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Who Has to Pay for Periods of Insolvent Insurance in Long-Tail Coverage Claims? New Jersey High Court Changes the Game in Favor of Policyholders.

Two new cases have changed the game in New Jersey for allocating defense and indemnity costs in long-tail environmental or toxic tort claims. The high Court has established that solvent insurers must absorb insolvent insurers' share of costs in long tail claims until all solvent insurance is exhausted, at which time insolvent shares will be borne by the Property-Liability Guaranty Association. In addition, the high Court has established that insurers have a right of contribution against other insurers when they pay more than their allocated share of defense or indemnity.

INTRODUCTION

If there is one thing that policyholders and insurance companies can agree upon, it is that courts across the country have repeatedly struggled with how to deal with claims for damages or injuries arising from exposure to hazardous conditions over many years and many different policy periods. The difficulty is evident in the fact that many jurisdictions have developed different, sometimes drastically different, methods for addressing this issue. The typical factual scenario in which these issues arise are toxic tort claims and environmental claims, where a person may be injured as a result of exposure to asbestos over a 40 year working career, or an industrial facility may be contaminated as a result of the discharge and continuing migration in groundwater of hazardous chemicals caused by operations over a fifty year period. These are commonly called "long-tail" or "latent" claims. In such scenarios, a responsible person usually

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purchased insurance over the years that may provide coverage for an injury or environmental damage. So, which policies cover the loss, and if many successive policies cover the loss, which one(s) have to pay and how much? What if the responsible person does not have insurance for a portion of the years that injuries were continuing to occur, often called the "trigger period?" What if the person just cannot find some policies but knows it purchased coverage? What if one of the insurers went bankrupt?

These questions are inherently complex and courts have come up with several different answers. For example, in some jurisdictions, the insured may call upon only one insurance company that issued one policy for a one year period to pay all defense and indemnity costs until that policy is exhausted, placing the burden upon the insurer to seek contribution from other insurers "on the risk" that issued applicable liability policies during the trigger period.[2] In other jurisdictions, like New Jersey, the coverage obligation is allocated among multiple insurers on the risk on a *pro rata* basis.[3] In some jurisdictions, defense costs may not be allocated to the insured, in other words, the defense obligation under a policy is joint and several, whereas the indemnity obligation is subject to an allocation among all insurers on the risk and the insured

[2] *See, e.g.*, *Koppers Co. v. Aetna Cas. & Sur. Co.*, 98 F.3d 1440, 1450 (3d Cir. 1996) (predicting that Pennsylvania Supreme Court would adopt its joint and several rule in long-tail environmental cases, as it had in asbestos cases); *J.H. France Refractories, Co. v. Allstate Ins. Co.*, 626 A.2d 502 (Pa. 1993) (adopting joint and several method for allocating losses among multiple policies covering asbestos injury caused by exposure over many years).
[3] *See, e.g., Owens-Illinois, Inc. v. United Ins. Co.*, 138 N.J. 437, 479 (1994).

must participate for periods of no insurance.[4] In still other jurisdictions, allocations are permitted but it is not established whether defense cost must be allocated and, if so, when and how.[5]

New Jersey, being a highly populated state with a long history of heavy industry, has a well developed body of long-tail insurance claim law and has been influential in the development of the law governing long-tail insurance claims in other states. The state of the law in New Jersey continues to develop, as shown by two major cases New Jersey's Supreme Court recently handed down: *Potomac Insurance Co. of Illinois v. Pennsylvania Manufacturers' Association Insurance Co.* ("*Potomac*")[6] and *Farmers Mutual Fire Insurance Co. of Salem v. New Jersey Property-Liability. Insurance Guaranty Association* ("*Farmers Mutual*")[7]. These landmark cases address the important issues of whether insurers may seek contribution from other insurers in long-tail claims, whether a policyholder must bear a portion of its own defense costs for periods when insurance is unavailable, and whether a policyholder must bear a portion of its own defense and pay a portion of settlements or judgments when some of its insurers have become insolvent. To understand the impact these new cases have on New Jersey's allocation law, it is first helpful to review the state of the law as it existed when the *Potomac* and *Farmers Mutual* cases were decided.

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[4] *See, e.g., Texas Property & Casualty Insurance Guaranty Association/Southwest Aggregates, Inc. v. Southwest Aggregates, Inc.*, 982 S.W.2d 600, 606 (Tex. App. 1998) (holding that in long term exposure to silica claims, duty to defend can never be apportioned to the insured because the duty to defend requires defense of all claims, so long as at least one falls within insurer's policy period, but indemnity cost could be).

[5] *Compare Continental Cas. Co. v. Rapid-American Corp.*, 80 N.Y.2d 640, 655-56 (1993) *and Stonewall Ins. Co. v. Asbestos Claims Management Corp.*, 73 F.3d 1187 (2d Cir. 1995) *and Olin Corp. v. Ins. Co. of N. Am.*, 221 F.3d 307, 324 (2d Cir. 2000) *with Con. Edison Co. of NY v. Allstate Ins. Co.*, 774 N.E.2d 687 (N.Y. 2002).

[6] *Potomac Ins. Co. of Illinois ex rel. OneBeacon Ins. Co. v. Pennsylvania Mfrs.' Ass'n Ins. Co.*, 215 N.J. 409, 414, 73 A.3d 465, 468 (2013).

[7] *Farmers Mut. Fire Ins. Co. of Salem v. New Jersey Prop.-Liab. Ins. Guar. Ass'n*, 215 N.J. 522, 536-37, 74 A.3d 860, 868 (2013).

I. NEW JERSEY'S EXISTING SCHEME FOR ALLOCATING COVERAGE OBLIGATIONS AMONG MULTIPLE SUCCESSIVE INSURERS IN LONG-TAIL CLAIMS.

a. Allocation Methodology.

In *Owens-Illinois, Inc. v. United Insurance. Co.*, the New Jersey Supreme Court created a method for allocating defense and indemnity costs among multiple successive insurance policies where a policyholder's liability arises from injuries caused by continuous long term exposure to injurious or hazardous conditions over many policy years.[8] First, the Court adopted what is commonly called the "continuous trigger theory," which is that "when progressive indivisible injury or damage results from exposure to injurious conditions for which civil liability may be imposed, courts may reasonably treat the progressive injury or damage as an occurrence within each of the years of a [comprehensive general liability] policy."[9] Thus, as a general example, if a person contracts mesothelioma as a result of exposure to asbestos over a 30 year period, a single "occurrence" triggering coverage is deemed to have taken place during each policy year between the time the injury first began to develop as a result of exposure up until the time of manifestation of the disease.[10] In adopting the "continuous trigger" theory, the Court declined to follow the approaches followed in other jurisdictions for determining when a policy is triggered, that is, when an "occurrence" takes place, in long term exposure cases, for example, the "injury in fact" trigger and the "manifestation" trigger.[11]

Having adopted the "continuous trigger" approach, the Court established a formula for allocating responsibility among multiple insurers whose policies were in effect during the trigger

[8] *Owens-Illinois, Inc. v. United Ins. Co.*, 138 N.J. 437, 479 (1994).
[9] *Id.* at 478, 650 *A.*2d 974 (alteration for clarity).
[10] *See id.*
[11] *See id.* at 474–77, 650 *A.*2d 974.

period.[12] First, the Court declined to adopt the "all sums" or "joint and several" allocation approach adopted in some jurisdictions, like Pennsylvania[13], where all policies in effect during the period that an injury continues are jointly and severally liable to the insured, allowing the insured to choose any one policy to respond to the loss and putting the onus of spreading costs through a judicial allocation on the targeted insurer.[14] The Court then adopted a *pro rata* formula “related to both the time on the risk and the degree of risk assumed.”[15] Under that method, losses are allocated among “the carriers on the basis of the extent of the risk assumed, *i.e.*, proration on the basis of policy limits, multiplied by years of coverage.”[16] The Court was sure to point out, however, that its ruling would not be the "last word" on the subject.[17]

In *Carter-Wallace, Inc. v. Admiral Ins. Co.*, the Supreme Court extended *Owens-Illinois’* allocation method to environmental property damage cases where environmental contamination is caused by the environment’s long term exposure to discharged hazardous substances.[18] In such cases, a single occurrence is deemed to take place during every policy providing pollution coverage issued between the time the contamination began and the time the contamination is discovered, on the basis that a release(s) of hazardous substances causes continuing and indivisible harm to the environment until remediated.[19] Importantly, *Carter-Wallace* refined *Owens-Illinois’* allocation method to account for excess liability insurance and how to allocate a

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[12] *See id.* at 474–76, 650 *A.*2d 974.
[13] *Koppers Co. v. Aetna Cas. & Sur. Co.*, 98 F.3d 1440, 1450 (3d Cir. 1996) (predicting that Pennsylvania Supreme Court would adopt its joint and several rule in long-tail environmental cases, as it had in asbestos cases); *J.H. France Refractories, Co. v. Allstate Ins. Co.*, 626 A.2d 502 (Pa. 1993) (adopting joint and several method for allocating losses among multiple policies covering asbestos injury caused by exposure over many years).
[14] *Id.* at 459–62, 650 *A.*2d 974.
[15] *Id.* at 479, 650 *A.*2d 974.
[16] *Id.* at 475, 650 *A.*2d 974.
[17] *Id.* at 478, 650 *A.*2d 974.
[18] *Carter-Wallace, Inc. v. Admiral Ins. Co.*, 154 N.J. 312, 318 (1998).
[19] *Id.*

loss among multiple successive stacks of primary and excess coverage.[20] The allocation method as refined by *Carter-Wallace* basically entails determining the number of years in which a carrier provided insurance and the amount of risk assumed by both primary carriers and excess carriers in each successive year within the trigger period.[21] Then, the available coverage in each year is separately divided by the total amount of coverage provided during the whole trigger period, yielding a percentage of the whole for each year.[22] The policy(ies) covering that year must indemnify according to that percentage, subject to the limits and terms of the policy.[23]

The Court acknowledged, however, that specific coverage situations may not lend themselves well to a rigid formula:

> we identified several public interest factors relevant to the appropriate method of insurance coverage. . . .Our jurisprudence in this area has not been marked by rigid mathematical formulas, and we do not advocate any such inflexibility now. Rather our focus remains on 'a fair method of allocation…that is related both to time on the risk and the degree of risk assumed.'[24]

The Court further refined the *Carter-Wallace* formula in *Quincy Mutual Fire Insurance Co. v. Borough of Bellmawr*, holding that because not all policies provide coverage for a full year, an

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[20] *Id.* at 325-27.
[21] *Id.* The "trigger period" or risk period is the time when the release or exposure first begins through to the time it is discovered or a disease manifests. *See id.*
[22] *Id.*
[23] *Id.* In *Carter-Wallace*, the Supreme Court provided the following example of the allocation scheme:

> Assume that primary coverage for one year was $100,000, first-level excess insurance totaled $200,000, and second-level excess coverage was $450,000. If the loss allocated to that specific year was $325,000, the primary insurer would pay $100,000, the first-level excess policy would be responsible for $200,000, and the second-level excess policy would pay $25,000.

Id. (internal citations omitted).
[24] *Id.* at 236.

allocation among carriers should be based upon the number of days that a policy covers the risk, not the number of years.[25]

b. <u>The Question Of Allocating Defense And Indemnity Costs To The Insured.</u>

In adopting its "time on the risk and degree of risk assumed" *pro rata* methodology, *Owens-Illinois* acknowledged that in some instances, a policyholder may not have insurance for certain points during a trigger period.[26] The Court stated:

> When periods of no insurance reflect a decision by an actor to assume or retain a risk, as opposed to periods when coverage for a risk is not available, to expect the risk-bearer to share in the allocation is reasonable....*Insurers whose policies are triggered by an injury during a policy period must respond to any claims presented to them and, if they deny full coverage, must initiate proceedings to determine the portion allocable for defense and indemnity costs*.[27]

Based upon this language, New Jersey Courts have stated that both defense and indemnity obligations may be allocated among insurers and also to the insured for periods when affordable insurance covering the loss at issue was reasonably available to the insured but the insured did not purchase coverage.[28]

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[25] *Quincy Mutual Fire Insurance Co. v. Borough of Bellmawr*, 172 N.J. 409, 431-32 (2002).
[26] *Id.* at 479, 650 *A.*2d 974.
[27] *Id.* (emphasis added).
[28] *See Champion Dyeing & Finishing Co., Inc. v. Centennial Ins. Co.*, 355 N.J. Super. 262, 271-77 (App Div. 2002) (addressing indemnity, but not defense); *Benjamin Moore & Co. v. Aetna Cas. & Sur. Co.*, 179 N.J. 87, 99, 843 A.2d 1094, 1102 (2004) (citing Donald C. Erickson, *Emerging Primary and Excess Coverage Issues in Continuous Trigger Regimes*, 28 *Brief* 18, 20 (Summer 1999)). The issue of coverage being "reasonably available" to the insured typically arises in long-tail asbestos cases and environmental contamination cases because the insurance industry began categorically excluding coverage for such liabilities in the mid 1980s. *Id*. It has been held that the advent of asbestos and "absolute pollution" exclusions rendered coverage for such liabilities "unavailable," thus a policyholder is not deemed to have declined to obtain insurance coverage and losses may not be allocated to the insured for periods where the coverage was not reasonable available or affordable. *See id.; see also Chemical Leaman Tank Lines, Inc. v. Aetna Cas. & Sur. Co.*, 177 F.3d 210, 231 (3d Cir. 1999) (holding that burden lies with carrier to prove availability of insurance for insured's specific environmental liability at time liability is discovered).

In *Spaulding Composites Co., Inc. v. Aetna Casualty & Surety Co.* and *Benjamin Moore & Co. v. Aetna Casualty & Surety Co.*, the Supreme Court arguably extended *Owens-Illinois* by stating in *dicta* that both defense and indemnity costs may be allocated to the insured not only for periods where the insured elected not to purchase reasonably available coverage for a given period, but when an issuing insurance company becomes insolvent or where a given policy's limits are exhausted.[29] The actual holdings of *Spaulding* and *Benjamin Moore*, however, did not directly address the issue of whether an insured must provide its own defense for periods when its insurers have become insolvent or insurance is unavailable.[30]

The issue of whether a policyholder must shoulder the defense or indemnity costs allocated to periods where it purchased coverage but that coverage is unavailable because of an insurer insolvency or for some other reason is significant because it is rather common in long-tail claims for at least some of a policyholder's insurers to have become insolvent. If the policyholder bears the brunt not only for periods where it has failed to purchase insurance, but for periods in which it in good faith purchased coverage but the insurer(s) became insolvent, or the policies are lost, the insurance funds available to cleanup a contaminated property or compensate injured persons can be drastically reduced.

[29] *Benjamin Moore & Co.*, 179 N.J. at 99, 843 A.2d at 1102 (holding that deductibles in each triggered policy must be paid before insured can access insurance funds under Owens–Illinois allocation scheme); *Spaulding Composites Co., Inc. v. Aetna Casualty & Surety Co.*, 176 N.J. 25, 36, 819 A.2d 410 (2003) (holding that “non-cumulation” clauses in insurance policies are inconsistent with and unenforceable under Owens–Illinois 's continuous-trigger and pro-rata allocation doctrines) (citing Donald C. Erickson, Emerging Primary and Excess Coverage Issues in Continuous Trigger Regimes, 28 Brief 18, 20 (Summer 1999)).
[30] *See supra*, note 29.

ANALYSIS

I. RECENT DEVELOPMENTS AND NEW QUESTIONS: *POTOMAC* AND *FARMERS MUTUAL* MODIFY HOW THE ALLOCATION SCHEME IS APPLIED IN NEW JERSEY.

a. The *Potomac* Case

The dispute in *Potomac* arose from a general contractor being sued by Evesham Township in New Jersey for a defective roof installed on a new school in Evesham.[31] The roof leaked and had other problems causing property damage over a ten year period from 1993 to 2003. The general contractor, Roland Aristone, Inc. ("Aristone") sought a defense and indemnity from several insurers that issued it comprehensive general liability policies during the period that the defective roof caused damage.

Between 1993 and 2003, Aristone purchased primary comprehensive general liability policies, all with limits of $1,000,000, from the following insurers: Pennsylvania Manufacturers' Insurance Company ("PMA"), Newark Insurance Company ("Newark"), Royal Insurance Company of America ("Royal"), OneBeacon Insurance Company ("OneBeacon"), Potomac Insurance Company of Illinois ("Potomac"), and Selective Way Insurance Company ("Selective").[32]

OneBeacon and Selective agreed to defend and indemnify Aristone, while PMA and Royal denied all coverage.[33] Aristone sued and after an arbitration and resulting settlement

[31] *Potomac Ins. Co. of Illinois ex rel. OneBeacon Ins. Co. v. Pennsylvania Mfrs.' Ass'n Ins. Co.*, 215 N.J. 409, 414, 73 A.3d 465, 468 (2013).
[32] *Id.* For the period of 1993 to 1995, Aristone was insured by PMA; from 1995 to 1996, by Newark Insurance Company ("Newark"), from 1996 to 1997, by Royal Insurance Company of America ("Royal"); from 1997 to 1998, by OneBeacon Insurance Company ("OneBeacon"), as transferee to Potomac Insurance Company of Illinois ("Potomac"); and from 1998 to 2003, Aristone was insured by Selective Way Insurance Company ("Selective"). All of the policies had $1,000,000 per occurrence limits. *Id.*
[33] *Id.* at 416, 469.

between Aristone and PMA, all carriers paid a share of the $700,000 underlying settlement, but OneBeacon and Selective had paid all of the defense costs, which exceeded $500,000, splitting them 50/50.[34] OneBeacon proposed an allocation of defense costs among the insurers based upon the "continuous trigger" and allocation methodology established by *Owens-Illinois.*[35] PMA and Royal refused, prompting OneBeacon to file a contribution claim against them for their share of Aristone's defense costs.[36]

PMA argued that OneBeacon could not maintain a contribution action because PMA had settled all of its obligations to the insured in the arbitration and any right OneBeacon had to recover costs was through subrogation against a wrongdoer, not contribution against another insurer.[37] OneBeacon countered that an allocation of defense costs, and the right to seek such an allocation through a contribution action against recalcitrant insurers, is entirely consistent with, and even necessary to, the allocation scheme set forth by the New Jersey Supreme Court in *Owens-Illinois*.[38]

The Supreme Court agreed with OneBeacon, holding that insurers have a right of contribution against other insurers when an insurer pays more than its *pro rata* share of defense costs where multiple successive policies are triggered for a single loss that occurred over a number of years.[39] The Court relied heavily on the "continuous trigger" and *pro rata* allocation scheme established in *Owens-Illinois*, stating: "Although the Court in *Owens–Illinois* considered an issue not raised by this case—co-insurers' obligations to indemnify their common insured—it

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[34] *Id.*
[35] *Id.* (citing *Owens-Illinois, Inc. v. United Ins. Co.*, 138 N.J. 437, 479, 650 A.2d 974, 995 (1994)). The proposed allocation under the *Owens-Illinois* allocation formula amounted to 50% to Selective, 10% to OneBeacon, and 20% each to Royal and PMA. *Id.*
[36] *Id.*
[37] *Id.* at 420, 472.
[38] *Id.*
[39] *Id.* at 425, 474-75.

envisioned a judicial determination of ‘the portion allocable [to each carrier] for defense and indemnity costs.’”[40]

The Court set forth four policy reasons supporting its holding that insurers have a right to contribution against each other for defense costs: (1) it promotes early involvement by all insurers and the efficient use of resources, (2) it encourages early settlement among insurers and the insured, (3) it incentivizes insureds to purchase seamless coverage due to the prospect of being responsible for defense and indemnity costs for gaps in coverage, and (4) it would be unfair to deny insurers that pay more than their *pro rata* share of defense costs under the *Owens-Illinois* and *Carter-Wallace* allocation scheme a right of contribution against insurers that owe coverage but have refused to pay, while at the same time improperly rewarding recalcitrant insurers.[41]

Finally, the Court rejected PMA’s argument that an insurer’s sole right to recover defense or indemnity costs it has paid is limited to its subrogation rights in a given policy, reasoning that “[t]he Court recognized in *Owens–Illinois* that the insurer's obligation to indemnify the policyholder may engender contribution claims between insurers that share the same insured, independent of any right of subrogation to the claims of the insured.”[42] Also of note, the Court rejected PMA's argument that it was entitled to contribution protection under the settlement agreement between Aristone and OneBeacon, reasoning that PMA was not a party to that agreement and the agreement contained no release of third party claims or indemnity of PMA.[43]

Potomac is significant because it confirms that insurance companies that make the

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[40] *Id.* (alteration by the Court) (quoting *Owens-Illinois, Inc. v. United Ins. Co.*, 138 N.J. 437, 479, 650 A.2d 974, 995 (1994)).
[41] *Id.*
[42] *Id.*
[43] *Id.* at 430, 477.

decision to provide a full defense and eventually indemnity to their insureds are not foreclosed from recovering costs from other insurers that have either refused to cooperate or whose policies were not identified until later in the underlying litigation, which happens with old policies in long –tail claims. As *Potomac* recognized, insurers' right of contribution against each other for expended defense and indemnity costs is a natural extension of the allocation scheme established by *Owens-Illinois* – if insurers are entitled to an allocation of the defense obligation to their shared insured, they should be able to obtain contribution from other insurance companies that do not pay their allocated share. If that were not the case, insurers would be discouraged from quickly stepping in and defending their insureds for fear of waiving their right to obtain reimbursement. Allowing contribution benefits both insurers and policyholders.

Another interesting aspect of *Potomac* appears in a seemingly innocuous footnote:

> In the relatively simple setting of this case, the defense costs were incurred by a single policyholder, Aristone, which purchased coverage for every relevant year. The underlying litigation was settled prior to trial within the limits of each policy and no excess carriers were involved. Accordingly, we need not reach the issue of allocation of defense costs when a litigant is uninsured or underinsured for a portion of the relevant period or address the obligations of excess carriers with respect to defense costs.[44]

By not reaching the "issue of allocation of defense costs when a litigant is uninsured or underinsured," but at the same time allowing insurers to seek contribution from each other, the Court is arguably leaving the door open to requiring insurers to absorb, at least temporarily, the percentage of defense costs allocated to periods where insurance was purchased but is for some reason not available to cover a loss.[45] This would be consistent with *Owens-Illinois,* which again stated that an insured must provide its own defense *only* when "periods of no insurance reflect a

[44] *Id.* at n. 6.
[45] For example, the policies may be lost but the evidence shows that the insured did not "choose to go bare" or, the coverage may have been issued by an insurer that has gone bankrupt and the claim is not a "covered claim" such that the New Jersey Property-Liability Insurance Guaranty Association would step into the shoes of the bankrupt insurer.

decision by an actor to assume or retain a risk, as opposed to periods when coverage for a risk is not available."[46] In turn, as established in *Potomac*, the insurers that absorb the defense obligation may seek contribution from the recalcitrant insurer.[47]

Surely, insurers will argue that *Potomac* did not leave any door open and under no circumstances can an insurer be required to pay more than its allocated share of defense costs or indemnity. Insurers will also likely argue that, at least in the case where it is known that an insured did not "go bare" but the policy is lost, it is the policyholder's burden of proving the existence of coverage, thus it would be unfair to push that obligation upon other insurers by requiring them to absorb the lost policy allocation and seek contribution to the extent the issuer of the lost policy can be identified. How these issues will play out in the courts remains to be determined, but the ruling in *Potomac* affirmatively establishing a right of contribution for defense costs on behalf of insurance companies may set the stage.

b. <u>The Farmer's Mutual Case: Allocation Of Defense And Indemnity When Insurers Become Insolvent.</u>

Just after *Potomac*, the New Jersey Supreme Court held in *Farmers Mutual* that in cases where an insurer has become insolvent and the New Jersey Property-Liability Insurance Guaranty Association ("NJPLIGA") must step into the shoes of the insolvent insurer, all solvent insurers on the risk must absorb the allocations to insolvent periods until the solvent insurers' policy limits are exhausted.[48] In so holding, the Court reversed prior precedent that placed the burden of paying for periods of insolvent insurance on the insured and NJPLIGA.[49]

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[46] *Owens-Illinois,*138 N.J. at 479, 650 A.2d 974.
[47] *Potomac Ins. Co. of Illinois.*, 215 N.J. at 425, 73 A.3d at 474.
[48] *Farmers Mut. Fire Ins. Co. of Salem v. New Jersey Prop.-Liab. Ins. Guar. Ass'n*, 215 N.J. 522, 549, 74 A.3d 860, 875 (2013). As explained by the Court:

Farmers Mutual involved two consolidated cases in which Newark Insurance Company ("Newark"), now in liquidation, issued a homeowners policy to one homeowner from 1999 to 2002 and to a separate homeowner from 1998 to 2002.[50] Coincidentally, Farmers Mutual issued homeowners policies to both homeowners from 2002 to 2003.[51] The policies, unlike most modern business liability policies, did not exclude pollution liability.[52] In the spring and summer of 2003, both homeowners discovered that their respective properties were contaminated due to leaking underground storage tanks existing at each property.[53]

There was no dispute in either case that Farmers Mutual only covered seven months of the contamination period for one homeowner and eight months for the other, while Newark covered three and four years, respectively.[54] Yet, Farmers paid for 100% of the remediation costs incurred by each homeowner.[55] As a result, Farmers sued NJPLIGA for reimbursement based upon its *pro rata* share under the *Owens-Illinois* allocation scheme for the periods of insolvent insurance.[56]

> When insurance companies are rendered insolvent, insureds no longer have the protection for which they contracted and claimants no longer have a source from which to be made whole for their losses. To mitigate the financial distress to insureds and claimants caused by an insurance company's insolvency, the Legislature passed the New Jersey Property–Liability Insurance Guaranty Association Act, N.J.S.A. 17:30A–1 to –20.
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> The PLIGA Act created the Guaranty Association—[which is] . . . .obligated to stand in the place of "an insolvent insurer and to pay certain claims up to the limit of the policyholder's contract, subject to a maximum liability of $300,000.

Id. at 540-41, 870-71 (internal citations omitted).
[49] *Id.* at 542, 871.
[50] *Id.* at 529-30, 864.
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*

NJPLIGA argued that its enabling statute, as clarified by a 2004 amendment thereto, established that it had no obligation to step into the shoes of Newark and reimburse Farmers for Newark's *pro rata* share of cleanup costs until Farmers' policy was first exhausted.[57] Specifically, section 12b of the New Jersey Property–Liability Insurance Guaranty Association Act ("PLIGA Act" or "Act"), N.J.S.A. 17:30A–12b, requires that "when a claim arises under policies issued by both a solvent and insolvent insurer, the claimant must first *exhaust* the policy of the solvent insurer."[58]

In the 2004 amendments, the Legislature added to the Act a definition for "exhaust" at N.J.S.A. 17:30A–5, which states:

> "Exhaust" means with respect to other insurance, the application of a credit for the maximum limit under the policy, *except that in any case in which continuous indivisible injury or property damage occurs over a period of years as a result of exposure to injurious conditions*, exhaustion shall be deemed to have occurred *only after a credit for the maximum limits under all other coverages*, primary and excess, if applicable, issued in all other years has been applied....[59]

Relying upon the 2004 amendment, NJPLIGA asserted that any periods of insolvent insurance must be excluded from a *pro rata* allocation until all solvent insurance has been exhausted, meaning that 100% of the coverage obligation owed to the insureds must first be allocated to Farmers, the only solvent insurer on the risk, until Farmers had paid out all of its limits, and only then could an allocation be made for the periods that Newark had issued coverage.[60]

The Supreme Court agreed with NJPLIGA. In doing so, the Court arguably recognized that a 1997 Appellate Division decision that held the opposite under the nearly identical

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[57] *Id.* at 534, 867.
[58] *Id.* at 542, 871 (emphasis added) (citing N.J.S.A. 17:30A–12b ("Any person having a claim ... under an insurance policy other than a policy of an insolvent insurer, shall be required to exhaust first his right under that other policy.")).
[59] N.J.S.A. 17:30A–5 (emphasis added).
[60] *Farmers Mutual*, 215 N.J. at 534, 74 A.3d 867.

provisions of NJPLIGA's sister statute, the Guaranty Fund Act, N.J.S.A. 17:22–6.79b, is superseded.[61] That decision was *Sayre v. Insurance Co. of North America*, in which the Appellate Division held the exhaustion requirement in the Guaranty Fund Act did not affect the *Owens-Illinois* allocation scheme, meaning that an allocation to periods where an insurer has become insolvent must be borne directly by the relevant guaranty fund and/or the policyholder, instead of being taken out of the allocation altogether until all other solvent insurance is exhausted.[62]

The Court was clear in stating that *Sayre* got it wrong with respect to its interpretation of the exhaustion requirement, prompting the Legislature to clarify its intent through the 2004 amendments:

> If the Legislature were content with the *Sayre* decision—a continuous-trigger case—in which the Guaranty Fund was required to step into the shoes of the insolvent carrier for proration purposes, there would have been little point to adding the 2004 amendments, N.J.S.A. 17:30A–5 and N.J.S.A. 17:22–6.72, defining exhaustion in cases of "continuous indivisible injury or property damage occur [ring] over a period of years as a result of exposure to injurious conditions." It is reasonable to conclude based on the statutory language that the Legislature intended to reverse the result in Sayre.[63]

As the Court stated, its interpretation of the Act is consistent with the "the principle that the Guaranty Association is an insurer of last resort."[64] Importantly, the Court was quick to reject an *amicus* argument that periods of insolvent insurance should not only be included in an allocation, but the insured should have to pay for those *pro rata* shares until all solvent insurance

[61] *Id.* at 544, 872. The Guaranty Fund Act serves essentially the same function as the PLIGA Act but for surplus lines insurance companies, which are insurance companies that are not license to write policies in New Jersey. *See supra*, note. 48.
[62] *Sayre v. Insurance Co. of North America*, 305 N.J. Super. 209, 701 A.2d 1311 (App. Div. 1997). Although *Sayre* did not involve the same statute as *Farmers Mutual*, the two statutes (one applying to admitted insurers and one applying to surplus lines insurers) are strongly analogous. Thus, the holding in *Farmers Mutual* arguably applies equally to the Guaranty Fund Act. *See supra*, note 61.
[63] *Farmers Mutual*, 215 N.J. at 544, 872.
[64] *Id.*

is exhausted, and only then would NJPLIGA's obligations be triggered.[65] Such an interpretation, the Court held,

> would turn the PLIGA Act on its head. The PLIGA Act created the Guaranty Association as a means of providing benefits to insureds who, through no fault of their own, have lost coverage due to the insolvency of their carriers. N.J.S.A. 17:30A–4 directs us to "liberally construe[ ]" the Act to achieve its purposes. One of those purposes is "to minimize financial loss to claimants or policyholders because of the insolvency of an insurer." N.J.S.A. 17:30A–2. That aim would be defeated by making the insured bear the loss for the carrier's insolvency before the insured received any statutory benefits from the Guaranty Association.[66]

Finally, the Court rejected Farmers' argument that the 2004 amendment constituted an unconstitutional interference with its existing contracts.[67] Farmers failed to meet the three prong test for showing that a law unconstitutionally interferes with vested contract rights because, most importantly, the 2004 amendment was merely a clarification of the pre-existing exhaustion requirement set forth at N.J.S.A. 17:30A–12b and how that requirement applies to continuing injury cases:

> Farmers *Mutual assumes that the 2004 amendment was something other than a clarification of the PLIGA Act's earlier exhaustion provision*....The way Farmers Mutual envisioned the *Owens–Illinois* allocation would work in the present case when it contracted with its insureds did not vest it with a right to the outcome it wanted.[68]

Importantly, the Court pointed out that solvent insurers will never be called upon to pay more than their policies' maximum limits, which is the very risk they undertook when issuing

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[65] *Id.*
[66] *Id.* at 544-45, 872.
[67] *Id.* at 546-47, 874-75
[68] *Id.* (emphasis added). The three prong test is: "Legislation unconstitutionally impairs a contract when it (1) "substantially impair[s] a contractual relationship," (2) "lack[s] a significant and legitimate public purpose," and (3) is "based upon unreasonable conditions and ... unrelated to appropriate governmental objectives." *Id.* (quoting *State Farm Mut. Auto. Ins. Co. v. State*, 124 N.J. 32, 64, 590 A.2d 191 (1991)).

policies in the first place.[69] The Court thus left no doubt that when allocating defense and indemnity obligations among many insurers in long-tail claims, to the extent any policies were issued by now insolvent insurers, those policies cannot be counted in the allocation until all solvent insurers have exhausted their limits. The only potential limitation to this rule is that the claim against the insolvent insurer arguably may need to be a "covered claim" such that NJPLIGA may eventually be obligated to stand in the insolvent insurer's shoes once all solvent coverage has been exhausted, and the statutory cap of NJPLIGA's obligation is set at $300,000 for both defense and indemnity costs.[70]

The true significance of *Farmers Mutual* can be best understood in analyzing its impact in a long-tail environmental or toxic tort claim. For example, assume that hazardous substances were released into the soil and leached into the groundwater at an industrial facility over a period of ten years between 1975 and 1985.[71] Assume that the person responsible for the contamination purchased ten primary liability policies covering the exposure period, all with $1,000,000 limits, with no excess coverage. Assume that the contamination is discovered in 2013 and the New Jersey Department of Environmental Protection or the U.S. Environmental Protection Agency performs a cleanup and demands reimbursement from the insured. Under *Carter-Wallace*, there would be a total of $10,000,000 in available coverage issued over a period of ten years. Because

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[69] *Id.* at 548, 875.

[70] *Id.* at 535, 541, 867, 871.

[71] These years are chosen in this example because the absolute pollution exclusion barring coverage for pollution claims came into being in approximately 1985, rendering pollution coverage generally unavailable. Thus, when allocating coverage obligations, years after 1985 are typically excluded because no pollution coverage for the existing contamination is available. *See supra*, note 28.

each policy has the same limits, and assuming the full limits are otherwise available, each policy period will be allocated a 10% share of defense and indemnity.[72]

Now assume that half of those policies were issued by an insurer that has become insolvent between the time it issued policies and the time the contamination was discovered years later. Under *Sayre*, now arguably superseded, the insured would have to pay for half of its defense costs and half of any settlement or judgment for cleanup costs. Under *Farmers Mutual*, the solvent insurers must pay for 100% of defense costs and indemnity costs up to their policy limits and the insured pays nothing until all of those limits are exhausted.[73] Because there are five solvent insurers in the example, each with $1,000,000 limits, that amounts to $5,000,000 worth of coverage for the insured before it must worry about NJPLIGA and being partially without insurance. Most importantly, the insured will not be exposed to the possibility of paying its own defense until a judgment or settlement exceeds $5,000,000.

Now imagine that, in the above hypothetical, the five solvent insurers did not have equal policy limits, *e.g.*, two of the solvent policies had limits of $500,000. The result in a *Carter-Wallace* allocation is that the two policies with lower limits will be allocated a slightly lower percentage, since they did not "assume" as much risk as the other policies. Additionally, because the limits are only half of the other solvent policies, they are certain to be exhausted before the other policies with larger limits, barring any major difference in the percentages allocated to the different policies.[74] When that happens, under *Farmer's Mutual*, the allocation to that now

[72] That is, each policy was "on the risk" for one of ten years, and each policy assumed an equal amount of risk, thus avoiding the need to further pro rate the allocation based upon different policy limits. Thus, each policy is allocated one tenth of the total risk ($1,000,000 / $10,000,000 = 10%).
[73] *Farmers Mutual*, 215 N.J. at 544, 872.
[74] *See id.*

exhausted policy must be absorbed by the remaining solvent policies, and so on, until every solvent policy is exhausted. Only then is NJPLIGA obligated to step in.[75]

Once NJPLIGA's obligation is triggered because the $5,000,000 in combined limits of the solvent insurers was paid out in a settlement or judgment, the insured arguably must begin paying the 50% share of the now exhausted solvent insurance, while NJPLIGA will pick up the insolvent portion. Prior to *Farmers Mutual*, the insured would have to immediately pay 50% of its defense – the NJPLIGA share – until the solvent coverage is exhausted, but then have to pay the exhausted solvent coverage share once NJPLIGA's obligation is triggered. Essentially, the insured would trade one 50% for the other. Thus, not only would the insured always have to pay at least 50% of its defense costs, but once the $1,500,000 in NJPLIGA coverage runs out ($300,000 statutory cap times five years), the insured must shoulder 100% of its defense and remaining indemnity.

The above illustration demonstrates the impact of *Farmers Mutual*. The "exhaustion" procedure confirmed in *Farmers Mutual* represents a substantial benefit to the insured, which would otherwise have to immediately shoulder 50% of its defense costs for the insolvent periods. What makes *Farmers Mutual* particularly significant, though, is the fact that it is very common in long-tail environmental or toxic tort matters for some of the insurers on the risk to have become insolvent before the loss becomes known. *Farmers Mutual* therefore is likely to have a real impact on a large number of cases.

II. THE NEW LANDSCAPE AND REMAINING QUESTIONS.

As outlined above, the *Potomac* and especially the *Farmers Mutual* decisions will undoubtedly have a substantial impact upon the allocation and sharing of defense and indemnity

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[75] *See id.*

costs in long-tail claims in New Jersey. As is usually the case, these two landmark decisions leave issues unresolved and open up new issues. Surely, insurers will seek to limit the impact of *Farmers Mutual* and will not acknowledge the possibility of an open door left by *Potomac* in terms of allocating defense and indemnity costs solely to insurers, as opposed to the insured, when the insured purchased insurance but for one reason or another that insurance is not available to contribute to a defense or indemnity. In contrast, policyholders will look to extend both decisions as far as possible.

For example, some commentators have argued that *Farmers Mutual* is of limited applicability because it only governs cases where the insolvent insurer in question was placed in liquidation after the 2004 amendments to the PLIGA Act.[76] If true, this would indeed limit the case's applicability, since a large number of cases involve insurer insolvencies that predate the 2004 amendments. Fortunately for policyholders, that argument is not without its problems.

The argument rests upon a provision in the 2004 amendments to the PLIGA Act stating the amendments "shall take effect immediately and shall apply to covered claims resulting from insolvencies occurring on or after that date."[77] Courts have interpreted this language to mean the amendments only apply prospectively to insolvencies that occur after 2004.[78] However, the

[76] Lorraine Armenti, Christopher Franges, Eduardo DeMarco, "Takeaways for Insurers from NJ High Court's Landmark Case," November 5, 2013, available at www.law360.com/articles/483642.
[77] *L.* 2004, *c.* 175, § 9; *ARCNET Architects, Inc. v. New Jersey Prop.-Liab. Ins. Guar. Ass'n*, 377 N.J. Super. 102, 104, 871 A.2d 728, 729 (App. Div. 2005) (discussing amendments).
[78] *See ARCNET Architects, Inc.*, 377 N.J. Super. at 104, 871 A.2d at 729; *Thomsen v. Mercer-Charles*, 187 N. J. 197, 204 n. 2 (2006) . Importantly, neither of these cases addressed the specific issue of how the exhaustion requirement at N.J.S.A. 17:30A-12b, which existed prior to the 2004 amendments, should be applied in long-tail claims involving multiple successive insurance policies. Rather, they addressed other aspects of the 2004 amendments that truly were new to the PLIGA Act. It is true that the definition of "exhaust" is new, but the language in *Farmers Mutual* suggests that the definition was merely a clarification of the existing word "exhaust" in N.J.S.A. 17:30A-12b in light of an incorrect ruling of an intermediate level appeals

exhaustion provision at N.J.S.A. 17:30A-12b lying at the heart of the *Farmers Mutual* decision predated the 2004 amendments.[79] As explained above, the Court was clear in stating that the definition of "exhaust" added at N.J.S.A. 17:30A-5 in the 2004 amendments merely clarified the existing “exhaustion” requirement established at N.J.S.A. 17:30A-12b.[80] Therefore, policyholders will likely argue that the *Farmers Mutual* holding is not limited to post 2004 insolvencies.

Moreover, the Court in *Farmers Mutual* squarely rejected Farmers Mutual's argument that the 2004 amendments as applied to a *Carter-Wallace* allocation unconstitutionally impaired its vested contract rights, where Farmers Mutual had previously relied upon the allocation approach in *Sayre*.[81] The Court reasoned that the highly regulated insurance industry can hardly expect the regulatory scheme governing it to remain in a rigid state and even *Owens-Illinois* stated that its holding was not the “last word” on allocation.[82] Policyholders will likely argue that the Court’s rejection of the vested rights argument suggests that the existing exhaustion requirement and *Farmers Mutual*’s interpretation of how it intersects with a *Carter-Wallace* allocation applies to allocations involving pre-2004 insolvencies.[83] In contrast, insurers will respond that the Legislature’s intent was clear in its 2004 amendments and the exhaustion requirement, or procedure, set forth in *Farmers Mutual* does not apply where the insolvent

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court. *See supra*, notes 66, 68 and accompanying text. Policyholders would likely argue that the Legislature did not intend the pre-existing word “exhaust” found in N.J.S.A. 17:30A-12b to have diametrically opposed meanings pre and post 2004 in the context of long-tail claims. *See also State*, *Dep't of Envtl. Prot. v. Ventron Corp.*, 94 N.J. 473, 498-99, 468 A.2d 150, 163 (1983) (existing cases are subject to new law pursuant to time of decision rule).

[79] *See Farmers Mutual*, 215 N.J. at 544, 546-47, 872, 874-75.

[80] *See id.*

[81] *See id.*

[82] *See id.*

[83] *See Id.*; *State*, *Dep't of Envtl. Prot. v. Ventron Corp.*, 94 N.J. 473, 498-99, 468 A.2d 150, 163 (1983) (setting forth standard for retroactive statute, including issue of impairing existing contract rights and issue where new legislation merely clarifies or supplements existing law).

insurer in question was placed in liquidation prior to the 2004 amendments. This may well be the next issue to reach the Supreme Court in the world of insurance allocation law.

In addition to the insolvency issue, insurance companies may also argue that an insured must first establish its right to coverage from NJPLIGA before NJPLIGA's share can be allocated to other solvent insurers. This argument, however, may run contrary to the Court's instruction that policyholders cannot be left to defend themselves for periods where its insurers have become insolvent.[84] Indeed, the *Farmers Mutual* Court explicitly rejected an *amicus* argument that insureds should bear the burden of insolvency until all solvent insurance is exhausted and only then that burden passes to NJPLIGA.[85] Also, the Court stated that insurers must "exhaust the limits of the policies issued by solvent insurers before applying to the Guaranty Association," suggesting that the obligation to establish the right to coverage from NJPLIGA is not triggered until all solvent insurance is exhausted.[86] The Court did not expressly address whether it must first be shown as a threshold matter that NJPLIGA will eventually be obligated to stand in the shoes of insolvent insurers before the solvent insurers must absorb NJPLIGA's share – and who bears the burden of making such a showing if required – but the Court did suggest this issue is not even ripe until at least one solvent insurer exhausts its limits. Arguably, so long as an insured has a *prima facie* "covered claim," *e.g.*, it has evidence of a policy issued by an insolvent insurer and the claim involves a loss in New Jersey, the solvent

[84] *Farmers Mutual*, 215 N.J. at 544, 872.
[85] *Id.* ("The PLIGA Act created the Guaranty Association as a means of providing benefits to insureds who, through no fault of their own, have lost coverage due to the insolvency of their carriers. N.J.S.A. 17:30A–4 directs us to "liberally construe[ ]" the Act to achieve its purposes. One of those purposes is "to minimize financial loss to claimants or policyholders because of the insolvency of an insurer." N.J.S.A. 17:30A–2. That aim would be defeated by making the insured bear the loss for the carrier's insolvency before the insured received any statutory benefits from the Guaranty Association.").
[86] *Farmers Mutual*, 215 N.J. at 545, 874-75.

insurers must absorb any allocation to insolvent insurers/NJPLIGA. When all solvent insurance is exhausted, if it is exhausted, the insured will then bear the burden of establishing its right to coverage from NJPLIGA. Anything to the contrary would put the burden of the insolvent insurance on the policyholder, which arguably contravenes the Court's express instruction in *Farmers Mutual*.[87]

Insurance companies are also likely to argue that the holding in *Farmers Mutual* is limited solely to cases where the PLIGA Act or the Guaranty Fund Act (for surplus lines) are implicated. Although it is probably true that the holding of *Farmers Mutual* is technically limited to such cases, the guidance and force of the opinion for all allocation cases cannot be denied. For example, the Court took pains to point out that it is fair for solvent insurers to absorb the allocation to other policy periods because they will still never have to pay more than their policy limits.[88] Thus, an allocation scheme that requires solvent insurers to absorb gaps in coverage that are not a result of the insured electing to "go bare," even when the PLIGA Act is not implicated, would also be “fair” according to *Farmers Mutual*.

Combining this reasoning with the fact that the Court in *Potomac* declined to address the issue of allocating to the insured for gaps in coverage where a policyholder has not elected to go bare but coverage is not available for some other reason, a signal from the Court arguably emerges – solvent insurers should absorb any coverage gaps, especially where the gap is caused by an insurer insolvency even though it is not a "covered claim" under the PLIGA Act, so long as the facts do not reflect a failure to purchase available insurance coverage.[89] As acknowledged by the Court in *Farmers Mutual*, any perceived harshness is mitigated by the fact that solvent

[87] *See supra*, note 85.
[88] *See supra*, note 69 and accompanying text.
[89] *See supra*, notes44-47, 65-69, and accompanying text.

insurers will never have to pay more than what they contracted to pay - their policy limits - and they have the right to seek contribution from other insurers pursuant to *Potomac.*

Finally, policyholders will likely seize upon the Court's strong statement that forcing policyholders to bear any portion of insolvent insurance "turns the PLIGA Act on its head" to argue that no share of insolvent insurance can be allocated to periods where policies have been lost.[90] Under a regular allocation scheme where insolvent periods are collapsed and gaps in coverage exist due to lost policies, a portion of the collapsed insolvent insurance will inevitably be allocated to the lost policy periods. The effect is that the insured will likely have to bear the portion of insolvent coverage that is allocated to lost policy periods. In such situations, policyholders will argue that the percentage of insolvent coverage that is assigned to years where policies have been lost should be redistributed to the solvent insurers based upon their *pro rata* share, such that no amount that would have been allocated to an insolvent period will be absorbed by the insured for periods where policies have been lost.

CONCLUSION

Potomac and *Farmers Mutual* have changed the face of allocation in long-tail coverage claims in New Jersey. The decisions on the balance favor policyholders, especially in situations involving gaps in coverage due to insurer insolvency. Like all landmark decisions, however, these two cases leave a number of questions unanswered and raise a host of new questions. For example, policyholders are likely to attempt to renegotiate cost sharing agreements to pass the burden of defense costs onto insurance companies in situations where NJPLIGA is not participating or its statutory cap has been reached. This is especially so given the Court's rejection of Farmers Mutual's vested contract rights argument. Also, insurers are likely to

[90] *Id.* at 544-45, 872.

challenge allocations that unfairly favor other insurers, especially given the now established right of contribution. For example, as some commentators have pointed out, it is not clear how *Farmers Mutual* affects situations involving more than one layer of insurance in a given year, where a solvent excess insurer issues an excess policy that sits on top of a primary policy issued by an insolvent insurer.[91] Furthermore, the question of whether the exhaustion requirement in the PLIGA Act as interpreted by *Farmers Mutual* applies to pre-2004 insolvencies is ripe for resolution. How these issues play out in light of *Potomac* and *Farmers Mutual* remains to be seen.

[91] Lorraine Armenti, Christopher Franges, Eduardo DeMarco, "Takeaways for Insurers from NJ High Court's Landmark Case," November 5, 2013, available at www.law360.com/articles/483642.