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Environmental insurance for contaminated property transactions

Many real estate deals disassemble when the specter of contamination arises as a potential issue on the target property. One or more of the deal parties – or their attorneys – either run from the deal, or run to their respective corners to dig in their heels until the other party gives sufficient concessions. Neither strategy productively resolves the deal.

This article will discuss the application of environmental insurance to bridge the gap between the concerns of the parties in contaminated property transactions by identifying key components of various policies and providing negotiating strategies to obtain the most coverage with the least exclusions. Environmental insurance offers an independent source of cost recovery to multiple insureds and is available from several major underwriters such as AIG, XL, Zurich and ACE. However, these policies can be complicated, with different forms issued by different companies. The application and underwriting process is equally complex. With the recent rise in the number of Brownfield (contaminated property) transactions, developers have come to rely more and more on their attorneys to evaluate whether the policy truly covers the risks the client seeks to insure.

The application process

Since the insurance policy is only as good as the company that issues it and its assets, it is important to qualify that the companies you are considering are financially rated “A” or better by AM Best (or has an equivalent designation from another rating agency), have a solid history of “writing” environmental insurance and have a good claims paying history. Clients or their attorneys should select an insurance broker with particular experience with environmental insurance placement. The



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broker, along with the attorney and environmental consultant, will be preparing the “underwriting package” to be distributed to the insurers for rating. At a minimum, the application and underwriting package needs to be accompanied by a Phase I Environmental Site Assessment (ESA). Depending on the results of the Phase I, a Phase II ESA may be required. Other environmental reports and correspondence with applicable environmental agencies should be provided to the insurance company, as well as a “term sheet” describing the development project. Your broker should “market” the deal to more than one underwriter to initiate a competitive process for premium indications. Quotes are typically issued for a range of limits of liability, self-insured retentions and policy periods, so that insureds can have alternatives from which to evaluate price versus coverage. Bear in mind that the policy ultimately issued incorporates the insurance application by reference, so attorneys should review this document with their client, since any misstatements or omissions can limit or even negate coverage.

Making a claim

Since environmental policies are “claims made,” the loss must be incurred and the claim first reported during the policy period. Prompt written notice must be provided in the event of a claim or a probable claim. The insured should certainly mitigate loss in the event of a claim, but should not initiate cleanup without notification, since there is a duty to cooperate with the insurer in the management of a claim and the insurer may select or at least will have to approve all contractors and/or consultants used in response to the claim.

Pollution legal liability policies

Let’s say your client is a developer

with plans for a condominium complex in up-and-coming Williamsburg, Brooklyn and the price is right for the site, which is an old warehouse a few blocks from the water. But the past use of the property included food processing and contains an E-designation from the New York City Department of Environmental Protection, since a few storage tanks were on site. In addition, the use of surrounding property raises issues, with one corner in use as a vehicle maintenance facility. The seller is not offering an indemnity and - in fact - wants a release from all environmental claims. Furthermore, your client’s lender (or investor) is looking for some assurance that the deal won’t collapse if unexpected pollution conditions are discovered during excavation and the city or state environmental agencies require cleanup, or if construction is delayed or if claims arise.

This is the perfect application for a “Pollution” or “Remediation Legal Liability” or “Environmental Impairment” (collectively, PLL) policy. This type of policy is site-specific and covers claims arising from pollution conditions at, on or migrating from the insured property. It offers insurance for (1) required cleanup by government agencies, (2) legal defense expenses and (3) third party bodily injury and property damage claims that might arise from either pre-existing or new pollution conditions that are discovered and reported during the policy period.

Additional PLL coverage grants

Other coverage grants are available for an additional premium, such as contractual liability, non-owned disposal site coverage and business interruption and extra expense coverage (including development delay damages). Since most insurance policies typically only cover tort liabilities, contractual liability coverage backstops specified obligations of the parties contained within the scheduled purchase and sale agreement, such as the

indemnity. It is important to note that the indemnity may not be completely coterminous with the form of the insurance, in which case the insurance terms will govern, so attorneys must either scale back the scope of the indemnification or negotiate additional coverage (the latter of which may not always be possible).

"Cradle-to-grave" liability of hazardous waste laws may persuade the insured to purchase Non-Owned Disposal site coverage. This coverage grant protects insureds from future claims in the event the scheduled disposal sites to which they transport their waste from the insured property become federal or state superfund sites, subject to required government cleanup, or subject to third party claims.

First party Business Interruption Loss arising from a pollution condition provides coverage, following a specified deductible period, for business income (rental income, payroll expense and rent for temporary premises), extra expense and development delay expense (additional interest on money the insured has borrowed to finance the development, additional realty taxes and other assessments, additional engineering, architectural and consulting fees and additional advertising or promotional expense and additional expenses resulting from the renegotiation of leases).

PLL policy factors and terms

The parties to be insured must decide on a policy period, which in today's market can be as long as ten years for pre-existing pollution conditions and as long as five years for new pollution conditions coverage. A one-time premium is paid upfront and is usually fully-earned (non-refundable) at policy inception. Even if the parties plan on selling the site after a short period, the insurance is assignable (depending on the financials of the assignee), and can be used as a marketing tool to assist in property transfer. There is a cost benefit to purchasing a longer term policy. Consideration should also be given to the potential future difficulty in obtaining policy renewal at the same terms.

Insured parties must also decide on the limits of liability for the term of the policy, since all coverage grants are subject to the policy limits and shared between the insureds. The decision on limits will depend on a risk assessment of the potential environmental liabilities relating to the target property and its planned use. Clients can turn to their environmental consultants and attorneys to help them with this risk assessment. However, limits purchased will also ultimately depend on the

"appetite for risk" of the stakeholders. Additionally, parties must choose a self-insured retention (SIR) or deductible, which must be satisfied in the instance of each claim before the policy is triggered. (The difference between these terms is that an SIR is payable by the insureds, whereas a deductible is payable by the insurer and then reimbursed by the insured.) Thus, negotiation of an "aggregate SIR" should be attempted for the lifetime of the policy to eliminate an unlimited number of co-payments for claims. This also enables multiple insureds to contribute a set amount to be set aside up-front for claims instead of debating who pays each time a claim comes up.

One term that causes much confusion in the placement of environmental insurance is the designation of the insureds. Usually, the development entity is named as the Primary Named Insured, responsible for the control of payment of premium, self-insured retentions and claim application. Other Named Insureds may be added to the policy, which might include other major investors in the deal or both the buyer and the seller. Being a Named Insured is a coveted status, as it gives these entities direct access to the policy limits of liability. Alternatively, Additional Insureds may be listed on the policy. However, they merely have vicarious access to the policy limits, as they must be named in an action along with the Named Insureds. Furthermore, in the event of a claim they must apply to the Primary Named Insured for coverage. Additional Insureds might include lenders or property management companies. Since an increase in the number of Insureds results in greater potential for the erosion of policy limits, the attorney may consider setting sub-limits of liability for certain insureds.

Policy definitions determine coverage

With a PLL policy, the scope of coverage can be expanded or restricted either through endorsement or by definition. For example, attorneys should check the definitions of "Cleanup" or "Remediation" to see if they include restoration, which can be important if mold claims are involved. The definition of "Property Damage" should include natural resource damages and property diminution claims, which are other common and potentially costly environmental claims. "Bodily Injury" should include other typical claims arising out of environmental exposures such as claims for mental anguish and emotional distress even in the absence of physical injury. Alternatively, if a known contaminant has been identified on site by the ESAs, such as volatile organic compounds in the soil in a certain area around a prior tank, the policy may

include an endorsement deleting those soil constituents at that location from the definition of "Remediation Costs." The attorney should aggressively negotiate policy language to both persuade the insurance company to be as discrete as possible with any coverage exclusions for specific known pollution conditions and to agree to reinstate coverage for that pollution condition if and when it is fully remediated.

PLL policy exclusions

One major exclusion that usually appears by way of endorsement in PLL policies is "Material Change in Use." For example, if the insurance company agreed to insure a light industrial use that later changes to heavy industrial use, this will vitiate the policy, as the insurer views this as insuring beyond the bounds of what was underwritten to be covered. Policies also generally exclude known underground storage tanks, unless they are in compliance with laws and specifically scheduled onto the policy by way of endorsement. Unknown "phantom" tanks are covered, only if – after appropriate due diligence – they were not initially discovered.

Other PLL policy exclusions include payment of fines and penalties, workers compensation claims, claims resulting from intentional non-compliance, nuclear hazards, pollution conditions resulting from the use of vehicles and claims resulting from war, hostile acts or terrorism. Additionally, the policy excludes pre-existing pollution conditions already known to the insured, specific contaminants such as asbestos and lead paint within buildings, radioactive materials and certain naturally occurring pollution conditions such as radon. More current exclusions relate to claims resulting from mold or other indoor air conditions, contamination discovered during the course of a capital improvement and failure to comply with engineering or institutional controls.

Other environmental policies are available that perform other uses in contaminated property transactions, such as Cost Cap or Remediation Stop Loss insurance, which insure against cost overruns in the cleanup of known contamination. A full discussion of such insurance is beyond the realm of this article. Suffice it to say, however, in each case of the placement of environmental insurance, the enlistment of a team of legal and technical professionals with knowledge and experience in this can mean the difference between claims paid or not.

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