Environmental Insurance Update

By William J. Squires

Buyers, sellers, owners and developers of real property and their lenders should be aware of potential environmental liabilities and should carefully consider options for minimizing their exposure to such liabilities. As a component of the environmental due diligence process, such parties should consider the merits of obtaining environmental insurance. Although environmental insurance does not eliminate the statutory liability of owners and operators of contaminated property, it is a potential vehicle to minimize exposure to these risks that can be used as a supplement to or in place of contractual allocation of liability between buyers and sellers of real property.

One major advantage of obtaining environmental insurance for newly acquired real property is that policies are issued by insurers with deep pockets who are backed by state insolvency funds, whereas environmental indemnification agreements are often issued by entities or individuals whose assets may be limited to the proceeds from the sale of the real property in question and from whom it may be difficult to collect. Nevertheless, the scope of coverage offered by an environmental insurer is often more limited than the scope of an indemnification given by a seller to a purchaser.

The federal Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") provides for strict, joint and several liability for parties potentially responsible for the release of hazardous substances. Potentially Responsible Parties ("PRPs") under CERCLA include, among others, current owners and operators of real property and past owners and operators of real property who owned or operated such property at the time of disposal of any hazardous substances. PRPs are liable for all remediation, response action and natural resource damages costs as well as certain other costs incurred as a result of the release of hazardous substances. States impose similar liabilities on PRPs for releases of hazardous substances, though such laws vary considerably from state to state. Liability protections available under CERCLA and state laws are limited and typically unavailable to most PRPs. Although not a panacea, environmental insurance is often helpful in mitigating exposure to environmental liabilities.

OVERVIEW OF ENVIRONMENTAL INSURANCE PRODUCTS

While insurers have different names for environmental insurance coverage for owners, operators and developers of real property and their lenders, the two most common types are typically referred to as Pollution Legal Liability ("PLL") and Cleanup Cost Cap ("Cost Cap" or "Stop Loss") policies.

In general terms, PLL policies provide some or all of the following coverage: cleanup costs, third-party claims, and business interruption for unknown pre-existing and new pollution conditions. Although limited coverage can often be negotiated for certain known pollution conditions under PLL policies, the basic policy form is intended to provide coverage for unknown or known and fully resolved pollution conditions.

Cost Cap policies essentially provide cost-overrun insurance for response actions associated with known contamination. In light of the significant risks to insurers associated with such coverage and the substantial efforts necessary for underwriting such policies, Cost Cap policies are usually used for sites with significant contamination (typically sites with response cost estimates well in excess of $2 million) that have been the subject of extensive environmental studies and subsurface investigations. The insured must have a detailed understanding of the extent of contamination and a robust estimate of future response costs necessary to achieve regulatory closure before an insurer might be willing to issue a Cost Cap policy. Cost Cap policies are most effective when combined with or supplemented by PLL coverage since PLL policies can provide coverage for any unknown pollution conditions discovered during the performance of subsurface investigations and other response actions associated with the known conditions covered by Cost Cap policies.

NEGOTIATING SCOPE OF COVERAGE

The scope of coverage under PLL and Cost Cap policies is often subject to extensive negotiations between the insured and insurer. Although the policy limit, policy term, self-insured retention amount (similar to a deductible) and premium are important considerations when negotiating any insurance policy, more mundane provisions shape the scope of coverage.

When negotiating a PLL policy with an insurer, the insured must decide what types of coverage should be included within the scope of the PLL policy. Specific types of coverage vary somewhat between insurers, but typical coverage options offered in PLL policies include on-site cleanup of pre-

CONTINUED ON PAGE 11

LOAN PURCHASE TRANSACTIONS, *CONTINUED FROM PAGE 10*

senior loan, and the intercreditor agreement should include sufficient time periods for the mezzanine lender to effectuate such purchase or foreclosure. The recent New York litigation involving Stuyvesant Town and Peter Cooper Village emphasizes the critical importance of clear and precise drafting in order to avoid unexpected results if the rights of the parties are challenged. In reviewing the intercreditor agreement, a prospective purchaser needs to identify and evaluate the sufficiency of the mezzanine lender's purchase, cure and enforcement rights. Failure of the intercreditor agreement to include such safeguards and to describe them accurately could create additional risks for a purchaser.

INTERDISCIPLINARY CONSIDERATIONS

In addition to the foregoing, a prospective note holder should also carefully consider the effects of a borrower bankruptcy or a potential foreclosure action on the transaction overall as delays caused by bankruptcy or foreclosure proceedings may dramatically affect investment returns. It should be noted that the Bankruptcy Code provides for accelerated proceedings in the event of bankruptcy or reorganization proceedings involving a single asset real estate debtor and that the time periods and procedures for completing a foreclosure vary greatly from state to state. Prospective purchasers will also want to carefully consider whether there are transfer tax implications to the transaction, both in connection with the purchase of the loan, but more likely in connection with a foreclosure proceeding or deed in lieu of foreclosure and upon subsequent sale of the underlying real estate. Finally, a prospective purchaser must carefully consider the income tax implications of the transaction as a whole with respect to the discounted purchase price and, if the purchaser is a REIT, the possibility of "bad income." These are all matters that should be analyzed by the prospective purchaser and its counsel in the early stages of the transaction, as they likely will impact underwriting assumptions.

CONCLUSION

An end to the market conditions resulting from the recent recession is not on the immediate horizon. It is expected that loan purchase transactions will continue to be a major factor in the marketplace, requiring multidisciplinary legal expertise and experience in areas such as finance, securities, real estate and bankruptcy. In particular, experience in the analysis and negotiation of the complexities of intercreditor arrangements will continue to be of critical importance to potential purchasers. <

ENVIRONMENTAL INSURANCE UPDATE, *CONTINUED FROM PAGE 5*

existing or new conditions, off-site cleanup of pre-existing or new conditions, third-party claims for on- or off-site personal injury and property damage, business interruption and liability for transportation, and off-site disposal of hazardous waste.

Once the type of coverage has been selected, the insured must carefully review the language of each coverage section as well as the extensive exclusions, limitations, conditions and restrictive definitions in the PLL policy to evaluate how they impact the scope of coverage. In our experience, negotiating coverage offered by a PLL policy often results in more than 20 endorsements modifying language contained in the standard PLL policy specimen.

Before the insurer binds coverage (and ideally at the beginning of the negotiation process), the insured must disclose all reports, data, documents and other information pertaining to the environmental condition of the insured property. Typically, insurers expect that an insured will, at a minimum, have an ASTM E1527-05 Phase I environmental site assessment relating to the subject property (which buyers and lenders should obtain as part of the environmental due diligence process for any real property, whether or not they intend to obtain environmental insurance). If environmental reports identify contamination or other potential environmental issues on the subject property, insurers will typically exclude or limit coverage for such matters under a PLL policy. While PLL policies do not typically provide coverage for known pollution conditions subject to ongoing response actions, careful negotiation can often broaden the scope of potential coverage for such known issues or, at a minimum, incorporate a reopener when the issue is resolved to the reasonable satisfaction of the insurer.

In light of these complexities, it is critical that a party seeking environmental insurance coverage work with a broker and a law firm who are experienced in negotiating environmental insurance policies and, ideally, also have experience asserting or defending against coverage claims under such policies. <