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Environmental law

Pollution Exclusion in D&O Policy Bars Coverage for What You Do, Not What You Say

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In a recent decision, the Appellate Division further cemented New Jersey's reputation as a policyholder-friendly jurisdiction that narrowly interprets insurance policy provisions excluding coverage for environmental losses. In *Sealed Air Corp. v. Royal Indemnity Co.,* No. A-5951-06T3 (August 15, 2008), the court held that, notwithstanding a pollution exclusion, a directors and officers ("D&O") insurance policy provided coverage for defense costs and damages to the insured corporation, which was facing a securities class action alleging misrepresentations about contingent liabilities for pollution claims.

The insured was the product of a multi-step corporate reorganization involving W.R. Grace & Co. ("Old Grace"), which had conducted mining operations in Libby, Montana, for approximately 30 years. Those operations resulted in Old Grace paying roughly $425 million in settlements and judgments for asbestos-related personal injury and property damage claims by 1995. In 1998, Old Grace reorganized its business through a series of transactions. First, it split its specialty chemicals and packaging businesses into two separate subsidiaries. Second, it spun off the specialty chemicals subsidiary ("New Grace") as an independent corporation that also assumed all of Old Grace's pollution liabilities. Next, Old Grace, which retained ownership of its packaging business subsidiary, merged with Sealed Air Corporation.

Before the merger, Old Grace's independent auditor, KPMG, issued a report that analyzed and quantified the extent of the company's future potential asbestos-related personal injury liabilities. KPMG opined that New Grace (which retained those liabilities) would remain solvent after the transaction. According to the complaint in the securities class action, that conclusion was based on "the apparent leveling off of the number of asbestos claims filed against Old Grace." A number of other public statements regarding the extent of Old Grace's potential asbestos liability were made from 2000 to 2002, including in filings with the Securities and Exchange Commission, to the effect that Sealed Air believed that future costs related to asbestos claims were not expected to have a material adverse effect on its operations or financial position. The class action plaintiffs alleged, however, that Old Grace had manipulated the number of filed claims by arranging with a number of leading plaintiffs' law firms for a moratorium on the filing of such claims.

In April 2001, New Grace filed for protection under Chapter 11 of the Bankruptcy Code as a result of asbestos-related lawsuits that had been filed against it. In May 2002, a creditors' committee brought an adversary proceeding alleging that the corporate reorganization of Old Grace constituted a fraudulent conveyance because the separation of the packaging business from the chemicals business left New Grace insolvent. In July 2002, the bankruptcy court ruled that New Grace's solvency on the date of the transaction had to be based on the actual value of future asbestos liabilities rather than a reasonable estimate of those liabilities. Sealed Air's stock dropped 41 percent after that ruling, and an additional 34 percent the next day, based on fears that, if the spin-off were found to be a fraudulent conveyance, Sealed Air might have to return the assets of the packaging business to the bankruptcy estate or be held responsible for New Grace's asbestos liabilities. Sealed Air subsequently settled with the creditor's committee for $850 million.

In September 2003, a class action was filed against Sealed Air, its directors and officers claiming that they had made false and misleading statements that caused the stock to trade at artificially inflated prices. Sealed Air sought coverage from its D&O insurer, Royal Indemnity Co. ("Royal"). Royal denied coverage based on the pollution exclusion in Sealed Air's policy, which excluded coverage for any loss resulting

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from claims made against any director or officer or, in the case of a securities claim, against the company, "based on, arising out of, or in any way involving:"

> (a) the actual, alleged or threatened discharge, release, escape, seepage, migration or disposal of Pollutants into or on real or personal property, water, or the atmosphere; or
>
> (b) any direction or request that the Company or the Insured Persons test for, monitor, clean up, remove, contain, treat, detoxify or neutralize Pollutants, or any voluntary decision to do so:
>
> including without limitation any Claim for financial loss to the Company, its security holders or its creditors based on, arising out of, or in any way involving the matters described in subparts (a) or (b) above.

Sealed Air sued Royal for declaratory relief as to Royal's duty to defend and indemnify Sealed Air in the class action. The trial court granted Sealed Air's summary judgment motion, finding that the policy's pollution exclusion did not bar coverage for the securities litigation. Royal appealed, claiming that the plain language of the policy exclusion barred coverage since the underlying securities litigation was based upon, arose out of, or involved pollution.

The Appellate Division affirmed, concluding that the pollution upon which Royal was basing its argument was too attenuated from the alleged damages arising from the misrepresentations in the underlying securities litigation. The court began its analysis with the "well-settled principles" of interpreting insurance contracts "which mandate broad reading of coverage provisions, narrow reading of exclusionary provisions, resolution of ambiguities in the insured's favor, and construction consistent with the insured's reasonable expectations" (quoting *Search EDP v. Am. Home Assurance Co.,* 267 N.J. Super. 537 (App. Div. 1993)). Moreover, although the court should not write a better policy for the insured than the one purchased, exclusions are to be strictly construed against the insurer to allow the insured all the protection that a reasonable interpretation permits.

Next, the court addressed whether the coverage provisions of the policy would be implicated by the underlying securities litigation. Noting that an insurer's duty to defend is triggered if the language of the policy and the language of the complaint correspond, the court found in favor of coverage because the complaint alleged violations of federal securities laws and the policy provided coverage for claims made by or on behalf of securities holders.

After disposing of this threshold inquiry, the court found that the language of the pollution exclusion did not apply. The court hinged its decision on an analysis of the policy exclusion phrase "based on, arising out of, or in any way involving" pollution.

Citing *Mortgage Corp. of N.J. v. Aetna Cas. & Sur. Co.,* 19 N.J. 30 (1955), the court stated that although the phrase "in any way involving" was "facially extremely inclusive," the phrase had to be read in conjunction with the surrounding words "based on" and "arising out of." In that context, "in any way involving" required a much more direct causal connection between the pollution and the harm for which damages were sought. Since the court found that the claims in the securities class action were not "based on, arising out of, or in any way involving" pollution, the court held that the D&O policy provided coverage.

In reaching that conclusion, the court interpreted "arising out of" as "originating from, growing out of or having a substantial nexus," but noted that an ambiguity that exists because an insurance policy fails to specifically define the boundaries of coverage should be construed in line with the insured's reasonable expectations. The court found that the basis of the damages for which Sealed Air sought coverage was the securities litigation, without which there could be no claim. Because it was reasonable for Sealed Air to expect coverage for securities claims under the D&O policy, and since there were too many intervening events to reasonably find a required "substantial nexus" between the pollution and the alleged securities holders' damages, the court held that the exclusion could not be construed to bar coverage.

Insurance carriers will undoubtedly seek to limit the decision in *Sealed Air v. Royal* to its facts, relying on the court's repeated references to the "remote" and "attenuated" connection between the underlying pollution that gave rise to Old Grace's liability and the alleged misrepresentations made by Sealed Air, including the spin-off of New Grace, its bankruptcy and the possible fraudulent conveyance.

By contrast, policyholders will interpret the case broadly as preventing carriers from relying on a pollution exclusion to deny coverage for securities and other contract or tort claims that may in some way involve pollution but do not directly seek damages caused by pollution.

Though New Jersey is known as a policyholder-friendly jurisdiction, it is unlikely that either of the foregoing approaches will be fully adopted. Instead, courts will probably find a middle ground. Courts will surely continue to broadly construe coverage provisions and narrowly construe exclusions, and will thus be reluctant to bar coverage for nonpollution claims that may have some indirect involvement with pollution. However, if there is a more substantive connection between the underlying pollution and the nonpollution claims — for example, if a company makes misrepresentations or omissions about environmental contamination it caused, without any of the intervening corporate reorganizations, spinoffs or similar events present in *Sealed Air* — a court might be willing to find the "substantial nexus" between the pollution and the misrepresentations that the *Sealed Air* court was unwilling to find. ■