

CLEAN-UP COST CAP INSURANCE: WAVE OF THE FUTURE OR WASHOUT?

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INTRODUCTION

Numerous types of insurance exist to transfer various environmental risks associated with existing or potential clean-up obligations. The apparent certainty these insurance policies provide can be attractive to government agencies as well as policyholders. Up-front payments can be used to purchase insurance and other financial services to cover projected future clean-up costs, the risk that cost projections are too low and to purchase guaranteed investment contracts to cover future operations and maintenance costs ("O&M"). Through the use of these innovative environmental insurance products, potentially responsible parties ("PRPs") can account for future clean-up obligations now, government environmental agencies obtain additional assurance that future clean-up obligations will be met and large insurance companies obtain additional premium dollars to invest. Collectively, these advantages can facilitate settlement of Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA") and other pending environmental actions. Several insurance companies offer these insurance services and at least one aggressively is marketing them via meetings with regional United States Environmental Protection Agency ("EPA") personnel.

A Consent Decree entered into December 8, 2000 with respect to the Iron Mountain Mining Superfund site in California illustrates how innovative environmental insurance products can be used as well as some of the pit falls involved. Acidic drainage from the former mine containing heavy metals impacts the Sacramento River and can have devastating ecological consequences, particularly following heavy rainfall events. The River is the most important salmon fishery in the state and is home to a host of endangered and threatened species. The selected remedy calls for neutralization and precipitation of collected drainage and has a 3000-year time horizon. The resulting metal-bearing sludges are to be disposed of on-site. Because of the ecologically beneficial nature of the remedy, natural-resource-damage claims have been addressed in the Consent Decree through a relatively modest payment. The main technical risks identified to date that could inflate clean-up costs involve high rain fall requiring treatment of higher volumes of drainage and the collapse of portions of the mine structures.

ENVIRONMENTAL INSURANCE

Prior to approximately 1986, traditional comprehensive general liability insurance policies could cover environmental property damage which generally involved historic groundwater contamination. Whether coverage for environmental liability is available generally is an issue of state law and how courts have interpreted the so-called "sudden and accidental" polluter's exclusion inserted into a lot of liability policies from approximately 1973 on. For the most part, liability coverage historically was based on the existence of a broadly-defined unintended and unexpected "occurrence" or liability-inducing event taking place whenever the insurance policy was in effect. Therefore, for example, an occurrence-based liability policy from 1969 could provide coverage now for costs to clean-up contamination caused by activities taking place in 1969.

Today, environmental insurance for clean-up costs (a/k/a finite risk), capping clean-up costs, business interruption, diminution in property value, environmental impairment liability ("EIL"), etc. only can be obtained on a "claims-made" basis. Claims-made policies require that any claim be made during the period the policy is in effect which limits coverage to events with known and fairly immediate environmental consequences. Theoretically, occurrence-based policies provide coverage indefinitely for contamination from an historic source.

IRON MOUNTAIN MINE CONSENT DECREE AND INSURANCE POLICY

At the Iron Mountain site, there essentially was one multi-national corporate PRP. The CERCLA Consent Decree was negotiated over a three-year period and expressly incorporated a finite risk and clean-up cost cap insurance policy (the "Policy"). The insurance company and clean-up contractor ("Scheduled Contractor") were included as parties to the Consent Decree. The Policy included the EPA and state agencies as "Named Insureds" (i.e., entitled to coverage) and provides coverage for more than \$300M in clean-up costs and potential cost overruns over a 30-year period. The up-front Policy premium was \$77M of which \$30M immediately went to the Scheduled Contractor and \$37M went into a special account and will be available to pay for remedy implementation. The deal also involved the purchase of an investment contract for approximately \$60M. The insurance company guaranteed a return on the contract and a Terminal Payment of more than \$500M in 30 years to fund O&M costs into perpetuity, if necessary.

The 31-page "manuscript" Policy with four endorsements and two schedules provides four separate types of coverage. First, approximately \$200M in clean-up coverage for remedial activities consistent with what is expected in the existing Scope of Work ("SOW") and the current remedial cost estimates. Second, \$100M of coverage for certain defined events as set forth in the SOW that could unexpectedly inflate estimated remedial costs. Third, coverage for off-site clean-up costs of up to \$35M as a result of legal liability for claims from "Pollution Conditions." And fourth, coverage for off-site legal liabilities of up to \$35M involving non-governmental claims in case someone gets hurt (bodily injury) or someone's property is damaged. The insurance company has a duty to defend against claims that come in, but the costs of doing so reduce available coverage. In addition, there are deductibles which must be paid by the Scheduled Contractor for unexpected events and certain covered claims which arise as well as aggregate limits which cap total coverage available under certain circumstances.

ANALYSIS

The following is not a detailed legal analysis and should not be relied on as legal advice or legal opinion. The Policy must be read as a whole and contains detailed terms and conditions some of which merely are summarized below.

Basically, the insurance is supposed to work as follows: the PRP pays out approximately \$140M up front and resolves its liabilities and future obligations (the actual premium amount is linked to interest rates and actually was closer to \$170M). The insurance company and Scheduled Contractor enter into a business arrangement using the \$140M and guaranteeing the government that clean up will be accomplished and paid for over 30 years regardless of unforeseen events. Once clean up is complete, moreover, a sum certain will be paid to the government for O&M. In fact, if the insurance company's financial position changes over time and it no longer is "A-rated," among other possible courses of action, its parent corporation may have to guarantee its obligations.

The interplay between the risks and responsibilities of the insurance company and the Scheduled Contractor is key to the success of the endeavor. The deductibles and other incentive measures affect the Scheduled Contractor's bottom line and create a tremendous incentive to keep costs down. The Scheduled Contractor is betting that it can accomplish the work within budget and ultimately pocket a proportion of unspent funds with the remainder going to the government. For example, after receiving the initial \$30M payment, the Scheduled Contractor is responsible for approximately \$47M worth of work over the first ten years. Clean-up costs in excess of this amount would be borne by the insurance company. If, however, the costs do not exceed approximately \$47M, the Scheduled Contractor retains a proportion of the savings.

The insurance company gets premium dollars today to assume many risks, including higher than expected clean-up costs, future legal actions and poor investment returns. In addition to the financial incentives built into the arrangement with respect to the Scheduled Contractor, however, the insurance company closely monitors all the work required and costs incurred through various consent and notice provisions in the Policy. Both the government and the Scheduled Contractor are required to provide notice of certain activities or claims to the insurance company. The insurance company also is protected by various exclusions and definitions in the Policy and the ability to control the defense of certain legal claims and potentially deny coverage. Further, the insurance company, must consent to, or can object following notice of, "modification of the Remedial Plan which results in clean-up, remediation or other tasks that are beyond the scope of the [SOW] ..." and thereby exclude certain increases in clean-up costs from coverage. Coverage associated with off-site transportation and inflation of clean-up costs because of third-party liability also is excluded. Significant disputes are to be resolved pursuant to the provisions of the Consent Decree, or if that does not apply and the "government is not a party to the dispute," via arbitration.

The government, unlike most policyholders, is protected by its unlimited legal resources, the high-profile and future-business implications of the project for the insurance company and, of course, the terms of the insurance policy contract and Consent Decree.

Three factors make the Iron Mountain Mine site unusual and contributed to resolving the CERCLA action as described above. First, there essentially was only one PRP and that PRP was amenable to paying more than it might otherwise be liable for in order to resolve the matter now. After all, if the insurance company and the Scheduled Contractor did not expect to gain something, they would not have responded to the request-for-proposal and initiated negotiations. Including previously-spent investigation costs, this may be the largest single payment by a PRP in CERCLA history. Second, with a 3000-year time horizon, long-term creative solutions involving financial certainty are essential. Improper or incomplete remedy implementation would not sufficiently protect the Sacramento River or the human and ecological communities that rely on it. Third, the site has been studied extensively and the problem is considered to be well constrained. The insurance company and the Scheduled Contractor obviously believed the risks were manageable which is not necessarily as likely at other sites with other problems. Whether recent developments in environmental-insurance products like these constitute the wave of the future or a washout remains to be seen. We will have to check back at Iron Mountain in the next 30 to 3000 years. In the meantime, the Scheduled Contractor has gone bankrupt and the insurance company is seeking an alternative vendor.

CONCLUSION

This case is unusual because PRPs generally retain liability and remain involved even if environmental insurance products are brought to bear. Most environmental insurance policies contain standard-form provisions and are purchased to address risks at less high-profile sites. Coverage disputes and litigation are inevitable. Thorough investigation, full disclosure and strict adherence to policy terms and conditions, particularly notice provisions, are essential. The insurance industry did not anticipate laws such as CERCLA, the Resource Conservation and Recovery Act ("RCRA") and the Toxic Substances Control Act ("TSCA") or the scope of potential problems associated with the wide-spread use of asbestos. Today, liability insurance companies routinely deny environmental claims under existing comprehensive general liability insurance policies. Some of these insurance companies now see an opportunity in environmental liability.

Potential policyholders and regulators need to understand the pit falls inherent in any insurance policy contract as well as what to negotiate for up front before considering purchasing any type of "environmental" coverage or bringing an insurance company into any settlement. In obtaining Cost Cap and other financial assurances, stakeholders may be subject to requirements imposed under contract which they did not anticipate, including more stringent review of what is to be spent and why. In addition, off-site contamination, bankruptcy of PRPs, orphan shares, contamination discovered after remedy implementation or outside of areas of concern originally identified, Remedial Plan modifications and use of unapproved contractors may not be covered. Changes in site conditions, clean-up requirements or even interest rates also can lead to disputes. Qualified and experienced legal advice is essential.

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