

Getting There from Here: New Environmental Insurance Policies Can Make Deals Work

Diane R. Smith

Diane R. Smith is a founding partner in Smith & Rendon, LLP, an environmental, construction, and business law firm with offices in Los Angeles and Irvine, California. The firm focuses its practice on environmental construction, real estate and related business matters. A large part of the firm's practice involves returning formerly contaminated properties into productive use. Ms. Smith is an author of a major treatise on environmental law and litigation. She acknowledges the assistance of attorneys Patrick Rendon, Tanya Tice, and Susan Parsons in preparation of this article. Ms. Smith can be reached at drsmith@smithrendon.com.

This article illustrates the way environmental insurance policies can be used, and discusses some of the major considerations that must or should be taken into account when making a decision both as to coverage and as to the structure of a transaction. Diane Smith has been practicing environmental law for over 25 years. In this article, she discusses using the new environmental insurance policies to facilitate deals. The issues raised have come up in one or more recent transactions that have utilized the new policy forms to make otherwise difficult or impossible transactions work. © 2001 John Wiley & Sons

INTRODUCTION

Buying, selling, developing, and even leasing a property that has or may have been affected by contamination can often be facilitated through the use of new insurance “products.” An understanding of how these policies can, will—and sometimes cannot or will not—protect the party buying them from liability is critical to any transaction. The process of evaluating both the “deal” and the policy allows those involved to make informed decisions about finalizing a transaction and assessing any residual risk that may exist.

It often comes as a surprise to clients that there is no one “standard” form of policy used by all insurance companies, and that insurers actually negotiate terms of coverage. It comes as more of a shock than a surprise when they learn that, unless a policy is actually negotiated, buying the coverage may not provide all of the protection they thought they were paying for. This article does not suggest in any way that these new insurance products are not worthwhile. They are truly valuable. But they are also *new* “tools” and their use is justified only when the specific policy or policies being considered is evaluated, negotiated, and purchased in the context of the facts of each transaction, with existing and future potential risks, parties, and claims in mind.

The price and the worth of a policy depend upon its terms. Policy forms in use today are more different than they are similar. Every transaction's

details, every property's condition, and every policy must be examined to determine how a deal can or should be put together, where potential problems could arise, and what can be expected if the coverage is ever actually needed to pay for a claim.

Whose policy will this be? Who will, should, or can be protected by the policy? Why? How?

Though "who should receive the benefits of a policy?" would seem to be a simple question, consider the following scenario: Your client is transferring *only part* of an industrial property that had been formerly heavily impacted. Part of the property has been remediated to residential standards and part has been remediated to commercial standards. A portion of the property is deed restricted, because of the presence of residual contamination in some limited areas.

The client is selling the portion of the property that has been remediated to and approved for residential use. Other portions of the property that have been cleaned up or authorized for commercial use are to be sold or leased in the future. All regulatory agencies have fully signed off on the cleanup, subject to some limited future monitoring in specific areas. The cleanup has taken years, and the property has been idle all that time. The client is anxious to sell or lease, but does not want high levels of continuing liability.

Since the property has been the subject of a major remediation, and some of the areas of the property contain residual levels of contamination, market forces require the client to give potential purchasers peace of mind. Further, the client wants to clearly limit its future financial exposure at the property.

You know that the client needs to be concerned about potential claims for future cleanup costs by the buyers, subsequent purchasers, or others. You also know that the client will want to be protected against the unlikely, but possible, cost of meeting any presently unforeseen future requirements from regulatory agencies. What about covering the risks of defending or paying any claims based on alleged exposures to persons who might later occupy or be present on the sold portion, or the adjacent, unsold portion of the property, including the deed-restricted portion?

Obviously, one answer to "who should be protected by the policy" is "the owner."

There are, however, parties other than the client to think about if a policy's use and effectiveness is to be maximized. What about potential future lenders for the purchasers of the portions of property that are not being sold with the residential portion? Since it will be much easier to sell the remaining parts of the property if potential lenders are satisfied that the policy covered them too, it is important to amend the policy to provide for such coverage.

Further, in the event that the client is unable to find purchasers for the other parcels, the intent is to lease portions of the property that are not being sold in this initial transaction. The possible demands of future tenants, as well as potential liability arising out of those tenants' activities, should be considered when deciding on coverage terms.

Though "who should receive the benefits of a policy?" would seem to be a simple question, consider the following scenario . . .

Additionally, it is only prudent to also consider the potential financial liability of individuals within the client's organization who may have been personally involved with managing the property in the past. In many cases, those persons are the individuals who are the major owners of the selling entity. And what about persons and companies related to the selling entity that might, under some conditions, be alleged to be "responsible parties?"

A careful analysis must be made regarding who should be the "insured," the "first named insured," the "additional named insureds," and the "additional insureds." Either all appropriate parties should be included as "named insureds," or the definition of "insured" has to be broad enough to cover all necessary parties. First-named insureds have control over the policy. Additional insureds generally only have coverage for the acts of the named insureds, *not their own acts*, under these particular types of policies. All persons or entities that are to be afforded coverage for their *own* legal liability must be included as additional-named insureds. Simply naming such persons or entities as "additional insureds" would afford them significantly less protection.

A careful analysis must be made regarding who should be the "insured," the "first named insured," the "additional named insureds," and the "additional insureds."

With respect to future lenders and purchasers, it is necessary to reach an agreement with the insurance carrier as to what will be required to add those parties to the policy if and when they are identified in future transactions. One approach is to agree that certain specified information relating to proposed use and development of any parcel sold will be submitted to the insurance company for review. Approval of adding the lenders and purchasers can be specifically stated to depend upon the insurance company's evaluation of any increased risk resulting from the development of the property as so proposed.

It is useful to consider the question of how to resolve any future questions about whether a proposed use will actually impact the insurer's risk. This question can be resolved by reference in the policy itself to agency cleanup standards applicable to the proposed development or use. For example, consider inserting, into the applicable endorsement, that a new use will be considered to impact risk only if it triggers more stringent cleanup requirements from a regulatory agency.

Does the client itself anticipate a change in use for the property in the future? Policy provisions usually state that the policy terminates, or can be terminated, or does not apply if use of the insured property changes so as to significantly affect the exposure of the insurance carrier. Be sure that intended future uses of the property are not going to make the policy worthless because future uses materially increase the exposure of the underwriter and allow cancellation of the policy. Set some standards as to what constitutes "increased risk."

Is there coverage for one insured's claims against other insureds?

The policy's severability provisions are critical. Unless the policy says that it applies separately to each insured against whom a claim is made or who discovers an on-site condition, there may not be much value to the insureds if one discovers a condition caused by the other.

What is “the property” anyway?

Sometimes, clients may elect to obtain coverage on an entire property that contains several parcels, rather than just on the small portion to be conveyed in a transaction that is being finalized. While this is more expensive than buying coverage on the smaller part only, if other portions are subject to conditions that might make it much more difficult, if not impossible, to cover those parts separately with another policy in the future, it might be “pound-wise” to purchase coverage on the entire property at the same time. Further, if a policy with less premium is purchased based on a reduced parcel size, the carrier will be less willing to negotiate some important terms. While it may be possible to save premium money by buying coverage only for a relatively small parcel being sold, any additional premium paid on account of portions of a property not being transferred may be a real bargain, and a real boon to development, in the long run.

Exactly what must the policy cover?

In all transactions, it is absolutely essential to determine what conditions, if any, must clearly fall within the scope of the coverage for the policy to have real value. The question of how the policy defines or describes the environmental conditions it will pay to remedy, and the types of damages it will pay, is naturally of paramount importance. The policy language is not always as clear as one might hope.

For example, if there is an abandoned oil well on a property, will the policy cover bodily injury and health claims arising as the alleged result of the continued existence of the well? If so, will it cover both claims of persons on and off the property? Will it cover any new contamination only, or will it cover anything that is on the property as of the date of the policy, so long as the insured did not know of it when the policy was purchased?

If there is a structure on the property that could, under some regulatory language, be considered an underground storage tank, what must be done to assure that any releases from the structure will be covered?

Will the insurance policy cover nuisance claims that may arise from odors? Will it cover damage to nearby wetlands? Will it cover asbestos in the ground, if the asbestos resulted from demolition of existing on-site buildings? What about lead-paint chips or dust from prior sand blasting in the area?

If a particular type of claim is covered, what items of cost or damages will the policy pay? Does coverage include the cost of investigation, bonds to release liens/attachments, costs of appeal bonds or pre- and post-interest judgment?

Are claims for both *on-site and off-site* bodily injury or property damage, personal injuries (such as emotional distress), cleanup costs, and property damage all covered? What about business interruption?

The possibility of off-site migration of on-site contaminants, with resultant possible *diminished value* of affected nearby properties, should be considered. Does the definition of property damage include loss of value or loss of use? Will the policy cover loss of use of tangible property

The question of how the policy defines or describes the environmental conditions it will pay to remedy, and the types of damages it will pay, is naturally of paramount importance.

that has not been physically injured or destroyed? What about damages to or destruction of the property of the insured or in the insured's care, custody, and control?

Claims of "toxic torts" such as exposure or ingestion of chemical constituents should be considered. Does the policy cover bodily injury, or both bodily and personal injury? The term "personal injury" is often used to refer to *mental anguish* and other such injuries that can be the result of exposure, while bodily injury refers to actual physical injury. Since many claims are based on personal as opposed to bodily injury, it is critical that defense and indemnity be afforded for that type of alleged injury, so that coverage for even spurious claims of exposure will be subject to defense-cost payment and indemnity for settlement.

Is the *insured's* business interruption covered? What about claims for the interruption of the business of others? What is the insured's exposure to business losses? When are those losses likely? What is a realistic projection of exposure? Business-interruption coverage for the insured may be valuable if the insured is operating a business on the property, but not if it is closing down its on-site business.

Policies frequently exclude coverage for claims arising out of injuries to employees, leased workers, and others, if injury occurs in the course of employment. If that exclusion exists, does it apply to all employees, or just to the insured's employees?

Does the policy cover liability assumed under a contract?

If, for example, the insured is likely going to end up being a landlord and likely to have to indemnify others in its leases, because of concerns on the part of potential tenants, what part of that assumption of liability, if any, will be covered by the policy? Do "covered contracts" have to be identified? Often, policies will exclude liability assumed by the insured by contract, unless the contract is designated as an "insured agreement." What if the insured agrees by contract to pay for "all damages" even if the other contracting party's negligence was partially the cause of the loss? What if they agree to cover even the *sole* negligence of the tenant or other contracting party? It can be as important to advise the client about what the policy *will not* cover as it is to advise them as to what it *will* cover.

How long will the policy's protection be in place?

Most, if not all, environmental insurance is written on a claims-made basis. That means that the policy only covers claims presented to the insurer during the policy period, regardless of when the event causing the claim occurred. Once the policy period is over, however, there is no coverage at all if an event has not been reported during the policy term. "Occurrence" type coverage, which covers "occurrences" during the policy period (regardless of when they are reported), is an entirely different type of arrangement that is often confused with a claims-made policy.

The fact that environmental insurance is "claims made" may make a policy less valuable to a client with a potential long-term exposure, such as third-party disposal site cleanup liability. Without an extraordinarily

Most, if not all, environmental insurance is written on a claims-made basis. That means that the policy only covers claims presented to the insurer during the policy period, regardless of when the event causing the claim occurred.

high premium, policy terms rarely exceed ten years, which has made the policies much less useful than longer terms, in some transactions. However, with a substantial premium incentive for the carrier, insurers may depart from the norm. Perhaps it is possible to negotiate at the outset a renewal option with a specified premium, or at least obtain the right to reinstate policy limits, as discussed below.

A particularly troublesome issue is whether or not there is coverage after a property has been sold or abandoned. This particular exclusion takes on special meaning where the client is a financial institution or the whole point of the transaction is to quickly “flip” the property.

What event “triggers” coverage under the policy?

“First-party coverage,” “on-site coverage,” or “remediation legal liability” coverage are terms used to describe coverage for cleanup costs that can be the result solely of discovery of on-site contamination by the insured, rather than a demand for action by an agency or a third-party claim. Some policies require that a claim be made by a third party or a governmental entity in a court of law before the insurance coverage will respond.

Some policies require that a claim be made by a third party or a governmental entity in a court of law before the insurance coverage will respond.

Whether regulatory-agency demands are covered should be carefully determined. A recent California case held that an administrative (agency) demand (e.g., an order from a local environmental agency to clean up the contaminated groundwater under the property) does not trigger defense coverage under comprehensive general liability (“CGL”) policies. CGL policies cover commercial liability, and modern policy forms completely exclude claims arising out of “pollution conditions.” But even under the old policy forms, which often do provide some coverage for pollution, this decision means that *neither the duty to defend or indemnify are triggered by an agency demand alone*. An agency demand is, however, one of the most common causes for incurrence of cleanup costs.

Insurers sometimes take the position that the agency is focusing on the wrong issues or the wrong parties and, therefore, there is no coverage for agency requirements. This has occurred where consultant reports are inconclusive, allowing the agency to ignore what is truly the cause of a particular condition. This problem usually arises when reports are not properly reviewed and evaluated prior to finalization, and conclusions are stated less clearly or definitely than required or justified by the findings.

Coverage for “new” vs. “existing” condition— or both?

It is also essential to assure that conditions that existed at the property prior to the inception of the insurance are covered, if the client wants to cover those risks with insurance, rather than retaining the risk themselves. “Existing” conditions can be discovered, for example, when old building foundations are removed, or excavations are done to install elevators or foundations for new buildings. Is coverage provided for ongoing monitoring and maintenance?

Perhaps the client should purchase coverage for “existing” conditions (those arising before the policy inception date), even though it has full “closure” from regulatory agencies and, therefore, no reason to anticipate

future claims for existing conditions. Perhaps the client should also purchase coverage for "new" conditions, even though it will not have ownership, operation, or control of the transferred parcel. Will it be possible to separate out "existing" from "new" contamination should a claim arise? What if grading results in "existing" contamination being moved to another location on the property?

An important question, if "new" conditions coverage is considered, is exactly what will constitute "new" conditions. What does "new" mean? How are new conditions defined or described in the policy? For example, are environmental conditions "new" if they existed when the policy was purchased, but were only discovered later? Or are they "new" only if they came into being after the effective date of the policy? How will the client show which is which? What will be required?

The distinction between coverage for new or existing conditions is an important distinction where a party is selling a property and requires, or elects to purchase, coverage only for documented "existing conditions." Not requiring coverage for "new" conditions can reduce premiums.

If, however, insurance is being considered in connection with property that is not being sold, but for property with a history of contamination, coverage for new pollution conditions (properly defined) may be well worth an additional premium.

Coverage for new pollution conditions helps to foreclose a carrier from arguing that an existing pollution condition actually constitutes a "new" pollution condition and, therefore, that there is no coverage under the policy. For instance, if a "new" pollutant exacerbates an existing condition, and the policy does not provide for coverage of new conditions, the carrier may argue that it is not responsible for the full amount of the claim.

What is the "retroactive" date of the policy, if any? If there is a retroactive date, conditions arising before that date may not be covered, even if a claim is made during the policy period. Some carriers may establish the policy inception date as the retroactive date. Nothing prior to that date will be covered by the policy.

Also examine what is necessary to obtain coverage for either existing or new conditions. Are existing conditions covered only if they were disclosed to the carrier prior to binding? Only if they were *unknown* to the client prior to binding? What does "known" mean? In one transaction, a client was concerned that "knowledge" of the fact that the site had been heavily impacted with a variety of substances in the past would be used to show that the client "knew" of contamination if contamination were discovered on the site in the future. How should the buyer or seller go about developing a sufficient body of information about the preexisting condition of the property? When? Doing additional on-site testing for any purpose after all necessary disclosures have been made to insurers but before the policy is bound can cause significant problems, where coverage for only "new" conditions is purchased. As with most important matters, timing is extremely important.

Notice of existing conditions is usually accomplished by supplying the carrier with copies of environmental reports. The full scope of all reports

... are environmental conditions "new" if they existed when the policy was purchased, but were only discovered later? Or are they "new" only if they came into being after the effective date of the policy?

submitted to insurers should be carefully reviewed to assure that all conditions are disclosed and all known reports furnished. It is helpful, but not always possible, to have the carrier acknowledge that submission of environmental reports by any named insured constitutes full disclosure of existing pollution conditions by the client insured in the application process. At a minimum, it is critical to have any submitted reports listed on a schedule of known conditions.

Deductibles and "SIRs"

The self-insured retention (SIR, the "deductible") for the policy is the amount that the insured will have to pay when a claim is made against the policy. Since the amount of the SIR or deductible is negotiable and has a great impact on the premium, clients may want to consider a higher SIR where risk is low, or where the client is willing to accept greater levels of exposure without coverage. Since SIRs usually apply per "occurrence," the definition of an "occurrence" or other triggering event is also crucial. Perhaps the definition of "occurrence" should be made broader, so that the total amount of SIRs is limited in circumstances where pollution conditions arise out of the same set of facts.

Since the amount of the SIR or deductible is negotiable and has a great impact on the premium, clients may want to consider a higher SIR where risk is low, or where the client is willing to accept greater levels of exposure without coverage.

If the property is large, the client may be better off if pollution conditions emanating from more than one location on the property are considered one "occurrence," thereby requiring the client to pay only one SIR. What is the definition of "occurrence" or "incident," if those terms trigger coverage? Some carriers offer the option of an aggregated self-insured retention. This option is valuable in the event of multiple claims, and effectively buys a "cap" on future losses. The self-insured retention can be structured so that once an insured incurs a certain level of SIR, the SIR for future claims is reduced. Does a SIR payment made by one additional insured apply against the overall SIR for the benefit of all additional insureds or additional-named insureds?

Cleanup standards

What cleanup standards apply to covered cleanups? That is, what level of cleanup will be covered by the policy? What cleanup levels do the agencies require, or the new owners? The usual approach is to refer to agency-mandated standards. Be sure that references to agency standards will not be read to refer only to "established standards" since most cleanups are now performed to clean up levels that are within the agency's discretion, and that are set on a case by case basis utilizing health-based risk assessments approved by the agency responsible for overseeing the cleanup.

Do defense costs "eat away" at the coverage?

Will defense costs be deducted from the policy limits, so that any payout by the insurance company to cover claimant's damages are reduced by the amount of defense costs paid? Or is payment of the legal fees outside the policy limits, thereby keeping the limits of coverage intact, even if defense costs are high? If defense costs erode coverage, as is usual, is it prudent to

include multiple parties with different exposures as insureds on the policy, thereby raising the risk of multiple defendants and very high defense costs reducing the level of coverage? Would it be better to purchase a higher limit on the policy because there are multiple insureds with multiple and differing risks? Be careful not to unknowingly risk erosion of coverage limits due to, for example, high exposures on the part of one party to spurious personal-injury claims that are unlikely to be made against all insureds. Some insureds have more and different exposures than others.

Does the policy cover transportation and eventual disposal of hazardous substances?

Is off-site disposal likely to be necessary? Does the policy cover risks associated with off-site disposal of hazardous substances? If so, must the particular off-site disposal facilities be listed when the policy is bound to be covered? If not, when must they be identified? If the policy period is only ten years, is off-site disposal coverage worth the cost?

Some carriers provide an option under which the insured can elect to purchase one reinstatement of policy limits at a specific premium. This may be a valuable option in the event of multiple claims.

Can the policy be renewed, or the policy limits reinstated?

What will premiums be on renewal, if renewal is permissible? Can the insured reinstate the policy limits, if one claim results in a payout that reduces available coverage? Under what conditions and at what cost? Some carriers provide an option under which the insured can elect to purchase one reinstatement of policy limits at a specific premium. This may be a valuable option in the event of multiple claims. For example, if the policy's limits are exhausted by a large claim, and then another claim is made, the second claim would be covered if the policy limits had been reinstated.

An election to reinstate will likely be conditioned on the client-insured having no knowledge of the second claim at the time the election to reinstate coverage is made. A new reinstatement premium can, for example, be based on a pro-rata calculation, multiplying the policy premium by the percentage of the policy period remaining at the time an election to reinstate the policy limits is made.

What exclusions apply to coverages provided under the policy?

There is no end to the ingenuity of the exclusions and endorsements. Be careful. Examples of exclusions include conditions "known to the insured as of the date the policy is bound, but not disclosed to the insurer." "Knowledge" on the part of an officer or environmental compliance person may be acceptable for the purpose of this exclusion, but if coverage is written on the basis that "knowledge" on the part of any employee excludes coverage, you may run into problems later, because of the knowledge of lower level employees. Other common policy provisions include exclusions for:

- Requirements for removal of lead paint, or claims based on injury due to exposure to lead paint;
- Removal of or exposure to of asbestos products, fibers, or asbestos dust;
- Removal of or the costs of remediation of leaks from underground

storage tanks, but only if the existence of such tanks is known to the insured and not disclosed to the insurer before the inception date of the policy;

- Liability assumed by the insured by contract;
- Use or operation of a vehicle or craft beyond the boundaries of the insured property;
- Fines, penalties, or punitive damages; or
- Claims arising as a result of willful, fraudulent, dishonest, intentional, or deliberate noncompliance with law or regulation.

In connection with exclusions for knowing or willful actions, be sure to clarify what will constitute “knowing” or “willful” actions. For example, can an argument be made that dumping things down the sewer was illegal at the time it was done, though no citation was issued, and thus, because of the illegality, there should be no coverage? Or that the maintenance man who may flush contaminated rinse water into a leaking sewer will be held to have acted “intentionally” and, therefore, there will be no coverage?

... the most well-known insurance company rating system is the Best rating, which is an indication of the financial strength of an insurance company to honor its obligation to policy holders.

Under what conditions can the policy be cancelled?

Usual examples of cancellation-enabling events include nondisclosure (misrepresentation) by the insured, the insured's failure to comply with the policy (including payment of premiums) and changes in use of the property that materially increase risk to the carrier. As noted above, the “changed use” provision can be softened somewhat by referring to certain standards, such as changes in required cleanup levels based on health-based risk assessment performed in accordance with some established and specified standard.

Evaluate the carriers

Regardless of the price of coverage, no premium is worthwhile if the insurance carrier won't be capable of paying claims, should any arise. Rating systems used to evaluate insurance companies are beyond the scope of this article, but it is critical that the insurer be in sufficiently strong financial health to be able to meet their obligations, if any claims should arise.

A good broker will guide you as to what companies to consider, but generally, the most well-known insurance company rating system is the Best rating, which is an indication of the financial strength of an insurance company to honor its obligation to policy holders. Basically, Best rates insurance companies on a rating scale of A to F, with the highest rating being A++. Best's ratings are considered by the insurance industry as leading indicators of insurance company financial health.

Other scenarios mean other issues...

Now let's think about other scenarios. What if your client is the new owner, not the seller? Should he get his own policy? Should he use the same insurance carrier as the seller, to avoid arguments between insurance companies later, if a claim arises? Should the seller and buyer get a policy jointly? How will policy proceeds be allocated? Who will pay the SIR(s)?

Who will be responsible for making any necessary timely claims or providing notices?

This article cannot possibly cover all the questions that come up because each deal is different, and because there are so many possible questions.

Conclusion

With environmental insurance premiums often running five or six figures, knowing what is being bought and what isn't, as well as what should or need not be purchased, is not just sensible, it is a prudent investment.

That decision-making process requires figuring out what the policy says, and then negotiating terms to reflect what the client needs and the deal requires. The entire exercise forces all involved to take a realistic look at how the financial impacts of transactions can—or maybe can not—be tempered for participants. The new environmental insurance policies can be a very valuable part of the property-development puzzle. Structuring transactions that work for everyone from financial, environmental, and insurance standpoints removes the major obstacles to reuse of current and/or formerly contaminated property. Reuse often means property that was not worth attention before can suddenly seem worthy of additional effort and investment. And that can have positive effects on entire communities.