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Risk management plays lead in environmentally impacted sites

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When the transfer of an actual or potential environmentally impacted property is part of a real estate or corporate transaction, it is increasingly important to carefully evaluate transactional risk management tools.

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Certainly, traditional protections such as indemnity agreements and escrow funding should be considered. But because of the increased scrutiny on contaminated properties and cleanup costs amid a bullish real estate market — which increasingly targets potentially contaminated properties for redevelopment — sophisticated buyers and sellers are considering more innovative risk management tools to:

- Facilitate the transfer of actual or potentially impacted properties.
- Control the risks they might assume through the transaction or that potentially remain long after they have transferred the property.
- Achieve an even higher level of certainty and protection in connection with environmental liabilities.

CONTAMINATED PROPERTY

Current environmental laws contain potentially broad liability provisions that could impact not only large mergers and acquisitions but shopping center owners, real estate investors and lenders, industrial developers and a host of others.

As a result, many parties have been simply unwilling to entertain transactions that would involve acquiring contaminated property, even if the property were otherwise ideal for their intended use. Similarly, other parties have been unwilling to transfer contaminated properties because of the fear that they would lose control over the site, attendant cleanup costs and potential long-term liabilities.

This need not be the case. Lawyers assisting in a transaction involving real estate routinely include indemnity provisions and assist in due diligence inquiries to identify and allocate environmental liabilities. Legal advisers who are experienced in the particular nuances of evolving environmental risk management tools and environmental liability transfer often can develop more effective risk management programs that are customized to a specific transaction to cost-effectively facilitate the transaction while protecting both parties.

TRADITIONAL TOOLS

In this context, it is important to identify and evaluate the full range of available risk management tools so that an optimal, cost-effective solution can be developed specific to a particular transaction. There are a number of risk management tools available, each with its own advantages, disadvantages, limitations and costs. Usually, multiple tools can be combined to achieve an optimal, cost-effective solution.

Traditional risk management involving transactions typically includes some combination of:

- Conducting due diligence to the extent possible.
- Using financial tools such as purchase price reductions and escrow accounts.
- Adding contractual protections in the form of indemnities, representations and warranties, and covenants to allocate environmental risk.
- Reliance on legislative protections designed to provide a degree of certainty for some environmental liabilities.

Traditional contractual provisions remain effective, viable solutions that are almost always used to some extent. But they may not fully protect either the buyer or the seller. Incomplete contractual protections may occur when the inevitable sunset provisions, caps and exclusions are also included in the contract documents, and contractual protections inherently involve credit and collection risk, future litigation risk and collection and litigation costs.

Traditional financial tools also can be effective. However, they, too, may fall short of providing protection against all likely risks. For example, if actual costs exceed escrowed/deducted funds or if the transaction itself does not support the amount necessary to be reserved. These financial tools also may be difficult to implement, as both parties must agree on the amount of future costs and risks.

LEGISLATIVE ACTION

Relatively recent legislation at both the state and federal level has provided opportunities in certain qualifying transactions for buyers, in particular, to obtain a degree of regulatory relief and protection from environmental liabilities, so long as they comply with the regulatory requirements.

In qualifying transactions, these programs and regulatory protections can be of significant benefit to the buyer and provide a cost-effective program for cleanup. However, the seller may need to explore additional risk management tools because these programs generally offer limited protection to the seller and are inconsistent with transactions in which the seller desires the buyer to assume environmental risks beyond the

cleanup required to obtain the regulatory protection.

Even from the buyer's perspective in qualifying transactions, these programs may need to be supplemented because they may not provide the comprehensive protection desired, as they are typically limited only to cleanup liabilities associated with known conditions and do not protect against a future change in standards or regulations. These programs also are subject to the willingness of regulatory agencies to provide the protection and to cooperate, may sometimes involve a long lead time to achieve and may require public comment/involvement.

ENVIRONMENTAL INSURANCE

The gaps that are present in all of the traditional protections heighten the need for a customized program that can evaluate the combination of multiple layers of protection to address the particular goals of a transaction. An additional, third-party financial tool to consider with traditional protections is environmental insurance which has been available in the market for some time and continues to be a popular and effective risk management tool that often is an ideal supplement to address the limitations of traditional tools.

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The numerous coverages and the pros and cons are lengthy, but the purchase of environmental insurance should be evaluated in nearly all real estate or business transactions involving ongoing or anticipated cleanup projects or other potential environmental liabilities.

Of course, environmental insurance — while effective and important — involves the limitations inherent in procuring any insurance product: Availability, cost, potential exclusions, dollar limits of liability, limited term of coverage and renewal conditions. Further, the demonstrated financial strength, rating, experience and committed resources of the insurer are critical to ensure that the premium paid actually results in the risk transfer desired, particularly when the project dictates that environmental insurance be procured for a term of five to 10 years or longer.

In this regard, the size and term of the project and the coverages desired may limit viable insurer options in the same way that the size, scope and attendant liabilities may affect the cost-effectiveness and economic viability of certain coverages.

In all cases, care should be taken to customize the insurance program for the specific risks and to integrate the insurance into the overall liability transfer program in an optimal way.

THIRD-PARTY LIABILITY TRANSFER

Once viewed hesitantly, third-party environmental transfer transactions are increasingly common and have been successfully used in many contexts — either alone or in conjunction with environmental insurance — as an effective environmental risk management tool.

In these transactions, a third-party agrees to assume environmental liabilities from the responsible parties and to perform the cleanup for a fixed fee. That fee is usually paid in advance or pursuant to agreed milestones, but in some cases the fee can be a percentage ownership interest in the project. These transactions often can provide the ideal solution to the inherent limitations of traditional tools and insurance. Certain companies in particular have been extremely effective in implementing these transfers and cost-effectively achieving their clients' risk management goals.

The transactions can range from insurance-backed lump sum contracts, with fixed scopes of work for certain known conditions, to full, unlimited, and perpetual liability assumption for all site risks, known and unknown.

In all cases, it is important to ensure that the third-party transferee chosen has the requisite experience, resources and financial strength that may be required in the context of the particular transaction. It is equally important to customize and specifically negotiate and underwrite the risk transfer transaction to ensure that the terms of the risk transfer and the financial assurance of the vendor's performance are sufficiently robust and secure to achieve the risk management goals.

For example, some transferees may utilize special purpose entities having no assets beyond insurance, which creates a potential credit risk

Transferees might also include cleanup exclusions, require that variance of site conditions from initial assumptions necessitates a change order and increased costs, offer only limited terms and only guarantee cleanup to a particular regulatory point, while other transferees provide significant financial assurance and an unlimited liability assumption.

While it is critical to customize the optimal transfer, third-party liability transfer can be extremely effective in facilitating real estate or corporate transactions involving impacted property, as well as in addressing overall management of environmental liabilities.

CUSTOMIZED SOLUTIONS

During the last several years, the use of environmental risk transfer has moved from an innovative concept that was viewed with skepticism to an accepted, effective risk management tool. When used in conjunction with traditional transactional protections, environmental insurance and third-party environmental risk transfer can make otherwise complicated transactions more successful.

While crafting a customized solution to specific transactional issues, it is crucial that the parties' advisers have experience in the particular nuances of environmental risk management and environmental liability transfer, as well as the particular legal, regulatory and financial tools available.

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