Insurance Client Advisory

SEPTEMBER 21, 2007

KELLEY DRYE

California Appeals Court Ruling Eliminates Insurance Coverage for Settlements

EXECUTIVE SUMMARY

In an opinion that could wreak havoc for policyholders, the California Court of Appeals, Third Appellate District, issued an opinion on September 13, 2007 holding that insurance companies are not liable under the terms of standard comprehensive general liability policies to indemnify policyholders for amounts the policyholders agree to pay pursuant to settlement agreements. The decision runs counter to the established law in most other jurisdictions, which holds that when an insurance company denies coverage for a third-party claim, the policyholder is entitled to settle the claim for a reasonable amount without jeopardizing its rights to coverage. According to the California court, however, insurance companies are only obligated to indemnify policyholders for amounts the policyholders are ordered to pay by a court, not amounts they incur as a result of a settlement agreement. Thus, a policyholder who decides to settle litigation against it, instead of allowing the suit to proceed to judgment, in effect forfeits its rights to coverage for the claim.

CASE BACKGROUND

The case, *Aerojet-General Corporation v. Commercial Union Insurance Co.*, arose in the context of a dispute over insurance coverage for environmental claims. In 2000 and 2001, various California regional water agencies sued Aerojet, alleging that Aerojet was liable under CERCLA and related laws for costs arising out of the alleged contamination of groundwater in the San Gabriel Valley. *Aerojet-Gen. Corp. v. Commercial Union Ins. Co.*, Nos. CV527932, 03AS01973, slip op. at 2 (Cal. App. Ct. 3d Dist. Sept. 13, 2007). All of Aerojet's excess carriers denied coverage for the lawsuits, and in 2002, Aerojet settled the lawsuits for approximately $175 million. Aerojet sued its excess insurers seeking indemnification for the settlement.

The policies at issue were comprehensive general liability policies stating (with slight variations in the exact language used) that the insurers would indemnify Aerojet for "all sums which the Assured shall become legally obligated to pay, or by final judgment be adjudged to pay, to any person or persons as damages . . . ." *Id.* at 4. The excess insurers contended that the term "damages" meant "damages . . . awarded against the insured by a court." *Id.* at 3. Thus, they argued, they were "not liable under their excess liability policies to indemnify Aeroje[t] for the groundwater remediation claims because the water entities claims were settled and not adjudicated against Aerojet to an award of damages." *Id.*

The California Court of Appeals agreed with the excess insurers, relying heavily on a case decided in 2001 by the California Supreme Court, *Certain Underwriters at Lloyd's of London v. Superior Court*, 24 Cal.4th 945 (2001) ("*Powerine I*"). In *Powerine I*, the California Supreme Court held that the duty to indemnify a policyholder for "damages" was limited to

"money ordered by a court" and did not "extend to expenses required by an administrative agency pursuant to an environmental statute." *Id.* at 971. Reading *Powerine I* literally, the *Aerojet* court held that "the term 'damages" as interpreted in *Powerine I* and as used in liability insurance indemnity provisions means only money ordered by a court to be paid." *Aerojet*, slip op. at 16. Because Aerojet had settled its environmental lawsuits and "there are no judgments entered in the record [of the underlying cases], . . . only stipulations and orders for dismissal without prejudice, and voluntary dismissals without prejudice," the court concluded that "the settlement costs are outside the scope of indemnity coverage in [the insurers'] policies." *Id.* This ruling runs counter to the law in many other jurisdictions where a policyholder does not jeopardize its rights by settling. *Cf. Luria Bros. & Co., Inc. v. Alliance Assurance Co., Ltd.*, 780 F.2d 1082, 1091 (2d Cir. 1986) ("When an insurer declines coverage, as here, an insured may settle rather than proceed to trial to determine its legal liability"); *Guillen v. Potomac Ins. Co. of Ill.*, 785 N.E.2d 1, 11-12 (Ill. 2003) (noting insurer's concession that "generally speaking, once an insurer breaches its duty to defend, the insured may enter into a reasonable settlement agreement without foregoing its right to seek indemnification"); *Fireman's Fund Ins. Co. v. Security Ins. Co.*, 367 A.2d 864, 868 (N.J. 1976) ("Where an insurer wrongfully refuses coverage . . . the insurer is liable for the amount of the judgment obtained against the insured or of the settlement made by him.") (internal quotation marks and citation omitted).

IMPLICATIONS FOR POLICYHOLDERS

Although *Aerojet* arose in the context of a coverage dispute for environmental claims, its scope may be much broader. The "damages" language construed by the court exists in almost all comprehensive general liability policies, and the decision therefore could potentially affect all types of policyholders, from non-profits to Fortune 500 corporations.

The practical effect of the holding is to force policyholders whose insurers have denied coverage into a catch-22 position. According to the *Aerojet* court, if a policyholder enters into a settlement to resolve the underlying lawsuit against the policyholder, the insurance company is absolved of its obligation to provide coverage for the settlement. If, on the other hand, the policyholder decides to litigate the underlying suit to judgment, the judgment could end up being massive, and the policyholder would be left to litigate with its insurers over whether the judgment is or is not covered. If it turns out not to be covered, the policyholder would be liable for the full amount of the judgment. In other words, the policyholder is left to choose between a settlement that it will have to fund on its own, or a potentially larger judgment that might or might not be covered by insurance.

The *Aerojet* court did allude to one possible escape from this conundrum. The court

suggested that if *Aerojet* and the administrative agencies "sought for the terms of the agreement to be entered as the judgments in the lawsuits," the settlement amount may have been covered. *Id.* at 16. This option is not without its own potential risks. First, the language is dicta, and it is therefore uncertain whether such a judgment would, in fact, be deemed "damages" by a court. Second, there is the obvious concern that having a judgment entered against a policyholder may present other problems that would outweigh the possible benefits of this course of action.

The *Aerojet* decision should be of concern to all policyholders, both inside and outside of California. Although decided under California law, the decision's impact may be much broader as other jurisdictions that have not decided the issue may look to the decision for guidance, or may determine to apply California law to particular claims. Accordingly, all policyholders considering settlement of underlying liability claims should consult with experienced coverage counsel to evaluate the potential impact of the *Aerojet* decision and whether a proposed settlement could negatively impact their coverage rights.

FOR MORE INFORMATION

Kelley Drye & Warren's Insurance Recovery Group has extensive experience representing commercial policyholders engaged in third-party liability coverage disputes with their insurers. The group is led by John Heintz, a 30-year veteran of insurance recovery law who has secured coverage on behalf of clients for, among other things, asbestos, lead, environmental, and other mass tort claims; class-action claims; first and third-party property damage claims; directors' and officers' liabilities; and residual value losses. For additional information about the *Aerojet* decision, coverage for settlements of environmental or other third-party liability claims, or any other insurance coverage topic, please contact:

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