Environmental Risk Management and the Role of Environmental Insurance

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Environmental insurance—especially the newer types of coverage introduced in recent years—can help protect your company from a range of potential liabilities. © 2000 Environmental Insurance Underwriters Agency, Inc. Used with permission.

The recent increase in the breadth of available customized environmental insurance products offers today's professional risk managers many valuable risk transfer tools in their battle against pollution-related liabilities. Small and large companies alike face the same daunting challenge: the complex web of federal, state, and local laws, rules, and regulations, as well as common law theories of environmental liability. Traditional risk management techniques often focus more closely on environmental risk control, rather than on merging effective risk control with prudent risk financing and transfer.

This article provides a basic framework and understanding of environmental insurance and its practical application in a commercial business operation for the environmental risk management professional.

THE EVOLUTION OF ENVIRONMENTAL INSURANCE

Over the past 20 years, environmental insurance has evolved from a narrow specialty into a more mainstream product with general business applications. During the 1980s, the demand for such insurance arose from a growing number of strict government regulations controlling mainly treatment, storage, and disposal facilities and transporters of hazardous substances. In fact, the market evolved as a result of the perceived "gaps" that traditional Commercial General Liability (CGL) and property coverages left behind. Absolute pollution exclusions have now been standard in most CGL and property policies for nearly 15 years; therefore, the market forced insurance companies to come up with products that filled the void.

Sensing the potential for a tremendous market opportunity, numerous insurance companies responded by offering various types of Environmental Impairment Liability (or EIL) insurance coverage. This coverage was often very expensive and carried high self-insured retentions or deductibles, as well as restrictive terms and conditions.

By the mid-1980s, most insurance companies had dropped out of the market due to severe losses. The reasons for such

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losses included the fact that this was a brand-new field and virtually no one in the industry had any experience in properly underwriting and pricing environmental risks. No historic information or actuarial statistics existed on which to base sound underwriting and pricing decisions. In addition, in the midst of an evolving environmental regulatory infrastructure, environmental engineering was still in its relative infancy and was unreliable at best.

Over time, insurance companies became more knowledgeable about proper underwriting methods and had the benefit of a more highly developed regulatory climate. This resulted in ongoing innovations in coverage and stabilization of pricing. Consequently, many risk managers now include environmental insurance products as a part of their company's overall risk management strategy—complementing traditional CGL and property/casualty coverage.

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RISK CONTROL VS. RISK FINANCING

A constant tug of war occurs for most risk managers between the levels of environmental risk to finance (either through risk retention or risk transfer) and the level of risk control techniques to employ (such as risk avoidance, loss prevention, and loss reduction). Striking the right balance between these two competing corporate interests is a monumental task. Concentrating more time and capital on one to the detriment of the other is a recipe for disaster. No amount of risk control, other than perhaps avoidance, can completely eliminate the potential for environmental losses; thus, a well-planned combination of risk control and risk finance should be employed to maximize the ultimate benefit for the company.

Effective environmental risk financing may be achieved in several different ways depending upon whether a risk management professional is concerned about an ongoing operation, a purchase and sale, a merger or acquisition, or a refinancing deal.

ENVIRONMENTAL RISK FINANCING THROUGH INSURANCE

Alternative Risk Transfer Theories for Environmental Liabilities

Risk management professionals are now looking at risk financing techniques (e.g., risk retention and risk transfer) from new perspectives. However, managing expense volatility is still a main concern for most companies. "Expense volatility means an unplanned increase in operating costs, which translates into lower profits or exceeding budget."[1] One benefit of utilizing environmental insurance as part of an overall risk financing strategy is that it can be used to manage expense volatility regarding environmental contingencies. This is particularly important from an accounting perspective given the fairly recent changes in accounting rules for environmental liabilities.

In 1996, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 96-1, Environmental Remediation Liabilities:

> SOP 96-1 creates a presumption of an unfavorable outcome if litigation, a claim or an assessment has been asserted, or is probable of assertion, and if the entity is associated with the site. The entity would then need to accrue at least the amount that can reasonably be estimated as the cleanup liability.[2]

The Securities and Exchange Commission also requires publicly traded companies to disclose in their SEC filings "any material effects that costs of environmental compliance may have on earnings, capital expenditures and com-

petitive position."[3] In addition, a "key benefit of insurance is that premiums are tax deductible, while contributions to a self-insurance fund, generally speaking, are not deductible."[4]

Given these important financial points, environmental insurance, when properly incorporated into an overall risk management plan, can act as a mechanism to reduce expense volatility and comply with new accounting and SEC requirements, while providing a tax benefit at the same time.

The Art of Environmental Science

To this day, environmental engineering continues to be as much an art as a science. However, it remains the most reliable means of investigating the environmental conditions of a site.

Typically, in the context of a purchase and sale or a merger or acquisition, risk management professionals will initially request a Phase I site assessment. Phase I site assessment parameters are set forth by the American Society for Testing and Materials (ASTM) and ensure a consistent benchmark for initial investigation. Standing alone, however, a Phase I site assessment cannot 100 percent guarantee a risk management professional that a site is free from contamination.

Accordingly, a Phase II site assessment will also generally need to be performed. Typically this includes soil borings and groundwater analysis. Laboratory methods used will detect certain kinds of targeted chemicals. One method used to detect gasoline constituents will not detect solvent constituents, and vice versa. Therefore, it is important to properly scope the Phase II site assessment.

Even with the best of investigations, there remains an element of uncertainty. Enter environmental insurance, which may be utilized in addition to traditional due diligence.

UNDERSTANDING ENVIRONMENTAL INSURANCE

The new environmental insurance products available in today's marketplace offer businesses more types of coverage than ever before. The following discussion outlines some of the typical coverages currently offered.

Specific policy language usually differs among insurance companies and, thus, should be carefully analyzed within the context of the specific needs of the contemplated transaction. Risk management professionals should consult with an experienced environmental attorney and a qualified environmental insurance agent or broker when structuring their organization's insurance program.

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Pollution Legal Liability Insurance

- ***First-Party and Third-Party Liabilities***

Pollution legal liability (or PLL) policies are generally intended to provide coverage for both first-party and third-party liabilities. Included within the targeted domain of PLL policies are environmental cleanup costs incurred as a result of pollution conditions at, on, or under the policyholder's property; pollution conditions that migrate onto the policyholder's property from an off-site source; and off-site bodily injury, property damage, and cleanup costs incurred as a result of pollution conditions emanating from the policyholder's property.[5] Business interruption coverage is also generally available to protect the policyholder in the event a catastrophic pollution loss causes a shutdown of its operations.

- ***Duty to Defend***

Another standard coverage addresses legal defense expenses, which are usually included within the applicable limit of liability. This coverage is now typically phrased in terms of a carrier's "right and duty to defend" the policyholder. By con-

trast, several years ago the policies stated that the carrier had the "right but not the duty to defend." This is an important aspect of the new coverage forms since legal fees and expenses can be significant and can have an adverse impact on a company's cash flow.[6]

- ***"To Pay on Behalf of" Language***

Many environmental policies have "pay on behalf of" language that requires the insurance company to directly pay, on behalf of the policyholder, all loss, costs, and expenses associated with a covered claim, rather than making the policyholder incur the expense first. A policy with traditional "indemnity" language requires the policyholder to pay the loss or expense up-front and then be "indemnified" or reimbursed by the insurance company. The "pay on behalf of" coverage enhancement allows the policyholder to maintain a predictable cash flow in the face of an environmental loss.

- ***Policy Period***

In previous years, the policy period was almost always limited to one year, with a "claims made and reported" trigger. Now, insurance companies routinely offer five-year terms, and in some cases up to ten years or more. However, the reporting triggers are usually still claims made and reported. This means that a claim must be made against the policyholder *and* reported to the insurance company during the policy period or the extended reporting period. Most insurance companies offer an automatic extended reporting period, as well as an optional extended reporting period of up to three years, for an additional premium charge. These longer policy terms are more attractive for policyholders due to the "long-tail" nature of most environmental claims.

- ***Preexisting and New Pollution Conditions***

Several years ago, insurance companies would offer coverage only for new pollution conditions discovered during the policy period. Any known, preexisting contamination would be excluded from coverage. Now, insurance companies are more willing to entertain the risk of a future claim from a preexisting pollution condition if that condition is unknown or disclosed to the carrier during the application process.

Typically, this underwriting consideration comes into play where contamination at a former industrial facility has been cleaned up, but may still be higher than the state's acceptable action levels. Depending upon the intended future use of the site and other factors, the state may be willing to provide the policyholder with a qualified "No Further Action" letter even if the cleanup falls short of technical standards. In such a case, provided there is no active site remediation planned or ongoing, and no third-party claims pending, insurance companies will consider covering the risk of a future claim from a known, preexisting pollution condition. This risk may arise from a so-called governmental "re-opener" or from the ever-present threat of a third-party lawsuit. If a site is the subject of planned or ongoing remediation, insurance companies will usually offer a "cost-cap" policy, discussed in more detail below.

Coverage is also generally granted for new pollution conditions that arise during the policy period and after the real estate transaction closes.

Remediation Cost-Cap Insurance

The cost-cap policy is designed for sites where an active cleanup is anticipated. This is essentially "stop loss" insurance that covers the potential cost overruns of a cleanup project.

Insurance companies will generally entertain this type of risk when a remedial action work-plan (RAW) is finalized and cost estimates for implementing the plan are proposed. The scope of coverage

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is directly related to the scope of remediation as outlined in the RAW. Coverage is usually provided for remedial activities at or adjacent to a specified location, as more fully defined in the RAW.

When there are remediation activities, new conditions are sometimes not discovered until after the project is under way. Therefore, coverage may be extended to unforeseen pollution conditions first discovered during the course of performing the cleanup pursuant to the RAW, as well as to change orders required by governmental authorities. In addition, coverage is available for cases where contamination is found to be more extensive than originally anticipated (for instance, where a contaminated groundwater plume is deeper and/or wider than originally thought).[7] The policyholder is required to provide the insurance company with regular status reports, including cleanup work completed and costs incurred.

Most such policies include both a "self-insured retention" (or SIR) and a "coinsurance provision." An SIR requires the policyholder to expend a set amount of funds before the insurance company will respond. An SIR is distinguished from a "deductible" in that an SIR is generally part of the coverage limit. For example, a cost-cap policy with a $1 million limit and a $100,000 SIR would require a policyholder to expend the first $100,000; the remaining limit on the policy would be $900,000. A "coinsurance" provision generally applies after the SIR is satisfied. It requires the policyholder to participate dollar-for-dollar with the insurance company (according to certain preset percentages) in paying the remaining cleanup costs up to the applicable limit of liability.

Some insurance companies offer coverage only for actual remediation, while others also offer coverage for the costs and expenses of investigation and monitoring. No coverage is generally afforded for attorney fees or other costs and expenses associated with litigation, arbitration, or dispute resolution, or for costs associated with preparing the RAW. Further, no coverage is afforded for any third-party liability (including bodily injury and property damage), for faulty workmanship or defective materials, or for time delays in operations due to such issues, including labor disputes.

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Secured Creditor Insurance

Secured creditor policies (SCP) are tailored to provide coverage to banks and other lending institutions that finance commercial real estate transactions. These insurance products are designed for all types of lenders, including local and regional banks, as well as multinational investment houses and banks.

Different types of coverages are available to lenders depending upon the nature of the financial institution. Some lenders, called "portfolio lenders," hold their commercial real estate assets on their books as a long-term investment. Other banks, called "securitized lenders," sell their portfolio of loans as a bond issue in the commercial mortgage backed securities (CMBS) market.

- ***Outstanding Loan Balance vs. "Lesser of" Policies***

Insurance companies offer two different types of environmental policy depending upon the type of lender involved. One option is a policy that protects the bank's outstanding loan balance (OLB) in the event a borrower is simultaneously in default on its loan and pollution conditions exist at the insured property. Other insurance companies offer only what is termed a "lesser of" policy, which provides coverage only for the lesser of the OLB or the estimated cleanup costs. This "lesser of" coverage option is more often favored by portfolio

lenders who wish to retain the real estate asset in their portfolio.

The distinction in available coverage becomes significant when investment bankers purchase environmental insurance in the CMBS market. Investment bankers and other "conduit" lenders pool various commercial real estate mortgages together. The securities rating agencies, such as Standard & Poor's and Moody's, rate the pools into different classes or "traunches" for sale in the CMBS market. All of the rating agencies require the OLB type of environmental insurance policies since they protect the full OLB, and thus the corresponding bond rating and investor principal of the security.[8] Environmental insurance policies are designed to protect the ratings of these bond issues in the event of both a default on the mortgage and accompanying pollution conditions at the insured property.

SCP policies have what is called a "dual trigger of coverage."

- ***Dual Trigger of Coverage Concept***

SCP policies have what is called a "dual trigger of coverage." The dual trigger concept means that a prerequisite for triggering the OLB payoff coverage under the policy is the default of a qualified loan scheduled onto the policy and the discovery of pollution conditions at the insured property. The default and discovery must both take place during the policy period or the extended reporting period. Another dual trigger applies to first-party discovery of pollution conditions after the bank forecloses on the insured property.

If the bank decides to foreclose on the insured property rather than take the OLB payoff, then the insurance company will pay (on behalf of the policyholder) the environmental cleanup costs, and in some cases the associated legal defense expenses. The dual trigger in this case would be foreclosure and discovery, along with reporting of pollution conditions to all appropriate governmental agencies.

"MERGING" EFFECTIVE RISK MANAGEMENT AND ENVIRONMENTAL INSURANCE

According to the Mergerstat website (www.mergerstat.com), which posts publicly announced merger and acquisition statistics for the last 37 years, 1999 was a record breaking year, with 9,278 "total deals" and a "total deal value" of over $1.425 trillion.[9] Through the first seven months of 2000, 5,413 total deals had already been reported.[10] Keep in mind that this includes only public company announcements, and does not take into account the countless private deals that go largely unreported in the news media. With this type of merger and acquisition "mania" going strong, environmental insurance is playing an increasing role in helping facilitate otherwise unworkable transactions.

CASE STUDY: ENVIRONMENTAL INSURANCE IN A CORPORATE ACQUISITION

Two privately held manufacturing companies were recently on the verge of a $75 million acquisition deal that involved the transfer of 28 properties. The company being acquired had leased and owned properties that spanned the entire range of commercial usage, from light industrial to warehousing, from wholesale to retail, as well as office buildings.

All of the properties had their own unique set of environmental conditions, as revealed in the Phase I or Phase II environmental site assessments performed. Some facilities had newly installed underground storage tanks (USTs). Others had existing or abandoned USTs, which, depending upon their age, posed a threat of leaking. Some of the industrial facilities had existing contamination. Several had active remediation ongoing, while others had groundwater monitoring programs in place from completed prior cleanup actions. The manufacturing processes that had taken place on some of the

properties involved various chemicals, including dyes, acids, solvents, and fuel oil. Some facilities had wastewater and air discharge permits.

The Buyer's Motivation

The buyer's motivation for purchasing environmental insurance in this case arose from several factors, including its general environmental risk management strategy.

The buyer wanted protection from undisclosed and/or undiscovered hazards. This included not only pollution caused by the sellers, but also any pollution caused by previous owners and operators. Obtaining historical environmental information on some of the older industrial facilities and former industrial sites proved difficult. Thus, the buyer looked to a PLL insurance policy to protect itself from unknown first-party pollution conditions, as well as from third-party lawsuits.

Environmental insurance was also used to support the buyer's corporate indemnity agreements and personal guarantees. The purchase and sale contract, as well as the mortgage documents, required corporate indemnity agreements and personal guarantees from the buyer's individual principals to pay for the cleanup of any pollution condition existing at the sites. The buyer was accepting the 28 properties "as is" and had agreed to indemnify the seller for any future claims arising from the divested properties. This was somewhat unusual, but the buyer was eager to acquire several key facilities and was willing to accept the added risk, which it passed on to the insurance company for the cost of its insurance premiums.

Indemnity agreements and guarantees are limited by the good will and financial ability of the party granting the indemnity. For this reason, the seller sought to be named as an additional insured under the buyer's PLL policy for third-party claims; in exchange for this coverage, the seller agreed to post a negotiated sum of money into an escrow account to pay for existing pollution conditions. In this case, environmental insurance was used in conjunction with agreements to protect the indemnified party (that is, the seller) from the risk of collecting on the indemnities, as well as to protect the buyer from any unexpected pollution conditions.

The buyer also received several conditional "No Further Action" (NFA) letters from three state environmental agencies that essentially relieved the seller from performing any additional governmental required cleanup. However, the buyer wanted protection in the event of a "re-opener" that could potentially force the buyer to investigate and clean up some previously undetected pollution condition. In addition, the buyer knew that a state NFA letter does not affect the federal government's or a private party's right to seek recovery of cleanup costs.

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The buyer understood that expenditures to clean up an unexpected pollution condition, or to pay legal fees and damages to third parties, would impair profitability and cash flow, and, ultimately, its ability to cover the debt service on its mortgage. Therefore, environmental insurance was purchased to limit these unexpected liabilities.

The Seller's Motivation

The seller's motivation for purchasing environmental insurance stemmed from its desire to protect the sale proceeds and to relieve itself and its successors of contingent liability after the closing. In the absence of other protections, including environmental insurance, the seller will generally retain the environmental liability associated with its historical operations and/or ownership.

In the purchase and sale agreement, the seller was required to provide the

buyer with representations and warranties about the environmental quality of all properties in the transaction. If these "reps and warranties" are inaccurate, they can form the basis of a subsequent lawsuit for breach of contract in the event that pollution conditions are later found to exist, or if they exist in a different form than was represented and warranted. The seller purchased PLL insurance as financial backup in case its reps and warranties were later challenged and unknown pollution conditions were found to exist on an insured property. In this context, the buyer also benefited from its PLL policy, knowing that all it had to do was present a claim to the insurance company, rather than waste time and resources enforcing the reps and warranties provisions.

Other motivations also spurred the seller to purchase environmental insurance.

Other motivations also spurred the seller to purchase environmental insurance. The seller, of course, wanted to receive as much money as possible from the sale of its properties. However, several sites with known or potential environmental conditions appeared quite unattractive to the buyer unless the seller agreed to part with the properties at a deep discount. The availability of environmental insurance helped the seller protect the true value of the properties by eliminating the environmental "wild card." In this case, the seller agreed to pay the insurance premium for the buyer's PLL policy, thus taking any perceived bargaining power over the true value of the properties out of the deal's equation.

Several sites with known pollution conditions were to be cleaned up prior to, or shortly after, the real estate closing. The seller established escrow accounts to pay for this cleanup, and was also required to continue the remediation operations after the closing. Cost-cap insurance was purchased to limit the seller's potential risk on those sites with known pollution conditions. The seller wanted stop loss protection in the event the escrow amounts negotiated were insufficient for the planned remedial work. In the absence of environmental insurance, underestimating the scope of cleanup costs could have significantly impaired the cash flow of its operation. In addition, the seller was able to negotiate a lower escrow amount because the cost-cap policy was in place. For the price of its insurance premium, the seller could fix its potential exposure and accurately account for the liability on its books.

The seller also purchased environmental coverage as a form of "sleep" insurance. Being a private company, the seller wanted to walk away from the deal free and clear to the greatest extent possible. The availability of environmental insurance allowed the seller's principals to sleep soundly at night knowing their interests were protected from an environmental liability standpoint.

The Lender's Motivation

The lender in this case was a large regional investment bank that held a 70 percent security interest in the transaction, with the 28 properties held as collateral for the loan. This portfolio lender's motivation for purchasing environmental insurance stemmed from its desire to protect the value and marketability of the collateral.

The value and marketability of an environmentally tainted piece of property held as collateral for a mortgage may be severely impaired. In the event of default on the loan, the lender could be stuck with properties that have diminished in value and could only be resold at a deep discount. A SCP policy was used to protect the bank's investment by indemnifying the bank for the outstanding loan balance in the event of default, or paying for cleanup of the impaired asset after foreclosure.

The SCP policy also protected the bank from lender liability in the event of foreclosure. Although the lender liability

laws now generally shield a secured creditor from environmental liabilities, if the creditor acts like a property owner or operator, it may risk liability for cleanup costs. In addition, the SCP policy would also protect the bank in the event that third-party claims were asserted against it for bodily injury and/or property damage.

Practical Considerations

The parties to a corporate or commercial real estate transaction can often benefit from the use of environmental insurance. From asset protection to coverage of legal defense expenses, the availability of environmental insurance may be able to facilitate an otherwise unworkable deal.

The lender, the buyer, and the seller may all gain added protection from unknown environmental risks when they utilize environmental insurance as a supplement for traditional due diligence. Due diligence activities such as transaction screens and Phase I and Phase II site assessments attempt to identify environmental risk. However, as discussed earlier, due diligence may fail to uncover the entire universe of potential environmental issues at a site.

Given the complexities of any corporate purchase and sale transaction, adequate information and time is essential to ensure a smooth process for all parties involved. In addition, environmental insurance underwriters need as much information on the insured locations as possible, including all environmental reports and real estate closing documents, such as indemnity agreements. Environmental insurance underwriters also need adequate time to review all the information and to ask relevant questions.

Keep in mind that most environmental insurance policies are structured with "manuscript" endorsements, which are tailored to each client's specific requirements. Environmental risk management professionals should make sure that all interested parties and their counsel have an adequate amount of time to review and comment on the "manuscript" policy language. Some give-and-take is generally required, and the environmental risk management professional should certainly consult with an experienced environmental attorney and insurance agent or broker while negotiating policy terms and conditions.

CONCLUSION

Managing the potential environmental liabilities facing your organization may mean the difference between success and failure. Environmental insurance can play an important role here. With recent innovations in coverage and pricing, now may be the right time to consider whether your organization can utilize environmental insurance as a prudent risk-transfer tool. The integration of effective risk management and environmental insurance can enhance a company's ongoing operations and value, as well as facilitate the transfer of property.

NOTES

1. Clark, B. (2000, March). State of the "ART"—new trends in financing risk. International Risk Management Institute.
2. Mandell, R., & Gerrard, M.B. (2000, March/April). Financial Executive at 32.
3. Id.
4. Id.
5. Contractual liability coverage is available for contracts scheduled onto the policy.
6. Some insurance companies offer this coverage only for third-party claims, while others offer it for first-party claims as well.
7. This coverage typically needs to be purchased via special endorsement.
8. Environmental insurance may also provide CMBS credit enhancement and a reduction in subordination rates on lower rated traunches of CMBS securities. A full discussion of environmental insurance in the CMBS market can be found on the S&P website at www.standardandpoors.com.
9. DeBerry, D.S. (1999). Seal the deal: Bridging the gap between buyer and seller. Global Reinsurance at 34, citing www.mergerstat.com/free_reports/free_reports_m_and_a_activity.html.
10. Id.

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