Aon Risk Solutions

THE USE OF CONTRACTUAL INDEMNITY AND ENVIRONMENTAL INSURANCE TO INCREASE CERTAINTY IN CONTAMINATED PROPERTY TRANSACTIONS

Empower Results®

Table of Contents

Introduction

The pace of property transactions, including mergers and acquisitions, involving former commercial and industrial properties has picked up in many urban and suburban areas in the past five years. With a general recovery in the real estate market, the demand for properties with development potential has outstripped the supply, making brownfield sites more attractive for commercial and mixed use rehabilitation in spite of the costs and uncertainties that accompany contaminated property transactions. This is particularly true for properties situated close to major cities where the value of the developed real estate can support the additional costs of cleanups and the additional risks of dealing with historic pollution conditions.

Purchasers are looking to resolve uncertainties associated with environmental liability for contaminated properties and sellers must receive assurance that properties will be properly cleaned up and that redevelopment activities will be carried out by the buyers in order to justify the loss of control over the remediation process that goes with a change in ownership prior to cleanup of contamination. Therefore, both parties are searching for mechanisms that can reduce the uncertainties associated with: (1) the scope of remediation required; (2) cost of the required cleanup, including long-term monitoring that may be necessary; (3) unpredictable regulatory actions, including changes in cleanup standards in the middle of remediation, and re-opening cleanup obligations after a no-further-action determination has been received; (4) potential third-party liability for past, present and future releases from the subject property; and (5) the ability to finance the purchase, remediation and development of a contaminated site.

Successful underwriting of a real estate transaction demands creating boundaries for these environmental risks along with the risks normally associated with property development (e.g., commercial aspects of the deal). The more clarity one can obtain with respect to risk issues, the more likely the deal will get done and the more likely it is to receive support from lenders as well as potential tenants of commercial and warehouse space, renters of apartments, and purchasers of condominium units.

Typically, business and tax considerations determine the structure of a transaction. However, environmental issues and risks may become the key points of discussion for former industrial sites where significant remediation will be required as part of the redevelopment and re-use process. Environmental risks must be openly discussed among the parties and then allocated in contract documents so that uncertainties are minimized to the greatest extent possible. Environmental allocation and risk-shifting provisions drafted during negotiations must support the business and tax objectives of the deal, as well as provide protection to the parties involved in the transaction. Uncertainties that remain as well as gaps in environmental risk management strategies within the purchase and sale agreement can derail a transaction. While purchasers are looking to the sellers for management and containment of remediation costs, sellers must also be concerned about the ability of buyers to successfully develop the property in a manner that does not threaten completed environmental remedies and assures that the property will not come back to them with additional remediation requirements as a result of the buyer's actions or inaction. Added to this is the importance of timing to all parties that drives cleanup, development and use of the property within the limits established by lenders, regulators, potential customers and local communities.

Overarching Environmental Regulations

Among the most significant environmental regulations for property owners (sellers) looking at remediation and purchasers looking at redevelopment and re-use of contaminated properties, the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA or Superfund) and its subsequent amendments stands alone as a potential source of environmental liability. CERCLA provides for strict, joint & several and retroactive liability for parties responsible for releases of hazardous substances. These parties (known in the Act as "potentially responsible parties" or "PRPs") include, current and former owners and operators of properties, those who arranged for depositing hazardous materials at the sites and generators of wastes that are found at third-party sites used for disposal, treatment and storage of hazardous wastes. Of greatest significance for redevelopment sites are the PRP categories of past, present and future owners.

CERCLA does not require a showing of fault – liability automatically attaches where a release of hazardous substances has occurred at a facility that has or will require cleanup. It also looks backward and assumes that former owners and occupants should have known what we know today about the hazardous nature of materials and their propensities to cause bodily injury, property damage and environmental damage. PRPs are liable for all remediation, response actions taken by the government in emergency situations or where owners are not willing to perform cleanups, natural resource damage costs, and damages for bodily injury and property damage caused by exposure to pollutants. They must also pay the administrative costs of operating a mandatory cleanup program as well as the legal costs of determining and allocating liability where more than one PRP is associated with the historic contamination.

Because CERCLA liability is joint and several, the buyer of a contaminated property may be forced to pay 100% of the clean-up costs, even if there are multiple PRPs. States impose similar liabilities on PRPs for releases of hazardous substances at sites that do not receive attention at the federal level. State laws may also impact real estate transactions by forcing buyers and sellers to address cleanups on a schedule that does not match development plans, and land use restrictions may be imposed as part of the remedy where contamination remains at any level in soil and/or groundwater.

With respect to the real property that is the subject of the purchase transaction, early and thorough environmental due diligence is essential to allow the parties and their legal counselors to consider the options available to appropriately mitigate environmental uncertainties and allocate the responsibility for environmental costs that will be required to address historic pollution conditions. Experienced advisors recognize the value of identifying and addressing environmental issues early in the due diligence and negotiation process in order to prevent surprises that can otherwise kill deals. The advice given to buyers and sellers is typically aimed at reducing uncertainty and making sure the parties will live up to obligations they commit to undertake in the contract documents.

While CERCLA and most state regulations do not permit responsible parties (sellers) to absolve themselves of all liability for historic pollution through contracts with purchasers, parties are free to allocate the known or potential costs associated with environmental liabilities through provisions of the purchase and sale agreements, specific environmental indemnity agreements, and other transaction documents. In general, these allocation and indemnification clauses will require one party to defend and hold harmless another party from any claims and costs arising from specified conditions. The language of such provisions is not standard and may contain limitations including monetary caps, time limits for recovery actions, and limits on the scope of covered conditions. While indemnity agreements in these contracts can provide comfort to indemnified parties, they are by no means foolproof. Many of the following uncertainties are likely to remain:

- Is property development addressed in the allocation and indemnity provisions?
- How does the indemnity apply if there is a change in property use?
- Does the indemnity cover the costs of investigating a potential issue, as well as the costs of required cleanup and damages arising out of third-party claims
- Does that agreement specify who will pay fines and penalties imposed by regulatory agencies for the discovery or failure to address pollution conditions?
- Will the indemnity respond if there is a change in the regulatory clean-up standards or "re-opening" of a formerly closed issue?
- If the purchase is a stock transaction, does the indemnity include all formerly owned, operated or leased properties of the acquired entity? Are past waste disposal activities and potential liabilities of the acquired entity also included in the indemnity?
- If an environmental issue arises, what is a reasonable response time from the party that has agreed to provide indemnity? Who decides if the response time and actions taken are satisfactory?
- What happens if the party that has agreed to provide an environmental indemnity does not have the financial resources to meet its obligations?
- Are environmental investigation and cleanup costs established (at least within a range of possible outcomes) as a part of the transaction? Is regulatory agency case closure a "certainty" or only a possibility?

Insurance Products and Contractual Tools to Address Environmental Uncertainties

An environmental insurance policy can be used to support or back-stop the contractual indemnity obligations in purchase and sales agreements. Site-specific environmental insurance policies typically provide a package of coverages that offer protection against third-party claims and pay for first-party cleanup costs associated with releases of contaminants on, under or from the insured property(ies). While these insurance policies are normally triggered by regulatory cleanup or investigation orders or third-party claims, other environmental "events" can also be insured. For example, the failure of a party to honor its indemnity obligations in a property transaction can be a triggering event that results in payments by the insurer.

With this type of structure, the environmental insurance coverage will respond to the indemnified party's request for payment under the terms of the P&S Agreement if the indemnitor fails to or is unable to pay. If payments are made to the purchaser/indemnitee, the insurance company then has the right to seek repayment from the seller/indemnitor. The purchaser is made whole and the cleanup/development moves forward with no significant delays.

This insurance, known as "Excess of Indemnity" coverage, is not available for transactions where the seller offering indemnity for cleanup costs or third-party liability claims is not financially stable and capable (at the time the policy is issued) of meeting its indemnity obligations. Policies are typically issued for multi-year terms, but not for more than a ten-year coverage period, so the support for an indemnity agreement is limited to that time period. Where cleanups are expected to take decades or could be perpetual (i.e., groundwater remediation in New Jersey), the limited terms of these policies must be considered. When structured in this manner, the insurance carrier can typically offer coverage to the purchaser for known contamination, including clean-up of known pollution conditions that would otherwise not be available. In addition to providing excess coverage over the indemnity agreement, environmental insurance policies can provide coverage that fills other gaps in the indemnity provisions in P&S Agreements. Examples of these additional coverages include:

- Insurance coverage that becomes primary after cleanup obligations have been met
- Third-party bodily injury and property damage coverage for claims arising out of a known pollution condition (while cleanup remains the uninsured obligation of the seller)
- Legal costs, including expenses related to enforcement of the indemnity agreement
- Coverage that "drops down" in the event the indemnitor does not or cannot respond to a request to meet their obligations under the P&S Agreement
- Coverage in excess of monetary caps within the indemnity provisions.

The insurance carrier underwrites this risk not only on the financial strength of the indmenitor, but also on the quantity and quality of environmental data regarding the subject property(ies). The current and future uses of the property or properties and the regulatory environmental are also important to the availability of this type of environmental insurance. However, there are other underwriting considerations for providing excess of indemnity coverage. In most cases, the following information/ data is important to the underwriting process:

- Structure of the indemnity agreement
- The relative magnitude of the environmental issue compared to the apparent ability of the indemnitor to pay
- The identity of the indemnitor and its relationship (if any) to a parent entity
- The adequacy of any monetary or time restrictions within the indemnity provisions
- Any active litigation or current claims
- The presence/identity of other potentially responsible parties to the cleanup or other funding to address known conditions
- The regulatory status of the cleanup (i.e., is there a consent order or record of decision that controls the cleanup process)
- The performance history of the indemnitor in similar situations (if any)

Insurance carriers support their underwriting decisions with respect to offering and pricing of excess of indemnity coverage through the use of in-house or outside counsel to review the indemnity provisions in P&S Agreements. These reviews are valuable to the insured parties as well as underwriters, as they provide another legal opinion on the adequacy and structure of the indemnity provisions.

The current environmental insurance marketplace is highly competitive, with many carriers providing site and contractor pollution products, including site-specific policies with excess of indemnity triggers of coverage. This competitive marketplace results in favorable coverage terms and premium for many insureds. Limits up to $50 million are available from a single carrier for this coverage, with limits in excess of $200 million for layered programs where several insurers participate in providing excess limits.

Cost certainty

Cost certainty for environmental issues associated with a property or portfolio of properties being acquired for redevelopment is dependent upon several factors, including the following:

- The stage (or "maturity") of the environmental issue(s) in the CERCLA or state-led remediation process
- The nature of the environmental issue, particularly the type of contaminants involved and their amenability to proven remedial technologies
- The type of long-term involvement of the insurance carriers desired by the buyer and seller
- The ability of remediation engineers to quantify the remedy(ies) to be applied to the environmental condition(s) involved at the subject property(ies)
- The degree of agreement between the likely remedy and available insurance products

The Role of Guaranteed Maximum Cost Remediation and Liability Buy-Out Contracts in Contaminated Property Transactions

There are a limited number of firms in the remediation space that offer to perform the required remediation of contaminated sites on a guaranteed maximum cost basis. Some of these same entities will contractually assume responsibility for the environmental liability of sellers for claims and costs associated with bodily injury or property damage arising out of releases of contaminants (both historic and prospective) from the property(ies) being purchased for redevelopment. Most "buy-out" firms take ownership of the subject property(ies) in order to control the remediation and redevelopment processes, and to make upside potential gains available to offset some of the downside risks. This may make buy-out agreements difficult to pursue where a third party intends to develop the site after remediation has been completed.

Guaranteed maximum cost remediation contracts are commonly used only where the expected costs are relatively low in relationship to the potential post-remediation value of the property. For example, a recent property where this approach was effectively employed had expected remediation costs of $9 million to $13 million and property values (for the clean site) of approximately $30 million.

In earlier periods, guaranteed cost remediation contracts were insured for cost overruns by environmental insurance policies known as cost cap insurance. These policies were last offered for transactions involving contaminated sites in 2009 and were withdrawn from the market due to heavy losses experienced by underwriters that participated in this segment of the market for more than 10 years prior to that year. Currently available maximum cost remediation contracts are not supported by cost cap policies. The few companies offering them take the risks of cost overruns themselves and are very selective about the deals in which they participate. They do, however, typically purchase environmental insurance to protect themselves and their deals from other risks associated with the known and unknown pollution conditions described above. Site-specific insurance policies with excess of indemnity triggers have also been purchased by sellers that have been offered indemnity for claims and cleanup costs in liability buy-out and guaranteed cost remediation contracts.

Keys to Successful Contaminated Property Transactions

Successful contaminated property transactions work best when the interests of the parties are aligned and where regulators are willing to take a reasonable approach to the scope and timing of required remediation. While corners cannot be cut, remediation techniques that allow contamination to remain onsite with caps or land use restrictions that limit occupancy to those that require cleanups to industrial standards have reduced the costs from previous requirements for unrestricted future use and complete removal of pollution conditions at contaminated sites. Development plans that incorporate remediation techniques have also been helpful where sites are large enough to accommodate various land uses or remediation to industrial standards is all that is required.

Sellers are motivated to sell contaminated properties by a variety of factors, including regulatory and local community pressure, reorganization and realignment of internal corporate divisions, need for cash and a desire to focus on core business functions. While some large industrial corporations have not been in a hurry to either sell or remediate historically contaminated sites, they may be under scrutiny from a number of parties to be better environmental citizens. Where they have significant sums shown on balance sheets for contingent or direct environmental liability related to past operations, there is now pressure to report these liabilities with greater accuracy. Since some obligations have been under-reported in the past, they may be motivated to address inactive sites rather than leave them as idle and contaminated properties.

Example of a Contaminated Property Transaction

A large former industrial property was offered for sale by an international chemical company that had utilized the property for decades as a manufacturing facility. Onsite disposal of chemical wastes left massive areas of the property contaminated by a wide variety of organic and inorganic chemicals that had seeped from lagoons and ditches into soil and groundwater. The company entered into a consent order to remediate the site with state regulators, and after decades of investigations, several areas of concern (AOCs) had been mapped and characterized. Remediation to industrial standards was nearly completed for only one of these AOCs, but the site was of interest to a prospective purchaser that had plans for the one cleaned up area as well as portions of the site that had not been contaminated by historic industrial operations.

A deal was structured that required the seller to continue to remediate all historic pollution conditions in accordance with the existing consent order. As NFAs are obtained, the portions of the site that have received regulatory approval will be turned over to the purchaser for development. The purchaser will have responsibility for future maintenance of engineering controls and for monitoring of pollution that remains in place under caps or in place under soil covers. The obligation for groundwater remediation and monitoring will also remain with the seller until an NFA is obtained from the state DEP.

While the seller appeared to be in a financial position to complete the required remediation and honor other indemnity obligations of the P&S Agreement, the buyer was concerned about the length of time the remediation would take and the possible consequences of third-party claims from both historic and current industrial activities at the site. Investors and potential tenants of industrial buildings planned for the property were also reluctant to proceed with lease given the potentially unlimited liability for claims arising out of environmental events.

An environmental insurance program was developed to support the promises of the seller that allowed the purchaser to proceed with this deal in spite of the uncertainties associated with unfinished remediation, possible unknown pollution conditions and the risks of financial default on its obligations by the seller. A site-specific environmental policy was used that provided standard coverages to the purchaser for claims arising out of truly unknown historic conditions or for new conditions caused by development and new industrial operations. The policy also provided coverage excess of the seller's indemnity for costs that were not paid in accordance with the promises made in the P&S Agreement. This coverage would also pay if the seller became unable to respond to these obligations during the term of the policy (drop-down coverage). The policy was issued for a 10-year term with a single premium paid at the time the coverage incepted. Because coverage was not provided for the seller, the policy was written on a much broader basis for the purchaser. Coverage was offered for any unknown conditions (defined by the characterizations of AOCs) and for bodily injury and property damage arising out of all known conditions. There were no exclusions for capital improvements or voluntary investigations undertaken to facilitate the redevelopment of the property so long as engineering and land use restrictions were not violated. Each of the AOCs will be added to the policy upon receipt of the NFA by the Seller and release of the parcels to the control of the purchaser.

While the seller was not a named insured on this policy, it received significant benefits from the insurer's support of the buyer's obligations with respect to redevelopment and use of the site. The site was purchased by a special purpose entity created for the transaction. Since this limited liability corporation had limited assets, the insurance policy took the place of a parental guarantee with respect to possible environmental liabilities. The environmental insurance also provided protection against claims arising out of site preparation, redevelopment and operating risks of new facilities being constructed by the buyer. The policy also gave the seller 10 years of protection against a possible financial downturn in the fortunes of the buyer that might limit its future ability to pay for environmental claims or cleanup costs resulting from its development and use of the subject property.

Conclusion

While complete protection against the environmental uncertainties associated with contaminated property transactions cannot be eliminated by insurance and risk management mechanisms available to buyers and sellers, significant support is available from environmental insurance that can allow deals to move forward in spite of remediation that is incomplete and risks of liability for third-party claims. The risk of remediation cost overruns cannot be transferred to insurers, so that risk may best be left with a seller that is financially capable of completing the required scope of work. Insurance can be used to support a promise by the seller to perform this work and for other promises made in the purchase and sale agreement. Excess of indemnity coverage is added to a site-specific environmental insurance policy to give a purchaser the additional protection of an insurer's obligation to pay in the event that costs exceed the seller's indemnity or the seller is financially unable to honor its promises to pay for any reason.

The development of these sophisticated insurance policies requires specialized skills and an understanding of the capabilities and appetites of insurers to address transaction risks. Aon employs a multi-discipline approach that utilizes legal analysis of contract documents, review of site characterization and regulatory information, and knowledge of the insurance marketplace to design and implement successful risk management programs for contaminated property transactions. We welcome the opportunity to work with buyers, sellers, developers and cleanup contractors to solve environmental risk problems that are holding up your brownfield property transaction.

Contacts

John Welter
Practice Leader
Aon Environmental Services Group
832-476-5730
john.welter@aon.com

Veronica Benzinger
Chief Broking Officer
Aon Environmental Services Group
561-253-2514
veronica.benzinger@aon.com

Daniel Sisler
National Sales Director
Aon Environmental Services Group
949-608-6302
daniel.sisler@aon.com

About the Business Unit

Aon Environmental is a corporate specialty practice dedicated solely to providing environmental risk management support to Aon clients and prospects. Aon Environmental was recently recognized by Risk & Insurance Magazine as the "best team of environmental brokers in the business who can handle the most complex environmental risks." Environmental risk management is highly specialized and Aon provides expert environmental assistance in the areas of insurance, claims, environmental risk management, and engineering expert

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

www.aon.com

GDM05196

Empower Results®