Transfer of Environmental Liabilities for Financial Institutions

The allocation of environmental liabilities can become a significant point of contention between the various transaction counterparties and a key consideration for equity investors and lenders.

New environmental risk transfer solutions are increasingly being used by financial institutions to facilitate deals, secure loan arrangements and maximise enterprise values.

In many cases, it is the perception of environmental risk rather than specific risk factors which leads to concern. Nevertheless such perceptions may still erode enterprise value, threaten deal completion and can sometimes become a barrier to otherwise attractive projects.

Contamination liabilities are amongst the hardest exposures to accurately quantify, verify and manage. Indeed, the full extent of the exposure may not manifest itself until well after completion.

Specialist insurance products are now playing a central role in the management of pollution and contamination risks associated with corporate transactions. They are increasingly used as a corporate finance tool and tailored to suit the specific requirements of lenders and private equity firms.

Environmental Insurance is being used by financial institutions to:

- eliminate/ mitigate potential project ‘deal breakers’
- protect equity investors from long tail environmental liability exposures after completion
- replace indemnities and/or warranties and ensure a ‘clean exit’ for equity providers
- provide security in the event of concerns about buyer or seller credit-worthiness
- quantify and cap actual or potential remediation liabilities or environmental obligations
- reduce lenders exposure to credit risk
- protect lenders’ from direct liability (e.g. in the event of foreclosure).

Coverage can be designed to transfer contamination legacy risks and/or insure against the losses associated with operational pollution risks. Products are also available which can cap ‘known’ liabilities such as remediation costs.

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It is also possible to exploit discounted funding techniques to design risk financing or ‘finite’ insurance programmes which can be used to transfer ‘known’ liabilities, such as restoration obligations, and spread the financial impact over a series of fiscal periods.

Long policy periods can be arranged with significant limits for multi-event or portfolio covers.

Policies can be worded so that they are fully transferable and often jointly insure various parties (e.g. acquirer and financial backers). They can be designed to protect the underlying venture itself or to directly protect the position of the lenders or equity providers. They can also be structured and worded so that they provide ‘back to back’ coverage of indemnity or warranty clauses.

Coverage can often be placed in extremely tight timescales on the evidence of existing survey reports.

Case Studies

1) Lender Liability
Willis structured environmental loan default protection for a UK bank looking to finance the acquisition of a number of power facilities. One of the bank’s prime concerns was the potential for default in the event of a major environmental loss.

By combining a number of different insurers, Willis was able to put together a lender protection programme which covered two separate £200 million loans for an eight year loan period.

The loan terms stipulated that the bank would be entitled to call in the loan after a generation interruption of over 12 months. In the event of a significant environmental loss and subsequent borrower default, the policy would pay off the balance of the loan.

2) Maximising Disposal Value
Willis helped a Vendor Group realise maximum value and achieve a clean exit from the sale of a global manufacturing operation. Significant legacy liabilities were considered likely to represent a major concern to potential purchasers and therefore reduce the return from the disposal programme.

Working with our client and its professional advisers, Willis devised a transaction strategy which involved using environmental insurance ‘in lieu’ of a vendor indemnity or purchase price reduction for environmental liabilities.

The insurance protection was arranged by the Vendor on the basis of a vendor due diligence exercise. The policy benefits were transferable to a purchaser and therefore the policy was offered as an ‘asset’ in the sale agreement. Upon deal completion the Vendor retained an interest on the policy to cover its contingent liability.