

THE HISTORY AND USE OF ENVIRONMENTAL INSURANCE

By

**Joe Naylor, JD
Senior Counsel
Enbridge Energy Company**

**David J. Dybdahl, CPCU, ARM, MBA
President
American Risk Management Resources Network, LLC**

INTRODUCTION:

Specialized environmental risk insurance policies can be a valuable tool for organizations when used to complement traditional insurance programs. Although specialized environmental risk insurance has been available in the US marketplace for over twenty five years, and many companies currently write various types of environmental insurance, it has been estimated that only a small portion of environmental risks are properly insured today. The fact that environmental risk insurance is not more widely written may be the result of a general perception that environmental coverage is narrow and does not fit most needs, as well as perceptions that coverage is too expensive. In fact, the market for environmental risk insurance has evolved to the point that there is now a wide range of coverage available at attractive prices, and in the opinion of the author, this powerful risk management tool is currently underutilized.

The purpose of this paper is to briefly outline the history of insurance coverage for environmental risks, describe the types of environmental insurance products that are currently available, discuss typical uses and benefits of these products in the oil and gas business, discuss considerations for negotiation of a policy, and along the way, review some of the problems and issues which may be encountered when insuring environmental risks.

1. HISTORY OF INSURANCE COVERAGE FOR ENVIRONMENTAL RISKS

A. Commercial General Liability Coverage Written Prior to 1970

A review of the history of insurance coverage for environmental risks is essential to an appreciation of the newer, specialized forms of environmental risk insurance which are now available. Beginning with the establishment of the Environmental Protection Agency in 1970, the nation began the enormous task of setting and implementing environmental standards to protect human health and the environment. As the standards were set and liabilities became clear, affected organizations began making claims on the most common type of business insurance in place at the time, the Commercial General Liability ("CGL") policy.

A typical CGL policy insures against third party liability for bodily injury or property damage resulting from an “occurrence”, provided the claim is not otherwise specifically excluded by the language of the policy. CGL coverage also typically obligates the insurer to defend the policyholder in the event of a third-party claim. By its inherent nature as liability insurance, CGL excludes coverage for losses to a policyholder’s own personal or real property, as well as risks pertaining to employee and automobile liabilities, and separate lines of coverage are available for these specific risks. Beyond these exclusions, however, policyholders might expect that a “general” liability policy would cover, among other things, liability related to environmental contamination, although this may not be the case, as discussed below.

The CGL policy was introduced in January, 1941, and coverage was generally broadened through the first five editions of the CGL form in 1941, 1943, 1947, 1955 and 1966¹. Prior to 1966, typical forms of CGL policies provided coverage for damage “caused by an accident”. The term “accident” was not defined in the policy, and “[t]he Texas Supreme Court has not articulated a hard and fast rule for when an accident occurs.”² Beginning in about 1966 insurers became generally willing to write coverage triggered by an occurrence, at least for bodily injury claims, sometimes by deleting the “accident” trigger, or by defining an occurrence to include coverage for “an accident, including injurious exposure to conditions, which results, during the policy period, in bodily injury or property damage neither expected nor intended from the standpoint of the insured”³. Whether triggered by an “accident” or “occurrence”, these older policies have the potential to “live forever” with injuries beginning decades earlier continuing to trigger claims to this day.”⁴

With regard to coverage of typical environmental risks related to oil and gas production operations, *Meridian Oil Production, Inc. v. Hartford Accident and Indemnity Company*⁵ provides interesting insight into the “accident” requirement. An Oklahoma jury had found the operator liable to the landowner for damage to the land caused by oil and gas production operations. Evidence was presented which indicated that the operator failed to protect a fresh water aquifer, discharged contaminants into open pits on sandy soil, and improperly plugged an abandoned well. The cited case followed Meridian’s demand for indemnity for the landowner damages under its CGL policies issued by the defendants.

Meridian argued that although its actions might have been deliberate, the damage to the landowner was accidental, analogizing the situation to that of a motorist, knowingly exceeding the speed limit, who accidentally causes an a crash. The Fifth Circuit reviewed the standard form coverage for “an accident” as defined in language similar to that of the 1966 revision, and supported denial of CGL coverage for the harm caused to

¹ See generally, Flanigan, “CGL Policies of 1941 to 1966”, CPCU e Journal, August, 2005.

² Harken Exploration Company v. Sphere Drake Insurance PLC, 261 F. 3d 466, 472.

³ See 1996 Policy Form, included as Appendix to Abraham, Environmental Liability Insurance Law (1991).

⁴ See generally, Flanigan, *supra*.

⁵ 27 F. 3d 150 (5th Circ.), reh’g en banc den’d, 35 F.3d 564 (1994).

the landowner, noting that “Regardless of whether the policies involved are worded to cover “accidents” or “occurrences”, all offer minor variations of the same essential concept; coverage does not exist for inevitable results which predictably and necessarily emanate from deliberate actions.”⁶ By focusing on whether the damage was foreseeable, and concluding that it was, the Court seems to have ignored the possibility of coverage for operator negligence, discounting one of the fundamental reasons why insurance coverage is obtained.

An opposite result was reached in *Harken Exploration Company v. Sphere Drake Insurance PLC*.⁷ Here certain landowners sued Harken alleging various causes based on alleged pollution of the land. Harken tendered the claim to its insurers, who denied Harken’s request for defense, based in part upon a contention that there was no “occurrence” under the policies. The policies in question defined an “occurrence” as “an accident”, without defining the word “accident”. The Court concluded that under Texas law “there is an accident when the action is intentionally taken, but is performed negligently, and the effect is not what would have been intended or expected”.⁸ The allegations here included an act deliberately taken (operation of the oil facility), negligent performance (breach of a duty to protect the environment from contamination) and an effect not intended or expected (contamination). Based on the allegations the Court held that the insurer had a duty to defend the claim.

B. The 1970 “Qualified Pollution Exclusion”

As a result of increased claims, better science and new laws, in 1970 the insurance industry developed a standardized CGL pollution exclusion which excluded claims due to pollution except where the event causing the pollution was sudden and accidental (hence a “qualified” exclusion.) This was typically written as follows:

“It is agreed that the insurance does not apply to bodily injury or property damage arising out of the discharge, dispersal, release or escape of smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials or other irritants, contaminants or pollutants into or upon land, the atmosphere, or any water course or body of water; but this exclusion does not apply if such discharge, dispersal, release or escape is sudden and accidental.”⁹

The meaning of the “sudden and accidental” exclusion has been the subject of a large number of cases. Policyholders have argued that the term “sudden” is ambiguous, because it can have two meanings: “abrupt” or “unintended”. Confusion also relates to whether the focus of the exclusion is on the release of pollutants or on the resulting damage (for example in cases where the policyholder intentionally discharged pollutants, perhaps in accordance with environmental standards of the time, but did not intend or

⁶ Id., at 151.

⁷ 261 F. 3d 466

⁸ Id., at 472

⁹ See, e.g., ISO Form GL 00 02 exclusion (f), included as an appendix to Abraham, *Environmental Insurance Law* at 291.

expect the resulting damage.) Insurers contend that the term “sudden and accidental” unambiguously precludes coverage for pollution caused by the gradual, expected or intentional release of pollutants. The debate continues to this day since many insurers cover environmental risk through amendment of a basic CGL policy by adding coverage through a “sudden and accidental” endorsement (see Section D, below.)

Whether “sudden and accidental” is ambiguous under Texas law appears settled, at least in the opinion of federal district courts construing Texas law. In *In re Texas Eastern Transmission Corp. PCB Contamination Insurance Coverage Litigation*¹⁰ the Court concluded “that, if faced with this issue, the Texas Supreme Court would decide that “sudden” is unambiguous and cannot reasonably be divorced from “swiftness”, “quickness”, or all temporal significance.” In *American States Ins. Co. v. Hanson Industries*¹¹ a Texas federal district court agreed that under Texas law the term “sudden” has a temporal meaning of ‘quick or abrupt’, not ‘unexpected’ or ‘unintended’.

C. Commercial General Liability Coverage After the 1986 “Absolute Pollution Exclusion”

Responding to the confusion caused by the Qualified Pollution Exclusion, in 1986 insurers drafted a standard form exclusion designed to unambiguously preclude coverage for pollution related liabilities, without regard to how the pollution was caused or by whom it was caused. This exclusion is known as the “Absolute Pollution Exclusion”¹².

Courts have struggled with the seemingly overbroad nature of the Absolute Pollution Exclusion, since almost anything can be construed to arise out of the discharge, dispersal, release, or escape of a pollutant. Questions remain concerning which substances are considered excluded “pollutants” and whether the exclusion is limited to traditional environmental matters. On the whole, however, the Absolute Pollution Exclusion seems to have effectively cut off most CGL claims with an environmental basis, and “with rare exception, courts have ruled that petroleum products become “pollutants” once they are introduced into the ambient environment.”¹³

An example of the operation of the “Absolute Pollution Exclusion” can be observed in the decision of the Texas Supreme Court in an oil and gas downstream industry case, *National Union Fire Ins. Co. v. CBI Industries, Inc.*¹⁴ In *National Union* the insured was

¹⁰ 870 F. Supp. 1293 at 1350.

¹¹ 873 F. Supp. 17, 25 (S.D. Tex. 1995)

¹² The standard form exclusion generally precludes coverage for bodily injury or property damage “arising out of the actual, alleged or threatened discharge, dispersal, release or escape of pollutants”, where “Pollutants” is generally not a defined term.

¹³ Bjorkman, Leitner & Simpson, *Law and Practice of Insurance Coverage Litigation*, §44:70 and cases cited.

¹⁴ *CBI Industries, Inc. v. National Union Fire Ins. Co.*, 860 S.W. 2d 662, rev'd 907 S.W. 2d 517 (Tex. 1995).

working as a contractor in a refinery turnaround, when a crane's load was dropped onto a pipe connected to a hydrofluoric acid tank. The accident caused a release of hydrofluoric acid, and numerous lawsuits resulted. These were tendered for coverage to several insurers, each of whom denied coverage under two slightly different versions of the Absolute Pollution Exclusion. The Court had little trouble in upholding a denial of coverage, holding that the "absolute" exclusion was just that, "absolute", and coverage was properly denied, notwithstanding the fact that the release was caused by an accident.

One exception to the otherwise pro-insurer effect of the Absolute Pollution Exclusion arose in *Kelley-Coppedge, Inc. v. Highlands Insurance Company*¹⁵ where the Texas Supreme Court addressed an issue arising out of cleanup costs incurred as the result of a crude oil spill from a pipeline on an easement located on land owned by a third party. KCI, a pipeline contractor, struck a pipeline, causing a release of oil. KCI tendered the claim to its CGL carrier, Highlands, under a policy which contained an Absolute Pollution Exclusion, which excluded coverage for damages arising out of the release of pollutants at any location "owned or occupied by" the insured. The Court concluded that the insured did not "occupy" the worksite where it caused the spill and therefore the Absolute Pollution Exclusion did not preclude coverage.

D. Time Element CGL Exceptions: Environmental Coverage by Endorsement to CGL Policy

The first deliberate environmental coverage was often written as a type of amendment or endorsement to a standard GL policy. This type of coverage is oftentimes referred to as Time Element Pollution, or Unexpected/Unintended Pollution or Sudden and Accidental Pollution coverage. Although the wording for this policy extension varies by underwriter, generally this type of coverage will respond only in the following circumstances:

- The incident that leads to an environmental loss must be unexpected or unintended or sudden and accidental, such as a pipeline break, which is detected when it occurs.
- It must be detected within a specified time period, which generally ranges from 120 hours to 30 days.
- It must be reported to the underwriters within a specified time period, which also generally ranges from 120 hours to 30 days.

This type of policy usually shares the policy limit with all of the general liability perils of the insured and is often aggregated on an annual basis. These policies only respond to third party property damage and bodily injury incidents, therefore creating a coverage gap. The endorsement also often fails to include definitions for critical coverage grants such as cleanup costs and natural resources damages. Through the use of these time element exceptions to the absolute pollution exclusion, the oil and gas industry does enjoy some unusually broad coverage for pollution events via standard liability insurance policies. However, it is important to note that a liability insurance policy that only

¹⁵ 980 S.W. 2d 462 (Tex. 1995)

addresses pollution events as an exception to an Absolute Pollution Exclusion is very different from the modern environmental insurance policies which are discussed in Section 2 below. In contrast to the endorsed CGL policy, a true environmental insurance policy will address pollution events within the insuring agreement of the policy, not just the exclusions section or by endorsement. While coverage of environmental losses is often debated under CGL policies, coverage litigation associated with true environmental insurance policies is rare.

*Primrose Operating Company v. National American Insurance*¹⁶ illustrates the problems which can occur when adding a pollution endorsement to a standard CGL policy. The action arose when the insured oil and gas operator brought suit for damages arising from its CGL insurer's alleged breach of a duty to defend the insured in a landowners' suit seeking damages caused by pollution. In addition to the insuring clause, the CGL policy at issue contained three relevant sections: an Absolute Pollution Exclusion, a Pollution Endorsement; and a Saline Substance Contamination Endorsement. The Pollution Endorsement contained six conditions necessary for application, including that the pollution incident be "sudden and accidental". The Court describes the procedural difficulty inherent in interpreting such a policy where first "the insured bears the initial burden of showing that there is coverage, while the insurer bears the burden of proving the applicability of any exclusions in the policy. Once the insurer has proven that an exclusion applies, the burden shifts back to the insured to show that the claim falls within an exception to the exclusion."¹⁷ The analysis is complicated since "Under Texas law, an insurance policy must be considered as a whole, and each part given effect and meaning."¹⁸ Further, under Texas law "an endorsement cannot be read apart from the main policy, and the added provisions will supersede the previous policy terms to the extent that they are truly in conflict."¹⁹ Here the Absolute Pollution Exclusion within the base policy eliminated coverage for "Pollutants", but the policy definition of "Pollutants" failed to include "saline substances". The Pollution Endorsement purchased by the operator ostensibly increased coverage, but defined "Pollutants" in nearly the same terms, simply including "saline substances" within the definition. The additional "Saline Endorsement" provided coverage for damages caused by "saline substances" but failed to specify whether it was subject to the other endorsements and exclusions. The insurer argued that the Saline Endorsement was not triggered since it was subject to both the Absolute Pollution Exclusion and the Pollution Endorsement, and was limited by the six conditions found in the Pollution Endorsement, which were not satisfied. As this reading would have rendered the purchase of the Saline Endorsement meaningless in this case, the Court held for the operator; however the case shows the difficulties inherent in interpreting such a policy.

Primrose Operating Company is also of interest concerning the interpretation of the "sudden and accidental" condition to the Pollution Endorsement in a typical oilfield situation. The policy in this case required that a pollution incident be "an accident and

¹⁶ 382 F. 3d 546

¹⁷ *Id.*, at 553.

¹⁸ *Valmont Energy Steel, Inc. v. Commercial Union Ins. Co.*, 359 F. 3d 770, 773

¹⁹ *Id.*, at 558. Internal citation omitted.

unintentional release” and that such an incident be “sudden and accidental”. The Court noted (as discussed previously) that in Texas the temporal requirement of “sudden and accidental” requires that the pollutant be released quickly. Some evidence indicated that the pollution condition resulted from various leaks and spills which occurred over a number of years, although testimony at trial revealed that the leaks, when they occurred, originated in flow lines which were operated at high pressure, and that when the lines leaked, the event occurred suddenly, sometimes resulting in a spray as high as forty feet in the air. The Court was persuaded that coverage was available under this situation, noting that “While the breaks causing the leaks and spills were undoubtedly caused by conditions created over a number of years, the policy’s “sudden” requirement is satisfied as long as the actual break is “sudden and accidental.”²⁰ It is unclear whether this would be the usual result, and this again illustrates the difficulties which can arise with traditional CGL policy coverage of environmental risks.²¹

2. CONTEMPORARY ENVIRONMENTAL COVERAGE

As the understanding of environmental risk became more clear and quantifiable beginning in about 1990, modern environmental insurance came of age. An additional factor, although beyond the scope of this paper, concerns compliance with Financial Accounting Standards Board Interpretation FIN 47 which requires businesses to value identified conditions associated with asset retirement obligations (such as remediation cleanups, tank closures, corrective action, and other contractual and environmental obligations.) Environmental insurance can help quantify such obligations.

Unlike the CGL policy, which is standardized and approved by all fifty state insurance commissioners, environmental insurance is usually written on an excess and surplus lines basis. Excess and surplus lines insurance does not require approval of the insurance policy form or rates by insurance commissioners. As a result, the policies can be highly customized to fit the needs of the buyer, without going through the laborious task of seeking regulatory approval; however, as a result there are no widely accepted industry standard policies for environmental insurance. Often different companies create custom brand names for essentially the same type of environmental coverage. (For example, Environmental Impairment Liability insurance and Pollution Legal Liability insurance are different names referring to similar coverage.) Underwriters have also added to the complexity by combining various forms of environmental coverage into packaged policies. At last count there were over one hundred different true environmental insurance policies available for purchase from top rated insurance companies. Each of these policies has dozens of endorsements available which allow the policy to be customized for the use of the insurance buyer.

In order to simplify the analysis, environmental insurance typically used in the oil and gas industry can be broken down into just a few basic coverage forms. The majority of

²⁰ Id., at 556.

²¹ Accord, *Harken Exploration Company v. Sphere Drake Insurance PLC*, id., at 475 (“The Rices alleged that the various lines, tanks, and wells ruptured releasing pollutants, including saline substances. The word rupture intimates that the release was sudden. Therefore....the release of the pollutants was sudden and accidental.”)

all environmental insurance placed in the oil and gas industry will consist of one or more of the following basic building blocks:

A. Pollution Legal Liability Insurance (“PL”)

Pollution Legal Liability (“PL”) or Environmental Impairment Liability (“EIL”) insurance is used to cover fixed site exposures; thus unlike general and excess liability policies that provide coverage to all operations of the insured, these environmental insurance policies are written on a site-specific basis. The policies may, however, be modified to include disposal site coverage as well as transportation coverage, for example to add non-owned salt water disposal wells. The coverage responds to loss arising from pollution conditions at, on, under or emanating from a facility, which, in general, requires a release of pollutants to trigger coverage under the policy. PL policies are provided on a stand-alone basis with dedicated limits for pollution incidents.

PL policies may be written with no retroactive date which would grant coverage to pre-existing conditions; therefore, the policy can provide full coverage for prior acts which are unknown to the applicant at the time the policy is purchased. (For example, without a retroactive date a slow leak in a pipeline that is detected and reported during the policy period should be covered by the environmental insurance in force at the time the claim is made, even though it is not clear exactly when the leak occurred.)

It is important to note that PL policies are usually written on a claims-made and reported basis, which means that a policy is triggered only when a claim is made during the policy period and reported as required by the policy. The exact “triggering” mechanism should also be carefully considered, as illustrated by the following cases.

In *Alan Corp. v. International Surplus Lines Insurance Co.*²², a fuel oil seller obtained a claims made policy for storage tanks at several locations. The policy provided coverage for a “legal obligation validly imposed through government action which is initiated during the policy period.” Alan became aware of contamination just prior to the expiration of the policy and notified the local fire department. After expiration of the policy the insured reported the contamination to the responsible pollution control agency, which ordered a cleanup. The First Circuit upheld denial of coverage, holding that placing a call to the local fire department during the policy period did not equate to a legal obligation imposed through governmental action.

Similarly, in *Wolf Brothers Oil Company, Inc. v. International Surplus Lines Insurance Company*²³ the insured operated a chain of gasoline stations for which it maintained a claims made PL policy from the defendant. At the end of the policy term the insurer declined to renew the policy, and Wolf Bros. exercised an option to purchase an “extended reporting period.” The base policy required that a claim for damages be first made against the insured “during the policy period” and reported to the insurer “during the policy period or within fifteen days after its termination”. The extended reporting period provided an extended period for reporting of claims, but its express wording provided that coverage only applied if the damage “occurred prior to the effective date”

²² 22 F. 3d 339 (1st. Cir. 1998)

²³ 718 F. Supp. 839

of cancellation of the base policy. After the effective date of cancellation but within the term of the extended reporting period a governmentally mandated environmental cleanup was begun. Wolf Bros. argued that it believed that by purchasing the extended reporting period option it was extending the term of the policy, such that a claim occurring during the extended period would be covered. The U.S. District Court for the Western District of Washington, however, had little trouble holding that there was no coverage for environmental cleanup costs since the policy explicitly required an occurrence during the policy period, which requirement was not altered by the wording of the added extended reporting period option. The insured's (mis)understanding of the effect of the extension was to no avail.

Known contamination at the time of application is not covered by PL policies (although, depending on the specific circumstances, it may be possible to place bodily injury and property damage coverage for third party claims due to known conditions.) Whether or not contamination is "known" to the insured at the time of application can be a difficult factual inquiry, however, as illustrated in *Goldenberg Development Corp. v. Reliance Insurance Co. of Illinois*.²⁴

In *Goldenberg* the policy barred claims for "known conditions" and further stated that coverage did not apply to losses arising at the inception of the policy "unless all the material facts relating to the pollution conditions were disclosed to [the insurer] prior to the inception of the Policy." The insured had provided copies of various reports concerning the insured site but had omitted one, although the missing report was cited in the material provided. The insurer denied coverage and upon review the Court held that the materiality of the information allegedly withheld was a question of fact, making summary judgment inappropriate. The case serves as a reminder to policyholders to disclose all information available at policy inception regardless of the perceived relevance of the information.

The PL policy is designed to be used to fill the gaps in business insurance coverage created by pollution exclusions in both property and liability insurance policies. The menu of coverage options allows for the design of a program tailored to meet the specific coverage needs of the applicant, and coverage may be restricted as a premium reduction tool. Coverage options include:

- First & Third Party Clean-up Costs
- Third Party Bodily Injury Liability
- Third Party Property Damage Liability and Natural Resource Damages
- Legal Defense Costs
- Costs of Business Interruption
- Diminution in Value of Property
- Transportation Off Site

It is interesting to note that these environmental "liability" insurance policies can provide insurance coverages for business interruption or first party clean up coverage, which would normally be covered in a property insurance policy. Because property insurance policies would normally have pollution exclusions, a well-structured environmental

²⁴ 2001 WL 872944 (E.D. Pa., May 15, 2001), an unreported decision.

insurance policy is usually the only practical and reliable way to fill the coverage gaps in property insurance policies for pollution related losses.

B. Storage Tank Liability Insurance

This specially designed PL policy provides coverage for third-party bodily injury and property damage from pollution conditions emanating from scheduled storage tanks for corrective action and cleanup. This policy can be utilized to meet state and federal storage tank financial responsibility requirements for underground and aboveground storage tank owners and operators, although most carriers will require the use of a specific policy form for this purpose. These policies can cover third party liability claims for bodily injury, property damage, off-site and on-site cleanup costs, and defense costs.

C. Contractors Pollution Liability Insurance (“CPL”)

The Contractors Pollution Liability Insurance (“CPL”) policy was first developed to address the environmental insurance needs of contractors performing environmental remediation services on contaminated sites. Today, this policy form is commonly used to insure the environmental loss exposures of traditional contractors as well. The form is designed to cover a contractor’s ongoing and completed operations. Contractors’ policies provide coverage for pollution related losses arising from the described operations of the named insured and may be available on a claims made or occurrence form. The coverage typically protects contractors against claims for third-party bodily injury, property damage or cleanup costs/environmental damage arising from pollution conditions caused by the performance of covered operations. This coverage applies to sudden and gradual pollution events and responds to cleanup costs, both on and off the work site.

It is particularly important for facility owners in the oil and gas industry to require CPL insurance in addition to CGL insurance from the contractors working in and around their facilities. Unlike the owners, contractors usually do not have time element pollution coverage available on their Commercial General Liability policies. Therefore, if there is a release of any material capable of contaminating something at the job site that leads to a loss, without CPL it is unlikely the contractor will have any insurance coverage available to protect it or the owner.

CPL policies usually provide for contractual liability coverage. Therefore, if a site owner requires CPL coverage naming the owner as an additional insured, the contractor will be providing primary insurance for claims arising out of the contractor’s operations that could very well be excluded on the site owner’s own insurance policies because of pollution exclusions on those policies.

D. Cleanup Cost Cap Insurance

Cleanup Cost Cap Insurance (or “Remediation Stop Loss Coverage”, or “Cost Containment Coverage”) is designed to insure remediation costs exceeding budgeted costs, thus addressing the risk and uncertainty associated with environmental remediation projects. These policies are typically tailored to specific transactions and generally require that a remedial action plan be in place, and sometimes require that the plan be approved by the responsible regulatory agency.

Cleanup Cost Cap Insurance provides coverage for cost overruns for the remediation of known conditions and the remediation of new conditions discovered during the performance of the remedial action plan. This coverage is useful in the following situations:

- Actual contamination greater than estimated.
- Offsite clean-up costs adjacent to the covered site that are part of the remediation plan.
- Offsite clean-up costs emanating from the covered site that are part of the remediation plan.
- Change orders by governmental authorities that are required during the policy term.

These policies are especially valuable since they:

- Reduce liability associated with fixed-price contracts.
- Provide assurance that funds will be available to complete remedial activities.
- Ensure unexpected cost overruns are not assumed by the property owner, investor, or contractor.

Coverage under a Cleanup Cost Cap policy is typically established by a trigger mechanism spelled out in the policy. Examples of coverage triggers include the following:

- Actual contamination greater than estimated.
- Discovery of additional contaminants during remediation.
- Clean-up methods which fail to work as anticipated.
- Government mandated change orders which are required during the policy term.

Cleanup Cost Cap Insurance generally excludes coverage for bodily injury, property damage, third party liability, fines, penalties and policyholder noncompliance or criminal acts.²⁵

3. NEGOTIATION ISSUES FOR ENVIRONMENTAL INSURANCE POLICIES

A. Underwriter Due Diligence and Application Requirements

Procuring environmental insurance is a fairly straightforward exercise if the needs of the underwriter are kept in mind, although the application process can be intimidating. The applications vary, however the underwriters are all looking for the same essential information, namely:

- The type and quantity of hazardous materials stored at the facility.
- Environmental exposure routes
- Target populations and potential receptors

²⁵ Howard, "New Issues in Environmental Risk Insurance", 40 Tort, Trial and Ins. Practice L.J. 957, at 960

- Knowledge of pre-existing environmental conditions and losses
- The financial ability of the applicant to pay the self insured retention
- The prior loss history experience of the applicant.
- An understanding of the operations of the applicant

There is an inverse relationship between premium and the level of information provided in the submission materials. To evaluate the key underwriting components, each underwriter has its own set of customized insurance applications which are designed to trigger rating variables in their proprietary rating models. To get the best value in the insurance purchase, it is suggested that the proprietary insurance application of each underwriter be utilized, which will enable the underwriter to apply the maximum number of rate credits. Another very important reason to use the specific insurance application of the underwriter insuring the risk is that the application actually includes the representation and warranties of the policy and becomes part of the insurance policy in most cases. A defective application could result in defective coverage if a claim arises which triggers a prior knowledge or non-disclosure exclusion.

In addition to a signed insurance application, a full submission to an underwriter should include Phase I and II audits if available, schedules of the applicant's environmental compliance protocols, and disclosure of all known environmental loss exposures at the properties for which coverage is desired. The underwriter will typically also require the following:

- A telephone survey.
- Information regarding on-site operations.
- Any environmental reports/assessments completed for the site.
- Financial information.
- Other information deemed necessary by the underwriter, such as database searches, regulatory correspondence, and engineering surveys

It is important for the applicant to have a very good idea of what risks need to be insured before a submission is provided to an underwriter. An insurance application should never reach an underwriter without a clear picture as to what the applicant wants to insure and a general idea of how much it wants to consider paying in premium. A submission that hits an underwriter's desk in the form of a puzzle is likely to go to the bottom of the pile for a period of time before it finds its way to the round file below the desk. If a quote is ever obtained on the "mystery application" it is likely to have very poor pricing.

B. Use of a Specialized Broker

The wide variety of choices in environmental insurance makes the selection of an insurance intermediary particularly important. Insurance brokers with specialized expertise in environmental risk management are usually the source of guidance through the maze of environmental insurance options. Brokers can assist the client by identifying exposures and negotiating an insurance contract which addresses their client's needs. However, it is important to note that insurance agent and broker licensing exams and continuing education programs are often lacking any information concerning environmental insurance. Therefore, it is advisable to engage the services of a qualified

environmental insurance broker before purchasing an environmental insurance policy of any kind. Because of the complexity of environmental risks and the dearth of industry standards for environmental insurance policies, it is entirely possible to pay top dollar for an environmental insurance policy that excludes nearly every risk the buyer actually has simply because an inappropriate policy form was selected from the myriad of options.

There are approximately one half dozen full service environmental insurance companies in North America today with many more offering limited types of environmental coverage. Obviously preparing a customized insurance submission for even six insurance companies would be a daunting task. A skilled environmental insurance broker will usually be able to quickly narrow the field of possible underwriters down to two or three based on the parameters of the particular risk to be insured. While it may be counterintuitive that the best terms will be obtained from an underwriter that is not faced with a large amount of competition, experience shows that negotiating with an underwriter with a proven appetite for a particular class of business will produce the best insurance value for the applicant. Preselecting the best markets based on past experience and current knowledge of the underwriting guidelines of all the underwriters is another very important role of the insurance broker, as well as providing independent and impartial advice.

4. EXAMPLE: USE OF ENVIRONMENTAL INSURANCE IN THE OIL AND GAS INDUSTRY

A. Overview

Environmental insurance can be used for many purposes in the oil and gas industry, including for example to cap remediation costs or to provide environmental coverage for contractors. However, a transaction involving the purchase and sale of an oil and gas asset presents perhaps the ideal situation for the use of environmental insurance, since the insurance can be utilized to facilitate the sale despite the presence of associated environmental liabilities.

Selling or buying a property with known or suspected environmental conditions can be a challenge because of many factors, including the following:

- Environmental costs are difficult to predict with certainty;
- Environmental costs can be very high, especially if bodily injury, property damage and potential natural resource damages are factored in;
- Changes in accounting rules and securities laws are forcing the recognition of more environmental liabilities and costs;
- Capital markets and lenders try to avoid unquantified environmental liabilities or charge risk premiums if they are identified;
- Given universal exclusions of pollution coverage on present day insurance policies, if an environmental loss is incurred it is unlikely there will be any

insurance coverage unless a separate environmental insurance policy is purchased.

Pollution related losses are infrequent but potentially catastrophic. As a result, environmental insurance has a distinct advantage in facilitating the sale of property, since such insurance is the only financial tool available that can create an affordable sum certain for a loss event with a low probability but potentially high cost if a loss is in fact incurred. Dealing with environmental liabilities through indemnities or hold backs of the purchase price in an escrow account are common, but can be a less satisfactory solution than the use of insurance, because of the inability to deal with the "Risk Adjusted Expected Liability", as described below.

Risk Adjusted Expected Liability may be defined to equal the cost of a loss multiplied by the probability that the loss will be incurred. Without an environmental insurance policy in place, 100% of the cost of a loss will need to be anticipated and accounted for by either the seller or buyer with no discount for the probability that the loss may not be incurred. This is because with out insurance if a loss is incurred 10% of it will have to be paid for out of pocket, not just some part of it. If the chances that a loss will be incurred are one out of a hundred, the insurance underwriter has an inherent advantage because the underwriter can collect even ten times the Risk Adjusted Expected Loss in the form of a insurance premium, and still provide coverage which is much less expensive than a fully funded indemnity or escrow hold back of the sales price.

Environmental insurance has other more subtle, but equally important, advantages, which include the following:

- By having and insurance company evaluate the risk and assign a premium (based on prescribed limits and policy terms) the buyer and seller can let an objective third party set the price for the environmental risks of a transaction. This can be a deal facilitator since taking environmental risks off the table early on in the negotiations can maintain goodwill so that other issues in the transaction can be addressed.
- Insurance is true risk transfer to an unrelated party; indemnities and holdbacks leave the risk in the transaction.
- Insurance premiums are tax deductible, while indemnities are not until they are paid.
- The establishment of an open ended environmental indemnities creates long term accounting issues due to rules that make it difficult to extinguish an environmental indemnity once it is on the books.
- Financial markets may assign a multiplier to the amounts shown as environmental contingencies, which can reduce the capitalized value of the enterprise by many times the amount of the contingency. For publicly traded entities, the environmental insurance used to replace an indemnity between the parties may actually increase the capitalized value of the entity by much more than the amount paid for the insurance premium.

B. Specific Example

The following example is designed to illustrate the use of environmental insurance in the sale of an oil and gas property. (Note that all figures used, including without limitation the assumed cost of insurance coverage, are for illustrative purposes only and may not represent the actual prices available from time to time in the market.)

Assume for purposes of discussion that a large natural gas processing plant is on the market with an agreed fair market value, absent consideration of environmental liabilities, of \$40,000,000. There is an environmental contingency related to a known environmental condition with a quantifiable remediation cost of \$1,000,000. In addition to the expected cost of clean up, the buyer, which will face potential strict liability for the environmental conditions at the property, determines the following environmental contingencies associated with the acquisition of the property following its due diligence review:

1. Remediation costs exceeding the amounts expected by the seller (\$1,000,000);
2. Potential third party claims for bodily injury and property damage plus the defense cost associated with these claims arising from undiscovered preexisting contamination (\$3,000,000);
3. The possible discovery of previously unknown contamination that needs to be cleaned up, including the buyer's cost of business interruption during the remediation process (\$10,00,000);
4. The potential for claims arising from non-owned disposal sites (\$1,000,000);
5. Potential environmental liability including potential natural resource damages claims arising from the ongoing operations of the facility, which cannot be delineated as to time or amount (\$5,000,000).

For simplicity, assume that the probability of each of these possible environmental costs is one 1 out of 100 and that they will all be incurred at the same time if there is a loss at all.

The Risk Adjusted Expected Liability for environmental defects in this transaction is:

1. \$1,000,000 expected cost of the remediation plus;
2. \$20,000,000 of environmental contingencies times the 1% probability of the loss being incurred, which is only \$200,000.

Will the property sell for \$40,000,000 less the \$1,000,000 of expected clean up costs, which the seller would surely advocate? Or will the gas processing plant sell for \$19,000,000, fully discounted in the amount of potential environmental liabilities identified by the buyer?

Without insurance to cover potential environmental liabilities, the buyer, its lenders and the seller are likely to negotiate either an unfunded indemnity or a partial hold back of

the sales price that will be limited in time. Ultimately the sales price will be between \$39,000,000 and the price fully discounted for the environmental contingencies, \$19,000,000. If for example the agreed upon sales price is \$35,000,000, the seller will recognize a loss from discontinued operations in the year of the sale of \$5,000,000, the buyer will be at risk for \$16,000,000 if the 1 out of a 100 loss event occurs, and neither party may be satisfied with the transaction.

If state of the art environmental insurance were utilized to back this transaction the following coverage might be utilized:

- A trust account could be established and funded by structured settlement annuities to pay for the known remediation costs. Assume that the cost of this might be approximately \$950,000.
- Remediation Cost Cap Coverage could be placed for the remediation with a \$1,000,000 limit of liability and a self-insured retention of \$150,000. Assume that the cost of this coverage might be approximately \$200,000.
- A PL policy might be placed with a 10 year policy term, with full coverage for on and off site clean up, liability for bodily injury and property damage, natural resource damages, claims arising from non owned disposal sites, fines, penalties and defense costs arising from previously unknown pollution conditions at the site as of the date of sale, with a \$20,000,000 policy limit, and a \$100,000 self insured retention. Assume that the cost of this policy would be approximately \$400,000.

In this example, by utilizing environmental insurance to facilitate the transaction the full \$21,000,000 of environmental contingencies would be fully funded within the 10-year policy term for a total premium cost of \$1,550,000 (without consideration of funding the self-insured retentions or paying insurance brokerage and other consulting fees which may be incurred.) This amount is only slightly above the Risk Adjusted Expected Liability but may be considerably less than the discount on the sales price that will be incurred without the environmental insurance in place.

5. CONCLUSION

As the nature of environmental liabilities has become more clear and quantifiable, Environmental Risk Insurance has evolved to provide valuable protection at reasonable costs. Companies in the oil and gas business should consider making more use of this powerful risk management tool to complement traditional insurance programs.