

Managing Environmental Risk with Bankruptcy

During the 12 month period ending September 30th 2008, the rate of businesses filing for Chapter 11 Bankruptcy protection increased by 49% over the prior year according to the Administrative Office of the U.S. Courts. The current economic climate will put pressure on the balance sheets and cash-flow statements of even financially robust companies, and will shift and elevate the risk profile for environmental obligations.

Environmental risks will be an important factor to manage for:

- companies entering bankruptcy and contemplating emergence,
- companies seeking to avoid bankruptcy, and
- business partners who may have contractual counterparty risk from past M&A deals, lending and joint ventures with companies in bankruptcy

It is possible to successfully navigate through bankruptcy to minimize financial impacts, and to be optimally positioned for emergence. There are three elements that must be considered as part of any success process and consideration around bankruptcy and environmental liabilities:

- Understanding risks and exposures,
- Alternatives for environmental liability disposition, and
- Solutions for managing environmental liabilities.

Understanding Risk and Exposures

Environmental risks and exposures can develop from widely diverse sources.

Operational Compliance.

Cash-flow pressure can influence compliance and risk investment decisions such as capital improvements and headcount. This can negatively influence overall environmental performance and possibly lead to increased probability of an operational event and release resulting in cleanup costs, and possibility of substantial third-party claims and business interruption.

Legacy Risks.

Existing environmental contamination and associated regulatory and contractual obligations represent the most common risk and exposure to be considered during bankruptcy. Known issues can result in substantial financial cleanup obligations and uncertainty around cost projections, and “unknowns” can create significant financial variability and uncertainty. Quantification, disposition and management of legacy risks represents the greatest challenge, particularly when considering the direct cost of cleanup and indirect costs such as third-party claims and legal defense costs.

For business partners, reliance on contractual mechanisms such as indemnification or prior insurance programs may not be adequate in the current environment.

A best practice is “risk mapping” to identify actual and potential exposures to assure that risk and exposures are properly and thoroughly identified. Once completed, the financial estimate around risks can be quantified using a variety of semi-quantitative and quantitative methods tailored to the risk and business analytical needs.

Alternatives for Liability Disposition Solutions

For a company entering bankruptcy with environmental liabilities, there are four common disposition strategies that can occur. Each alternative has advantages and disadvantages as well as opportunities and risks.

Discharge of Environmental Claims. Companies entering bankruptcy may seek to have outstanding claims discharged or essentially erased. This provides the greatest relief upon emergence. In practice it is difficult for companies to have full discharge and it is more common for claims to be settled with the government and Principal Responsible Parties in exchange for release from future claims against the

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reorganized company. Such settlement can put business partners at risk as they may be saddled with an increased share of the liability. In addition, companies relying upon indemnities for unknown pre-existing risks could be wholly unprotected.

Section 363 Asset Sales. Companies in bankruptcy reorganization may seek to raise cash through sales of assets- individual property or business units. Environmental liability runs with the land, and a potential purchaser can be within the chain of successor liability since a 363 court order and the associated “free and clear of all liens and claims language” in Section 363 may not eliminate successor liability.

Environmental Trust. Section 554 of the bankruptcy code provides bankrupt companies the potential to abandon assets of limited value. In reality, this ability is very limited for contaminated property based on case law. The typical outcome is for the bankrupt company to create an “environmental trust”. The trust owns the property, has the responsibility to remediate contamination and subsequently sell the property. Remediation obligations are typically funded and the proceeds from the sale is returned to the bankrupt’s estate.

Rejection of Indemnity Obligations. The bankruptcy code provides the ability for companies to seek rejection of one-sided executory contracts, in particular environmental indemnity obligations with one-sided performance obligations. Where such rejection and discharge is possible, it may create a significant financial risk to the other party who was relying upon future performance of that indemnity.

Each of these scenarios provide opportunities for companies entering into bankruptcy to mitigate liabilities if financial uncertainties around known and unknown risks can be quantified and risk managed as part of the process. These outcomes can also create increased risk for third-party business partners. However, it is possible to substantially mitigate these increased risks to third parties through risk management solutions.

Environmental Risk Management Solutions

In each of the scenarios above, environmental risk and exposures have two basic types of financial uncertainties:

1. Cost Escalation around known risks; and
2. New costs surfacing from previously unknown risks.

Managing these financial uncertainties is a critical necessity when trying to:

- maximize asset value from sales under Section 363 and Environmental Trusts for companies in bankruptcy;

Marsh can help you or your client work through these issues. For more information or discussion, contact your local Marsh Environmental professional.

- minimizing or eliminating liability to third parties from environmental liability discharges and rejection of contractual indemnities.

Parties can use any of the three following risk management tools to control the financial uncertainties discussed above.

Pollution Legal Liability. This insurance policy covers the risk from unknown risks that may emerge. It can include legacy risks or operational risks. Core coverage can include: cleanup, third-party bodily injury and property damage, legal defense and business interruption. These policies can be manuscripted and coverages enhanced to meet client and situation-specific needs. In addition, Excess of Indemnity coverage can also be provided to protect third parties from failure of bankrupt companies to meet indemnity obligations. PLL is the policy most frequently used to control risk and there is a wide range of carriers who can provide this coverage.

Remediation Cost Cap. This insurance policy is used to cover cost over-runs around known environmental risks. Cost Cap requires that there is sufficient information known around a pollution condition so that a remediation plan, schedule and cost can be forecasted. The insurance carrier underwrites the risk and agrees on an “attachment point” for the remediation cost above which it will play claims should the attachment point be exceeded or overrun.

Environmental Liability Buyouts. An imbedded assumption in many transactions and outcomes is that an existing party must retain liability or that the liability is apportioned between buyer and seller. An alternative exists using an environmental liability buyout. A number of consulting and brownfields companies have evolved from doing remediation to contractually assuming liability. These companies will assess and value the liability and contractually assume remediation and regulatory obligations in exchange for being paid to take on the forecasted liability. Environmental insurance is typically used to wrap around the contractual obligation using a combination of PLL and/or Cost Cap. Environmental liability buyouts have been used successfully on Section 363 sales so that emergent companies can emerge risk free.

Summary

Bankruptcy is an event that creates significant uncertainty and financial risk for companies and business partners, particularly involving environmental obligations. A thorough analysis of risk and thoughtful use of environmental risk management vehicles can help enable positive outcomes around cash generation and minimize risk to third parties.

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