

Environmental Liability Transfers:

An Alternative Approach to Transferring Risk in a Post-Environmental Cost-Cap/Stop-Loss Insurance World

ABSTRACT

During the 1990's and early 2000's, guaranteed fixed price remediation (GFPR) and Cost Cap insurance contracts offered by national environmental engineering firms and supplemented with environmental cost cap insurance policies offered by the major insurance providers was in its heyday. Engineering and insurance firms formed alliances that secured hundreds of millions of dollars in GFPR/Cost Cap contracts that enabled owners of legacy industrial properties and developers to define and secure the fixed dollar amounts for remediation of known environmental conditions at their properties enabling more accurate estimations of return on investment and facilitating real estate transactions. However, the impact of the "Great Recession", dollar losses due to unforeseen site conditions, convoluted project management and regulatory factors caused firms providing these services to exit the marketplace. The demand for environmental liability transfers has not diminished and continues to afford many benefits to the environment and to a growing local and national economy.

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STATE OF ENVIRONMENTAL INSURANCE

During the 1990's and into the early 2000's, guaranteed fixed price remediation (GFPR)/Cost Cap insurance contracts offered by large national environmental engineering firms and supplemented with environmental cost cap stop-loss insurance policies offered by the major insurance providers was in its heyday.

Engineering and insurance firms formed alliances that helped secure hundreds of millions of dollars in GFPR/Cost Cap contracts that enabled major corporations, owners of legacy industrial properties and developers to define and secure the fixed dollar amounts for remediation of known environmental conditions at their properties enabling more accurate estimations of return on investment and facilitating real estate transactions.

As these programs matured, it became evident that the net losses by the engineering firms and the insurers were piling up due to a number of factors and by the 2007 to 2009 timeframe, which coincided with the Great Recession, insurers were getting out of the environmental cost-cap market altogether. Engineering firms were also feeling the pain of financial losses due to inaccurate cost estimation and budget overruns due to a variety of factors including; unexpected field conditions, protracted time and expense dedicated to project management and regulatory issues and subcontractor cost control.

As Cost Cap insurance programs matured, the net losses by the engineering firms and the insurers became unsustainable.

The demand for environmental cost certainty and liability transfer in the industrial and Brownfield marketplace has not diminished; in fact, it is as strong as ever as the demand for urban in-fill development has increased since the last recession. The migration of young people to urban areas along with the baby-boomer generation wanting to downsize and live in town and urban centers located close to shopping and community amenities has fueled the demand for development of urban areas.

Urban migration has engulfed cities and populated areas which were once occupied by former nineteenth and twentieth century industrial sites particularly in the northeast, mid-west and west coastal areas of the United States. On the sell side, the Sarbanes-Oxley Act, enacted by Congress in 2002 requiring

public companies to disclose their cash reserves to cover environmental liabilities, has kept the demand for environmental risk transfer and management solutions in the forefront, for legal, financial and public perception reasons.

Today there are few options available in the insurance market for stop-loss policies in the environmental space for known environmental conditions. Several major firms currently offer environmental cost-cap policies but premium costs and terms have hardened due to the lessons learned from the past. The market for coverage for unknown environmental conditions covered by Pollution Legal Liability (PLL) policies have remained relatively stable and a good value from a cost perspective.

Companies with combined experience in real estate development and valuation, environmental risk underwriting and site remediation have recognized the demand for environmental liability protection for known environmental conditions and have in effect filled the void left behind by the insurers exit from the environmental costcap insurance market. This article will discuss and provide examples of how environmental risk transfer transactions can be structured without reliance on cost-cap policies to protect owners of environmentally-impacted industrial properties from past, current and future environmental liability.

ENVIRONMENTAL LIABILITY TRANSFERS IN A POST COST CAP INSURANCE MARKET

A key reason for the post-recession retreat of the GFPR/Cost Cap market was the reliance of a disparate group of professional resources in different fields to come together to formulate a comprehensive secured risk transfer package for buyers and/or sellers of environmentally impacted properties. Technical, legal, regulatory and insurance resources with very different sets of internal goals and administrative requirements had to be assembled to develop an agreement and ultimately execute a remediation program with a guaranteed firm fixed price.

However, it wasn't until the first few shovels hit the ground that the scope, level of effort and cost became truly clear. The different risk models and risk factors used by the GFPR/CostCap contractors to determine the probable cost and contingency and the methods to track budgets and anticipate problems became less reliable.

Predicting and quantifying the consequences of State and Federal Regulatory decisions during the investigative and remedial processes also made controlling costs all the more difficult. Decisions by regulatory project management staff and their superiors were often influenced by public and/or political pressures, newsworthy events related to environmental issues of the time and distrust of the responsible parties and their environmental contractors. To the latter, right or wrong, many regulators sensed that the environmental contractors were trying to cut corners to save money. As a result, the project management costs of environmental projects tended to expand uncontrollably and drag on much longer than expected.

It was very common for catastrophic cost overruns to occur during large-scale GFPR/Cost Cap soil excavation projects resulting in numerous insurance claims and costly litigation. The cause of the overruns was often due to mischaracterization soil chemistry and miscalculation of the volume of impacted soil thought to be “non-hazardous” by RCRA definition, based on soil sampling and analyses performed prior to the initiation of the fixed-price site remediation phase.

In today’s economy, the value of predictability and cost-certainty when assessing environmental liabilities has never been more important.

Once the soil excavation remedy that was budgeted in the GFPR/Cost Cap contract started, it was not uncommon for suspect chemical odors

or discoloration to be observed in the field that required further testing. If the new test results indicated that the soil was “hazardous” by RCRA definition, the transportation and disposal (T&D) costs could increase anywhere from 2 to 4 times greater than estimated. Often the soil disposal facility would test the soil before accepting it, if it was determined to be unacceptable the soil would be sent back to the source at the owner’s cost.

In addition, regulatory mandated “end-point” soil sampling of the newly characterized soil around the excavated areas and laboratory wait times to turn results around (2 to 3 weeks) generated large unanticipated volumes of soil adding to the cost for T&D, professional and contracted labor, laboratory services and fees for heavy equipment.

In the end, the major providers and insurers of GFPR/Cost Cap insurance contracting all had one or more projects in their risk pool go significantly over-

budget, sometimes by tens of millions of dollars. Stockholders and management of the firms providing GFPR/Cost Cap services quickly lost their appetite for taking on further risk and quietly exited the market.

The value of predictability and certainty revolving around environmental costs and liability has never diminished since the great recession, in fact it has increased. The reasons for the continued demand include; high demand for more city-centric development and housing, more rigorous lending requirements within the banking industry, an uptick in the corporate mergers and acquisitions, corporate consolidation and shareholder aversion and/or concern about environmental stigma and liability. To meet these demands, environmental liability transfer firms today have abandoned the combined engineering/insurance management mold. The biggest difference with the environmental liability transfer model in the post-cost cap era is the emphasis on restructuring the key skill sets and financial infrastructure.

Firms providing risk transfer services in the post-cost cap environment have moved away from their reliance on having separate technical, financial and insurance entities. The more streamlined approach to assess, finance and manage environmental liability enables environmental liability transfer providers to be nimbler in the risk decision-making process, environmental project execution, overall property management and disposition. Environmental liability transfer firms today also have the benefit of experience and “lessons learned” from successes and failures after almost three decades of environmental risk transfer contracting in the marketplace.

Environmental liability transfer firms in the post-cost cap insurance era have added an important element to the equation - real estate asset purchase and development.

Environmental risk management firms in the post-cost cap insurance era have also added an important skill set to the equation - real estate. Valuation of real estate assets is now more commonly integrated into the risk transfer and management process. Environmental liability transfer firms experienced with industrial real estate valuation and management understand the “real risk” of environmental liability and can leverage or blend real estate value in the overall risk model.

Environmental risk transfer firms today by virtue of their real estate experience can not only assume risk but also take title to legacy or underutilized industrial properties. This enables them to be more flexible in structuring liability transfer terms within purchase and sale or leasing agreements. As an owner of both the environmental liability and the property asset, the environmental liability transfer firms are further incentivized to clean up and reposition properties in order to monetize them as quickly as possible.

ENVIRONMENTAL LIABILITY TRANSFERS: ARE THEY SECURE?

Environmental liability transfers come with corporate indemnifications from past and future environmental liability caused by the seller or their predecessor's actions in perpetuity. The new owners and/or operators of the property, their lenders and tenants benefit from the indemnification unless they themselves create or exacerbate environmental impacts.

The first question on every seller/transferor's mind is "what kind of financial resources are behind the guarantees and indemnifications? "What if...?" As before in the early GFPR/Cost Cap risk transfer days, financial strength of the environmental risk transferee is of paramount importance to the seller/transferor of environmental liability due to concern about having the liability revert back to them in the event of the transferee's inability to complete the remedial work for financial or other reasons.

The environmental liability transfer providers today are generally not publicly-traded companies and their finances are not disclosed to the public, as such. To overcome any seller/client concerns about surety, environmental liability transfer companies establish self-insured retention funds (SIRs), the most secure is in the form of independently managed and bankruptcy-proof trusts earmarked for the specific projects in its portfolios.

As far as financial disclosure, providers typically open up their books after the terms and costs associated with the project are first agreed upon by both

CHECKLIST FOR VETTING ENVIRONMENTAL LIABILITY TRANSFER FIRMS

- 1)** Track Record of Successful Environmental Liability Transfer Transactions
- 2)** Financial Capacity and Risk Tolerance to Absorb Unknown Environmental Issues
- 3)** Vision to Reposition Distressed Assets for New Sustainable Development

parties. The environmental risk transferor's track record in successfully executing risk transfer projects along with their financial soundness are key to the process and should always be thoroughly vetted.

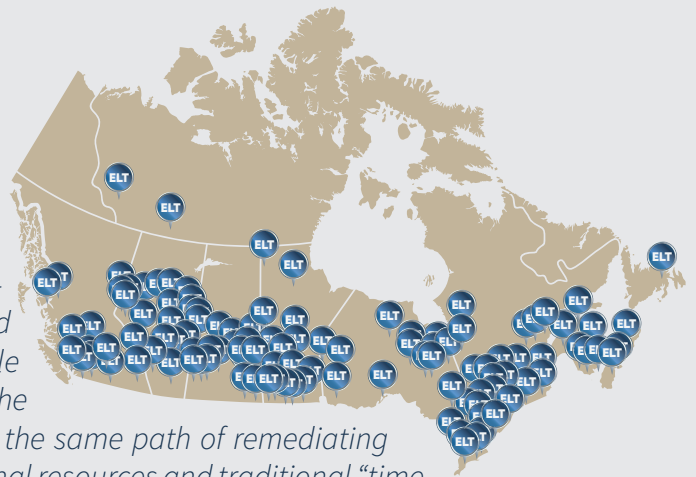
The fact that Fortune 100 global corporations are now opting to transfer environmental liability to outsourced providers lends to the efficacy of today's environmental liability transfer programs. In the past, large corporations have been reticent to outsource environmental liabilities for a variety of reasons, mostly, fearing a loss of liability control and risk management, public perception, internal job security issues and concern about the environmental liability reverting back to them in the event the environmental liability transfer firm fails to perform or experiences financial difficulties. However, as described in the case study below, many large corporations are now recognizing the value of outsourced environmental liability management.

CASE STUDY: Transfer of Environmental Liability Leads to Widespread and Expedited Environmental Cleanup Across Canada

In 2015, a Fortune 10 petroleum company transferred land title and environmental liability of more than 130 properties in Canada to a national environmental liability transfer firm.

The portfolio was comprised of bulk petroleum storage terminals, distribution centers and refineries. The financial vetting process that preceded the transfer was prolonged and involved multiple layers of corporate management. In the end, the company conceded that if they continued down the same path of remediating and selling the properties themselves, using internal resources and traditional "time and materials" providers, it would have taken twice as long to divest the sites, at almost twice the cost.

Within 3 years, the environmental liability transfer firm cleaned up and sold 90% of the properties in the portfolio, whereas, the petroleum company using conventional environmental contracting had only remediating and sold a handful of properties over the prior 20-year period.



DEALING WITH ENVIRONMENTAL UNKNOWNNS

In the past, GFPR/Cost Cap insurance contracts only covered known scopes of work which included detailed metrics and volumes concerning the contaminants to be addressed. Environmental cost cap insurance policies were used as the first “stop loss” layer of risk management after the GFPR firm’s (environmental contractor) fixed deductible to cover cost overruns to remediate known conditions.

The unknown conditions, which included newly discovered contamination, 3rd party bodily injury and property damage claims were and still are covered by Pollution Legal Liability (PLL) policies. PLL policies exclude coverage of the known conditions covered under the GFPR contract. Therefore, should the volume of contaminated soil from a known source area, like underground storage tanks (USTs), exceed covered estimates it would not be considered an unknown condition and consequently would not be covered by the PLL policy. This scenario would ostensible be covered by the cost cap policy if the deductible or self-insured retention (SIR) was exceeded, as a result of the miscalculation of the impacted soil volume.

PLL policies still play an important role in the post-cost-cap era and complement the contractual indemnifications offered by today’s environmental risk transfer providers. Coverage for 3rd party personal injury and/or property/business damage claims cannot be anticipated and quantified as part of the GFPR/Risk Transfer process and the needs in many cases are specific to certain business operations.

Environmental insurance professionals continue to play an important role in tailoring the PLL policies to meet the risk transfer project requirements. Though not common, some PLL providers cover potential Natural Resource Damage (NRD) claims, which through a complex valuation process assigns monetary value to natural resources which may be damaged by pollution. These resources may include potable groundwater aquifers, surface water bodies, fish and wildlife habitats, biota, recreational resources and more.

This coverage has become essential as polluters are held responsible to reimburse designated trusts, as assigned by the USEPA as part of cost recovery actions under the Federal CERCLA (Superfund Program) and Oil Pollution Act (OPA).

CASE STUDY: Environmental Liability Transfers as a Catalyst for New Economic Development

A project that exemplifies the broader benefits of environmental liability transfers as a mechanism to spur economic development, is the former Bethlehem Steel Plant located at Sparrow's Point in Baltimore, MD, which is now a large scale commercial and industrial complex called Tradepoint Atlantic.

Poor market conditions led to the steel mill's bankruptcy and produced the largest brownfield site in North America, comprised of approximately 3,100 acres. An environmental liability transfer firm purchased the property out of a bankruptcy court settlement in 2014.



As a condition of the settlement, the environmental liability transfer firm assumed responsibility for Orders of Consent with the USEPA and the Maryland Department of the Environment (MDE) and agreed to remediate the property for development. Over the next 3 years, the firm engaged in an extensive redevelopment plan which prepared Sparrows Point for new development. The plan consisted of environmental remediation, improvements to bulkheads, demolition, and more. Ultimately, the environmental liability transfer company sold the entire complex to private equity investors for new development.

The assumption of environmental liabilities was the catalyst behind the quick development of Tradepoint Atlantic, an international trade hub which is expected to create \$2.9 billion in economic activity and yield as many as 10,000 jobs over the next 10 to 15-years.

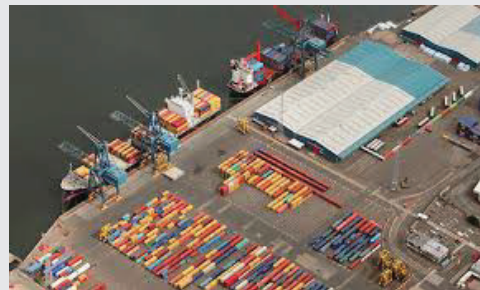
ENVIRONMENTAL LIABILITY TRANSFERS: WHAT'S NEXT?

While ports, petrochemical, and manufacturing facilities continue to be the mainstay of brownfield redevelopment activity, the nation is rapidly shifting from old energy to new energy. This trend has opened the door for many new opportunities to utilize environmental liability transfers. Properties such as landfills, closed lagoons, reclaimed mining operations which may be difficult or unsafe to repurpose for worker or resident-occupied structures may now be suitable for “green energy” projects such as solar or power storage farms. Environmental liability

transfer companies are also focusing on soon-to-be obsolete power plants slated for decommissioning as the country moves further away from coal-fired generated electricity toward more economic and/or “green” energy alternatives. Power plants are ideal properties for repurposing since they are generally large and usually built on waterfront properties with infrastructure to handle marine, highway and rail access.

CASE STUDY: Environmental Liability Transfers Jumpstart Development at Retired Power Plants

In October 2016, an environmental liability transfer firm assumed the environmental liabilities and took title to the 725-acre retired “Tanners Creek” Power Plant from Indiana & Michigan Power. Since that time, the firm has been engaged in decontamination and demolition of the power plant - preparing the site for sustainable reuse.



Redevelopment of this site is expected to be an important economic catalyst for the region and has received tremendous political and local support, including from then Governor Mike Pence who said a port-related project “could unleash enormous economic investment throughout the southeast region of our state.”

CONCLUSION

Although the environmental liability transfer programs have maintained a lower profile since the concept was first introduced to the marketplace in the 1990s, opportunities will continue to present themselves to utilize specialty firms that are experienced with executing successful environmental liability transfer projects. The demand and need for repositioning derelict and legacy industrial properties in urbanized areas of the country in the post-GFPR/Cost Cap insurance era is great and has many benefits, not least of which are to the environment and to a growing local and national economy.

ABOUT THE AUTHOR

Thomas Lobasso, is an Executive Vice President with Environmental Liability Inc. (ELT). With over 38-years of experience in the environmental consulting and risk transfer field, Mr. Lobasso has directed environmental investigations at Federal Superfund sites, petrochemical and government facilities throughout the United States. Throughout his career he has developed and utilized innovative contracting to transfer environmental liability at legacy industrial and former hazardous waste sites and played a key role completing in two award-winning Brownfield redevelopment projects in New England.



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ABOUT ELT

Environmental Liability Transfer, Inc. (ELT) is a comprehensive environmental liability assumption company providing clients complete and final environmental liability transference services since 2004. With strong financial backing and a unique blend of expertise – real estate, environmental, demolition, liquidation, legal, insurance, and sustainable redevelopment planning – ELT has successfully assumed over \$1.5 billion USD in corporate environmental liability for its clients throughout North America.

For more information about this white paper or to schedule a confidential discussion regarding your environmental liabilities, please contact us.



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