Environmental Risk

Willis

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In our first Environmental Risk newsletter of 2004 we begin with a feature article reviewing the latest market developments. This edition also includes a topical article on the creative use of environmental insurance to facilitate corporate transactions and finally, an update on the Willis Environmental Practice.

Environmental Insurance Market Review 2004

By Michael Balmer and Adrianne Cronas, Willis Environmental Practice

Headlines and Highlights:

- Carriers differ significantly as respects target clientele, capacity, policy terms and special-purpose Environmental coverage offerings.
- Finite programs associated with legacy environmental liabilities continue to grow, driven by corporate governance activities.
- Mold remains a major issue for the US real estate and construction industries.
- Property-related transactions are heating up as M&A activity rebounds with the recovering economy.

The continued growth of the environmental insurance market is being driven and shaped by many factors including changes in legislation, complex business transactions, and the mounting pressure on companies to demonstrate adequate risk control to shareholders.

From being a relatively small niche market in the early 1990s, it has grown to represent a significant business for many insurance companies and has become an important component in the overall insurance and risk management strategy of many businesses.

The evolution of the environmental insurance market has also led to the development of innovative risk finance programs that have facilitated business opportunities that, in the past, may have been viewed as too risky. By way of example, environmental insurance has played a pivotal role in the growing trend for 'brownfield' redevelopment in the US and it is increasingly being used to remove or transfer liabilities which previously were viewed as deal impediments.

Willis is committed to the further development of this high growth business. This article provides an update on recent developments and trends in this dynamic marketplace.

The Environmental Markets

The key environmental insurance carriers continue to expand their presence in this specialty market, capacity remains strong, and this sector continues to avoid the remarkable premium increases seen in the recent past in other insurance market segments.

A number of new players have entered the market during the past year or so. They have

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injected further competition into this market segment and will continue to challenge the more established carriers. During 2003, one insurance company also disappeared from the environmental market as its parent elected to exit from all of its underwriting businesses.

The market continues to exhibit 'double digit' growth with global environmental premiums exceeding $2.3 billion for 2003, with the overwhelming majority of premium applying to US risks. Environmental insurance is beginning to be viewed as a mainstream business with broad applicability across very diverse market segments. The major carriers have reported that they are budgeting for premium growth of 15 to 20 percent in 2004.

The market growth is fueled by the increasing institutionalization of the purchase of environmental coverages. The specific drivers of this growth include:

- Increased emphasis on corporate financial disclosure and corporate governance obligations
- Greater penetration of M&A/divestiture market
- Ongoing expansion of privatization initiatives
- Greater use of fixed price contracting within the environmental services industry and
- Increased market awareness and product breadth

The environmental market has however shown some signs of hardening as challenges appear in underwriting terms and engineering requirements. A key factor for the direct insurers has been the stance of the reinsurance market which has been seeking opportunities to improve the terms of their treaty arrangements with insurance carriers.

Conservative underwriting attitudes have begun to impact carrier appetites for unusual placements. As a consequence, more effort and innovation is now required for the complex, challenging deals, thus highlighting the importance of working with a broker with the necessary specialist skills and experience.

Coverage Developments

Mold emerged as one of the hot topics of 2002 and showed no signs of abatement in 2003. Headline cases such as the $55 million Hilton Kalia Tower remediation kept the issue front and center. Mold exclusions to Liability and Property policies are now a fact of life, but thankfully all major environmental markets offer some form of coverage under Pollution Liability forms.

As organizations approach Environmental risks with increasing sophistication, the implementation of programs grows in sophistication as well.

Long popular, Contractors Pollution Liability came into play in the past year as a key coverage instrument through which builders can address mold risks that have been excluded from their general liability policies.

A similar pattern is also evident for Bioterrorism coverage. This risk is excluded from virtually all terrorism coverage outside of TRIA; once again environmental carriers have stepped in to offer coverage via site-specific pollution policies.

Liability Transfers and associated 'blended finite' insurance programs for legacy liabilities continue to be a strong focal point for the environmental insurance market. The increasing scrutiny surrounding financial disclosure combined with a desire to present environmental liabilities in the best possible light continue to drive this important market component.

The beginnings of economic recovery appear to be stimulating renewed mergers and acquisitions activity, and with it increasing demand for Property Transfer Coverage. Also known as Warranty and Indemnity cover, these policies are designed to back environmental representations, warranties and indemnities. They are also being used as a primary risk allocation device in transactions, in lieu of warranties or indemnities. Coverage enhancements such as Natural Resource Damages, Non-Owned Disposal Sites, and contingent protection, in the event of financial failure of any of the parties to a transaction, will likely remain popular.

As organizations approach environmental risks with increasing sophistication, the insurance program design grows in sophistication as well. For Remediation Cost Cap programs, probabilistic cost modeling is now routinely used to frame cost expectations and thereby set policy attachment points.

Underground Storage Tank (UST) coverage also re-emerged as a significant issue in 2003, driven by the insolvency and sunset provisions of many State UST Funds. Coverage ranges from individual tanks operated by contractors to multi-site convenience store portfolio programs.

Future Trends

In the past year, the market has experienced significant growth in business related to the redevelopment of previously contaminated land. The growing acceptance of risk-based corrective actions means that it will be more commonplace for contamination to remain in place at redevelopment sites following a negotiated agreement between the party responsible for the clean up and the local government, regulators or other involved parties.

This will act as a driver for further market growth, as organizations seek protection from potential "re-openers" that could, after redevelopment of the site in question, expose them to additional risk.

The passage of Sarbanes-Oxley has increased the pressure on companies with environmental exposures (known or unknown, past or future) to take a proactive approach in communicating meaningful and useful information to shareholders and prospective investors concerning their environmental liabilities.

Appropriately structured environmental insurance programs can be used to demonstrate compliance with corporate governance obligations while also building certainty for shareholders regarding the potential maximum costs of contamination at specific sites. This desire for transparency and balance sheet improvement is expected to become an increasingly significant market component in the next few years.

In today's market there is no reason to risk having an uninsured environmental loss or to hope that General Liability policies will provide adequate pollution protection. Increased demand for operational pollution coverage, possibly structured to provide catastrophe protection, will be integrated into the wider environmental risk management functions and insurance programs.

Overall, penetration rates are still very modest. The scope for further market growth is enormous and premium volume is expected to rise substantially in the coming years. Over time, increased competition and the pressure to innovate can only be good news for insurance buyers.

"Insuring" a Good Deal

By Michael Balmer and Michael Long
Willis Environmental Practice

The success of any commercial venture, be it a development project, merger, acquisition, joint venture or other equity sharing transaction, depends on the effective management of risk.

Environmental risks, such as historic contamination, are among the hardest risk issues to accurately identify, quantify, verify and therefore manage. Indeed, the full extent of an exposure may not manifest itself until well after a project or deal is completed.

In addition, recent changes as respects corporate governance obligations (see article on Sarbanes-Oxley in the Fall 2003 issue of *EnviroRisk Manager*) can make potential environmental liabilities much more visible to shareholders, financiers and purchasers.

In many cases, it is the perception of environmental risk rather than specific risk factors themselves that leads to concern. Perceived or real, environmental problems can and do impact the success of transactions, eroding enterprise value, threatening deal completion and sometimes becoming a barrier to otherwise attractive projects.

Many companies experience enough anxiety managing their own legacy contamination issues and can therefore be reluctant to take on additional liabilities associated with an acquisition or merger. As a result of these concerns, extensive environmental due diligence, i.e., the identification and evaluation of such liabilities, has now become routine. Consequently, the subsequent allocation of ongoing responsibility between the parties can become an issue of significant contention.

Purchasers in the post-Enron era are reluctant to rely on vendor indemnities. They will often seek to offset environmental cost uncertainties through price discounts, escrows or "hold back" provisions. In these cases, purchasers will inevitably push for contract language that reflects the highest possible estimates of the risk. Such overcompensation can erode deal values and kill otherwise viable deals. Even with over-cautious provisions, deal terms may still fail to satisfy cash-flow-sensitive acquirers.

Financiers also tend to be very cautious about environmental issues. Thus, the ability of deal participants to effectively manage these risks, particularly long-term environmental exposures, can have a significant impact on the availability and cost of funding.

The Insurance Option

An increasingly attractive solution is the transfer of these risks into the insurance market. For a single, fixed premium, environmental insurance can be used to cap the cost of known cleanup obligations and protect against the risk of unexpected future losses. A recent acquisition by Dyno Nobel, one of the world's leading explosives companies, highlights the facilitating role that environmental insurance can play.

The company was considering the acquisition of a number of production facilities in North America. The facilities had been in existence for some time and due diligence revealed the presence of certain known remediation obligations as well as other potential pollution risks.

The sites were being offered for sale "as is" and thus Dyno Nobel was concerned about assuming undefined and unquantified environmental risks. Dyno Nobel's Risk Manager, Alf Lysberg, said, "Environmental issues became a significant concern in connection with the transaction. Without some cost certainty and liability protection we had reached a roadblock."

Willis worked with the Dyno Nobel acquisition team and other professional advisers to arrange a long-term, combined cost cap and pollution liability policy that satisfied the environmental concerns of all the parties and enabled the deal to go forward.

Alf Lysberg reported that, "Despite the considerable technical challenges, Willis and our insurance partners were able to deliver a cost-effective solution within a very tight deadline."

Special Products, Many Solutions

Specialist insurance products are now playing a central role in the management of pollution and contamination risks associated with corporate transactions. These products are increasingly being used to:

- Eliminate/mitigate potential deal breakers and facilitate transactions
- Reassure financiers and reduce debt service costs
- Protect acquirers from environmental liability exposures
- Strengthen negotiating positions and maximize transaction values
- Ensure clean exits for sellers, equity investors, etc.
- Ensure immediate access to sale proceeds for sellers
- Underpin or replace contractual mechanisms such as warranties and indemnities

The market is still developing, but there is increasing awareness within commercial organizations that environmental insurance not only adds value to a deal, but can literally mean the difference between success and failure.

The Willis Environmental Team: New People News

The latest addition to our staff is Rich Sheldon. He brings with him 15 years of experience in a broad range of environmental disciplines, from environmental consulting to underwriting to brokerage. He joins us from IMA Environmental Insurance. While Rich will be part of our national practice, he will work out of our Radnor, PA office.

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