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PROPERTY TRANSACTIONS & ENVIRONMENTAL RISK

USING ENVIRONMENTAL INSURANCE TO MAKE A DEAL WORK

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INTRODUCTION AND BACKGROUND

Over the past 10 years, many commercial real estate and related businesses have realized that the investment in and the cleanup and redevelopment of contaminated, non-performing or abandoned industrial and commercial real estate (sometimes called brownfields) is essential to the revitalization of America's cities. With more than 450,000 of these properties to address[1], it is clear that the methods that have been employed in the Superfund and other mandatory cleanup programs are not appropriate for these sites.

As with any real estate transaction, contaminated sites have commercial or business risks associated with them. Unlike other properties, brownfield remediation projects also involve other risks that are unique to the cleanup and re-use of contaminated sites.

This paper was developed by Aon's Environmental practice. Aon is the world's leading risk advisor and insurance brokerage organization. Our fundamental objective in this role is to assist our clients succeed in the face of risk. Aon's Environmental practice consists of environmental risk, engineering, loss control, and insurance professional who help our clients (1) identify the environmental loss exposures they face, (2) analyze them in terms of potential frequency and/or severity, (3) examine the appropriate loss control mechanism (pre- and post-loss) and (4) design, negotiate and implement the appropriate environmental risk financing mechanisms, including insurance.

[1] From EPA's own website on 1/17/06, http://www.epa.gov/brownfields/about.htm

THE RISKS ASSOCIATED WITH PROPERTY TRANSACTIONS

The risks that arise from contaminated property transactions, the remediation process itself, and from the work of environmental consultants and contractors who develop and execute remediation plans, include the following:

- The risk of finding unknown environmental contamination that requires cleanup, or causes third-party bodily injury or property damage claims.
- The risk that contaminants will be released from the site during the remediation process by construction activities. This could cause third party bodily injury, property damage or require additional cleanup at the site or on the property of others.
- The risk that the remediation plan which was approved by regulators and/or selected by the owner (in a voluntary cleanup) will not be effective.
- The risk that additional remediation activities will be required by the identification of previously undiscovered contamination or by newly established cleanup standards.
- The risk that hazardous materials being removed from the site for treatment or disposal will be released while being transported to or after deposit at the treatment or disposal facility.
- The risk of being found responsible for damage to natural resources.

Protection can be provided for many of the risks that are identified above through the purchase of insurance for environmental damage claims, for cost overruns on remediation activities, and for the risks associated with releases caused by cleanup activities at the site. Environmental insurance can, and often does, play an important role in developing contaminated by limiting some of the risks that are faced by both developers, lenders, buyers and/or sellers of property. When used, environmental insurance is most often done in concert with, and in support of, other environmental risk management tools like due diligence and contractual controls (for example, hold harmless and indemnity agreements).

Overview of Environmental Insurance

Although environmental insurance has been available in the U.S. since 1980, it first really became a focus within the overall insurance industry when pollution exclusions became prevalent in 1985 and 1986. This is the period when the Insurance Services Office (ISO) introduced new pollution exclusions on commercial general liability insurance policies. Many excess/umbrella liability insurance policies followed suit.

These pollution exclusions left significant coverage gaps in insurance programs throughout the U.S. Although there has been a market for environmental liability insurance since 1979, until the mid-1990s, coverage was relatively restrictive, limits were sometimes inadequate and premiums were often not cost-effective.

The market for pollution liability insurance has dramatically changed over the past 10 years or more. Environmental insurers are offering broader coverage and cost-effective rates and adequate limits are almost always available. In response to the need for protection against pollution risks, underwriters that have written environmental liability insurance have also developed a group of insurance products that address the special needs of persons that are involved in the remediation of contaminated real estate.

The environmental liability insurance market today is approximately $2 billion in annual premiums. The six leading environmental insurers include AIG, Zurich, XL, ACE, Chubb and Liberty International Underwriters.

Because most environmental insurance is provided on a surplus lines basis, each environmental insurer has its own coverage forms. This equates to over 100 different environmental insurance policies available in the U.S. However, for simplicity sake, these can be summarized into the following categories:[2]

- **Fixed Site**[3] – basic policy coverage pays for cleanup, third-party bodily injury and third-party property damages associated with pollution conditions at, or emanating from a site. These policies can be modified to insure business income exposures, development soft costs caused by pollution conditions, non-owned locations (warehouses, disposal sites, etc.), and transportation exposures. Other enhancements can be made to meet the specific needs of the insured. Coverage can be written to insure the environmental risks associated with one or a portfolio of sites.
- **Contractor's Pollution Liability (CPL) and Professional Liability** – coverage can be written under one policy or under separate policies. CPL coverage can be provided on either a claims made or occurrence basis. It pays for third-party claims of bodily injury, property damage and cleanup costs that result from a pollution condition caused by a contractor's work. Professional liability coverage pays for claims, including pollution coverage, related to the negligent acts, errors or omissions of the insured.
- **Cleanup Cost Cap/Remediation Stop-Loss** – pays for the costs that exceed original cleanup plan estimates. Costs associated with finding new contamination during a cleanup and costs related to design negligence could also be covered.
- **Lender's Pollution Liability** - designed to protect lenders (banks) and equity investors (Real Estate Investment Trusts, private equity, specialty lenders, etc.) from the environmental risks associated with secured properties. Although the Lender Liability Protection Act of 1996, and similar state laws, offer lenders/banks protection from Superfund liability for their pure lending activities, creditors and lenders still face significant exposures (third-party claims) and credit risks associated with environmentally impacted properties.
- **Finite-/Blended-Risk Insurance** – there are many instances where expected environmental losses (e.g. cleanup costs over a number of years) are combined with the fixed-site and/or cleanup cost cap coverage noted above into one environmental risk-financing package. These finite-/blended-risk insurance programs are used for environmental liability transfers, fixed-price environmental contracts, and/or balance sheet and/or income statement smoothing exercises. In any event, these programs often involve close coordination with an organization's risk and insurance management, finance/controller/tax, counsel and environmental professionals.

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[2] The coverage descriptions provided herein are general and are used for discussion purposes only. Each policy contains specific coverage terms, conditions and exclusions and must be referenced for a complete description of coverage.

[3] This is a generic term. Specific product terms from the insurers include Pollution Legal Liability (PLL), Environmental Impairment Liability (EIL), Pollution and Remediation Legal Liability (PARLL), Environmental Site Liability (ESL), Premises Pollution Liability (PPL) and Real Estate Environmental Liability (REEL).

A summary of environmental liability insurance coverage is described in the table below.

Insurance Policy Type	Risks Insured	Limits
Fixed Site	1. Unknown contamination is found requiring cleanup. 2. Unknown contamination is found after a site is cleaned up or sold. 3. After a site is cleaned up, the government requires additional cleanup. 4. Third-party bodily injury and property damage claims caused by a pollution condition at an insured site. 5. Non-owned disposal sites. 6. Transportation of waste and/or products leads to a pollution event. 7. Defense of claims.	Determined on a site-specific basis. Up to $50,000,000 per loss and $50,000,000 aggregate limits are available from a single insurer. Over $150,000,000 in limits are available by stacking insurers.
Environmental Wrap-up	1. Failure of a cleanup project because of a bad design caused by the consultant's negligence. 2. Pollution conditions are worsened because of a cleanup contractor's work. 3. Written on a single site, or a group of sites.	Limits up to $25,000,000 per loss and aggregate are available – up to $35,000,000 limits are available for government projects (e.g. Base Realignment and Closures – BRAC).
Cleanup Cost Cap (also known as Stop Loss)	1. Cost overruns associated with the non-performance of an approved remediation system. 2. Additional contamination is found after the cleanup has begun. 3. Written on a single site, or a group of sites.	Determined on a site-specific basis. Up to $20,000,000 per site, and increasing to $200,000,000 aggregate for all insured sites are available

Insurance Policy Type	Risks Insured	Limits
Lender's Environmental Liability Coverage	1. In the event of a pollution condition at the secured property and default by the borrower, the insurer will pay the outstanding balance of the loan or the costs of cleaning up the property, whichever is less. *Loan balance only coverage is available on a limited basis.* 2. The insurer will pay for the costs of cleanup required of the insured (bank) by a governmental authority.[4] 3. The insurer will pay for losses incurred as claims by third parties related to a pollution condition at or emanating from the secured property. Such claims include cleanup, bodily injuries or property damages.[5] 4. The insurer will pay for defense of claims.	Typically written with lower per-loan limits ($1 million to $10 million) with a higher aggregate limit covering a portfolio of commercial loans.
Finite-, or Blended-Risk Insurance	Designed to address any of the risks identified above, blending risk financing and risk transfer.	Capacity exists to address over $100 million in environmental liability exposures over 20 years or more.

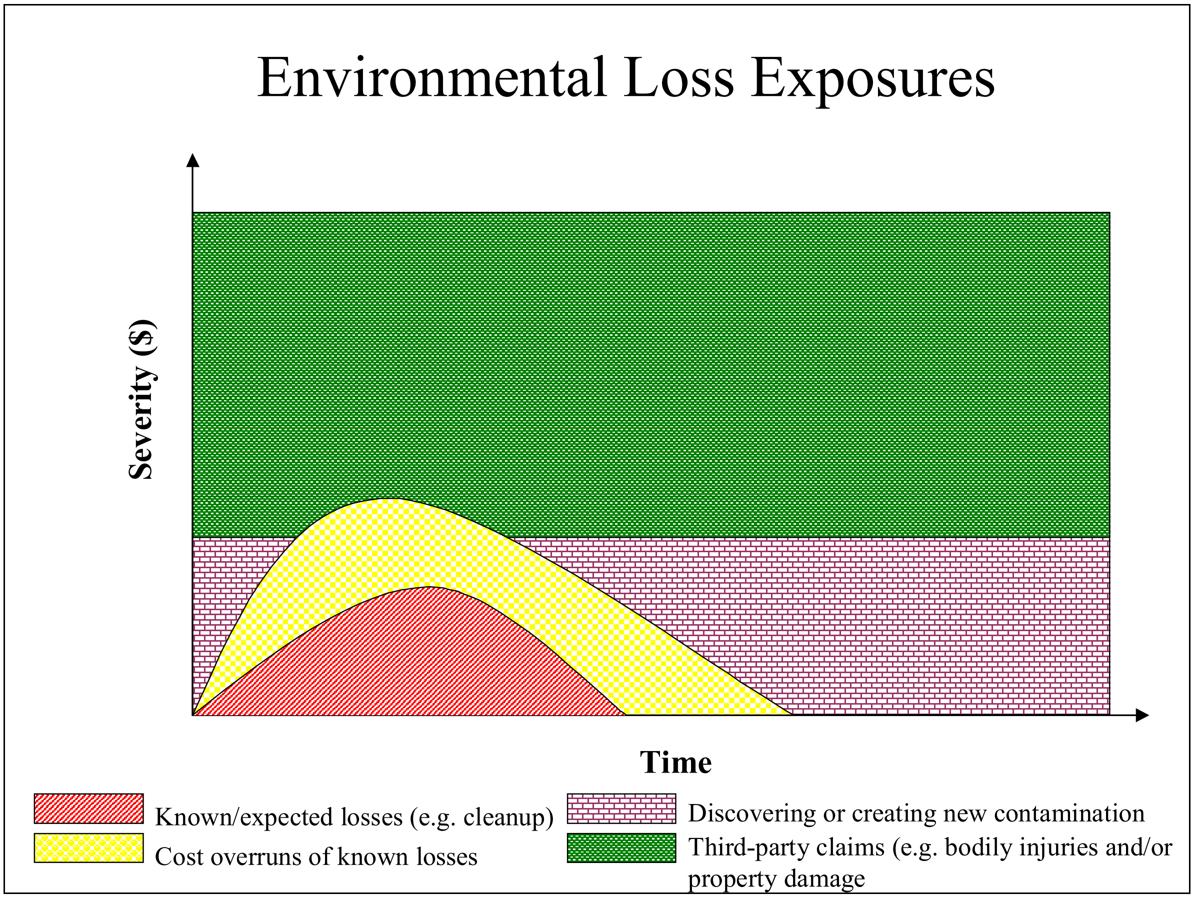
When and insurance program is designed for a property transaction, the insured risks can be broken down into for major categories:

1. The expected costs of cleaning up known contamination,
2. Excess costs, or cost overruns related to cleaning up known contamination,
3. Risk of either creating or discovering new contamination in the future, and
4. Third party claims caused by pollution conditions at, or emanating from the location(s).

[4] Many banks/lenders may consider this coverage to be "contingent" since there is a Lender Liability Protection law on a federal level and on many state levels. However, to be protected under these laws, the lender (bank) must act within specified guidelines (strictly as a lender) and not as a manager. If the lender (bank) acts outside these guidelines, they could be held responsible for cleanup.

[5] This is potentially significant coverage because the Lender Liability Protection laws referenced above typically do not protect the lender from third-party actions (for example, neighboring properties).

These risks and the corresponding environmental insurance program are shown in the figure below.



ENVIRONMENTAL RISK FINANCING AND LIABILITY INSURANCE EXAMPLES

- **Commercial Real Estate Developer:** One of the most prominent commercial real estate developer uses environmental insurance as a "back-stop" on almost every development. In some cases (on an increasing frequency), environmental insurance is used on specific deals to mitigate financing and or other risk issues unique to the deal and can have a material effect as to if the deal proceeds.

- **Railroad Terminal Site:** Vacant site is remediated and re-developed as a city park. Developer purchased pollution insurance coverage for claims from unknown contamination, third party liabilities, and remediation cost overrun insurance. The site would not have been redeveloped without environmental insurance protections.

- **Steel Mill Site:** Former 475-acre steel mill site is remediated and redeveloped for commercial usage and sports complex. Environmental insurance is purchased to provide protection from remedial cost overruns and unknown liabilities that arise during and after redevelopment. Ten-year term environmental policy is purchased.

- **Chemical Plant Site:** Shopping center owner purchases former chemical plant site with soil and groundwater contamination. Site is remediated and redeveloped into a shopping center. Environmental insurance provides protection for remedial cost overruns and unknown liabilities that arise during and after redevelopment.

- **Warehousing District:** Site is remediated and redeveloped into a sports stadium. Environmental insurance is purchased to cover unknown contamination and cap the cost of remediation. Insurance is also structured to cover all contractors in the event a pollution release occurs during construction.

- **Petroleum Tank Farm:** Large petroleum company sells inactive site, which is remediated and redeveloped into residential properties. Environmental insurance protects against costs for cleanup of unknown contamination and third-party liabilities. Ten-year term policy with high limits of liability is purchased.

- **Aluminum Smelter Facility:** Former smelting facility with heavy metals contamination is redeveloped into an office park. Environmental insurance facilitates the sell and redevelopment. Developer and lender would not have pursued this project without environmental insurance protections.

- **Automotive Engine Plant:** Former manufacturing site is redeveloped into commercial and residential properties. Environmental insurance is purchased to protect the owner for claims from third parties and costs for unknown contamination. Redevelopment would not have occurred without insurance protections.

- **Municipal Transportation Garage:** Former industrial site, which included prior dry cleaning operations is redeveloped into townhouses and condos. Significant contamination of both soils and groundwater were present at the site. A long-term pollution insurance policy with high limits is negotiated to protect against claims from third parties including residents.

SUMMARY

The environmental insurance industry is well positioned to assist organizations with their environmental risk financing objectives. It often takes a well-organized approach with risk management, legal, finance and operations/environmental personnel to implement an effective environmental risk management program. Aon's Environmental practice is well-positioned to assist in this effort. Please call your Aon representative, or Kenn Anderson, for further information. Kenn can be reached at 312.381.4226; Kenneth_Anderson@ars.aon.com.

DISCLAIMER

This discussion paper presents many insurance, legal, and/or financial and accounting ideas, terms and concepts. These issues are not to be taken, nor are they intended, as advice nor counsel. Specific counsel must be sought by an organization with respect to the insurance, legal, financial, and accounting approaches are most applicable and appropriate to its situation.

Additionally, this paper presents certain environmental insurance policies and their coverage. This presentation is for discussion purposes only and is not a complete description of all coverage terms, conditions, definition, modifications and/or exclusions. Specific reference to the insurance policy and all of its modifications must be made for a complete understanding.