ENVIRONMENTAL INSURANCE: INSURANCE AS A MEANS OF TRANSFERRING RISKS IN ENVIRONMENTAL LIABILITY TRANSFERS

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This article is the third in a trilogy of articles on Environmental Liability Transfers in this publication. Each of the previous articles identified insurance as a key consideration in the effective transfer of environmental liability from Seller to Buyer in these transactions. The Seller's key consideration is to ensure that the transferred liabilities do not revert to Seller if the Buyer cannot fulfill its ongoing and future environmental obligations. Similarly, the Buyer must ensure that it complies with any obligations imposed by the policy as Buyer remediates and then sells or develops the property. As a result, parties wishing to utilize insurance as a tool regarding their deal must carefully negotiate an acceptable policy with the insurers. Environmental Liability Transfers (particularly those that are "upside down" as described in the previous articles) present some unique challenges for insurance coverage. However, because each deal is unique, the parties must understand the basic applicability and availability of insurance products in order to determine their applicability to their particular transaction.

Traditional tools to allocate risk, including indemnification clauses, representations and warranties, and escrows, are not always applicable in a liability transfer and cannot always resolve disputes over environmental risks. The unique situations encountered in Environmental Liability Transfers have further increased the need for alternative risk allocation options. The insurance industry has gradually developed a broad range of risk-specific environmental insurance products to meet the needs of the parties involved in these transactions.

The environmental insurance products available today differ from the traditional comprehensive general liability policies that spawned decades of litigation over environmental coverage issues. Although environmental insurance has been available since the early 80s, it wasn't until about 10 years ago that insurance companies began offering policies with broader coverage and at more competitive prices, resulting in a viable mechanism to transfer certain environmental risks. Numerous factors, including the insurance industry's growing experience in underwriting environmental risks, the expansion of the market, and the regulatory trend favoring risk-based cleanups, have increased the availability of broader insurance coverage for reduced premiums. Environmental insurance policies can be tailored to specific situations and, particularly when used in conjunction with more traditional risk shifting mechanisms (indemnifications, representations and warranties, escrows, etc.), these policies can be very useful in transferring certain types of environmental risk.

This article focuses on the Pollution Legal Liability policy, the most common choice for transferring risk in the Environmental Liability Transfer context. The article will also summarize the standard environmental insurance products, identify several companies offering these policies, outline the process for binding coverage, and discuss a number of issues to consider in evaluating and negotiating environmental policies.

Types of Environmental Policies

While the majority of environmental policies are provided on a surplus lines basis, with each insurer having its own coverage forms, the policies commonly offered can be summarized as follows:

1. <u>Pollution Legal Liability Policy (PLL) (also Premises Pollution Liability or Environmental Impairment Liability)</u>. Depending on the company providing the insurance, basic policy coverage includes the cost of cleanup (on-site and off-site) required by law and third party bodily injury or property damage arising from known and unknown environmental contamination.

2. <u>Cleanup Cost Cap Policy (CCC) (also Remediation Stop Loss)</u>. With CCC, coverage is designed to limit the cost of remediating known contamination by covering costs that exceed the original cost estimate

based on the approved remediation plan, or to cover new or additional contamination found after the cleanup work begins. This coverage is often purchased in addition to a PLL in the Environmental Liability Transfer context.

3. Contractor's Professional Liability (CPL). The CPL policy is written to cover third party claims for bodily injury, property damage, or cleanup costs that result from a pollution condition associated with environmental work performed by contractors, consultants, or architects. CPL includes coverage for claims related to pollution conditions caused by the negligent acts, errors, or omissions of the contractor.

4. Lender's Pollution Liability Policy (LPL). The LPL policy is designed to protect lenders from environmental risks associated with real estate being held as collateral for a loan. Generally, coverage is limited to the lesser of (i) the outstanding balance of the loan, or (ii) the cost of cleaning up the contamination.

Application

The process of securing insurance coverage for environmental risks starts by engaging an experienced attorney and contacting a broker. Initial conversations should focus on the risks to be transferred and the information known about those risks. Once the risks, or potential risks, are understood, the broker will submit this information to the insurance market and seek to procure multiple coverage proposals, often referred to as an indication. A growing number of companies sell environmental insurance policies, including: AIG Environmental, ACE INA, Chubb, XL Insurance, and Zurich. It is important to obtain and evaluate multiple proposals. While many of these companies offer similar types of policies, distinct variations exist in each insurer's standard form policy, also known as a specimen policy. Furthermore, individual companies make different underwriting decisions affecting the breadth of coverage offered, the level of premiums charged, and the insurer's relative willingness to tailor policy language to meet the needs of a particular insured.

Once a specific company has been selected, or the list of prospective insurers has been narrowed, an application will need to be prepared. While there will always be deal-specific issues, the following are some of the basic issues that should be considered when preparing an environmental insurance application:

Disclosure of Documents

One of the most important issues with the application is the disclosure of documents. The application will include inquiries concerning the applicant's knowledge about environmental conditions and a request for any environmental surveys/audits related to the subject property for at least the last three years. It is in the applicant's best interest to provide all documents related to environmental issues at the property. The insurer will deny coverage should a claim arise from a condition that was known to the insured and not disclosed to the insurer during the underwriting process. The known-but-not-disclosed pre-existing condition exclusion underscores the need for policyholders to be extremely thorough in completing applications, and in documenting the materials provided to the insurance company during the underwriting process. The insured should ask the insurer to acknowledge receipt of each specific document and the insured should also keep a separate copy of all documents provided to the insurer.

Identification of the Named Insured

Identification of the named insured and additional named insureds, if any, can be very important. In the liability transfer setting, policies frequently need to permit multiple parties to make a claim. This is accomplished by identifying additional insureds and/or additional named insureds, with each title carrying different rights and responsibilities under the policy. In such situations, the first named insured should consider obtaining a severability endorsement to minimize the possibility that a claim by one insured could be jeopardized by an act, omission, or knowledge of another insured. The first named insured may also want to consider a sub-limit on the coverage available to an additional named insured and/or additional insured in order to reduce the possibility of other claimants significantly reducing the coverage limits available to pay claims made by the first named insured.

Operations of the Insured

Most policies include a provision whereby coverage will be denied if there is a material change in use at the facility. The change of use is directly tied to the description of the insured's operations provided in the application. Therefore, the description of the insured's operations on the application can be very important.

Underwriting

After submission of the application, most insurers provide a relatively quick turnaround on an initial indication. This document will provide certain initial terms of coverage, premium with deductible amounts, length of coverage, etc. The insurance companies will also provide a specimen policy with some endorsements that modify the specimen. After the underwriters have a chance to review all the information disclosed in the application, the insured will receive a new indication, sometimes with a revised premium amount and new endorsements.

Coverage

While there are dozens of different environmental insurance products, the PLL model is most often used in the Environmental Liability Transfer setting. Within a PLL policy, there are typically nine coverage options. The coverage options generally include: on-site cleanup of pre-existing conditions; on-site cleanup of new conditions; third party claims for off-site cleanup from pre-existing conditions; third party claims for off-site cleanup from new conditions; third party claims for on-site bodily injury and property damage; third party claims for off-site bodily injury and property damage, third party claims for on-site and off-site clean up and liability at non-owned disposal sites; and transporter liability. Applicants should carefully review the indication to determine which of the nine coverages are being offered, as well as the specific scope of coverage, as it will vary by insurer.

The policy term and any extended reporting periods are important as well. PLL policies are typically issued as claims made or claims made and reported policies, rather than on an occurrence basis as historically was the case with comprehensive general liability policies. With a claims made PLL, coverage generally is provided only for claims made against the policyholder and reported to the insurance carrier within the policy period and/or an extended reporting period. Therefore, the policy term, any extended reporting period(s), and the policyholder's right to renew the policy are extremely important in analyzing the extent of the coverage provided.

Costs

Most environmental policies are written so that all, or substantially all, of the premium is deemed to be earned as of the start of the policy period, and the insurance company typically will not refund any of the premium if the policy is later cancelled. Premiums paid for certain types of environmental policies may be tax-deductible as an insurance expense. In addition to the quoted premium, the insured typically must pay surplus lines taxes, which vary significantly by state. Depending on the number of sites to be insured and the state(s), some options can be exercised to minimize the taxes. The broker is paid by commission. The percent commission will be identified on the indication. The typical range is between 10 percent and 15 percent of the premium.

Specific Terms

The value of an environmental insurance policy is not only the amount of the coverage, but the terms and conditions under which the coverage is provided. The term of the policy, the monetary limits of the policy, the amount of the premium, the deductible or SIR (self-insured retention) and whether the deductible is aggregated are among the basic criteria typically used to compare indications. However, numerous other terms and conditions can dramatically affect coverage. Significantly, insurance companies selling these types of policies are often willing to negotiate modified policy language in an attempt to minimize ambiguities and address concerns raised by potential policyholders. When evaluating policies and indications, a prospective purchaser should review the entire policy and attempt to modify ambiguous or unfavorable language.

Exclusions

As with any insurance policy, there are many exclusions and provisions that limit the coverage afforded under environmental policies. Below are some of the more common exclusions that can jeopardize coverage for certain risks that frequently arise in an Environmental Liability Transfer scenario:

<u>Cancellation.</u> The insurer may cancel the policy for the following reasons: misrepresentation by an insured, failure to comply with the terms of the policy, failure to pay the premium or deductible, or a change in operations.

<u>Contract.</u> Liabilities assumed by the insured by operation of contract will be excluded from coverage, unless the contract is specifically identified in a manuscript endorsement as an insured contract. In a liability transfer context with any indemnification obligation, it is imperative that the transfer agreement be scheduled as an insured contract.

<u>Definition of a Claim</u>. The policy may include a definition of a claim such that the policy only covers cleanup costs incurred in response to written claims asserted by a third party or a government agency.

<u>Excluded Hazards.</u> Most PLL policies contain specific exclusions or limitations on coverage related to asbestos, lead paint, and mold.

<u>Fraud/Concealment.</u> If any material facts or circumstances were concealed from the insurer relating to the granting of coverage, the description of any of the insured properties, or the interest of the insured in such properties, the entire policy may be void.

<u>Intentional Noncompliance.</u> Any claims arising out of intentional noncompliance that was not disclosed to the insurer will not be covered.

<u>Known Condition Exclusion.</u> The insurer will almost certainly exclude coverage for any known environmental conditions, as defined in the policy. If there is a manuscript endorsement that excludes from coverage a particular known contaminant, the insured will want to consider negotiating a re-opener to the coverage based on satisfactory cleanup of the known condition. Based on recent case law, the insured will also want to pay particular attention to the drafting of this exclusion and seek to limit the exclusion to the specific known release of a particular contaminant instead of the contamination in general. See *Denihan Ownership Co., LLC v. Commerce and Indus. Ins. Co., et al*., 37 A.D.3d 314 (N.Y. App. Div. 2007) and *D.C. USA Operating Co., LLC v. Indian Harbor Ins. Co., et al*., 2007 WL 945016 (S.D.N.Y. Mar. 27, 2007).

<u>Non-disclosure.</u> Any claims related to conditions known to an insured and not disclosed to the insurer will not be covered.

<u>Material Change in Use.</u> The insurer may cancel the policy based on a change in use from the intended use at any of the facilities. The intended use is defined in the application and typically mirrored in a cancellation endorsement.

<u>Underground Storage Tanks.</u> The policy typically will not cover claims related to Underground Storage Tanks (USTs) that are known by the insured unless the UST is disclosed to the insurer. The specifics of the UST generally must be included on a schedule to be included in coverage.

<u>Voluntary Environmental Investigation</u>. Some policies attempt to restrict a policyholder's right to perform intrusive investigations in the absence of a directive from a regulatory authority. Potential insureds should carefully consider whether this is practical given the possible changes in the use of the property, future expansion or development, or the likely demands of the policyholder's lender(s), potential purchaser(s), or tenant(s).

Additional Considerations

In the Environmental Liability Transfer context, it often is necessary to coordinate the interaction between environmental insurance and traditional risk transfer mechanisms. For example, if an escrow is to be established as part of the transfer or if a potential policyholder may have a right to recover cleanup costs from other responsible parties, the policyholder should consider (a) seeking an endorsement designed to maximize the policyholder's ability to pursue different alternatives and the order in which those options are pursued (i.e., recovery under the policy, from the escrow and/or from other responsible parties), and (b) explicitly limiting the insurance company's recourse against the escrow.

Upon binding (buying) the policy, you will receive a binder which is a draft of the policy, endorsements, and the indication. Be sure to review the binder to ensure it reflects the negotiated changes. Some time (often a few months) after the policy is bound, you will receive the final policy. Again, be sure to review the final document to ensure all the requested changes and manuscript endorsements are attached to the policy.

Conclusion

When faced with the potential for acquiring environmental risk, or when looking for a way to minimize potential exposures, environmental insurance can be a cost effective option to transfer certain risks. Although it has been utilized in many Environmental Liability Transfers around the world, every environmental insurance policy must be negotiated with a specialized understanding of the environmental issues and the insurance industry, to ensure that the policy is appropriately tailored to the particular Environmental Liability Transfer.

LIKE TO WRITE?

The Environmental Transactions and Brownfields Committee welcomes the participation of members who are interested in preparing this newsletter. If you would like to lend a hand by writing, editing, identifying authors, or identifying issues please contact the one of the co-editors:

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IS IT HOT IN HERE? PRACTICAL POINTERS FOR CLIMATE CHANGE DISCLOSURE

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As greenhouse gas (GHG) emissions take their turn in the spotlight of the environmental movement, public companies are facing increasing pressure to determine their carbon footprint and make this information available to their investors. This article highlights recent attempts to push companies for more GHG disclosure in their public filings and offers some practical pointers on climate change disclosure.

I. Subpoenas and SEC Petitions

On Sept. 14, 2007, New York Attorney General Andrew Cuomo issued subpoenas under the state's securities law to five energy companies seeking information regarding their analysis of climate change risks and their disclosure of these risks to investors. (Copies of the letters accompanying the subpoenas are available at http://www.oag.state.ny.us/press/2007/sep/sep17a_07.html.) The attorney general expressed concern that these companies provided little or inadequate disclosure relating to the financial, regulatory, and litigation risks arising from carbon dioxide (CO_2) emissions and existing and proposed GHG regulations. He specifically noted the lack of disclosure concerning the additional amounts of CO_2 likely to be emitted if the companies proceed with planned projects to build coal-fired power plants.

Separately, on Sept. 18, 2007, a twenty-two member coalition consisting of Environmental Defense, Ceres, the New York attorney general, state treasurers and comptrollers, pension fund managers, and others petitioned the Securities and Exchange Commission (SEC) to provide interpretative guidance on climate risk disclosure. (The petition is available at http://www.ceres.org/pub/docs/Full%20Petition.pdf (hereinafter the "Petition").) The Petition requests that the SEC issue an interpretative release clarifying that