MARSH

MANAGING ENVIRONMENTAL RISK AMID BANKRUPTCY

Going through bankruptcy proceedings is difficult enough without environmental challenges that can put unnecessary financial burdens on owners, buyers, and sellers. Marsh's Environmental Practice advises organizations in bankruptcy situations about insurance solutions that can offer some protection against the unknown costs related to pollution events.

UNDERSTANDING RISK AND EXPOSURES

According to PricewaterhouseCoopers' 2015 CEO survey, the US fared better than the rest of the global economies in growth prospects, although only 37% of CEOs thought global economic growth will improve, down from 44% last year. While that may or may not signal more bankruptcies, geopolitical concerns — along with other macroeconomic challenges, such as those arising from a depressed oil market — can weigh heavily on small and large firms.

Environmental exposures are crucial considerations for companies and business partners that:

- Are entering bankruptcy and contemplating emergence.
- Are seeking to avoid bankruptcy.
- Are buyers of companies or assets that are in bankruptcy.
- Have contractual counterparty risk from past M&A deals, lending, and joint ventures with companies in bankruptcy.

Environmental risks typically develop through compliance and legacy sources. A thorough analysis of risk and thoughtful use of environmental risk management vehicles can help reduce the financial burdens from environmental pollution events and minimize risk to third parties.

OPERATIONAL COMPLIANCE

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

LEGACY RISKS

Existing environmental contamination of a property and associated regulatory and contractual obligations represent the most common risks and exposures to be considered during bankruptcy. Known environmental issues can result in substantial financial cleanup obligations and uncertainty around cost projections. Unknown environmental issues can create significant financial variability and also create uncertainty. The quantification, disposition, and management of legacy risks represent some of the greatest challenges in a bankruptcy, particularly after taking into consideration 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. Risk mapping, by showing a visual representation of risks, helps to more fully identify the actual and potential exposures stemming from environmental challenges. Once the risk map is completed, financial estimates can be quantified using a variety of semi- and fully quantitative methods tailored to the risk and business analytical needs of all parties involved in a bankruptcy.

ALTERNATIVES FOR LIABILITY DISPOSITION SOLUTIONS

For bankruptcies in which a company has environmental liabilities, there are four common disposition strategies. Each alternative has advantages and disadvantages as well as opportunities and risks. These include:

DISCHARGE OF ENVIRONMENTAL CLAIMS

Companies entering bankruptcy may seek to have outstanding claims discharged, or essentially erased. This provides the greatest relief upon emergence from bankruptcy. In practice, however, 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 reorganized company. Such settlement can put business partners at risk as they may be saddled with an increased share of the environmental 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 under Section 363 of the Bankruptcy Code, whether individual property or business units. Environmental liability, however, attaches to the land, so 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. However, case law suggests that the ability to abandon these assets can be of limited utility for contaminated properties. The typical outcome has been for the bankrupt company to create an environmental trust that owns the property, is responsible to remediate contamination, and subsequently sells the property. Remediation obligations are typically funded and the proceeds from the sale are returned to the bankrupt party'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, however, create a significant financial risk to the other party that was relying upon future performance of that indemnity.

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

ENVIRONMENTAL RISK MANAGEMENT SOLUTIONS

Environmental risk and exposures have two basic types of financial uncertainties: cost escalation around known risks and new costs surfacing from previously unknown risks. Managing these financial uncertainties is critical when trying to either maximize asset values from sales under Section 363 of the Bankruptcy Code and environmental trusts for companies in bankruptcy, or when trying to minimize or eliminate liability to third parties from environmental liability discharges and rejection of contractual indemnities. Parties should consider using any of the following risk management tools to control financial uncertainties:

POLLUTION LEGAL LIABILITY (PLL)

This type of insurance covers unknown risks that may emerge, including legacy risks or operational risks. Core coverage can include: cleanup, third-party bodily injury, property damage, legal defense, and business interruption. Policies can be manuscripted and coverages enhanced to meet client and situation-specific needs. Excess of indemnity coverage can also be provided to protect third parties from a failure on the part of bankrupt companies to meet indemnity obligations. PLL, which a wide range of carriers can provide, is the policy most frequently used to control risk.

REMEDIATION COST CAP

This type of insurance policy is used to cover cost overruns around known environmental risks. Cost cap requires that there be sufficient information and an approved remediation plan, in order to develop a schedule, and cost. The insurer underwrites the risk and agrees on an "attachment point" for the remediation cost above which it will pay 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 specialty firms 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 sales under Section 363 of the Bankruptcy Code so that emergent companies can come out risk free.

SUMMARY

Bankruptcy 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 reduce the financial burdens from environmental pollution events and minimize risk to third parties.

ABOUT MARSH'S ENVIRONMENTAL PRACTICE

Marsh's Environmental Practice advises organizations in bankruptcy situations about insurance solutions that can offer some protection against the unknown costs related to pollution events.

The practice can help tailor the most effective environmental insurance solutions for businesses of all sizes. Grounded in years of practical industry experience, claims expertise, and legal advisory, the environmental team works with companies to reduce environmental liability that can influence financial performance, reputation and brand, cash flow, and shareholder value.

Marsh's Environmental Practice can help companies navigate through bankruptcy and minimize the financial impact from environmental liabilities by providing:

- Access to experienced professionals that fully understand environmental risks and exposures.
- Expertise involving alternatives for environmental liability disposition.
- Risk solutions that can help manage environmental liabilities.

ABOUT MARSH

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