

## **STATEMENT OF INTEREST OF *AMICUS CURIAE***

United Policyholders is a non-profit organization founded in 1991 and dedicated to education on insurance issues and consumer rights. The organization is tax-exempt under §501(c)(3) of the Internal Revenue Code. United Policyholders is funded by donations and grants from individuals, businesses, and foundations.

While much of its work is aimed at individuals and businesses affected by disasters, United Policyholders actively monitors legal and marketplace developments affecting the interests of all policyholders. United Policyholders receives frequent invitations to testify at legislative and other public hearings and to participate in regulatory proceedings on rate and policy issues.

A diverse range of personal and commercial line policyholders throughout the United States communicate their insurance concerns on a regular basis to United Policyholders. United Policyholders advances policyholders' interests in courts throughout the country by filing *amicus curiae* briefs in cases involving important insurance principles.

United Policyholders' *amicus* brief was cited in the U.S. Supreme Court's opinion in *Humana, Inc. v. Forsyth* (1999) 525 U.S. 299 [119 S.Ct. 710, 142 L.Ed.2d 753]. United Policyholders has filed

*amicus curiae* briefs on behalf of policyholders in over one hundred and twenty cases throughout the United States in the past six years. Several divisions of the California Court of Appeal have invited United Policyholders to participate in oral argument as *amicus curiae*. The California Supreme Court cited with approval arguments from United Policyholder's *amicus curiae* brief in *Vandenburg v. Superior Court* (1999) 21 Cal.4<sup>th</sup> 815 [88 Cal. Rptr.2d 366, 982 P.2d 229]. United Policyholder's activities are limited only to the extent that United Policyholders exists exclusively on donated labor and contributions of services and funds. No party to this case has contributed directly or indirectly to the preparation of this brief.

United Policyholders has a vital interest in seeing that insurance companies do not attempt to shift risk assumed in insurance policies back to their policyholders through schemes unsupported by insurance policies or public policy. United Policyholders has an interest in ensuring that insurance companies live up to their promises to their policyholders.

United Policyholders seeks to appear as *amicus curiae* to address certain issues presented in this case that are of significance well beyond the application of law to the specific facts of this case. These important issues will affect policyholders nationwide.

## I. FACTS AND PROCEDURAL HISTORY

United Policyholders adopts and incorporates herein by reference the statement of facts contained in the brief of the Cold Creek policyholders.

This is an insurance coverage action in which Cold Creek Compost, Inc. (“Cold Creek”), Martin Mileck (“Mileck”) and M&M Feed, Inc. (“M&M”) (collectively “the Cold Creek policyholders”) seek coverage from their insurance company State Farm Fire & Casualty Company (“State Farm”) in connection with a lawsuit filed against the Cold Creek policyholders, captioned *Preserve Country Neighborhoods, et al. v. Cold Creek Compost, Inc., et al.*, Case No. SCUk CVCV 98-78986 (Mendocino County Sup. Ct., California) (the “Underlying Action”). The Cold Creek policyholders are seeking a declaration that State Farm was obligated to indemnify the Cold Creek policyholders in connection with the Underlying Action under the insurance policies that State Farm sold to them, and also sought damages from State Farm for breach of contract and bad faith in refusing to indemnify them for the judgment entered against them in the Underlying Action.

On April 25, 2006, the trial court granted State Farm’s motion for summary judgment and entered judgment under CCP § 437c

against the Cold Creek policyholders on May 30, 2006. (AA0537-38; AA0534.) The trial court ruled that State Farm had no duty to defend or indemnify the Cold Creek policyholders in connection with the Underlying Action based on the so-called “absolute pollution exclusion” contained in State Farm’s insurance policies.<sup>1</sup> (AA0538.)

## **II. STATEMENT OF THE ISSUES**

United Policyholders adopts and incorporates herein by reference the State of the Issues contained in the brief of the Cold Creek policyholders.

## **III. STATEMENT OF APPEALABILITY**

Following an order granting State Farm’s motion for summary judgment, the trial court entered a final judgment on May 30, 2006. (AA0534.) The Cold Creek policyholders timely filed their notice of appeal on June 21, 2006. (AA0542.)

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<sup>1</sup> In *MacKinnon v. Truck Ins. Exch.* (2003) 31 Cal.4<sup>th</sup> 635 [3 Cal. Rptr.3d 228, 73 P.2d 1205], the California Supreme Court eschewed the use of the term “absolute pollution exclusion,” noting that insurance policies themselves do not use it and that it suggests the exclusion is broader than it actually is. 31 Cal.4<sup>th</sup> at 644, n.3. The Supreme Court indicated its preference for the term “current pollution exclusion” or simply “pollution exclusion.” *Id.* United Policyholders follows the Supreme Court’s nomenclature in its brief and hereafter refers to the “pollution exclusion” as distinguished from the previous “sudden and accidental” or “qualified” pollution exclusion.

#### **IV. STANDARD OF REVIEW**

The trial court's grant of summary judgment is subject to *de novo* review on appeal. *MacKinnon v. Truck Ins. Exch.* (2003) 31 Cal.4<sup>th</sup> 635, 641 [3 Cal. Rptr.2d 228, 73 P.2d 1205]. Further, the interpretation of an insurance policy is a question of law that is reviewed *de novo* as well. *Id.*

#### **ARGUMENT**

This case involves the proper scope and application of the “reasonable expectations doctrine,” a doctrine of great importance to policyholders in the State of California and throughout the United States as a means to balance the scales which otherwise tip overwhelmingly in favor of insurance companies. Under well-settled California law, a policyholder that has a reasonable expectation of coverage for liabilities arising out of his normal business operations must be granted that coverage. Hypertechnical, legalistic interpretations of insurance policy language do not defeat the policyholder's reasonable expectations.

The reasonable expectations doctrine arose out of courts' recognition of the need to protect policyholders' purpose in purchasing insurance to obtain security and peace of mind. Policyholders reasonably expect that they will receive prompt

payment in times of need from the insurance companies that sell them insurance. However, insurance policies are contracts of adhesion, and insurance companies can dictate the terms and conditions in any way they choose, creating an inherent unfairness to policyholders. The courts redress this imbalance to some extent by not allowing vague, unclear, complicated and highly technical insurance policy language to defeat policyholders' reasonable expectations of coverage.

In order to carry out the purpose of insurance, courts determine policyholders' reasonable expectations of coverage based on the type of insurance they purchase, whether exclusions are "conspicuous, plain and clear" in describing what they exclude, and the basis of policyholders' liability, including policyholders' normal business operations. General liability policies, such as those sold by State Farm to the Cold Creek policyholders, provide the broadest spectrum of protection against liability based on ordinary negligence and other fault-based conduct. Exclusions in general liability policies thus must "conspicuously, plainly and clearly" exclude specific acts in order to defeat policyholders' reasonable expectations of coverage.

The California Supreme Court holds that the current pollution exclusion's definition of "pollutant" is so broad as to be meaningless. The policyholder's reasonable expectations must be taken into account

when determining whether a particular liability is excluded by the pollution exclusion. The pollution exclusion does not exclude every type of liability that involves an “irritant or contaminant,” but only excludes liability that involves what an ordinary person would understand to be traditional environmental contamination.

In the present case, the trial court ruled in favor of State Farm because it “believe[d] that an odor emanating from a compost plant that reaches the point of being declared a nuisance is pollution as defined by the *MacKinnon* Court.” (AA0537.) In so ruling, the trial court overlooked the Cold Creek policyholders’ reasonable expectation of coverage for this type of claim. In fact, the trial court appeared to substitute its understanding of what “pollution” is as opposed to attempting to ascertain whether a reasonable policyholder would consider odors to be environmental pollution.

Policyholders such as Cold Creek are in the business of composting primarily “green material,” that is, lawn and yard trimmings, vegetative material from nearby vineyards, wood and other plant material. Thus, composting policyholders reasonably expect coverage for liability that arose out of the normal course of their composting business. Everyone, including the average person with a backyard compost pile, knows that compost creates offensive odors.

Consequently, the Cold Creek policyholders would reasonably have expected coverage when they were sued for nuisance caused by the normal odors created in their ordinary composting process.

The Cold Creek policyholders' expectation of coverage is made more reasonable by the regulatory scheme in which they operate. The California Integrated Waste Management Board, which regulates composting businesses (among others), not only does not consider compost to be a hazardous waste that must be strictly controlled and limited, but encourages the creation and use of compost as beneficial to the environment. The regulations expressly exclude compost from the definition of hazardous waste. The regulations pertaining to odor control nowhere indicate or even intimate that odors emanating from a composting business constitute hazardous or toxic waste. Faced with this regulatory environment, the ordinary policyholder would not consider composting operations to be creating "environmental pollution," even if the process does create bad smells. Therefore, the Cold Creek policyholders' expectation of coverage for liability arising out odors is entirely reasonable and must be upheld, resulting in payment from State Farm for the Underlying Action.

**I. Principles For Construing Insurance Policies Under California Law**

## A. Fundamental Principles of Construction

In *MacKinnon v. Truck Ins. Exch.* (2003) 31 Cal.4<sup>th</sup> 635 [3 Cal. Rptr.2d 228, 73 P.2d 1205], the California Supreme Court set forth the basic principles of construction that govern the interpretation of all contracts, including insurance policies, in California. 31 Cal.4<sup>th</sup> at 647-48. The fundamental premise is that the interpretation of a contract must give effect to the mutual intention of the parties at the time the contract is formed. *Id.* at 647. If possible, this intent is inferred from the plain language of the contract. *Id.* The ordinary and popular meaning of words and phrases controls, unless the parties used them in a technical sense or gave them a special meaning. *Id.* at 647-48. A contract provision is ambiguous when it is capable of two or more constructions, both of which are reasonable. *Id.* at 648. The contract language must be interpreted as a whole and in the context of the circumstances of a particular case; *i.e.*, the language cannot be considered in the abstract. *Id.*

There are certain rules of construction that apply specifically to insurance policies. Insurance coverage is interpreted broadly so as to afford the greatest possible protection to the policyholder. *Id.*

Consequently, exclusionary clauses are interpreted narrowly against the insurance company. *Id.* As the California Supreme Court explains:

An insurer cannot escape its basic duty to insure by means of an exclusionary clause that is unclear. As we have declared time and again “any exception to the performance of the basic underlying obligation must be so stated as clearly to apprise the insured of its effect.” [Citation.] Thus, “the burden rests upon the insurer to phrase exceptions and exclusions in clear and unmistakable language.” [Citation.] The exclusionary clause “must be *conspicuous, plain and clear.*”

*Id.* (emphasis in original). In turn, the question of whether exclusionary language is conspicuous, plain and clear is examined from the standpoint of how an ordinary policyholder might reasonably interpret the language. *Id.* at 649. The burden is on the policyholder to establish that the claim is within the basic scope of coverage and on the insurance company to establish that the claim is specifically excluded. *Id.* at 648.

## **B. The Reasonable Expectations Doctrine**

The above rules relating to the interpretation of exclusionary provisions apply with particular force “when the coverage portion of the insurance policy would lead an insured to reasonably expect coverage for the claim purportedly excluded.” *Id.*; *see also Gray v. Zurich Ins. Co.* (1966) 65 Cal.2d 263, 272-73 [54 Cal. Rptr. 104, 419 P.2d 168]. Thus, the California Supreme Court has explicitly adopted what is known as the “reasonable expectations doctrine” to interpret insurance policies. *MacKinnon*, 31 Cal.4<sup>th</sup> at 648-49; *Smith v.*

*Westland Life Ins. Co.* (1975) 15 Cal.3d 111, 122 [123 Cal. Rptr. 649, 539 P.2d 433]; *Gray*, 65 Cal.2d at 270-71.

### **1. The Origin and Purpose of the Reasonable Expectation Doctrine**

Insurance companies provide a vital service in modern society. *See Egan v. Mutual of Omaha Ins. Co.* (1979) 24 Cal.3d 809, 820 [169 Cal. Rptr. 691, 620 P.2d 141] (describing this “vital service” as “quasi-public in nature”). A policyholder does not enter into an insurance contract seeking profit, but rather “seeks security and peace of mind through protection against calamity.” *Delgado v. Heritage Life Ins. Co.* (2d Dist. 1984) 157 Cal. App.3d 262, 277 [203 Cal. Rptr. 672]. The bargained-for peace of mind comes from the assurance that the policyholder will receive prompt payment in times of need. *Id.* A policyholder purchases insurance in exchange for the payment of premium in order to avoid financial liability for its own negligent or fault-based conduct causing injury to others. *Kransco v. American Empire Surplus Lines Ins. Co.* (2000) 23 Cal.4<sup>th</sup> 390, 407 [97 Cal. Rptr.2d 151, 2 P.3d 1]. Consequently, “the courts will not sanction a construction of the insurer’s language that will defeat the very purpose or object of the insurance.” *Ritchie v. Anchor Cas. Co.* (2d Dist. 1955) 135 Cal. App.2d 245, 257 [286 P.2d 1000].

However, although the service they provide is vital, insurance companies have many unfair advantages over policyholders. In fact, insurance policies are contracts of adhesion, in which the insurance companies have a greatly superior bargaining position over policyholders. *Smith*, 15 Cal.3d at 122 n.12; *Gray*, 65 Cal.2d at 269. At least as far back as 1910, the California Supreme Court acknowledged the inherent unfairness to policyholders in their relationship with insurance companies:

It is a matter almost of common knowledge that a very small percentage of policyholders are actually cognizant of the provisions of their policies and many of them are ignorant of the names of the companies issuing the said policies. The policies are prepared by the experts of the companies, they are highly technical in their phraseology, they are complicated and voluminous – the one before us covering thirteen pages of the transcript – and in their numerous conditions and stipulations furnishing what sometimes may be veritable traps for the unwary.

*Raulet v. Northwestern etc. Ins. Co.* (1910) 157 Cal. 213, 230 [107 P. 292]; *see also Insurance Co. of N. Am. v. Electronic Purification Co., Inc.* (1967) 67 Cal.2d 679, 690 [63 Cal. Rptr. 382, 433 P.2d 174] (noting that insurance policies contain language “which even a lawyer . . . would find difficult to comprehend” and consist of “[a] confused attempt to set forth an insuring agreement” that is then “assailed by such a bewildering array of exclusions, definitions and conditions,

that the result is confounding”). It is generally recognized that policyholders can only assent to the general scope or type of insurance provided, the premium, and the policy limits. *See, e.g., C&J Fertilizer, Inc. v. Allied Mut. Ins. Co.* (Iowa 1975) 277 N.W.2d 169, 175; *Pressley v. Travelers Prop. & Cas. Corp.* (Pa. Super. 2003) 817 A.2d 1137, 1139; Note, *A Common Law Alternative to the Doctrine of Reasonable Expectations in the Construction of Insurance Contracts* (1982) 57 N.Y.U. L.Rev. 1175, 1193.

In recognition of the inequitable positions of policyholders and insurance companies, California courts have long accepted the reasonable expectations doctrine as a fundamental principal of insurance policy construction. In *Gray v. Zurich Ins. Co.* (1966) 65 Cal.2d 263 [54 Cal. Rptr. 104, 419 P.2d 168], the California Supreme Court traced its first use in California back to at least 1936, in the case *Coast Mut. B.-L. Ass’n v. Security T.I. & G. Co.* (2nd Dist. 1936) 14 Cal. App.2d 225 [57 P.2d 1392]. *Gray*, 65 Cal.2d at 270 n.7. In *Coast Mutual*, the California Court of Appeals explained that the doctrine was “well-established” even back then:

In the decision of this question, we are to be guided by well-established rules relating to the construction of insurance policies. Not only the provisions of the policy as a whole, but also the exceptions to the liability of the insurer, must be construed so as to give the insured the

protection which he reasonably had a right to expect, and to that end doubts, ambiguities, and uncertainties arising out of the language used in the policy must be resolved in his favor.

14 Cal. App.2d at 279.

The “take it or leave it” quality of insurance policies creates a different set of standards by which to interpret them, one of which is the reasonable expectations doctrine:

As this court has held, a contract entered into between two parties of unequal bargaining strength, expressed in the language of a standardized contract, written by the more powerful bargainer to meet its own needs, and offered to the weaker party on a “take it or leave it” basis carries some consequences that extend beyond orthodox implications. Obligations arising from such a contract inure not alone from the consensual transaction but from the relationship of the parties. [Citations and footnote omitted.]

Although courts have long followed the basic precept that they would look to the words of the contract to find the meaning which the parties expected from them [footnote omitted], they have also applied the doctrine of the adhesion contract to insurance policies, holding that in view of the disparate bargaining status of the parties [footnote omitted] we must ascertain that meaning of the contract which the insured would reasonably expect. [Footnote omitted.] Thus as Kessler stated in his classic article on adhesion contracts: “In dealing with standardized contracts courts have to determine what the weaker contracting party could legitimately expect by way of services according to the enterpriser’s ‘calling’, and to what extent the stronger party disappointed reasonable expectations based on the typical life situation.” (Kessler, *Contracts of Adhesion* (1943) 43 Colum. L.Rev. 629, 637.)

*Gray*, 65 Cal.2d at 270.

The circumstances described by the California Supreme Court in 1910 and 1966 continue to exist today, and in fact may have gotten worse, as evidenced by the “strong modern trend” of courts to adopt the reasonable expectations doctrine. *See Saltarelli v. Bob Baker Group Med. Trust* (9<sup>th</sup> Cir. 1994) 35 F.3d 382, 386; *Atwater Creamery Co. v. Western Nat. Mut. Ins. Co.* (Minn. 1985) 366 N.W.2d 271, 277; *Computer Corner, Inc. v. Fireman’s Fund Ins. Co.* (N.M. App. 2002) 46 P.3d 1264, 1269-70; *see also MacKinnon v. Truck Ins. Exch.* (2003) 31 Cal.4<sup>th</sup> 635, 652 [3 Cal. Rptr.3d 228, 73 P.3d 1205] (utilizing reasonable expectations doctrine to interpret pollution exclusion based on what “ordinary policyholder” would consider “pollutant”). Thus, the reasonable expectations doctrine remains an important tool to help balance the scales back towards policyholders and ensure that they receive the insurance that they intended to purchase.

## **2. The Scope of the Reasonable Expectation Doctrine**

In order to carry out the “purpose or object” of the insurance which a policyholder purchases, courts determine a policyholder’s reasonable expectations of coverage with reference to three major factors: (1) the type of insurance purchased; (2) whether exclusionary

language is “conspicuous, plain and clear” in describing what precisely is excluded from being insured; and (3) the basis of the policyholder’s liability, including whether that liability arose out of the policyholder’s normal business operations. *See MacKinnon*, 31 Cal.4<sup>th</sup> at 649, 654; *Gray*, 65 Cal.2d at 272.

The California Supreme Court has clearly stated that general liability insurance policies, such as those which State Farm sold to the Cold Creek policyholders, are intended to provide very broad insurance for a wide variety of circumstances:

“The purpose of CGL policies is to provide the insured with the ***broadest spectrum*** of protection against liability for unintentional and unexpected personal injury or property damage arising out of the conduct of the insured’s business.”

*MacKinnon*, 31 Cal.4<sup>th</sup> at 654, quoting Michael W. Peters, *Insurance Coverage for Superfund Liability: A Plain Meaning Approach to the Pollution Exclusion Clause* (1987) 27 Washburn L.J. 161, 166 (emphasis added). The general liability policies’ agreement to insure “all sums for which the insured becomes legally obligated to pay as damages caused by bodily injury, property damage or personal injury,” demonstrates an intent to provide “general protection” for “ordinary acts of negligence” and other fault-based conduct by policyholders. *MacKinnon*, 31 Cal.4<sup>th</sup> at 649; *Gray*, 65 Cal.2d at 272.

An exclusion in a general liability policy thus must “conspicuously, plainly and clearly” apprise the policyholder that certain acts are not covered in order to be effective in any particular case. *MacKinnon*, 31 Cal.4<sup>th</sup> at 649.

## **II. The Trial Court Erred In Granting Summary Judgment To State Farm Because A Reasonable Policyholder Would Expect Coverage For Liability Arising Out Of Odors Created During Its Normal Business Operations**

The California Supreme Court holds that the current pollution exclusion, including the meaning of the word “pollutant,” is not plain and clear in what it purports to exclude. *Id.* at 652 (“the definitional phrase ‘any irritant or contaminant’ is too broad to meaningfully define ‘pollutant’”). As an exclusion to the “general protection” provided in general liability policies, the current pollution exclusion excludes coverage *only* if a reasonable policyholder would not expect to be insured by a general liability policy under the particular facts that gave rise to his liability. *Id.* at 652-53.

More specifically, the reasonable policyholder must understand that the cause of the injury or damage for which the policyholder is liable is an “irritant or contaminant commonly thought of as . . . environmental pollution.” *Id.* at 653. Whether the reasonable policyholder would consider an irritant or contaminant to be

“environmental pollution” can be determined by reference to the laws that regulate the irritant or contaminant at issue, if any, as they are applied to the policyholder’s operations. *Id.* (pollution exclusion was intended to exclude coverage for liability arising out of anti-pollution laws); *see also Garamendi v. Golden Eagle Ins. Co.* (1<sup>st</sup> Dist. 2005) 127 Cal. App.4<sup>th</sup> 480, 485-86 [25 Cal. Rptr.3d 642]; *Regional Bank of Colorado v. St. Paul Fire and Marine Ins. Co.* (10<sup>th</sup> Cir. 1994) 35 F.3d 494, 498 (substance in question must “occur in a setting such that they would be recognized as a toxic or particularly harmful substance in industry or by government regulators”). A policyholder that is liable for “ordinary acts of negligence involving harmful substances” stemming from his normal business operations does not expect that the pollution exclusion excludes coverage for his liability. *MacKinnon*, 31 Cal.4<sup>th</sup> at 653; *see also Pipefitters Welfare Educ. Fund v. Westchester Fire Ins. Co.* (7<sup>th</sup> Cir. 1993) 976 F.2d 1037, 1044 (pollution exclusion does not apply to “injuries resulting from everyday activities gone slightly, but not surprisingly awry”).<sup>2</sup>

In the present case, the Cold Creek policyholders’ liability arose from “everyday activities”, their composting operations and the

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<sup>2</sup> In *MacKinnon* the California Supreme Court discussed with approval the reasoning of the Federal Seventh and Tenth Circuits in *Pipefitters* and *Regional Bank*. *MacKinnon*, 31 Cal.4<sup>th</sup> at 650, 652.

offensive smells that were emitted as a normal part of those operations. The regulations applicable to composting operations do not consider odors to be environmental pollution. Under these circumstances, the reasonable policyholder would not consider the odors from composting operations to be environmental pollution. Therefore, the pollution exclusion in State Farm's insurance policies does not exclude coverage for the Cold Creek policyholders' liability in the Underlying Action.

**A. The Cold Creek Policyholders' Normal Business Operations Necessarily Included the Creation of Odors**

Cold Creek Compost, Inc. has a permit from the California Integrated Waste Management Board ("CIWMB") to operate a "Composting Facility (Green Waste)." (Facility/Site Summary Details for the Cold Creek composting operation are available from the CIWMB's website at <http://www.ciwmb.ca.gov/swis/detail.asp?SITESCH=23-AA-0029>.) The CIWMB defines "Compost" as:

[T]he product resulting from the controlled biological decomposition of organic wastes that are source separated from the municipal solid waste stream, or which are separated at a centralized facility. "Compost" includes vegetable, yard, and wood waste which ***are not hazardous wastes***.

See <http://www.ciwmb.ca.gov/swis/Definitions/default.asp?VW=>

SITE (emphasis added). Also according to the CIWMB:

Compost is the product of an aerobic process during which microorganisms decompose organic matter into a stable amendment for improving soil quality and fertility. During composting, microorganisms use the organic matter as a food source, producing heat, carbon dioxide, water vapor, and humus as a result of their furious growth and activity. When applied to and mixed into the soil, humus can promote good soil structure, improve water- and nutrient-holding capacity, and help to control erosion.

California Integrated Waste Management Board (June 2001) *Compost Microbiology and the Soil Food Web*, available at <http://www.ciwmb.ca.gov/publications/default.asp?pubid=857>.

Policyholders such as Cold Creek primarily compost “green material,” wood waste and other plant material from residential and commercial sources. The CIWMB defines “green material” as:

[A]ny plant material that is separated at the point of generation, contains no greater than 1.0 percent of physical contaminants by weight, and meets the requirements of section 17868.5. Green material includes, but is not limited to, yard trimmings, untreated wood wastes, natural fiber products, and construction and demolition wood waste. Green material does not include food material, biosolids, mixed solid waste, material processed from commingled collection, wood containing lead-based paint or wood preservative, mixed construction or mixed demolition debris.

*See* 14 Cal. Admin. Code § 17852(a)(21). In other words, “green material” composting operations create compost using much of the same material that the average homeowner uses in his backyard compost pile, only on a much larger scale.

It is beyond dispute that **any** amount of material being turned into compost, large or small, will emit an offensive odor as the material within it decomposes. Thus, liability of composting entities for such odors arises out of their “everyday activities” that go “slightly, but not surprisingly awry” in generating odors that cause some nearby homeowners to complain.

The significance of liability based on the policyholder’s normal business operations to the application of the pollution exclusion is exemplified by the Indiana Supreme Court’s decision in *American States Ins. Co. v. Kiger* (Ind. 1996) 662 N.E.2d 945. In that case, citizens of Danville, Indiana complained to the Indiana Department of Environmental Management (“IDEM”) about petroleum vapors in their homes. IDEM determined that the vapors were caused by gasoline that had leaked from an underground storage tank underneath Kiger’s service station. IDEM cleaned up the gasoline and sued Kiger to recover the costs. Kiger’s insurance company denied coverage, relying on the pollution exclusion.

The Indiana Supreme Court held that Kiger was insured for the cost of cleaning up the gasoline notwithstanding the pollution exclusion:

Clearly, this clause cannot be read literally as it would negate virtually all coverage. For example, if a visitor slips on a grease spill then, since grease is a “chemical,” there would be no insurance coverage. Accordingly, this clause requires interpretation. . . . We are particularly troubled by the interpretation offered by American States, as it makes it appear that Kiger was sold a policy that provided no coverage for a large segment of the gas station’s business operations. . . .

In any event, since the term “pollutant” does not obviously include gasoline and, accordingly, is ambiguous, we once again must construe the language against the insurer who drafted it. Appellant claims that in common parlance gasoline is sometimes referred to as a pollutant. That may be correct, but the ambiguity remains. If a garage policy is intended to exclude coverage from damage caused by the leakage of gasoline, the language of the contract must be explicit.

*Id.* Other courts similarly hold that the pollution exclusion cannot be interpreted to negate coverage for liability arising out of a policyholder’s everyday business operations. *See, e.g., Keggi v. Northbrook Prop. and Cas. Ins. Co.* (Ariz. App. 2000) 13 P.3d 785, 792; *Western Alliance Ins. Co. v. Gill* (Mass. 1997) 686 N.E.2d 997, 999; *West Am. Ins. Co. v. Tufco Flooring East, Inc.* (N.C. App. 1991) 409 S.E.2d 692, 697-98; *Nautilus Ins. Co. v. Mike’s Roofing Co.* (1<sup>st</sup> Cir. 1999) 188 F.3d 27, 30; *Westchester Fire Ins. Co. v. City of*

*Pittsburg, Kansas* (D. Kan. 1991) 768 F. Supp. 1463, 1468; *In re Hub Recycling, Inc.* (D. N.J. 1989) 106 B.R. 372, 375.

Here, the Cold Creek policyholders, like the garage owner in *Kiger*, were found liable because something normally generated in the course of their ordinary business operations leaked off of their property and onto neighboring homeowners' property. In the case of the Cold Creek policyholders, odors invaded the homeowner's property; in *Kiger* it was gasoline vapors. The Indiana Supreme Court held that the pollution exclusion did not exclude coverage for the garage, even though the pollution exclusion includes "vapors" as a type of "irritant or contaminant." *Kiger*, 662 N.E.2d at 948. "Odors," by contrast, are not included in the list.<sup>3</sup> Thus, policyholders like Cold Creek reasonably expect coverage for odors arising out of their ordinary business operations.

As a counter-example, *Ortega Rock Quarry v. Golden Eagle Ins. Corp.* (4<sup>th</sup> Dist. 2006) 141 Cal. App.4<sup>th</sup> 969 [46 Cal. Rptr.3d 517],

<sup>3</sup> Insurance companies do, however, know how to draft a pollution exclusion that includes the word "odor" as a type of "irritant or contaminant." See, e.g., *IKO Monroe, Inc. v. Royal & Sun Alliance Ins. Co. of Canada, Inc.* (D. Del. Dec. 7, 2001) 2001 WL 1568674 (insurance policy defined term "pollutant" used in the pollution exclusion as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, **odour**, vapour, soot, fumes, acids, chemicals, and waste" (emphasis added)). If State Farm had wanted to, it easily could have included the word "odor" in its version of the pollution exclusion. Its failure to do so is strong evidence that not even State Farm considered odors to be "pollutants" within the definition of the pollution exclusion at the time it sold the insurance policies to the Cold Creek policyholders.

did not involve liability arising out of the policyholder’s “normal” business operations. In *Ortega*, a storm washed out the only road leading to the policyholder’s rock quarry. 141 Cal. App.4<sup>th</sup> at 973. The policyholder placed fill dirt from the quarry along the road in order to repair it. *Id.* This fill entered the creek next to the road, and thus became a “pollutant” as expressly defined in the Clean Water Act. *Id.* at 973-74. The Fourth District held that the pollution exclusion was not ambiguous as it related to coverage for cleaning up the creek, because the definition of “pollutant” in the Clean Water Act expressly included rocks and dirt and the dirt fill had been placed in the creek by the policyholder’s “unnatural process” of repairing the road. *Id.* at 980-81.<sup>4</sup>

The Cold Creek policyholders, by contrast, did not engage in any “unnatural process” that caused odors to emanate from their property. Odors are a normal part of the natural process of composting. Moreover, as discussed below, none of the laws that

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<sup>4</sup> The Fourth District’s reasoning in *Ortega* is questionable insofar as it held that the pollution exclusion was unambiguous. 141 Cal. App.4<sup>th</sup> at 990. The Fourth District appeared to believe that the pollution exclusion could be ambiguous in some circumstances, but not in others. However, the California Supreme Court holds that “the definitional phrase ‘any irritant or contaminant’ is too broad to meaningfully define ‘pollutant’” regardless of the underlying circumstances. *MacKinnon*, 31 Cal.4<sup>th</sup> at 652. The correct analysis focuses on whether an “irritant or contaminant” is “commonly thought of as pollution.” See *Garamendi*, 127 Cal. App.4<sup>th</sup> at 645. In turn, whether a substance is “commonly thought of as pollution” depends on whether a reasonable policyholder would expect coverage for liability based on that substance.

regulate composting in California define compost or any part thereof as “environmental pollution.” In fact, the CIWMB expressly defines compost as “not hazardous wastes.” Therefore, the pollution exclusion is ambiguous as to whether odors are “pollutants” and must be interpreted in accord with composting policyholders’ reasonable expectations of coverage.

State Farm, of course, must have been aware of the type of business activity in which the Cold Creek policyholders engaged. As the North Carolina Court of Appeals observed in *Tufco*:

West American was aware of the type of business activity in which Tufco was engaged. Yet . . . West American does not deny that it never told Tufco of its interpretation that the CGL policy did not cover damages arising out of Tufco’s regular business activities. . . . To allow West American to deny coverage for claims arising out of Tufco’s central business activity would render the policy virtually useless to Tufco. If this Court accepted West American’s interpretation of the CGL policy, we would be allowing an insurance company to hide behind ambiguities in the policy and deny coverage for good faith claims that arise during the course of the insured’s normal business activity. Such an interpretation would constitute the height of unfairness.

*Tufco*, 409 S.E.2d at 697-98. Similarly, to deny coverage for claims arising out of the Cold Creek policyholders’ central business activity would render the State Farm policies virtually useless to the Cold Creek policyholders and “constitute the height of unfairness.”

**B. A Reasonable Policyholder Would not Consider  
Odors from Composting Operations to be  
“Environmental Pollution” Under the  
Applicable State Regulations**

California regulates composting operations and facilities. *See* 14 Cal. Admin. Code § 17850 *et seq.* (the “Composting Regulations”). These regulations demonstrate that California does not consider the composting process to result in the creation of “environmental pollution.” In fact, the CIWMB and the United States Environmental Protection Agency (“US EPA”) both encourage and support businesses that create compost because it is an environmentally beneficial material that can be used, among other things, to eliminate pollution from the environment. A reasonable policyholder, operating in such a regulatory environment, would in no way believe or understand that it was involved in the creation of environmental pollution in their composting operations. Therefore, it would reasonably expect to be covered for liability arising out of those operations, including private nuisances from offensive odors.

**1. Odors from Composting Operations Are not  
Regulated as “Environmental Pollution” in  
California**

The California regulations relating to solid waste handling and disposal generally (of which the Composting Regulations are a part) define “Composting” as:

[A] controlled microbial degradation of organic wastes yielding a safe and nuisance free product.

14 Cal. Admin. Code § 17225.14. The regulations, significantly, define “Hazardous Wastes” separately as:

[A]ny waste material or mixture of wastes which is toxic, corrosive, flammable, an irritant, a strong sensitizer, which generates pressure through decomposition, heat or other means, if such waste or mixture of wastes may cause substantial personal injury, serious illness or harm to humans, domestic animals, or wildlife, during, or as an approximate result of any disposal of such wastes or mixture of wastes as defined in Article 2, Chapter 6.5, Section 25117 of the Health and Safety Code.

14 Cal. Admin. Code § 17225.32. Hazardous wastes, of course, are the paradigmatic source of “environmental pollution.”

Thus, California considers composting generally to be “safe and nuisance free,” which does not fit the definition of “hazardous wastes.” Indeed, the CIWMB, which is charged with enforcing the regulations, recognizes that “compost includes vegetable, yard, and wood waste which *are not hazardous wastes*.” Furthermore, the Composting Regulations state that the “composting of hazardous

waste is prohibited,” 14 Cal. Admin. Code § 17855.2(c), thus clearly differentiating composting from hazardous waste.

Composting facilities like Cold Creek generate compost mainly from “green material.” As discussed above, the Composting Regulations define “green material” as “yard trimmings, untreated wood wastes, natural fiber products, and construction and demolition wood waste.” 14 Cal. Admin. Code § 17852(a)(21). This material is not “commonly thought of as pollution” under anyone’s definition, particularly not the average policyholder. For example, the CIWMB states that in discussing compost it generally “uses the term ‘materials,’ as opposed to ‘waste,’ food ‘waste,’ and wood ‘waste,’ to reflect the resource conservation benefits inherent in these materials.” See “Organic Materials Recycling Marketing Guide,” <http://www.ciwmb.ca.gov/organics/MarketGuide/Default.htm>.

The Composting Regulations define “Active Compost” as:

[C]ompost feedstock that is in the process of being rapidly decomposed and is unstable. Active compost is generating temperatures of at least 50 degrees Celsius (122 degrees Fahrenheit) during decomposition; or is releasing carbon dioxide at a rate of at least 15 milligrams per gram of compost per day, or the equivalent of oxygen uptake.

14 Cal. Admin. Code § 17852(a)(1). The only things expressly listed as being emitted by active compost are heat and carbon dioxide,

neither of which are commonly thought of as pollution. As noted above, the CIWMB describes the composting process as “producing heat, carbon dioxide, water vapor, and humus.” Again, these are not thought of as pollution.

Although the Composting Regulations require composting businesses to have a “Composting Impact Minimization Plan,” 14 Cal. Admin. Code § 17863.4, this regulation nowhere mentions or even implies that odors are hazardous wastes or environmental pollution. It is clear that the Composting Regulations recognize what is obvious to everyone: that composting operations can cause offensive odors, and that it is desirable that such odors be minimized as much as possible for the convenience of nearby property owners. The goal of minimizing offensive odors, however, does not indicate a belief or understanding that such odors are environmental pollution.

In the trial court, State Farm contended that odors are “air pollutants” as defined by the California Health and Safety Code § 39013. However, this definition is found in Division 26 (“Air Resources”) of the Health and Safety Code. The definition of “air pollutant” in § 39013 applies only to this division, and no other:

Unless the context requires otherwise, a definition set forth in this chapter [Chapter 2, Part 1, Division 26] shall govern the construction of *this division*, unless and until

rules and regulations are adopted by the state board pursuant to Section 39601 which revises such definition.

Health and Safety Code § 39010 (emphasis added). Division 26 does not specifically relate to or regulate composting operations.

The CIWMB is the California agency that is charged with regulating composting operations, and it has enacted its own specific regulations. The Composting Regulations, as discussed above, do not consider odors from composting operations to be hazardous wastes or environmental pollution.

**2. State and Federal Environmental Agencies Encourage the Production and Use of Compost Rather than Restrict It as a Source of “Environmental Pollution”**

Not only is composting not regulated as pollution, the CIWMB and the US EPA positively encourage composting operations as a way of helping the environment. For example, the CIWMB offers free advertising and marketing guides to composting businesses. *See* “Organic Materials Recycling Marketing Guide,” <http://www.ciwmb.ca.gov/organics/MarketGuide/Default.htm>. The CIWMB explains why it does this:

With over 30 percent of California’s waste stream consisting of compostable organic materials, it’s critical to find ways to keep these useful materials from ending up in landfills. To this end, the California Integrated Waste Management Board actively funds programs and

projects – in partnership with local governments, compost producers, users of compost and mulch, and others – that promote waste prevention and recycling of organic materials.

*See* “Demonstration Projects,” <http://www.ciwmb.ca.gov/organics/GreenTeam/default.htm>.<sup>5</sup>

The US EPA also encourages the production and use of compost:

Yard trimmings and food residuals together constitute 24 percent of the U.S. municipal solid waste stream. That’s a lot of waste to send to landfills when it could become useful and environmentally beneficial compost instead!

Composting offers the obvious benefits of resource efficiency and creating a useful product from organic waste that would otherwise have been landfilled.

*See* “Composting,” <http://www.epa.gov/compost>. Among the reasons the US EPA does this are that “compost helps cleanup (remediate contaminated soil,” “compost helps prevent pollution,” and composting materials “are relatively clean and biodegradable,” rendering disposal in landfills unnecessary. *See* “Environmental Benefits,” <http://www.epa.gov/epaoswer/non-hw/composting/>

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<sup>5</sup> *See also* “Agricultural and Erosion Control,” <http://www.ciwmb.ca.gov/organics/GreenTeam/Target6/ProjMap.htm>:

One of the goals of the CIWMB is to divert organic materials from landfills by encouraging the use of compost and mulch by California’s growers and governing agencies. The partnership projects listed below were undertaken with the purpose of increasing acceptance of compost and mulch use throughout the State.

[benefits.htm](#); “Frequent Questions,” <http://www.epa.gov/epaoswer/non-hw/composting/questions.htm>. Interestingly, the US EPA considers that composting is preferable to burning leaves and other yard wastes because burning this material “pollutes the air.” See <http://www.epa.gov/epaoswer/non-hw/composting/questions.htm>.

It is not reasonable to conclude that the CIWMB and the US EPA would encourage the creation and use of compost to such an extent if they considered any part of the composting process to result in “environmental pollution.” The state and federal governments make it easier, not more difficult, for entities to engage in composting, which is the opposite of what occurs with operations that create environmental pollution. Quite simply, a reasonable policyholder operating under a regulatory agency that encourages, rather than limits, its operations, and considers such operations to be environmentally beneficial, would not consider that any part of those operations, including offensive smells, constitutes a “pollutant” or “environmental pollution.”

To summarize, composting facilities create offensive odors in the ordinary course of business by composting mainly “green materials,” *i.e.* grass, shrubs, trees, wood and other plant material. The government regulations specifically directed towards composting

operations nowhere state that odors are “pollutants” or “environmental pollution.” In fact, the regulations expressly distinguish composting from “hazardous wastes.” The state agency that regulates composting operations considers them to be environmentally beneficial and encourages entities like Cold Creek to produce more compost. A reasonable policyholder under these circumstances would not consider the odors produced by its operations to be an environmental pollution. Therefore, the pollution exclusion in State Farm’s policies does not exclude the Cold Creek policyholders’ liability in the Underlying Action.

### **CONCLUSION**

Wherefore, for the foregoing reasons, United Policyholders respectfully urges that this Court reverse the summary judgment in favor of State Farm General Insurance Company and grant summary judgment in favor of the Cold Creek policyholders, holding that the pollution exclusion does not exclude coverage for the Cold Creek policyholders’ liability in the Underlying Action.

Dated: December \_\_, 2006

San Francisco, CA

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