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Applying Pro Rata Allocation To Defense Costs

Law360, New York (August 5, 2011) -- In its landmark decision in Boston Gas Co. v. Century Indemnity Company, 454 Mass. 337 (2009), the Supreme Judicial Court of Massachusetts (SJC) rejected joint and several allocation of environmental indemnity losses in favor of a pro rata approach.

However, the Boston Gas court did not specifically address the question of how defense costs should be allocated, and policyholders and insurers have continued to wrestle with that issue absent further direction from the SJC. As explained below, the analysis underlying the SJC's decision in Boston Gas supports applying pro rata allocation to defense costs as well as indemnity costs.

The Boston Gas Holding

Courts across the country have struggled with the question of whether, under standard commercial general liability policy language, losses relating to progressive injuries (such as environmental and asbestos losses) should be spread among all years in which injury occurred (the "pro rata" approach), or whether a policyholder can select a single triggered policy to respond to the losses (the joint and several or "all sums" approach).

In a lengthy and well-reasoned decision, the SJC in Boston Gas adopted a pro rata methodology, relying primarily on a four-pronged analysis:

1) Policy Language

The CGL policies at issue in Boston Gas contained fairly typical definitions of "occurrence" and "property damage," which required that any covered "property damage" must take place "during the policy period." Boston Gas, 454 Mass. at 356. Relying on this language, the court concluded:

"The most reasonable reading of these provisions is that the Century policies provided coverage for that portion of Boston Gas's liability attributable to the quantum of property damage occurring during a given policy period. Our reading of this policy language is consistent with that of other courts that have construed CGL policies with similar provisions." Id. at 359 (collecting cases).

2) Reasonable Expectations

The Boston Gas court held that, unlike a pro rata approach, an "all sums" allocation methodology does not comport with the reasonable expectations of the insured. Id. at 362-63. The court concluded:

"No reasonable policyholder could have expected that a single one-year policy would cover all losses caused by toxic industrial wastes released into the environment over the course of several decades. Any reasonable insured purchasing a series of occurrence-based policies would have understood that each policy covered it only for property damage occurring during the policy year." Id. at 363.

3) Judicial Economy

As the Boston Gas court acknowledged, the joint and several allocation approach is inefficient in that it does not ultimately resolve the allocation issue. Instead, it simply postpones it by dividing the dispute into two separate proceedings — in the first, the policyholder selects which of the triggered insurers to pursue, and in the second, the triggered insurer sues any remaining insurers for contribution. Id. at 364-65.

As a result, the joint and several approach increases litigation costs, which are then passed on to policyholders via higher premiums. Id. In contrast, the pro rata approach resolves all coverage and allocation issues in a single proceeding.

4) Equity and Public Policy

Finally, even beyond issue of judicial economy, the Boston Gas court recognized the public policy benefits of adopting a pro rata allocation method in which the policyholder bears the risk of uninsured years. Id. at 365 ("pro rata allocation produces a more equitable result than joint and several allocation").

Specifically, the court held that the joint and several method "'creates a false equivalence between an insured who has purchased insurance coverage continually for many years and an insured who has purchased only one year of insurance coverage.' ... This false equivalence would tend to 'reduce the incentive of ... property owners to insure against future risks.'" Id. at 365-66. Conversely, the pro rata method of allocation places the risk of uncovered years with the policyholder that made the decision as to what coverage to (and not to) purchase.

Applicability Of Boston Gas To Defense Costs

The four-prong analysis set forth above supports the conclusion that pro rata allocation should apply to defense costs. In fact, courts that have adopted the pro rata approach to indemnity, including several cases on which the Boston Gas court expressly relied, apply the same approach to defense costs. See, e.g., Ins. Co. of N. Am. v. Forty-Eight Insulations Inc., 633 F.2d 1212 (6th Cir. 1980); Towns v. Northern Sec. Ins. Co., 184 Vt. 322 (2008); Security Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., 264 Conn. 688 (2003); Owens-Illinois Inc. v. United Ins. Co., 138 N.J. 437 (1994).

1) Policy Language

Primary CGL policies typically obligate the insurer to defend any suit against the insured seeking damages for "bodily injury" or "property damage" caused by an "occurrence." The standard CGL definitions of "bodily injury," "property damage" and/or "occurrence" require that any covered "bodily injury" or "property damage" take place "during the policy period" of the policy. As a result, the insurer's defense obligation, like its indemnity obligation, is limited to defending suits alleging damage "during the policy period."

In a typical environmental claim, the plaintiffs allege "bodily injury" or "property damage" that falls both within and outside of the relevant policy period. In such circumstances, to mandate that an insurer pay 100 percent of defense costs would require a court to read the "during the policy period" language out of the policy — a result that would be inconsistent with the Boston Gas holding. See also Security Ins., 264 Conn. at 710-11 ("we cannot torture the insurance policy language in order to provide [the policyholder] with uninterrupted insurance coverage where there is none.").

2) Reasonable Expectations

As set forth above, the Boston Gas court concluded that a reasonable insured would not expect to receive complete coverage under one policy, where losses spanned years or even decades. It is no more reasonable for a policyholder to expect to recover 100 percent of defense costs in the same circumstance. See Forty-Eight Insulations, 633 F.2d at 1225 ("Were we to adopt Forty-Eight's position on defense costs, a manufacturer which had insurance coverage for only one year out of 20 would be entitled to a complete defense of all asbestos actions the same as a manufacturer which had coverage for 20 years out of 20. Neither logic nor precedent support such a result.").

3) Judicial Economy

Applying a joint and several approach to defense costs would largely eliminate the judicial economy benefits attendant to pro rata allocation. If a policyholder is entitled to pick any one carrier to provide a complete defense, that carrier likely would be forced to institute contribution proceedings against other potentially responsible carriers, thereby creating the same multiple litigations the Boston Gas court sought to avoid. See Towns, 184 Vt. at 346 (recognizing the benefits of "reducing the necessity for subsequent indemnification actions between and among the insurers.").

Moreover, the joint and several approach typically results in discovery disputes and motion practice between nonsettling and settling insurers which are largely unnecessary in pro rata jurisdictions, because each carrier is liable only for its own share. Thus, a pro rata approach is simple, efficient and litigation-minimizing.

4) Equity and Public Policy

Once again, the precise same public policy rationales concerning the incentives of policyholders that support prorating indemnity costs support prorating defense costs. See Olin Corp. v. Ins. Co. of N. Am., 221 F.3d 307, 323 (2d Cir. 2000) ("Allocation also forces an insured to absorb the losses for periods when it is self-insured and can prevent it from benefiting from coverage for injuries that took place when it was paying no premiums."); Towns, 184 Vt. at 347 (collecting cases).

The Peabody Essex Decision Does Not Properly Apply the Boston Gas Analysis

Despite the fact that the reasoning behind the Boston Gas court's adoption of pro rata allocation applies with equal force to defense costs, a Massachusetts federal court, after a cursory analysis, reached the opposite conclusion. See Peabody Essex Museum Inc. v. U.S. Fire Ins. Co., 2010 U.S. Dist. (D. Mass. Sept. 30, 2010). After acknowledging that "some of the policy rationales for dividing indemnity costs, such as limiting insurance premiums and providing incentives to maintain insurance, arguably apply to defense costs as well," the court nonetheless declined to apply a Boston Gas methodology.

The Peabody Essex court relies primarily on the so-called "in for a penny, in for a pound rule," by which courts have held that where a litigation involves both covered and uncovered claims, the duty to defend extends to the entirety of the litigation, even if the defense of covered claims provides a collateral benefit to uncovered claims. Peabody Essex, 2010 U.S. Dist. at **46-47.

However, an insurer seeking to pay a pro rata share of defense costs is not attempting to avoid its duty of defense; instead, it is seeking only to allocate defense costs between covered and uncovered claims. See Financial Resources Network Inc. v. Brown & Brown, Inc., 754 F. Supp.2d 128, 141 (1st Cir. 2010) ("An insurer is therefore liable for all defense costs unless it can show an allocation of such costs between covered and uncovered claims.").

While such an allocation is often difficult in a standard litigation involving covered and uncovered causes of action — because the work of defense counsel in connection with covered and uncovered claims often is intertwined — such is not the case under Boston Gas, where the proper method of allocating costs (pro rata by time on the risk) has already been delineated. See Forty-Eight Insulations, 633 F.2d at 1224-25 ("An insurer must bear the entire cost of defense when 'there is no reasonable means of prorating the costs of defense between the covered and the not covered items.' ... These considerations do not apply where defense costs can be readily apportioned.").

The Peabody Essex court also relies on a footnote in Boston Gas, in which the SJC addressed the policyholder's citation to a First Circuit case applying an all sums approach to defense costs under Rhode Island law. See Boston Gas, 454 Mass. at 366, n.38 (citing Emhart Indus. Inc. v. Century Indemn. Co., 559 F.3d 57 (1st Cir. 2009)).

However, the vast majority of the footnote is aimed at describing Rhode Island's unusual, modified manifestation trigger — rejected in Massachusetts — and explaining why that trigger is inconsistent with a pro rata allocation. At the very end of its lengthy footnote, the SJC states that "the Emhart case is distinguishable because it involved allocation of defense costs, while this case involves allocation of indemnity costs." Id.

The court did not profess to undertake, in this one sentence at the end of a lengthy footnote, a comprehensive analysis of whether and how the reasoning underlying the remainder of its opinion might apply to defense costs.

Significantly, the Peabody Essex court did not address much of the reasoning behind the Boston Gas court's decision to adopt a pro rata methodology, including: (1) the "during the policy period" language that underlies the Boston Gas decision; (2) the judicial economy benefits, which are largely eliminated by applying joint and several allocation to defense costs; and (3) the court's reasonable expectations arguments. As described above, these critical prongs of the Boston Gas analysis support a pro rata allocation of defense costs.

Conclusion

The SJC, in 2009, finally and clearly resolved the question of how environmental losses should be allocated under CGL policies. The rationales underlying that opinion apply equally in the defense cost context, and it is illogical and inefficient to apply an entirely different allocation regime to defense costs.

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