Chapter 20
YOU WANT TO BUILD WHAT? WHERE?: USING ENVIRONMENTAL INSURANCE TO MANAGE CLEANUP AND DEVELOPMENT RISKS

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Synopsis

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§ 20.01 Introduction*

New environmental insurance products are rapidly entering the marketplace and becoming cost-effective vehicles for settling environmental disputes, shifting environmental risks, and facilitating site cleanup and development. Cost cap, pollution legal liability (PLL), finite risk, and related insurance policies can enable companies with environmental liabilities to obtain seamless insurance coverage to finance cleanup, cover cost overruns and regulatory reopeners, and protect

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against third-party liability. These new policies differ sharply from comprehensive general liability policies because they are tailored and drafted to cover specific risks. Tax-advantaged structures can reduce policy acquisition costs.

This paper will describe these new environmental insurance products and discuss how to tailor them to meet companies' specific needs. The paper will also highlight the applicability of such products to natural resource industries and properties.

§ 20.02 Environmental Insurance Scenario

[1] The Environmental Problem

Modern Mines, Inc. (Owner) owns the inactive Old Forge Mill and Smelter Complex. It includes a concentrator, smelter, and associated disposal facilities (tailings pond, etc.). In 1993, Owner, two prior owners, and ten mining companies with former tolling agreements entered into an administrative order on consent with the United States Environmental Protection Agency (EPA). The consent order contemplated a three-phase approach to investigating and cleaning up the property: (1) historical due diligence to identify prior operations and waste deposits; (2) a remedial investigation and feasibility study (RI/FS); and (3) a recommended remedy. The historical investigation took almost three years. The RI/FS process has consumed nearly five years, due in part to decisions by potentially responsible parties (PRPs) to limit sampling and additional analyses. The PRPs' baseline risk assessment has also been mired in some controversy, with the PRPs' and EPA's toxicologists debating data adequacy, data quality, exposure assumptions, and other risk assessment parameters. In addition to on-site soil contamination, the RI indicates metals contamination in groundwater and in residential soils immediately adjacent to the Old Forge Mill and Smelter Complex. The RI/FS identifies a range of remedial alternatives—from fencing and institutional controls to demolishing the buildings, capping the tailings, and developing the property. The PRPs cannot agree on a proposed remedyEPA is threatening to issue an order under section 106 of the Comprehensive Environmental Response, Compensa-

tion, and Liability Act (CERCLA)[1] to compel a demolition and capping solution, with long-term institutional controls. Nearby residents have also expressed increasing concern over potential health issues and diminution in property values.

[2] The Insurance Solution[2]

Anxious to develop the property, Owner approached EnviroInsur (Broker), a large international insurance broker. Working with Broker, Owner approached several underwriters regarding the possibility of using insurance to finance the remediation and provide cost cap and third-party liability coverage. At the same time, Owner and Broker presented to the PRPs the possibility of using a comprehensive environmental insurance policy as a vehicle for settling their liabilities and closing out the site.

The PRPs settled their differences and gave Owner control over cleanup and development of the property in the following comprehensive insurance and settlement transaction:

- Owner and insurance company InsurCo entered into an insurance policy agreement whereby the insurer provided pre-funded (finite risk) coverage and third-party cleanup and liability coverage (PLL) (including coverage for third-party bodily injury and property damage claims) up to $50 million.
- Owner and the other PRPs structured the insurance purchase through a settlement agreement and a "qualified settlement fund" (Fund), which may facilitate early deduction of premium payments made by the Fund on behalf of the settling PRPs.
- EPA recognized the transaction by issuing conditional releases to the PRPs, enabling them to exit the transaction, take the tax benefits, and clean their balance sheets.

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[1]Pub. L. No. 96-510, 94 Stat. 2767 (1980) (codified at 42 U.S.C.A. §§ 9601-9675 (1995 & Supp. 2000)), *as amended by* the Superfund Amendments and Reauthorization Act of 1986 (SARA), Pub. L. No. 99-499, 100 Stat. 1613 (1986) (codified at 42 U.S.C.A. §§ 9601-9675 (1995 & Supp. 2000)).

[2]The types of insurance coverages and benefits identified in this scenario are discussed throughout this paper.

[3] Five Years Later

Using the finite risk insurance funds, Owner has demolished the mill and smelter and disposed of the remnants at a nearby industrial landfill. It has capped the tailings, installed a downgradient slurry wall, and is conducting ongoing groundwater monitoring. Relying on the PLL coverage, Owner has entered a joint venture with GrandVenture to develop a golf course on the capped tailings and to build an apartment, condominium, and retail/commercial complex on the remaining portions of the mill and smelter site. Community concerns regarding the property have substantially dissipated with completion of the remediation and plans for property development. Further, to facilitate construction financing, GrandVenture has entered into construction lending agreements and purchased secured creditor/impaired property insurance to finance development of the site as it proceeds.

§ 20.03 What Are the New Environmental Insurance Products?

[1] Comprehensive General Liability Policies

Following the adoption of CERCLA, both former and current landowners and operators of contaminated properties have faced significant environmental cleanup liabilities. Environmental cleanups often involve several millions of dollars.[3] Faced with this prospect, private landowners and operators often must pursue claims against other responsible parties and insurers to recover all or part of the costs of cleanup and damages arising from environmental contamination.[4] In addition to cost recovery litigation under CERCLA and other

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[3]Remediation at hazardous waste cleanup sites often involves multiple operable units (e.g., separate operable units for soil remediation and groundwater remediation). The average cost to perform a remedial investigation and remedial design is now estimated at approximately $1.35 million and $1.26 million, respectively, per operable unit. The average cost to complete a remedial action is estimated at $21.96 million per operable unit. *See* 60 Fed. Reg. 8212, 8216 (Feb. 13, 1995).

[4]*See* Hal J. Pos, "Strategic Considerations in Litigating and Settling Private Cost Recovery Actions for Environmental Cleanups," 40 *Rocky Mt. Min. L. Inst.* 6-1, 6-38 (1994).

federal statutory[5] and state common law theories, claims against insurance policies have also emerged as a fertile ground for recovering environmental cleanup costs.[6]

Coverage for environmental claims is most often provided under the bodily injury and property damage liability provisions of a standard comprehensive general liability (CGL) policy.[7] These policies, drafted by the insurance industry to provide broad liability coverage to insureds, transfer the risk of loss to an insurer absent specific exclusion. CGL policies provide coverage against liability, whenever imposed or threatened to be imposed, as a result of bodily injury or property damage that occurs[8] during the policy term. CGL policies can be very important because they provide coverage for any bodily injury or property damage that took place during the policy term, no matter when the bodily injury or property

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[5]Private parties may also be able to import causes of action or standards of care from other environmental statutes and regulations promulgated thereunder. Such statutes may include the Resource Conservation and Recovery Act, 42 U.S.C.A. §§ 6901-6992k (1995 & Supp. 2000); Emergency Planning and Community Right-to-Know Act, 42 U.S.C.A. §§ 11001-11050 (1995); Toxic Substances Control Act, 15 U.S.C.A. §§ 2601-2692 (1998); Clean Water Act, 33 U.S.C.A. §§ 1251-1387 (1986 & Supp. 2000); Clean Air Act, 42 U.S.C.A. §§ 7401-7671q (1995); and the Safe Drinking Water Act, 42 U.S.C.A. §§ 300f to 300j-26 (1991). Furthermore, mini-CERCLA statutes and underground storage tanks statutes may provide additional causes of action. *See, e.g.*, Utah's Underground Storage Tank Act, Utah Code Ann. §§ 19-6-401 to 19-6-427 (1998 & Supp. 2000).

[6]*See* George R. Lyle, "Why You May Have More Insurance Coverage for Environmental Claims Than You Thought," 46 *Rocky Mt. Min. L. Inst.* 15-1 (2000).

[7]First introduced in 1940, the standard CGL policies have undergone significant, substantive revisions—in 1966, 1973, and 1986. Generally speaking, the 1966 revision changed the standard policy from an "accident-based" to an "occurrence-based" policy. In 1973, the "sudden and accidental" pollution exclusion clause was added. As a result of adverse judicial decisions limiting the scope of the "sudden and accidental" pollution exclusion and mounting coverage claims for environmental liabilities, the insurance industry expanded the pollution exclusion with the so-called "absolute pollution exclusion." This exclusion was designed to absolutely preclude coverage of environmental claims except for very limited circumstances.

[8]"Occurrence" policies provide coverage for liability for bodily injury or property damage arising during the policy term, regardless of the year in which a claim alleging liability for such damage is brought. These policies are to be distinguished from "claims-made" policies. Under claims-made policies, coverage is effective if the claims alleging liability are made within the policy term, or any extended reporting period under the policy, and result from an occurrence that took place after the retroactive dates stated in the policy declarations. The new environmental policies, discussed in this paper, are claims-made policies.

damage is discovered. Thus, CGL policies issued in the 1950s, for example, may provide coverage for recently discovered environmental contamination or recently filed environmental liability claims that arise from releases or threatened releases of hazardous substances to the environment during the policy term. These older CGL policies are particularly important at sites, such as the historic Old Forge Mill and Smelter Complex, where the prior owners and operators are required to incur significant environmental cleanup costs related to historic releases of hazardous substances to the environment. As the insurance industry has continued to substantially restrict the scope of insurance coverage under CGL policies through various exclusions, such as the pollution exclusion, the importance of these older CGL policies has increased, as those policies have become the most likely means for recovery of environmental claims.[9]

Because of the magnitude of environmental claims, such claims often result in coverage litigation. Environmental coverage litigation is complex and often protracted, fiercely contended, and expensive. In many instances, an insured or an insurer has much more at stake than the resolution of who should pay for the environmental cleanup liabilities associated with a particular site. An insured may be seeking to establish its coverage position concerning several other cleanup sites, while an insurer may be guarding against coverage liability to other insureds with identical insurance policies or similar coverage claims.[10] At the heart of this complexity is the patchwork of decisions in different states on critical coverage issues pertaining to, for example, the "pollution

[9]In the early 1980s, insurers added an environmental impairment liability (EIL) insurance policy to the insurance package offered to insureds. This policy was designed to cover the gap in coverage created by the "sudden and accidental" pollution exclusion in CGL policies. These EIL policies were typically issued through separately-created subsidiaries or new entities to protect the parent insurer from significant environmental claims. Though the EIL coverage was popular at its inception, such coverage was, for the most part, discontinued due to a significant increase in premiums charged to cover the rising number of environmental claims.

[10]For an insightful discussion of strategic considerations and environmental coverage litigation, see Thomas H. Milch, "Strategic Considerations When Choosing a Forum," *The Brief* 19 (Summer 1993).

exclusion"[11] and whether coverage is triggered[12] under a particular policy.[13] Because state law governs the interpretation of insurance policies, the scope of coverage under the same insurance policy effectively differs from state to state. Thus, the outcome of a particular environmental coverage claim often turns on complex choice-of-law rules that determine which state's law applies to the insurance contract and the substantive coverage issues in the case. Additionally, if an

[11]The "sudden and accidental" pollution exclusion consists of two parts: an exclusion and an exception to the exclusion. The "pollution exclusion" excludes coverage for property damage arising out of the discharge, dispersal, release, or escape of contaminants or pollutants *unless* such discharge, dispersal, release, or escape is "sudden and accidental." Those cases upholding coverage have consistently interpreted the pollution exclusion to preclude coverage only if an insured "intended or expected" the damage resulting from its operations, and not to exclude coverage merely because the pollution resulted from the regular course of that insured's business. *See, e.g.*, Nat'l Grange Mut. Ins. Co. v. Cont'l Cas. Ins. Co., 650 F. Supp. 1404, 1409-12 (S.D.N.Y. 1986); Jackson Township Mun. Utils. Auth. v. Hartford Accident & Indem. Co., 451 A.2d 990, 993-94 (N.J. Super. Ct. 1982). Moreover, in following this rule, these cases have interpreted the term "sudden and accidental" to mean "unexpected and unintended," relying on dictionary definitions of the term "sudden" which impute no temporal significance to that term. *See, e.g.*, Queen City Farms, Inc. v. Cent'l Nat'l Ins. Co., 882 P.2d 703, 720-21 (Wash. 1994); Outboard Marine Corp. v. Liberty Mut. Ins. Co., 607 N.E.2d 1204, 1216 (Ill. 1992). However, a number of courts have interpreted the "sudden and accidental" clause to exclude coverage. *See, e.g.*, U.S. Fid. & Guar. Co. v. Morrison Grain Co., 999 F.2d 489, 493 (10th Cir. 1993); Sharon Steel Corp. v. Aetna Cas. & Sur. Co., 931 P.2d 127, 134-36 (Utah 1997). In interpreting the pollution exclusion, these cases focus not on the *harm*, but on the *release* of contaminants into the environment. These cases find coverage excluded by the pollution exclusion if the release of the pollutants into the environment was expected or intended by an insured. Moreover, these cases specifically reject the line of cases that read "sudden and accidental" as meaning merely "unexpected or unintended." Instead, such cases find that the term "sudden" is not ambiguous, and that it has a temporal connotation in the sense of instantaneous or abrupt. Thus, coverage is precluded for gradual, long-term releases to the environment.

[12]Trigger-of-coverage theories that have been articulated by courts include the "exposure" trigger, the "actual injury" or "injury-in-fact" trigger, the "manifestation" trigger, and the "continuous" trigger. The challenge for the insured is to advocate the trigger-of-coverage theory that not only supports coverage, but maximizes, to the extent possible, coverage under the facts of the case.

[13]In addition to the "pollution exclusion," other significant coverage issues raised by environmental claims include: whether the claim involves an "occurrence" as defined in the policy at issue; whether the coverage is "triggered" under the policy at issue; whether environmental claims constitute "property damage"; whether the term "damages" in the subject policy includes coverage for cleanup costs; and whether the "owned property" exclusion excludes or significantly limits the coverage for cleanup costs. For a good discussion on these and other coverage issues in CGL policies, see generally Lyle, *supra* note 6.

insured and insurer are residents of different states, the insured may have an opportunity, based on diversity jurisdiction, to litigate an environmental coverage claim in federal court. Whether an environmental coverage claim is brought in state or federal court can affect choice-of-law determinations, which, in turn, affect what substantive insurance law is applied in the case.[14]

This patchwork of decisions in different states on important substantive coverage issues under CGL policies, coupled with the application of complex choice-of-law rules and the availability of federal court jurisdiction, can create great uncertainty in the final outcome of an environmental coverage claim. Given this level of uncertainty in coverage, CGL policies are generally not reliable vehicles for shifting environmental risks, facilitating site cleanup and development, or settling environmental disputes.

In addition to these uncertainties, a standard CGL policy is not tailored or drafted to cover specific environmental risks. Coverage under a standard CGL policy is limited on its face to claims for bodily injury and property damage only. Depending on the policy years, the coverage under a CGL policy may be further limited by specific exclusions such as the pollution exclusion. Thus, properly so, a standard CGL policy is not viewed as a vehicle to address specific environmental risks important to, for example, landowners or prospective purchasers who intend to clean up and develop contaminated properties or to parties in mergers and acquisi-

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[14]This difference between state and federal courts may arise when a relevant federal court or entire federal circuit has addressed a substantive coverage issue, but the law in the relevant state court is unclear or undecided. For example, the Fourth and Eighth Circuits have held that under Maryland and Missouri law, respectively, CERCLA response costs are not covered as "damages" under a CGL policy. Md. Cas. Co. v. Armco, Inc., 822 F.2d 1348 (4th Cir. 1987), *cert. denied*, 484 U.S. 1008 (1988); Cont'l Ins. Co. v. Northeastern Pharm. & Chem. Co., 842 F.2d 977 (8th Cir. 1988), *cert. denied*, 488 U.S. 821 (1988) (NEPACCO). On that basis, federal district courts in Maryland and Missouri have been bound to rule the same, but a Maryland or Missouri state court can reach a contrary result because their respective state supreme courts have either not resolved the issue or have resolved the issue differently. *See, e.g.*, Bausch & Lomb, Inc. v. Utica Mut. Ins. Co., 625 A.2d 1021 (Md. Ct. App. 1993) (rejecting the Fourth Circuit's view of Maryland law in *Armco*); Farmland Indus., Inc. v. Republic Ins. Co., 941 S.W.2d 505, 510 (Mo. 1997) (rejecting the Eighth Circuit's interpretation of Missouri law in *NEPACCO*).

tions who desire to allocate among themselves financial responsibilities for existing or future environmental liabilities. Similarly, due to its inherent uncertainties and limited scope of coverage, a standard CGL policy is not commonly considered a vehicle to resolve third-party disputes concerning environmental risks and liabilities. However, the new environmental liability policies can be structured to eliminate the uncertainties and risks associated with environmental coverage under a CGL policy.

[2] Tailored to Address Specific Risks

Unlike the generalized coverage provided by CGL policies, the new environmental insurance policies are structured, negotiated, and manuscripted to address specific environmental risks at individual sites. They are tailored to meet the needs of a given transaction such as a PRP settlement, a merger and acquisition, financing and developing environmentally impaired property, financial assurance for site closure, and balance sheet cleanup for "generators" or "arrangers" with multi-site, off-site CERCLA exposure.

Available coverages generally include finite risk, excess cleanup costs, PLL (cleanup and third-party liability), legal expenses, natural resource damages, contractors' pollution legal liability, off-site transport and disposal (past and future), non-owned sites, pollutant-specific coverage, business interruption, and impaired collateral. Insurable conditions may include existing and new pollution conditions, known and unknown pollution conditions, on-site and off-site conditions, and soils, surface water, and groundwater conditions.

Underwriters[15] vary in the length of coverage they offer. Terms of ten years are most common. Twenty- and thirty-year coverage terms—of greater value in providing financial finality to insureds—are available from underwriters with greater experience and more aggressive marketing programs. The availability of terms depends primarily on the ability of underwriters to transfer risks to the reinsurance market.

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[15]For purposes of this paper, the term "underwriters" refers to the parties negotiating environmental insurance policies on behalf of prospective insurers. The term "insurer" refers to the company that actually issues the insurance policy.

[3] Due Diligence and Disclosure

The new insurance policies are priced to reflect the specific risks to be assumed by the insurer. Consequently, the due diligence and disclosure associated with underwriting a complex site or series of sites more closely resemble a natural resource acquisition or transaction than a CGL policy application. Prospective insureds are expected to assemble comprehensive data rooms, as closely managed as in a sensitive natural resource acquisition. Underwriters are expected to sign broad nondisclosure agreements. Underwriters may seek representations in the policy application regarding completeness of disclosure. In contrast, prospective insureds may seek to shift some risk of nondisclosure to the underwriters by including underwriter acknowledgements that all requested categories of documents have been provided.

[4] Specialized Brokers Assist in Due Diligence and Risk Profiling

Another significant feature of the new environmental insurance policies is the role of specialized environmental analysts within the brokerage industry. The major brokerage firms placing policies in this area have in-house environmental consulting organizations or obtain the same expertise through outsourcing. The purpose of these organizations is to conduct a parallel due diligence exercise with underwriters in an attempt to forge a consensus on the environmental risk profile, which underwriters ultimately must price, using a combination of premium amount, attaching point (self-insured retention), policy term, and other significant policy variables. These specialized broker-service organizations provide a technical bridge between the prospective insured and the underwriter by bringing a unique combination of environmental consulting expertise and knowledge of the environmental insurance industry and how it evaluates and prices perceived environmental risks.

[5] Policies are Individually Manuscripted

Each of the insurers offering specialized environmental coverage has its own policy specimens. They resemble Chinese menus, with the prospective insured presumably able to select

coverage grants, definitions, exclusions, representations and warranties, and other policy clauses to fit its particular needs. Not surprisingly, the policy specimens favor the insurers. Consequently, the policies are individually negotiated and manuscripted to yield policies with structure and language agreeable to both parties, or no policy at all.

§ 20.04 Are These Environmental Policies Right for Your Site?

Environmental insurance provides long-term assurances concerning the financial ability of parties to carry out their obligations in transactions involving potentially significant environmental risks. Such assurances may be required, for example, in a major cleanup and development project involving contaminated property such as the Old Forge Mill and Smelter Complex, where the insurance facilitated a multi-party PRP settlement, an EPA liability release, and site cleanup and development. Environmental insurance effectively shifts cleanup and third-party environmental risks to financially secure insurers and reinsurers, thereby providing a funding source that is independent of the parties to the transaction and is not dependent on the future financial condition of the parties.

[1] Potential Benefits

Whether an environmental insurance policy may be beneficial to a particular transaction depends largely on the magnitude of the environmental risks at issue and the parties' objectives in managing those risks on a going-forward basis. By shifting liability risks associated with contaminated property to insurers and reinsurers, environmental insurance policies can provide the following potential benefits to landowners:[16]

[16]For purposes of this paper, the term "landowners" includes numerous parties that could benefit from an environmental insurance policy, such as landowners, prospective purchasers and developers of a contaminated property, and PRPs involved at a contaminated property.

[a] Finality of Cleanup and Third-Party Liability

Environmental insurance policies can enable landowners facing significant environmental liabilities to purchase seamless insurance coverage to finance cleanup, cover cost overruns and regulatory reopeners, and protect against third-party liability. In transactions involving cleanup and development such as the Old Forge Mill and Smelter Complex, these policies can provide coverage for expected cleanup costs (finite risk coverage); cost overruns to complete the required cleanup; additional cleanup costs as a result of newly discovered contamination; third-party claims for cleanup costs, property damage, and bodily injury arising from the presence or release off-site of contaminants; and other environmental costs. These other costs can include natural resource damages; governmental reopeners triggered by, for example, changes in cleanup standards or cleanup technologies; remedy failure; and legal defense and investigation costs. Additionally, environmental policies can include protection for lenders who provide financing for the purchase, cleanup, and development of contaminated property; delays in completion of the cleanup that result in business interruption losses or liabilities; errors and omissions by cleanup contractors; and risks resulting from the prospective release of contaminants from new operations following cleanup. Such comprehensive coverage provided by these new environmental policies effectively shifts environmental risks to insurers and reinsurers, thereby providing landowners of contaminated property, such as Owner and the settling PRPs, with a substantial degree of finality concerning cleanup and third-party liability risks.

[b] Financial Reporting and Financial Statements

Companies are often required to disclose in 10-Ks, annual reports, or in private offering memoranda significant environmental liabilities such as expected cleanup costs and potential third-party claims arising from contaminated property.[17]

[17]For example, Item 103 of Regulation S-K, which details the items required by Form 10-K, requires disclosure of administrative or judicial proceedings related to regulations governing "the discharge of materials into the environment" if such

Additionally, auditors may require companies to reserve or book against earnings expected cleanup costs or potential environmental liabilities material to a company's financial condition.[18] By tailoring comprehensive environmental coverage to effectively shift cleanup costs and third-party liability to financially secure insurers and reinsurers, such coverage may have the added benefit of eliminating, at least for publicly-traded companies, 10-K and annual reporting obligations, as well as free booked reserves relating to contingent environmental liabilities identified in corporate financial statements.

[c] Tax-Structured Advantages

As discussed below,[19] another potential benefit of environmental policies is to accelerate tax deductions for cleanup costs incurred. In most cases, the landowner of contaminated property can write off cleanup costs only as it incurs the costs of cleanup. If, however, a landowner such as Owner purchases an environmental policy with finite risk coverage that requires the pre-funding of cleanup costs, and there is adequate risk transfer in the insurance policy, then Owner may be able to accelerate the tax deduction for environmental cleanup costs in the year in which the environmental insurance policy is purchased.

[d] Settlements with PRPs and Historic Insurers

Environmental policies can also be effective vehicles to settle long-standing disputes between PRPs or between insureds

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proceedings are "material to the business or financial condition" of the issuer. Instruction 5, 17 C.F.R. § 229.103 (2000). A proceeding is defined as "material" if it "involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges or charges to income." *Id. See also* Robert H. Feller, "Environmental Disclosure and the Securities Laws," 22 *B.C. Envtl. Affairs L. Rev.* 225 (1995).

[18]The Securities and Exchange Commission (SEC) requires compliance with FASB (Financial Accounting Standards Board) standards for the disclosure of contingent liabilities, which call for the use of a probability/magnitude test in order to determine when a possible liability must be recognized. Feller, *supra* note 17, at 230-31, n.30 (citing FASB No. 5). *See also* Gerard A. Caron, Comment, "SEC Disclosure Requirements for Contingent Environmental Liability," 14 *B.C. Envtl. Affairs L. Rev.* 729 (1987).

[19]*See infra* § 20.05[10].

and their historic insurers under CGL policies concerning contaminated property. By tailoring comprehensive environmental coverage to protect against cleanup costs and third-party liabilities, a landowner such as Owner, in exchange for a capital contribution to cover a share of the cleanup costs, can (1) buy out the liability of the other PRPs; (2) assume all environmental liabilities, including contracting and managing remedial construction, operation and maintenance, and risks of future claims; and (3) indemnify the PRPs for any claims made against them arising from past, present, and future environmental liabilities at the property.[20] This contribution or payment by the PRPs can help defray Owner's cleanup costs, including long-term operation and maintenance costs, and the insurance premium to purchase long-term (20 years or more) environmental coverage for significant, site-specific environmental risks.

Similarly, in a coverage dispute with an insurer involving CGL policies, often the sticking point in settlement negotiations is an insurer's demand for a full policy release as a condition to settlement with an insured. Not surprisingly, insureds typically are unwilling to agree to a full policy release because they do not want to be exposed to potentially significant, unknown, future environmental liabilities relating to their historic operations or contaminated properties. However, by purchasing an environmental policy that effectively shifts these potential, future environmental liabilities to deep-pocket insurers and reinsurers, an insured may be able to reach a final settlement with its historic insurers by providing, in exchange for monetary consideration, a full policy release under historic CGL policies and an indemnification for all future environmental claims covered by the environmental policy.

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[20]Similarly, in a merger and acquisition transaction involving contaminated property, the parties can purchase comprehensive environmental coverage that protects against all significant known and unknown environmental liabilities, including, without limitation, finite risk, cleanup cost overruns, and third-party liability. Through the use of comprehensive environmental coverage, environmental risks associated with the merger and acquisition can be adequately addressed to allow the transaction to proceed.

[e] Cleanup and Development Control by Landowner

As is the case at the Old Forge Mill and Smelter Complex, environmental investigations and cleanup can be gridlocked for many years as PRPs fight over, among other issues, sampling locations, data interpretation, and allocation of investigation and cleanup costs and liability. This gridlock often results in increased cleanup costs and delays in property development. To eliminate these additional costs and delays, a landowner of contaminated property may wish to control the cleanup and development of the property. By purchasing a comprehensive environmental policy that effectively allows it to buy out the liabilities of the other PRPs, a landowner such as Owner can take control over negotiations with federal and state regulators concerning the cleanup and development of its contaminated property without significant financial risk. Additionally, the comprehensive environmental policy can eliminate the transactional costs associated with gridlock between Owner and the PRPs, as well as provide insurance protection to future interested parties at the property, including, without limitation, investors, joint venture partners, lenders,[21] and tenants.

[f] Other Benefits

In addition to the potential benefits outlined above, environmental insurance may also increase the market value of Owner's environmentally impaired asset by removing the "stigma" associated with such an asset.[22] Also, environmental insurance may allow a landowner of contaminated property to

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[21] Environmental insurance coverage can include protection for lenders by providing "collateral value" protection. This protection covers the risk of contamination being discovered on the collateral (contaminated property) that supports the loan, the collateral depreciating, the borrower (landowner) failing to service the loan, and the resulting default on the loan.

[22] Environmental insurance policies generally do not cover stigma damages. These damages are not viewed by insurers as being associated with any pollution event; rather, they are typically associated with the operation and characterization of the contaminated property. Additionally, insurers have been unwilling to insure for stigma damages because it is difficult to quantify and to determine the appropriate premium for such coverage. Also, stigma damages are typically driven by other factors that are not environmentally related, such as real estate values or the economics of the real estate market at the time the stigma arises.

respond more quickly to newly-discovered contamination. For example, a landowner who finds newly-discovered contamination that exceeds regulated levels may be able to clean up the contamination voluntarily through an amendment to its remedial action plan approved by the applicable federal or state regulatory agency. In contrast, a landowner relying on coverage under historic CGL policies may need to wait for the federal or state regulator to bring an enforcement action against it in court to trigger coverage under the CGL policies.[23]

Environmental insurance policies can also provide the added benefit of financial assurances to federal and state environmental regulators that adequate funding is available through an environmental policy to fund the expected cleanup costs, any cost overruns or additional costs incurred as a result of newly-discovered contamination on the property, governmental reopeners, or remedy failure. These policies can also be drafted to insure against potential liabilities that may arise from work performed by environmental consultants and cleanup contractors at a contaminated property.

[2] Potential Disadvantages

Although these new environmental policies can be very beneficial in addressing significant environmental liabilities such as those facing Owner and the PRPs at the Old Forge

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[23]The standard form CGL policy states that the insurer will defend any "suit" against the insured. For the purpose of activating the insurer's obligation to defend the insured, no one disputes that the term "suit" involves lawsuits filed in a court by governmental agencies or by third parties such as neighboring landowners. Under federal and state environmental laws, governmental agencies may bring claims against insureds in administrative proceedings (letters or notices of violations) instead of traditional lawsuits filed in court. In environmental insurance cases, insurers often argue that they do not have a duty to defend these administrative proceedings because they are not "suits," even though the insured's liabilities are determined in these proceedings quite as conclusively as they would be in a court of law. *See, e.g.*, Ray Indus., Inc. v. Liberty Mut. Ins. Co., 974 F.2d 754, 757 (6th Cir. 1992); Aetna Cas. & Sur. Co. v. Gen'l Dynamics Corp., 968 F.2d 707, 713 (8th Cir. 1992). Most courts that have considered this issue agree that a formal lawsuit is not necessary to trigger the insurer's duty to defend. *See, e.g.*, Aetna Cas. & Sur. Co. v. Pintlar Corp., 948 F.2d 1507, 1516-18 (9th Cir. 1991); Avondale Indus., Inc. v. Travelers Indem. Co., 887 F.2d 1200, 1206 (2d Cir. 1989); Quaker State Minit-Lube, Inc. v. Fireman's Fund Ins. Co., 868 F. Supp. 1278, 1309-11 (D. Utah 1994). Consequently, if the insured receives a demand or communication from EPA or a state regulatory agency that states that the insured is or may be responsible for an environmental problem, such demand or communication is considered sufficient to trigger the duty to defend under CGL policies.

Mill and Smelter Complex, these policies do not come without some difficult and potentially costly tradeoffs to insureds.

[a] Transaction Costs: Due Diligence and Manuscripting

As discussed below,[24] the process of purchasing a manuscripted environmental insurance policy requires extensive due diligence by the underwriters. This due diligence, critical to the underwriters' understanding of the environmental risks and their ability to tailor specific environmental coverage needs at an acceptable pricing structure, requires robust site characterization of existing contamination; review of development plans, considering all possible future land uses; a comprehensive remedial action plan consistent with planned future land uses; review of documents that describe the existing property conditions, the approved remedial action plan, and proposed development of the property; interviews with regulators; and development of a comprehensive set of insurance specifications to assure adequate protection against all identified and insurable environmental risks.

In addition to the due diligence process, negotiations over the actual environmental policy language and contract administering the claims under the policy can be lengthy and expensive.[25] These negotiations are critical to assure that the language in the environmental policy meets the specific requirements of the particular transaction and addresses all insurable environmental risks. Particularly in cases where the environmental insurance is used to fund expected cleanup costs, it is important that the claims administration contract be drafted to assure prompt payment of claims as cleanup costs are incurred. The standard policy used by environmental underwriters is typically the starting point for negotiations. Amendments to the standard policy form are made through endorsements and changes to policy language. This negotiating process often requires numerous meetings with the underwriters over the course of several weeks or even months.

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[24] *See infra* §§ 20.05[6][c], [8][a].

[25] *See infra* § 20.05[9][a]-[k].

[b] Pre-Funding Cleanup Costs

Another potential disadvantage of these new environmental insurance policies is the finite risk funding program.[26] Under this program, a landowner pre-funds the expected cleanup costs rather than spreading those costs out over time as such costs are incurred, which is typically the case when environmental insurance is not used. Depending on the magnitude of the contamination, pre-funding the cleanup costs could involve a substantial sum. If, for this or any other reason, the landowner decides not to purchase finite risk coverage, the underwriter would likely increase the expected cleanup costs to include a buffer to reflect, in part, the time value of money had the expected cleanup costs been pre-funded under finite risk coverage. A landowner such as Owner would be required to pay the adjusted expected cleanup costs (equivalent to a deductible or self-insured retention) before environmental coverage for cleanup cost overruns or additional cleanup costs relating to newly-discovered contamination, would be triggered under its policy.

[c] Claims-Made Policy

In contrast to the "occurrence-based" CGL policies, the new environmental insurance policies are issued on a "claims-made" basis. Claims-made coverage is, in and of itself, a limita-

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[26] Finite risk coverage works essentially as follows. Assuming that the expected cleanup costs are $5 million, the insurer will typically add a 10% buffer, in excess of the expected cleanup costs, such that the attachment point, or the point at which coverage is triggered under the policy, would be $5.5 million. The insurer typically offers a one-to-one relationship of what the expected cleanup costs are to the policy limits. Thus, for expected cleanup costs of $5 million, the insured may purchase another $5 million of excess coverage. Pricing for excess coverage generally runs about 6-8%. Based on a 6% rate, the cost of $5 million worth of additional coverage would be approximately $300,000. If the $5 million cleanup is extended over 20 years, then the insurer will do a net present value calculation to determine what the premium would be in the year the policy is purchased. If you assume the net present value on $5 million over 20 years to be $3.5 million, then the insured would pay that amount ($3.5 million) plus the amount of the premium ($300,000) on the $5 million excess coverage to cover the risk transfer layer. Thus, for an additional $300,000, the insured would obtain a $10 million limit policy for a $5 million cleanup with a zero deductible, and the insurer would be required to pay out the claim from the first day of the cleanup. Stated another way, for a pre-payment of $3.8 million, reflecting the net present value plus the risk transfer premium, the insured would get a zero deductible policy and the insurer would pay out the cleanup claim over time, beginning with the first day of the cleanup.

tion on coverage because it only covers claims made during the policy period.[27] For example, a release to the environment at the Old Forge Mill and Smelter Complex that occurred in 1965 and is discovered in 1993 would trigger a claim under an occurrence-based policy issued in 1965. However, under a claims-made policy, there must be an environmental policy in effect in 1993 when the claim is made to cover a release to the environment in 1965. Thus, there must be a policy in effect at the time that the claim is made or the contamination is discovered. Since environmental contamination tends to involve gradual, long-term releases to the environment, it is important that a landowner negotiating an environmental insurance policy seek the maximum policy term, typically 20 or 30 years.

In defense of the claims-made environmental insurance policy, the long-term nature of the policy arguably provides almost the same protection as an occurrence-based policy. In most instances, environmental contamination at a property undergoing cleanup and development either is discovered fairly quickly, or can be addressed within the effective term of the policy. Similarly, in transactions involving long-term environmental indemnities, the risk to an indemnitor generally decreases with time. Thus, a 20- or 30-year environmental insurance policy may adequately cover the years in which the insured environmental risks are most likely to arise.

[d] Policy Interpretation

There is a well-established general rule of law that standard form insurance contracts such as CGL policies are contracts of adhesion. Consequently, any ambiguities in these policies are construed against the insurer.[28] However, this rule of law

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[27] In very limited circumstances, occurrence-based environmental policies have been written where the cleanup assures that the property will have no remaining environmental problems. These limited circumstances may arise in connection with a residential-based cleanup.

[28] *See* Thomas J. Lipton, Inc. v. Liberty Mut. Ins. Co., 314 N.E.2d 37, 39 (N.Y. Ct. App. 1974); Raska v. Farm Bureau Mut. Ins. Co., 314 N.W.2d 440, 441 (Mich. 1982). Also, a sharp division in judicial authority construing a particular provision is evidence of the term's ambiguity. United States Fid. & Guar. Co. v. Thomas Solvent Co., 683 F. Supp. 1139, 1155-56 (W.D. Mich. 1988), *vacated and clarified on other grounds*, 683 F. Supp. 1139, 1174-77 (W.D. Mich. 1988).

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appropriate environmental coverage that addresses existing and potential environmental liabilities concerning the property.

Underwriters fear what they do not know. While underwriters will most likely write coverage on a property that is poorly characterized and presents gaps in soil, surface water, or groundwater data, they will generally transfer that risk to a landowner in the form of a higher premium. The lack of information or data gaps will be resolved against the landowner, and the underwriter will therefore assume a worst-case scenario concerning the environmental conditions of the property. Thus, a contaminated property that has been thoroughly characterized will, even if the data is unfavorable, likely qualify for a reduced premium, so long as the conditions are more favorable than the worst-case scenario. Also, it goes without saying that a landowner must understand the environmental conditions on its property and the existing and potential liabilities arising from those conditions before it can make an informed decision on what environmental coverage to purchase. Environmental insurance coverage does not come cheaply, and the landowner must be careful to avoid the temptation to purchase coverage that it may not need. The most effective way to achieve this goal is to thoroughly characterize the property and understand the liabilities posed by the property.

A proper characterization of the property includes complete and thorough environmental assessments by well-respected environmental consulting firms. These assessments should be supported by the appropriate amount of testing and should analyze all potential sources of contamination. The underwriters' ability to trust and rely on the thoroughness and accuracy of these assessments cannot be overemphasized. It gives the underwriters an added sense of security, which tends to lower the cost of the premium and speed up the underwriting process.

Underwriters will expect that the prospective insured[29] will allow them access to all data, testing results, environmental reports, correspondence with governmental agencies, and other relevant documents so that they may best understand the property conditions. If the number of documents is small, the prospective insured will simply copy and transmit those documents to the underwriters. If, however, the documents exceed 1,000 pages or so, the prospective insured may want to create a "data room," as discussed below.[30]

[2] Analyze the Environmental Conditions for Which You Need Insurance Protection

One of the chief objectives of performing a thorough environmental assessment is to identify those environmental conditions that require coverage to protect a landowner of contaminated property. Examples of questions a landowner should ask itself include:

- Does the company require coverage for only historical contamination or also for contamination that is still being released?
- Is the company concerned more about on-site contamination because it, like Owner, intends to develop the property, or is it primarily concerned that the contamination might be migrating off-site?
- Given the contaminants, their levels, and their mobility, is a natural resource damages suit a real possibility?
- Given the contaminants and their levels, are third-party claims a real possibility?
- What is the possibility of "unknown contamination"?

The answers to these questions will assist a landowner in selecting from the available choices of coverage described in the next section.

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[29] For purposes of this paper, the use of the terms "prospective insured," "insured," "client," and "taxpayer" refer to, among others, landowners, prospective purchasers and developers of a contaminated property, and PRPs involved with a contaminated property.

[30] *See infra* § 20.05[6][c].

[3] Outline the Coverages You Need

[a] Pollution Legal Liability

This is a commonly written coverage. PLL coverage provides a landowner with a menu of coverages to choose from that address both on- and off-site liabilities. For instance, this type of coverage can include bodily injury claims or off-site, third-party claims such as toxic tort and cleanup costs caused by a condition emanating from the property.

[b] Remediation Cost Cap

This type of coverage indemnifies a landowner for financial losses that arise when anticipated remediation costs are exceeded. This is generally requested in most insurance policies that involve remediation.

[c] Pre-Funded Cleanup

This type of coverage, also known as finite risk coverage, involves the pre-funding of expected cleanup costs. If the cleanup extends over a number of years, the premium will reflect the net present value of cleanup costs in the year in which the coverage is purchased.

[d] Remedy Failure

No remedy is foolproof, even when agreed upon by all the best and brightest minds. This type of coverage protects a landowner in the event the remedy fails, regardless of whether it was properly designed. If the remedial action plan for a property contemplates that contaminated soils will be transported off-site for disposal, this type of coverage is not as important as when the remedy involves, for example, either on-site treatment or storage of contaminated soils.

[e] Regulatory Reopeners

In many instances, even if a landowner is successful in obtaining either a "no further action" letter or covenant not to sue from a relevant regulatory agency, the letter or covenant not to sue will likely contain language that reserves the agency's right to reopen the regulatory process under certain conditions. This coverage insures against a reopener event.

[f] Changes in Standards and Regulations

Commonly, EPA will revisit and revise established performance or treatment standards or regulatory thresholds for various contaminants.[31] This coverage protects against a regulatory agency, state or federal, changing standards and regulations either during or after the cleanup that affect cleanup costs, so long as the changes are made during the policy term.

[g] Contractors' Errors and Omissions

This coverage protects a landowner from its design or remediation contractors' errors and omissions that either exacerbate or fail to solve the environmental problem at a contaminated property. This coverage is particularly useful where a landowner is treating contaminated soils on-site, capping contaminated soils in place, or placing such soils in a designed, on-site landfill.

[h] Natural Resource Damages

Natural resource damages lawsuits can generate significant defense costs and liability risks.[32] This coverage protects against such risks or uncertainties associated with natural resource damages claims. Landowners such as Owner should consider this coverage if contaminants at the property have a potential pathway to an identifiable natural resource such as groundwater.

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[31] A recent example of a potential change is the drinking water standard for arsenic. In January 2001, at the close of the Clinton Administration, EPA reduced the maximum contaminant level for arsenic in public water supplies from 50 parts per billion to 10 parts per billion, to be phased in by 2006. *See* 66 Fed. Reg. 6976 (Jan. 22, 2001). The Bush Administration, however, has delayed the effective date of the new standard to February 22, 2002 to review the science and cost-effectiveness of the new standard. *See* 66 Fed. Reg. 20,580 (Apr. 23, 2001).

[32] *See, e.g.*, United States v. Montrose Chem. Corp. of Cal., No. CV 90-3122-R, 2000 EPA Consent LEXIS 849, at *22 (setting forth $30 million natural resource damages settlement in Montrose Chemical's consent decree with EPA); "ARCO to Pay $215 Million to Montana in Consent Decree," *Mealey's Litig. Reps.: Superfund* (Mealey Publications, Inc., King of Prussia, Pa. Aug. 1998) (indicating ARCO's agreement to pay $118 million in cash and to transfer real property in natural resource damages settlement).

[i] Off-Site Transport and Disposal

A landowner may be required, as part of its remedial action plan, to transport soils for off-site disposal. Such activities can be expensive and pose the threat of significant liability. This coverage protects an insured against the expense of off-site disposal and the risks of third-party liability relating to the transportation and disposal of contaminated soils.

[j] Business Interruption

A landowner's business operations may sustain business interruption losses arising from cleanup activities or the discovery of additional contamination. Such business interruption could substantially impair a landowner's business. If, for example, the proposed future use of the property is a real estate development as is the case with the Owner joint venture, the interruption of the construction phase due to the discovery of additional contamination could be financially damaging. This coverage protects against such loss. Business interruption coverage is not a standard coverage grant. It is generally disfavored among insurers and, therefore, may be difficult to obtain.

[k] Diminution in Property Value/Impaired Collateral

This coverage generally protects against loss from a default accompanied by an environmental condition on a commercial real estate loan secured by an insured property. In such a situation, the policy will pay the outstanding loan balance or the cleanup costs, depending on how it is written. It can also be written to cover third-party claims and to protect a lender if foreclosure on a property is necessary.

[l] Stigma Damages

This coverage is very difficult to obtain. As stated above,[33] coverage for stigma damages is not generally available in the marketplace.

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[33] *See supra* note 22.

[4] Determine the Appropriate Term and Limits

Once a landowner determines what coverage grants it needs, it must then determine the appropriate policy term and limits for each or all of the grants. Manuscripted policies provide the flexibility of varying the term and limits for each coverage, or making them uniform, according to the insured's preference.

[a] Policy Term

Many landowners desire to purchase environmental insurance that provides coverage to infinity. However, underwriters are understandably reluctant to insure a risk too far into the future. Most underwriters offer a maximum term of ten years for a policy that is not pre-funded. If a policy is pre-funded under a finite risk program, then an underwriter may be more willing to increase the policy term to twenty years. In rare instances, involving large pre-funded policies, underwriters may write an environmental policy with a thirty-year term.

In determining the length of policy term that is appropriate, a landowner should base its decision on what types of coverage it has chosen and the future use of the property. For example, if a landowner is interested primarily in third-party liability coverage, a longer policy term is probably appropriate. However, a landowner may be able to accept a shorter policy term if the only coverage purchased pertains to actual cleanup. The exception to this rule may arise where a landowner believes that there exists a significant risk that the applicable regulatory agency will enforce a reopener provision or that regulatory standards regarding applicable contaminants may change in the future.

[b] Policy Limits

In determining the appropriate policy limits, a landowner should again carefully analyze the coverage grants it has selected. Coverage for situations such as natural resource damages claims and third-party liability claims may be appropriate for larger limits. To analyze available coverage that relates to the cost of the cleanup itself, a landowner should ask itself: "What is the risk that there will be a cost overrun?" and "If there is a risk, what is the most likely

amount of the overrun?" If, for example, a landowner desires to purchase a policy with coverage limits exceeding $100 million and is willing to pay a larger premium commensurate with the higher coverage limits, an underwriter may be willing to write such coverage.

[5] Select the Brokerage Team

Once a landowner has determined what coverage it needs and the appropriate policy term and limits, it should select a brokerage team. This team should include: (1) a specialized insurance broker with a high degree of expertise concerning the placement of environmental insurance; (2) specialized insurance legal counsel experienced both in the placement of insurance and the manuscripting of environmental insurance policies; and (3) a client who has been educated by the broker and counsel as to what to expect with regard to both the cost of the insurance and the length of time required to negotiate, manuscript, and place the coverage. Once selected, the team is charged with obtaining quotes, selecting an underwriter, and manuscripting the policy to execution.

[a] Knowledge of the New Products

The broker who is selected must have up-to-date knowledge of what new environmental insurance products are available. In this ever-changing industry, underwriters are constantly creating new products, not only to meet new needs, but also because these new products have no competition in the marketplace and, therefore, the profit margins on the premiums charged for these products tend to be significantly higher. It is critical that the broker understand and be able to properly assess the premiums charged for the new products. Likewise, insurance counsel should understand the legal meaning of the numerous terms of art contained in the new environmental insurance products and should be able to properly negotiate the nuances of a lengthy and complicated manuscripted insurance policy.

[b] Knowledge of the Markets and Their Dynamics

In this niche market, underwriters come, go, and come again. The dynamics of the environmental insurance market

change quickly due to both the volatility of the market and the fact that each underwriter relies on reinsurance treaties and its relationship with the reinsurers, which also can be volatile. As new underwriters and products enter the marketplace, the dynamics of the market and the vulnerabilities of each individual underwriter become apparent. It is an important function of the insurance broker to understand these dynamics and to be able to assess their influence, not only on the market, but also on each underwriter.

[c] Experience with the Underwriters

The community of environmental insurance brokers and underwriters is small, a fact that heightens the importance of the relationships between the two camps. The selected environmental insurance broker should have a great deal of experience with the individual underwriters and should also be viewed as credible and professional. An experienced broker who has favorable relationships with underwriters may be able to negotiate a lower premium, a longer policy term, or other favorable policy conditions. Negotiating positions such as, "You gave my client that price in the Able & Baker deal, why not here?" or "You know I'll get that price and term from another underwriter, so why don't you give me the same deal?" are not uncommon in the underwriting process.

[d] Knowledge of the Underwriting Process

Both the insurance broker and insurance counsel should have substantial knowledge of and familiarity with the underwriting process. The two work together with the client to disclose the appropriate documents, select the appropriate coverage grants, negotiate the appropriate deal, and, perhaps most importantly, manuscript the appropriate language to complete the deal. Insurance counsel is heavily relied upon to make legal judgments with sometimes little time for reflection or research during the manuscripting process. Thus, insurance counsel must be comfortable with the underwriting process and must have traveled down the manuscripting path before.

[e] Environmental and Statistical Competence

Both the insurance broker and insurance counsel should be well-versed in the fields of environmental law and statistics and must be able to speak the language of these disciplines. Additional experts can be hired in these fields to assist the broker and counsel. However, the client will realize a cost savings if the broker and counsel are each skilled in these disciplines.

[f] Loyalty to Client

During the underwriting process there will be many late nights, frustrating negotiating sessions, and failed attempts at negotiating certain policy provisions. Loyalty among the client, insurance broker, and insurance counsel will be greatly tested and of great importance during the process.

[g] Reasonable Fees

Cost must be taken into account whenever an insurance broker and insurance counsel are selected. While the stakes in the placement of an environmental insurance policy are often large enough that a client may direct, "Get me the best policy at any cost!", the statement is usually made in haste, and rarely is it truly meant.[34]

[6] Approach Underwriters for Preliminary Interest

Once the brokerage team has been selected, the next step is for the broker to contact the individual underwriters to determine whether they are interested in the deal. The broker should contact each of the underwriters that has the capability of meeting the client's needs to determine whether each is interested in making a presentation to the client. Most—if not all—underwriters will move forward at this point and make a presentation to the client.

[a] Confidentiality Agreements

At this stage in the process, it is a reasonable precaution for the client to require each underwriter to sign a confidentiality agreement. This agreement should apply to all communications between the parties involved and to any documents

[34]This reminds the authors of the old story about the golf course developer who once remarked, "I gave my architect an unlimited budget, and he exceeded it."

given to the underwriters. Underwriters will not be surprised if this agreement is broad and requires them to return the information in the event that a policy is not placed. However, underwriters will likely insist on language that if a policy is placed, the insurer will be allowed to retain, in a confidential location and without making copies, a copy of all information given to it or its representatives.

[b] Confidential Submission

Once the underwriters have signed a broad confidentiality agreement, the broker can create and distribute a confidential submission to each underwriter interested in the deal. This submission, generally given to the underwriters in advance of the opening presentation, includes information on the prospective insured, a history of the contaminated property, a description of future goals for the property, and, in some instances, information regarding the nature and extent of contamination. The submission will most likely contain preliminary information regarding the scope of coverage that the prospective insured may need, as well as a suggestion of what policy term and limits it may require. The underwriters should carefully review the submission prior to the meeting with the prospective insured so that the underwriters and brokerage team can have a frank discussion regarding the possibility of proceeding to the next stage. Any underwriters not proceeding beyond this stage must be required to return the confidential submission to the brokerage team.

[c] Data Room/Preliminary Due Diligence

The data room is an important aspect of the underwriters' due diligence. It is a central repository where all documents pertaining to the property or project are kept. Representatives of the underwriters are invited to visit the data room to review relevant documents gathered by the prospective insured. Visitors have to sign a daily check-in sheet that demonstrates when they were in the data room, and that they are subject to specific rules known as a "data room protocol." The data room should contain an index listing all documents according to where they are located in the data room. It is the obligation of the underwriter's representative to check the data room index against the actual documents in the data

room and notify the prospective insured of any discrepancies. While data room protocols contain a variety of different rules and regulations, three rules are essential. First, the documents must be reviewed within the confines of the data room; no documents can leave the room at any time. Second, all visitors must sign a daily check-in sheet that identifies when they were in the data room and requires them to verify that they are subject to the protocol and the necessary nondisclosure agreements discussed above. Third, to receive copies of any of the documents in the data room, visitors must complete a document copy request form. The brokerage team will then copy the requested documents and send the copies to each underwriter. These three rules assist the prospective insured in maintaining absolute control over the documents.

While this process may sound onerous and somewhat pedantic, proper documentation of exactly what was disclosed to each underwriter during the process may become critical if the prospective insured becomes involved in a coverage dispute with its insurer, particularly a dispute over the adequacy of disclosures.

[7] Obtain Underwriters' "Indications"

After the underwriters have read the submission, met with the prospective insured, and reviewed the available documents in the data room, the next step is for the broker to obtain the underwriters' "indications." The elements of the indications include coverages, exclusions, policy term, and policy limits.

[a] Coverages

This is the stage where the underwriter determines and informs the brokerage team whether it can provide the coverages that the prospective insured seeks. The prospective insured may find that different underwriters will write different coverages, but none will write all the coverages requested. This leaves the prospective insured in the difficult

position of purchasing an environmental insurance policy that does not include all the coverages it desires.[35]

[b] Exclusions

Obtaining an indication for desired coverages is half the story. The other half is what exclusions go along with them. Each policy will contain coverage exclusions. The brokerage team must negotiate and manuscript these exclusions as carefully as the coverage grants themselves.

[c] Policy Term and Limits

The indication should include a preliminary decision by the underwriters regarding the policy term and limits. In some instances, the prospective insured may negotiate a different policy term and limits for each of the coverages, depending on which coverages are selected.

[d] Preliminary Estimate of Price

Because premium costs are often the determining factor in selecting a lead underwriter, the indication should include a preliminary estimate of the premium price. This estimate is not binding, but assists the prospective insured in separating underwriters who are truly interested in the deal from those who are not.

[8] Select Lead Underwriter

At this stage, the decision-making shifts back to the brokerage team for purposes of selecting a lead underwriter. While this selection can later be undone, if necessary, the costs to the prospective insured in terms of time, energy, and fees would most likely be significant. Each brokerage team bases its decision on different criteria, but such criteria should include: (1) policy provisions offered (the indications); (2) willingness to manuscript policy language; (3) ability to pay claims; (4) willingness to pay claims; (5) ability to resolve coverage disputes short of litigation; (6) treatment of existing insureds; and (7) references.

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[35] Another option, although dangerous and complicated, is to buy different coverages from different insurers for the same property during the same applicable time period. Such an approach could lead to an epic "finger-pointing" coverage battle between the two (or more) insurers.

At least one member of the brokerage team should be assigned to acquire the necessary information to assess the underwriters using the above criteria. This should include interviewing the underwriters' references (current insureds) to determine how each underwriter rates particularly with respect to criteria (2), (4), (5), and (6). Extensive interviews of current insureds may reveal important differences between the underwriters' philosophies and implementation of their policies. This information, together with a general sense of how the underwriter responds to issues concerning its insureds, is critical to the decision process.

[a] Detailed Diligence

Once selected, the lead underwriter will perform additional due diligence. At this juncture, the lead underwriter may request that additional categories of documents be placed in the data room and may request to speak directly to the applicable governmental regulators and environmental consultants. An underwriter is generally reluctant to perform this type of extensive diligence until it has been selected as the lead underwriter. Underwriters will not give an insured a "hard" or binding policy quote until this additional due diligence has been performed.

[b] Probabilistic Remedial Cost Analysis

The lead underwriter will perform probabilistic remedial cost analysis to come up with its hard policy quote. This analysis assigns probabilities to each potential outcome, ranging from the worst-case scenario to the best-case scenario, then runs each of these scenarios through thousands of analytical trials (often referred to as the "Monte Carlo analysis"). For the brokerage team to understand (and dispute, if necessary) the accuracy of the method and ensuing policy quote, the team must understand this process.

[c] Policy Quote

Following the probabilistic remedial cost analysis, the lead underwriter gives the prospective insured a hard quote upon which it can rely.

[d] Keep Other Insurers on Hold

It is good business to have a second-choice underwriter waiting in the wings in case the hard policy quote differs greatly from the preliminary quote or in case the manuscripting process breaks down.

[9] Manuscript the Policy

Each underwriter offers specimen policies with a range of coverages. As discussed earlier,[36] important clauses—coverage grants, definitions, exclusions, and conditions—must be negotiated and redrafted specifically to meet the needs of the individual transaction. Coverage language must be negotiated to meet the insured's risk protection needs without paying for unnecessary protection.

Other key policy clauses include the following:

[a] Disclosure Representations

The insured's representations regarding disclosure of known environmental conditions are fundamental to policy enforcement. If coverage is limited to new or newly discovered conditions, the disclosure stakes are high, as undisclosed known conditions may be grounds for coverage denial or policy cancellation.[37] If coverage is more comprehensive, including pre-existing as well as new conditions, nondisclosure of pre-existing known conditions can also lead to coverage denial or cancellation.[38] Thus, notwithstanding the coverage grants, representations regarding disclosure and management of the disclosure process are critical to placing the policy.

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[36] *See* discussion *supra* § 20.05[1]-[4].

[37] *See* SCA Servs., Inc. v. Transp. Ins. Co., 646 N.E.2d 394, 397 (Mass. 1995).

[38] *See, e.g.*, Advanced Micro Devices, Inc. v. Great Am. Surplus Lines Ins. Co., 245 Cal. Rptr. 44, 45-49 (Cal. Ct. App. 1988) (denying pollution coverage for failure to disclose knowledge of pre-existing contaminating conditions prior to policy enactment). Insurers have also denied coverage under the new environmental policies for nondisclosure of pre-existing contamination. *See, e.g.*, "Insureds Tell California Court that Recycling Contamination Cleanup Expenses Covered," *Mealey's Litig. Reps.: Ins. Supplement* (Mealey Publications, Inc., King of Prussia, Pa. Oct. 1998) (discussing *Owens Fin. Group Inc. v. Am. Int'l Group Inc.*, No. MSC 98-04117 (Cal. Super. Ct. filed Sept. 30, 1998 and dismissed July 28, 1999), wherein insurer alleged failure to disclose knowledge of pre-existing contamination to defend denial of pollution coverage under a PLL policy).

The lead underwriter may request unqualified representations that all material information has been provided to it. The insured may wish to qualify these representations in several ways: (1) limit nondisclosure liability to the insured's intent to commit actual fraud; (2) limit the disclosure period to a defined time; (3) include the lead underwriter's acknowledgment that it has received all material documents and all requested documents; and (4) include a sunset or expiration date after which the insurer may not cancel based on failure to disclose.

[b] Contractual Liability

Contractual liability is usually excluded unless individual contracts are scheduled on the policy or the insured would otherwise be liable. This exclusion becomes important in the case of contractual indemnities between a PRP and other parties, such as lenders and purchasers.

[c] Insured vs. Insured

Litigation among insureds is often excluded. If there is a prospect of multi-PRP contribution litigation, including multiple insureds and other parties, eliminating or limiting this exclusion may be important relative to the insureds' ability to recover defense costs under the policy.

[d] Choice of Law and Forum

Insurers prefer New York since the substantive insurance laws in New York are generally much more favorable to insurers than to insureds. If the parties cannot reach agreement, this clause may be best left silent, leaving the courts to decide choice of law and forum issues.

[e] Subrogation

If the insured anticipates contribution litigation against other PRPs, a subrogation waiver may make sense. Alternatively, if the underwriter insists on subrogation, a premium adjustment should follow, since the insurer may recover part of the premium from other parties.

[f] Additional Insureds

In a brownfields situation, the insured may want the ability to add additional insureds, such as buyers, lenders, joint venturers, and tenants, to facilitate development and sales.

[g] Typically Excluded Pollutants

Underground storage tanks, asbestos, and lead paint are typically excluded. If the insured needs any of these coverages, they must be specifically added.

[h] Cancellation Among Insureds

If a policy includes multiple insureds, it behooves each insured to limit cancellation specifically to the breaching insured, so as not to endanger all for the acts or omissions of one.

[i] Other Insurance

The insured would be better served by excluding any obligation to pursue coverage first against other insurers, including historic CGL insurers and other parties' (e.g., contractors' pollution legal liability) present insurance coverage.

[j] Insured's Covenants

General cooperation covenants are reasonable. The insured may wish to scrutinize detailed cooperation, disclosure, cost minimizing, and other covenants that may lead to claim denials.

[k] Legal Expenses

The insured may wish to include the right to select independent counsel at reasonable market rates, in contrast to the insurer selecting insurance defense counsel. Typically, legal expenses are subject to the same policy limit as other losses. Consequently, the insured may wish to evaluate both potential legal expenses and damage losses when choosing an appropriate policy limit. Further, the insured may wish to include first-party (investigative) legal expenses as well as traditional defense costs.

In summary, in approaching the policy negotiation, the prospective insured may be well advised to consider retaining specialized insurance counsel in negotiating and manuscripting the final policy. Often, a specialized insurance broker and

specialized insurance counsel can bring to the insured's table unique assets: (1) a judgment of how much the underwriter wants the business and may yield on significant points of policy language; (2) knowledge of where the underwriter's flexibility may be constrained by factors arising from the reinsurance markets; (3) experience in how particular phrases and clauses have been construed by the courts; (4) governing law considerations; (5) representation and warranty considerations and the role they may play in future cancellation or claim denial; and (6) claim processing procedures, including alternative dispute resolution and other factors.

[10] Consider Tax Implications

It is in the insured's interest to accelerate tax deduction of as many cleanup costs as possible. Generally, the insured must meet two tests to deduct cleanup costs. First, the costs must be ordinary business expenses rather than capital expenditures. Second, a deduction can occur only when "economic performance" occurs, i.e., when the remedial work is actually performed.

Before last year, all but a few taxpayers generally could deduct remedial costs only if they were ordinary and necessary business expenses.[39] An Internal Revenue Service (IRS) revenue ruling allowed the deduction of cleanup costs if their purpose was to restore a property to its condition prior to the taxpayer's contamination of it.[40] However, if the purpose of the remedial expenditures was to make permanent improvements or to increase the value of the estate, the expenses had to be capitalized.[41]

Congress partially liberalized the current expense and capital improvement distinction in the Taxpayer Relief Act of 1997.[42] Taxpayers who owned "qualified sites"—generally sites subject to EPA brownfield pilot grants or located in

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[39]I.R.C. § 162(a) (1988).

[40]Rev. Rul. 94-38, 1994-1 C.B. 35 (1994).

[41]I.R.C. § 263(a) (1988); Rev. Rul. 94-38, 1994-1 C.B. 35 (1994).

[42]26 U.S.C.A. § 198 (Supp. 2000).

Housing and Urban Development "improvement zones"—could expense their remedial costs without regard to the expense and capitalization distinction.[43] These restrictions severely limited the scope of tax relief for many taxpayers.

However, in the year 2000 Congress erased the distinction between environmental expenses and capital improvements paid or incurred between December 22, 2000 and December 31, 2003. The Community Renewal Tax Relief Act of 2000[44] provides a significant, albeit temporary, broadening of taxpayers' ability to deduct remediation expenses.

With the current expense and capital improvement distinction eliminated for remediation costs at least until the end of 2003, the next hurdle to deductibility is the "economic performance" test. Normally, deduction of environmental remediation expenses is allowed only when remediation is actually performed.[45] However, "economic performance" of remediation tasks undertaken by a qualified settlement fund (QSF) under Internal Revenue Code (IRC) § 468B is deemed to occur when qualified payments are made to the fund. Thus, if the prospective insured purchases an environmental policy through a QSF, it may be able to deduct payments made to the fund in the year contributed. This feature can reduce the effective acquisition costs of an environmental insurance policy by accelerating deductions otherwise permissible to be taken only in later years.

A QSF is a fund, account, or trust which (1) is established pursuant to an order of approval by a governmental authority, and subject to that authority's continuing jurisdiction; (2) extinguishes the liabilities that it was formed to resolve;[46] and (3) is either a trust under applicable state law, or an account or fund whose assets are segregated from the other assets of

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[43] *See id.*

[44] Pub. L. No. 106-554, 114 Stat. 2763 (2000).

[45] I.R.C. § 461 (1988); Treas. Reg. § 1.461-4(d) (as amended in 1999); Rev. Rul. 98-39, 1998-2 C.B. 198 (1998).

[46] Treas. Reg. § 1.468B-1(f) (as amended in 1993).

the transferor or related persons.[47] As a practical matter, title companies, banks, or other financial institutions may administer QSFs, so long as they are not "related" to any of the transferors.[48]

Perhaps the most difficult aspect of qualifying a QSF is the requirement that the fund "extinguish" the liabilities it was formed to resolve.[49] This requirement implies that prospective insureds obtain from EPA or a parallel state agency a substantial release of liability as PRPs. The IRS has given little systematic guidance on the requirements for QSF status, including the extinguishment requirement. In one ruling, the IRS stated that a trust established to settle hazardous waste claims was a QSF where the parties paid into an escrow fund under a reorganization plan filed with the Bankruptcy Court.[50] In other cases, the IRS has offered to approve QSFs where funds were transferred into escrow to satisfy legal claims.[51] The key point is "settlement," whereby a regulatory agency with jurisdiction over PRPs approves the QSF and releases or substantially releases the insured PRPs from their environmental liability.

Of course, until remediation is complete, someone must remain responsible for it. Escrow agents do not savor this responsibility. They are typically financial institutions unskilled and unaccustomed to managing environmental cleanups. Insurers do not desire this responsibility either. Their role is to pre-fund the remedy under a finite risk policy or to pay losses under pollution legal liability and related coverage.

As a practical matter, the ability of prospective insureds to qualify for QSF status requires that a single "super-PRP" undertake the obligations of the other prospective insureds. In practice, these super-PRPs are often environmental con-

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[47] Treas. Reg. § 1.468B-1(c) (as amended in 1993).

[48] I.R.C. §§ 267(b), 707(b)(1) (1988).

[49] Treas. Reg. § 1.468B-1(f) (as amended in 1993).

[50] Priv. Ltr. Rul. 95-52-009 (Dec. 29, 1995).

[51] *See, e.g.*, Priv. Ltr. Rul. 96-09-041 (Mar. 1, 1996).

sulting firms with a remedial construction group or brownfield developers.[52] These firms and developers apparently believe they can perform cleanups faster and at a lower cost than the other prospective insureds.

[11] Close the Transaction

Depending on the purposes for which the insurance policy is being obtained, closing the transaction may be as complex as a substantial natural resource merger and acquisition transaction. For example, if one of the purposes of the policy is to facilitate a multi-party PRP settlement, the closing may include purchase of the policy and a multi-party PRP settlement agreement, an escrow and funding agreement, a full or partial release agreement from EPA or state regulatory agencies, loan agreements by prospective insureds, possibly including additional policies for impaired collateral loans, and related documentation. The demands of the entire transaction may require distinct but coordinated negotiating teams, particularly by the "super-PRP," to coordinate the insurance, settlement, tax, and financing aspects of the transaction.

§ 20.06 How Should the Policy be Implemented?

Once placed, the new insurance policies create a "working partnership" between the insured and the insurer. Though the insured typically retains management control over remedy selection, design, and implementation, the insurer has an understandably strong interest in how the insured manages site evaluations, remedial decisions, and remedial design and implementation tasks. As in any other insured-insurer relationship, both parties have an interest in collaboration, but both parties also have obviously distinct interests respecting the ultimate allocation of financial risk.

The insurer typically has an in-house technical staff that first reviews loss claims. Building an effective working relationship between the insured's project manager and the insurer's technical team is vital. Mutual technical respect, constant information flow (draft regulatory reports, monthly progress reports, etc.), and periodic technical briefings are

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[52] *See generally* Melissa Mangum Warren, "Reclaiming Provenance," *Urban Land*, June 2000, at 48.

methods that can help maintain a perspective by the insurer that the insured is competently managing the cleanup project and attempting to minimize the insurer's risks.

A concept one hears from the insurer's technical staff is "moral hazard." This is the insurer's way of expressing its concern that an insured, having obtained a policy, henceforth has little incentive to control remedial costs. The insurer's concern regarding that lack of incentive may be reflected in policy clauses regarding, for example, the insurer's right to assume the cleanup, cancellation or coverage denial based on excessive costs, cooperation and cost minimization covenants, information provision clauses, and other provisions in the manuscripted policy.

In summary, the new environmental insurance policies effectively create a de facto joint venture or joint operating arrangement akin to those formed in a natural resource transaction. Trust, information sharing, and technical collaboration are as important to the functioning of these insurance policies as they are to a joint venture or a major/junior operating relationship. Each party has a substantial stake in making the transaction work. If relationships begin to deteriorate, each side likely will choose its battles carefully.

§ 20.07 Conclusion

Today's new environmental insurance products provide a viable tool for landowners, prospective purchasers, developers, and PRPs to resolve long-standing environmental disputes[53] and facilitate cleanup and development of contaminated prop-

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[53]These new products have become remarkably effective in settling disputes where the parties had previously lost hope that the dispute could ever be settled. This type of insurance can assist legal counsel in fulfilling the role that John W. Davis spoke of in his March 16, 1946 address to the New York City Bar Association:

> True, we build no bridges. We raise no towers. We construct no engines. We paint no pictures—unless as amateurs for our own principal amusement. There is little of all that we do which the eye of man can see. But we smooth out difficulties; we relieve stress; we correct mistakes; we take up other men's burdens and by our efforts we make possible the peaceful life of men in a peaceful state. We may not construct the levers, pistons and wheels of society, but we supply the lubrication that makes its even running possible.

Address by John W. Davis, Proceedings of a Special Meeting to Commemorate the Seventy-Fifth Anniversary of the Association of the Bar of the City of New York 37 (Mar. 16, 1946).

erties. While these new products are still evolving and have yet to be extensively tested by coverage litigation, parties are well advised to consider the use of these products in transactions involving contaminated properties.