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An Overview of Environmental Risk Transfers

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The unknowns concerning contaminated properties are a frequent source of frustration for potentially responsible parties (PRPs). Will cleanup be required? At what cost? When? And what is the chance of third-party tort claims? Such uncertainties can make it difficult to sell or finance contaminated properties, or to resolve disputes about responsibility for the cleanup. Recognizing the difficulties posed by these uncertainties, the financial markets have developed a group of products frequently referred to as "risk transfer" or "liability transfer" contracts. In the typical risk transfer, an environmental contractor assumes a PRP's obligation to perform government required remediation for a fixed price. In many cases, the contractor's assumption of liability is backed by specialized insurance covering remediation cost overruns as well as certain kinds of toxic tort liabilities.

Risk transfers are not the solution for all contaminated properties. However, in our experience, in the right circumstances, they can play a critical role in helping companies contractually cap some or all of their risk exposure with regard to a contaminated property or portfolio of properties. The ability to place a dollar value cap on a risk is often particularly important in connection with mergers, initial public offerings (IPOs), sales of businesses, and sales of real property. For some companies, risk transfers also play an important role in the every day management of their contaminated property portfolios. This summary provides a brief overview of some of the basic elements of risk transfers, their pros and cons, and some key considerations when structuring a risk transfer.

WHAT IS A RISK TRANSFER?

The term "risk transfer" is actually somewhat of a misnomer. In the great majority of cases, a PRP cannot contractually eliminate its liability to a government or other third party for a contaminated property.[1] What the PRP can do, however, is enter into agreements where others, typically an environmental consultant and/or an insurer, agree to step into the PRP's shoes and perform some or all of the PRP's obligations, whatever those may be. The assuming party takes the risks that confront PRPs in the ordinary course, such as the uncertainties concerning what remediation will be required and how much the remediation will cost. Thus, most risk transfer contracts contain a provision whereby a risk transfer contractor assumes responsibility for discharging some defined amount of the PRP's legal obligations with regard to a contaminated property. The degree of the assumption is open to negotiation, and, as with all contractual relationships, will be a function of, among other things, the parties' tolerance for risk and willingness to pay a premium for greater protections against risk. The assumption obligation can be defined temporally, *e.g.*, for a fixed number of years versus *in perpetuity*, as well as by scope, *e.g.*, industrial cleanup versus residential cleanup standard.

Risk transfers frequently supplement the contractor's contractual assumption with one or more layers of specialized environmental insurance. Such insurance gives the PRP comfort that the transfer is backed by something more than the contractor's balance sheet. Likewise, the insurance helps contractors protect against a single disastrous site bankrupting their business.

There are two main kinds of insurance products utilized in risk transfers. The first, which is referred to as costcap or stoploss insurance, protects against cost overruns in performing known remediation. While there are differences in the costcap/stoploss products offered by different carriers, most products share the basic concept of the insurer indemnifying the insured for the cost of remediating known contamination once some negotiated amount of funds has been incurred by the insured. The dollar level at which coverage begins is frequent!y referred to as the "attachment point" and is computed by estimating the expected cleanup costs and then adding a premium. Not infrequently, insurers and insureds disagree as to the estimated cleanup costs. When this occurs, the parties exchange their models for estimating cost and attempt to negotiate a mutually acceptable resolution. In most risk transfers, the contractor is the first named insured for the costcap/stoploss coverage and the PRP is listed as a second named or additional insured.

The second insurance product typically employed in risk transfers is referred to as Pollution Legal Liability or PLL insurance. PLL insurance is actually a menu of different coverages from which the insured can pick and choose. Two key components of PLL insurance are coverage for the cleanup of pre-existing but currently unknown contamination and coverage for tort claims. Coverage for cleanup of unknown contamination typically requires that the contamination pre-date the inception of the insurance, but that the discovery of such contamination does not occur until after insurance coverage begins. Such coverage usually has a per-incident deductible, although it is sometimes possible to employ an aggregate deductible where multiple sites are involved. PLL tort coverage, which provides for payment of defense costs as well as judgments and settlements, also typically involves a per incident deductible. Other available components of PLL insurance include coverage for future releases, coverage for releases during transport, and coverage for releases at disposal facilities. The PRP typically is the first named insured under the PLL coverage, with the risk transfer contractor having second named insured or additional insured status.

WHEN SHOULD A RISK TRANSFER BE CONSIDERED?

Risk transfers usually are not the least expensive means of managing environmental liabilities when viewed from the perspective of near-term expenditures. That is because the assuming parties, the contractor and the insurer, need to hedge their bets and thus build premiums into their pricing. Thus, if reducing near-term costs is the paramount driver in developing a remediation strategy, a risk transfer probably is not likely to be the preferred or the appropriate device.

Where, however, a PRP's risk calculus places more value on minimizing uncertainties and worst case scenarios than on reducing near-term costs, a risk transfer may make sense. Companies sometimes find risk transfers to be valuable tools when selling or buying contaminated properties, when merging businesses which hold the liabilities for contaminated properties, when preparing for IPOs, or simply when seeking to gain greater certainty as to future remediation costs. Sellers and purchasers of properties and businesses are often hesitant to assume responsibility for historical environmental liabilities given the uncertainties associated with such liabilities. But if the cost to the parties can be fixed through a risk transfer, the parties can more readily work out as a business matter how to allocate the price of the risk transfer and consummate the transaction. Similar interests may make a risk transfer attractive as a vehicle for settling litigation concerning contaminated properties or as a mechanism for complying with CERCLA cleanup obligations.

THE LIMITATIONS OF RISK TRANSFERS

Risk transfers are contracts. Like all contracts, the strength of the drafting and the behavior of the contracting parties often makes the difference between success and failure. From the PRP's perspective, a risk transfer is only as good as the contractor's and insurer's compliance and balance sheets. In addition, given that risk transfer contracts and related insurance contracts are still in their relative infancy, there is not yet robust precedent as to how courts will interpret such agreements.

Risk transfers sometimes prove infeasible for very large sites that have a wide range of possible, realistic remedies. In such circumstances, the premium required by the risk transfer contractor and insurer may be prohibitively high.

WHY INVOLVE A CONTRACTOR IN ADDITION TO AN INSURER?

It is possible to buy stand alone environmental insurance coverage without also entering into an agreement with an environmental contractor. And doing so might make sense if the parties are willing to remain involved with the management of the remediation. If the parties do not want to be involved with the remediation, however, a full risk transfer transaction involving a contractor and an insurer allows the parties to transfer responsibility for the execution of the remediation as well as the financial risk.

SOME KEY CONSIDERATIONS WHEN STRUCTURING A RISK TRANSFER

Like any complex contract, careful consideration of strategy and drafting terms goes a long way toward achieving one's objectives. The following is a non-exhaustive list of issues that should be considered when structuring any risk transfer:

- *Selecting the Contractor.* One question to consider is whether regulators will respond positively to the particular contractor assuming the PRP's responsibilities. If the answer is no, the regulator will continue looking directly to the PRP rather than to the contractor. In addition, assessing the strength of the contractor's balance sheet (including, its pre-existing liabilities) is critical.
- *The Scope of the Assumption.* Is the contractor assuming all historical liabilities at the site, or just a select portion? How long will the assumption and corresponding indemnity run—in perpetuity or for a fixed time? Will the assumption apply to reopeners? There are no boilerplate answers to these questions. They involve a balancing of the benefits of expanded transfer versus each incremental cost of the expanded protection. In some cases, the desire to maximize the transfer may outweigh paying increased premiums. In other cases, the value of expanded assumption may be dwarfed by the price. A similar calculus should be considered when determining the desired duration.
- *The Impact of Future Owners on the Transaction.* Risk transfer contractors and insurers typically will not assume the risks posed by future users of the property, even as it relates to historical contamination. For example, it is typical for risk transfer contracts to exclude from coverage remediation necessitated by future changes in use or development activities. Deed and use restrictions may be helpful tools for reducing the risk that a future user will take action that weakens the coverage of the risk transfer. In addition, where the PRP is not the current owner or is selling the property at the same time as the implementation of the risk transfer, the PRP should consider contractually binding the current/new owner to require in any future contract of sale that its purchaser not take actions inconsistent with the risk transfer.
- *Financial Structure of Risk Transfers.* In the typical risk transfer, the PRP(s) agrees to pay the risk transfer contractor a sum of money in consideration for the contractor's assumption of remediation responsibilities. Many PRPs are uncomfortable with making a lump sum payment to the contractor at the beginning of the process. There are several alternatives to a lump sum payment to the contractor. One possibility is to establish an escrow account whereby the contractor is paid as it performs work. Relevant considerations when creating an escrow account include the proper benchmarks for releasing payments, who will police the escrow fund, how will the escrow funds be invested, and who bears the risk of loss and enjoys any gains from such investments. Another alternative is to purchase what is referred to as a "finite" insurance policy. With a finite policy, the PRP pays the anticipated costs of remediation directly to the insurer. The pot of money held by the insurer is often referred to as a "commutation account." The insurer, which takes the risk on the investment of the funds, pays the funds to the contractor as work is performed. In a finite structure, the insurer and contractor are both incentivized to ensure that the remediation is performed in an effective and efficient manner.

DO LIABILITY TRANSFERS ALLOW COMPANIES TO WRITE OFF RESERVES OR REALIZE TAX BENEFITS?

Liability transfers may allow for tax benefits, depending on the fact-specific circumstances of the transaction. Accounting for environmental liabilities is a developing area that is receiving more and more regulatory attention. A party to a risk transfer should seek the advice of accounting experts and/or counsel on matters concerning reserves and tax deductions.

CONCLUSION

Risk transfers are not panaceas for the problems posed by all contaminated properties. In the right circumstances, however, they introduce a level of certainty not previously available and assist PRPs and other interested parties in crystallizing the costs of environmental liabilities in a manner that allows property transactions, mergers, and litigation settlements to proceed. Given that each risk transfer is unique and involves multiple complex contracts, significant drafting and negotiating are typically required. In our experience, the process of bringing a risk transfer to fruition typically takes a few months. It is thus advisable to perform the calculus as to whether a risk transfer makes sense as early as possible in a transaction.

NOTE

[1] There are limited exceptions. In some very limited cases, government regulators are willing to release a potentially responsible party and substitute in its place the risk transfer contractor upon the execution of a risk transfer contract.