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Damages and DIY: Coverage for Corrective Measures Undertaken By the Insured

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The typical liability policy insures the policyholder against "damages" but does not define what that word means. In most cases, the damages that the insured pays, whether because of a judgment or because of a settlement, will consist of money paid to another entity. However, in some circumstances, there is a strong argument that internal costs the insured incurs to remediate the harm it has caused a claimant can constitute covered damages that the insurer must reimburse.

This application of the word "damages" should be particularly useful in the context of professional liability or Errors and Omissions ("E&O") coverage, providing professionals and other insureds under E&O policies with the ability to fix their own mistakes, at a savings to themselves and their insurers.

Narrow and Broad Constructions of 'Damages' in General Liability Policies

In the 1980s and 1990s, it was common for insurers in environmental coverage actions to argue that environmental remediation costs, such as costs paid to contractors to clean up a hazardous waste site, were not "damages" within the meaning of general liability policies. The insurers' argument asserted that the word "damages" had a technical meaning, and that it referred only to monetary awards set by courts in traditional litigation and paid directly to the plaintiff. Anything else, such as sums paid to dig up and dispose of contaminated soil or to capture and treat chemical-laden water, was, in the insurers' view, closer to equitable relief than to "legal damages."

Under this narrow reading, an enormous percentage of the costs that corporate America incurred in response to CERCLA and other environmental statutes would not constitute damages, since large sums were paid to engineering firms and remediation consultants that planned and executed cleanup remedies, rather than to the government or other claimants.

Although a handful of courts accepted the insurers' position, *see*, *e.g.*, *Maryland Cas. Co. v. Armco, Inc.*, 822 F.2d 1348 (4th Cir. 1987), the great majority rejected it. By 1993, in *Morton International, Inc. v. General Accident Insurance Co. of America*, 629 A.2d 831 (NJ 1993), the New Jersey Supreme Court surveyed the case law and concluded that the "clear weight of authority … among both federal and state courts adopts the view that the undefined term 'damages' in CGL policies should be accorded its plain, non-technical meaning, thereby encompassing response costs imposed to remediate environmental damage." *Id.* at 845.

Under this majority rule, then, the sums paid by insureds to third parties — such as environmental contractors — to remediate the property damage are properly reimbursable by insurers as "damages."

The Insured's Remediation Costs As 'Damages' Under General Liability Coverage

By the same logic, if the insured itself performs the remediation or otherwise solves the problem for which it is responsible, the insurer should reimburse it for the reasonable costs of doing so.

Take as a hypothetical a company capable of conducting an environmental cleanup, such as the removal of oil from navigable waters following a spill that it has caused. Assume further that the government has given the company the choice of cleaning up the spill itself or hiring a third party to conduct the remediation. Finally, assume that if the company does not include its own overhead or any profit in calculating its cost to conduct the remediation, it could perform the cleanup more cheaply than could the third party.

In this hypothetical, if the insured conducted the remediation itself, it would save the insurer money — but it would be asking the insurer to pay it for its efforts. An insurer taking the narrow, largely rejected interpretation of "damages" might say that if the insured wanted its liability policy to cover the cleanup costs, the insured was required to let the government hire others to perform the cleanup and then file suit against the insured.

Far from hypothetical, these were the facts in *Chemical Applications Co. v. Home Indemnity Co.*, 425 F. Supp. 777 (D. Mass. 1977), an environmental cleanup case. In that case, Senior Circuit Judge Bailey Aldrich, sitting by designation, held that there was coverage. The court held that the insurer was obligated to agree to the policyholder's reasonable action, and that the policyholder's "proposal to perform cleanup work itself at cost could not do other than benefit the insurer, since the total cost of the cleanup was thereby minimized." *Id.* at 779. The Massachusetts Supreme Judicial Court has endorsed the *Chemical Applications* decision, describing its holding as follows: "The insured's actions minimized the cost to the insurer, and the insurer therefore had an obligation to agree to those actions." *Sarnafil, Inc. v. Peerless Ins. Co.*, 636 N.E.2d 247, 253 n.6 (Mass. 1994).

Errors and Omissions Policies

The principle of *Chemical Applications* is likely to be of modest utility in the general liability context. After all, general liability policies usually respond to tort-type situations, in which

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the insured has allegedly caused bodily injury or property damage to a third party. For example, in both the asbestos bodily injury context and the environmental property damage context, often the defendant is a manufacturer, not a company whose business includes providing medical care or performing large-scale environmental remediation. Although exceptions do exist (such as Chemical Applications Company), it would be the unusual case rather than the ordinary one in which the insured happened to be capable of treating or remediating the very type of damage that it had caused.

However, in the Errors and Omissions or professional liability context, it is far more common for the alleged harm to be solvable by recourse to the precise skill set of the person or entity that made the mistake in the first place. For example, if an architect designs a building with inadequate lateral support, so long as the problem is recognized while the building is still standing, one would expect an architect to be brought in to design a "fix." The cost of this second architect would be an ordinary element of the building owner's claim, and an element that the insurer would recognize as "damages."

Because a claim in the E&O context could give rise to an opportunity for the insured to participate in the resolution of the problem it has allegedly caused, policyholders facing E&O or professional liability claims should remember the principle of *Chemical Applications*. On the proper facts, this principle could be a powerful tool for the policyholder.

Let us take a new hypothetical. Say that a scientific research company is running a large-scale test of a new compound on behalf of a customer and it makes a mistake during part of that test — for example, it sets the temperature too high when testing certain samples and thereby invalidates the results. In order to put the customer in the position it would have been in absent the error, the insured could pay the customer the fee that the customer would have to incur to have another testing company rerun the test without the mistake — or it could rerun the test itself, this time at the correct temperature.

In this scenario, it may well be far less expensive for the insured to conduct the experiment. After all, the insured has already incurred the costs necessary to procure any specialized equipment, has already developed the necessary protocols, and is already familiar with the compound. Another research company would be starting from scratch, and the duplication of at least some of the work would increase the total cost of the re-work. Moreover, if the insured agreed to perform the work at cost, that is, making no profit, it would likely be able to do the work at a substantial discount relative to the other company.

An enlightened insurer would double-check the policyholder's claim that it could perform the work more cheaply, and if the claim checks out, would readily agree to reimburse the policyholder for the cost of redoing the work. In this way, it would save itself money.

A more cynical insurer might deny coverage for the internal costs of any re-work performed by the insured, asserting that because no money has left the company those costs are not "damages" — and hope that, despite the denial, the insured will remedy the problem itself anyway. The insurer in *Chemical Applications* took a similar tactic, delaying its denial of coverage in the expectation that the insured would perform the cleanup itself and thereby minimize the claim even if the denial was not upheld in court. *See* 425 F. Supp. at 779 ("Indeed, I find that, at least in part, [the insurer]'s delay in notifying plaintiff of its disclaimer for the cost of work performed by plaintiff, was based on conscious realization that the more work plaintiff did, the cheaper it might be for defendant itself in the long run, even if it ultimately had to pay the cost thereof, a matter which it could still contest.").

The insurer might object that the policyholder is offering to perform the re-work for reasons other than reducing its insurer's exposure …

A policyholder facing an insurer refusal to credit internal re-work costs as "damages" should take practical steps to support its position. For example, it should obtain good data concerning what it would cost to have another company undertake the work that the insured itself could perform. Such data could be in the form of actual quotes or they could be based on market data. The insured should also confirm that it could do the same work at lower cost. And it should confirm with the claimant that this would be an acceptable solution, since not every Errors and Omissions claimant would be ready to give a second chance to the party that had made a significant error on its first effort.

Armed with the comparative cost data and the claimant's consent, however, the policyholder should be in a strong position to argue that it should be allowed to remediate the problem — and have its internal costs reimbursed as "damages." This result is economically efficient from a societal point of view, from the insurer's point of view, and from the insured's point of view.

The insurer might object that the policyholder is offering to perform the re-work for reasons other than reducing its insurer's exposure, such as to protect or rebuild its reputation, to avoid introducing its client to one of its competitors, or even to keep some of its employees busy. While the insured might accrue any or all of these collateral benefits, however, so long as the insured can demonstrate convincingly that it can offer a cost savings over others in the industry by solving the problem itself, the insured should have a strong argument that, under the rationale of *Chemical Applications*, the costs it incurs to remedy its prior error or omission are "damages" and thus properly reimbursable by the insurer under the applicable policy. A court could easily hold that the undefined term "damages" does not make coverage turn on who performs the remediation, and that it is contrary to the reasonable expectations of the insured that coverage would exist only if the insured were to choose the economically irrational course of conduct in response to a loss.

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