ENVIRONMENTAL INSURANCE AS A POLICY ENFORCEMENT TOOL IN DEVELOPING COUNTRIES

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1. INTRODUCTION

Environmental issues pose a vexing threat to the global community, apparently defying any single solution. To use a military analogy, it is a war that must be fought on many fronts. This concept is perhaps best evidenced by the development of environmental policy in the United States,[1] where both public and private actors have been instrumental in addressing environmental problems. For example, under careful public scrutiny, private lenders now frequently guarantee their client's compliance with public environmental policy.[2]

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[1] The beginnings of public concern with environmental policy can be clearly seen in the passage of the National Environmental Policy Act ("NEPA") and the creation of the Environmental Protection Agency ("EPA") in the early 1970's. For a comprehensive overview of the origins and initial impact of NEPA, see Risa Vetri Ferman, Comment, *Environmental Disclosures and SEC Reporting Requirements*, 17 DEL. J. CORP. L. 483, 485-500 (1992). For a comprehensive discussion of the origins of the EPA, see MARC K. LANDY ET AL., THE ENVIRONMENTAL PROTECTION AGENCY: ASKING THE WRONG QUESTIONS FROM NIXON TO CLINTON 22-45 (1994).

[2] The rapid development of this particular relationship has been aptly described as "the environmental liability roller coaster." Stephen L. Kass & Michael B. Gerrard, *New Worries for Banks*, N.Y.L.J., June 25, 1993, at 3. This ride began with a breath-taking plunge into federal court. *See* United States v. Fleet Factors Corp., 901 F.2d 1550, 1557-60 (11th Cir. 1990) (establishing lender liability for borrower's environmental actions). It then leveled out briefly due to administrative action. *See* Lender Liability Under CERCLA, 57 Fed. Reg. 18,344, 18,374-80 (1992) (providing a "safe harbor" for lenders from liability for borrower's environmental actions); George C. Weir, *Lender and Fiduciary Liability Under the EPA's Final Rule*, PROB. & PROP., July-Aug. 1993, at 14 (discussing the implications of the EPA's "safe harbor"); Brian S.B. Lee, Comment, *A Ride on the Environmental Roller Coaster*, 12 PACE ENVTL. L. REV. 445, 468-70 (1994) (discussing the implications of the Poling letter); Letter

This multi-front mentality is also being adopted internationally. In addition to developing increasingly sophisticated public enforcement mechanisms, the international community has begun to rely on private parties, such as the World Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development, to implement environmental policy. These practices might also be used to reinforce public environmental policies through the imposition of private environmental requirements on borrowers.[3]

While the components of public international environmental policy are becoming increasingly clear, what remains unclear is the means by which private parties, such as lenders, may strictly enforce the environmental compliance provisions they routinely place on their clients. This becomes a key issue for all institutions involved in lending funds to support industrial development. In the United States, lenders increasingly rely on private third-party institutions to enforce environmental compliance among their borrowers.[4] Environmental insurance plays an increasingly important role as both a mechanism to assume the environmental risk associated with industrial projects and as an indirect compliance tool to assure that environmental requirements are being met.[5] In the complex world of multinational lending, however, insurance does not yet play a role as a lender's tool for assuring compliance.

This Essay will explore the benefits of using environmental

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from Stanley J. Poling, Director, Federal Deposit Insurance Corporation ("FDIC"), to Chief Executive Officers of FDIC-Supervised Banks (Feb. 25, 1993) (providing guidance to lenders in avoiding liability for borrower's environmental actions). The ride then plunged again into federal court. *See, e.g.*, Kelley v. EPA, 15 F.3d 1100, 1108-09 (D.C. Cir. 1994) (vacating the EPA's "safe harbor"). Somewhat winded by the ride, private lenders have opted to get off the roller coaster, voluntarily adopting more stringent, private measures than any previously suggested by the federal government to this point. *See Property Specific Transactions*, STANDARD & POOR'S CREDITWEEK, Mar. 8, 1993, at 7, 9.

[3] *See, e.g.*, Ian A. Bowles & Cyril F. Kormos, *Environmental Reform at the World Bank: The Role of the U.S. Congress*, 35 VA. J. INT'L L. 777, 822-35 (1995); John Linarelli, *The European Bank for Reconstruction and Development and the Post-Cold War Era*, 16 U. PA. J. INT'L BUS. L. 373, 382-84 (1995).

[4] *See* Gary Hector, *A New Reason You Can't Get a Loan*, FORTUNE, Sept. 21, 1992, at 107, 108.

[5] *See* Michael Quint, *Insuring Environmental Liabilities*, N.Y. TIMES, Feb. 17, 1994, at D1.

insurance as a tool in commercial lending practice in the United States, and will extrapolate by analogy the benefits which may be available to international lenders as they assess the available means to ensure compliance with environmental policies. This Essay will first discuss the environmental liability concerns faced by lenders. Then, it will describe the environmental insurance strategies used to limit these concerns in the United States. Finally, this Essay will conclude with an analysis of the potential application of these practices to international lending.

2. NATURE OF ENVIRONMENTAL CONCERNS

As specifically relates to domestic projects secured by real property assets, lenders have two areas of concern regarding environmental policy. Both concerns have had a chilling effect on lending institutions and their willingness to pursue secured loans.[6]

The first, and most critical, concern is the impact environmental policy may have on the operations, and thus the financial condition, of a lender's customers. In particular, lenders ask themselves if the ongoing business operations of borrowers will result in environmental liability that affects the borrower's ability to repay its loans.[7] Satisfaction of this concern demands that the ongoing business operations of a borrower remain in compliance with environmental policy. Generally, the lender requires assurance that the operations of the borrower will be conducted in a manner consistent with operating permits provided to the borrower by government agencies, and that the levels of pollutants created and dispersed by the borrower are within regulatory guidelines. This concern has intensified as governmental policy has substantially increased the potential liability of commercial firms for the environmental consequences of their corporate activities.[8]

Second, lenders are concerned about incurring direct environ-

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[6] *See* Barnaby J. Feder, *New Policy on Pollution*, N.Y. TIMES, June 9, 1991, at F7; Ron Suskind, *Fleet Financial to Broaden Requirement of Environmental Liability Insurance*, WALL ST. J., June 24, 1992, at A2; Rodd Zolkos, *Lending Banks a Hand on Superfund*, BUS. INS., Oct. 2, 1995, at 17.

[7] *See* Feder, *supra* note 6, at F7; Suskind, *supra* note 6, at A12; Zolkos, *supra* note 6, at 17.

[8] Risk management expert H. Felix Kloman identifies environmental liability as the "risk of the decade" for corporate risk managers. H. Felix Kloman, *Issues for 1995*, RISK MGMT. REP., Jan. 1995, at 1, 4.

mental liability when exercising operational control over an impaired collateral asset, should they have to foreclose.[9] In the United States, this concern is a direct result of federal Superfund legislation,[10] as well as its state and local counterparts. This legislation addresses responsibility for prior environmental contamination. Superfund, and its associated judicial interpretations, make an owner of real property responsible for all costs incurred in remediating environmental contamination arising from prior activities.[11] A current owner is responsible for the environmental legacy of a property, even if the owner is new and has had no prior relationship to the property.[12] Often, the costs of resolving old contamination on property can be substantial[13] and can even exceed the value of the property itself.

3. STRATEGIES USED TO ENSURE ENVIRONMENTAL COMPLIANCE

Lenders employ three strategies to minimize these liability concerns when lending to borrowers with projects secured by real property: 1) preliminary evaluation of environmental impact, including review of past, present, and future environmental conditions; 2) initial assessment of compliance of the project with appropriate government standards of environmental behavior; and 3) ongoing monitoring of borrower behavior to assure continued compliance with acceptable standards of conduct.[14]

With regard to the first strategy, the lender must determine the known environmental issues associated with a project, and study the expected environmental impacts of the project. For example, lenders for large new projects often require environmental impact assessments to be performed and approved before

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[9] *See* Feder, *supra* note 6, at F7; Hector, *supra* note 4, at 108; Suskind, *supra* note 6; Zolkos, *supra* note 6, at 17.

[10] Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. §§ 9601-9675 (1994) (also known as "Superfund").

[11] *See* LLOYD S. DIXON, FIXING SUPERFUND: THE EFFECT OF THE PROPOSED SUPERFUND REFORM ACT OF 1994 ON TRANSACTION COSTS 3 (1994).

[12] *See id.*

[13] *See* LLOYD S. DIXON ET AL., PRIVATE SECTOR CLEANUP EXPENDITURES AND TRANSACTION COSTS AT 18 SUPERFUND SITES 20-25 (1993).

[14] *See* Jill A. Kotvis, *Lender Liability Issues*, *in* ENVIRONMENTAL ASPECTS OF REAL ESTATE TRANSACTIONS 80, 97-108 (James B. Witkin ed., 1995).

projects begin.[15] These assessments are designed to identify the impacts of projects upon specific protected groups, including endangered species, wetlands, and culturally significant lands. The assessment may also uncover prior contamination or environmental impairment affecting a project property's initial condition.[16]

In implementing the second strategy, the lender requires that the borrower obtain all appropriate permits or performs appropriate procedures necessary to assure initial compliance with the applicable environmental standards for the project. The environmental standards required of the borrower usually mirror well understood governmental policies and procedures. Useful benchmarks may include: permits for release of hazardous materials,[17] instructions regarding the installation of specified pollution control devices,[18] and reporting protocols that identify materials stored at a facility.[19] In the absence of such well-defined regulations and procedures, the standards may be laid out by the lender itself, on the basis of specifications established by environmental groups, donor nations, and other international agencies.[20]

The third strategy involves the lending institution focusing on contractual obligations within the loan documents. Lenders will incorporate environmental issues as part of the contractual obligations.[21] Generally, these concerns are addressed in the representations and warranties made by the borrower to the lender, the violation of which constitutes a default under the loan agreement.[22] For example, the lender will usually have the

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[15] *See, e.g.*, WORLD BANK, THE WORLD BANK OPERATIONAL MANUAL, OPERATIONAL DIRECTIVE NO. 4.01, ENVIRONMENTAL ASSESSMENT 17 (1991).

[16] *See, e.g.*, AMERICAN SOCIETY FOR TESTING AND MATERIALS (ASTM), STANDARD PRACTICE NO. E1528-93, ENVIRONMENTAL SITE ASSESSMENT TRANSACTION SCREEN PROCESS (1996).

[17] *See* Resource Conservation and Recovery Act (RCRA), 42 U.S.C. §§ 6901-6992k (1994).

[18] *See* Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. §§ 9601-9675 (1994) (also known as "Superfund").

[19] *See* Emergency Planning and Community Right-To-Know Act (EPCRA), 42 U.S.C. §§ 11001-11050 (1994).

[20] *See* Bowles & Kormos, *supra* note 3, at 782-83.

[21] *See* Kotvis, *supra* note 14, at 97-108.

[22] *See id.* at 105-06. For excellent examples of such representations and warranties in an environmental context, see Gail V. Karlsson, *The Impact of*

borrower represent that the project will be operated in compliance with current environmental standards and warrant that all actions required to remain in compliance with environmental standards will be undertaken by the borrower.[23] The borrower may also be required to indemnify the lender for any consequences related to the borrower's failure to comply with the environmental representations and warranties.[24]

4. THE ROLE OF ENVIRONMENTAL INSURANCE IN CURRENT LENDING

Increasingly, lenders rely upon third party mechanisms to assist them in implementing these strategies. Some of these mechanisms, such as environmental impact statements and environmental audits, have been used with varying degrees of success.[25] Environmental insurance has been increasingly used in this capacity as well.[26] Of the available options, however, insurance has two distinct advantages for lenders. First, insurance performs the dual role of both identifying and assuming risk. While an environmental impact statement or audit can identify a potential risk, insurance can assume that risk based on specific contractual provisions. Second, insurance provides continual evaluation of an insured's activity by the insurance company. By insisting that a risk be insured, a lender requires its borrower to be subject to the review and monitoring requirements of the insurance carrier. Since the insurance company assumes risk with respect to the insured's activities, the willingness of the insurance company to issue coverage with respect to a defined exposure is based on its ability to underwrite the risk, which includes appropriate inspection of the operations of the insured.

In the environmental area, three types of insurance coverage have proven to be of particular benefit to lenders. First, insurance coverage exists which can fix the cost of remediating known

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Environmental Liabilities on Real Estate Contract Negotiations, 8 PACE ENVTL. L. REV. 37, 44-47 (1990).

[23] *See* Karlsson, *supra* note 22, at 44-47.

[24] *See id.*

[25] *See* Zolkos, *supra* note 6, at 17.

[26] *See* Quint, *supra* note 5, at D5. For a detailed discussion of the transfer of environmental risk through insurance, see PAUL K. FREEMAN & HOWARD KUNREUTHER, MANAGING ENVIRONMENTAL RISK THROUGH INSURANCE 75-82 (1997).

contamination.[27] With increasing frequency, a borrower will purchase a property with existing contamination, budget remediation expenses for the desired project, and still be able to turn a profit.[28] The success of such ventures, of course, relies on the accuracy with which remediation expenses can be predicted. Often, this is very uncertain. However, by purchasing this type of insurance, the borrower can effectively cap its remediation expenditures at the predicted level, thereby addressing the lender's concern that remediation cost overruns may affect the borrower's ability to repay its loans.

The second type of insurance also addresses a lender's concern over whether a borrower may repay its loans, by assuming any liability for accidental environmental contamination from present and future business operations.[29] This coverage pays for damages associated with hazardous materials emanating from a defined location and causing injury to property or people. By insisting that a borrower maintain coverage for this risk, lenders take advantage of the willingness of the insurance company to assume the risk based on the monitoring and inspection the insurance company must perform in order to define and limit the risk. The inspection process encourages the borrower to engage in loss-prevention measures, so as to minimize premium charges.

The third type of insurance can assume the liabilities associated with unknown contamination.[30] Should insured real property used as security for a project still have hidden contamination on-site, despite the best efforts of the borrower and insurer to locate it, this insurance compensates for the future consequences of this contamination should it ever be detected. This coverage addresses both the lender's concern that an unexpected risk from prior contamination may affect the borrower's ability to repay its loan and the lender's concern that it will incur unanticipated liability

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[27] This type of environmental insurance is often referred to as Stop-Loss or Cost-Cap coverage. For a more detailed description, see The Wharton Forum on Environmental Strategy, Insuring Environmental Risks 17 (1997) (on file with the *University of Pennsylvania Journal of International Economic Law*).

[28] *See* Barbara Mooney, *Firm Finds Value in Land That Has Been Contaminated*, CRAIN'S CLEV. BUS., Oct. 17, 1994, at 15, 15.

[29] This type of environmental insurance is often referred to as Post-Remediation coverage. *See* The Wharton Forum on Environmental Strategy, *supra* note 27, at 18.

[30] One such product is called Property Transfer Liability Insurance. *See id.* at 15.

should it have to foreclose on the property.

Increasingly, these insurance products have become an integral component of domestic lending in resolving environmental issues which affect their lending policy. Often insurance permits transactions to proceed which may otherwise be stalled by environmental concerns.

5. THE ROLE OF ENVIRONMENTAL INSURANCE IN MULTINATIONAL LENDING

While environmental insurance is playing an increasing role in domestic lending policy and practice, environmental insurance has almost no role in multinational lending. Multinational lending institutions have consistently expressed the same concerns regarding environmental issues and their lending practices as expressed by U.S. domestic lenders, but have not been as active in using third parties to address these concerns. Perhaps this partially explains the difficulties many multinational lenders face in enforcing environmental provisions on an international scale.[31] For this reason, the direct and indirect benefits of environmental insurance may be of even greater importance to multinational lenders.

In domestic lending, a bank may require its customers to comply with environmental policies dictated by governmental agencies.[32] It may then insist that insurance be procured to pay for violations of government standards.[33] This strategy relies to a certain extent upon existing environmental standards to determine acceptable environmental behavior.

Similarly, given international environmental standards, it is possible to use an insurance contract as a means to enforce international environmental behavior. For example, an international lending document could require that the borrower provide insurance to pay for damages resulting from releases of hazardous materials. The insurance company, as a contractual condition of issuing and renewing the policy, could require that the insured

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[31] World Bank borrowers comply with only twenty-two percent of World Bank financial covenants. *See* Daniel D. Bradlow, *International Organizations and Private Complaints: The Case of the World Bank Inspection Panel*, 34 VA. J. INT'L L. 553, 564 (1994).

[32] *See supra* Section 3.

[33] *See supra* Section 4.

adhere to safety, pollution control, equipment maintenance, worker protection, and other behaviors and procedures. The insurer would then inspect and examine its insured's operations. As with domestic lending practices, this process could conceivably create and enforce a private regulatory framework which reflects public environmental values.

The complicating issue is, of course, that no true uniform international environmental standards currently exist. This creates an intranational problem for the lender attempting to lend to borrowers outside its country of origin. To the extent that the country in which the borrower is located has a national environmental policy that is well articulated and enforced, there is less of a problem. But particularly in developing countries, where competing public policies of creating a modern infrastructure and protecting the environment may conflict, such viable public environmental policies may not exist, making it difficult for lenders and insurers to play a role in enforcing public environmental policy.

Even among nations which have viable environmental policies, there is an international problem facing the institution trying to lend to borrowers outside its country of origin. In requiring adherence to the environmental laws of another nation, the lender raises questions of international law as to whether those commitments may be viewed and enforced as "treaty" obligations.[34] Of course, that is not the proper role of lending institutions. As in the United States,[35] the answer may continue to be for lenders to rise above these intra- and international difficulties by creating a private standard which addresses public environmental concerns.

Multinational lenders may be able to partially enforce such standards, thereby accomplishing environmental compliance goals, by requiring environmental insurance on their loans. Insisting on specific coverages, the lender defines for the insurer the risks with which it is concerned. For example, a lender may insist that a borrower provide insurance to pay for damages resulting from the release of chemicals from a manufacturing facility. This request effectively defines the risk for the insurer in such a way that the insurer can then calculate which terms, conditions, requirements, and premiums would be necessary to provide the risk transfer

[34] *See* Linarelli, *supra* note 3, at 426-27.

[35] *See supra* note 2.

requested. The insurers would establish the standards of behavior to be met by potential insureds as a precondition for the provision of this insurance. Since underwriting requirements must be met before insurance coverage will be placed, these underwriting standards become an informal, but potent, tool to regulate the behavior of insureds with respect to projects funded by multinational lending institutions.

The use of insurance in international lending will require significant effort to adapt policies created for domestic markets to meet international lending needs; however, this process should be feasible. Many of the insurance companies actively involved in the environmental market in the United States are active international companies. Some are large multinational insurance and reinsurance firms. These companies understand the risks, know the risk management strategies required to control the risks, and have extensive monitoring and compliance experience. To the extent that major U.S. or European firms may be involved in supporting projects for which the multinational firms are lending, their domestic operations would have had considerable experience with the environmental insurance marketplace requirements. While insurance can be expensive, its value-added monitoring services may more than offset the costs.

6. CONCLUSION

Domestically, lenders and insurers have played a complimentary role to public actors in enforcing public environmental policy. The potential for these private actors to play a similar role on an international scale is quite promising. This is not to say that it will be easy. Such a scheme will continue to require lenders to adopt universal environmental standards as pre-conditions to lending, and will require insurers to adapt so as to be able to enforce these standards. Nevertheless, the situation certainly cannot be seen as being more complex than that faced in the United States just a few years ago, though the scope is larger. Private parties overcame the obstacles then, and can use the experience gained to do the same on a much larger scale today. It is critical that the international community use all of the weapons at its disposal to prevent the fervor for economic development from becoming an environmental threat.