Allocating RI/FS Expenses between Defense and Indemnity Provisions of Old Insurance Policies

Alan B. Schafer
Alan.Schafer@chicagounbound.edu

Follow this and additional works at: http://chicagounbound.uchicago.edu/uclf

Recommended Citation
Available at: http://chicagounbound.uchicago.edu/uclf/vol1997/iss1/20

This Comment is brought to you for free and open access by Chicago Unbound. It has been accepted for inclusion in University of Chicago Legal Forum by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.
Allocating RI/FS Expenses Between Defense and Indemnity Provisions of Old Insurance Policies

Alan B. Schafer†

We must avoid, at all costs, another war of experts to determine how much of the costs should be allocated to defense and how much to indemnity. —Supreme Court of New Jersey

Cleaning up pollution is expensive. Deciding who should pay for cleaning up pollution under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") is also expensive. Too expensive. One of the latest episodes of CERCLA litigation centers on whether insurers or their policyholders should pay the unforeseen costs of investigating polluted sites.

Under CERCLA, a party that has been targeted as possibly liable for a polluted site, a "Potentially Responsible Party" ("PRP"), must pay the costs of the remedial investigation/feasibility study ("RI/FS"). Because liability under CERCLA is both strict and retroactive, the Environmental Protection Agency ("EPA") holds polluting companies responsible for contamination that may have begun twenty or thirty years ago, when it may have been legal. Because of the resulting large and unanticipated investigation and cleanup costs, PRPs with Comprehensive General Liability ("CGL") insurance and their insurers now face off against each other in expensive legal battles over RI/FS expenses should be covered.

Because of the open-ended nature of the CGL policies in effect at the time of the pollution, PRPs and their insurers dis-

† B.A. 1990, University of Chicago; J.D. Candidate 1998, University of Chicago.
1 General Accident Insurance Co. v Department of Environmental Protection, 672 A2d 1154, 1162 (NJ 1996).
2 42 USC § 9601 et seq (1994).
3 See Domtar, Inc. v Niagara Fire Insurance Co., 552 NW2d 738, 743 (Minn App 1996) (cost of defense was $1.154 million).
4 See, for example, United States v Monsanto Co., 858 F2d 160, 173-74 (4th Cir 1988).
agree over whether RI/FS expenses should be classified as a cost of defending the PRP, which would increase an insurer's liability, or as a cost of cleaning up the pollution, which would increase the PRP's liability. While courts might resolve this issue by simply deciding to classify RI/FS expenses one way or the other, such a simplistic solution would not address the complexity of the underlying equitable considerations. Due to the dual nature of RI/FS expenses, which arguably are necessary for both defense and cleanup purposes, courts have not yet arrived at a simple and fair method of addressing this issue. In 1996 alone, various courts have said that "the applicable caselaw . . . is jumbled," that courts have not yet arrived at "any clear consensus," and that no case "provides a comprehensive principle of decision."

Because PRPs and their insurers do not have the certainty of a simple and fair method of allocating RI/FS expenses, they tend to be unwilling to settle. Instead, the two sides bring their dispute into the courtroom, which wastes time and resources that the parties could better devote to cleaning up the pollution. The certainty of a simple and fair method of allocating RI/FS expenses would allow insurers and policyholders to anticipate a judicial outcome, to settle their differences, and to focus their efforts on cleaning up the pollution at hand.

This legal uncertainty and waste of resources is unnecessary. By combining the best parts of two existing legal tests, courts could have a simple and fair legal rule.

Part I of this Comment will describe the context surrounding RI/FS expenses. Part II will present the jumbled state of the current law and argue that within a general trend toward a middle ground, three principal approaches have emerged. In Part III, the Comment will first describe the characteristics of an ideal test while describing the shortcomings of each of the three existing approaches. It will then show that a combination of two of the tests would best serve the fairness and simplicity goals of an ideal test. Finally, the Comment will discuss potential implementation issues and conclude that a combination test would save resources that are being wasted today.

6 Domtar, 552 NW2d at 751.
7 General Accident, 672 A2d at 1160.
8 See, for example, Jerry L. Anderson, The Hazardous Waste Land, 13 Va Envir L J 1, 4 (1993).
I. IN THE CONTEXT OF CGL INSURANCE, RI/FS EXPENSE CATEGORIES OVERLAP

Taken together, remedial investigations and feasibility studies constitute one of the first legally mandated steps in the regulated process of cleaning up a polluted site under CERCLA. That process begins when the EPA or its state equivalent decides to take action on a polluted site. The EPA decides which party or parties it believes may have caused the pollution and notifies them of their designation as a PRP under CERCLA.\(^9\) Under CERCLA, the next step is to conduct an RI to determine the extent of the problem and who is liable, and an FS to determine which cleanup strategy to use.\(^10\)

Although the PRP has the option to remain inactive, forcing the EPA to conduct the RI/FS on its own and then bill the PRP for the full cost, the PRP will generally save money if it gets the EPA’s permission to take the lead in carrying out the RI/FS.\(^11\) PRPs can “maximize” their cost savings by leading the studies that, among other things, put them “in a better position to influence the choice of the remedy.”\(^12\)

Remedial investigations and feasibility studies serve distinct purposes. Remedial investigations assess pollution and liability.\(^13\) The PRP investigates the polluted site, often by hiring specialized engineering firms, to determine: (1) the full extent of the pollution, (2) the extent to which it is responsible, and (3) the extent to which any other potential polluters are responsible.\(^14\) Concurrently, or subsequently, the PRP conducts feasibility studies to “evaluate alternatives to the extent necessary to select a remedy.”\(^15\) Because the cost of remedial alternatives can range

---

\(^9\) Whether this notification, called a PRP letter, triggers coverage under CGL policies varies from state to state. For example, in Michigan, a PRP letter triggers CGL coverage, while in Illinois, it does not. *Michigan Millers Mutual Insurance Co. v Bronson Plating Co.*, 519 NW2d 864 (Mich 1994); *Forest Preserve District of DuPage County v Pacific Indemnity Co.*, 665 NE2d 305 (Ill 1996).

\(^10\) 42 USC § 9604(aX1).

\(^11\) *Aerojet-General Corp. v Transport Indemnity Co.*, 53 Cal Rptr 2d 398, 408 (Cal App 1996). See also *Aetna Casualty & Surety Co. Inc. v Pintlar Corp.*, 948 F2d 1507, 1517 (9th Cir 1991) (“In many instances, it is more prudent for the PRP to undertake the environmental studies and cleanup measures itself than to await the EPA’s subsequent suit in a cost recovery action.”).


\(^13\) 40 CFR § 300.430 (1994).

\(^14\) Telephone interview with Val Britton, Engineer, Science Management Consulting—Environmental Services Group, GeoSciences Division, (Jan 8, 1997).

\(^15\) 40 CFR § 300.430(aX2).
from expensive to exorbitant, the PRP uses feasibility studies to find the most cost-effective cleanup alternative.

Under a long-standing interpretation of CGL policies, insurers have a duty to pay the insured PRP’s damages and to defend the PRP against any charges for damages. Although the duty to defend and the duty to indemnify arise out of the same insurance policy, they are distinct in several ways. The duty to defend is broader than the duty to pay damages. An insurer has a duty to defend if the allegations “arguably” come within policy coverage, even if the allegations may be “groundless or frivolous.” As noted in Aerojet-General Corp. v Transport Indemnity Co., if the claim seems rationally related to the areas covered by the CGL policy, the insurer has a duty to defend, even if the court later finds that the claim falls outside the policy coverage. Thus, the insurer may not be ultimately liable for the cleanup but may still have a duty to defend the PRP. The duty to indemnify, on the other hand, is the narrower duty of paying meritorious claims.

The most important difference between the duty to indemnify and the duty to defend is that often one is capped by the policy limit while the other is not. Most CGL policies in place at the time pollution occurred contained defined limits on what the insurer would pay for damages, but did not contain a corresponding cap on the cost of defense. Thus, because the extraordinarily high cost of cleaning up pollution often reach the indemnity limits of the PRP’s insurance, both parties care very much whether courts treat what can be substantial RI/FS expenses as cleanup damages or as defense costs. PRPs want RI/FS expenses to be covered as defense costs, while insurers want RI/FS expenses to be included in the policy cap as damages.

---

18 Id.
19 Id.
21 Id.
22 Millpore Corp. v Travelers Indemnity Co., 115 F3d 21, 35 (1st Cir 1997); La Farge Corp. v Travelers Indemnity Co., 118 F3d 1511, 1516 (11th Cir 1997).
23 Hartford Fire Insurance Co. v California, 509 US 764, 771 (1993) (“CGL insurance has traditionally provided that the insurer would bear the legal costs of covered claims against the insured without regard to the policy’s stated limits of coverage . . . ”).
24 See, for example, Domtar, 552 NW2d at 743 (cost of defense was $1.154 million, while damages were $1.664 million).
The dual nature of RI/FS expenses stems from the fact that investigation is necessary both to prepare an adequate defense and to clean up the site. Preparing an adequate defense is a defense cost, while cleaning up the site is covered under the indemnity provisions. For example, if an investigation showed either that the pollution did not exist, or that the PRP could not have been responsible, one could easily consider the investigation expenses as part of the cost of defense. On the other hand, if a PRP immediately admitted complete liability and began working with the EPA to clean up the site, much of the very same investigation would be a necessary first step in the cleanup process, which would be covered as damages.

Because of the dual nature of RI/FS expenses and the opposing financial interests of the parties, insurers and PRPs take opposing positions. Insurers often argue that all RI/FS expenses should be classified as indemnity costs. They contend that an RI/FS is not only an essential first step in cleaning up the polluted site, but is also a mandated result of the EPA's CERCLA action, making it akin to damages. On the other hand, PRPs argue that all RI/FS expenses should be classified as defense costs. They insist that all RI/FS expenses are for defense because they are necessary to limit liability or to reduce the amount of damages. Courts face the task of developing a legal test that will resolve the conundrum fairly and allow future parties to settle the matter with minimal legal expense.

II. REVIEWING CURRENT CASELAW: THREE APPROACHES

Even though insurers may continue to maintain that all RI/FS expenses are solely indemnity costs, and PRPs may forever claim that RI/FS expenses are solely defense costs, the emerging trend is toward a middle ground. Courts initially tended to resolve the allocation issue entirely in favor of one side or the other. More recently, however, courts have reconsidered their own rulings or have overruled lower courts because they believe that the dual nature of RI/FS expenses makes a one-sided conclusion contrary to the "[p]rinciples of simple justice."25

In 1995, a New Jersey appellate court issued a declaratory judgment that RI/FS expenses were entirely defense costs.26 In

25 General Accident Insurance Co. v Department of Environmental Protection, 672 A2d 1154, 1163 (NJ 1996) (overturning a lower court ruling that all RI/FS expenses were defense costs).
26 General Accident Insurance Co. v Department of Environmental Protection, 651 A2d
1996, however, the New Jersey Supreme Court reversed, ruling that the lower court should have arrived at a "fair" allocation based on multiple factors, not just a legal ruling for one side or the other.27

In 1994, the Northern District of California ruled that all of the PRP's RI/FS expenses were defense costs.28 In 1995, the court reconsidered its decision, stated that it had "clearly erred," and asked the parties for the evidence needed to allocate costs between defense and indemnity.29

In 1996, the California Court of Appeals issued a declaratory judgment reversing the trial court's jury instruction that classified RI/FS expenses as primarily indemnity costs.30 The court cited the "dual utility" of site investigations and ruled that RI/FS expenses should qualify more easily as defense costs.31 Thus, the trend in the case law is to move away from an "either/or" answer to the RI/FS question of classification and toward a middle ground.

Despite the trend toward a middle ground, courts still describe the caselaw as "jumbled"32 and lacking any "clear consensus."33 States have generally adopted three approaches to the RI/FS question of classification: (1) The "Michigan test" (Michigan, California, and Minnesota), (2) The "New Jersey test" (New Jersey), and (3) The "New York test" (New York).

A. The Michigan Test

The "Michigan test"34 defines defense costs broadly, in practice allocating most RI/FS expense liability to the insurer. This approach presumes RI/FS expenses mandated by CERCLA are

---

27 General Accident Insurance Co. v Department of Environmental Protection, 672 A2d 1154, 1162 (NJ 1996).
31 Id at 410.
34 See, for example, Fireman's Fund Insurance Cos. v Ex-Cell-O Corp., 790 F Supp 1318 (E D Mich 1992); American Bumper & Manufacturing Co. v Hartford Fire Insurance Co., 550 NW2d 475, 481 (Mich 1996); Aerojet, 53 Cal Rptr 2d at 412.
ALLOCATING RI/FS EXPENSES

indemnity costs. However, PRPs may rebut this presumption by showing that the RI/FS expenses in question were part of a reasonable and necessary defense either to defeat or limit the scope of liability or to limit the cost of remediation for the PRP. The PRP cannot rebut the presumption if the RI/FS expenses either would have been spent eventually as a normal cost of business even without the EPA action or would not have been undertaken voluntarily as reasonable and necessary to prepare a defense if there had been no governmental request or order. Under the Michigan test, defense costs include RI/FS expenses incurred to limit the cost of remediation. In limiting the cost of remediation to the PRP, the Michigan test does not consider the policy limits on the CGL insurance, requiring only that the defense costs be "reasonable and necessary." Typically, feasibility studies seek to find the least expensive remediation alternative. Therefore, under the Michigan test, remediation study expenses are usually considered defense costs as long as they are part of a "reasonable and necessary" defense.

The Michigan test excludes feasibility studies from defense costs only if such studies involve the actual implementation of the cleanup. For example, because studies carried out to effectuate a chosen cleanup alternative or to monitor the continuing spread of contamination address implementation issues, they fall outside the realm of limiting liability or damages. If a PRP was likely to incur an RI/FS expense even without a CERCLA action, courts categorize the expense as an indemnity cost. In American Bumper, for example, the court categorized the investigation costs that the PRP would have spent to renew one of its permits in the absence of a CERCLA claim as indemnity costs.

B. The New Jersey Test

As articulated by the New Jersey Supreme Court in General Accident Insurance Co. v Department of Environmental Protec-

---

35 Ex-Cell-O, 790 F Supp at 1338.
36 Id.
37 American Bumper, 550 NW2d at 486.
38 Aerojet, 53 Cal Rptr 2d at 412.
39 American Bumper, 550 NW2d at 485-86.
40 Id at 485.
41 40 CFR § 300.430 (1994).
42 American Bumper, 550 NW2d at 485.
43 County of Santa Clara, 1995 WL 638568 at *4 n 1.
44 American Bumper, 550 NW2d at 486.
tion, the New Jersey test establishes the same rebuttable presumption found in the Michigan test that RI/FS expenses are damages. Likewise, to rebut the presumption, the PRP must show that allocating an RI/FS expense to indemnity would relieve the insurer of a cost that it otherwise would have incurred under its obligation to defend. Under the New Jersey test, the court attempts to be more equitable than legal, thus freeing itself from the constraint of maneuvering around a bright-line "reasonable and necessary defense" rule. Unlike the Michigan test, the court does not define defense costs broadly to include all expenses that limit damages, but instead makes a "fair allocation" based on four broad factors: (1) the relative risk that the PRP would have borne if it had not produced the RI/FS; (2) the extent to which environmental agencies may have mandated the details of the RI/FS; (3) the extent to which the RI/FS provided a means for the insurer or PRP to mitigate potential claims for damages; and (4) the cost of producing the RI/FS in relation to the policy limits provided. These factors limit what might otherwise be included in Michigan's broader test of "reasonable and necessary" for an adequate defense.

Furthermore, the second factor, which involves the extent to which expenses were mandatory, also diverges from the Michigan test, which finds "no logical nexus" between the extent to which RI/FS expenses "are mandated" and the distinction between defense and indemnification cost.

The fourth factor, which considers the level of RI/FS expenses in relation to the policy limits, is a particularly distinctive feature of the New Jersey approach. No courts in California, Michigan, or Minnesota discussed as carefully, if at all, the parties' rational expectations of defense costs as they relate to the size of the policy and damages limits. In pursuit of flexibility, New Jersey's General Accident decision did not create any specific guidelines relating the size of policy limits to possible limits on allocations of costs to defense. Instead, the court posed the rhetorical question of whether "an insurance company that had

---

45 672 A2d 1154 (NJ 1996).
46 Id at 1162.
47 Id.
48 Id.
49 672 A2d at 1162.
50 Id.
51 See American Bumper, 550 NW2d at 485.
issued a policy with limits of $100,000 would expect to undertake a remedial study that might cost millions of dollars.\textsuperscript{55}

C. The New York Test

The New York test follows the equitable allocation method of the New Jersey test, but in the interest of clarity and simplicity, it strictly divides the activities that reduce liability (remedial investigations) from those that reduce damages (feasibility studies). The court then exercises broad discretion in allocating or dividing expenses that cannot otherwise be separated.\textsuperscript{56} The New York test is developed in \textit{Endicott Johnson Corp. v Liberty Mutual Insurance Co.} \textsuperscript{57}

To the extent that an expense is primarily attributable to remedial investigations—which address the sources and extent of the contamination, whether environmental damage can be mitigated by controlling the sources, or whether additional action is necessary because of migration of contaminants from the site—the expense will be treated as a defense cost.

To the extent an expense is primarily attributable to feasibility studies—which comprise plans for selecting and implementing the remediation alternative for the site—the expense will be treated as damages to be indemnified.

Finally, to the extent the Court cannot determine based on written submissions whether an expense is attributable to either RI or FS, the Court will have broad discretion to allocate the expense in an equitable manner.\textsuperscript{58}

The \textit{Endicott Johnson} court criticized the New Jersey test for its legal and scientific complexity, especially in light of the New Jersey Supreme Court’s stated goal of creating a rule with black-letter simplicity.\textsuperscript{59} Instead of employing the four factors in the New Jersey test, the New York test explicitly disregards any factors other than whether an expense has as its primary pur-

\textsuperscript{52} 672 A2d at 1160.
\textsuperscript{53} \textit{Endicott Johnson}, 928 F Supp at 184.
\textsuperscript{54} 928 F Supp 176 (N D NY 1996).
\textsuperscript{55} Id at 184.
\textsuperscript{56} Id at 183.
Pose the goal of remedial investigation or feasibility study.\textsuperscript{57} For example, the \textit{Endicott Johnson} court stated that it would disregard the extent to which the EPA explicitly mandated an RI/FS expense, contrary to the New Jersey test’s second factor.\textsuperscript{58}

By bifurcating expenses based on the purposes of remedial investigations and feasibility studies, the New York test differs from the Michigan and New Jersey tests by classifying expenses that attempt to reduce damages as costs of indemnity.

\section*{III. The Ideal Allocation Method Should Be Both Simple and Fair, Unlike the Existing Tests}

On the one hand, not every complex problem has a simple solution. On the other hand, “fair” solutions that are too complex can be so expensive and unpredictable that they are fair to no one. An ideal allocation method consists of the optimal combination of simplicity and fairness. In \textit{General Accident}, the New Jersey Supreme Court most clearly articulated this need:

\begin{quote} [W]e believe that the only \textit{fair} result is a balanced solution that takes multiple factors into account . . . . At the same time, we do not want to encourage needless litigation. The advantage of a black-letter rule is \textit{simplicity} in administration. We must avoid, at all costs, another war of experts . . . . \textsuperscript{69} \end{quote}

The Michigan, New Jersey, and New York tests each fall short of the optimal mix of fairness and simplicity. The Michigan and New York tests do not fully consider the reasonable expectations of the parties, and the New Jersey and Michigan tests are too complex. Courts should combine the simplicity of the New York test and the fairness of the New Jersey test to achieve a better method of allocation.

\subsection*{A. What the Parties Agree Is Fair Today May Indicate What Would Have Been Fair in the Past}

One of the most fundamental themes in insurance and contract law is that the outcome should fulfill the fair or reasonable

\footnotesize
\textsuperscript{57} Id at 184.
\textsuperscript{58} 928 F Supp at 184 n 2.
\textsuperscript{59} \textit{General Accident Insurance Co. v Department of Environmental Protection}, 672 A2d 1154, 1162 (NJ 1996).
ALLOCATING RI/FS EXPENSES

Courts in RI/FS cases recognize that neither insurers nor PRPs could foresee huge CERCLA claims when they signed the CGL policies at issue.

One way for courts to assess the fair expectations of the parties is to estimate what the parties would have bargained for if they had known at the time of their agreement what they know now. Absent any documentation regarding the thoughts of the parties in the past, courts should find it useful to look at the terms that current-day parties have reached as a result of bargaining on a relatively level playing field in which both sides understand the reach of CERCLA and the rise in defense costs.

One conclusion that may be drawn from today's environmental insurance market is that insurers did not expect to pay for RI/FS expenses that have often exceeded the indemnity limits of policies. In 1941, the predecessors of the Insurance Services Office drafted the first industry-wide CGL policy. Such CGL policies provided general coverage for accidents and occurrences, but did not mention environmental cleanup or explicitly limit defense costs. After 1966, standard CGL policies partially limited defense costs with a provision stating that the insurer would no longer be obligated to defend after the policy limits had been exhausted by the payment of judgments or settlements. In 1970, insurers began to limit pollution claims in standard CGL coverage, and in 1986, after CERCLA had come into force, CGL policies began to absolutely exclude all pollution-related claims.

Today, environmental insurance is a specialized product that addresses specific kinds of pollution. The policies either in-

60 Id at 1161.
61 See, for example, Owens-Illinois, Inc. v United Insurance Co., 650 A2d 974, 991 (NJ 1994) ("At least in the case of property damages due to environmental contamination, the retroactive imposition of absolute liability under laws like CERCLA . . . was surely unknown, if not unknowable.").
62 Because most PRPs are businesses, the PRPs and their insurers negotiate on a relatively level playing field. Contract-of-adhesion principles will rarely apply.
64 Barry R. Ostrager and Thomas R. Newman, Handbook on Insurance Coverage Disputes §5.03(b) at 135 (Prentice Hall 1994).
65 Id §5.03(b) at 133.
67 American International Group, Pollution Legal Liability Select (PLL Select), (visit-
clude defense costs in the policy’s limits or cap them separately. In states that do not allow caps on defense costs, insurers charge higher premiums. Insurers also adjust their premiums to reflect whether their customers want pollution coverage under existing regulatory standards alone, or under all possible future regulations.

Today, bargaining between insurers and their business customers has resulted in explicit limits on defense costs. Economically, this result makes sense. To stay in business, insurers must charge enough in premiums to cover their expected losses. If the claims for defense costs are unexpectedly large, customers have to pay significantly higher premiums in the future. Presumably, if enough customers wanted to pay significantly higher premiums to purchase unlimited litigation insurance, some insurers would sell it. It follows from observing current market offerings, where the only insurance products generally available have caps on defense costs, that customers have chosen to accept limits on defense costs in order to avoid paying a higher premium.

While PRPs with CGL coverage dating back twenty to thirty years would not reasonably have expected their insurers to pay for runaway RI/FS defense costs, they also would not have expected to pay such expenses themselves. Presumably, they paid the insurance premiums in order to assign the risk to their insurers.

Furthermore, courts typically resolve insurance contract clauses with reasonably uncertain meanings in favor of policyholders, not insurers. Thus, a policyholder might reasonably expect an insurance policy that is "comprehensive" and "general" to pay for absolutely everything. In fact, most courts have found that costs considered solely as part of a reasonable defense must be covered by insurers. However, this conclusion leads to quite

---


id.

id.

Based on insurance programs offered by Commerce & Industry, the primary environmental insurance member company of American International Group, Inc. ("AIG"), the leading U.S.-based international insurance organization. American International Group, PLL Select (cited in note 67).

Chamberlain Interview (cited in note 68).

See Aerojet, 53 Cal Rptr 2d at 407. The benefit of such a rule is that it forces the insurer, the party initially writing the contract, to use clear language.

See American Bumper & Manufacturing Co. v Hartford Fire Insurance Co., 550
unreasonable results. An insurer should not have to pay millions of dollars to defend a policyholding PRP with CGL policy limits of $100,000.

Therefore, to balance the reasonable expectations of both policyholders and insurers fairly, the ideal solution should follow the New Jersey test in looking to the policy limits as a factor in allocating RI/FS expenses between defense and indemnity costs. If a test does not include this factor, it cannot be understood as following the reasonable expectations of the parties, especially given the ambiguous, dual nature of RI/FS expenses. None of the recent cases employing the Michigan or New York tests even mentions the "policy limits" factor. Though, in New York's Endicott Johnson decision, which criticizes the New Jersey test, the absence of a discussion of the policy limits factor is notable. Only the policy limits factor emerged unscathed from any criticism.

B. Simplicity Leads to More Certainty and More Settlements

The New York test is the most simple and certain of the three tests. Assuming that having fewer subjective factors increases the predictability of a test, that more predictable results lead to increased rates of settlement, and that settlements are much quicker and cheaper than trials, a simpler test will increase the number of settlements. By encouraging and facilitating voluntary settlements, a simpler test thus furthers a fundamental goal of CERCLA.

In establishing the New York test, the Endicott Johnson court criticized the New Jersey test for failing the New Jersey court's own goal of establishing a "simple approach." In establishing the New York test, the Endicott Johnson court criticized the New Jersey test for failing the New Jersey court's own goal of establishing a "simple approach."
Johnson noted that three of the New Jersey test's four factors were inherently too subjective. Given that subjective factors logically have less predictive value than more objective ones, following the New Jersey test would lead to less certainty, fewer settlements, and more time fighting in court.

The Michigan test is also more complex and difficult to administer than the New York test. The Ex-Cell-O decision, which became the basis for the Michigan test, acknowledged that the simplicity of the New York test made the task of allocation easier. The Ex-Cell-O court, however, decided to make its decision more difficult by holding that feasibility studies would be considered defense costs if they would have been part of a "reasonable and necessary" defense. The complexity and uncertainty of the Michigan test is due to the fact that courts must hypothesize how RI/FS expenses would have been spent in a "reasonable and necessary" defense. Besides making the inquiry more difficult, the Michigan test does not reflect the foreseeability factor described and applied in the New Jersey test. Thus, the gain in fairness does not offset the increase in the administrative burden of decision costs.

C. A Better Method of Allocation Combines the Best Aspects of the New York and New Jersey Tests

Courts, and if necessary, legislatures, should leave more resources available for cleaning up the environment by adopting a test that combines the simplicity of the New York test and an element of fairness from the New Jersey test. Because courts and the parties can fairly characterize RI/FS expenses as both a defense and indemnity costs, an intelligent and predictable division of costs between the PRP and the insurer would make more sense than an all-or-nothing allocation. The insurer would pay for remedial-investigation-type expenses as uncapped defense costs and feasibility-study-type expenses as damages subject to the policy limits. The court would have broad discretion to divide any remaining expenses.

---

82 Id at 183-84. The three factors are: (1) the relative risk the PRP bore if it did not lead the RI/FS, (2) the extent to which the EPA mandated RI/FS details, and (3) the extent to which RI/FS provide a means for the PRP to mitigate damages.
84 Id at 1321.
ALLOCATING RI/FS EXPENSES

This broad discretion would take into account one of the four factors in the New Jersey test, namely that of the RI/FS expenses relative to the policy limits. While the broad equity afforded courts should not be limited by an arbitrary borderline, courts should scrutinize more closely defense costs that add up to more than the policy limits. One may reasonably assume that insurers included the duty to defend in CGL policies in order to protect their economic interest in limiting or eliminating indemnity claims. Because no rational insurer would want to pay more to defend a claim than the claim itself is worth, it is reasonable to compare the amount of RI/FS expenses with the policy limit.\(^8\)

If courts used the combination test, the results of the cases would not differ wildly from what they are today. The combination test simply means that the court separates RI from FS expenses and then allocates any remaining amount equitably, keeping in mind the relation between defense cost allocation and the CGL policy limits. For example, in a case such as American Bumper, where the PRP ultimately was not liable for cleanup, the combination test would have allocated RI/FS expenses as defense costs since the investigations were designed to show that the level of potentially hazardous material was completely harmless.\(^8\)

Even where the PRP accepted liability right away and cooperated with the EPA in cleaning up the site, courts following the combination test would still consider remedial investigations to be defense costs. This result would conform with the goal of CERCLA to enable settlements and cooperative behavior.\(^7\) A PRP would not face the perverse incentive to delay its admission of liability or its cooperation with the EPA simply to maximize the allocation of RI/FS expenses to defense costs. This combination test would contain no excessively complex factors, nor would it need to show that an investigation was part of a "necessary and reasonable" defense.

\(^8\) This statement does not say that a rational insurer would never pay more to defend a claim than the value of the claim itself. Throughout the litigation process, the insurer's offer to settle would depend not on the total litigation cost, but on the insurer's incremental cost of future litigation. The amount already spent on defense would be a sunk cost and rational insurers would not consider it in deciding future action. Thus, an insurer would reassess and continue spending money on defense as long as the foreseeable defense costs were less than the expected amount of the damages award. In this way, an insurer acting rationally may spend more in defense than the policy limits would otherwise dictate.

\(^8\) See American Bumper, 550 NW2d at 485.
\(^7\) See 53 Fed Reg 5298 (cited in note 80).
Courts in search of speed should also appreciate the simplicity of a combination test based on the New York approach. A fixed rule lowers decision costs. Courts would find it much easier to draw a line between a remedial investigation purpose or a feasibility study purpose of a given expense than to draw a line between defense costs and damages.

D. Implementation Issues

While the line between remedial investigations and feasibility studies may seem clear in theory and in reports to the EPA, insurers or PRPs cooperating with their environmental engineering contractors may find ways to shift expenses unilaterally from one category to another. Such expense shifting, if pervasive enough, would upset the balance between the parties' reasonable expectations that the combination test achieves. For example, according to one leading environmental engineer, such shifting between RI and FS categories can occur in the data collection process. If an environmental engineer's client wanted to load costs into the RI, where the client's insurer pays for them as defense costs, the engineers would meticulously collect all conceivable useful data during the RI. On the other hand, if the insurers were influencing the actions of the environmental engineers, the engineers probably would engage in a somewhat cursory RI. Later, in the FS stage, when they calculated and chose the least costly remedy, they might find an "unexpectedly" large number of "data gaps" that would require the expense of further data collection.

Most of the data collection and field testing expenses are attributable to the purposes of the RI. Most FSs include some data collection expenses, but FSs primarily involve analyzing data already collected to determine the most cost-effective remedy. Although during the FS, environmental engineers inevitably must fine-tune or retest some data collected during the RI, the bulk of data collection expenses should occur during the RI. Even though each case is unique, judges should ask for specific explanations of large data collection expenses occurring during the FS.

---

88 Telephone interview with Val Britton, Engineer, Science Management Consulting—Environmental Services Group, GeoSciences Division, (Jan 8, 1997). Mr. Britton has fifteen years of environmental engineering experience.

89 Id.

90 Id.

91 Id.
stage, especially if the insurer chose the environmental engineering firm.

The combination test faces two other implementation risks. First, the judge's discretion to allocate expenses that do not clearly fall on one side or the other will be too broad. Even subject to a policy limits factor, broad discretion may prevent the combination test from attaining the predictability to which it aspires. Second, the "basic explanation" requested of each party by the judge will become more than just basic. Given the large dollars involved, and especially if the combination test does not perform predictably in practice, each party may be inclined to hire mutually contradictory experts to "help" the judge understand each party's breakdown of its RI/FS expenses.

Judges, insurers, and PRPs employing the combination test, however, are in a better position than their counterparts who struggle under other tests because it is easier to determine whether an expense is more closely attributable to an RI or to an FS than it is to distinguish between a defense cost and an indemnity cost. Not only do the purposes of the RI and FS diverge, but they often occur sequentially, and thus may be separated also by time. Finally, because the categories are easier to distinguish, the combination test can rely on the expertise of the parties themselves to watch for any potential expense shifting between the categories.

**CONCLUSION**

Combining the New York test and the policy limit factor of the New Jersey test is a better solution for allocating RI/FS expenses between indemnity and defense. It combines both fairness and administrative simplicity. In doing so, it gives insurers confidence that the reasonable expectations of the parties will be enforced. This, in turn, lowers the uncertainty involved with judicial interpretation in the future and consequently lowers price of premiums that insurers would otherwise charge to account for such uncertainty. By allowing more certainty in the outcome, the combination test also leads to more settlements and

---

92 Endicott Johnson, 928 F Supp at 184 n 3.
93 See 40 CFR § 300.430 (1994). Because the FS usually uses data collected during the RI, the bulk of FS activity occurs after the RI.
94 Future premiums would be kept lower to the extent that they would not have to take into account a disproportionate and unreasonable allocation by the courts of any future unexpected costs.
less strain on the already overburdened courts. Finally, it reduces the amount of money spent on the allocation fight, possibly freeing up resources for greater environmental cleanup.

Given the great number of environmental contamination sites, any increased speed in the process helps ease the burden of the resulting litigation.