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Expert Analysis

Second Circuit Finds an Exception To Pro Rata Allocation Rule

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For over a decade now, courts across the nation have wrestled with the appropriate approach to allocating loss in insurance coverage cases concerning continuous property damage that takes place over many years. In trying to resolve this issue, judges face a number of significant obstacles. First, the policy language in the general liability policies that are usually implicated does not squarely address the issue, in part, because most of these occurrence-based policies were issued many years before long-term environmental damage became a widely understood phenomenon. Second, it is rarely possible to ascertain, even with the assistance of experts, what portion of the property damage—for example, groundwater contamination—took place in a given year within the period of years at issue.

Courts typically, either based on policy language or public policy, or some combination of both, end up in one of two camps applying one of two approaches: (i) the pro rata allocation approach, in which liability for property damage is divided over the applicable period of years, with an equal portion of the damages allocated to each policy year; or (ii) the all sums approach, in which the insured can recover the entire amount of damages, subject to policy limits, from any one policy, and the insurer must then seek contribution from the other insurers that issued policies during the applicable time period.

New York

Both the New York State Court of Appeals and the U.S. Court of Appeals for the Second Circuit have previously adopted the pro rata allocation approach. In *Consolidated Edison of NY v. Allstate Insurance*, the Court of Appeals adopted pro rata allocation, finding that "pro rata allocation under these facts, while not explicitly mandated by the policies, is consistent with the language of the policies."[1] The court explained that, in contrast, the all sums approach is inconsistent with policy language because it requires the insurance policy to respond to occurrences or damage that take place outside the policy period. The court further explained that "[m]ost fundamentally, the policies provide indemnification for liability incurred as a result of an accident or occurrence during the policy period, not outside that period."[2]

In this latest 'Olin' ruling, the Second Circuit determined that specific language in the insurance policy required a departure from pro rata allocation.

In *Olin Corporation v. Insurance Company of North America*, which was actually decided two years before *Consolidated Edison*, the Second Circuit adopted pro rata allocation, also finding that approach consistent with policy language.[3] Like the Court of Appeals, the Second Circuit relied in part on the concept that "[a]n insured purchases an insurance policy to indemnify it against injuries occurring within the policy period, not injuries occurring outside the policy period."[4]

The Second Circuit also found that "shoehorning all damages into one policy period" under the all sums approach is "intuitively suspect."[5] In addition, the court relied on public policy considerations, finding that the pro rata approach correctly shifted the burdens associated with recovering from multiple other insurers, insolvent insurers and self-insured periods on to the policyholder rather than on one insurer selected by the policyholder.

The Recent 'Olin' Ruling

In *Olin Corporation v. American Home Assurance Co.*, however, the Second Circuit stressed that the pro rata allocation rule is a default rule, to be applied where (i) the facts do not permit a determination as to extent of damages that took place in a given year; and (ii) there is no express contractual language to the contrary.[6] In fact, in this latest *Olin* ruling, issued in December 2012, the Second Circuit determined that specific language in the insurance policy required a departure from pro rata allocation because the policy expressly provided coverage for damages that continued after the end of the policy period.

The most recent *Olin* case is part of a series of coverage actions, commenced in 1984, concerning environmental damage at Olin manufacturing sites across the United States. Each of the Olin sites presents its own unique factual and legal issues. Therefore, the Southern District and the Second Circuit have addressed coverage issues on a site by site basis, resulting in numerous *Olin* decisions addressing a plethora of insurance issues.

The latest *Olin* ruling concerns contamination at a manufacturing site in Morgan Hill, Calif., where Olin manufactured signal flares beginning in 1956. According to the Second Circuit, operations at the Morgan Hill site resulted in the dispersal of perchlorate powder, which seeped into the ground and contaminated groundwater. The court determined that an underground plume of contaminated groundwater gradually spread until it reached equilibrium in 1987. At that point, the plume extended approximately 10 miles from the site and Olin now estimated that it would cost in excess of $102 million to fully remediate the groundwater.[7]

Based on precedent, the Second Circuit first confirmed that property damage that takes place over a number

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of policy periods will be allocated over the time during which the property damage occurred. In this case, the court determined that property damage took place from 1956-1987, and therefore that liability would be allocated to the policies issued during that 31-year period.

Next, the court reiterated that, "in the absence of contractual provisions to the contrary or evidence indicating that ascertainable amounts of damage occurred in certain years," the damage would be allocated on a pro rata basis. If that were the courts' final determination, in accordance with such a pro rata allocation, the court would have divided the $102 million in damages by 31 and allocated approximately $3.3 million to each policy year. However, while the court found no factual basis to calculate the amount of groundwater contamination that occurred in any given year, it did identify a policy clause that required a departure from pro rata allocation.

Condition C

The dispute before the Second Circuit in *Olin* concerned the coverage obligations of American Home, an excess insurer that issued policies to Olin which followed form to underlying excess policies issued by Underwriters at Lloyd's London. American Home had issued two excess policies, one covered the period from 1966-1969 and one covered the period from 1969-1972. Each of the American Home policies provided coverage for up to 10 percent of $10 million excess of $30.3 million in underlying limits.

The Southern District had granted summary judgment to American Home on the grounds that damages, allocated on a pro rata basis, would not exceed the underlying limits. Olin appealed the ruling to the Second Circuit. On appeal, the Second Circuit focused on Condition C of the policies, which provided as follows:

> Prior Insurance and Non-Cumulation of Liability
>
> It is agreed that if any loss covered hereunder is also covered in whole or in part under any other excess policy issued to the Assured prior to the inception date hereof, the limit of liability hereon…shall be reduced by any amounts due to the Assured on account of such loss under such prior insurance. Subject to the foregoing paragraph and to all the other terms and conditions of this Policy, *in the event that personal injury or property damage arising out of an occurrence covered hereunder is continuing at the time of termination of this Policy, Underwriters will continue to protect the Assured for Liability in respect of such personal injury or property damage without payment of additional premium*.[8] [emphasis added]

The Second Circuit held that the second clause in Condition C expressly imposed liability on American Home for covered property damage that continued beyond the expiration of the policy. Therefore, even though the American Home policy expired in 1972, the court vacated the Southern District ruling and held that American Home was liable for property damage that occurred during the policy period as well as any property damage that continued during the period from 1972 through 1987. The court also concluded that property damage from the migration of chemicals in an expanding groundwater plume falls within the scope of continuing damage contemplated by Condition C.

American Home protested the court's interpretation of Condition C on the grounds that the result would be contrary to the pro rata allocation rule adopted by the Second Circuit. The court rejected this argument, explaining that the prior pro rata allocation rulings "simply provide that when insurance contracts do not adequately define how progressive environmental damage is to be apportioned across multiple triggered policies, and the evidence cannot make that distinction, New York law requires damage to be allocated pro rata."[9] The court further explained that the general pro rata allocation rule does not preclude the insurer from including policy terms that specifically address the issue by providing indemnification for damages allocated to the years after termination of the policy.

The 'Olin' decision by the Second Circuit does not alter New York's pro rata allocation rule, but it does make clear that the federal courts, at least, view this as a default rule and that courts should review the policy language at issue to make sure the default rule applies.

The Second Circuit also resisted American Home's invitation to follow the lead of courts in all-sums jurisdictions, many of whom have simply rejected certain policy clauses, like non-cumulation clauses, on the grounds that such clauses contradict the forum's chosen allocation method. Further, the Second Circuit rejected any suggestion that Condition C mandated an all-sums type approach.

Instead, the Second Circuit indicated that damages would be allocated over the 31-year period, but that subject to policy limits, pursuant to Condition C, American Home would be responsible for the damages allocated to the period from 1966-1987. The court did not address whether or how policies issued to Olin by other insurers during those same years would share in the liability.

Fortunately for American Home, having enforced clause two of Condition C, the Second Circuit also enforced the non-cumulation provision in clause one of Condition C. The court found that clause one confined American Home's liability to the $1 million policy limit of the policy issued for the period from 1969-1972, since the amount recoverable under the second policy would be reduced by any amount recovered under the first policy.

Looking Forward

Although courts in other states continue to wrestle with the appropriate allocation method for progressive property damage cases, it appears that the majority of courts (but certainly not all courts) that have addressed the issue have adopted pro rata allocation, including relatively recent decisions issued by the highest courts in Massachusetts and Vermont.[10] The recent *Olin* decision by the Second Circuit does not alter New York's pro rata allocation rule, but it does make clear that the federal courts, at least, view this as a default rule and that courts should review the policy language at issue to make sure the default rule applies. In *Olin*, the presence of express language mandating coverage for property damage that continued beyond the policy period justified an exception to the pro rata allocation rule. However, one would expect that, in most cases, where policies only cover damage that takes place during the policy period, the pro rata allocation rule will be routinely applied.

While in *Olin*, the Second Circuit found an exception to pro rata allocation based on unique policy language, it remains possible that an exception could also be justified in a case where the evidence presents a factual basis to allocate damages. For example, the U.S. District Court for the District of Massachusetts recently issued a ruling in which it determined that the default pro rata allocation rule did not apply, because expert testimony provided a basis to calculate the amount of soil contamination that occurred during the applicable policy periods.[11] Thus, instead of a pro rata allocation, the court assigned to the insurer the damages incurred to remediate the volume of soil contamination that occurred during the years in which the insurer had issued policies. Given the recent decision in *Olin*, a New York court presented with sufficient scientific evidence to determine the actual damages that occurred during a given policy year may similarly find an exception to the pro rata allocation rule.

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1. *Consolidated Edison of N.Y. v. Allstate Ins.*, 98 N.Y.2d 208, 224, 774 N.E.2d 687 (2002).
2. Id. at 224.
3. *Olin Corporation v. Insurance Company of North America*, 221 F.3d 307 (2d Cir. 2000).
4. Id. at 322.
5. Id. at 322-323.
6. *Olin Corporation v. American Home Assurance*, 704 F.3d 89 (2d Cir. 2012).
7. Id.
8. Id.
9. Id.
10. *Boston Gas v. Century Indemnity*, 454 Mass. 337, 910 N.E.2d 290 (Mass. 2009); *Bradford Oil v. Stonington Insurance*, 190 Vt. 330, 54 A.3d 983 (Vt. 2011).
11. *Peabody Essex Museum. v. U.S. Fire Insurance*, No. 06cv11209, 2012 WL 2952770 (D. Mass. July 8, 2012).