. 1997).

167. *Sentry*, 74 N.E.3d at 1128–30.

168. *Id.* at 1128.

169. Oral Argument at 10:16, *Sentry*, 2017 IL App (1st) 161785 (1-16-1785), Mar. 7, 2017, [http://multimedia.illinois.gov/court/AppellateCourt/Audio/2017/1st/030717\\_1-16-1785.mp3](http://multimedia.illinois.gov/court/AppellateCourt/Audio/2017/1st/030717_1-16-1785.mp3).

Though Justice Gordon's hypothetical was merely a fictional scenario and does not track the particular facts before the court in *Sentry*, the hypothetical helps drive home the key point: the line between liability and coverage issues is not always easily and clearly defined. In the underlying cases, the claims against the physicians group turned on whether the group was negligent in its efforts to maintain, store, and preserve the samples, and what actions it took to monitor the tank or to safeguard the plaintiffs' samples. The Illinois Appellate Court reasoned that the evidence bearing on those issues would be the same type of evidence that would inform whether the professional services exclusion applies.<sup>170</sup> Once the coverage court heads down that path, it runs the risk of confronting factual issues that lie at the core of the underlying proceedings and could estop the plaintiffs (albeit indirectly) from pursuing a theory of liability or preclude the physicians group from raising a defense. The appellate court recognized this danger, noting that "the question of what [the physicians group] did—or did not do—as part of its cryopreservation program is what the Underlying Actions are all about."<sup>171</sup>

By rejecting the narrow construction of the *Peppers* doctrine proffered by the insurers, the *Sentry* court implicitly acknowledged that the application of the *Peppers* doctrine is not always cut and dried. As a corollary, a court faced with a coverage dispute need not be certain that a coverage issue will overlap with a liability issue in order for the *Peppers* doctrine to be available, as long as it "believe[s]" the coverage issue has "the *potential* to affect the underlying lawsuit."<sup>172</sup> Notably, the court did not go so far as to say that resolving the professional services exclusion in the case before it would require the adjudication of ultimate facts; it merely recognized that doing so "could touch on [the insured's] liability for negligence."<sup>173</sup> The upshot of the *Sentry* court's opinion is that the *Peppers* doctrine is not a "yes or no" proposition; it is a fluid concept that functions as a guiding principle for courts faced with overlapping coverage and liability issues.

Of course, it remains to be seen the extent to which the *Sentry* decision will have a lasting impact on the role of the *Peppers* doctrine in Illinois jurisprudence. One potential ramification of the *Sentry* opinion is that it may encourage practitioners to more frequently seek a stay—as opposed to a dismissal—where a *Peppers* issue arises. The *Sentry* court noted several times in its opinion that its conclusions were informed by the fact that "[i]n determining whether to stay proceedings, the circuit court has dis-

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170. *Sentry*, 74 N.E.3d at 1129.

171. *Id.*

172. *Id.* (emphasis added).

173. *Id.* (emphasis added).

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cretion to consider factors such as the ‘orderly administration of justice and judicial economy,’ as well as its inherent authority to control the disposition of the cases before it.”<sup>174</sup> Though courts confronted with *Peppers* issues have historically dismissed claims they determined to be premature, more recent cases have allowed circuit courts to stay the declaratory judgment action pending the resolution of the underlying case.<sup>175</sup> The *Sentry* case picks up on this trend and has already been cited for this proposition.<sup>176</sup> One thing is clear, however. Forty years after its inception, the *Peppers* doctrine remains alive and well and will continue to play a role in protecting the interests of policyholders in Illinois for years to come.

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174. *Id.* at 1124 (quoting *TIG Ins. Co. v. Canel*, 906 N.E.2d 621, 629 (Ill. App. Ct. 2009)).

175. *See, e.g., TIG*, 906 N.E.2d at 629.

176. *Motorola Sols., Inc. v. Zurich Ins. Co.*, 2017 WL 3388822, at \*11 (Ill. App. Ct. Mar. 24, 2017) (“We also note that, in situations where the *Peppers* doctrine is at issue, a court will often order a stay of the coverage litigation pending the resolution of the underlying litigation.”) (citing *Sentry*, 74 N.E.3d 1110).

