Using Environmental Insurance in Commercial Real Estate Transactions

By Jack Fersko and Ann M. Waeger

For approximately two decades now, real estate lawyers have wrestled with the broad liability net of federal and state environmental laws and regulations and the resulting economic impact on industrial and commercial real estate transactions. For many years the consequence was that contaminated industrial and commercial properties, the so-called brownfield sites, were left abandoned. Eventually a number of strategies and techniques evolved to address the liability and cost risks associated with the environmentally challenged real estate project. Cleanup standard initiatives were enacted to provide alternatives to removal as the sole cleanup method. Tax incentives, grant programs, and low-interest loan programs were passed to lower cleanup costs.

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Liability protections were enacted to provide comfort to the lending community. Also, an increasing number of government initiatives, including smart growth legislation and urban enterprise zone and environmental opportunity zone legislation, were enacted to stimulate the redevelopment of urban areas where most of these environmentally challenged properties arelocated.

Because of these new laws and regulations, both the development and the lending communities have become interested in the brownfield-type project. The reaction of the insurance community to this phenomenon has been quite interesting. During the past five years particularly, the insurance community has developed and refined a host of environmental insurance products that positively influence many real estate transactions.

Because environmental insurance has emerged as a vehicle for managing the complex liability scheme and the significant financial risk of federal and state environmental laws and regulations, real estate lawyers must have a basic understanding of the various types of environmental insurance policies that are available. They must understand the anatomy of an environmental insur-

ance policy (including the definition, exclusion, and condition provisions) and the issues that must be examined when reviewing an environmental insurance policy.

Environmental Insurance—Generally

Environmental insurance can offer buyers, sellers, landlords, tenants, and lenders solutions to regulatory, contract, and lender requirements and obligations by providing protection for on-site and off-site cleanup and bodily injury and property damage resulting from pollution conditions. The nature and extent of coverage required will vary with each transaction. Policies, more often than not, will thus need to be customized, or "manuscripted," by way of endorsements that delete or modify policy exclusions, revise policy definitions, and temper policy conditions. There is little in the way of case law on which to rely in evaluating policy coverage. Consequently, it is particularly important that the nature and extent of coverage be carefully examined in each transaction to ensure that the policy will provide the intended coverage. It is equally important to examine the carrier's rating and experience in the marketplace to determine its capacity to handle a policy claim.

An environmental insurance policy is written for a term of years, and a one-time premium is paid when the policy is issued. Although the per square foot cost of a policy, when amortized over its life, may be small, there is nevertheless a significant up-front capital expenditure. Other than contractor's pollution legal liability insurance, which is available on an "occurrence basis," most types of coverage are written on a "claims made" basis. Therefore, coverage will be available only for a claim made and reported to the carrier during the policy period, or in some instances during an extended reporting period. It is important to evaluate properly the length of the policy term when acquiring an environmental insurance policy.

Types of Coverage

The main environmental insurance coverage offerings are pollution legal liability insurance, cost overrun insurance, brownfield insurance, institutional control environmental insurance, and secured creditor insurance. Insurance carriers refer to these forms of coverage by different names, and some offer variations on the same theme, depending on the risk involved.

Pollution Legal Liability Insurance

Pollution legal liability insurance is the generic designation for the type of insurance issued by all carriers that is designed to provide coverage for on-site cleanup costs, claims for off-site cleanup costs, and claims for on-site and off-site bodily injury and property damage resulting from a pollution incident. This type of insurance also includes legal defense costs (which will be both subject to and deducted from policy limits) and may include business interruption and extra expense coverage, as well as diminution in property value because of a pollution incident. Coverage is available for preexisting and new conditions on a site, and depending on site conditions, coverage may be available for known conditions (for example, where contamination has been left in place with government permission and is being controlled by way of engineering controls, such as a cap).

Each insurance carrier has its own set of minimums for policy deductibles, but by way of a broad generalization, policy deductibles range from $5,000 to $10,000. In addition, policies can be written for a term of up to 10 years and can contain policy limits of up to $100 million per occurrence and $200 million in the aggregate. Most insurance carriers will require a Phase I site assessment before issuing a policy, although in certain situations additional site investigation may be required.

Cost Overrun Insurance

Cost overrun insurance, which is also known as stop gap, cleanup cap, cleanup cost containment, and remediation stop loss insurance, is designed to cover an increase in the cost of a known cleanup because of cost overruns. Typically, cost overrun insurance is issued when an insured has completed a site investigation and has received an approval from a governmental authority of its remedial action plan. Today, however, many insurance carriers have their own risk control groups and will issue coverage if their risk control group is satisfied with the cleanup plan.

Depending on the insurance carrier, policy limits for cost overrun insurance can be as high as $100 million per occurrence and $200 million in the aggregate, and policies can be written for a term of 1 to 10 years, and possibly longer, if an insurer can obtain reinsurance for the risk. As mentioned previously, these policies are written on a "claims made" basis. Consequently, when determining a policy term, an insured must consider whether the site will be the subject of a development. The insured must also consider whether part of the development (such as improvements to be built) will serve as an engineering control in connection with the cleanup, thereby requiring the insured to account for the time period for obtaining development approvals and constructing the improvements. Notwithstanding the policy term, cost overrun coverage normally will end when a "No Further Action Letter" is issued for the cleanup, if that takes place before the expiration of the policy term. In addition, the cost overrun policy will contain a self-insured retention, which normally will equal the estimated cost of a cleanup plus a mul-

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tiple (10% to 30%) of the estimated cost of cleanup. Policy premiums generally will be a percentage of the estimated cost of cleanup, although the setting of the premium will be affected by the limits of liability, the self-insured retention, the nature and anticipated duration of the cleanup, and the remediation contractor.

A relatively new form of cost overrun coverage is finite risk cost cap coverage. Although this coverage has existed for a number of years, only recently has it been used in conjunction with smaller cleanups, i.e., cleanups of $50 million and less. Similar to the traditional cost overrun coverage, this insurance is designed to shift to the insurance carrier the risk of cleanup cost overruns. In contrast to traditional cost overrun coverage, however, there is no buffer or coinsurance provision, and there is no policy term. In addition, because the cost of cleanup is paid in the form of a policy premium, the payment can be deducted for federal income tax purposes in the year in which it is incurred, rather than expensed or capitalized (depending upon the particular aspect of the cleanup being paid for) as the cleanup proceeds. This type of policy must be carefully created by the insured, with input from its tax, legal, and insurance advisors.

The main environmental insurance coverage offerings are pollution legal liability insurance, cost overrun insurance, brownfield insurance, institutional control environmental insurance, and secured creditor insurance.

Brownfield Insurance

Brownfield insurance is a policy that combines both pollution legal liability insurance and cost overrun insurance into one policy. A brownfield-type policy is the preferred choice when an insured is redeveloping a site on which a cleanup must be performed. The insured can better protect against a gap in coverage that easily can result if two different policies must be negotiated, with potentially two different sets of definitions, exclusions, and conditions.

Institutional Control Environmental Insurance

This policy is a special niche policy just recently created to cover four types of risks associated with institutional and engineering controls. Institutional controls generally take the form of easements, covenants, or deed notices that will be recorded in the public recording offices and will publish the access rights that may have been reserved to governmental agencies, as well as the use restrictions placed upon the property because of environmental contamination remaining on the property, the location of that contamination, and the engineering control in place to contain that contamination. Engineering controls can be as basic as a cap on top of remaining contamination, such as a parking lot or newly constructed building, designed to prevent the exposure of humans and the environment to such contamination, or more sophisticated in form, such as a slurry wall designed to prevent the migration of contamination.

The first risk for which this type of policy provides coverage is cost overruns in the design and implementation of institutional and engineering controls. The second is errors and omissions by the professionals who design and establish the controls, which include coverage for bodily injury, property damage, and cleanup costs. The third is the failure of a properly designed system of engineering and institutional controls, such as when there is a change in site conditions. Finally, the policy can cover bodily injury, property damage, and cleanup costs arising out of an error or omission by the professionals who are responsible for maintaining or enforcing engineering and institutional controls.

Secured Creditor Insurance

Depending on the insurance carrier issuing the policy, coverage under the secured creditor policy can be as high as $100 million per occurrence and $200 million in the aggregate, and the policy term can be as long as 20 years. Again depending on the insurance carrier, the policy can be written to cover first-party cleanup costs, claims for third-party cleanup costs, claims for third-party bodily injury and property damage, legal defense costs, and payment of the outstanding loan balance. Typically, a secured creditor policy is written to cover the lesser of the loan balance (provided there is a default under the loan) or cleanup costs (provided there is a foreclosure). More recently, however, coverage is available to recover the loan balance after default, if there has been a pollution condition at the collateralized property. In this latter instance, a lender can recover the loan balance following a default and a pollution condition without having to first foreclose on the property and determine the extent of cleanup costs. It is important to note that the default cannot be the existence of the pollution condition, but rather an independent event of default under the loan documents.

The Anatomy of an Environmental Insurance Policy

An environmental insurance policy generally includes the following:

- an insuring agreement;
- a definitions section;
- an exclusions section;
- a section setting forth the conditions of coverage, which may or may not be separate from the notice and reporting provisions and duties of the insured;
- a limits of coverage section; and
- an extended reporting provision.

The policy must be reviewed carefully. Each section of the policy will

affect the overall scope of coverage. The following sections of this article will provide the real estate lawyer with some examples of policy terms that require negotiation. The examples are by no means exclusive, however.

Definitions

Definitions of policy words and terms determine the extent of coverage afforded by the policy. Therefore, definitions must be constructed with precision. The following is an example of modifications that should be negotiated to the various defined terms in an environmental insurance policy.

- *Bodily Injury*. This term needs to be broad enough to include all theories of relief on which "bodily injury" claims may be based. Thus it is important that a bodily injury claim include a claim for shock, medical monitoring, and fear of disease.
- *Business Interruption*. Although many insureds purchase coverage for business interruption loss, few realize that their property insurance policies contain a pollution exclusion and therefore will not cover a loss from a pollution condition. Business interruption coverage in an environmental insurance policy will generally provide the insured with reimbursement for its actual loss or lost rental value and for the extra expense incurred by the insured during the restoration period. It is important that the policy not condition coverage on the pollution condition's being the sole and exclusive cause of the loss. Also, some insurance carriers will limit the extra expense component of the coverage to those expenses that reduce the actual loss or the lost rental value. Extra expenses may be incurred to minimize the interruption of business operations, but may not necessarily reduce the actual loss or the lost rental value.
- *Claim*. The term "claim" is frequently crafted to require a written demand against the insured that seeks a remedy against the insured and asserts liability on the part of the insured. The term needs to be more broadly crafted so that any demand on the insured will trigger coverage, including administrative orders, consent decrees, lawsuits, and petitions filed against the insured.
- *Cleanup Costs*. This term is usually drawn to include the removal, disposal, and treatment of pollutants or contaminants, to the extent required by environmental law. It is important that the definition be broadened to include investigation, monitoring, immobilization, in-situ treatment, and neutralizing.
- *Environmental Laws*. "Environmental Laws" should be drawn broadly to include more than just the laws of federal, state, or local governments. It should include ordinances, rules, regulations, orders, directives, policies, amendments to each of the foregoing, new enactments and promulgations, as well as compliance with state voluntary cleanup programs. In addition, the definition should include the common law.
- *Insured*. Because an additional insured's coverage is derivative of that of the named insured, the policy "insured" needs to include all persons and entities that are intended to be covered, rather than merely to list one named insured and a group of additional insureds.
- *Pollution Condition*. This definition should be broad enough to include the following: the presence of pollutants (whether or not in a container); seepage and migration; conditions naturally occurring in the environment, so long as the conditions detected exist in amounts or concentrations different from those that naturally occur in the environment; a discharge into or on structures on the land; and a midnight dumper or a tenant's illegal abandonment of pollutants.
- *Property Damage*. Two key components of this definition must be diminution in value and natural resource damages. Some carriers are now including one or both of these concepts automatically; others will include one or both of these concepts by way of endorsement.

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Exclusions

The insuring agreement section of a policy sets forth the broad array of coverage that will be afforded by a policy. The exclusions section of a policy is truly the heart of the policy, however, for it is here that the insurance carrier narrows and removes coverage ostensibly afforded by the insuring agreement. Consequently, the exclusions must be examined with utmost care and with a creative sense of how each exclusion may be used in the future to limit or deny a claim. The following are some examples of exclusions that typically require modification.

- *War and Terrorism*. As a result of the horrific events of September 11 most carriers will exclude from coverage events arising out of war, invasion, acts of foreign enemies, hostilities, and acts of terrorism. Some carriers will, however, offer sub-limits of coverage for an additional premium and deductible, depending upon

the location of the property and the type of use being made of it.

- *Mold*. Claims for bodily injury, property damage, and cleanup costs arising out of mold have become the new hot topic for insurance companies over the last year. Mold is present in the environment and individuals live with mold on a daily basis, generally with no adverse effect. But because claims against general liability and first-party property damage policies are on such a rise and have resulted in staggering verdicts in favor of insureds, certain insurers issuing environmental insurance policies have begun automatically including exclusions for mold in their premium indication for each new policy. Insureds may find, however, depending upon the risk, that underwriters will agree to add this coverage back to the policy.
- *Contractual Liability*. Many policies will exclude liability that an insured may have as a result of a contract. Consideration should be given to scheduling certain contracts, however, thereby providing coverage—for example—for loan agreements, management agreements, joint venture agreements, sale agreements, partnership agreements, and lease agreements.
- *Divested Property*. This exclusion takes away coverage once a property is sold. Some policies will also exclude coverage when property is given away (such as gifting for estate tax purposes) and when property is abandoned or condemned, or when the insured loses operational control. In most of these instances an insured will want and should be entitled to coverage since a former owner may still be liable as a responsible party. Consequently, this exclusion should be deleted.
- *Intentional or Illegal Acts*. This is a broad exclusion that takes away coverage for any dishonest, willful, intentional, or deliberate act or omission by or at the direction of the insured, or any deliberate noncompliance with law or notices of violation. At a minimum, an insured should limit this provision to the acts of certain specified individuals responsible for environmental affairs or officers of an insured. Also, this exclusion must be deleted in the context of a cost overrun policy, because the carrier enters into the insuring arrangement knowing the condition of the covered location and how it resulted. The carrier, therefore, should not have the opportunity to exclude coverage after the fact.
- *Insured vs. Insured*. Policies frequently exclude from coverage claims made between insureds. If a landlord lists a tenant on the policy, however, it is critical that this exclusion not operate to preclude claims between such insureds. Also, when there are multiple insureds on a policy, it is important that the policy contain a severability clause, so that the bad acts of one insured do not serve as the basis for a denial of coverage for another insured.
- *Known Conditions*. Most policies have a known conditions exclusion that excludes coverage for conditions known to the insured pre-policy but not disclosed to the carrier. The critical issues are what constitutes a known condition and whose knowledge is relevant. Some policies will provide that a condition is known if a defined group of people could have expected that the condition would result in a claim or constitute a pollution condition. There should be a distinction between "*could have expected*" and "*should have known.*" Also, the definition must limit the group of people whose knowledge is determinative of whether a condition was "known." The group should be specifically identifiable people who have knowledge of the environmental affairs at the covered location and who have both the ability and responsibility to address the condition. In addition, all facts and conditions disclosed in any reports provided to the carrier should be deemed to constitute disclosure for purposes of the known conditions exclusion. See *Goldenberg Development Corp. v. Reliance Insurance Co. of Illinois*, No. 00-CV-3055, 2001 WL 872782 (E.D. Pa. June 25, 2001).
- *Material Change in Operations*. Most policies will exclude coverage if there has been a material change in operations at a covered location. Depending on the nature of the transaction (such as the redevelopment of an industrial facility into a residential facility), this exclusion will need to be either modified or deleted. Some environmental insurance policies express this concept as a condition of coverage, rather than as an exclusion, and further provide that the insurance carrier can terminate coverage in the event of a material change in operations. If the concept must be in a policy, it should be limited to excluding coverage of an individual incident and not afford a basis for terminating coverage.

The exclusions section of a policy is truly the heart of the policy, for it is here that the insurance carrier narrows and removes coverage ostensibly afforded by the insuring agreement.

Conditions

- *Access to Information.* Many policies condition coverage on the insured's providing the insurance carrier with access to all information relating to a pollution condition or a claim. This condition should be narrowed to exclude information that is subject to a privilege (such as the attorney–client privilege).
- *Assignment.* Many policies prohibit assignment of policies. In our merger and acquisition-oriented business society today, however, assignment by operation of law should be expressly permitted.
- *Choice of Law/Choice of Forum.* Many policies will provide that New York will be the forum for any claim between the insurance carrier and the insured and that New York law will govern the dispute. Insurance carriers designate this forum because New York law heavily favors insurance companies. These conditions should be removed from the insurance policy. Recently, some carriers have begun to provide for the jurisdiction of the covered location to control for purposes of choice of law and choice of forum.

Conclusion

Although there are a number of ways to address environmental risks, including site investigations and contract indemnities, environmental insurance policies should certainly be considered as a viable tool for managing environmental risks. It is critical that the policy be structured properly, however, to satisfy the needs of the insured and the particular transaction at hand. In this respect, the real estate lawyer should recognize that the foregoing lists of issues are not exclusive. The particular coverage must be crafted to address the known and potential environmental conditions peculiar to the covered location. Consequently, real estate counsel must work closely with environmental counsel, and a knowledgeable environmental consultant and insurance broker, to ensure that the policy properly accounts for the particular site conditions and affords the broadest protection available for the particular transaction. ■