Environmental Insurance: Paper Worth Millions

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Your client calls frantic because he has just been served with a lawsuit from an adjacent property owner who claims that the historic dry-cleaning operations on your client's property have contaminated the groundwater. The complaint seeks millions of dollars for cleanup costs. Another client calls. She wants to purchase a commercial property for redevelopment into residential units but is concerned about potential future environmental liability. Both have sought advice on how to address these concerns. Fortunately, the same answer may be the solution for both—insurance.

Potential Environmental Liability Comes from Many Sources

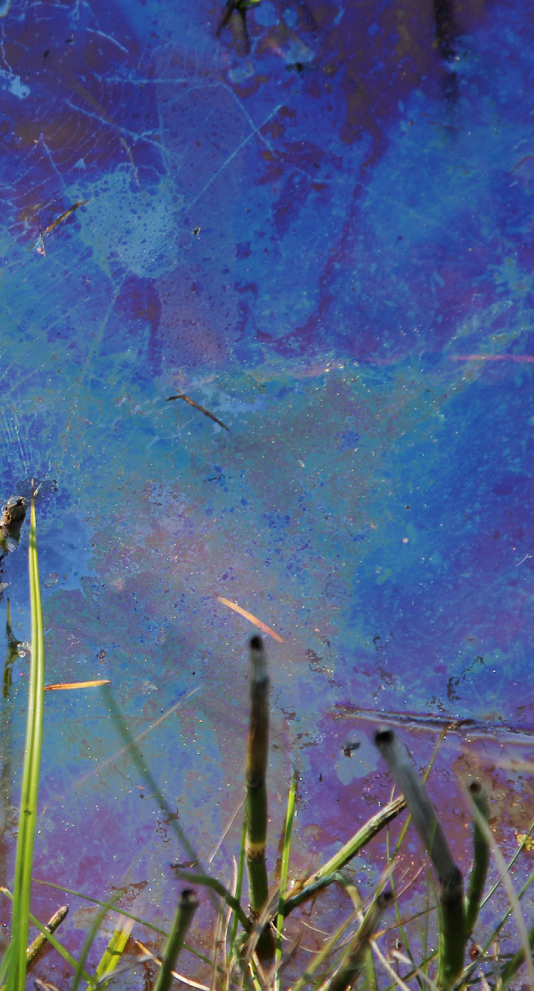
Federal, state, common law, and contractual obligations can all lead to environmental liability. Federal law and state analogs address contamination in air (Clean Air Act) and water (Clean Water Act), cleanup of contaminated properties (Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)), and hazardous waste (Resource Conservation and Recovery Act). These environmental liability provisions are far-reaching. CERCLA, for example, imposes retroactive, joint and several, strict liability (i.e., without fault) on past and present owners and operators of contaminated sites. In other words, if you are a current owner of a contaminated property, you can be held strictly liable for all costs to clean up the contamination even if you did not cause the problem.

Common-law causes of action, such as nuisance and trespass, and contractual obligations, such as indemnity provisions, may also be sources of potential environmental liability. Due to the breadth of possible environmental liability, it is important to understand strategies for minimizing risk, including environmental insurance.

Evolution of Environmental Insurance

Like all things environmental, environmental insurance has evolved over the past half-century. Passage of environmental laws began about 50 years ago, and the corresponding rise in environmental liability led many policyholders to seek coverage from their existing comprehensive general liability (CGL) policies.

In the early 1970s, insurers sought to limit the scope of coverage under these CGL policies by clarifying that environmental coverage only extended to "sudden and accidental" events. Many courts, however, interpreted this provision as still allowing coverage for events that were unanticipated or unforeseen, thereby extending coverage beyond what the insurers claim they and the policyholders originally intended. In response, in approximately 1986, insurers adopted the absolute pollution exclusion in CGL policies to definitively establish that CGL policies do not cover



environmental liability.

As a result, post-1986 CGL policies generally do not afford protection for environmental liability. Thus, to obtain environmental liability protection, policyholders must procure a specific environmental insurance policy (also known as environmental impairment insurance, pollution legal liability insurance, or a variation thereof). Policyholders who rely on their current (or historical post-1986) CGL policy to provide them with protection from environmental liability may be underinsured and will likely be barred from obtaining any coverage for environmental liability.

Using Historical CGL Policies to Obtain Environmental Coverage for Past Contamination

Back to the first scenario: your client wants to know how he can possibly pay for the cost to clean up the groundwater from historic dry-cleaning operations. Your client is right to be concerned. Cleaning up groundwater contamination from chlorinated solvents used in dry-cleaning operations, such as tetrachloroethylene (also known as PCE or PERC), can potentially cost millions of dollars and take years to remediate. Under the environmental laws, the current property owner can be liable for the entire cleanup cost.

Fortunately for your client, historical CGL policies may cover at least a portion of these cleanup costs. Older policies can potentially cover environmental investigation costs, remediation/cleanup costs, and legal fees, provided they do not contain an absolute pollution exclusion found in post-1986 policies. Historical CGL policies are "occurrence-based" polices, meaning they may provide coverage, subject to other exclusions, as long as the property damage caused by the contamination occurred during the policy period. In this sense, these applicable CGL polices never expire and can provide coverage for contamination that occurred decades earlier but was only recently discovered.

In many cases, the biggest hurdle to obtaining coverage is locating the old CGL policy. When faced with environmental liability from historic operations, it is important to locate all potentially applicable insurance policies, including those of past tenants, bankrupt entities, and deceased individuals with some relation to the property. Many leases required tenants to name landlords as additional insureds under the tenants' insurance policies. Secondary sources, such as leases, tax records, agency files, and other third-party files can provide leads in determining whether an applicable CGL policy exists. These old pieces of paper stored for decades in attics and basements can be worth millions of dollars in insurance coverage. Even if the actual policy cannot be located, reference to the existence of the policy, such as in a renewal certificate, may be sufficient evidence of coverage.

Once an applicable policy (or evidence of a policy) is located, the

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policyholder must tender coverage to the insurer as soon as possible to avoid late-notice exclusions. The policyholder must also be prepared to present evidence to the insurer regarding why the policy covers the environmental liability. This process typically requires a review of the policy terms and a detailed factual investigation of the circumstances of the environmental liability.

Obtaining Environmental Insurance to Cover Existing or Future Environmental Liability

Procuring an environmental insurance policy may be the solution for the client in the second scenario. Environmental insurance policies come in many forms to address myriad potential environmental liability issues. Unlike CGL polices, these environmental insurance policies are "claims-made" policies, meaning the claim must be made against the policyholder and reported to the insurer during the policy period (subject to certain automatic or purchased extended reporting periods). The policies are also typically property-specific, meaning coverage only extends to environmental claims impacting the specific property identified in the policy.

Coverage Scope

There is no one-size-fits-all approach to obtaining environmental insurance. The scope of coverage and the policy terms are subject to negotiation just like any other contract. The three primary areas of property-related environmental coverage include coverage for (1) pre-existing known contamination, (2) pre-existing unknown contamination, and (3) new contamination.

As the name implies, coverage for known contamination is coverage for contamination that the policyholder already knows about. For example, a developer may be interested in developing a brownfield site (i.e., a site with known or potential contamination). As part of the acquisition process, a prudent developer undertakes environmental due diligence. This process includes inspection of the site and surrounding properties; review of relevant government databases; historic information, such as aerial photographs and fire insurance maps; and interviews with key site-persons. Based on this initial review, further site investigation may be conducted to determine whether containments exist on the property by taking groundwater, soil, or soil vapor samples in and around the property.

This environmental investigation forms the basis for the "known" contamination, and all reports and findings from the investigation must be provided to the insurance company. Coverage for known contamination generally only extends to claims for offsite or onsite bodily injury, offsite property damage, and certain other risks. Just like you cannot get fire insurance to insure a burning building, a policyholder generally cannot obtain coverage for known onsite cleanup costs. A policy may, however, provide "springing" cleanup cost coverage for known onsite contamination, meaning that coverage will come into effect, often pursuant to a future endorsement from the insurer, if an agency in the future makes a "no further action" determination.

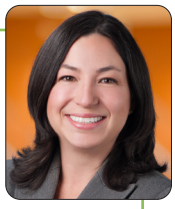
Unlike coverage for known contamination, policyholders generally can obtain coverage for onsite property damage/cleanup costs for pre-existing, unknown contamination and new contamination, although an insurer will require sufficient environmental investigation to ensure it is not insuring a hypothetical "burning building." A policyholder may also mix-and-match the scope of coverage by obtaining coverage for known and unknown contamination.

Coverage Policy Period and Premium

Typically, environmental insurance includes a five-year or 10-year policy period. It is sometimes possible to obtain an extension of the policy term for reporting claims; however, many policyholders opt to obtain a new environmental insurance policy. Most insurers limit coverage to $10 million, but higher limits can sometimes be negotiated.

The premium is a one-time payment paid at the time of policy inception and can vary depending on the amount of coverage, the policy period, deductible, and coverage scope. Coverage for a new environmental condition can increase the premium, because the insurer is taking on the risk of unknown future environmental conditions. Again, all of these terms are subject to negotiation. Therefore, it is imperative not to wait until the last minute to obtain coverage, particularly in the context of real estate acquisitions.

Environmental insurance is only one option for minimizing environmental liability and risk. Understanding the scope of potential environmental liability is critical to minimizing risk when dealing with environmentally impacted or potentially impacted properties that can cost millions of dollars and take decades to remediate. When faced with potential environmental liability, it is important to engage with qualified environmental counsel who understands the risk and can help minimize your exposure.



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