

New Environmental Insurance Products to Mitigate Environmental Risks

By Howard Tollin and Daniele Cervino

Given the scarcity of suitable land for development in some parts of the country, it has become necessary to remediate areas with identified pollution. Recent federal and state brownfield laws have provided significant tax credits and other financial incentives for developers to clean up and redevelop properties with historical contamination issues. This is particularly true where changes in the character of a neighborhood have resulted in the possibility of future uses that differ from those of past periods. For example, housing shortages have resulted in a rezoning in many neighborhoods from commercial to residential use. As a result, lenders receive an increasing number of loan applications for commercial properties with potential or actual environmental impairments.

Most lenders have become familiar with the use of environmental insurance as the means to provide protection to both them and their borrower from the consequences of defaulting on the loan due to a pollution condition. A pollution condition is typically defined as the discharge, dispersal, release or escape of any solid, liquid, gaseous or thermal irritant or contaminant—such as smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, medical waste and waste materials—into or on land, a structure on land, the atmosphere or body of water. Because such pollution conditions affect the ability of the borrower to repay the loan, environmental due diligence and insurance products are now deemed a necessary part of risk management. Borrowers and lenders regularly use environmental insurance to provide cost certainty to the estimated clean-up

costs for a known pollution condition and to provide protection to the borrower and lender for unforeseen circumstances that can typically arise with redevelopment projects.

New environmental insurance products have taken the place of contractual escrows or environmental indemnity agreements in many complex commercial lending transactions. They can provide additional protection that addresses a wide range of environmental uncertainties and improves credit ratings for large securitizations. The new insurance products can also be used to manage and quantify risks prior to foreclosure.

Environmental liability insurance policies replaced general comprehensive liability policies that contained absolute pollution exclusion since the late 1980s as the mechanism for covering environmental liabilities and remediation costs. Environmental liability insurance includes coverage for liability for known losses, for example, expected remediation costs (known as cleanup cost cap coverage), and liability for unknown losses or claims, for example, preexisting unknown or known pollution that has not yet resulted in a claim (that is, a third-party claim for property damage or bodily injury) caused by pollution and legal defense costs.

Borrowers and lenders regularly use environmental insurance to provide cost certainty to the estimated clean-up costs for a known pollution condition.

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Secured Creditor Policies

On properties that do not appear to have any potential environmental issues, some lenders have purchased a policy, often called a secured creditor portfolio policy, that enables them to insure the loan against environmental liabilities without requiring Phase I and/or Phase II reports. The coverage under these policies will either pay the lender the loan balance or the cleanup costs, whichever is less, if there is a default on the loan associated with a pollution condition. The secured creditor policy was designed to protect the lender from financial losses due to defaults caused by environmental conditions. The policy coverage can be customized depending upon whether the transaction is for a single-site, portfolio or securitizations. Some lending institutions use this policy as an alternative for a Phase I site assessment for seemingly green properties.

For a property with known or potential historical contamination issues, that loan will be denied inclusion into the portfolio policy. For a property loan not qualified for the portfolio policy, lenders may request that the borrower pay for a secured creditor policy for the individual property that would provide protection to the lender if there were a default on the loan. These portfolio and individual lender policies were more attractive in their first iteration when the lender was repaid the loan balance regardless of the amount of cleanup costs. This market has tightened considerably over the last few years due to significant loss history. Secured creditor policies protect only the lender and not the borrower. Insurers have further narrowed the coverage available under these policies. Borrowers have been faced with purchasing the secured creditor policy for the lender and purchasing a separate pollution liability policy (discussed below) to protect themselves against claims. The economics of the transaction, however, may not warrant that the borrower purchase both policies, particularly when there is an alternative solution. Many lenders are now requiring the borrower to purchase a pollution liability policy on which the lender is named an additional named insured, rather than requiring the purchase of the secured creditor policy.

The secured creditor policy was designed to protect the lender from financial losses due to defaults caused by environmental conditions.

Pollution Liability Policy

The pollution liability policy is an effective tool to protect the borrower and lender from an environmental exposure that threatens the repayment of the loan. Coverage under a pollution liability policy can be afforded for on-site and off-site cleanup of pollution conditions, claims by third parties for on-site and off-site bodily injury and property damage, claims by third parties for on-site cleanup of disposal sites used during the cleanup of hazardous materials, costs of defending claims and lawsuits, and business interruption losses.

Often, the borrower is the purchaser of a brownfield property that is being redeveloped.

The risk of a default on a loan because of a pollution condition may be attributable to the borrower facing liability for an unknown preexisting condition that was present and undetected before purchasing the property or for a known

pollution condition that was being remediated. In addition, the borrower may become liable for a new pollution condition that arises after taking ownership of the property. The pollution liability policy generally covers unknown conditions. Sources of potential liability on a redevelopment project, which can be covered by a pollution liability policy, include the following:

- An unknown pollution condition is discovered while remediating a known pollution condition, or a pollution condition is discovered during redevelopment of the site.
- Regulators determine that additional cleanup is needed for a prior pollution condition, or cleanup standards change that dictate more stringent cleanup standards.
- Neighbors file third-party claims alleging that pollution has migrated from the subject property and has damaged their land.
- Tenants allege bodily injury or property damage as a result of exposure to toxic substances on the subject property.
- Owners of neighboring properties claim that the values of their real estate have been harmed by

the presence of pollution on the subject property (stigma or diminution of values).

- Natural resource damage claims are filed by trustees of state or federal governments where permanent irreversible environmental damage is alleged.

If the borrower is covered for these risks, it is less likely that the borrower will default on the loan due to a pollution condition. The lender should also be included as an additional named insured on the pollution liability policy for any claims against the lender, whether or not attributable to a default or foreclosure on the loan. Upon foreclosure, the policy can be assigned to the lender. Pollution liability policies are typically written for terms of five to 10 years, with sufficient limits of liability that are deemed necessary by the borrower and lender to protect the property's value and loan amount.

Cost Overrun Insurance

Many brownfield property transactions have some required cleanup, and a remedial action plan to address the contamination may or may not be approved by a regulatory agency. The cost cap insurance policy provides protection against unexpected cost overruns in executing the remedial action work plan. The policy can provide limits from 100 percent to 200 percent of the estimated cleanup costs and typically contains two insuring agreements. One is for known pollutants; the other is for unknown preexisting pollutants discovered during plan implementation. Cost overrun insurance can provide the lender with comfort that there are sufficient funds in place to clean up the property, which significantly decreases the likelihood of a default due to insufficient funding of the cleanup obligation.

The insurer agrees to pay cleanup costs in excess of a self-insured retention that the insured incurs for the cleanup of pollutants identified in the remedial plan. The policy pays for cleanup costs in excess of the self-insured retention that the insured incurs for the cleanup of pollutants.

The attachment point for coverage in the cost cap policy is established by adding a buffer or self-in-

sured retention (SIR) to the expected cleanup costs. Buffers typically range from 10 to 100 percent of expected cleanup costs. For cleanups where the expected costs are less than \$1 million, the buffers tend to be larger than for cleanups where higher remediation costs are anticipated. Since the buffer may represent an additional amount that must be borne by a borrower, it may be necessary to have the borrower escrow the amount of the cleanup costs and buffer that comprise the total SIR.

Coverage under a pollution liability policy can be afforded for on-site and off-site cleanup of pollution conditions.

One of the important terms is the definition of "cleanup costs." This is usually specified in an endorsement to the policy, which should be the detailed estimate of costs provided by the contractor performing the

remediation. The insured should have its engineers who are responsible for the execution of the remedial plan prepare the estimate of costs.

Another important endorsement is the identification of the "scheduled contractor." This endorsement should identify the firm that has contracted to perform the approved remedial action plan. This can be changed in the event of a default by the contractor.

The coverage under a cost cap policy ends when the remedial action plan has been completed or at expiration of the policy period. All cost overruns must be incurred during the policy period to be covered, since these are claims-made policies and not occurrence-based policies.

Insured Guaranteed Fixed-Price Remediation

One factor that should be viewed favorably by a lender is when the borrower has arranged to have the remediation work done under an insured guaranteed maximum cost contract. Under such a contract, the remediation firm bears the costs in excess of the amount that is specified as the guaranteed maximum that is not covered by the insurance included in the contract. The contractor may further guarantee the cleanup to the satisfaction of the regulators notwithstanding policy period or cost limitations in the cost cap policy. Contractors that are willing to offer these

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contracts will typically add a buffer or contingency cost to their own estimates of the costs so they are less likely to experience cost overruns. Insurers will consider this in determining if any buffers are required in establishing the self-insured retention for the policy.

The cost cap provides protection against known pollution conditions and incidental unknown conditions that are discovered in the course of executing the remedial action plan. Pollution liability insurance should be purchased at the same time cost overrun insurance is purchased for environmental risks not

attributable to the cleanup. Certain contractors, including Environmental Waste Management Associates, will offer a guarantee and have a combined form policy that provides both cost cap and pollution liability coverage to provide a comprehensive risk mitigation package for the lender and the borrower.

In the event of a loan default or foreclosure, environmental insurance policies protect a lender from a wide range of environmental exposures arising from pollution conditions at the property used as collateral for a loan.

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