



Best's Review

REDUCING ENVIRONMENTAL LIABILITY
A CLAIMS MANAGEMENT APPROACH
(CLAIMS MANAGEMENT CUTS ENVIRONMENTAL LOSS COSTS)

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The insurance industry faces up to \$35 billion in potential environmental claims over the next 10 years, according to estimates from various industry analysts. Considering the staggering potential costs associated with environmental remediation of contaminated sites, an aggressive claims management approach to controlling those costs is essential for insurers. The goal of such an approach is to control costs while maintaining compliance with federal, state and local environmental regulations and long-term relationships with insureds without interfering with the cleanup process in ways that could jeopardize policy limits and stop loss provisions. The complex technical and regulatory issues associated with environmental cleanups are forcing insurers to bring in a whole range of consultants to develop innovative remedial strategies, oversee the process of remediation and establish procedures within which the insurer can monitor the remediation process and protect its own interests.

The following case study, which employs a case management approach, is based on our work with the insurer in the case. It involves a leaking underground storage tank in Sacramento, California. The insurer is a well-known national multiline carrier.

In 1988, residents of a neighborhood across the street from a large bakery and warehouse complex detected gasoline odors in water from their domestic wells. The state of California initiated an investigation in an attempt to identify the source of the suspected petroleum contamination. Through the installation of some test wells and an historical analysis of business operations in the area, the baking company and warehouse complex were identified as the potential source of the contamination.

The facility had underground tanks for fueling its vehicle fleet and the state surmised that these tanks may have leaked and contaminated the soil and groundwater. Subsequently, it required the

bakery/warehouse owner and operator (the insured), under an administrative order, to conduct an investigation to determine whether the insured's tanks had leaked, and if so, to remediate the site.

The insured retained an environmental engineering firm to conduct the initial investigation, which determined that the tanks indeed had leaked and that the soil underneath the tanks as well as groundwater had been contaminated. The insured then notified his insurance company of a potential claim under an Environmental Impairment Liability policy – with a maximum policy limit of \$2 million – on the business' underground tanks.

After determining that coverage existed, the insurance company took no initial action, allowing the insured's consultants to continue to conduct the investigation and to design a remedial action for the site. After the initial deductible was met, the insurer paid approximately \$600,000 to the insured's consultant for investigation and capital costs associated with the implementation of a remedial system, which was designed to operate over a period of approximately 10 years – the period of time estimated to be necessary to meet soil and groundwater cleanup standards.

After about two years, the insurer determined that the remediation was not progressing as expected and that it seemed likely that the project would approach the \$2-million policy limit. At this point, the insurer retained its own environmental consulting firm to review the status of the remediation and to recommend ways to reduce operation and maintenance costs and perhaps accelerate the process, with the objective of limiting the loss to the insurance company.

After a detailed analysis of the existing site data and some limited additional field investigations, the consultants determined that contamination from an adjacent site was contributing to the problem. In fact, it appeared that the present remediation system actually might be drawing off-site contamination onto the insured's site. At the time, the insured was not motivated to conduct additional investigations since the owner and operator felt he had the situation under control and was well within his \$2 million policy limit. Clearly, in this situation, the interests of the insured and the insurer diverged at this point. The insurer did have an ongoing interest in controlling – and reducing – the total cost of remediation on the site, since it was obligated to pay up to the \$2 million policy limit.

Following investigations by the insurer's consultant, the remediation system was modified by replacing and moving the groundwater extraction wells and identifying the source of contamination on the adjacent property. At that point, the insurer's technical representative became directly involved with the insured's contractor and the appropriate regulatory agencies to limit the scope of the remediation activities so the insured's site-related problems would be remediated but the adjacent site's contamination problems would be shifted to those responsible for that site. In addition, the insurer's consultant successfully negotiated with the state of California and local regulatory agencies for new cleanup standards that protected human health and the environment, yet resulted in a significant decrease in the ultimate cost of the remediation.

As a result of the activities of the insurer's consultant, which cost the insurer approximately \$150,000, the ultimate remediation costs – originally estimated to be about \$1.8 million, including the capital and operations maintenance costs – were reduced by 30%. The total cost to the

insurance company was just over \$1.3 million, which included all of the costs incurred by the insurer's consultants. In addition, the site currently is in the process of being closed and it is anticipated that the remediation will be completed this year, as four years earlier than the original target for completion. The total savings to the insurance company was \$500,000.

This case represents one example of how a claims management approach can significantly reduce the ultimate cost of environmental claims to insurers. Since most massive environmental cleanups are measured in tens of millions of dollars, these potential savings are significant. In fact, in this case if a claims management approach had been in place from the start the life-cycle remediation costs may have been reduced by up to 50%.

APPROACH OVERVIEW

Following the passage of a constellation of environmental statutes, numerous multiparty, complex environmental cases involving contamination of air, land and/or water have been moving through the court systems. Since the goal of the environmental laws is to identify the parties responsible for the damage and force them to clean it up, every company even remotely connected to an identified environmental site rushed to locate any and all current insurance policies they had at present or during the past 40 years, based on the retroactive nature of the laws. Considerable litigation followed as all the parties scrambled to figure out who was going to get stuck with the bill.

While different courts on both the state and federal levels have yielded inconsistent results, as a general statement, the insurance industry has been caught in the legal net. As evidenced by the dramatic reserves taken by insurers in this area in 1995, the insurance industry is steeling itself for heavy losses.

In addition to establishing which parties are responsible for the damage, these environmental cases have addressed insurance coverage issues under both the commercial general liability policies and environmental impairment liability policies held by those parties identified as responsible under the law. What is atypical about the environmental statutes is that, among other things, some apply retroactively and impose "joint and several" liability (that is, the Comprehensive Environmental Response Compensation and Liability, commonly referred to as Superfund). Retroactivity means the laws apply to lawful-at-the-time actions taken in the past that have resulted in contamination in the present. Joint and several liability means that if 100 parties are determined to have contributed hazardous or toxic waste to a dump site, *each* of those parties is potentially liable for the cleanup of the entire site. Clearly, the goal of the Superfund regulations is to get someone to clean up the contaminated sites. As stated, these statutes cast a wide net in which the insurance industry often is caught.

As a result, it is critical for insurance companies to utilize all possible means to control the costs associated with their established liability under the various policies issued over the past 40 years. This need, combined with the evolving complexity of technical and regulatory issues associated with the environmental cleanups, requires insurers to take a careful look at how they can control costs without jeopardizing policy limits and stop loss provisions.

Most insurance companies do not want to assume direct responsibility for managing environmental cleanup projects for which they have established coverage. However, at the same time, they need sufficient oversight involvement to substantiate and, more importantly, to control costs incurred by the insured in implementing covered remediations. A tested and successful claims management approach for major liability and property insurance companies dealing with environmental claims involves both in-house and outside resources and consists of five key elements, shown in Figure 1.

The process integrates the insurer into the planning and decision-making process through an auditing-not-management role and identifies key points where insurer approval is required before the insured moves to the next major cost phase. This level of involvement increases the insurer's control of expenditures and reduces its total exposure, while avoiding direct management of the environmental cleanup actions.

STEP 1: TECHNICAL CONFIRMATION OF RESPONSIBILITY OF INSURER

When a claim has been made against policies dating as far back as the 1950s, insurers first must determine that the claim is valid in terms of the technical positions presented by the insured, such as the type and timing of an alleged release. CERCLA, or Superfund, is effective retroactively and imposes strict liability as well as "joint and several liability." These legal concepts constitute a wide net for identifying the parties responsible for environmental degradation.

Those parties constitute the policyholders seeking compensation from their insurers for complex environmental cleanups. The insured's operations and the potentially hazardous substances they generated – alleged to be responsible for the environmental damage – must be thoroughly examined. Technical information useful in this analysis includes aerial photographs of the site, flow diagrams of the engineering process, industrial site plans and adjacent and subsequent land-use data. If site-specific data are incomplete, process flow diagrams can be generated from knowledge of comparable business operations. This data must be assembled to determine whether the historic practices of the insured generated Superfund-regulated wastes or effluents, and if so, their nature, volume, disposition, fate and role in driving the technical basis for the claim.

Similarly, toxic torts or claims of bodily injury by citizens living or working on-site must be evaluated in terms of valid coverage from a technical perspective. Data on the toxicity and mobility of the substances used by the insured are assembled and screening risk assessments is performed to determine if a probable worst-case scenario indeed results in potential insurer exposure.

In many cases, technical and regulatory documents can be prepared to document the determination of "no coverage" based on the fact that environmental liabilities resulting in government agency actions or orders for remediation were not attributed to the insured. In those cases where it can be demonstrated that the insured is not responsible, subsequent steps can be avoided and the case closed. Negotiations with "potentially responsible parties" and regulatory agencies may be necessary before the case can be closed and the insurer excluded from further participation.

STEP 2: DETERMINING THE MAGNITUDE OF INSURER'S EXPOSURE

Once coverage under the insured's policy is determined or unsuccessfully litigated, the next major task for the insurer is to evaluate whether there is sufficient technical information available to determine the magnitude of the insurer's exposure resulting from the insured's operations, and if not, to structure the assembly of additional data so the liability can be quantitatively defined.

While assembly of this data is the responsibility of the insured, it may necessitate site characterization activities, the cost and focus of which should be controlled by the insurer with an audit of the technical work plan, competitive bid process and field implementation activities and costs. For this task, efforts should be made to require the insured to examine life-cycle costs and regulatory options for limiting remediation costs. Should the liability of the insurer be relatively small with respect to total remediation costs, or if the overall exposure is small, a *de minimis* settlement with the insured should be pursued at this step to close the claim.

STEP 3: EVALUATING REGULATORY AND TECHNICAL ALTERNATIVES

Upon completion of the data assembly task, the "alternatives evaluation phase" is designed for flexibility so that a response or remediation strategy is developed that is most responsive to the obligations of the insurer. The screening and selection of a remedial strategy for any specific site requires an evaluation of environmental management strategies, taking into consideration the overall costs to the insurer and the maintenance and/or enhancement of the proposed or existing land use. A key feature in this phase is to require that the insured adopt an open-minded approach when gathering information on life-cycle costs relative to various applicable cleanup or regulatory compliance strategies.

Following the gathering of data on the range of possible technologies or solutions available, a screening process must be undertaken by the insured to determine candidate processes, optimal technologies or strategies for further study. Review of the screening process and participation by the insurer's technical representatives will ensure integration of the insurer's program objectives. The screening evaluation covers a broad set of economic, scientific, operational, regulatory, political and stake-holder acceptance factors.

STEP 4: PREFERRED OPTION SELECTION/IMPLEMENTATION

The options filtered out of the screening process should be subjected by the insurer to a rigorous life-cycle analysis that encompasses such factors as technical feasibility, including systems engineering and preliminary design; capital, operation and maintenance costs; and safety/risk management. Under some tasks, additional field data, including treatability studies, may be warranted to adequately address site-specific issues before the selection of an optimal remedial strategy. If additional field investigations must be conducted, competitive not-to-exceed cost estimates should be required from the insured and field activities should be audited to require optimization of resources allocated to this step.

A preferred strategy for cleaning up or closing out a site will be selected upon completion of an analysis of the alternatives, and, if necessary, a final cleanup design and cost estimate will be prepared for review and approval by the insurer.

STEP 5: INSURANCE CLAIM/CASE CLOSURE

Since cleanup actions require many years for completion, a concerted effort must be made by the insurer's technical representatives to evaluate the effectiveness of the remediation system as designed or to decide whether it needs enhancement or is achieving its objective. The goal of this phase is to pursue site closure as soon as practicable by augmenting the remediation system when warranted and negotiating more reasonable cleanup standards if the regulatory climate or physical environment changes. Routine reporting by the insured must include trends analyses to predict the closure schedule. Firm fixed-price remediations are negotiable and an incentive program could be developed to provide financial awards to the remediation firm on contract to bring the site to closure before schedule and under budget.

ENSURING SUCCESS

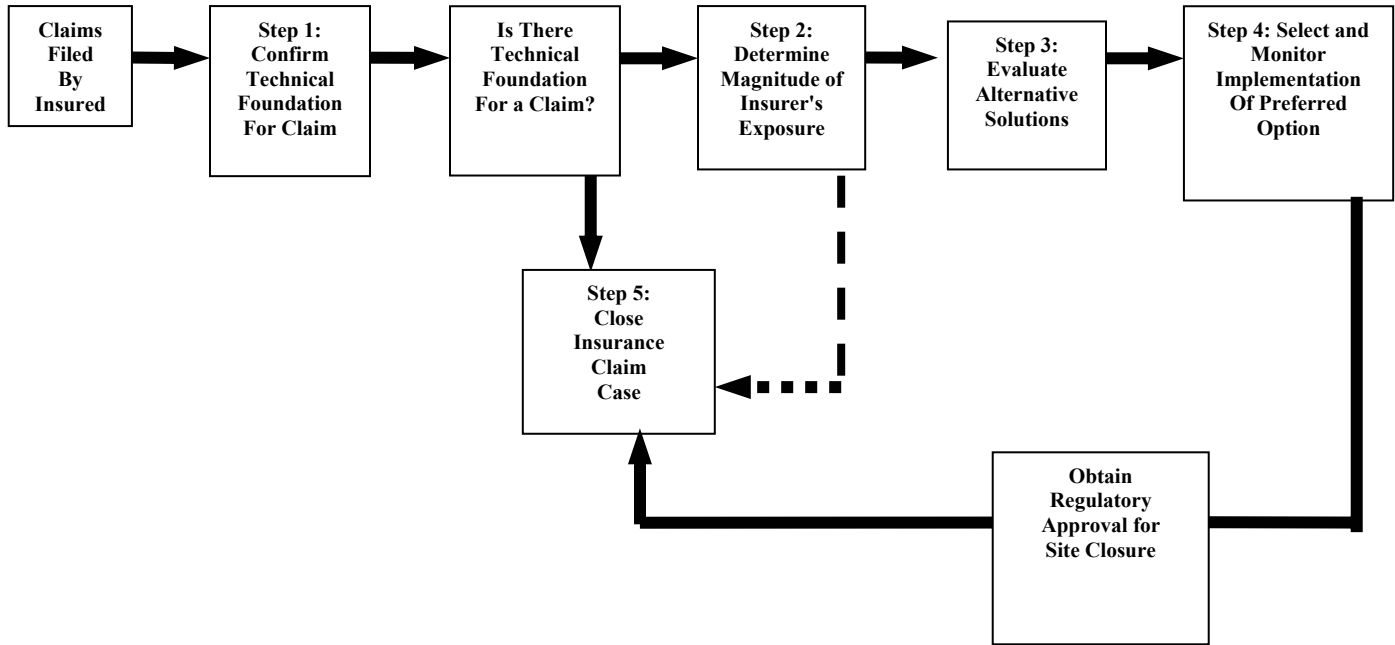
This five-step process works best when supplemented by program support designed to assist insurers in training and educating their employees and facilitating access to outside technical resources. By providing training and education, some claims management tasks described above can be effectively conducted in-house, except for particularly large or difficult claims or classes of claims. Program support, which can be obtained from a handful of environmental consulting firms experienced with these types of programs, can involve a number of services, including preparing guidelines for conducting cost-effective investigations and remediations; conducting comprehensive and refresher training in technical issues critical to claims management; and developing litigation or settlement papers and providing expert testimony as appropriate. This program works best when insurers have a small in-house staff that specializes in claims management for environmental projects and works closely with outside technical specialists.

An important aspect of any successful program is to have an in-house team of claims management specialists and adjusters trained in this specific area to serve as the focal point for the required technical and regulatory services that can most cost-effectively be outsourced. Effective training sessions for adjusters should be developed in partnership with the subject matter experts and representative of the insurance company. A partnership created through this type of a structure allows various discussion topics to be moderated and fosters an ownership of the program on the part of the insurer's representatives. Workout sessions are advantageous, because they allow participants to focus on particular issues and obtain ideas for resolution of more complex cases.

The ultimate goal of the program is to avoid unnecessary costly regulatory enforcement, litigation and cleanup situations. Even after coverage issues are resolved, many cleanup actions and involved parties, including insurance companies, end up in court. In these cases, it is particularly important to involve technical environmental experts who are skilled in cleanup cost allocation support, expert witness testimony and site-specific issues involved in determining sources of contamination. In some cases, technical support is needed to negotiate creative solutions to

environmental cleanup problems with regulators and to reduce the ultimate life-cycle costs that will have to be paid by an insurer under a covered claim.

If an insurer can develop a system of compensation for its technical consultant that provides incentives based on total costs saved, it can be a win-win solution for the insurer and the environmental consulting firm. Experience with implementation of a claims management program has demonstrated that it is an effective mechanism by which to control and reduce the actual costs of covered environmental claims by an average of 15% to 35%.



INVESTIGATIONS AND REMEDIATIONS GUIDELINES

One important component of a successful program includes having guidelines which have been professionally prepared for the insurer to critically evaluate the cost implications of the remedial strategies proposed by the insured or its consultants. The guidelines should be tailored to the particular insurer's portfolio. Topics addressed may include:

- Data gathering, manipulation, and analysis and information processing for preparing actuarial analyses and for preparing technical documents
- Assembly of a complete administrative record to comply with all applicable regulatory requirements
- Formatting technical reports to maximize utility in cost containment

- **Selection of an environmental laboratory, analytical method and computerized data presentation format**
- **Development and implementation of quality assurance/quality control programs**
- **Effective use of subcontractors and strategies to obtain volume pricing**
- **Use of multimedia sampling**
- **Use of screening technologies for delineation of soil and groundwater contamination**
- **Use of nonpermanent groundwater sampling techniques**
- **Minimization of wastes generated during investigation tasks**
- **Strategies for negotiating cleanup standards**
- **Strategies for negotiating remediations under the most aggressive regulatory framework**
- **Facilitating transfer of effective remediation technologies/Environmental management strategies between sites**
- **Management of natural resource damage claims and toxic tort claims**

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