# Contracting Out Pollution: A Proposed Interpretation of Environmental Liability Exclusion Clauses

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*This article is concerned with the judicial interpretation of the pollution exclusion clause (PEC) commonly found in commercial general liability insurance policies. The PEC removes from coverage claims arising out of the insured's discharge of pollutants. Conflicting expectations about the scope of such exclusion has resulted in frequent litigation between insurers and policyholders. Insurers often rely on the PEC to deny coverage for claims arising out of workplace accidents that incidentally involve chemical discharges. By contrast, policyholders submit that the PEC should be interpreted more narrowly in light of the purpose and commercial context of the policy. Canadian case law is unsettled. The lack of a uniform interpretive approach creates legal uncertainty, which compromises the insured's or policyholder's ability to determine the likelihood of a claim being paid and prevents the parties to a coverage dispute from predicting the outcome of the litigation process.*

*This article identifies the sources of the legal uncertainty surrounding the interpretation of the PEC and proposes an interpretation that promotes greater clarity and coherence in the interpretation process. Its main thesis is twofold. First, it argues that the interpretive constructs used by courts are conceptually flawed and incapable of determining the applicability of the PEC in a coherent and predictable manner. Second, it argues that greater coherence and predictability can be attained by recognizing the fortuity-based rationale underlying the PEC. The target of the PEC is the fortuity-frustrating behaviours by the insureds, who subjectively mean to bring about the pollution-related loss. In light of this premise, the PEC should be interpreted as removing from coverage the pollution-related losses that are expected or intended from the standpoint of the insured. This is the only way to interpret the PEC that promotes its underlying purpose and is consistent with the principles of insurance policy interpretation established by the Supreme Court of Canada.*

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# Introduction

This article addresses the judicial interpretation of the pollution exclusion clause (PEC) that is commonly found in commercial general liability (CGL) insurance policies. CGL policies are designed to provide broad, comprehensive coverage for third-party liability claims that commercial policyholders are most likely to confront as a consequence of their normal business operations. Proper implementation of CGL policies plays a crucial role in the effective functioning of the economic system by contributing to the efficient allocation of business

risk and shaping the incentives needed to prevent accidents.[1] Furthermore, well-functioning CGL policies serve an important social function, as they provide compensation to accident victims.[2] These considerations suggest that how courts interpret and enforce CGL policies has a significant impact on the deterrence, compensation, and risk-management functions that are relevant to legal and economic orderings.

CGL policies are standard form contracts. The commonly used standard CGL form contains a PEC that removes from coverage claims arising out of the insured's discharge of pollutants.[3] A pollutant is "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids,

1. See Steven Shavell, "On the Social Function and the Regulation of Liability Insurance" (2000) 25:2 Geneva Papers on Risk and Insurance 166; Michael G Faure, "Environmental Liability" in Michael G Faure, ed, *Tort Law and Economics* (Cheltenham, UK: Edward Elgar Publishing, 2009) 247 at 264; Ronen Avraham, "The Economics of Insurance Law—A Primer" (2012) 19:1 Conn Ins LJ 29 at 37–42.

2. See Jeffrey W Stempel, "The Insurance Policy as Social Instrument and Social Institution" (2010) 51:4 Wm & Mary L Rev 1489.

3. This paper examines the most frequently litigated version of the PEC that is incorporated, with minor variations, in most CGL policies. The standard language of the PEC, which is based on the advisory model wording drafted by the Insurance Bureaus of Canada, has changed considerably over the decades. Starting from the 1973 form, the PEC would not apply when the release of pollutants was "sudden and accidental". The US courts interpreted the "sudden and accidental" exception in the PEC as being applicable to damages resulting from gradual pollution, even though the pollution in question was not sudden. This interpretation was in tension with the underwriting rationale of the "sudden and accidental" PEC, which was to exclude gradual pollution as a likely instance of expected or intended pollution. In fact, gradual pollution is more likely to be either expected or intended by the insured than a sudden and accidental discharge, as it is likely to depend on the extent to which the insured who has caused pollution takes steps to eliminate the source of pollution or mitigate the damage once the pollution is discovered. In response to the interpretation given by courts, in the early 1980s, insurers removed the "sudden and accidental" exception to the PEC and introduced the absolute PEC. The insurers' intent in eliminating the words "sudden and accidental" was to broaden the scope of the PEC and preclude coverage for gradual pollution. That is, the underwriting rationale of the removal of the words "sudden and accidental" is consistent with the principle of fortuity, as it aims at excluding a form of pollution that is more likely to be expected and intended from the insurance standpoint.

For analysis of the historical development of the PEC in the US, see E Joshua Rosenkranz, "The Pollution Exclusion Clause Through the Looking Glass" (1986) 74:4 Geo LJ 1237; Jonathan C Averback, "Comparing the Old and the New Pollution Exclusion Clauses in General Liability Insurance Policies: New Language—Same Results?" (1986) 14:4 BC Envtl Aff L Rev 601; E David Hoskins, "Striking a Balance: A Proposal for Interpreting the Pollution Exclusion Clause in Comprehensive General Liability Insurance Policies" (1989) 19 Envtl L Rep News &

alkalis, chemicals and waste".[4] This exclusion has been the subject of litigation between insurers and policyholders. The source of dispute is conflicting expectations about the interpretation and scope of the exclusion. Insurers often rely on the PEC to deny coverage for claims arising out of workplace accidents that incidentally involve chemical discharges. They urge courts to interpret the PEC literally and exclude from coverage any liability claim that involves the release of chemical substances that fall under the broad policy definition of a pollutant. By contrast, policyholders submit that the PEC should be interpreted narrowly in light of the context of the policy, including the drafting history of the exclusion and the objectively reasonable expectations of the parties. In the policyholders' view, the PEC is intended to exclude from coverage only industrial environmental pollution. Losses caused by workplace accidents or business mishaps that only accidentally involve the discharge of chemical substances should not be removed from coverage, as the released substances fail to meet the notion of "pollution" in its ordinary sense.

Canadian case law is unsettled regarding PEC interpretation and application. A first line of cases interprets the PEC narrowly, within the

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Analysis 10351; R Stephen Burke, "Pollution Exclusion Clauses: The Agony, the Ecstasy, and the Irony for Insurance Companies" (1989) 17:2 N Ky L Rev 443; Nancer Ballard & Peter M Manus, "Clearing Muddy Waters: Anatomy of the Comprehensive General Liability Pollution Exclusion" (1989-1990) 75:3 Cornell L Rev 609; Carl A Salisbury, "Pollution Liability Insurance Coverage, the Standard-Form Pollution Exclusion, and the Insurance Industry: A Case Study in Collective Amnesia" (1991) 21:2 Envtl L 357; Thad R Mulholland, "The Saga of the Pollution Exclusion Clause: How a Sudden Change Occurred Gradually" (1994) 2:1 Mo Envtl L & Pol'y Rev 26; Jeffrey W Stempel, "Reason and Pollution: Correctly Construing the 'Absolute' Exclusion in Context and in Accord with Its Purpose and Party Expectations" (1998) 34:1 ABA Tort & Ins LJ 1.

For analysis of the development of the PEC in Canada, see Mario D Faieta, "Liability Insurance for Environmental Contamination in Ontario" (1990) 2 CILR 125; Andrew R Hudson & Jeffrey K Friesen, "Environmental Coverage Under Comprehensive General Liability Insurance Policies in Canada" (1995) 5 J Envtl L & Prac 141; Larry A Reynolds, "New Directions for Environmental Impairment Liability Insurance in Canada" (1996) 6 J Envtl L & Prac 89 at 103–13; Michael S Teitelbaum & Laila J Brabander, "Environmental Insurance Coverage Issues: Will U.S. Developments Filter Into the Canadian Courts?" (2003) 21:5 Can J Ins L 57; Jonty T Bogardus, "Environmental Liability: Are You Insured? Part 1—The CGL Policy" (2005) online: <dolden.com> [perma.cc/UF7B-BPCJ]; Craig A B Ferris, "Pollution Exclusion Clauses an Analysis of the Canadian Jurisprudence" (2008) online: <lawsonlundell.com> [perma.cc/5N9L-HYUM].

4. *Construction Distribution & Supply Company Inc v Continental Casualty Company (CNA Insurance)*, 2024 ONCA 405 at para 2 [*Construction Distribution*].

limits of the exclusion's historical use and purpose.[5] In this view, the scope of PEC is restricted to environmental pollution caused by any insured that can be categorized as an "active industrial polluter". A second line of decisions interprets the PEC more broadly by extending the application of the exclusion to all situations in which the insured's ordinary business activities carry a "known" or "inherent" pollution risk.[6] This lack of a uniform interpretive approach creates legal uncertainty, which compromises the insured's ability to determine the likelihood of a claim being paid and prevents the parties to a coverage dispute from predicting the outcome of the litigation process.[7]

To make coverage determinations, courts generally emphasize the importance of considering the allegations contained in a third party's claim against the insured. Based on this premise, pro-insurer decisions emphasize that the plaintiff's allegations are framed as a claim for damage to the natural environment,[8] while pro-coverage decisions emphasize that these allegations are based on negligence, nuisance, or property damage and pollution that only incidentally characterize the accident.[9] However, the judicial emphasis on the legal significance of the allegations contained in the pleadings fails to provide a sufficient juridical basis for interpreting the scope of the PEC. The legal significance of the third party's allegations is determined by the judge in light of the ascertained meaning of the underlying insurance policy. That is, prior to examining the pleading, the judge must establish what kind of connection between the insured's activity and pollution-related loss must be pleaded for the PEC to apply. When factual allegations in the pleadings contain reference to both the insured's negligence and its release of pollutants, the judge must determine whether to qualify the claim as a (covered) negligence claim or as an (excluded) pollution liability claim. In such cases, drawing the line between negligence and a pollution liability claim requires clarification of the legally relevant connection between the insured's conduct and the pollution. It is the interpretation of the policy language that determines the insurance significance of the allegations in the pleadings; it is not the pleadings that orient the interpretation of the words in the policy.

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5. *Zurich Insurance Co v 686234 Ontario Ltd*, 2002 CanLII 33365 (ONCA) [*Zurich*]; *Hemlow Estate v Co-operators General Insurance Company,* 2021 ONCA 908 [*Hemlow*]; *Construction Distribution*, *supra* note 4.

6. *ING Insurance Company of Canada v Miracle*, 2011 ONCA 321 [*ING*]; *Kin v Ecclesiastical et al*, 2022 ONSC 1655.

7. For the impact of legal uncertainty on the liability insurance market, see Michael J Trebilcock, "Social Insurance-Deterrence Dilemma of Modern North American Tort Law: A Canadian Perspective on the Liability Insurance Crisis" (1987) 24:4 San Diego L Rev 929.

8. *Hemlow*, *supra* note 5 at para 20; *Construction Distribution, supra* note 4 at para 8.

9. *Zurich*, *supra* note 5 at paras 37–39.

This article proposes an interpretation of the PEC that promotes greater clarity and coherence in the interpretation process. The ultimate goal of the analysis is not necessarily to change adjudicative outcomes but to identify the source of the legal uncertainty surrounding the interpretation of the PEC and enhance transparency and predictability in judicial decision-making. The main thesis is twofold. First, it argues that the interpretive constructs used by courts to determine the applicability of the PEC are conceptually flawed and incapable of resolving the tension between text and context that characterizes the interpretation of such clauses. Second, it argues that greater coherence and predictability in the adjudication of pollution coverage disputes can be attained by recognizing the fortuity-based rationale underlying PECs.

The purpose of the PEC is to promote the effective functioning of the fortuity principle in the context of pollution-related losses by mitigating the informational asymmetries between insurers and policyholders that generate adverse selection and moral hazard problems. Once this is recognized, it becomes clear that the target of the PEC is the fortuity-frustrating behaviours by the insureds, who subjectively mean to bring about the pollution-related loss. In light of these premises, the only sensible way to interpret the PEC is to remove from coverage the pollution-related losses that are expected or intended from the standpoint of the insured. It is maintained that this is the only way to interpret the PEC that promotes its underlying purpose and is consistent with the principles of insurance policy interpretation established by the Supreme Court of Canada. It is further argued that the evidentiary challenges and contractual freedom concerns that might arise under the proposed interpretation are worth the potential gains that would result.

The discussion is organized as follows. Part I reviews the relevant case law and highlights the conceptual limitations of the current jurisprudential approaches. Part II inquires into the economic rationale underlying the fortuity principle and argues that the PEC's economic purpose is to reinforce this principle in the context of pollution-related losses. Part III develops a conceptual framework for interpreting the PEC in line with its fortuity rationale.

# I. Legal Analysis

### *A. The Legal Framework of Coverage Disputes*

In pollution coverage disputes, the central legal issue is whether the insurer owes a duty to defend and indemnify the policyholder in the lawsuit brought against the insured by a third-party plaintiff alleging liability for pollution-related losses. Three main sets of rules regulate the adjudication of pollution coverage disputes: (i) the principles governing the insurer's duty to defend, (ii)

the principles of insurance policy interpretation, and (iii) the (standardized) language of the insurance policy.

### 1. The Duty to Defend

The insurer's duty to defend is determined based on the allegations made against the insured in the underlying pleadings.[10] This principle is referred to as the "pleadings rule".[11] The insurer's duty to defend is independent of whether the facts alleged in the pleadings are proven to be true or whether the insured is actually held liable.[12] What is required to determine the insurer's duty to defend is the "mere possibility" that the facts alleged in the pleadings, if proven to be true, would require the insurer to indemnify the policyholder for the claim.[13] If the insured succeeds, the onus shifts to the insurer to prove that the claim either does not fall under the initial grant of coverage or is clearly and unambiguously precluded by exclusion clauses.[14]

### 2. The Interpretation of Insurance Policy

In determining whether the claims as pleaded fall within the insurance coverage, the judge must first refer to the language of the insurance contract. A set of well-established jurisprudential principles governs the interpretation of the policy language.[15] In standard-form insurance contracts, the words used must be given their ordinary meaning "as they would be understood by the average person applying for insurance, and not as they might be perceived by

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10. *Nichols v American Home Assurance Co*, [1990] 1 SCR 801 at 808, 1990 CanLII 144 (SCC) [*Nichols*]; *Monenco Ltd v Commonwealth Insurance Co*, 2001 SCC 49 at para 28; *Jesuit Fathers of Upper Canada v Guardian Insurance Co of Canada*, 2006 SCC 21 at paras 54–55 [*Jesuit Fathers*].

11. *Nichols*, *supra* note 10 at 808.

12. *Progressive Homes Ltd v Lombard General Insurance Co of Canada,* 2010 SCC 33 at para 19 [*Progressive*].

13. *Ibid*.

14. See Craig R Brown & Julie B Pollack, "Overview of Environmental Coverage Litigation for Comprehensive General Liability Policies" in *Environmental Insurance Coverage Claims and Litigation* vol 1 (New York: Practicing Law Institute, 1994) 9 at 18.

15. *Consolidated-Bathurst Export Ltd v Mutual Boiler and Machinery Insurance Co*, [1980] 1 SCR 888 at 899–902, 1979 CanLII 10 (SCC) [*Bathurst*]; *Brissette Estate v Westbury Life Insurance Co*, [1992] 3 SCR 87 at 92–93, 1992 CanLII 32 (SCC); *Non-Marine Underwriters, Lloyd's of London v Scalera*, 2000 SCC 24 at paras 67–71 [*Scalera*]; *Jesuit Fathers*, *supra* note 10 at paras 27–30; *Co-operators Life Insurance Co v Gibbens*, 2009 SCC 59 at paras 20–28 [*Gibbens*]; *Sabean v Portage La Prairie Mutual Insurance Co*, 2017 SCC 7 [*Sabean*].

persons versed in the niceties of insurance law".[16] When the language of the policy is unambiguous, effect should be given to this language.[17] When the language is found to be ambiguous, the courts must resolve the ambiguity by employing the general rules of contract construction.[18] According to these rules, courts should favour interpretations that are consistent with the parties' reasonable expectations, provided that such interpretations can be supported by the text of the policy.[19] Courts should therefore avoid interpretations that would give rise to an unrealistic result or a result that could not have been in the contemplation of the parties at the time that the policy was concluded.[20] It is a well-established principle that "[c]ertainty and predictability are in the interests of both the insurance industry and their customers";[21] therefore, courts should strive to ensure continuity in interpreting similar insurance policies and should only reluctantly depart from judicial precedents interpreting particular policy wordings.[22] Finally, if these general rules of interpretation fail to resolve the ambiguity, the courts will construe the insurance contract *contra proferentem,* against the insurer.[23] One implication of the *contra proferentem* rule is that coverage provisions are interpreted broadly and exclusion clauses narrowly.[24]

16. *Gibbens*, *supra* note 15 at para 21. See also *Ledcor Construction Ltd v Northbridge Indemnity Insurance Co*, 2016 SCC 37 at para 27 [*Ledcor*].

17. *Scalera*, *supra* note 15 at para 71; *Progressive*, *supra* note 12 at para 22; *Ledcor*, *supra* note 16 at para 49.

18. *Bathurst*, *supra* note 15 at 900–02; *Ledcor*, *supra* note 16 at para 50. These rules of construction are applied to resolve ambiguity. They do not operate to create ambiguity where there is none in the first place.

19. *Gibbens*, *supra* note 15 at para 26; *Scalera*, *supra* note 15 at para 71; *Bathurst*, *supra* note 15 at 901. For an excellent analysis of the reasonable expectations principle in Canada, see Barbara Billingsley, "Reasonable and Expected? The Evolution of the Doctrine of Reasonable Expectations as a Principle of Insurance Contract Interpretation in Supreme Court Jurisprudence" (2019) 89 SCLR (2d) 253–81.

20. *Scalera*, *supra* note 15 at para 71; *Bathurst*, *supra* note 15 at 901.

21. *Gibbens*, *supra* note 15 at para 27.

22. *Gibbens*, *supra* note 15 at para 27. The interpretation of a standard form contract has precedential value. See *Ledcor*, *supra* note 16 at para 24.

23. *Gibbens*, *supra* note 15 at para 25; *Scalera*, *supra* note 15 at para 70; *Bathurst*, *supra* note 15 at 899–901.

24. *Ledcor*, *supra* note 16 at para 51; *Jesuit Fathers*, *supra* note 10 at para 28; *Scalera*, *supra* note 15 at para 70; *Progressive*, *supra* note 12 at para 24.

## 3. The Language of the CGL

CGL policies, with minor variations across different policy insurances, provide that the insurer indemnifies policyholders for all sums that the insured becomes legally obligated to pay as compensatory damages because of bodily injury or property damage caused by an occurrence to which the insurance applies. Occurrence is defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions".[25] The insurer has the right and duty to defend the insured against any action seeking those compensatory damages.

Most CGL policies contain a PEC that, with some variations in the language among policies, reads as follows:

> 1. [This insurance does not apply to] "Bodily injury", "property damage" arising out of the actual, alleged or threatened spill, discharge, omission, dispersal, seepage, leakage, migration, release or escape of "pollutants":
>
> (a) at or from any premises, site or location which is or was at any time owned or occupied by, or rented or loaned to, any insured [ . . . ]
>
> 2. Any loss, cost or expense arising out of any:
>
> (a) request, demand, order or statutory or regulatory requirement that any Insured or others test for, monitor, clean up, remove, contain, detoxify or neutralize, or in any way respond to, or assess the effects of, "pollutants", . . . [26]

25. Jason Mangano & Zack Garcia, "The CGL Policy: Coverage A Concepts" (May 2017) at 1, online (pdf): <blaney.com/files/22959_The-CGL-Policy-Coverage-A-Concepts.pdf> [perma.cc/JNG4-44BU].

26. *Construction Distribution, supra* note 4 at para 2. The advisory model wording drafted by the Insurance Bureau of Canada excludes from the scope of the PEC the bodily injury or property damages "arising out of an unexpected or unintentional spill, discharge, emission, dispersal, seepage, leakage, migration, release or escape of pollutants provided such spill, discharge, emission, dispersal, seepage, leakage, migration, release or escape of 'pollutants': 1) results in the injurious presence of 'pollutants' in or upon land, the atmosphere, drainage or sewage system, watercourse or body of water; and 2) is detected within 120 hours after the commencement of such spill, discharge, emission, dispersal, seepage, leakage, migration, release or escape; and 3) is reported to us within 120 hours of the detection of such spill, discharge, emission, dispersal, seepage, leakage, migration, release or escape; and 4) occurs in a quantity or with a quality that is in excess of that which is routine or usual to the business of the insured";

The policy defines pollutants as follows: "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapour, soot, fumes, acids, alkalis, chemicals and waste. Waste includes materials to be recycled, reconditioned or reclaimed".[27]

### *B. Two Jurisprudential Approaches*

When interpreting the PEC, courts adopt different argumentative strategies based on alternative conceptualizations of the interpretive question governing the application of the PEC. Courts have adopted two main ways of framing the relevant interpretive issue: (i) whether the insured can be categorized as an active industrial polluter, and (ii) whether the insured's business activity carries a known or inherent risk of pollution. The remainder of this section examines these two argumentative strategies separately. It is maintained that none of these interpretive schemes provides a coherent and predictable interpretation of the PEC.

#### 1. The Active Industrial Polluter

The Ontario Court of Appeal in *Zurich Insurance Co v 686234 Ontario Ltd* (*Zurich*) provides the clearest judicial articulation of the proposition that the PEC applies to only active industrial polluters who knowingly pollute the environment.[28] The owner of an apartment building was sued by its tenants for damages caused by carbon monoxide poisoning owing to the apartment's defective furnace. The Court found that the PEC included in the CGL policy did not apply to the facts and that the insurer had a duty to defend and indemnify the insured for any damages caused by the carbon monoxide leak.

Writing for the majority, Borins JA reviewed the US and Canadian authorities concerning claims arising from carbon monoxide poisoning. He found that the bulk of these cases interpret the PEC in light of its history, its purpose, and the parties' reasonable expectations.[29] He also found that the

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Insurance Bureau of Canada, *Pollution Liability Exclusion – Limited Pollution Liability Coverage (120 hours)* (Insurance Bureau of Canada, 2009) at s 4. This exception is not contained in the CGL policies which have thus far been the subject of coverage disputes adjudicated by Canadian courts.

27. *Construction Distribution, supra* note 4 at para 8.

28. *Zurich*, *supra* note 5 at para 18.

29. *Ibid* at para 20, relying on *American States Insurance Co v Koloms*, 687 NE (2d) 72 (Ill Sup Ct 1997) at 456 [*Koloms*]. Borins JA relied on *Koloms*, which also involved carbon monoxide poisoning resulting from a defective furnace, where "the purpose of the clause was to exclude coverage for entities which knowingly pollute the environment."

PEC's drafting history suggests that such exclusion "bars coverage for classic environmental degradation pollution"[30] but "does not bar coverage of the average tort incidentally accompanied by contaminants".[31] Consequently, the situation of a building owner with a defective furnace must be distinguished from that of a party involved in a pollution-creating activity; the former "did not discharge or release carbon monoxide from its furnace as a manufacturer discharges effluent, overheated water, spent fuel and the like into the natural environment".[32] Since the regular business activities of an apartment building owner do not "place [the owner] in the category of an active industrial polluter of the natural environment",[33] "it would produce an unfair and unintended result to conclude . . . that defective machinery maintenance constitutes 'pollution', even when it gives rise to carbon monoxide poisoning".[34]

The distinction between "active" and "passive" polluter does not provide a sound basis for interpreting the scope of the PEC. First, the rationale underlying the distinction, as evinced from the PEC drafting history, is rooted in the US statutory framework and is not automatically applicable to the Canadian context. The Ontario appellate court clarified this point in *Ontario v Kansa General Insurance Co* (*Kansa*).[35] Labrosse JA emphasized that the distinction between active and other kinds of polluters "was based upon provisions in the New York Insurance law requiring all liability insurance policies to exclude coverage for active pollution".[36] These statutory provisions were enacted to ensure the effectiveness of environmental standards by preventing polluters from shifting their expected liability costs to insurance companies. The statutory origin of the exclusion justifies the conclusion that the PEC is intended to apply only to actual polluters, as they were the targets of the environmental protection standards that the exclusion aimed to strengthen. However, this line of reasoning is not applicable to the Canadian regulatory context, which does not recognize the distinction between active and passive polluters. As the Court in *Kansa* emphasized, "[u]nder Ontario law, the passive polluter who permits

30. *Ibid* at para 15.

31. *Ibid.*

32. *Ibid* at para 38.

33. *Ibid.*

34. *Ibid.*

35. 1994 CanLII 626 (ONCA).

36. *Ibid* at para 12. The concept of "active polluter" was introduced by the New York Supreme Court in *Niagara County v Utica Mutual Insurance Co*, 427 NY (2d) 171 (NY Sup Ct 1980), which was subsequently upheld by the New York Court of Appeal. For criticism of the court's reading of the history of the clause, see Rosenkranz, *supra* note 3 at 1270.

pollution to take place is just as much a polluter as the active polluter who discharges or causes the discharge of pollution".[37]

Second, it is questionable methodology to interpret the language of a contract in light of the legislative intent underlying a statutory provision without evidence that contracting parties have decided to incorporate the legislative intent into their agreement. The distinction between "active" and "passive" polluter was originally based on the assumption that the objective intent of the parties who consented to the PEC was to incorporate the legislature's intent into their agreement. However, other considerations may have been taken into account by the insurance industry when it drafted the wording of the PEC. Arguably, while the legislative intent is to protect the environment by limiting pollution, the insurance industry's goal is to ensure profitability by limiting insurance costs. Therefore, when interpreting the PEC, the parties' objective intent could be to exclude from coverage behaviours that are not targeted by the environmental statutory standards. As Rosenkranz observes, "the parties that assented to the pollution exclusion . . . might have intended to restrict coverage even more than necessary to accomplish [the legislative] goal".[38] This suggests that reading the PEC in light of the goal of strengthening statutory environmental protection standards may distort the process of contractual interpretation and lead to a potentially underinclusive PEC interpretation.

Finally, the idea that the PEC applies when the insured can be categorized as an active industrial polluter conflates evidence with substance. As will be argued, the basis of the PEC is that the event generating the pollution-related loss is expected or intended by the insured and is therefore not accidental. On this basis, the industrial nature of the insured's organization may have evidentiary relevance, as the more frequently an activity causes damage, the more likely it is that the insured expected or intended for the pollution-causing event to occur. However, the same conclusion may be supported by other circumstantial elements, even absent the industrial nature of the insured. Therefore, limiting the application of the PEC to active industrial polluters leads to an underinclusive interpretation of it.

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37. *Ibid* at para 17. The court referred to section 14(1) of the *Environmental Protection Act*, RSO 1990, c E 19, which reads, "Despite any other provision of this Act or the regulations, no person shall discharge a contaminant or cause or permit the discharge of a contaminant into the natural environment that causes or is likely to cause an adverse effect" [at para 16]. It also referred to the offence created by section 32(1) of the *Ontario Water Resources Commission Act*, RSO 1970, c 332 at para 16; in reading this provision, the SCC's decision in *R v Sault Ste Marie*, 1978 CanLII 11 (SCC), stated, "Only one generic offence was charged, the essence of which was 'polluting' . . . the Legislature did not intend to create different offences for polluting, dependent upon whether one deposited, or caused to be deposited, or permitted to be deposited. The legislation is aimed at one class of offender only, those who pollute."

38. Rosenkranz, *supra* note 3 at 1270.

## 2. The Well-Known Risk of Pollution

Recent case law has limited the holding in *Zurich* by upholding the proposition that the PEC excludes coverage when the insured engages in activities that carry a *known* risk of pollution or, synonymously, when the risk of pollution is *inherent* to the activity. The clearest statement of this principle is found in the Ontario Court of Appeal's decision in *ING*.[39] The insured operated a convenience store and gas bar. Gasoline escaped from the underground storage tank owned by the insured and migrated onto adjacent lands owned by Canada. The federal government brought an action for damages against the insured. The insurer claimed that it had no duty to defend the insured, as the government's claim was excluded from the coverage. The Court held that PECs extend to all the "activities . . . that carry a known risk of pollution and environmental harm".[40] Because in this case "the insured was engaged in an activity that carries an obvious and well-known risk of pollution and environmental damage," the Court concluded that the PEC applied in favour of the insurer.

The same emphasis on the well-known risk of pollution is found in a few subsequent pro-insured decisions. In *Hemlow*, the deceased insured, who was an oil sample technician working as an independent contractor, and his estate were sued by a client for negligence, nuisance, and breach of contract.[41] While working, the insured opened a valve to a pipe containing pressurized ammonia. The ammonia exposure killed the insured and caused significant damage to the client's property. The insurer denied that it had a duty to defend by invoking the application of the PEC. The Court distinguished *ING*, arguing that the type of activity in which the insured was engaged was a factor that differentiated the two cases. In the *ING* case, the insured was engaged in an activity that involved a well-known risk of pollution; however, in the instant case, the insured "was not engaged in work that generally involved risk from pollution".[42]

Similarly, in *Construction Distribution & Supply Company Inc v Continental Casualty* (*Construction Distribution*), the Ontario appellate court approached the interpretation of the PEC by inquiring into whether the insured's activity involved an inherent risk of pollution.[43] The insured was sued for damage caused to a third party's property by a leak of liquid chlorine stemming from its premises. The Court distinguished this case from *ING*. In *ING*, "the [insured] was engaged in an activity (storing gasoline in underground containers) that carried a well-known risk of pollution".[44] By contrast, "while liquid chlorine

39. *ING*, *supra* note 6.

40. *Ibid*.

41. *Hemlow*, *supra* note 5.

42. *Ibid* at para 22.

43. *Construction Distribution*, *supra* note 4.

44. *Ibid* at para 8.

can cause damage if spilled, its storage for the purpose of resale does not comprise an inherent risk of pollution," nor was such a risk alleged in the claim as pleaded.[45]

The legal construct of "known" or "inherent" risk does not in itself provide a valid conceptual basis for the interpretation of the PEC. The proposition that a pollution-related loss is excluded from coverage when the insured engages in activities carrying a known risk of pollution rests on the premise that when a risk of loss is known, this loss is not accidental and is therefore not insurable. Without further qualification, this premise is inconsistent with the economic and commercial logic underlying the insurance mechanism, which entails transferring a predictable risk of loss from the insured to the insurer.[46] For the contractual reallocation of risk to take place through an insurance agreement, the risk must be identifiable by and known to both parties. To properly calibrate insurance premiums, the insurer must be able to predict and measure the risks that it undertakes, while prospective policyholders are willing to pay insurance premiums only to the degree that they appreciate the risk's existence and extent. Because an insurable risk must be predictable for both parties—and, in this sense, must be well-known—knowledge of the risk alone cannot be taken as the factor that triggers the pollution exclusion. A rule that excludes well-known risks from coverage, without further qualification, would virtually nullify the economic benefit of the policy by excluding from the scope of coverage the most frequent type of claim for which parties obtain CGL policies.[47] Accordingly, the Supreme Court of Canada has clarified that the word "accident" contained in a comprehensive business liability insurance policy includes a calculated risk or an inherently risky operation.[48] Therefore, construing the word "accident" to deny recovery of losses that result from an inherently dangerous operation is "contrary to the very principle of insurance

45. *Ibid* at para 8.

46. See Kenneth S Abraham, "Environmental Liability and the Limits of Insurance" (1988) 88:5 Colum L Rev 942 at 946–47 [Abraham, "Environmental Liability"]; Richard L Fruehauf, "The Cost of Knowledge: Making Sense of 'Nonfortuity' Defenses in Environmental Liability Insurance Coverage Disputes" (1998) 84:1 Va L Rev 107 at 120–23; Kenneth S Abraham, "Peril and Fortuity in Property and Liability Insurance" (2001) 36:3 Tort Trial & Ins Prac LJ 777 at 800–02 [Abraham, "Peril and Fortuity"].

47. See Jeffrey W Stempel & Erik S Knutsen, *Stempel and Knutsen on Insurance Coverage* (New York: Wolters Kluwer, 2015) at 1–47.

48. *Canadian Indemnity Co. v Walkem Machinery & Equipment Ltd.*, [1976] 1 SCR 309 at 316–17, 1975 CanLII 141 (SCC) [*Walkem*].

which is to protect against mishaps, risks and dangers".[49] The predictability of risk is a prerequisite for the correct functioning of insurance and, as such, can hardly guide the logic of insurance exclusions. The remainder of this paper will propose an alternative understanding of both the rationale underlying the PEC and its normative content.

## II. The Function of the Pollution Exclusion

This section argues that the function of the PEC is to exclude from coverage the insured's fortuity-frustrating behaviours that result in pollution-related losses. This point is demonstrated by first summarizing the economic rationale underlying the fortuity principle and then highlighting the features of the environmental damage that make it particularly susceptible to fortuity-frustrating behaviours by the insured.

### *A. The Law and Economics of Fortuity*

A loss is fortuitous when it is "unforeseen or unexpected and occurs as a result of chance".[50] The principle that only fortuitous (or accidental) losses are insurable captures the fundamental economic condition for the functioning of insurance markets. Markets for the coverage of non-accidental losses could not function, as insurers could not operate a profitable or financially sustainable insurance business by selling coverage for non-fortuitous losses. It is useful to illustrate the economic significance of the fortuity principle by briefly expanding on three related analytical propositions: (i) insurance can operate only where losses are probabilistic; (ii) by accurately predicting the probability and magnitude of losses, insurers can reduce the total level of risk associated with a given pool of policyholders; and (iii) the insurers' ability to accurately calculate the probability and magnitude of losses is undermined by the informational asymmetries between insurers and policyholders, which cause adverse selection and moral hazard problems.

49. *Ibid* at paras 316–17. Pigeon J, writing for the majority, reasoned that "negligence is by far the most frequent source of exceptional liability which a businessman has to contend with" at para 13; therefore, a liability insurance policy "which would not cover liability due to negligence could not properly be called 'comprehensive'" at para 13. Because foreseeability of loss is an essential element of negligence, one would wonder what would be left in the scope of coverage if calculated risks and dangerous operations were excluded.

50. Stempel & Knutsen, *supra* note 47 at 1–43.

### 1. Probabilistic Losses

Although insurance cannot operate in the realm of excessive uncertainty, it works in the sphere of probabilistic losses.[51] For insurance purposes, a probabilistic loss can be defined as an adverse event that is uncertain with respect to its occurrence, its timing, or the magnitude of the loss.[52] Insurance operates most effectively when both the frequency and magnitude of insured losses are highly *predictable*—that is, the probability of the insured event can be described through a probability distribution function.[53] By predicting the frequency and magnitude of losses, insurers can estimate the expected costs of losses and charge policyholders the correct prices for their risk-bearing services. By contrast, when faced with unpredictable losses, insurers cannot estimate the costs of their risk-bearing services and cannot charge policyholders the correct prices. By preventing correct marginal pricing, excessive uncertainty hinders the functioning of the insurance mechanism.

### 2. Risk Reduction and Predictive Accuracy

At the aggregate level, the contractual reallocation of risk through insurance reduces the total level of risk associated with the activities of a given pool of policyholders and the total cost of losses that they suffer.[54] The reduction of total risk results in significant benefits to the policyholders and society. In fact, the reduction of the total risk reduces the costs of the risk-bearing services offered by insurers, thereby enabling them to charge lower premiums. In turn, the reduction of insurance premiums expands the availability of insurance coverage to society.[55]

Insurance companies can accomplish their risk-reducing function more effectively the more accurately they predict the risk of losses. Insurers improve their predictive accuracy in two distinct ways. First, insurers aggregate statistically independent losses into risk pools.[56] Risk aggregation improves

51. See Abraham, "Environmental Liability", *supra* note 48 at 946. See also, Kenneth S Abraham, *Distributing Risk: Insurance, Legal Theory, and Public Policy* (New Haven, Yale University Press, 1986) at 65.

52. Stempel & Knutsen, *supra* note 47 at 1–41.

53. See Abraham "Environmental Liability", *supra* note 46 at 946–47; Benjamin J Richardson, "Mandating Environmental Liability Insurance" (2001) 12:2 Duke Envtl L & Pol'y F 293 at 301; George L Priest, "A Principled Approach toward Insurance Law: The Economics of Insurance and the Current Restatement Project" (2017) 24 Geo Mason L Rev 635 at 641.

54. Priest, *supra* note 53 at 640.

55. *Ibid* at 640.

56. *Ibid* at 638–39.

the insurer's predictive accuracy by exploiting the law of large numbers.[57] The larger the number of pool members, the more accurately the insurer can predict the likelihood of losses. Second, insurers engage in risk segregation by discriminating between policyholders with different risk levels and assigning them to separate risk pools.[58] Risk segregation improves predictive accuracy by diminishing the risk variance within risk pools. Additionally, it facilitates cost internalization on the part of the policyholder. By segregating risk, insurers can charge premiums that more accurately reflect the risk level associated with the policyholder; in this way, the policyholder internalizes the marginal cost that is associated with its activity and precaution choices.[59]

### 3. Asymmetries of Information

The fortuity principle is susceptible to being undermined by the presence of information asymmetries between insurers and policyholders. When the policyholder has more information than the insurer about the insured risk, the insurer loses the ability to ensure that only fortuitous losses are covered by insurance. One major threat to fortuitous underwriting by the insurer occurs when an adverse event is under the control or influence of the policyholder and the insurer cannot monitor the degree of the policyholder's control over the event. Under these circumstances, the insurer cannot effectively discriminate risk and charge a lower premium to a low-risk policyholder and a higher premium to a high-risk policyholder. When the policyholder has more information than the insurer on the risk, the insurer faces adverse selection and moral hazard problems.

Adverse selection occurs when the insurer cannot accurately discern the risk profile of insurance applicants, thereby failing to estimate the individual policyholder's marginal contribution to the pool risk.[60] Faced with the impossibility of identifying the marginal cost of insurance-bearing services, insurers calibrate insurance premiums in consideration of the average cost. Premiums calculated on the basis of the average cost attract a disproportionate number of high-risk policyholders and incentivize the low-risk policyholders"to terminate their policies. In this manner, average cost pricing raises the total level of risk, which results in further increases in insurance costs and insurance premiums.

57. *Ibid* at 640–42.

58. *Ibid* at 643–45.

59. *Ibid* at 645.

60. See Richard A Ippolito, *Economics for Lawyers* (Princeton: Princeton University Press, 2005) at 299–313.

Moral hazard occurs when informational deficiencies prevent the insurer from monitoring the insured's behaviour.[61] Usually, insurers design contractual devices aimed at monitoring the insured's behaviour and inducing cost internalization by the policyholder. However, when informational deficiencies undermine the insurer's monitoring capacity, the policyholder faces diminished precaution levels and incentives to take efficient activity; consequently, the frequency or magnitude of losses increases and raises the insurance costs. In turn, increased insurance costs result in higher premiums and reduced availability.

The foregoing considerations illuminate the functional relationship between the fortuity principle and the problems of moral hazard and adverse selection. When the insured has information concerning the insured risk that the insurer does not, the insurer is unable to exclude from coverage losses that are under the insured's control or influence. Because these losses are non-random, the insurer cannot make accurate actuarial calculations as to the risk of loss; thus, the insurance mechanism is likely to result in the transfer of excessive or unsustainable risk to insurance providers. The legal principle of fortuity serves the economic function of neutralizing the information asymmetries that generate adverse selection and moral hazard problems by excluding the insurability of risks that are particularly susceptible to incurring such problems. The next step is to explain the economic connection between the fortuity principle and pollution-related losses.

### *B. Fortuity and Pollution*

One common way in which insurers manage the risk of moral hazard and adverse selection is to exclude from coverage risks that are associated with events that are under the control of the policyholder and in respect of which the insured has information that the insurer does not.[62] In keeping with this rationale, exclusionary provisions that are commonly found in liability insurance agreements are often aimed at excluding from coverage events that are non-fortuitous, which either amount to moral hazard or increase the risk of adverse selection. The PEC in CGL policies is one example of these fortuity-expressing exclusion clauses aimed at protecting the functioning of the insurance market.[63]

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61. *Ibid* at 349–56. See also Tom Baker, "On the Genealogy of Moral Hazard" (1996) 75:2 Tex L Rev 237.

62. George W Goble, "The Moral Hazard Clauses of the Standard Fire Insurance Policy" (1937) 37:3 Colum L Rev 410; Abraham "Environmental Liability", *supra* note 46 at 951; Fruehauf, *supra* note 46 at 146–47; Kenneth S Abraham & Daniel Schwarcz, "The Limits of Regulation by Insurance" (2022) 98:1 Ind LJ 215 at 38–39.

63. Abraham, "Environmental Liability", *supra* note 46 at 952–53; Abraham, "Peril and Fortuity", *supra* note 46 at 800.

The law and economic literature has demonstrated that environmental damage presents characteristics that make it particularly susceptible to generating problems of moral hazard and adverse selection.[64] As compared to other business risks, environmental damage risk is often more likely to be the expected result of the normal operation of business rather than merely the accidental consequence of business mishaps.[65] For example, the permitted use of polluting plants is often associated with the risk of expected losses resulting from gradual pollution. Gradual pollution is characterized by long periods before its detection and often becomes apparent only after reaching catastrophic proportions.[66] Because of the low (short-term) detectability of environmental damage, policyholders are more likely to engage in activities that cause gradual losses in the hope that they will never be caught, thereby creating a moral hazard. Abraham accurately captures this point: "Firms insured against liability for gradual pollution [have] a reduced incentive to structure new operations so as to optimize the risk of gradual pollution. The pollution exclusion is intended to reduce this moral hazard risk".[67] Additionally, because of its low detectability, gradual pollution is more likely to be conducive to the increased risk of adverse selection because insurers may not be able to properly discern the risk profile of prospective policyholders and may not be able to charge higher premiums to high-risk polluters. As Schwarcz and Siegelman point out, "[f]irms with private knowledge of their significant potential pollution liability would be able to insure against such liability at rates that do not reflect their higher-than-average risk".[68]

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64. E Donald Elliott, "Goal Analysis Versus Institutional Analysis of Toxic Compensation Systems" (1985) 73:6 Geo LJ 1357 at 1369; Peter S Menell, "The Limitations of Legal Institutions for Addressing Environmental Risks" (1991) 5:3 J Econ Perspect 93 at 106; Joseph Tanega, "Implications of Environmental Liability on the Insurance Industry" (1996) 8 J Envtl L 115 at 118; Howard C Kunreuther & Paul K Freeman, "Insurability, environmental risks and the law" in Anthony Heyes, ed, *The Law and Economics of the Environment* (Cheltenham: Edward Elgar Publishing, 2001) 302; Michael G Faure, "The Limits to Insurability from a Law and Economic Perspective" (1995) 20:4 Geneva Papers on Risk and Insurance 454; Michael G Faure, "Environmental Damage Insurance in Theory and Practice," in Timothy Swanson, ed, *An Introduction to the Law and Economics of Environmental Policy: Issues in Institutional Design* (Leeds: Emerald Group Publishing Limited, 2002).

65. Abraham, "Environmental Liability", *supra* note 46 at 953.

66. James A Hourihan, "Insurance Coverage for Environmental Damage Claims" (1980) 15:4 ABA Tort & Ins LJ 551 at 552.

67. Abraham, "Environmental Liability", *supra* note 46 at 953. See also Rosenkranz, *supra* note 3 at 1242.

68. Daniel Schwarcz & Peter Siegelman, "Law and Economics of Insurance" in Francesco Parisi, ed, *The Oxford Handbook of Law and Economics: Volume 2: Private and Commercial Law* (Oxford: Oxford University Press, 2017) 481 at 495.

Furthermore, owing to the complexity and heterogeneity of the various forms of pollution, it is often difficult for the insurer to define in a standard insurance policy the precautionary measures and standards that the insured must meet to remain covered.[69] Consequently, it is often challenging for the insurer to specify *ex ante*, with sufficient precision, the circumstances in which a pollution event caused by the insured should be removed from coverage. This *ex ante* uncertainty over the scope of liability insurance exacerbates the adverse selection problem confronted by the insurer, who may be unable to accurately define and estimate the insurance applicant's risk profile.[70] Additionally, the lack of a clear definition of the scope of coverage exacerbates the moral hazard problem, as it provides an incentive to the policyholder to increase claims against the insurer beyond the level of insurance services that it would have purchased if not insured.[71]

# III. Interpreting the Pollution Exclusion

This section argues that the only sensible application of the PEC that is consistent with its underlying fortuity-expressing rationale is to exclude from coverage pollution-related losses that can be attributed to the policyholder by virtue of the degree of control that they have exercised over the pollution event. Regarding this view, the PEC removes from coverage those pollution-related losses that the insured subjectively "intended or expected" to occur as a direct consequence of its deliberate actions. This interpretation is consistent with the interpretive framework currently established by Supreme Court of Canada case law.

## *A. The Attribution of the Pollution Event*

A principled interpretation of the PEC must be informed by a coherent conceptualization of the criteria for attributing the pollution-related loss to the policyholder ("attributing criteria"). A useful starting point for defining the attributing criteria is the recognition of the fortuity-expressing rationale underlying the pollution exclusion. As demonstrated in the previous section, insurers draft the PEC to neutralize the economically detrimental effects of the

69. See eg, Elliott, *supra* note 64 at 1369 (discussing the heterogeneity of toxic torts); Menell, *supra* note 64 at 98 (emphasizing the heterogeneous nature of pollution sources); Kunreuther & Freeman, *supra* note 64 at 306 (discussing the lack of a measurable baseline standard of behaviour).

70. See Menell, *supra* note 64 at 106.

71. Hans-Bernd Schäfer & Claus Ott, *The Economic Analysis of Civil Law* (Cheltenham: Edward Elgar Publishing, 2022) at 324, 326.

moral hazard and adverse selection problems generated by the policyholder's fortuity-frustrating behaviour.[72] A fortuity-frustrating behaviour occurs when the insured controls or significantly influences, through their deliberate conduct, the likelihood or magnitude of a loss. It follows that a control issue lies at the heart of a fortuity-based interpretation of the PEC. To determine PEC applicability, the interpreter must establish under what circumstances the insured can be deemed to have control over the pollution event so that it can be attributed to them. If the pollution event is attributed to the insured, the loss is not probabilistic (nor contingent or accidental) and is thus removed from coverage.

The determination of the control issue raises two distinct sub-issues: identifying (i) the legal standard for determining control over the pollution event ("standard of control"), and (ii) which elements of the pollution event should be under the insured's control for the purposes of making coverage determinations.

### 1. The Standard of Control

#### *(i) The Objective Perspective*

The scholarly and jurisprudential debate surrounding the application of the fortuity principle has identified two major conceptual approaches to determine the standard of control.[73] The first approach understands control objectively as a matter of "reasonable foreseeability" of the loss resulting from the insured's intentional act. Under this approach, the judge determines fortuity by inquiring into whether the loss that resulted from the insured's acts or omissions was a foreseeable consequence of the insured's conduct from the perspective of the reasonable policyholder. This line of case law often qualifies the loss attributable to the insured as the "natural and probable results" of the policyholder's act.[74]

The conceptual apparatus involved in the objective approach to the control issue closely resembles the tort standard of negligence. As in the tort of negligence, the subjective intent of the tortfeasor is irrelevant to the

72. I borrow this expression from Erik S Knutsen, "Fortuity Clauses in Liability Insurance: Solving Coverage Dilemmas for Intentional and Criminal Conduct", (2011) 37:1 Queen's LJ 73 at 78.

73. M Elizabeth Medaglia & Kent E Lewis, "Expecting/Intending New Coverage Disputes: What Have We Learned from Environmental Coverage Litigation?" (1996) 31:4 Tort Trial & Ins Prac LJ 797 at 807–11; Knutsen, *supra* note 72; James E Scheuermann, "Fortuity, Intent, and Causation in Liability Insurance Law" (2017) 9:2 Elon L Rev 329 at 336–47; Stempel & Knutsen, *supra* note 47 at 1–76 to 1–79.

74. Stempel & Knutsen, *supra* note 47 at 1–76.

determination of the breach of the standard of care (and, consequently, to the determination of the attributability of loss to the defendant) in the same way that the subjective intent of the insured is irrelevant to the resolution of the control issue relevant to coverage determination. The only intent that matters for coverage determination purposes relates to the physical action that sets in motion the chain of causation culminating in the loss, irrespective of the insured's underlying subjective desires and beliefs.

In the context of liability insurance, the objective approach to the control issue is incongruent with the fortuity-promoting rationale underlying the PEC. The target of the fortuity requirement is not the insured's failure to act reasonably but, rather, the insured's deliberate transfer of a risk from the realm of fortuity to the realm of certainty, thereby generating adverse selection and moral hazard problems.[75] However, not all conduct that fails to meet the reasonable foreseeability test is deliberately meant to influence the likelihood and extent of the pollution-related loss. Therefore, the application of the objective standard of control removes from coverage conduct that is fortuitous from the perspective of the policyholder. Nonetheless, if the policyholder did not subjectively mean to cause the loss-generating event, moral hazard and adverse selection are not present and the reason for excluding the loss from coverage is nullified. Therefore, ignoring the insured's subjective intent results in overinclusive reading and thus the overdeterrent application of the PEC.[76]

The foregoing considerations suggest that equating non-fortuity with reasonable foreseeability does not allow the judge to accurately assess the control issue at the heart of the fortuity principle.[77] An interpretive approach that is consistent with the fortuity principle must assess the control issue from the perspective of the insured and recognize that an insurable loss may be probabilistic from the insured's subjective perspective, even if it may not be deemed probabilistic from the standpoint of objective reasonableness.[78] As Scheuermann notes, "the fortuity requirement imposes [a constraint] on

75. Knutsen, *supra* note 72 at 88; Erik S Knutsen & Jeffrey W Stempel, "Insuring Fortuity—and Intent: A Comment on Professor French's Insuring Intentional Torts" (2022) 83 Ohio St LJ Online 218 at 222–23.

76. Knutsen, *supra* note 72 at 88; Erik S Knutsen, "Fortuity Victims and the Compensation Gap: Re-Envisioning Liability Insurance Coverage for Intentional and Criminal Conduct" (2014) 21:1 Conn Ins LJ 209 at 220.

77. Scheuermann, *supra* note 73 at 377.

78. For discussion of the differences between tort- and insurance-law approaches, see Eugene R Anderson & Carol A Matthews, "The Importance of Concepts of Expectation and Intention to Coverage under General Liability Insurance" (1989) 1:3 Envtl Claims J 299 at 300; Stempel & Knutsen, *supra* note 47 at 222–23; Peter N Swisher, "Insurance Causation Issues: The Legacy of Bird v. St. Paul Fire & Marine Ins. Co." (2002) 2:2 Nevada LJ 351 at 383–84.

what counts as a satisfactory liability insurance-specific concept of intent".[79] Without this subjective element, the insured cannot be deemed to have the kind of control over the likelihood and magnitude of the pollution event that defeats the imputation to fortuity of the loss.

*(ii) The Subjective Perspective*

The second approach to the control issue holds that the insured had effective control over the loss-generating event when they subjectively intended to cause the event that resulted from their actions. Conceptually, this approach is coherent with the fortuity principle informing the PEC. By mandating judges to assess the subjective intent and knowledge of the policyholder, the subjective approach excludes from coverage only those losses that are meant by the insured to cause the pollution-related loss, while it imputes to fortuity those losses that (albeit causally related to the insured's intentional acts) do not correspond to the insured's subjective intent or reasons for action.

The subjective approach enables the interpreter to target the moral hazard of the insured. Moral hazard occurs when an insured reduces its precautionary efforts, counting on the expectation that insurance coverage will reduce the potential liability costs resulting from losses.[80] That is, the insured acts consciously in response to the availability of insurance coverage. In this sense, moral hazard *presupposes* opportunistic behaviour by the insured, who exploits the insurance relationship by undertaking a level of risk that they would not have consciously undertaken in the absence of coverage. By mandating judges to assess the policyholder's subjective intent, this approach enables the interpreter to target the application of the fortuity principle to neutralize the insured's moral hazard.

*(iii) The Expected/Intended Requirement*

Once the subjective approach is recognized as the correct legal standard for determining the control issue, the major challenge in applying the PEC is to define the specific content of the insured's subjective intent. Two minimal propositions can reasonably be assumed to be uncontroversial among interpreters of the PEC. First, an event can be deemed to be under the insured's effective control only if the insured has "effective physical control over [their] bodily movements", and their conduct is not the result of duress or other factors overpowering their will.[81] If this minimal condition is not satisfied, the

79. Scheuermann, *supra* note 73 at 378.

80. Ippolito, *supra* note 60 at 349–56

81. Scheuermann, *supra* note 73 at 380.

pollution event must be attributed to fortuity. Second, an event can be deemed to be under the control of the insured if the insured has full subjective intention to cause the liability-generating loss that resulted from its deliberate actions. The subjective intent is "full" when the insured acts with the purpose or desire to cause the discharge of the pollutant as well as the related liability-generating loss. These two propositions can be succinctly summarized as follows: (i) an intentional action is a *necessary* condition for the attribution of the pollution event, and (ii) a fully intentional pollution event is a *sufficient* condition for the attribution of the pollution event that is directly caused by the insured.

However, pollution events giving rise to coverage disputes generally lie along a continuum between the two scenarios of merely intentional conduct and a fully intentional pollution event. The policyholder engages in intentional conduct without having the full intention of causing pollution-related losses, even though they foresee, to varying degrees, the occurrence of the pollution event. In this case, the necessary condition for attributing the pollution event is satisfied, while it is unclear whether the policyholder exercised sufficient control over the causation of the event for it to be imputed to them. Under these circumstances, adjudicating the control issue necessitates the assessment of intermediate degrees of subjective intent with corresponding intermediate degrees of control over the pollution event.[82] To capture these intermediate situations, the notion of subjective intent must be further articulated and qualified.

Rosenkranz clarifies the distinction between two frequently occurring intermediate scenarios lying along the continuum between merely intentional actions and fully intentional pollution events.[83] In the first segment of the continuum, the insured "take[s] a conscious risk that he *expects* will cause losses, although he does not *intend* to discharge or disperse pollutant or to cause any loss".[84] A pollution event falls within this segment when the triggering conduct is the only fully intentional element. The discharge, loss, and legal liability are not part of the purpose or desire underlying the insurers' conduct. However, while undertaking their actions, the insured accepts the risk that their conduct could result in the substantial probability of pollutants being dispersed into the environment, causing liability-generating losses. By accepting the substantive probability of directly causing a pollution-related loss, the insured has in fact transferred the pollution event from the realm of accidents into that of non-fortuitous events. In this sense, the pollution event is deemed to be "expected". Including these types of losses in the scope of insurance coverage would

82. For challenges associated with accommodating matters of degree in insurance policy interpretation, see Kenneth S Abraham, "'Incomplete' Insurance Coverage" (2020) 26:2 Conn Ins LJ 115 at 133 [Abraham, "'Incomplete' Insurance Coverage"].

83. Rosenkranz, *supra* note 3 at 1284.

84. *Ibid*.

increase the risk of adverse selection and moral hazard problems. Therefore, it is consistent with the fortuity-based rationale underlying the pollution exclusion to attribute the expected pollution event to the insured's control and exclude it from coverage.

In the second segment of the continuum between merely intentional actions and fully intentional pollution events, the insured's intentional conduct results in a pollution-related loss that, although not foreseen by the insured, the insured *could* have foreseen. Similar to expected events, the triggering conduct is the only element of the pollution event that is fully intentional. However, in the case of merely foreseeable events, the discharge, loss, and liability are neither fully intended nor expected by the insured. Merely foreseeable events may acquire insurance significance only in light of an objective notion of control, which targets all the objectively foreseeable consequences of the insured's intentional act. However, as previously emphasized, the attribution of an objectively foreseeable loss to the insured without further inquiry into the policyholder's state of mind is inconsistent with the fortuity rationale underlying the pollution exclusion. If, at the time of the triggering conduct, the policyholder did not foresee the triggering of the pollution sequence and, therefore, did not accept the risk of a pollution-related loss resulting from its actions, the insured cannot be deemed to have transferred the pollution event from the realm of accidents into that of non-fortuitous events. Therefore, in keeping with the fortuity rationale underlying the PEC, the foreseeable but unexpected pollution event should be imputed to fortuity and included within the coverage.

The distinction between expected and foreseeable losses enables the interpreter to conceptualize the outer boundaries of the scope of the PEC in a way that is consistent with the fortuity-based rationale of such a clause. The PEC excludes from coverage pollution-related losses that are expected or intended from the perspective of the insured, while losses that are unintended and unexpected from the policyholder's perspective cannot be excluded from coverage on the basis of the PEC, even if they constitute the foreseeable consequence of the insured's intentional acts. This is the only interpretation of the policy language that is consistent with the PEC's fortuity-promoting nature.

One could wonder whether the proposed interpretation of the PEC contains, in practice, a similar legal test than that Canadian courts have applied in *Hemlow*, *ING*, and *Construction*, in which the PEC has been held to apply to activities that carry a "known risk" of pollution.[85] These cases could be viewed as holding that, because the risk of pollution should have been so obvious to the insured, the insured must have expected pollution to result from her

85. I am grateful to an anonymous reviewer for encouraging me to clarify the distinction between the proposed test and the "inherent" or "known" risk test.

actions. However, the difference between the expected-intended test and the known-risk test becomes clear in light of the distinction between objective and subjective notion of control.

Under the legal construct of the known or inherent risk, the obviousness of risk (a) is understood in terms of objective foreseeability of loss, and (b) provides per se legal ground to impute the pollution event to the insured. The substantive rule is that an objectively foreseeable loss (a loss that "should have been foreseen" by the reasonable insured) is not fortuitous and as such it is not included in the scope of coverage. By way of contrast, under the proposed interpretation of the PEC, a pollution event is attributed to the insured only if the loss was expected or intended from the subjective standpoint of the insured at the time of the loss-generating conduct. The qualification of the pollution event as expected or intended does not automatically follow from the objective foreseeability of the event; it is rather the result of a judicial assessment of the available evidence about the insured's state of mind at the time of the loss-generating conduct.

Under the proposed test, the obviousness of risk may have evidentiary significance, but it is not an element of the decision rule. For example, the more frequently an activity has caused damage in the past, the more likely it may be deemed that the insured expected or intended for the pollution-causing event to occur as a result of that action. In this case, the foreseeability of the risk provides the evidentiary basis for the factual assessment of the expected-intended test, but it does not per se give ground for the application of the pollution exclusion. The conclusion that the pollution event was expected or intended by the insurer may be supported by other circumstantial elements, even absent objective foreseeability of risk.

### 2. The Elements Under the Control of the Insured

The language of the PEC (as interpreted by courts) identifies the elements of the pollution event as having insurance significance. Although there may be minor variations across different CGL policies, the PEC's standard language excludes coverage for "'bodily injury' or 'property damage' arising out of the actual, alleged or threatened discharge, dispersal, release or escape of pollutants".[86] Based on this language, the pollution event can be conceptualized as a causal sequence comprising four distinct elements.[87] First, the insured's conduct (actions or omissions) triggers the pollution sequence. The triggering conduct results in the discharge (or release or dispersal) of pollutants. The dispersion of the discharged pollutant in the environment results in a loss. The third-party victim of loss sues the insurer, who may incur legal liability.

86. See *Construction Distribution*, *supra* note 4 at para 2.

87. Rosenkranz, *supra* note 3 at 1282.


A principled application of the subjective approach to the control issue requires identification of the elements of the pollution event that must be expected or intended for the loss to be attributed to the policyholder. The extent to which legal liability resulting from the pollution-related loss should be known or expected by the insured is controversial. It is tempting to argue that for the PEC to be applicable, the insured should have knowledge of the actual liability resulting from the intended or expected loss-generating event. On this view, the insurable loss would not be established by the mere occurrence of an accident causing damage or injury to third parties but, rather, by the occurrence of a litigation process resulting in actual liability. Because the pollution event has no insurance significance until it results in the actual imposition of liability, the legally relevant pollution event cannot be deemed to be expected or intended if a liability judgment is not expected by the policyholder.

However, several factors suggest that this interpretation is untenable.[88] First, the insured's duty to defend is activated by the mere possibility that the facts alleged in the pleadings would result in a judgment of liability against the insured. Therefore, the potential for moral hazard exists independent of the outcome of the litigation process. The insured's knowledge of their potential liability is sufficient to provide them with incentives to seek defence for a loss that the insurer did not intend to insure. Second, in the third-party liability context, the asymmetry of information between insurer and policyholder occurs only with respect to the elements of the pollution events on which the policyholder exerts some degree of control. However, neither the insured nor the insurer has much information regarding the third-party claim (eg, whether claims will be filed, the number of claims that will be filed, or the amount of money that the claims will demand). Because no significant asymmetry of information between the insured and insurer exists with respect to the element of actual liability, there is no reason to require knowledge of actual liability by the insured to determine PEC applicability.

### *B. Doctrinal Foundations*

The proposed fortuity-based interpretation of the PEC is consistent with the analytical framework for interpreting insurance policies developed by the Supreme Court of Canada. The existing interpretive framework is articulated

88. See M Elizabeth Medaglia, Gregory H Horowitz & Gina S Love, "The Status of Certain Nonfortuity Defenses in Casualty Insurance Coverage" (1995) 30:4 ABA Tort & Ins LJ 943 at 967. Fruehauf, *supra* note 46 at 124–26; Scheuermann, *supra* note 73 at 342.

in two steps.[89] First, the courts must give effect to the language of the policy as it "would be understood by the average person applying for insurance".[90] Second, if the policy language is found to be ambiguous, the courts must resolve the ambiguity by employing the general rules of contract construction.[91] Specifically, the courts should resolve ambiguities in the policy language by favouring interpretations that are consistent with the reasonable expectations of the parties.[92] If the ambiguity persists, the courts apply the *contra proferentem* rule and interpret the disputed policy language against the interest of the party who drafted it.[93]

### 1. The Latent Ambiguity of the PEC

A clause or provision in the insurance policy document is considered ambiguous if "two reasonable but differing interpretations of the policy" are possible.[94] In assessing ambiguity, the judge is not only concerned with the literal meaning of the policy language abstractly considered but also with the meaning that is relevant in the context of applying the language to the concrete facts of the case. Therefore, a latent ambiguity may be revealed by the uncertainties encountered by judges in applying the policy language to the facts at hand, even though the language may appear unambiguous at first glance. Regarding the PEC, the unsettled case law concerning its interpretation testifies to the latent ambiguity of its wording. As noted earlier, a few courts have held that the language of the PEC is clear and unambiguous and that its plain meaning provides sufficient grounds to deny coverage,[95] while other courts have held that its language is vague and ambiguous and should be interpreted in favour of the policyholder.[96]

Three main factors contribute to the latent ambiguity of the PEC: (i) the overbroad definition of pollution, (ii) the indeterminate causal language, and (iii) the lack of prescriptive clarity regarding the connection between insurable loss and pollution. First, pollutant is defined as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids,

89. Billingsley, *supra* note 19 at 254.

90. *Gibbens*, *supra* note 15 at para 21.

91. *Bathurst*, *supra* note 15 at 900–02; *Ledcor*, *supra* note 16 at para 50.

92. *Gibbens*, *supra* note 15 at para 26; *Scalera*, *supra* note 15 at para 71; *Bathurst*, *supra* note 15 at 901; *Progressive*, *supra* note 12 at para 23.

93. *Gibbens*, *supra* note 15 at para 25; *Scalera*, *supra* note 15 at para 70; *Bathurst*, *supra* note 15 at 899–901; *Progressive*, *supra* note 12 at para 24.

94. *Sabean*, *supra* note 15 at para 42.

95. *ING*, *supra* note 6 at para 24.

96. *Zurich*, *supra* note 5 at para 39.

alkalis, chemicals and waste".[97] This broad definition is the source of conflicting expectations by the parties over the scope of coverage. In fact, when taken literally, this definition includes substances that fail the common-sense notion of pollution as it is understood by the average person purchasing insurance.[98] Commenting on the PEC language, Abraham clarifies this point:

> [The definition of pollutants] is broad enough that it could easily be applied to harm caused by substances that in most settings are not pollutants in any plausible sense, such as catsup or salt, which could irritate a person's eye or contaminate a batch of flour. *The breadth of the policy language leaves unstated which substances the insurer will actually classify as pollutants* and which it will not when a claim for coverage is actually made. [Owing to this overbroad language,] insureds have less ability to determine whether a claim is likely to be paid, and *both insureds and insurers have less ability to predict the outcome of disputed claims in litigation*.[99] [emphasis added]

Second, the language of the PEC describes the pollution event in terms of the causal connection between the third party's loss and the discharge of the pollutant. However, the coverage-limiting causal language in the PEC is highly indeterminate, as it excludes from coverage all losses that "arise out of" pollution; this language fails to identify the specific set of causal conditions for which the insurer excludes coverage, and it therefore ambiguously defines the causal trigger of the exclusion.[100] It is unclear, for example, whether the exclusion is triggered only when the damage-causing pollution is the result of the insurer's liability-generating act or also when the actual loss suffered by the third party is caused by pollution irrespective of the discharge being caused by the liability-generating act of the insurer. By failing to specify the mechanics of the causation, the language of the PEC fails to identify a necessary feature of the target of the exclusion—that is, the loss being non-fortuitous and, as such, within the causal control of the insured. In this manner, the overbroad language of the PEC enables overinclusive interpretations of it, excluding from coverage losses that are not fortuitous.

Third, the pollution event is described exclusively (albeit indeterminately) in terms of the causal connection between the third party's loss and pollution.

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97. *Construction Distribution*, *supra* note 4 at para 7.

98. Stempel, *supra* note 3 at 44–56.

99. Abraham "'Incomplete' Insurance Coverage", *supra* note 82 at 135.

100. For a well-structured analytic process for the interpretation of the causal language in insurance policies, see Erik S Knutsen, "Causation in Canadian Insurance Law" (2013) 50:3 Alta L Rev 631.

In this way, the PEC fails to specify the degree of subjective control over the pollution event that the policyholder must have for the exclusion to be applied consistently with its fortuity rationale. As previously clarified, the control issue is of central importance to interpreting and applying the PEC in a way that is consistent with its fortuity-based rationale. A contractual gap in the subjective control issue inevitably results in an overinclusive interpretation of the PEC's exclusion of non-fortuitous losses from the coverage.

The combination of the overbroad definition of pollution, indeterminate causal language, and the gap in the control issue results in an interpretive misalignment between text and context. The textual interpretation favoured by insurers removes from coverage claims—such as claims in negligence—for which policyholders purchase the policy, thereby conflicting with the parties' reasonable expectations at the time of contract formation and with the current framework of insurance policy interpretation. The Supreme Court of Canada has stated that the contractual "literal meaning should not be applied where to do so would bring about an unrealistic result or a result which would not be contemplated in the commercial atmosphere in which the insurance was contracted".[101]

### 2. The Parties Reasonably Expect Non-Fortuitous Losses to be Excluded

The judge must resolve the ambiguity of the disputed wording by choosing the insurance policy interpretation that is consistent with the parties' reasonable expectations, provided that such interpretation can be supported by the text of the policy.[102] According to Supreme Court of Canada case law, the doctrine of reasonable expectations mandates courts to interpret the policy language by giving effect to "the reasonable intention of the parties as determined by the purpose and context of the contract".[103] Scholars have variously emphasized that the notion of reasonable expectations lacks clear prescriptive content and therefore fails to provide clear guidelines for the interpretation of the policy language.[104] In fact, although Canadian courts have consistently proclaimed adherence to the doctrine of reasonable expectations, they have failed to reach a settled and coherent interpretation of the PEC. However, it is submitted

101. *Bathurst*, *supra* note 15 at 901–02.

102. *Gibbens*, *supra* note 15 at para 26; *Scalera*, *supra* note 15 at para 71; *Bathurst*, *supra* note 15 at 901.

103. Billingsley, *supra* note 19 at 265.

104. See e.g. Jeffrey E Thomas, "An Interdisciplinary Critique of the Reasonable Expectations Doctrine" (1998) 5:1 Conn Ins LJ 295 at 299; Stephen J Ware, "A Critique of the Reasonable Expectations Doctrine" (1989) 56:4 U Chicago L Rev 1461; Stephen A Smith, "The Reasonable Expectations of the Parties: An Unhelpful Concept" (2009) 48:3 Can Bus LJ 366.

here that such a doctrine can be coherently operationalized by grounding the interpretation of the PEC firmly in the fortuity principle.[105] The consideration of the fortuity-expressing rationale of the PEC helps judges anchor their interpretive effort to the underwriting purpose of the pollution exclusion, as this is generally understood and reasonably expected by the insurer or policyholder.

The doctrine of reasonable expectations is related to two well-established interpretive principles that constrain the outcome of the interpretive process in two complementary ways. First, an interpretation that virtually nullifies the purpose for which the insurance was sold should be avoided ("nullification doctrine").[106] This principle implies that the interpretation of an ambiguous policy should not result in a denial of coverage that contradicts the underwriting purpose stated in the description of the insurance policy. Schwarcz uses the expression "insurance harm" to indicate cases in which a denial of coverage frustrates the substantial benefit expected by the insured *and* the justification invoked by the insurer is inconsistent with the underwriting purpose of the applicable insurance exclusion.[107] Based on this definition, the nullification principle can be restated as mandating courts to adopt interpretations that minimize the risk of insurance harm.

Second, an interpretation of the insurance policy that results "in either a windfall to the insurer or an unanticipated recovery to the insured is to be avoided".[108] This principle implies that courts should avoid interpretations that undermine the minimum conditions of insurability. An interpretation that undermines the conditions for insurability hinders the functioning of the insurance market, ultimately reducing (at the extreme, eliminating) the availability of insurance coverage to society.[109] Interpretations that enable policyholders to obtain coverage for losses that are not probabilistic—and therefore not predictable with sufficient accuracy by the insurer—should be

105. See also Stempel, *supra* note 3 at 42 (arguing that when interpreting the PEC, reasonable expectation analysis should be the "prerequisite to determining the meaning of words and the possible ambiguity of words").

106. *Indemnity Insurance Co of North America v Excel Cleaning Service*, [1954] SCR 169 (SCC) at 177–80, 1954 CanLII 9 (SCC); *Bathurst*, *supra* note 15 at 902; *Amos v Insurance Corp of British Columbia*, [1995] 3 SCR 405 at paras 16–17, 1995 CanLII 66 (SCC); *Zurich, supra* note 5 at para 28; *Cabell v Personal Insurance Co*, 2011 ONCA 105 at paras 14–16.

107. Daniel Schwarcz, "A Products Liability Theory for the Judicial Regulation of Insurance Policies" (2007) 48:4 Wm & Mary L Rev 1389 at 1447–48.

108. *Brisette Estate v Westbury Life Insurance Co*, [1992] 3 SCR 87 at 92–93, 1992 CanLII 66 (SCC). See also, Geoff R Hall, Canadian Contractual Interpretation Law, 3rd ed (Toronto: LexisNexis Canada, 2016) at 250; *Bathurst*, *supra* note 15 at 901.

109. For discussion of the economic conditions for insurability, see Kunreuther & Freeman, *supra* note 64 at 305–06.

avoided. As noted previously, the insurance mechanism cannot operate when the insurer cannot identify and accurately estimate the risk of loss.

The foregoing considerations suggest that a fortuity-based interpretation of the PEC is consistent with the reasonable expectations of both insurer and policyholder because it concurrently (i) prevents insurance harm and (ii) promotes the minimum conditions for insurability.[110] It is worth briefly expanding on these two aspects.

*(i) Preventing Insurance Harm*

Both commercial common sense and the long history of judicial litigation surrounding the PEC suggest that policyholders do not expect to be denied coverage on the ground that a chemical substance has been accidentally discharged as a result of a business mishap or workplace accident. Denial of coverage in this latter case is inconsistent with the comprehensive nature of the CGL policy purchased by the insured, and it nullifies coverage for the most obvious risk for which the policy has been issued. Furthermore, unintentional business mishaps do not implicate adverse selection and moral hazard issues. Therefore, excluding such losses from insurance coverage is not justified on the basis of the underwriting intent and risk management purpose of the pollution exclusion. These considerations suggest that invoking the PEC to deny insurance coverage for pollution-related losses generated by workplace accidents or business mishaps constitutes insurance harm. As Stempel observes, "[a] CGL policy that fails to cover the ordinary business mishaps leading to litigation is a woefully defective risk management product that should not be sold".[111]

The proposed fortuity-based interpretation of the PEC contributes to avoiding the risk of insurance harm by delimiting the scope of the exclusion within the conceptual limits of its underlying economic rationale. As noted, the source of insurance harm traces back to the latent ambiguity of the policy wording; the locus of the ambiguity is the failure to specify the required degree of control of the pollution event by the insured. The proposed interpretation of the PEC redresses the latent ambiguity of the clause by supplementing the contractual gap and introducing the "expected or intended" requirement for the application of the exclusion.

110. See *Bathurst*, *supra* note 15 ("the courts should be loath to support a construction which would either enable the insurer to pocket the premium without risk or the insured to achieve a recovery which could neither be sensibly sought nor anticipated at the time of the contract" at 901–02).

111. Jeffrey W Stempel, "The Insurance Policy as Thing" (2009) 44:3/4 Tort Trial & Ins Prac LJ 813 at 852.

*(ii) Meeting the Insurability Conditions*

The proposed interpretation of the PEC is consistent with the minimum condition of insurance profitability. By reading into the PEC an "expected or intended" requirement, the proposed interpretation explicitly requires the interpreter to remove from coverage the fortuity-frustrating behaviours of the insured that hinder insurance profitability by generating adverse selection and moral hazard problems. Second, by specifying the required degree of subjective control of the pollution event by the insured, the expected-intended requirement contributes to redressing the latent ambiguity of the PEC, which is the cause of much legal uncertainty over the scope of the clause. In this way, the proposed interpretation improves the insurer's ability to predict the outcome of disputed claims in litigation.

*C. Objections*

Before concluding, it is worth addressing two concerns that the proposed interpretation of the PEC could raise. These concerns regard issues of evidence and the contractual freedom of the parties.

1. Evidentiary Challenges

The expected-intended requirement poses the issues of what proof may satisfy the subjective standard of control and the available source of such proof in the context of a pollution coverage dispute. In theory, the insured's subjective intent can be directly proven through the policyholder's admission of their knowledge or intent at the time of the conduct triggering the pollution sequence. Additionally, when the insured's activity is conducted through a complex business organization, subjective intent can be established by the organization's internal documents or by testimony of the organization's employees showing that at the time of the acts, the insured knew that their conduct would certainly or most likely result in a pollution-related loss.[112] In practice, however, these sources of evidence may not be available for coverage litigation. The insured is usually reluctant to admit their knowledge or intent and has a vested interest in limiting access to relevant documents or testimony that could compromise their chances of winning.[113]

When direct proof of subjective intent is unavailable, the state of mind of the policyholder can be established by means of circumstantial evidence. The judge can determine the degree of expectedness of a pollution event by

112. See Medaglia & Lewis, *supra* note 73 at 813.

113. *Ibid*.

identifying facts from which to infer what the insured knew at the time of the acts, the degree of certainty with which the insured knew it, and when the insured acquired this knowledge. Examples of these probative elements include the amount of the pollutant discharged into the environment, its degree of toxicity, the size of the fissure generating the leakage, and the proximity of the source of pollution to the damaged land or injured victim.[114] These elements can provide a factual basis for inferring the insured's state of mind with respect to various elements of the pollution event, thereby helping determine whether the loss was foreseen or expected and intended by the insured.

When the only available class of evidence is circumstantial, the litigants involved in a pollution coverage dispute face the challenge of identifying the source from which such evidence can be gathered. Medaglia and Lewis identify the following sources from which circumstantial evidence of the insured's expectation or intent can be gathered:

> Files from regulatory agencies at all levels of government (including local health boards, fire departments, and sanitation departments); testimony from involved regulatory officials; testimony from neighbors of manufacturing facilities or contaminated sites; media accounts (local newspapers and television stations); industry publications; historical [geological survey] maps and aerial photographs; . . . investigators, and experts regarding historical knowledge of pollutants and their toxic properties.[115]

An additional challenge stems from assessing circumstantial evidence. The difficulty lies in identifying the evidentiary threshold to be satisfied to prove the expected-intended requirement in cases that lie at the periphery of expectedness and foreseeability. In such cases, it may become difficult to distinguish a foreseeable pollution sequence from an expected one because, as previously mentioned, the distinction is one of degree rather than one of kind. The trier of fact is likely to infer the degree of intent from the level of risk associated with the factual features of the pollution event, such as the amount of discharged pollution, its level of toxicity, or the proximity of the triggering conduct to the source of pollution. As the risk associated with these elements escalates, the degree of conscious participation that can reasonably be inferred from these

114. See Rosenkranz, *supra* note 3 at 1285.

115. See Medaglia & Lewis, *supra* note 73 at 813. For a detailed discussion of different jurisprudential approaches to the assessment of circumstantial evidence of the insured's expectation and intent, see Robert D Chesler & Robyn Ann Valle, "Great Expectations: A New Look at the Expected or Intended Defense" (2001) 13:2 Envt Claims J 123.

elements also increases; conversely, as the risk decreases, the inferable degree of conscious participation diminishes.

In light of these considerations, it may be objected that the proposed interpretation of the PEC places an excessive burden of proof on the insurer while giving too great an advantage to the policyholder.[116] In particular, advocates of the objective approach to the control issue may argue that the expected-intended requirement is an illogical rule that ultimately conditions the applicability of the PEC "on the willingness of a claimant to confess to motivations that will utterly defeat its claim".[117] Because proving the insured's state of mind is an elusive task, so the objection would go, the expected-intended requirement would make it nearly impossible for insurance companies to bar coverage for intentional losses.[118] The practical effect "would be to tempt wrongdoers to protect themselves in advance from the known consequences of their deliberate acts, by the simple expedient of purchasing CGL insurance coverage prior to acting on some malevolent intent".[119] These considerations have led critics to support an interpretation of the PEC that is based on the objective notion of the insured's control.

Although these concerns have weight, they do not justify the adoption of an interpretation of the PEC that is based on the objective notion of control. First, the premise of the objection is incorrect. As previously discussed, while it is true that state of mind is rarely capable of being proven through direct proof, the insurer can overcome the insured's denial of intent (or plea of ignorance) by proffering persuasive circumstantial evidence of their expectation or intention at the time of the triggering conduct. Circumstantial evidence consists of objective facts supporting the inference that the insured knew that the pollution-related loss was substantially certain to occur as a direct consequence of their deliberate act. The history of pollution coverage litigation provides examples in which courts have inferred the insured's expectation or intention from objective circumstantial evidence, such as the business records of the insured or testimonies of their employees.[120]

Second, the problems that would arise under the objective approach to the control issue are not worth the gains to insurance companies that would result

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116. James P Schaller, M Elizabeth Medaglia, & Kenneth E Ryan, "An Attempt at a Balanced Perspective on Expected/Intended" (1992) 5:1 Envtl Claims J 67.

117. *Ibid* at 69. Although the analysis of Schaller et al refers to the expected-intended requirement in the definition of occurrence, their argument also applies to the expected-intended requirement included in the pollution exclusion.

118. See Medaglia & Lewis, *supra* note 73 at 808, 810.

119. Schaller, Medaglia & Ryan, *supra* note 116 at 68.

120. See James L Rigelhaupt, Jr, Annotation, *Construction and Application of Provision of Liability Insurance Policy Expressly Excluding Injuries Intended or Expected by Insured*, 331 ALR 4th 957 (1984) ss 5(c), (f); Chesler & Valle, *supra* note 115.

from employing it. As repeatedly emphasized, the objective standard of control is inconsistent with the principle of fortuity and results in an overinclusive application of the PEC that virtually nullifies coverage for the most frequent type of claim for which parties purchase CGL policies. Depriving the insured of the substantial benefits expected from coverage can hardly be justified as a means of alleviating the evidentiary burden on insurers in proving insurance exclusions. Insurance companies possess stronger expertise on insurance matters than the average policyholder and can invest greater cognitive and financial resources in the coverage litigation process. As Quinn notes, under these circumstances, "it would be inequitable to permit insurers to require that insureds prove potentially complex and nuanced matters in order to get their claims paid".[121] Furthermore, it must be emphasized that the allocation of the burden of proof on the insurer reflects the social function of the insurance. Anderson and Matthews clarify this point:

> The rule that places the burden of proof on the insurance company to disprove coverage arises out of the special fiduciary relationship between insurance companies, their policyholders, and the public at large. Because insurance companies occupy a unique position of public trust, they are duty-bound to conduct themselves in accordance with the highest standards of good faith.[122]

### 2. Freedom of Contract Concerns

Critics may object that the proposed interpretation encroaches on the principle of freedom of contract. By reading into the PEC an "expected or intended" requirement that is not expressly stated in the policy language, courts would inadmissibly deviate from the contractual text and effectively create a new agreement. Given the central importance of contractual freedom in the common law of contract, courts should be expected to promote the objective intentions of the parties by simply giving effect to the policy language chosen and assented to by the parties.

This objection has no force. While the principle of freedom of contract is a fundamental tenet of the Canadian common law of contract, its relevance and application must be commensurate with the nature of the specific contractual relationship at issue. Insurance policies are drafted by the insurers

121. Michael Sean Quinn, "Fortuity, Insurance, and Y2K" (1999) 18:3 Rev Litig 581 at 601.

122. Anderson & Matthews, *supra* note 78 at 304.

and subscribed to by the insureds on a take-it-or-leave-it basis.[123] Policyholders neither choose nor have the possibility to influence the content of the policy terms—only insurers do. Owing to their lack of bargaining power, policyholders do not exercise genuine contractual freedom.[124] Furthermore, owing to various informational and cognitive limitations, policyholders often fail to appreciate the content of the insurance agreement or the quality of the insurance product that they purchase.[125] As Abraham puts it,

> policyholders usually do not read their policies or have a meaningful choice about the coverage provisions these policies contain. So, in a sense, policyholders are not agreeing to a set of contract terms. Rather, they are buying a commodity—insurance—in the hope that it will provide them with what they need.[126]

In this context, the principle of freedom of contract cannot be considered the paramount concern informing the interpretive exercise, and focusing on the policy text alone may inhibit the attainment of an appropriate interpretive outcome. Scholars have repeatedly noted that insurance policies exhibit statute-like or product-like characteristics.[127] Moreover, they have long recognized the role of insurance as an institutional instrument that is crucial to the functioning of the social and economic orders. These characteristics enhance the case for an interpretive approach that is anchored in the underwriting purpose of the

123. James M Fischer, "Why Are Insurance Contracts Subject to Special Rules of Interpretation? Text versus Context" (1992) 24:3 Ariz St LJ 995 at 1008–09; Christopher C French, "The Butterfly Effect in Interpreting Insurance Policies" (2019) 82:4 Law & Contemp Probs 47 at 49–52; Susan Randall, "Freedom of Contract in Insurance" (2007–08) 14:1 Conn Ins LJ 107 at 125.

124. It may be objected that insurance applicants can indirectly influence the content of the insuring agreement by choosing among competing insurance providers. However, in most cases, "insurers offer the same standard policy on the same take-it-or-leave-it basis"; therefore, the insurers' ability to influence the content of insurance is limited. See Kenneth S Abraham, "Four Conceptions of Insurance" (2007–08) 161:3 U Pa L Rev 653 at 660 [Abraham, "Four Conceptions of Insurance"]. But see Daniel Schwarcz, "Reevaluating Standardized Insurance Policies" (2011) 78:4 U Chi L Rev 1263 (emphasizing that carriers' homeowners policies differ with respect to numerous important coverage provisions).

125. See Abraham, "Four Conceptions of Insurance", *supra* note 124 ("For virtually all individuals, insurance policies are complex documents with terms they neither read nor understand" at 660); Randall, *supra* note 123 ("[i]nsurance policies are complex and technical documents that very few policyholders can read or understand" at 107).

126. Abraham, "Four Conceptions of Insurance", *supra* note 124 at 674.

127. Jeffrey W Stempel, "The Insurance Policy as Statute" (2009) 41:2 McGeorge L Rev 203.

policy as understood by insurer and policyholder.[128] In keeping with these considerations, the interpretation of the PEC that is here proposed does not eliminate or revise the policy term but construes it in a manner that is consistent with its fortuity rationale and with the insurance and policyholder expectations.

## Conclusion

The lack of clarity regarding the criteria for attributing the pollution-related loss to the insured creates uncertainty over the scope of the PEC. The case law analysis shows that the criteria identified by the courts (i.e., active industrial polluter and knowledge of risk) are either insufficient or unsuited to inform a predictable and coherent interpretation of the PEC. As demonstrated, the recognition of the fortuity-based rationale of the PEC enables the interpreter to conceptualize the connection between pollution-related loss and the conduct of the insured. The pollution-related loss should be attributed to the insured when they have deliberately controlled or influenced the likelihood or magnitude of the loss. Based on this premise, the PEC should be interpreted as removing from coverage only those pollution-related losses that are expected or intended from the standpoint of the insured. Unintended or unexpected losses cannot be excluded from coverage on the basis of the PEC, even if they constitute the foreseeable consequence of the insured's intentional act from the perspective of the reasonable policyholder. The proposed interpretation of the PEC is consistent with the reasonable expectations of both insurer and insured, as it prevents insurance harm and promotes the minimum profitability condition of insurance.

128. Jeffrey W Stempel & Erik S Knutsen, "Rejecting Word Worship: An Integrative Approach to Judicial Construction of Insurance Policies" (2021) 90:2 U Cin L Rev 561 (making the case for an approach to insurance policy interpretation that integrates contextual and purposive elements); Erik S Knutsen, "The Insurance Policy: Contract or Not? (And Why That Matters for Insurance Coverage Cases)" (Supreme Ct L Rev, forthcoming).