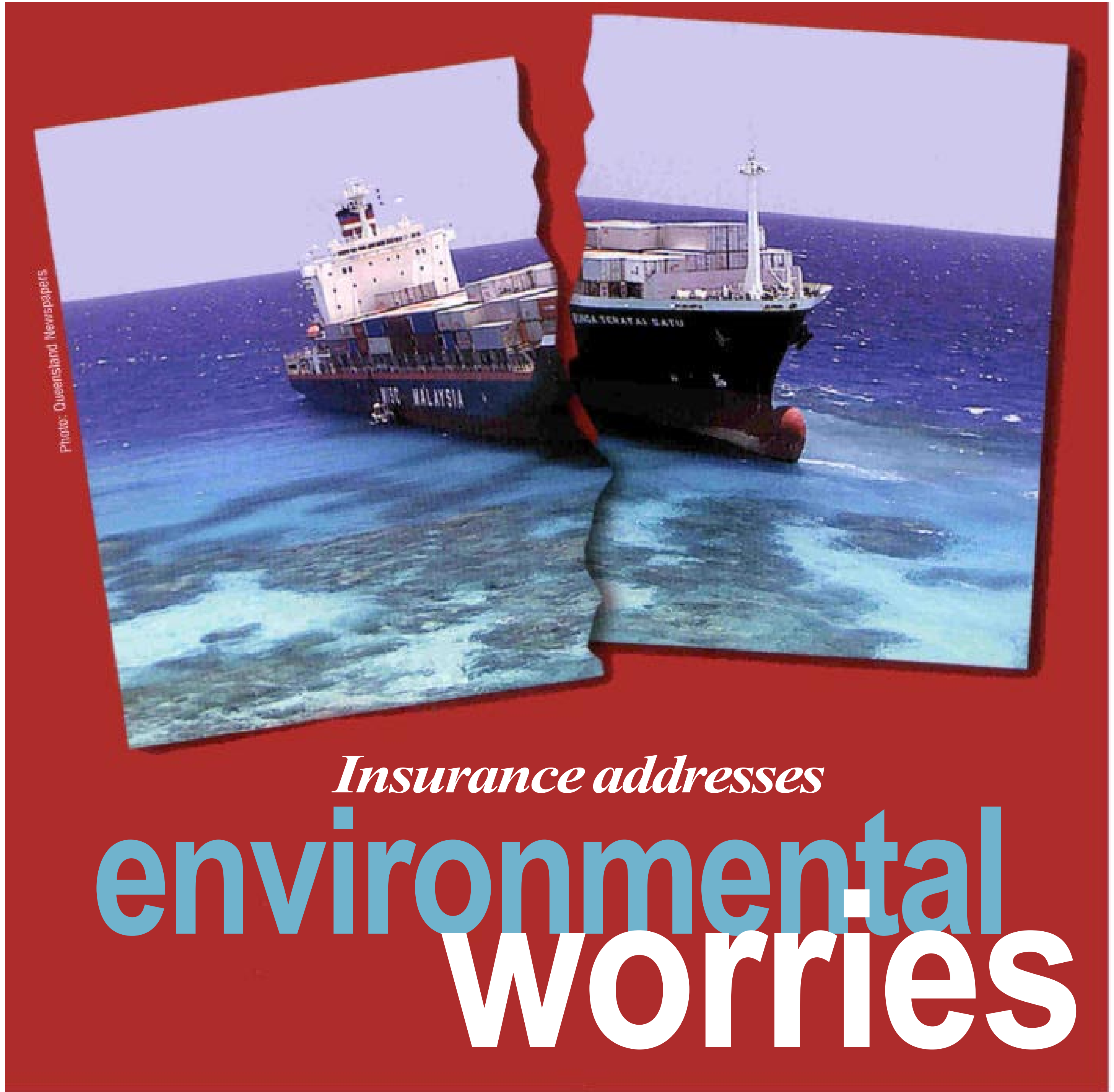

Photo: Queensland Newspapers

Insurance addresses environmental worries

Michael A Rossi, US lawyer, investigates growth of environmental insurance

Insurance products expressly designed to address environmental risks have been evolving in the US for the past two decades, ever since the so-called 'absolute' pollution exclusion was introduced in commercial general liability insurance policies in the early 1980s. The US market for such products has been growing slowly over the years without really being that much noticed, although the premium volume for such insurance is now quite substantial (several billions of dollars per year). However, the publicity surrounding this type of insurance has exploded in the past couple of years, because of its use in mergers, acquisitions and other transactions.

This explosion has not been limited to the US. For example, such insurance is being sold by UK insurers to their domestic and oversees clients who are involved in mergers, acquisitions and other transactions. With respect to such insurance being sold in Australia, until recently the coverage for the most part, if

not entirely, has been sold out of the US or UK. However, more US and UK insurers are opening up offices in Australia or moving some of their environmental insurance underwriters to their already established Australian offices to better serve the Australian market.

Australian risk managers might have several questions on their minds. What is this environmental insurance for mergers, acquisitions and other transactions? How does it work? What issues should I consider when purchasing such insurance? The author has been advising corporate insureds in connection with such insurance for the past several years in a variety of different transactions. Although the issues are discussed from a US perspective, this discussion is useful for Australian risk managers who are just learning about this insurance, as well as those who already are familiar with it.

In brief, environmental insurance products are being used to address environmental issues in mergers, acquisitions and other transactions so that they facilitate such transactions. By using these insurance products, deals that would otherwise not be consummated are negotiated to successful conclusion.

Similarly, targets that otherwise would not even be approached because of environmental risk concerns are not only being approached but are being purchased. And a variety of other types of transactions other than mergers and acquisitions are being facilitated by the use of such insurance (eg. real estate purchases, sale and leasebacks, lease terminations, etc.). Thus, any risk manager who wants to play an important role in his or her company's merger and acquisition activities, or even just real estate activities, should understand how these and other M&A-related insurance products (such as representation and warranty insurance or warranty and indemnity insurance and loss mitigation insurance) can be used.

The best policies

Two types of policies appear to be most popular for use in mergers, acquisitions and other transactions. One type of policy covers cost overruns for clean-up of known pollution conditions, but usually only when the expected clean-up is fairly well defined (eg. pursuant to a remedial action plan or RAP). This type of policy is typically called clean-up cost cap or remediation stop loss.

The other type of policy covers third-party claims for bodily injury and property damage arising from known and unknown pollution conditions, as well as first-party clean-up responsibilities for unknown pollution conditions. Some carriers will amend this type of policy to insure a number of other issues as well, including but not limited to: (a) clean-up obligations for known pollution conditions that are not that well-defined (eg. not subject to a RAP) and, therefore, not suitable for a cleanup cost cap/remediation stop loss program, (b) business interruption -for inability to use a site because of the discovery of pollution conditions, and (c) diminution in value of the site because of the discovery of pollution conditions.

Finally, you can buy this insurance to cover only pollution conditions that commence prior to the policy's inception date, or to also cover pollution conditions that commence after the policy's inception date (ie. to insure the post-closing activities of the buyer at the site). This second type of policy is typically called something like 'pollution legal liability' or 'pollution and remediation legal liability'.

Depending upon the particularities of the deal at issue, sometimes only the pollution legal liability type of policy is needed. Rarely, however, is only the clean-up cost cap/remediation stop loss type of policy needed — because that policy is not going to respond to third-party claims for bodily injury and/or property damage arising from the pollution conditions that are the subject of the clean-up. Accordingly, if you are contemplating the purchase of a clean-up cost cap/remediation stop loss policy for a particular deal, you should also contemplate purchasing a remediation legal liability policy as well.

When the policies are purchased together, they are intended to work 'hand-in-glove'. The costs related to the clean-up of the site should fall within the clean-up cost cap/remediation stop loss policy. The costs associated with discovery of pollution conditions not falling within the scope of the clean-up, and third-party claims and other legal liabilities related to known and unknown pollution conditions, should fall within the pollution legal liability policy.

Saving a deal

There are two general ways to use pollution insurance in the context of a merger, acquisition or other transaction. The first is to save a deal that is in jeopardy because of the environmental issues that play out during deal negotiations. The second is to use the insurance to one's advantage when the other side in the transaction does not know one is using the insurance. The following is an example of the first type of use.

Assume that the buyer wants to acquire the assets of another company, including some property on which the seller's principal manufacturing site is located. The manufacturing site is one of the key assets at issue for the proposed acquisition. The problem, however, is that the due diligence for the deal (eg. a phase one report) has identified some pollution conditions at the property that might be above actionable levels. The seller is only willing to sell the property 'as is' and is requiring the buyer to give an indemnity to the seller for environmental liabilities arising from the site.

Assume further that the buyer does not want to buy the property with its associated uncertainties regarding environmental liabilities. How much will it cost to clean-up the known conditions? What other pollution conditions might be out there that were missed by the due diligence? What if the government, neighboring landowners and/or businesses or persons who have frequented the property over the years bring claims against the buyer because of injury or damages sustained by exposure to pollution conditions at or emanating from the site? Because of these uncertainties, negotiations stall and the deal is in jeopardy of falling apart. How can this deal be saved?

In such a scenario, a pollution legal liability type of policy can be used to save the deal. Either buyer or seller (or both) can be named insureds on the policy, and the indemnity obligations between buyer and seller pursuant to the deal documents can be covered by the policy (subject, of course, to the policy’s other terms and conditions). So, for the buyer, such an insurance solution brings a level of certainty to the deal, because the buyer knows that its liability for environmental liabilities with respect to the property should be capped at the premium paid for the insurance and the self-insured

retention or deductible amount of the insurance. (Obviously, coverage disputes are always a possibility, and the limits of the policy might not be sufficient, but the insurance solution brings a level of certainty that is absent from the deal without the insurance.)

With that certainty, the buyer can now go forward with the deal, building the premium for the insurance and the self-insured retention or deductible into its cost model for valuation purposes to negotiate purchase price and other deal points with the seller.

In different circumstances, a cleanup cost cap/remediation stop loss type of policy might also be needed in addition to the pollution legal liability type of policy. Let's take for example the hypothetical scenario described above. Now add to the property a known on-site landfill subject to an order of consent requiring the cleanup of the landfill. Pursuant to the RAP for the landfill, it is estimated that the landfill can be cleaned up for $3 million. But what if neither the buyer nor the seller wants to assume the risk that the clean-up effort might cost more than $3 million? If neither is willing to budge on this issue, how can one save the deal from cratering?

This is when a clean-up cost cap/remediation stop loss type of policy can be used. Such a policy will insure the cost to clean up a site subject to a self-insured retention or deductible that equals the estimated cost to clean up the site plus a buffer for cost overruns.

It should be noted that you can also purchase the policy for 'first dollar' coverage by paying a very large premium — typically equal to the amount of the expected cost of the cleanup plus a buffer for cost overruns, but discounted for time, value for money and for the fact that the insurer is earning investment income on the large premium payment for some time before even expected losses are paid out. Some parties like this latter type of program because, depending upon a number of variables, there might be tax advantages in paying expected clean-up costs as premiums to an insurer.

Adding value to a negotiation

In addition to using environmental insurance for a transaction where both buyer and seller know that the insurance is being used to facilitate the transaction, there is also another use for the insurance. The insurance can be used by one party to the transaction, whether buyer or seller, without the other party knowing about it. The party using the insurance can agree to accept responsibility for certain environmental liabilities associated with the deal, in return for some concession by the other party.

For example, let's assume that in a particular deal the issue of who will assume the risk of environmental liabilities is up for negotiation. The seller, without the buyer's knowledge, looks into insuring those liabilities, and obtains a quote for a pollution legal liability policy that will insure the seller for its direct liability and for its indemnity obligations to the buyer. The seller looks at the premium ($175,000) and the deductible ($25,000) for the coverage, and advises the buyer that it will retain the environmental liabilities and indemnify the buyer for environmental liabilities for an increase in the purchase price of $1 million. The buyer agrees. As far as the seller is concerned, it just added $800,000 of value to the deal by using the insurance, and the buyer isn't any the wiser.

Similarly, let's assume the same deal is at issue, but the buyer is the one who looks at an insurance option for itself. The buyer, without the seller's knowledge, looks into insuring the environmental liabilities if it assumes them and agrees to indemnify the seller for all environmental liabilities. The buyer looks at the premium ($175,000) and the deductible ($25,000) for the coverage, and advises the seller that it will assume the environmental liabilities and indemnify the seller for a decrease in the purchase prices of $1 million. The seller agrees. As far as the buyer is concerned, it just added $800,000 of value to the deal by using the insurance, and the seller isn't any the wiser.

These deals are happening and will continue to happen. The only question is whether your company is going to be the one using the insurance to its advantage, or whether your company is going to be taken advantage of by the other party to the transaction who is using the insurance without your company's knowledge.

Other examples of how to use pollution insurance to facilitate mergers, acquisitions and other transactions abound. For example, many companies buy such insurance before putting their company 'in play' to clean up the balance sheet and make the company look more attractive to potential buyers.

Also, real estate developers are using such insurance to insure against the risk of environmental liabilities arising after the purchase of property where such liabilities might interfere with developing and/or leasing the property. And any party to a transaction involving real property who has to give an indemnity to the other party for environmental liabilities can use the insurance to insure those indemnity obligations.

Issues to consider

For many environmental insurers, the product lines discussed above — pollution legal liability insurance and clean-up cost cap/remediation stop loss insurance — in their 'off the shelf forms are not yet well suited for use in mergers, acquisitions and other transactions. The 'off the shelf forms must be amended, sometimes substantially, to make them work in this context. Set forth below are several issues that should be addressed when structuring an insurance program in the context of a merger, acquisition or other transaction using one of these products. The discussion is intended to be illustrative; the discussion is not exhaustive of all of the issues that should be addressed when structuring such a program.

Severability of interests

These programs typically have multiple, unrelated named insureds. For example, it is typical to have as named insureds on a policy at least both seller and buyer, and if the transaction is financed-based, then also buyer's lender. Accordingly, it is important to have 'severability' between the different

named insureds. A 'severability of interests' or 'separation of insureds' clause does this by stating that the policy is deemed issued separately to each named insured. In this way, if a claim is not covered for one named insured because of some particular reason, that does not mean that the claim automatically is also not covered for all other named insureds. For example, if one of the named insureds acts with the intent to cause damage, then that named insured might be barred from coverage because of the 'intentional acts' exclusion. However, because of the 'severability of interests' clause, that intentional conduct is not imputed to all of the other named insureds, so coverage for them can still apply.

Insuringindemnity

Most pollution policies have two exclusions that are standard for professional liability policies, but are very problematic when such insurance is used in the context of a merger, acquisition or other transaction. The exclusions are the contractual liability exclusion and 'insured v. insured' exclusion. The contractual liability exclusion bars coverage for liability assumed in a contract. The 'insured v. insured' exclusion bars coverage for a claim brought by one insured against another insured. These exclusions are problematic if (a) the pollution coverage is being used to insure the indemnity and hold harmless obligations from one of the parties to the other party, as set forth in the deal document, or (b) both parties to the deal are going to be insureds on the program.

Unless the contractual liability exclusion is amended to except from its scope the indemnity and hold harmless obligations undertaken in the deal document (whether that is an asset purchase agreement, merger agreement, purchase and sale agreement, lease agreement, etc.), the insurer might deny coverage for an indemnity claim made against the insured by the other party to the transaction by arguing that the indemnity claim is liability assumed by contract. Obviously, this issue should be addressed, so as to expressly confirm the insurer's intent to insure (subject, of course, to the policy's other terms and conditions) the indemnity obligations undertaken in the deal document.

Unless the 'insured v. insured' exclusion is amended to except from its scope claims for indemnity, the insurer might deny coverage for an indemnity claim made against the insured by the other party to the transaction if both parties have been added to the policy as insureds. As with the contractual liability exclusion, this issue should be addressed if there are multiple, unrelated parties added to the policy as insureds, so as to expressly confirm the insurer's intent to cover (subject, of course, to the policy's other terms and conditions) the indemnity obligations undertaken in the deal document.

Most pollution policies have a provision that prohibits assignment of the insurance policy without the consent of the insurer. However, when pollution insurance is used in the context of a merger, acquisition or other transaction, it often is important to the party buying the insurance or requiring the insurance that it be able to assign its interests to the insurance to others (eg. a future buyer, future lender, etc). For such deals, it is important to amend the 'no assignment' clause to allow for such assignments without the insurer's consent.

Intentional acts exclusion

There are a couple of different issues that an insured should try to negotiate for this type of exclusion. First, the insured should address the issue of whose acts can be imputed to it for purposes of applying the exclusion. If the insured is a corporation, the exclusion should be amended to be as narrow as possible, so that only acts of certain persons can be imputed to it (eg. the person responsible at a site for environmental compliance). Second, sometimes an insured is faced with an emergency situation where the insured must discharge contaminants in order to prevent a more serious injury or damage from occurring. Accordingly, the exclusion should be amended to except from its scope conduct the insured undertakes in response to an emergency.

Although the market for the insurance is small, the insurers selling pollution coverage are quite large and have been selling a lot of such coverage in the past several years. The insurers that are considered the real players in the US market are AIG, ECS (used to write on Reliance paper but now writes on XL paper), Kemper and Zurich. These carriers and/or their affiliates also operate in the UK for non-US transactions. It appears that Australian transactions in the past have been handled by some of these carriers either out of their US or UK offices. However, several of these carriers are opening up offices in Australia and/or sending environmental underwriters to their already established Australian offices.

It is very much worth noting that for some transactions, representation and warranty insurance (or warranty and indemnity insurance) and/or loss mitigation insurance might be better. These products were discussed in the November 1999 issue of *Corporate Risk* in my article 'Representations and Warranties: The US Perspective'. In theory, a pollution legal liability policy used in the context of a merger, acquisition or other transaction is just one form of representation and warranty insurance. Also, in theory, a cleanup cost cap/remediation stop loss policy used in this context is just one form of loss mitigation insurance.

Accordingly, one should not feel limited to the environmental insurance market when trying to address environmental issues in the context of a merger, acquisition or other transaction. In that regard, Australian risk managers interested in such insurance solutions should also look to SRS Limited in Australia as a source of coverage. SRS has been selling warranty and indemnity insurance and loss mitigation insurance in the UK for nearly two decades, and they opened an Australian office almost a year ago to service the Australian market.

With this article, and my previous story, I have tried to impress upon Australian risk managers the following two points. First, those who know how to use an insurance solution in the context of a merger, acquisition or other transaction can keep a deal alive where otherwise the deal might die. Second, those who know how to use an insurance solution in the context of a merger, acquisition or other transaction can add value to the deal by using insurance to negotiate a better deal for their company than the company otherwise would have obtained.

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