Pollution Liability Exposure:

How to get off the "Sudden and Accidental" Timebomb?

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The deplorable results of providing coverage for losses arising out of "sudden and accidental" pollution under General Liability policies in the United States are well known. Yet most markets, with the exception of - in chronological order of the introduction of a comprehensive pollution exclusion clause — Italy, USA, Germany and France, either have no pollution exclusion at all or still offer "sudden and accidental" pollution coverage under General Liability policies.

Perhaps those who support this practice believe that the problem plaguing U.S. insurers could only happen under the "crazy American legal system". But the belief that this cannot happen "in our market" might turn out to be an expensive error: both the insurance and reinsurance clauses aimed at excluding gradual pollution actually achieve much less. So we are sitting on a timebomb.

What exactly is pollution?

The problem starts with the basics. What exactly is pollution? To clarify this question it may be helpful to recapitulate the chain of events leading to a pollution liability claim. Such development can take up to eight logically discernable steps:

1. a pre-condition setting the ground for the future problem, e.g. corrosion of an underground storage tank;
2. the cause of the escape of a pollutant, e.g. the rupture of the tank;
3. the actual escape of the pollutant into the environment, e.g. the leakage of fuel oil;
4. the (often not perceived) presence of the pollutant in the environment, e.g. the presence of fuel oil in the soil;
5. the changing situation of the pollution condition, e.g. the migration of the fuel oil via the groundwater to adjacent land;
6. the occurrence of a legally relevant loss, e.g. property damage to the adjacent land;
7. the manifestation of such loss, e.g. the damage associated with fuel contamination becoming noticeable;
8. a claim being made or a clean-up being mandated by the Government.

The oldest, yet internationally most widely used pollution exclusion clause, Lloyd's clause NMA 1685, was developed in 1970,

The article is based on a lecture given at the 1995 Rendez-vous de Septembre in Monte Carlo.

i.e. at a time when hardly anybody had an idea of the full extent of the problem. It does, like many if not most clauses used in other markets, not address the definition of pollution at all. Conceivably, almost any of the eight steps can qualify as pollution. The more recently developed clause of the Association of British Insurers (ABI) makes reference to the presence of pollutants in structures, water, land or the atmosphere, i.e. the above steps 4, 5 or 6.

Furthermore, what is meant by "incident", the undefined focal point of the ABI clause, or "happening", as used by its counterpart NMA 1685? Is it the escape of the pollution (step 3 above) or is it the event causing such discharge (step 2)? Is it each case of careless spilling of polluting substances, or is it the whole series of messy mishaps?

Do we realize that the pollution loss caused by an underground storage tank that leaks over a prolonged period as a result of a specific, abrupt event is not considered "gradual pollution" and therefore *not* excluded? If such leakage is not discovered until years after it commenced, when will that "gradual loss" be deemed to have occurred? In other words: which policy(ies) will be triggered?

None of these questions are answered by the above clauses.

The reinsurance clause used the world over in all reinsurance treaties based on English wordings, LMC 1 (b), is no clearer on such issues.

What is the lawyer's point of view?

Thorough analysis by expert insurance lawyers suggests the following:

- The standard clauses of the London and the UK market, which are also used in many other markets, the Lloyd's clause NMA 1685 and the ABI Gradual Pollution Exclusion Clause respectively, fall far short of limiting coverage to abrupt pollution accidents, and leave intact significant coverage for pollution that occurs gradually.
- With respect to the Lloyd's clause NMA 1685, it also remains to be seen whether temporal coverage restrictions that are designed to prevent a stacking of multiple policy limits will ultimately survive judicial scrutiny. The lack of an annual aggregate limit alone is an alarmingly serious disadvantage of this clause.
- The structure and terminology of the reinsurance clause LMC 1 (b) are such that the clause accomodates both the ABI and the NMA 1685 exclusion clauses. Hence, problems inherent in the clauses incorporated in the original policy will be mirrored at the reinsurance level.
- The situation is exacerbated by the "losses occurring" coverage trigger typically found in Public or General Liability policies: this presents formidable intricacies when applied to losses which occur gradually over time, and it is difficult to prevent, in a legally watertight fashion, the stacking of multiple policy limits.
- The already alarming size of this massive long-tail exposure is further increased by general coverage issues under Public Liability policies, such as the recoverability of clean-up costs, especially relating to work performed on the insured's site.
- Since each of the above items will, whether judicially or otherwise, be resolved many years or even decades "after the fact", insurers and their reinsurers may one day be forced to contribute to payments relating to exposures that were never contemplated, and certainly never paid for.

If this analysis is correct, we are covering a lot more pollution exposure than we have always thought. If so, we are being extremely foolhardy by covering the risk on the most unsuitable basis conceivable, the "losses occurring" basis. We cover the risk without analysing it, without assessing it, and, last but not least,

without charging any premium for it. This would seem to be a safe way to the next liability disaster.

Although the U.S. seems to have stolen all the headlines regarding policy wording disputes and legal precedents, a recent Australian decision (Australian Paper Manufacturers Ltd., v. American International Underwriters (Australia) PTY Ltd.) demonstrates that also courts in common law jurisdictions other than the US are quite inclined to engage in a technical analysis of pollution exclusion clauses and to consider the various discernable steps that lead to a pollution liability claim.

How can insurers and reinsurers get out of this quagmire?

Even if one is not completely convinced of the negative outcome of judicial interpretation, it must be admitted that the above scenario is at least a serious possibility, if not a probability. If this is the case no one can say after the fact that such a development could not possibly have been foreseen. Lawyers have warned us and it is lawyers who eventually construe insurance policies and exclusion clauses. Therefore, no responsible management can continue "business as usual".

Unfortunately, we cannot undo the sins of the past; thus, if the above scenario should materialize, we would inevitably have to pay for past accident years. What can, however, be rectified and saved are future accident years. This is absolutely imperative: it would be grossly irresponsible for each market, market participant and senior management to ignore it any longer. Insurers and reinsurers alike are called upon to find a way out of this impasse.

As many attempts have shown, it is virtually impossible to draft a watertight exclusion clause that limits pollution coverage to really abrupt accidents. But why is that distinction between "abrupt" and "non-abrupt" so desirable? Liability does not follow this distinction, nor does the risk manager's way of thinking.

The only solution can be to introduce a comprehensive pollution exclusion under Public and General Liability policies and to develop a comprehensive Environmental Impairment Liability (EIL) insurance product. This would, at long last, enable the insurance industry to offer industrial and commercial insurance buyers the scope of coverage that they really need.

Why did EIL insurance not fly in the past?

We have already seen sporadic attempts to develop EIL insurance as a stand-alone product, but, with few notable exceptions, without much success. Understanding the reasons for the failure of past attempts could be the key to a fresh and more promising start.

Most past attempts to offer EIL insurance as a stand-alone product were much too complicated and inflexible: insurers would not release a quote, often not even give an indication, without extensive physical inspection of each and every site to be insured. What is more, the applicant was required to pay for such inspection. Nevertheless, such payment would not guarantee that coverage would actually be offered. Even if an occasional applicant successfully went through this cumbersome procedure, the capacity offered at the end of the day often proved insufficient, since, with few exceptions, reinsurers would not give capacity for "gradual" pollution. In contrast to this, "sudden and accidental" coverage was abundantly available under General Liability policies without any pollution-specific questions being asked, without any risk assessment or evaluation, up to the full General Liability limit and, amazingly, free of charge.

All these stumbling blocks have to be removed if another attempt is to prove successful.

A new approach is necessary

In order for EIL insurance to develop as a separate line, we have to create a broad appeal. That would seem to imply that not only the top end of the exposure should be insured; rather, we must devise a concept whereby EIL insurance also appears attractive for all presumably innocuous and "normal" risks. Such "normal" risks should be insurable, without complicated procedures, on the basis of suitable risk assessment questionnaires and at (low) prices commensurate with the (low) risk. Even in the case of the middle segment of EIL exposures (whatever the definition of this term might ultimately turn out to be), it should be sufficient for fire inspectors or other technically-minded insurance professionals to "have a look at" the risk. Only the top end of exposures as well as those "normal" and "middle" risks that raise suspicions on the basis of the completed questionnaire would then be subject to a full-blown physical site inspection.

In addition, reinsurers should abandon their practice of making obligatory capacity available only for "sudden and accidental" pollution events. Instead, General Liability treaties should be opened up to all fortuitous pollution events, be they sudden or gradual, *provided that:*

- a comprehensive pollution exclusion is agreed for the premises section of any Public/General Liability insurance policy and the entire pollution exposure (i.e. sudden and gradual) is written as a stand-alone EIL policy;
- such separate EIL policy is on a claims-made basis with an aggregate limit, is site-specific and excludes past pollution as well as all non-fortuitous pollution events such as chronic/ongoing pollution from normal, undisrupted operations.

Too revolutionary?

Too revolutionary an approach? No, just the lesser of the two evils once the existing situation, as outlined above, is taken into consideration.

In order to make such a new approach more acceptable to the reinsurance industry, the most hazardous types of operations should be excluded from obligatory treaties and reinsured on the basis of facultative or specialty arrangements.

In sum, insurers and reinsurers are called upon to take concerted action: insurers need to develop a separate insurance product and to transfer the exposure from Public/General Liability policies to stand-alone EIL contracts. The reinsurance industry must provide the capacity needed for such a reform, open up General Liability treaties to all fortuitous pollution events and no longer restrict them to so-called "sudden and accidental" events. The insurance-buying community will appreciate such a move, for it will afford them clearly defined, comprehensive EIL insurance coverage with limits that are in line with their needs and demands.

Such an approach would enable coverage to be provided

- on the basis of terms and conditions that are appropriate for this type of long-tail exposure;
- in the context of controlled underwriting parameters which can be modified as circumstances require;
- at a price commensurate with the risk.

Unfortunately, the timebomb we are sitting on with regard to the past cannot be deactivated (in more serious terms: it is not possible to eliminate the problem of potential liability under old policies retroactively). With regard to the future we can avert an even greater liability disaster. Can we afford not to do it?