PREFACE

Environmental insurance for lenders is an emerging market segment, with new products, possibilities and concerns for all who participate. It represents a significant step forward in the evolution of meeting and transferring environmental risks from the participants in a transaction to an insurer. Obtaining the maximum benefits from this form of risk transfer requires an understanding of what is involved, how the policies operate, and where more traditional forms of risk assessment and analysis still have a role to play.

The purpose of this document is to provide the reader with a fundamental guide to these issues and how this area evolved, how the policies operate, and what role they can play in lending transactions. It is a basic guidance and educational document, rather than a comprehensive treatise or a legal treatise, addressed to an audience in the lending industry. Necessarily it must be something of a snapshot, because even during the period of its preparation, the market for environmental insurance addressed in this document evolved significantly. This process will continue, and this area promises to remain exciting for a long time to come.

The Mortgage Banking Association
Environmental Insurance Task Force

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1.0 INTRODUCTION AND OVERVIEW

(a) The Road to Environmental Insurance

(1) Environmental insurance has evolved from a "due diligence" product to a "risk transfer" product similar to other offerings in the commercial real estate arena. Just as title insurance can replace title searches and an owner's assignment of property and casualty insurance to a lender can replace property inspections by engineers; environmental insurance can be used to supplement, and sometimes to replace environmental assessments.

(2) Insurance is another tool in the risk analysis process.

(3) Environmental insurance can transfer potential environmental risk of both liability and collateral devaluation, from the policyholder to an insurer, in exchange for a finite amount of money i.e. "a premium," resulting in increased certainty.

(b) Background and history of environmental insurance

(1) Prior to 1966, liability insurance policies did not address issues associated with pollution.

(2) The insurance industry's first reaction to the unknown loss potential associated with new forms of pollution liability was to avoid the risk. After the 1966 Santa Barbara oil spill and the passage of the first modern federal environmental legislation, however, insurers added "pollution exclusions" ranging from the now notorious "sudden and accidental" exclusion to several kinds of "absolute" exclusions to CGL and other liability policies.

(3) The exclusions created a market for environmentally specific insurance products. Insurers initially created an owner-driven product line to respond to liability imposed by RCRA (Resource Conservation and Recovery Act which, among other things, regulates, the generation, treatment, storage and disposal of hazardous wastes), CERCLA ("Superfund," which addresses liability for releases of hazardous substances), regulations implementing them and similar statutes. Policy types included:

(A) Environmental Impairment Liability ["EIL"] insurance;

(B) Pollution liability insurance [PLI] insurance; and

(C) Closure and post-closure products to provide financial assurance at RCRA treatment, storage and disposal sites.

(4) Insurers developed other products as the environmental risks of non-property owners became known. These products covered entities that handled, investigated and/or remediated or transported pollutants and included such products as:

(A) Contractor's pollution liability coverage;

(B) Consultant's pollution errors and omissions coverage; and

(C) Transporter's pollution liability insurance.

(5) In the 1990s, the financial risks and costs associated with pollution and polluted properties became increasingly predictable because of advancements in investigation and remediation technologies and promulgation of standardized and risk-based remediation goals. This development led to new forms of environmental insurance focusing on developers, borrowers, financial institutions and other lenders.

(6) Today, three broad coverage categories of environmental insurance have the most relevance to the sale and development of polluted or potentially polluted properties:

(A) Lender's coverage, which reimburses commercial real estate lenders for loan payments or clean-up costs in the event of borrower default and a pollution condition.

(B) Pollution liability insurance covering the insured's (usually the property owner's) exposure to third party damage claims, third party remediation claims, remediation costs on the insured's property and legal expenses associated with these exposures.

(C) Cost cap/stop loss coverage, which protects against cost overruns for a planned remediation of polluted properties.

(7) Lender policies have further evolved into policies intended to transfer risks associated with loan portfolios or all commercial real estate loans held by a lender. Some lenders are replacing traditional environmental due diligence with lender policies for certain commercial real estate transactions.

(A) Such policies generally are called "program policies," "portfolio policies," "warehouse policies," or "master policies."

(B) Coverage is similar to other lender policies, but as loans are made, each property meeting the underwriting criteria can be added by simple endorsement to a pre-existing policy.

2.0 WHO'S WHO – THE ROLE OF THE PARTICIPANTS IN AN ENVIRONMENTAL INSURANCE TRANSACTION

(a) The line-up in an environmental insurance transaction does not differ greatly from those in more familiar insurance transactions, although the role each participant plays may differ somewhat from other transactions. Generally, however, the names are familiar.

(1) The agent or broker.

(A) Although they may assist a person or business in obtaining insurance, "agents" are typically representatives of the insurer and are under contract with one or more specific insurers to produce a targeted amount of business at a predefined loss ratio. There generally is a profit sharing relationship between an "agent" and the insurer.

(B) A "broker" is typically a representative of the customer or "insured" and is expected to place the interests of the customer above all. There typically is no written contractual agreement between the broker and the companies it uses.

(C) CAVEAT: State law, statutory or otherwise, may have an impact on who is considered an “agent” or a “broker” if a dispute arises.

(2) The underwriter.

(A) An underwriter is employed by an insurer to evaluate, select and price risks to be accepted by that insurer.

(B) The underwriter may or may not have authority to accept risks without higher approval.

(C) Similarly the underwriter may be an employee of the insurer or an outside person or entity to whom the insurer delegates this function.

(3) Although there is overlap (and sometimes conflict) between the roles played by agents and brokers on one hand and underwriters on the other, generally the agent/broker and underwriter have the roles described below.

(b) Role of the agent/broker

(1) Information gathering. As necessary, the agent/broker gathers information in some or all of the following areas:

(A) The insured’s operations, including:

(i) Complete description of present operations and products.

(ii) Complete description of discontinued operations and products.

(iii) Time in business.

(iv) Information on operations gathered through physical inspections or testing by appropriate personnel or entities as necessary for each insured.

(B) The Insured’s exposures, including:

(i) A breakdown or itemization of the exposure base for its operations – where losses are likely to come from.

(ii) An historical perspective on the exposure base for a minimum of three years.

(iii) Information as to why there have been fluctuations in the exposure base, if any.

(C) The Insured’s loss experience, including:

(i) At least a three year summary of losses broken down by product line of insurance (e.g., commercial general liability, products, property, crime, environmental, professional errors and omissions).

(ii) Appropriate supplemental information if large losses, high loss frequency or similar circumstances are apparent from the loss experience information (e.g., why, likelihood of future recurrence, insured's efforts to remedy problem).

(D) Information on prior insurers, including:

(i) Names of insurers in relevant lines of business for the last three years.

(ii) Prior cancellations or non-renewals and reasons for these actions.

(E) Coverage information, including:

(i) Terms desired by the insured.

(ii) Proposed modifications to standard coverage terms or manuscript language if requested.

(iii) Limits of liability, additional insureds and similar information.

(F) Additional information as necessary from internal or external sources.

(2) Analysis of an insured's exposure and needs. The agent/broker examines and analyzes an insured's potential exposures to loss to help design and implement a program to transfer risks through:

(A) Identification and quantification of the risk of losses, including types, frequency and severity of losses.

(B) Evaluation of loss control activities and programs, including methods for improving them.

(C) Consideration of whether exposures may be minimized or avoided.

(D) Evaluation of appropriate risk transfer mechanisms.

(E) Evaluation of changing needs over time.

(F) Examination of the insured's financial situation and business priorities.

(3) Analysis of the market. The agent/broker is expected to be knowledgeable of changing insurance markets and to take steps to assist an insured in gaining advantages in the market.

(A) Hard market (insurance is difficult to obtain) considerations.

(i) The agent/broker is more apt to supply detailed exposure information to underwriters.

(ii) Coverage restrictions of all types are more frequent and more easily accepted.

(iii) Premiums are higher and increase more often.

(iv) Agents/brokers should assist insureds in exploring new markets or alternative means of transferring risks.

(B) Soft market (insurance is easy to obtain) considerations.

(i) Less information flows from insureds, and agents/brokers supply less detailed information to underwriters.

(ii) Underwriters are less likely to probe for fear of losing business.

(iii) Efforts to impose coverage restrictions or higher prices prompt agents/brokers to move their insureds' business elsewhere.

(4) Liaison between insured and insurer. Generally, the agent/broker should coordinate aspects of the insured's affairs as they pertain to insurance, including the following:

(A) During negotiations, the agent/broker provides information requested by the insurer's underwriting department.

(B) During the application process, the agent/broker assists the insured in preparing the application and coordinates preparation of additional information submitted as a part of that application.

(C) The agent/broker secures quotations and policy terms from the underwriter, analyzes them against the insured's needs, and counsels the insured on its alternatives.

(D) Once the policy is in effect, the agent/broker assists the insured in handling losses and claims, through submission of information or by its own claims department or group.

(E) The agent/broker assists in the renewal process in much the same manner as during the initial application process.

(c) Role of the underwriter

(1) Gathering of information. The underwriter generally gathers the information necessary to determine whether and on what terms an insurer will provide coverage. As a part of this process, the underwriter:

(A) Reviews submissions by and on behalf of prospective or renewing insureds, including:

(i) The coverage terms sought by the prospective or renewing insured.

(ii) The limits, deductible/retention and policy term sought by the prospective or renewing insured.

(iii) Any other relevant policy terms or changes from standard forms sought by the prospective or renewing insured.

(B) Reviews additional information about prospective or renewing insureds, including:

(i) Publicly available information about the insured and its industry, including annual reports, trade journals and other similar information.

(ii) Publicly available information about the risks to which the insured and its industry is exposed, including loss histories, governmental environmental and enforcement databases.

(iii) Information developed at the underwriter's request, including inspection reports and engineering or other studies.

(iv) SIC classifications and other relevant rating classifications for the insured's operations.

(C) Reviews financial information on the insured's trends and profitability, including:

(i) P&L and balance sheet information.

(ii) Loss histories.

(iii) Information on prior insurers, the coverages provided (or not provided), limits, deductibles or retentions, and terms.

(2) The coverage determination. The underwriter generally decides or coordinates the insurer's decision to accept or reject a particular submission. If the decision is to accept, the underwriter's function includes the following tasks:

(A) Categorization of the risk according to SIC codes or other standard classifications.

(B) Selection of appropriate policy language, forms, exclusions and endorsements for the prospective or renewing insured and the jurisdiction where it operates.

(C) Determination of whether or not to accept, reject or modify any proposals by the insured.

(D) Determination of appropriate policy periods, limits, aggregates, and deductibles or retentions.

(E) Determination of type and extent of reinsurance necessary or appropriate.

(3) Pricing. The underwriter assists in or coordinates this decision, which is closely related to decisions as to coverage, through the following determinations:

(A) Finding a rating for or conducting a premium work-up on the risk. (For example, an underwriter may obtain from insurance rating services rates of injury in particular industries, which can be used in determining premiums for certain kinds of coverage.)

(B) Consideration of costs associated with deductibles or retentions, limits, forms of coverage (claims made vs. occurrence), and aggregates.

(C) Consideration of the extent to which reinsurance can be used and the costs associated with reinsuring a risk.

(D) Assessment of the insurer's experience with the forms of risk being insured and appetite for the area.

(E) Assessment of market conditions and competition for the prospective or renewing insured.

(F) Confirmation that the price offered generally conforms to the insurer's filings within the appropriate jurisdiction.

(4) Negotiation. During the application process, the underwriter generally acts as negotiator/spokesperson for the insurer, performing generally the same function the agent/broker does for the prospective or renewing insured.

(5) Renewal. When a policy comes up for renewal, the underwriter performs many of the same tasks that arise during the initial policy application. Often these are done less rigorously, but the underwriter should remain involved and assist in the same kinds of decisions that are made for a new insured's policy.

3.0 ANATOMY OF THE POLICY: BASIC COVERAGE PARTS AND OPTIONS BY PRODUCT TYPE

(a) Environmental insurance for lenders.

(1) The origin of environmental insurance for lenders.

(A) Environmental insurance coverage first became available for lenders in 1996.

(B) Insurers created environmental coverage for lenders because:

(i) Lenders were concerned as to whether they could claim the benefits of the "safe harbor" provisions in federal and state environmental laws, which may not have applied if a lender participated in management of the facility or day to day operations of a borrower or foreclosed on contaminated property.

(ii) Some lenders wanted an additional risk management tool that compensated for the uncertainty presented by the existing Phase I/Phase II environmental assessment process.

(iii) Lenders wished to provide faster service.

(2) The basis for environmental insurance for lenders.

(A) There are several environmental risks associated with lending. These include:

(i) Loss of collateral value, which can occur, for example, when pollution is discovered on a piece of property.

(ii) Liability for clean-up costs on foreclosed/owned/recovered property, as might occur when pollution was discovered on a piece of property after foreclosure.

(iii) Liability to third parties for bodily injury or property damage, including attorney's fees, from pollution on or escaping from a piece of property.

(B) Historical efforts at environmental risk management by lenders.

(i) Lenders were exposed to the risk of environmental liabilities associated with polluted properties.

(ii) Lenders tried to minimize the risks of environmental loss by loan underwriting guidelines, environmental policies and procedures, "Phase I" environmental assessments, questionnaires, database searches and similar methods.

(iii) Some required financial collateral as a hedge against environmental loss or held funds in escrow to protect against losses due to environmental hazards.

(iv) A significant number of lenders managed risk by avoidance; that is, by refusing to make loans where any perceived environmental risk existed.

(v) These tools sometimes could be time consuming, costly, of little value if the environmental assessment failed to detect existing contamination, and generally would not protect against detection of new contamination during the loan term.

(C) Environmental policies can protect lenders by:

(i) Protecting collateral value by minimizing the risk associated with the failure of a environmental assessment to discover existing pollution.

(ii) Protecting lenders from shouldering pollution-related losses if foreclosure or similar proceedings become necessary.

(iii) Potentially speeding the loan approval process.

(iv) Potentially reducing costs for environmental assessments and diversion of proceeds to indemnity or escrow funds.

(3) Available lender policies.

(A) Although there is some variation in nomenclature among insurers, there are two basic forms of environmental insurance specifically addressed to lenders.

(B) "Lesser of" policies or coverage provide insurance to the lender for the lesser of the outstanding loan balance [OLB] or clean-up costs and expenses in the event a borrower defaults on a loan secured by property on which pollution is found.

(i) "Lesser of" policies frequently offer thresholds that drive the determination of how a claim will be dealt with. If the clean-up costs exceed 50% of the policy limits or the OLB, the insured lender can choose which sum to take. If the clean-up costs are below the threshold, the insured lender's recovery is limited to the clean-up costs.

(ii) Some insurers require the lender to foreclose as a condition of payment, while others do not.

(iii) Most insurers do not require the discovery of pollution to occur before the default; they simply require both to exist before coverage is triggered.

(iv) Most insurers require that the default be triggered by a default other than the default related to the pollution condition.

(C) "Outstanding Loan Balance" or "OLB" insurance pays the outstanding loan balance and extra loan-related expenses to the lender if a borrower defaults on a loan secured by a piece of property on which pollution is found.

(i) As with "lesser of" coverage, most insurers do not require the discovery of the pollution before the default; they simply require both a default and pollution condition to exist before coverage is triggered.

(D) Additional coverages common to "lesser of" and "OLB" insurance. While "lesser of" and "OLB" coverage can be purchased as separate stand alone policies, most insurers "bundle" them with other forms of environmental insurance coverage in an effort to make their policies more attractive. These include:

(i) First party clean-up coverage, which reimburses the lender for or pays on behalf of the lender pollution-related clean-up costs it must bear generally after foreclosure on properties with pollution. (These properties are sometimes called OREO/REO properties by lenders.)

(ii) Third party liability coverage, which pays on behalf of the lender costs for bodily injury and property damage to others caused by the pollution at, under or coming from the insured property. This coverage also pays for the lender's legal fees and defense costs, but generally uses up available policy limits in doing so.

(iii) Third party coverage can include a provision that pays on behalf of the insured remediation costs and natural resources damages claims brought by governmental agencies. This coverage also pays for legal fees and defense costs but again uses up available policy limits in doing so.

(iv) Third party coverage may also include coverage for the insured against claims arising from pollution migrating onto the insured property from another site.

(v) Extra expense coverage. Although terms vary, these policies can provide coverage for some of the lender's extra expenses, including, for example some amount of accrued interest (usually up to six months), small amounts for advances to protect the property, and legal fees.

(vi) Terrorism coverage may be available on some buildings for an additional premium.

(E) Other key provisions and definitions

(i) Policy term varies but can be as long as the loan term, which can be up to twenty years, plus extensions.

(ii) These policies generally are claims-made or claims made/reported policies covering claims made against an insured or claims made and reported to the insurer during the policy period

(iii) Lender policies generally cover specified locations or properties endorsed onto a master policy.

(iv) These policies cover unknown, pre-existing and new pollution from ongoing operations.

(v) Default. This definition is highly idiosyncratic; some policies speak in terms of monetary default, and others include technical default.

(vi) Pollution events or conditions sufficient to trigger coverage generally are defined in terms of applicable laws and regulations and pollution must exceed applicable state action levels. Some polices have a discovery trigger while others require the trigger to be a written mandate by regulators.

(vii) Outstanding loan balance is the principal balance.

(F) Principal exclusions. No coverage for:

(i) Pollution conditions known to persons or classes of persons defined in the policy, unless disclosed to the insurer and/or specifically endorsed onto the policy.

(ii) Asbestos, lead or mold.

(iii) Naturally occurring conditions (such as radon).

(G) Other important provisions.

(i) The lender's interest under the policy generally is freely assignable to a successor lienholder.

(ii) If an individual mortgage in a portfolio is sold, the insurer generally must offer similar coverage to the purchaser if that purchaser meets underwriting standards.

(iii) If an insurer pays the outstanding loan balance, the insurer may require an assignment of the mortgage from the lender.

(b) Environmental insurance for borrowers/owners

(1) The origin of environmental insurance for borrowers/owners.

(A) Environmental insurance for property owners first became available in the late 1980s.

(B) Insurers created environmental coverage for borrowers/owners because:

(i) Property owners were concerned about exposure to environmental liability under RCRA, Superfund and similar state laws, as well as the risks of "reopeners" allowing governmental entities to reopen remediation proceedings on properties already closed.

(ii) As toxic tort litigation spread through the 1990s, property owners wanted protection from third-party claims.

(iii) Prospective purchasers were seeking protection from environmental risks in lieu of or in addition to environmental indemnities.

(iv) Lenders required owners or prospective purchasers to obtain such coverage as a means of ensuring that a borrower would have adequate means of dealing with possible environmental exposure while still being able to service the debt.

(2) The basis for environmental insurance for owners/borrowers.

(A) There are obvious and hidden risks to owners/borrowers associated with pollution:

(i) As with lenders, owners/borrowers use insurance to protect collateral value of property, whether or not subject to loans.

(ii) Environmental insurance can protect the owner's cash flow by ensuring an adequate reservoir of resources to conduct a clean-up or protect against third-party lawsuits and litigation costs, including attorney's fees.

(iii) Environmental insurance can protect the insured from exposure to governmental claims requiring reopening of a prior environmental remediation project.

(iv) Environmental insurance can be used to meet governmental financial security requirements for sites where remediation has been performed but pollution may remain.

(v) Independent of any financing concerns, sellers can use environmental insurance as an inducement to buyers and to avoid complicated environmental indemnities in sale agreements.

(B) Historical efforts at environmental risk management by owners/borrowers.

(i) Owners were exposed to the risk of environmental liabilities associated with polluted properties.

(ii) The most common means of minimizing the risks of environmental loss for owners, buyers and sellers was by performing environmental due diligence, i.e., environmental assessments, questionnaires, database searches and similar methods.

(iii) Some buyers required financial collateral as a hedge against environmental loss or held funds in escrow to protect against losses due to environmental hazards.

(iv) A significant number of prospective property purchasers managed risk by avoidance; that is, by refusing to make purchases where any perceived environmental risk existed.

(v) These tools sometimes could be time consuming, costly, of little value if the site assessment failed to detect existing contamination, and generally would not protect against detection of new contamination.

(3) Available owner/borrower policies.

(A) As with lender policies, there is some difference in nomenclature between insurers, but the coverages offered generally fall into several categories.

(B) Owner / Occupant Clean Up Coverage.

(i) This type of environmental insurance provides coverage only for an insured's obligation to a governmental unit to clean-up or otherwise remediate newly discovered pollution.

(ii) This type of insurance originally was site specific, that is, it covered pollution on or emanating from the insured site. As time went on, insurers broadened coverage to include obligations to clean-up pollution coming onto the insured's property from another site.

(iii) Owner/occupant clean up coverage generally only extends to clean-up responsibilities based on governmental demands for remediation such as a Superfund PRP letter, and not to obligations voluntarily assumed or obligations assumed through other means.

(C) Owner / Occupant Third Party Liability Coverage.

(i) This coverage is the most common form of owner/borrower insurance.

(ii) Virtually all owner/occupant third party liability insurance provides protection against a governmental demand for remediation.

(iii) Additionally, these policies provide coverage for claims by third parties for bodily injury or property damage from pollution conditions on the site.

(iv) Currently, this insurance offers coverage for liability claims arising from the off-site migration of pollution or from the migration of pollution onto the insured site.

(v) This type of coverage generally applies to new pollution conditions from ongoing operations and pre-existing but undiscovered, pollution.

(D) Owner/Occupant Clean Up and Third Party Liability coverages are frequently bundled.

(i) These bundled policies are often referred to as Environmental Impairment Liability (EIL) coverage or Pollution Liability Insurance (PLI).

(ii) Some insurers provide additional coverage, for an additional premium, such as:

(a) Business interruption coverage in EIL and PLI policies, usually covering lost income during the period a site is unable to operate because remediation is underway.

(b) Diminution in value.

(c) Terrorism coverage can be included for "non-high profile" sites.

(E) Other key provisions and definitions.

(i) Policy period is flexible, although terms longer than ten years are increasingly rare.

(ii) These policies generally are claims- made or claims made/reported policies covering claims made against an insured or claims made and reported to the insurer during the policy period.

(iii) These policies generally cover specified locations or properties endorsed onto a master policy, although recently some insurers have become willing to consider coverage not tied to particular sites.

(iv) These policies cover unknown, pre-existing and new pollution from ongoing operations.

(v) Pollution events or conditions sufficient to trigger coverage generally are defined in terms of applicable laws and regulations and pollution must exceed applicable state action levels. Some policies have a discover trigger, while others require the trigger to be a written mandate by regulators.

(vi) Some policies allow the insured to manage its own defense and pay legal costs, but deplete policy limits by payment of fees and costs. Others allow the insurer to assume control of the defense.

(F) Principal exclusions. No coverage for:

(i) Pollution conditions known to persons or classes of persons defined in the policy, unless disclosed to the insurer and/or specifically endorsed onto the policy.

(ii) Asbestos, lead or mold.

(iii) Naturally occurring conditions (such as radon).

(G) Other important provisions.

(i) PLI policies generally are assignable but only upon written consent of the insurer, which generally may not be unreasonably withheld.

(ii) Renewal is possible, but generally the renewal is subject to the insurer's underwriting criteria then in effect.

(4) Miscellaneous forms of owner/borrower insurance.

(A) Cost cap/stop loss coverage.

(i) Cost cap coverage provides coverage in the event the costs associated with cleaning up existing pollution exceed a specified amount.

(ii) Generally, cost cap coverage requires the insured to bear a substantial amount of the clean-up costs, often as much as $500,000, before coverage will apply.

(B) Financial responsibility insurance.

(i) Many federal and state environmental statutes require property owners or operators to have financial assurance or responsibility coverage.

(ii) This coverage provides protection in two circumstances – for those regulated businesses which are required to maintain such coverage (e.g., operators of landfill sites) and businesses which have post-closure obligations under state or federal law.

(C) Environmental errors and omissions coverage.

(i) Environmental errors and omissions coverage provides coverage for persons or corporations involved in environmental remediation projects.

(ii) Covered parties can include engineers or contractors who design or execute remediation plans, but occasionally it can be issued to transporters of waste or other similar parties.

4.0 WHAT TO EXPECT: UNDERWRITING REQUIREMENTS FOR LENDER ENVIRONMENTAL INSURANCE GENERALLY REQUIRED BY INSURERS

(a) Routinely requested information for Lender Environmental Insurance for single loans.

(1) Completed and signed application including the following information.

(A) Full name and address of lender and borrower.

(B) Environmental assessments.

(C) Loan documents including:

(i) Default definition.

(ii) Any applicable environmental indemnities.

(D) Policy limits requested.

(E) Policy deductible requested.

(F) Policy term requested.

(G) Loan amount, term, DSCR and LTV ratio.

(H) If loan is a balloon loan, balloon payment date and amount.

(I) Is the loan a renewal, a refinance or a new loan?

(2) Information that lender may think could lead to potential environmental claims.

(3) All information as to whether the lender has received inquiries from any governmental entity or been determined to be an owner or operator under Superfund's lender liability rule or state equivalents.

(4) Information as to whether the lender has restructured any commercial real estate loan or refrained from foreclosing on any property due to the presence of a pollution condition.

(5) Signature of authorized representative.

(A) The application is attached to and made a part of most commercial policies.

(B) Misrepresentation in an application incorporated in a policy is grounds for rescission of a policy if the misrepresentation is material.

(b) Additional information for Lender Environmental Insurance routinely requested if coverage is for a portfolio.

(1) Complete copy of Lender’s environmental policy and procedures.

(2) Itemization of whether the coverage is for new and/or existing loans.

(3) Information on deductible requirements, limit for each loss, aggregate limit and policy period.

(4) Historical default and foreclosure rate for all commercial real estate loans for the preceding five years.

(5) Definition of default used in Insured’s commercial real estate loan documents.

(6) Environmental loss history including reserves and write-downs on portfolio over the last five years.

(7) Information on borrowers’ environmental requirements.

(8) Ratio of balloon loans to total loans.

(9) Insured’s current maximum loan to value ratio and minimum debt service coverage ratio.

(10) Due diligence process used if insured acquires loans from other lenders.

(11) Information on any anticipated changes in lender’s loan practice.

(12) Composition of loan portfolio by industry and property type.

(13) Projections for new loan to be insured under the portfolio(s) by industry and property type.

(14) 2 years of year-end financials for the lender

(c) Information routinely requested by underwriters for owner/occupant coverage.

(1) Full name and address of applicant.

(2) Information on key policy terms.

(A) Limits of liability for each loss.

(B) Aggregate liability.

(C) Deductible amount, with some underwriters requiring audited financial statements if the requested deductible exceeds $50,000.

(D) Policy period requested and effective date.

(E) Optional or additional coverages requested.

(i) Mortgagee/Additional Insured/Assignment provisions.

(ii) Business interruption or loss of rental value coverage.

(iii) Diminution in value (DIV) coverage.

(iv) Underground storage tank coverage.

(3) Available environmental assessments or information.

(4) Information on past, present and future property use(s), including potentially hazardous use(s) (e.g., gasoline stations, manufacturing operations, dry cleaners).

(5) Adjacent property uses.

(6) Specific information on underground storage tanks used at any time on property, including information showing proper closure.

(7) Environmental claims history of property owner for last five years.

(8) Claims history of owner focusing on environmental claims and reportable releases or spills regardless of where they occurred.

(9) Information on property occupier (tenants) if not the owner.

(10) Any other relevant information.

(11) Application signed by authorized representative.

(A) The application is attached to and made a part of most commercial policies.

(B) Misrepresentation in an application incorporated in a policy is grounds for rescission of a policy if the misrepresentation is material.

(d) Information routinely requested for Stop Loss/Cost Cap coverage for known pollution conditions.

(1) Name and address of proposed insured.

(2) The insured's relationship to the property.

(3) Identities of all parties responsible for remediation of the property.

(4) Complete, detailed description of the remediation plan.

(5) Complete list of professionals or contractors involved in the project and for each:

(A) The scope of work performed.

(B) Cost Estimate.

(C) Qualifications.

(D) Resumes for key personnel.

(E) Evidence of appropriate training and certifications.

(F) History of professional liability or pollution claims.

(G) Quality assurance/Quality control plans.

(H) Project communication plan.

(I) Copies of performance and surety bonds.

(J) Corporate safety procedures.

(K) Warranties, certifications and service agreements.

(L) Current certificates of general liability, professional liability, pollution liability and builder’s risk insurance.

(6) A copy of the contract between the applicant and the remediation contractor.

(7) Information on any owner’s representative or project manager that may be used.

(8) Information on dispute resolution procedures between parties to the remediation contract.

(9) Information on the quantity and amount of hazardous materials to be used in the remediation.

(10) Information on off-site locations for off-site disposal, treatment or storage activities.

(11) Information on applicable remediation standards.

(12) Information on how highly contaminated materials will be handled or treated on site.

(13) Information on the nature and extent of operations and maintenance activities on site.

(14) Information on the nature and extent of monitoring that will be required.

(15) Information on non-remediation activities that will be required.

(16) Information on project scheduling, including:

(A) Project milestones.

(B) Critical path information.

(C) Time lines for regulatory approvals.

(D) Project scheduling.

(17) Other information that may be requested.

(A) A detailed description of the current environmental condition of the property.

(B) All previous environmental assessments.

(C) Yearly costs projected for remediation.

(D) Details concerning potential changes in the remediation plan.

(E) Contingency plans for unplanned schedule changes in the remediation plan.

(F) All Consent Orders or Agreements applicable to the site.

(G) Third parties and non-applicant properties affected by the existing contamination and plan or map delineating the property lines.

(H) Details of other environmental activities that will be conducted but are not included in the remediation plan.

(18) Signature of authorized representative.

(A) The application is attached to and made a part of most commercial policies.

(B) Misrepresentation in an application incorporated in a policy is grounds for rescission of a policy if the misrepresentation is material.

5.0 THE USE OF ENVIRONMENTAL INSURANCE WITHIN LENDING INSTITUTIONS

(a) Commercial Real Estate Lending/Underwriting

(1) This is the most obvious (and frequently discussed) area where lender environmental insurance is used.

(2) Real estate lenders may desire protection through insurance on individual loans or through portfolio coverage, in which individual properties are added to or removed from coverage under a master policy as appropriate.

(3) Environmental insurance may have a number of advantages over traditional due diligence.

(A) Insurance can provide a method for dealing with and resolving questions that may be more reliable than dealing with environmental risk soley through Phase I environmental assessments or other similar studies through coverage of unknown pollution conditions.

(B) Insurance may increase the speed with which lenders can make a decision as to whether money will be lent since it may be less time consuming to cover a property through a master policy than obtain a Phase I environmental assessment.

(C) Environmental insurance may broaden the underwriter’s flexibility in terms of what transactions can be considered.

(i) Risk averse lenders may be able to use insurance to move into areas they would not previously have considered – brownfields lending.

(ii) More aggressive lenders may be able to use insurance through single or portfolio policies to increase their market presence.

(D) Insurance may be able to materially ease drafting issues associated with loan transactions.

(i) It may be easier to negotiate loan agreements based on insurance agreements than agreements requiring indemnities or hold-backs.

(ii) It may be easier to create loan documents requiring the purchase and maintenance of an insurance program than to create environmental indemnity provisions.

(E) Insurance can resolve some of the uncertainty associated with whether a lender qualifies for protection of statutory "safe harbors."

(4) There are benefits to borrowers.

(A) The Lender policy may be viewed more favorably by lenders and may be a more cost effective and attractive alternative for borrowers as compared to the posting of escrows or providing indemnities.

(B) By obtaining lender coverage, the borrower may be offered owner/occupant coverage at reduced rates.

(C) The application process for obtaining environmental insurance is sometimes easier and faster than trying to obtain and evaluate a Phase I environmental assessment or other similar environmental study.

(5) Economic benefits. For both borrower and lender, there may be significant economic benefits from using an environmental insurance program, either alone or in tandem with a traditional due diligence program.

(A) The borrower pays a premium for environmental insurance only if the loan closes.

(6) Interface between lender and borrower during the application process.

(A) Generally, in addition to materials required to obtain the loan in any circumstance, the borrower must complete the insurer's application for insurance and provide a designated level of information on the environmental conditions on the property.

(B) The lender should receive a response as to whether the loan will be scheduled under the insurance program within three days.

(b) Credit Administration.

(1) A lender's credit administration department generally is responsible for establishing the criteria that must be met by a borrower before the lender will extend credit.

(A) The Credit Administration Department's responsibility ranges from determining acceptable forms of collateral to loan-to-value ratios or other economic terms or conditions to be imposed.

(B) Where uncertainty or contingency is involved, the credit administration department must establish rules or standards that must be met to minimize the uncertainty.

(C) The Credit Administration Department also analyzes risks posed by proposed transactions and measures them against the lender's standards for extending credit.

(2) Environmental contingencies sometimes are difficult to analyze using traditional methods of credit analysis.

(A) Because the nature and extent of environmental contamination may not be determined without extensive and expensive testing, it is difficult to analyze.

(B) A borrower's potential liability for clean-up or remediation costs can be speculative.

(C) It also is difficult to estimate possible loss of collateral value from even the stigma of potential environmental responsibility.

(D) For Credit Administration Departments, environmental insurance programs may be able to bring more certainty to the process of analysis.

(c) Risk Management Departments/Corporate Management.

(1) Most large businesses maintain risk management groups, who are responsible for protecting against risks to that institution from various sources.

(2) Along with management of the business, up to and including the board of directors, risk management departments protect stakeholders in the business from losses, liabilities and contingencies that will affect the business's profitability or continuity of operations.

(3) The obligation to take such steps is more widely distributed than might at first be imagined. Examples include:

(A) Boards of a Real Estate Investment Trust [sometimes called a REIT] have a fiduciary obligation to its shareholders to maximize returns and protect assets.

(B) Corporate trustees have fiduciary duties to their clients to protect real property entrusted to their care against loss.

(C) Banks are obligated to create a reserve against diminution in collateral value caused by environmental issues.

(D) ERISA fiduciaries such as pension fund managers have obligations to the organizations they work with and to individuals who make contributions.

(4) There also are obligations to report and account for environmental contingencies, which may have a material affect on a business's profitability.

(A) Even prior to the passage of the Sarbanes-Oxley Act materially strengthening corporate disclosure requirements, the Securities and Exchange Commission, and generally accepted accounting standards required publicly traded corporations (including banks and other lenders) to disclose certain environmental contingencies.

(i) SEC Item 101 requires the disclosure of material environmental contingencies and how these may affect capital expenditures, earnings and the competitive position of the corporation.

(ii) SEC Item 103 requires disclosure of threatened or pending material legal proceedings, whether civil, criminal or administrative in nature unless the corporation believes that monetary sanctions will not exceed $100,000.

(iii) SEC Item 303 requires management of the corporation to discuss, in narrative form, liquidity, capital resources and results of operations, including environmental proceeding that might not yet rise to the level of exposure required for Item 103 reporting.

(iv) FASB Statement of Accounting Standards No. 5 (FASB-5 as it is sometimes called) requires disclosure by corporations in the financial statements of contingent liabilities, including liabilities for environmental matters, and a charge to income if it is probable that an asset is impaired and the amount of loss can reasonably be estimated.

(B) Beginning in 2002, the Sarbanes-Oxley Act broadened and deepened management's duties of disclosure.

(i) Management must make detailed disclosures of many new matters and contingencies.

(ii) Management must provide the assumptions used in financial computations concerning uncertain matters, the sensitivity of financial results to changes in assumptions and ranges of estimates used.

(iii) As a general principle, Sarbanes-Oxley reporting strongly disapproves of assumptions, estimates and non-specific disclosures.

(C) Environmental insurance may be able to assist in certain disclosure decisions and reporting.

(i) Owner/occupant, cost-cap/stop loss and other forms of environmental insurance that protect collateral value or ensure cash flow can serve as risk management tools and help a business address obligations to its own stakeholders.

(d) Workout groups and special servicing groups.

(1) Workout or special servicing groups address situations in which a loan or borrower is not performing according to the terms of a loan agreement.

(2) Although it is difficult to generalize, workout or special servicing groups generally do not become involved with a loan or borrower until a serious problem has developed.

(3) The goal of the workout or special servicing group generally is to find a way to restructure the loan or relationship in such a fashion as to minimize losses to the lender.

(4) Workout groups may become involved through the request or action of a borrower as well as at the direction of the lender.

(5) A corollary to the workout group's general goal of minimizing loss to the lender is the principle that it should minimize uncertainty. Environmental insurance can assist in achieving that goal.

6.0 ENVIRONMENTAL INSURANCE CONSIDERATIONS FOR SECONDARY MARKET LENDERS

(a) Prior sections of this paper have focused on environmental insurance where the parties are only the borrower, lender, and insurer.

(b) Environmental insurance also can play a role where commercial real estate loans are used as the basis for issuance of a security, usually called a Commercial Mortgage-Backed Security or CMBS.

(1) CMBS or secondary market for commercial mortgages is a complex field but for purposes of a discussion of the role of environmental insurance, it can be summarized as follows.

(A) An investor in a CMBS is, in effect, purchasing a proportionate share of the cash flow from a pool of mortgages that are the backing for the particular CMBS he has purchased.

(B) The CMBS issuer and those who provide mortgages for inclusion in mortgage pools used to back a CMBS therefore have a strong interest in ensuring that the cash flow from all mortgages in the pool continues without reduction or pause – i.e., that the mortgagors do not go into default or reduce their payments because of an unforeseen contingency.

(C) Additionally, the interest rate that must be paid by the issuer of a CMBS depends on how much risk there is of a default or reduction in cash flow from loans in the pool – the riskier the loan, the higher the interest rate that must be paid to investors and the lower the profit to the issuer from a pool of a given size.

(2) Participants in the CMBS process – from the entities who underwrite the mortgages initially to those who service the loans included in a CMBS pool – have an interest in preventing defaults or reductions in cash flow from mortgages to be included in a CMBS.

(3) Because CMBS is often a rated security, there is another entity potentially involved in the lending process, a rating agency such as Standard & Poor’s, Fitch or Moody’s.

(A) Rating agencies evaluate the quality of debt securities offerings and make an assessment of various factors designed to determine whether the cash flow from the mortgages backing the securities will be sufficient over time to ensure that the bondholders will be repaid.

(B) CMBS issuers seek favorable ratings from the rating agencies because it enables them to pay lower interest rates to persons purchasing the CMBS.

(C) The rating agencies tranche ratings of CMBS transactions reflect the agencies assessment of how likely it is that investors will actually receive the promised yield on the purchased bonds. As noted above, the higher the risk, the more yield that must be paid to make investors accept it.

(c) Rating agencies have established criteria regarding environmental insurance on loans to be placed in a CMBS deal. As a general rule, rating agencies are credit neutral when environmental insurance is used as a substitute for environmental site assessments on small balance loans, generally accompanied by a borrower-completed detailed questionnaire, which was provided to the insurer by the lender and the insurer’s search of environmental databases. However, the use of insurance as a substitute for investigation on large loans will typically penalize CMBS issuers.

(d) Rating agency criteria concerning environmental insurance can affect - the underwriting, placement and loan origination process,

(e) Rating agency criteria for lender environmental insurance.

(1) Insuring agreement.

(A) Must provide that default by borrower plus existence of a pollution condition triggers coverage.

(B) Insuring agreement may not require remediation as a condition for coverage to be triggered.

(2) Named insured.

(A) Trustee for the pool of mortgages should be only named insured on policy.

(B) Special servicer – the entity that will be responsible for dealing with any mortgage that stops performing – should also be named as an insured.

(C) Other entities involved in an individual mortgage are not included as insureds, because the insurance proceeds are intended to protect the investors in the CMBS.

(3) Policy period.

(A) Policy period generally must be equal to five years beyond the stated loan maturity date.

(B) If a pool policy, policy period generally must be five years beyond the latest stated loan maturity dated.

(C) This allows loan extensions until two years before the end of the policy period.

(4) Amount of coverage.

(A) Policy must pay OLB in full.

(B) Policy must provide additional coverage equal to 25% of OLB to cover accrued interest and servicer advances.

(C) Reasonable cap on legal fees and on certain other advances, except for interest payments and property protection expenses for real estate taxes and insurance, may be permitted.

(D) No deductible permitted.

(5) Requirements for other policy provisions.

(A) Foreclosure by trustee may not be required before insurer is required to pay OLB.

(B) Policy should continue to provide first party clean-up and third party liability coverage protection after foreclosure by the Trustee.

(C) Policy may not nullify or exclude coverage for any action or knowledge of any parties involved in ownership of property, loan origination or securitization once it has occurred and ownership has passed to the Trustee.

(D) If Coverage for mold/fungus, asbestos and lead paint are excluded, a property site assessment with respect to these issues is necessary.

(E) Trustee can assign its interest or effect a change in servicer without prior written permission.

(F) The policy must be fully paid prior to securitization and cannot be cancelled by the insurer.

(G) The insurer itself must meet minimum rating requirements.

(f) Additional information on particular agency requirements may be found at their websites.

(1) Fitch: Fitchratings.com/Sectors/CMBS/Criteria Reports

(2) Moody's: Moodys.com

(3) Standard & Poor's: Standardandpoors.com

7.0 SUMMING UP: ENVIRONMENTAL INSURANCE VS. DUE DILIGENCE

(a) Each transaction presents a specific combination of risks and issues that must be evaluated with an eye to the following factors.

(1) The parties' level of risk aversion.

(2) Goals of the transaction.

(3) Possible interest of rating agencies.

(4) The need to satisfy governmental agencies or regulators.

(5) The likelihood of liability to third parties or litigation involving the property.

(6) Issues involving resale or later use.

(b) The Phase I environmental assessment/due diligence process has the following benefits:

(1) If properly conducted, all parties benefit from site visits, examinations and analysis as well as a formal written environmental report.

(2) An environmental assessment can assist in the selection process for loans, eliminating properties with potentially higher transaction costs or with a greater likelihood of environmental risks, which would affect value.

(3) An environmental assessment may help refute allegations of contamination and assist in supporting the sale price for the property.

(4) Some level of analysis by parties to a transaction may be necessary to obtain environmental insurance, particularly on more difficult sites.

(5) The performance of an environmental assessment also is an important element in establishing the property owner's right to rely upon the bonafide purchaser, contiguous landowner or innocent landowner defenses to Superfund liability.

(6) Environmental insurance generally does not cover asbestos, mold or lead paint, so environmental assessments remain necessary to determine whether these conditions exist.

(7) Environmental insurance, particularly lender policies, have not had a significant claims payment history.

(8) The environmental insurance industry has experienced significant disruption.

(c) Environmental insurance has the following benefits.

(1) Insurance is designed to pay for covered environmental remediation (clean-up) costs.

(2) Lender insurance is designed to pay for collateral losses including outstanding loan balance or clean-up costs and other sums in the event of a default and discovery of an environmental condition at a site used as collateral for a loan.

(3) Insurance may provide some protection against third party claims.

(4) Insurance may pay for attorney's fees and costs (defense costs) in lawsuits filed by third parties for damages or by governmental units for remediation.

(5) Coverage can extend over the full term of the loan.

(6) Coverage may protect against past or future losses and, in some limited circumstances, against known or contingent losses.

(7) Coverage generally is transferable to the purchaser of a loan or portfolio.

(8) Insurers may conduct some amount of due diligence themselves.

(9) There is no cost to the borrower if the loan does not close.

(10) Costs to lenders under portfolio programs are generally lower than the cost of traditional Phase I environmental assessments.

(11) Insurance may allow for quicker decisions.

8.0 LOOKING AHEAD: A GLIMPSE AT THE FUTURE OF ENVIRONMENTAL INSURANCE

(a) Development of the environmental insurance marketplace.

(1) Environmental insurance, particularly in the OLB and "lesser of" segments, is a new and immature market.

(A) There exist significant and often material differences in policy language among insurers (and sometimes between policies issued by the same insurer at different times).

(B) Although insurers participating in this market segment have made efforts to understand how it operates, policy provisions and definitions often do not reflect the realities of lenders' businesses.

(C) There have been few, if any, serious claims in the Lender's insurance segment of the market, and lenders are concerned that there exist no reliable procedures for handling or paying claims. However, many claims have been paid under owner/occupant policies insuring similar property types.

(D) Unlike other market segments, there are no or very few court decisions construing policy provisions that do exist.

(2) The financial underpinnings of this market appear to be unsettled at this time.

(A) There does not yet appear to be substantial support for this market segment from reinsurers.

(B) It is not yet clear whether the premiums being charged can support the limits being written.

(C) Some market leaders in this field have recently reduced the kinds of coverage, limits, and policy terms they wish to offer.

(3) Lenders remain uncertain about some aspects of these coverages.

(A) The negotiation process can be time consuming, and it varies between insurers.

(B) The variation in policy terms can lead to a perception that there will be gaps in coverage, in contrast to other areas where policy terms have been settled.

(C) The skills necessary to conduct these negotiations and evaluate the policies are not universal, making some lenders reluctant to approach the market.

(b) New, immature markets offer new opportunities.

(1) New policies are being developed.

(A) Contingent responsibility for another's obligation to a governmental unit to conduct a site remediation may soon be insurable.

(B) Contingent liability for failure of another to complete a voluntary clean-up may soon be insurable.

(2) New entrants are or soon will be in this market segment.

(3) The ability to negotiate insurance contract terms gives increased flexibility as compared to more traditional market segments.

(A) This flexibility may enable lenders to obtain benefits not often available in other market segments.

GLOSSARY

Agent. Representatives of the Insurance Company under contract with one or more specific insurers to produce a targeted amount of business at a predefined loss ratio. There generally is a profit sharing relationship between an "agent" and the insurer.

Broker. Representative of the customer or "insured" who places the interests of the customer above all. There typically is no written contractual agreement between the broker and the companies it uses.

Claims made coverage. Claims made policies or coverages, provide coverage to the insured if the claim, as defined in the policy, is first asserted against the insured during the policy period even if the injury or damage did not occur during the policy period. Claims made coverage can lower the cost of insurance because the insurer's exposure to claims ends when the policy period ends.

Commercial Mortgage Backed Security [CMBS]. Debt security sold publicly and backed by mortgages on properties included in a package of properties securitized.

Cost cap/stop loss insurance. A form of environmental insurance providing reimbursement of unforeseen cost overruns on pollution remediation projects.

DSCR – Debt service coverage ratio. Measures a mortgage property's ability to cover monthly payments, as a ratio of net operating income over the mortgage payments.

EIL Insurance – Environmental Impairment Insurance. A form of environmental insurance providing first party clean up coverage and third party bodily injury and property damage liability coverage for pollution conditions. **Errors and omissions coverage**. Errors and omissions insurance provides coverage for professionals such as engineers or contractors involved with environmental remediation projects.

Financial responsibility insurance. Financial responsibility insurance provides coverage for an insured's obligation to a governmental agency to meet financial responsibility requirements associated with ownership or operation of a particulare site or property.

Lesser Of Insurance. "Lesser of" insurance is a form of environmental insurance issued to a lender with coverage for the "lesser of" costs necessary to clean-up a piece of property or the insured lender's outstanding loan balance on it.

LTV – loan to value. The ratio between the principal amount of the mortgage balance to the current value of the underlying real estate collateral.

Occurrence coverage. Occurrence coverage provides coverage for the insured if the injury or damage takes place during the policy period, even if the claim is not made until after the policy period has ended.

OLB. Outstanding loan balance.

OLB Insurance – Outstanding Loan Balance Insurance. OLB insurance is issued to a lender and pays the outstanding loan balance and some extra expenses defined by the policy on a piece of property where pollution is discovered and a default occurs.

PLI Insurance – Pollution Liability Insurance. A form of environmental insurance providing first party clean up coverage and third party bodily injury and property damage liability coverage for pollution conditions. PLI insurance also provides EIL insurance.

Portfolio coverage. Insurance, usually a single master policy, for all of the loans in a particular portfolio.

Program coverage. Insurance, usually by a single master policy, for all of the loans in a particular program.

Reinsurance. A risk-shifting device in which one entity, a reinsurer, agrees for a price to assume part of an insurer's obligation to pay a loss to an insured.

Sarbanes-Oxley. Federal statute enacted in 2002 mandating stringent disclosures by management of publicly traded company. Sarbanes-Oxley also refers to a series of implementing rules issued by the Securities and Exchange Commission and effective in 2003.

SIC Codes. Standard Industry Classification Codes created by the United States Government for classifying various industries, and used by insurers to assess the risks associated with particular activities for underwriting purposes.

Special Servicer or Servicing Group. Entity that works with a borrower whose loan has gone into default or is not performing within the terms of the loan agreement. In CMBS transactions, special servicers generally must comply with detailed requirements as set forth in the loan documents.

Underwriter. A person or entity employed by an insurer to evaluate, select and price risks to be accepted by the insurer.

Workout group. Entity or team in a lender's organization whish works with non-performing loans or borrowers in an effort to preserve collateral and cash flow and minimize loss to the lender.

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