

IN PRACTICE

INSURANCE LAW

Using Insurance to Manage Environmental Risk in Transactions

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Insurance can be used to manage environmental risks in real estate and commercial transactions, so that the insurer assumes the risks that the parties to the transaction would prefer to avoid. For example, the parties to a transaction may have difficulty agreeing who will pay the cost to clean up pre-existing contamination that may be discovered on the insured property in the future or who will pay if neighboring property owners successfully bring claims for property damage or bodily injury arising from pollution conditions that have migrated from the insured property. Even if the parties agree that those risks have a low probability of occurring, neither may be willing to be the one left on the hook. Environmental insurance may allow the parties to overcome these issues that are sometimes significant obstacles to closing the transaction.

Unlike most insurance policies,

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which are contracts of adhesion, environmental insurance policies are routinely negotiated with the insurer. To obtain coverage that best meets the needs of the parties, someone familiar with the transaction, the environmental condition of the insured property and the language of environmental insurance policies needs to negotiate the language of the endorsements to ensure that the policy will cover the risks that impede closing of the transaction.

To seek environmental insurance, one needs an insurance broker, as insurers typically will not communicate with a potential insured unless they have a broker. The selection of a broker with significant environmental insurance experience can save time and money. An experienced broker can help select the companies from which to pursue coverage (i.e., the least risk averse and with a high financial strength rating), choose the right coverage for the matter at hand and preliminarily negotiate the language of the policy endorsements in an attempt to obtain the coverage sought by the parties. While the broker works for, and represents the interests of, the insured, as compensation they receive a percentage of the premium from the insurer. A bro-

ker with environmental insurance experience can save the client substantial legal fees by performing tasks that would otherwise be performed by an attorney.

Pollution Legal Liability Coverage

Pollution legal liability (PLL) policies are the policies most often used to manage transactional environmental risks and can provide coverage for certain cleanup costs, third-party claims and other environmental risks, discussed below. A number of large insurance companies issue such PLL coverage. An experienced broker can help select the insurer or insurers from which coverage should be sought in a particular situation.

• Cleanup Costs

PLL policies provide two types of cleanup coverage for pollution occurring at the insured property: coverage for new discoveries of pre-existing conditions and coverage for new conditions.

Coverage for the discovery of pre-existing pollution conditions is for conditions in existence, but *not known to the insured*, prior to the inception of the policy period. Coverage for pre-existing pollution conditions known to the insured prior to the inception of the policy period are typically excluded from coverage under a PLL policy, but may be covered by cost cap coverage, discussed below. Sometimes it is possible to negotiate pre-existing pollution conditions coverage for conditions known to exist on the site which either have been the subject of regulatory closure (i.e., written confirmation they have been cleaned up) or have little risk of giving rise to a cleanup obligation exceeding the deductible. If those pollution conditions somehow later

require further cleanup, then those costs would be covered. Further, some policies provide that known pollution conditions that are excluded from coverage at policy inception will be covered upon both regulatory closure during the policy period and insurer approval in the event those issues are later reopened and further remediation is required.

New-conditions coverage is for pollution first arising during the policy period. Typically, this is coverage for the risk that current operations on the insured property may cause pollution conditions. The insurer will ordinarily prepare a policy endorsement describing the types of operations for which there will be coverage, which may exclude coverage if the operations change. Even if the main transactional concern is the risk of discovering pre-existing pollution conditions, by purchasing new-conditions coverage the insured can avoid future disputes with the insurer over the timing of the discharge for which coverage is sought.

• *Third-Party Claims for Bodily Injury or Property Damage*

PLL policies ordinarily provide coverage for property damage and bodily injury to third parties arising from pollution conditions on, or migrating from, the insured property.

Property damage includes the “tangible” property of a third party, including real and personal property, as well as diminution of property value, stigma damages, loss of use and natural resource damages. Cleanup costs are not included in the definition of third-party property damage because they are insured, if at all, under the cleanup coverage discussed above. Property damage coverage excludes damage to the insured property.

Bodily injury often includes disease, mental injury or death resulting from a pollution condition. Third parties are often defined to exclude the employees of any named insured. While the employees of a named insured would ordinarily be covered by workers’ compensation, the exclusion may result in one named in-

sured having no insurance for claims by the employees of another named insured (which would *not* be covered by the workers’ compensation policy of the insured who is not their employer). Care must be taken during policy negotiation to avoid or minimize coverage gaps.

Although the cleanup of pollution conditions known to exist at policy inception are excluded from coverage under a PLL policy, ordinarily coverage can be negotiated for third-party claims for property damage and bodily injury arising from all types of pollution conditions, including those that are known.

• *Other PLL Coverage*

PLL coverage is also available for business interruption or loss of rent at the insured property. To obtain this coverage, the insurer often requires significant amounts of information concerning the covered business. Unless the business is established, the uncertainty often makes underwriting difficult and premiums uneconomical. Many clients conclude this coverage is more trouble than it is worth, especially given how rare it is for environmental remediation to cause a significant business interruption.

PLL policies cover legal costs to defend claims covered by the policy. For example, the policy would provide coverage for the legal fees incurred overseeing the remediation of pollution conditions on, or migrating from, the insured property. Generally, the insurer has the right and obligation to defend the claim, usually with counsel chosen by the insured where permitted by law. Even where no such law applies, some insurers will consent to using the insured’s counsel if they accept the legal fee rates ordinarily paid by the insurer in that locale.

Cost-Cap Coverage

Cost-cap policies are sometimes used, along with PLL policies, in contaminated property transactions to cover the risk that the cost to clean up the contamination known to exist at the inception of the policy exceeded expectations. Coverage

is not provided until such costs exceed the self-insured retention (“SIR,” similar to a deductible) and any co-insurance layer above the SIR which must be paid before coverage attaches. Generally, the SIR is based upon, and equal to, the price under a guaranteed cleanup cost contract (sometimes referred to as a fixed price contract) entered into between an environmental consultant and the client or other party responsible for the cleanup. The consultant under the guaranteed cleanup cost contract agrees to pay all costs in excess of the guaranteed cost or SIR, including any co-insurance layer. Several years ago, some insurers issued cost-cap coverage for certain consultants without either an approved cleanup plan or any co-insurance layer, usually for those consultants with a good claims history. Today, approved cleanup plans and a co-insurance layer are routinely required to obtain cost-cap coverage.

Few insurers are willing to provide such coverage these days, as excessive claims made cost-cap coverage an unprofitable product for them. Recently, insurers’ engineering and underwriting for cost-cap coverage have become problematic, the co-insurance layers have gotten larger (sometimes equal to the amount of the guaranteed cleanup cost or SIR), the coverage limits are capped (e.g., not exceeding the amount of the guaranteed cleanup cost or SIR) and the premiums have gotten larger. The few insurers issuing cost-cap coverage have come to view it as catastrophic coverage, and not to be routinely used to cover the risk of cleanup cost overruns. For these reasons, many of those involved with environmental insurance have concluded that, for most intents and purposes, cost-cap coverage is no longer available.

Practitioners whose clients are involved in real estate or commercial transactions where the risks of contaminated property are (or could become) an obstacle to closing should advise them that obtaining environmental insurance coverage could help resolve those issues. ■