

Environmental Risks Affecting the Financial Sector

Financial Institutions (FI) have always faced environmental risk exposures as a result of liability imposed upon them under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA, also known as Superfund) for cleanup and reimbursement costs associated with the release of hazardous substances. In spite of various defenses under CERCLA's "safe harbor" provision for lenders, an FI's activities associated with bankruptcies, workouts or divestment of assets may not shield them from liability. Environmental risks can have a significant impact on financial performance and are more critical given new realities with the economy, including the fact that:

- More companies are entering or emerging from bankruptcy which does not always relieve them from environmental liabilities. The case law with regard to environmental liabilities in bankruptcy is not always clear or consistent and depends on the courts' interpretation of various aspects of the bankruptcy filing, including whether or not there are known pollution conditions at sites, when bankruptcy filings were made and whether or not there is an immediate threat to the environment as a result of pollution conditions at properties being considered as part of the bankruptcy proceedings.
- During bankruptcy, FI environmental liens can be superseded by environmental regulatory costs or 'super liens', which are liens by environmental regulatory authorities to recoup clean up costs for properties. These 'super liens' typically supersede most other creditor liens.
- More companies are involved in asset sales which typically address environmental liabilities via indemnification agreements. This includes Section 363 asset sales or purchases of impaired properties out of bankruptcy.
- More companies are defaulting on bank loans, some of which are secured by properties that have environmental issues. In the current economic climate FI's have to manage growing portfolios of foreclosed properties that may have environmental risk which could create challenges in assessing exposures within the portfolio and doing the appropriate "work out." Environmental risk can limit the ability to monetize foreclosed properties at their maximum valuation.
- More companies are looking for ways to improve opportunities to borrow from capital markets as a means to continue operations or for project financing.
- More companies have been involved in activities or set up company structures which leave them open to parental environmental liability claims.
- Companies involved in commodity trading can be considered "owners" which can bring them into the chain of environmental liability under environmental regulations.

The combination of environmental risk and these new realities can result in transaction delays or, in the worst case scenario, cancellations. It can prevent the achievement of a variety of financial goals related to portfolio management and sales of properties. In addition, many companies are participating in the popular corporate "green" movement, with its environmental stewardship protocols and practices, which creates additional pressures on these companies due to increased scrutiny from their business partners and the general public.

Environmental Exposures – ‘Hidden in the Fine Print’

Most FI's have internal environmental resource departments to put environmental due diligence policies and procedures in place. Some FI's even have specialized risk management departments.

FI's are facing the same consequences of staff reductions in their risk management departments that other sectors are facing which leaves their remaining environmental staff with increased workloads - or in some cases - with very few staff to manage the increased liabilities associated with bankruptcies, workouts or divestments. Marsh's Environmental Practice can provide services that support environmental risk management departments by providing clients with advice and solutions to both mitigate risk and, more importantly, to realize improved financial outcomes by reducing risk management operating costs. These services include:

- Consultative advice beyond the standard environmental due diligence during acquisition or loan period
- Use of SBS DiscoverySM, a service developed by RTI International and Marsh to develop divestiture strategies for assets taken as security during foreclosure(s) that have adverse environmental conditions
- The development and broking of environmental insurance solutions to address the risks associated with the company activities previously discussed

Following are examples of insurance solutions to the challenges that FI's face:

- **Bank Loans.** Environmental insurance can be used to provide coverage in the event of a loan default where there is also a pollution condition discovered. This can be done using a site pollution liability policy or a lender liability policy which can be designed to cover the lesser of the cost of remediation of the pollution condition or the outstanding loan balance.
- **Improved Aggregate Borrowing Costs.** A site pollution liability policy can be written to apply to all of a company's real estate holdings to eliminate the risk of unknown environmental liabilities. If there are known environmental liabilities, a “stop loss” or funded risk solution can be used to wrap around the known liabilities. These solutions (together or combined) can lessen risk to capital markets and result in lower borrowing costs.

- **Improved Acquisition/Post Acquisition Performance.** Environmental policies can be used to manage pro-forma risk on acquired assets, providing greater certainty around post-acquisition performance costs. These policies can be used not only for current transactions but also can be used to forecast fixed costs associated with future transactions because of the ability to assign policies to future purchasers.
- **Reliance on Indemnity.** Most transactions rely on environmental indemnifications to manage environmental risks. Most environmental indemnities we review have shortcomings, gaps or “grey areas” that can be used to deny an indemnity obligation. Entities relying exclusively on indemnities to address environmental liabilities also leave themselves open to counter-party credit risk. Environmental insurance products are available to be used in lieu of an indemnity or to wrap around “excess of indemnity” to respond to environmental issues in the event of third party insolvencies.
- **Parent Company Liability.** Environmental insurers have recently created tailored solutions to address liabilities that provide protection against “piercing the corporate veil.” Marsh is able to work with FI's to assess company-specific exposures, and deliver tailored solutions for their particular environmental risk issues.
- **Exit Strategy Support for Foreclosed Assets.** Environmental insurers have developed products that can be used by FI's that have foreclosed on properties with legacy environmental issues. For business partners (buyers), reliance on contractual mechanisms to resolve legacy environmental issues may not be adequate in the current financial environment.
- **Support and Reinforcement of Risk Management Protocols.** Quantification, disposition and management of legacy environmental risks tend to compromise the most significant environmental challenges associated with FI activities. Marsh is able to assist clients with “mapping” their risk and identifying actual and potential exposures and quantifying them in order to develop the most effective (cost and approach) solution available.

A well-managed and proactive environmental risk management program can allow an organization to find the upside of risk and give you a competitive advantage.

The following are sample claims that Financial Institution clients have recently experienced:

- A state attorney general's office reached a settlement with a bank to pay penalties and reimburse the state for response costs at an abandoned chemicals manufacturing facility. The lawsuit alleged that the bank seized the manufacturing facility's operating funds and operations were forced to close, leaving behind abandoned chemicals and products. The attorney general's office alleged that the bank knew of the abandoned chemicals and did not contact appropriate state environmental officials or any state or local emergency responders to report the threat to the surrounding environment. A building inspector conducted an inspection of the property in 2005 and alerted environmental officials to site conditions that could pose a threat. The bank was ordered to pay response costs and fines totaling close to US \$1 million.
- One of the lenders to the former operations of a property was found to be liable under CERCLA because the lender had sent an officer of the bank to the site. The bank officer made frequent visits and assisted in decisions relating to operations. As a result, the bank was found to be an "operator" of the site.
- A lender did not actually foreclose on a property, but did foreclose on the equipment and inventory. Although the lender was not found to be an "operator" of the property prior to foreclosure ("operators being entities that can be held responsible under CERCLA), the lender was found to be liable because of its capacity to influence cleanup costs as a result of response costs incurred during the sale of the equipment.

Why Marsh?

Some of the key differentiators of our group include:

- Consistently one of the largest producers of environmental insurance to all major markets.
- The largest producer of environmental risk management products that involve true risk transfer.
- Global network of more than 80 risk management professionals who provide a full suite of environmental risk management solutions and environmental risk consulting.
- Experience in working with thousands of clients domestically and internationally to identify pollution exclusions in standard insurance programs and introducing methods to bridge the gaps utilizing environmental insurance products that comply with local environmental/insurance requirements.

Specialists in Marsh's Global Environmental Practice understand existing and emerging environmental risks and collaborate with our global colleagues to provide seamless solutions to our FI clients.

Contact Us

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