TAILORED TO FIT

by Susan Neuman

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More sophisticated insurance tools are making it easier to protect your property

Contaminated properties represent a huge investment opportunity, but much of it lies untapped because of environmental liability concerns. Anyone who buys property that is actually or potentially contaminated should consider insurance as a risk management option, and they should do so very early in the brownfield transaction process. Two types of insurance policies are now available that provide meaningful and inexpensive coverage to sites that are actually or potentially contaminated: the new pollution liability policy and the cleanup cost cap policy. It's important to understand these policies and know how to use them most effectively as part of the contaminated-property transaction process.

The pollution liability policy

The original environmental policy primarily sold by AIG, Zurich and ECS (now XL) from the early and middle '80s to the mid-'90s was highly restrictive and very expensive. It covered damages caused by pollution conditions at a specific site and was known as the environmental impairment liability (EIL) or pollution liability (PL) policy. Trigger of coverage was not an occurrence, but a claim made and reported during the one-year policy period. Pre-existing pollution conditions were covered only if they were unknown. The new PL forms issued by five companies each have different names, but provide basically similar coverage. As outlined in the table, coverage applies to pollution conditions from or at a specified location. The pollution condition can be new, meaning it can happen during the policy period and arise out of ongoing operations. It can also be pre-existing and unknown‹or known, as long as it is disclosed on the application and not otherwise excluded. A pre-existing known condition will typically be covered if the environmental agency has issued a no-further-action letter with regard to the known condition; this is known as "re-opener" coverage. The ability to cover known pollution was a huge advantage over the earlier PL policies, which strictly excluded known pollution. The cleanup cost cap policy also has this ability but uses it in a different way.

The pollution condition inevitably leads to or causes certain damages. The primary damages covered by these policies are third-party bodily injury and property damage and cleanup costs. Other types of damages that may be covered include business interruption, transportation, costs of delayed construction and natural resource damages. All the policies cover on-site or first-party cleanup costs, in contrast to the old policies, which were strictly third-party or off-site. But the current policies differ in the extent to which they explicitly cover voluntary cleanup costs. The Gulf, Kemper and Zurich policies do so explicitly by reference to risk-based corrective action (RBCA) standards or voluntary cleanup plans. The AIG and XL policies do so only implicitly, by using a discovery trigger for cleanup costs.

The trigger of coverage for cleanup costs is usually a claim made and reported or a condition discovered and reported during the policy period. A "double trigger" used to be an onerous requirement when the policy periods were one year in length. However, the double trigger no longer seems to matter much because the policy periods can be as long as 10 years. A related issue is whether the policies have a "tail" of some kind, such as the AIG policy five year notice of potential claim provision.

All the policies have a duty to defend and cover defense costs, although within the limits of liability. Unlike the other three, the Kemper and XL policies define defense costs as a separate coverage rather than as something associated with other coverages. In fact, the main division among policies is in how they divide the world of damages, and with how many resulting separate insuring agreements or coverage parts. All the policies have multiple coverage parts or insuring agreements, ranging from two to 10. Two of them (AIG and United Capitol) separate coverages by distinguishing current from pre-existing conditions. Three of them (AIG, United Capitol and Zurich) distinguish first-party or on-site cleanup costs from third-party or off-site cleanup costs. The ones that have more of these distinctions (i.e., AIG and United Capitol) are more flexible than the others are, but they are also more confusing.

Flexibility is another advance over the old policies. It means that the policies (and underwriters) are more amenable to tailoring a specific policy to a specific transaction or liability, which is a vital part of the insurance role in the transaction process. Such tailoring is achieved not only by shuffling of coverage parts, but also by re-drafting or "manuscripting" of special endorsements. In order to assure that the policy matches the liability and the transaction‹and truly protects the insured‹environmental insurance experts should review and negotiate these provisions with underwriters on behalf of the insured.

In terms of cost, the policies are rated based on a variety of considerations, including specific site assessments and subjective factors. There can be a great variation in prices quoted for the same risk by different carriers because of these considerations and because of the flexibility and manuscripting involved in creating particular forms. Therefore, generalizations about price are difficult. However, underwriters from all five companies agree that for the average PL policy‹one location with some existing contamination, $5-million limits, a five-year term and a $50,000 deductible‹the total premium would range between $35,000 and $45,000.

What's new
The cleanup cost cap policy is an entirely new and highly innovative policy that was probably the first response to the need for coverage of known pollution created by the movement to redevelop brownfields. While the PL policy may cover future liability arising out of known contamination, the cost cap policy addresses the situation where the known pollution has already resulted in a claim and remediation is planned. It essentially covers cost overruns above an estimated or guaranteed cost. These policies are enormously useful in such brownfield situations because they assure that the costs will be capped and because they provide a clear method of quantifying the risk. Another advantage of the cleanup cost cap policy is that it can be used as a financial assurance mechanism for corrective action under RCRA.

As this is written, Kemper and ECS are at least temporarily not writing the cost cap policy, presumably because of adverse loss experience. This kind of thing is to be expected. The cleanup cost cap policy, unlike the PL policy, is relatively new, and underwriting decisions must suffer from a lack of experience and loss history. Undoubtedly, the companies will soon be issuing the policies again.

These policies are even more heavily manuscripted and tailored to specific transactions than the PL policies. Generally, however, the covered cleanup cost overruns must be connected to a remedial action plan, with a particular scope of work, at the location defined in the remedial study. The remedial plan often, but not always, must be approved by a regulatory agency. The policies usually cover unknown as well as known pollutants, change orders and increased levels of pollution.

The carrier issuing the cost cap policy indemnifies the insured for costs above the self-insured retention (SIR), which is usually identical to the estimated costs plus a buffer or additional retention level. For instance, a $1-million cleanup may require a $100,000 retention amount. This means that coverage under the policy begins after $1.1 million has been spent on the covered remediation project. Pricing credits are granted to insureds who elect to co-insure above the retention level. As with the PL policy, coverage periods can be for as long as 10 years or more.

The cost cap policy premium is based on a percentage of the guaranteed costs in combination with the limits (assuming the limits are almost equal to the cost of the cleanup). Until recently, the range was said to run between 4 percent and 10 percent for a cleanup of up to $10 million. However, those percentages may have increased to as much as 15 percent due to adverse loss experience. It is also difficult to give an average price for a typical policy, because price depends on size of cleanup.

If the estimated cleanup costs are sufficiently high, it is possible to purchase what is known as "finite risk insurance" to apply to the estimated costs and therefore the SIR. Finite risk insurance is essentially a funding mechanism, somewhat like whole life insurance. It allows the insured to pay a premium representing the net present value of the estimated costs. The insurance company invests that premium and is therefore assuming the financial and timing‹but not underwriting‹risks connected with the property. Such finite risk insurance, applied to the estimated cleanup costs, can provide substantial tax advantages as well as the opportunity to remove environmental liabilities from the company's balance sheet.

Fitting insurance into the program
There are two basic guidelines for using these policies most effectively in a contaminated property transaction: (1) Environmental experts should structure the transactions including the use and placement of the policies, and (2) they should make the policies an integral part of the transaction process from the beginning. That does not mean that a policy should be purchased every time you are investing in contaminated property. But people who

understand environmental risk and environmental insurance coverage should always consider such a policy, up front, along with other risk management options.

It seems obvious that environmental experts should manage the entire contaminated property transaction process, just as environmental engineers are clearly needed to perform environmental risk identification and environmental risk control, and environmental transactional lawyers are needed to handle liability concerns and negotiate the environmental provisions of the contracts. While it may be obvious, many transactions have floundered because these people were not called on.

By the same token, environmental insurance experts must take part in the environmental insurance process. This process, like any insurance process, consists of brokering‹including information gathering and marketing of the risk‹underwriting, selection among quotations, and negotiation of policy language. The five companies mentioned here all have environmental underwriting experts on staff, many of them with engineering and legal experience. Similarly, brokers should understand environmental risk, environmental underwriting and environmental coverage under these types of policies, so they can ensure that the policy will match the risk. They should also be able to market the risk to all of the carriers mentioned. Price and coverage among quotations for one particular risk can vary surprisingly because of the increased flexibility of the policies and because environmental underwriting is more art than science.

Insurance should come up early in the deal process during the preliminary, informal stages leading to a letter of intent. This is when the buyer and seller have their initial discussions about liability concerns and indemnification objectives. Insurance is increasingly viewed as preferable to indemnification for pre-existing contamination or at least as a vehicle to assure the financial responsibility inherent in the indemnification. In the more formal stages of negotiating the purchase and sales agreement, insurance can be one of the environmental risk allocation provisions, along with the warranties and representations, the covenants and the indemnification clauses. During these formal stages, when the insurance and transaction processes come together, the policy terms will be thrashed out in a way that dovetails with the terms of the agreement and the underlying liability.

These two insurance policies can mean the difference between the success and failure of a transaction involving contaminated property. They can remove environmental risk from contaminated property by transferring it to a financially sound insurer and thus turn distressed property into a solid investment.

Sidebar
Setting an example
In early 1998, LandBank, a leader in brownfield development, became aware of a 14-property portfolio that an oil company was interested in divesting. Twelve of the sites were former bulk oil storage terminals. The seller wanted to divest all 14 properties as a portfolio, but also wanted full indemnification from the buyer for all pre-existing environmental conditions and damages arising from the site, whether known or unknown. LandBank responded by presenting the seller with two types of policies‹a cleanup cost cap and environmental liability policy‹which could be used as a means of supporting the financial responsibility in the indemnification. The cost cap policy would insure the estimated cost to remediate known conditions at the sites to standards sufficient to achieve no-further-action letters. The environmental liability policy would cover first-party (on-site and adjacent site) cleanup arising from pre-existing conditions, known and unknown, after a no-further-action level or letter was achieved, as well as for third-party cleanup costs, bodily injury and property damage. These policies were designed to dovetail with each other so that third-party coverage under the PL policy would be effective immediately, while its first-party coverage would be effective when the cost cap policy coverage expired.

Because several sites had a lower real estate value than originally thought, the purchase and sale agreement had to be renegotiated, and LandBank had to reduce expenditures in order to maintain as much of the sales price as possible. Insurance was one of these areas, so LandBank arranged with the insurer to purchase blanket policies for most of the sites, rather than individual policies for all sites.

LandBank’s insurance experts worked with the underwriter and the insurer to tailor the policies to fit these requirements and to adjust per-site limits, policy aggregate limits and deductibles. The purchasing entity, a LandBank subsidiary, and the selling entity were made named insureds. LandBank is currently managing remediation at eight sites, all of which are expected to close in 2000 except for one.

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