



MANAGING THE RISK IN PROPERTY TRANSFER

FEATURE



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AS THE NATURE OF ENVIRONMENTAL LIABILITIES HAS BECOME MORE CLEAR AND QUANTIFIABLE, ENVIRONMENTAL INSURANCE HAS EVOLVED TO PROVIDE PROTECTION AND CLOSE THE WINDOW OF UNKNOWN LIABILITY FOR STAKEHOLDERS. ANTHONY SAUNDERS LOOKS AT THE ISSUES INVOLVED.

“Correct insurance provides an important mechanism to manage risk in property transactions. It may not cover pollution that is known to exist on the property.”

Environmental insurance can be used for many purposes, including capping remediation costs or providing environmental coverage for contractors. However, a transaction involving the purchase and sale of a “brownfields” asset presents perhaps the ideal situation for the use of environmental insurance, since the insurance can be utilised to facilitate the sale.

Insurers need to understand the risks

The risk associated with contaminated land may be in direct proportion to what we know about the site. Key elements are:

- geology
- historic usage and diversity of use
- proposed remediation method
- insurance claims history.

These elements also may allow an insurer to discern that certain components of risk may result in or lead to an event of worse case proportions.

The difference between what is known versus what is unknown may be insured.

A “Responsible Person or Entity” (appointed, nominated, in charge of or as owner) of a contaminated site, accepts that there are certain commercial outgoings that may have to be expended to avert further contamination.

Where development of a site may be considered, unexpected events may still arise that may result in time delays and unexpected cost outlays.

Remediation insurance applied during the process of reinstatement of contaminated sites offers the safest financial solution for all stakeholders. Insurers who provide such cover are willing to take on the risks in “partnership” with stakeholders provided that they too obtain an intimate knowledge of the site in question.

Unknown risks can lead to policy exclusions

The commercial risks associated with contaminated land abound in potential arguments that insurers have become familiar with, hence many complex policy limitations have developed over the years. One may consider that specialist environmental insurance is an essential element in any undertaking when managing the risk in any property transference.

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

1. environmental clean-up costs are difficult to predict with certainty
2. environmental clean-up costs can be very high, especially if bodily injury, property damage and potential natural resource damages are factored in
3. changes in accounting rules and securities laws are forcing the recognition of more environmental liabilities and costs



4. capital markets and lenders try to avoid unquantified environmental liabilities or charge risk premiums if they are identified
5. pollution is excluded (refer to common industry policy exclusion) under present day insurance policies unless otherwise negotiated through specialist coverages.

Correct insurance provides an important mechanism to manage risk in property transactions. It does not cover pollution that is known to exist on the property. What it does cover is the possibility that the pollution may be worse than initially expected. That uncertainty or risk can impact negatively on property transactions so insurance provides a mechanism to reduce or remove the financial risk from the transaction.

Understand what insurance is providing

To provide effective and economical protection for those involved in the transfer of property there needs to be an understanding by those being insured about what sort of cover is being provided, and the insurer needs to understand the risks.

If an insurer is uncertain of the risks he or she may include exclusions in the contract to reduce the potential risk or add a risk premium to the cost of the insurance. Inadequate research by the person seeking insurance could result in insurance cover that does not provide the protection required or at a cost in excess of what is fair for the insurance cover being supplied.

Pollution law-related losses are infrequent but potentially catastrophic and therefore of concern to those involved in the transfer of potentially contaminated or contaminated property. If coverage can be obtained, the entity with the cover has a distinct advantage in facilitating the sale of the property, as insurance is often the only affordable way of managing the risk.

Indemnities and holdbacks

Dealing with environmental liabilities through indemnities or holdbacks of the purchase price in an escrow account are commonly contemplated. However, these do not create an escrow to a level equivalent to a maximum liability, or deal with the "Risk Adjusted Expected Liability". An escrow, of course, is an account established for the purpose of holding funds until the consummation or termination of a transaction.

Risk Adjusted Expected Liability is the cost of a loss multiplied by the probability of it being incurred. Without an environmental insurance policy in place, one hundred per cent of the loss will need to be anticipated and reserved by either the seller or buyer with no discount for the probability that the loss may not be incurred. This is because without insurance, if the chance of occurrence is ten per cent, it will still have to be one hundred per cent available. In comparison, an underwriter can collect ten times the Risk Adjusted Expected Loss from other insurers in the form of an insurance premium, and still provide coverage which is much less expensive than a fully funded indemnity or escrow holdback of the sale price.

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

- ☐ By having an 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 in the negotiations can maintain goodwill so that other issues in the transaction can be addressed.
- ☐ Insurance offers a true risk transfer mechanism to an unrelated party; indemnities and holdbacks leave the risk in the transaction/property ownership transfer.
- ☐ Insurance premiums are tax deductible, while indemnities are not until they are paid.

- ☐ Insurance removes long-term accounting issues created by open-ended and indeterminate environmental exposures.
- ☐ Financial markets may assign a multiplier to the amounts shown as environmental contingencies, which can reduce the capitalised value of the enterprise by many times the amount of the contingency.

Many companies have the potential to create pollution through the use of chemicals in their business. The types of insurance cover available are also many and varied. Insurance can be obtained for:

- ☐ cleanup of contaminated sites including cost capping
- ☐ brownfields restoration and development
- ☐ liability for potential injuries and death due to pollution
- ☐ pollution legal liability
- ☐ property transfer
- ☐ transporter insurance
- ☐ storage tank pollution liability
- ☐ professional and contractor environmental liability
- ☐ site closure and post-closure insurance.

Conclusion

Not all policies are the same and those seeking insurance need to carefully look at what is being offered, particularly in regard to exclusions. When dealing with any professionals, the best advice is often from those who have experience and understanding of your industry.

As the nature of environmental liabilities has become more clear and quantifiable, environmental insurance has evolved to provide valuable protection at reasonable cost, closing the window of unknown liability. Stakeholders dealing with brownfield sites should consider making more use of this powerful risk transfer tool as part of their overall management strategy. **II**

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THE COMMON POLLUTION LAW EXCLUSION

The following is an example of a common policy exclusion, which may be utilised by an insurance claims manager to deny liability where environmental pollution has taken place.

- (a) Personal Injury or Damage to Property caused by or arising directly or indirectly out of the actual, alleged or threatened discharge, dispersal, release or escape of smoke, vapours, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials or other irritants, contaminants or pollutants into or upon any property, land, the atmosphere or any water course or body of water (including ground water) unless such discharge, dispersal, release or escape:
 - (i) is neither reasonably expected nor intended by any of the persons insured; and
 - (ii) is the consequence of a sudden and instantaneous cause which takes place at a clearly identifiable point in time during the period of insurance.
- (b) any costs or expenses incurred in preventing, removing, nullifying or cleaning up any discharge, dispersal, release or escape as described in (a) above, unless such costs or expenses are consequent upon an unexpected, unintended sudden and instantaneous cause which has taken place at a clearly identifiable point in time during the period of insurance which results in personal injury or damage to property neither of which is otherwise excluded by this policy.

Notes

- i Previously used commercial or industrial land which can be re-used.