ENVIRONMENTAL INSURANCE BASICS

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ABSTRACT

What do "brownfields," M&A transactions, real estate transactions, pollution remediation, and military base closures have in common? All represent potential environmental liability exposures that may be managed by using various environmental insurance products. Environmental problems are not restricted to big chemical manufacturers or toxic waste haulers. Almost any small business (e.g., dry cleaners, farmers, mini-storage operators, gas stations) as well can have significant environmental risks resulting from its operations or (previous) uses of its site. A business even may be responsible for cleaning up contaminants that migrated to its site if the responsible party cannot be found or is insolvent.

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Expanding Environmental Insurance Market

Insurance agents often mistakenly overlook the environmental risks faced by "main street" businesses, and their clients are unlikely to call attention to these exposures.[1] Many agents think environmental coverage is just for environmental-oriented accounts (e.g., asbestos-abatement contractors, Superfund sites), but any business that regularly deals with materials that insurers consider environmentally hazardous can benefit from environmental coverage.[2] Unfortunately for businesses that forego such coverage, standard general comprehensive liability (CGL) insurance policies written since 1985 contain a pollution exclusion, and insurance companies have been reluctant to pay for pollution occurring before 1986 under policies then in force.[3] Businesses that ignore potential environmental exposures are essentially self-insuring environmental liabilities. As typical pollution losses range between $200,000 and $400,000, an uninsured loss may be more than a small business can handle.[4] The CGL's exclusion bars coverage for bodily injury or property damage resulting from "the actual, alleged or threatened discharge, dispersal, seepage, migration, release or escape of pollutants" from the insured's premises and goes on to exclude any loss, cost, or expense arising out of any request or requirement to clean up any pollutant. It defines pollutants as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals, and waste. Waste includes materials to be recycled, reconditioned or reclaimed." Every day, many businesses use materials that fit this definition. For example, pesticides are fine on trees in an orchard, but not in ground water supplies.

Environmental liability concerns have derailed numerous business transactions since Congress began enacting "pollution" legislation in the 1970s. A recent study across a range of industries found that (1) 50% had declined to purchase environmentally damaged property, and (2) a significant number of business transactions—including mergers and acquisitions—failed for environmental reasons.[5] Further, corporate planners have been challenged by the magnitude and uncertainty of potential environmental liabilities. For example, even remediated sites receiving "no further action" letters from state environmental officials may be subject to further liabilities as state environmental agencies reopen files in response to advances in science and shrinking levels of "acceptable" contamination. Such risks can be transferred from property owners to environmental insurance companies.[6]

In the past decade or so the scope of coverage of environmental insurance products has greatly increased while prices have been kept down by competition among insurers. As these products have evolved since the 1980s, they have become more flexible and can be tailored to fit a specific set of environmental problems.

Various Environmental Insurance Products Offered

Environmental insurance may provide first-party (insured's premises cleaned up) or third-party (liability) coverage. Table 1 lists some of the businesses/professional services and risks that may be covered. Policies may be written on an "occurrence" basis, only covering losses that occurred during the policy period, or on a "claims made" basis, covering any claim presented during the policy period even if the loss occurred in a different policy period.

Environmental insurance policies permit a number to be placed on environmental risk in a real estate or M&A transaction. Rarely today does a commercial real estate transaction take place without addressing possible environmental problems. Property buyers have no desire to inherit legacy environmental liabilities. Sellers want to be "free" from their former properties and not find themselves responsible years later for pollution on these sites. Lenders are concerned that the borrower's cash flows may be seriously impaired due to unforeseen cleanup expenses thus affecting the borrower's ability to service the loan. Worse, the lender may become responsible for the cleanup if they have to foreclose on the property. Traditional Phase 1 site assessments, designed to evaluate a site's history and identify potential environmental problems, do not adequately deal with these transactional risks, but they may be transferred to insurers.

Risk management consultants are increasingly involved in M&A transactions to assist both buyers and sellers to assess—and possibly insure against—environmental risks. Premiums—which can vary widely—are affected by the length/level of coverage, deductible amounts, coinsurance, and site specifics and can easily run between 2% and 10% of the purchased insurance limit.[7] Policies are available with coverage limits of $75 million (or more) and policy periods of up to 10 years. Here's an overview of some of the environmental insurance policy types that are now available.

<u>Pollution legal liability</u> covers remediation costs of unknown pre-existing and new pollution conditions. It covers both on- and off-site remediation expenses, contamination-caused bodily injury and property damage—including sick building syndrome, costs that result from project delays due to contamination cleanup, neighboring properties' value declines due to contamination at the insured's site, legal defense expenses, and—with appropriate policy enhancements—underground storage tanks.

<u>Cost cap coverage</u> provides protection against a more expensive than anticipated cleanup of known conditions such as more contamination found than was expected, a different contaminant also discovered that requires remediation, contamination found to have migrated to adjoining properties that also require cleanup, or legal changes during the cleanup that require a more thorough cleanup than originally anticipated.

<u>Secured creditor impaired property coverage</u> encourages lenders to finance projects involving known/suspected contamination by paying the outstanding loan balance in the event of borrower default so that the lender does not need to foreclose on the property and thus become responsible for its cleanup.

<u>Consultant's environmental liability insurance</u> provides coverage for acts, errors, and omissions, as well as pollution conditions arising from the insured's professional services.

<u>Contractor's pollution legal liability</u> covers environmental exposures that would be excluded under a general liability policy. It insures against conditions arising from covered operations performed by, or on behalf of, the named insured. (Because a firm that hires another firm could be held liable for environmental hazards caused by the other firm, contractors should require subcontractors to carry adequate insurance.[8])

In addition to writing insurance, many environmental insurance providers offer loss control and claims management services in conjunction with their policies. These services can be quite valuable to the insured's program of risk management, and critical in the event of an environmental loss.

Shopping for Environmental Insurance and Filing Claims

Understanding environmental insurance can be difficult, thus it's prudent to seek the assistance of a knowledgeable insurance broker or attorney. Keep in mind that not all insurers write environmental coverage,[9] and less than 100 broker/dealers in the U.S. write five or more environmental policies a year.[10] Before seeking environmental insurance, a business should clearly identify the risks it wants to cover. Determining the degree of a site's (potential) contamination is crucial to procuring the appropriate kind and amount of insurance. Doing so requires a decent understanding of technical information about the site and may involve working with contractors and environmental consultants to identify what contaminants are or may be present and what remedies are available and at what costs. Those negotiating the terms of the policy should also be familiar with environmental law—including case law developed in the wake of the Superfund Act.

It's important to review environmental insurance products carefully. The environmental insurance industry is made up of a small group of carriers that do not all take the same approach to pollution issues and exposures; thus, coverage offerings for the same site may differ significantly in both premiums and what is covered. Premiums may be reduced with some insurers by having a sound loss avoidance/control program in place.

Urgency should characterize any environmental claim both to contain the incident and the company's liability and expense. This may mean dispatching consultants and contractors to the scene of an accident or promptly dealing with on-site leaks, etc. It's much easier to mount the necessary response to an environmental incident if "what might go wrong" is foreseen and contingency response plans are in place. Insurers should be promptly notified of an environmental problem. Often, the insured has been involve with an environmental problem long before the insurer is brought in which may be prejudicial to the insurer.[11]

Financial Reporting When Environmental Insurance Is In Effect

SFAS No. 5, “Accounting for Contingencies,” requires that a loss contingency be accrued by a charge to income if it is probable that a liability has been incurred and the loss amount can be reasonably estimated. In cases of a probable loss that cannot be reasonably estimated, or a loss that is only reasonably possible, disclosure is required. Questions have been raised regarding whether claims for recovery of such losses from insurers (or other parties potentially responsible for the environmental damage) may be offset against the liability in the balance sheet. The EITF (Issue No. 93-5) reached a consensus that an environmental liability should be evaluated independently of any potential claim for recovery and that the reported loss should be reduced only when recovery is probable. The SEC’s staff favors separate disclosure of the gross liability and any related claims, noting that litigation over insurance policies’ coverage of environmental liabilities indicates that significant uncertainties regarding the ultimate realization of insurance claims exist. This guidance was issued in the early 1990s when numerous claims under CGL policies were being challenged in court. There is no reason to believe that this same level of uncertainty exists regarding environmental claims filed against environmental insurance policies of the type previously outlined so accountants should make themselves aware of what coverage is in effect when determining proper reporting of environmental problems.

Conclusion

Most CPAs do not need to become environmental insurance experts to adequately serve their clients. However, as environmental concerns and regulations mount, and insurance markets respond with an increasing array of offerings, CPAs should keep enough abreast of these developments to (1) understand their risk ramifications, and (2) be able to effectively interface with experts in the field when necessary.

Table 1

List of pollution risks accepted by various insurance carriers[12]

- Manufacturers
- Underground storage tank owners
- Truckers
- Hazardous materials/wastes transporters
- Landfills
- Municipalities
- Financial Institutions
- Chemical Plants
- Property developers (including "brownfields" redevelopers)
- Pollution/professional liability insurance for:
    - Architects and engineers
    - Environmental consultants
    - Emergency response contractors
    - Asbestos/lead abatement contractors
    - Remediation contractors
    - Testing labs
    - Mold remediation
    - General contractors

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[1] Strzewski, Len, "Small Risks Can Have A Large Environmental Exposure," Rough Notes, Indianapolis, July 2002, pp. 52.55.
[2] Pritchard, William G. Jr., "Evaluating Environmental Exposures," American Agent & Broker, February 2000, pp. 32-41.
[3] The Society of Environmental Insurance Professionals reports that $1 billion a year is spent litigating environmental damage claims on policies that have pollution exclusions.
[4] Wernick, Neil, "Survival With Environmental Insurance," Pollution Engineering, September 2002, pp. 16-18.
[5] Rich, Motoko, "Environmental Risk Is Drawing Closer Scrutiny," Wall Street Journal, New York, NY, October 23, 2002, pg. B8.
[6] Keiter, Allen, "No Further Action Letter's Status Can Change," The Appraisal Journal, October 2002, p. 374.
[7] Green, Paula A., "Slowing Market for Mergers and Acquisitions Keeps Insurers Busy," Global Finance, June 2001, p. 64.
[8] Catanese, Joseph, "Insurance: Are Your Business Partners Properly Insured?" Waste Age, April 2001, p. 18.
[9] "A Directory of Markets for Pollution Insurance," American Agent & Broker, February 2002, pp. 57-67.

[10] Glover, Lynne, "The Benefits of Environmental Insurance Apply to All Businesses," Pittsburgh Business Times Journal, October 12, 2001, p. 32.
[11] Jaipaul, Cecil, "Claims Management and the Environment," Canadian Underwriter, January 1999, pp. 44-48.
[12] "A Directory of Markets for Pollution Insurance," American Agent & Broker, February 2002, pp. 57-67.