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Fixed-Price Cleanups: Using Captives and Other Cost Cap Alternatives

Lessons From Accomplished FPCs, When and Why to Use CCAs, and the Mechanics of Using a CCA

TUESDAY, JANUARY 11, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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FIXED PRICE CLEANUPS:
USING CAPTIVES AND OTHER COST CAP ALTERNATIVES

From the Perspective of Parties Involved in Real Estate Transactions

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NEED FOR FIXED PRICE CLEANUPS IN REAL ESTATE TRANSACTIONS

Try to Ensure Selling Client Realizes the Benefit of the Real Estate Sale

- Attempt to Preserve Deal Profit Where Seller Has Post-Closing Remedial Obligation

Where Buyer/Developer Accepts Obligation to Perform Post-Closing Cleanup

- Attempt to Cap Upside Remedial Costs

Sometimes used to convince Lender to provide Funding for Purchase Price.

UNIVERSE OF ENVIRONMENTAL RISKS IN REAL ESTATE TRANSACTIONS

1. Cost to Remediate Known Contamination – Only Risk Not Routinely Covered by Pollution Legal Liability Policy. How much? Whose money?
    a. Cost Cap Coverage – Unavailable or Impractical
    b. Use Fixed Price Cleanups

2. Cost to Remediate New Discoveries of Pre-Existing Contamination
    a. Reopeners of Supposedly Finished Cleanups

3. Cost to Remediate New Conditions
    a. Avoid Disputes Over Whether It's Pre-Existing or New

4. Third Party Lawsuits for Property Damage and Bodily Injury
    a. Natural Resource Damages

5. Business Interruption Losses of Landlord & Tenant Caused by Contamination or Its Remediation

6. Off-Site Liability Arising from Transport or Disposal of Contaminated Media

COST CAP COVERAGE IS AVAILABLE (OR IS IT?)

1. High Priced Premiums – 15% of Liability Limit

2. Insurance Company Appetite for Cleanups Above $5 Million (e.g. - Minimum Premium $750,000)

3. Insured is Remediation Contractor, not Owner
   a. Contractor on the hook (e.g. – 100% of initial cost overrun layer, co-insurance above that)

4. Short Terms – not 10 years, more 5 years or less.

5. Approved Cleanup Plans

6. Scope Limits
   a. No off-site migration, preference for on-site contamination.
   b. Dig & haul preferred over groundwater remediation (despite historical losses).
   c. No dioxane or perfluoroalkyl substances (PFAs).

ALTERNATIVES TO COST CAP COVERAGE

1. Fixed Price Contract Contractor.

   a. Some Contractors assume uncapped risk. Financial ability of Contractor?

   b. Generally capped at some agreed upon amount above fixed price, such as a deductible and co-pay above the fixed price. (E.g.- Fixed price of $10 million). Cost in excess of $10 million the contractor pays a deductible of 20% of the fixed price (i.e.- $2 million), and a percentage of the costs (e.g.- 15%) in excess of the deductible up to an agreed-upon cap (e.g.- $20 million). Contractor paid $10 million, with risk of having to pay $3.2 million.

   c. Balance of the cost overruns previously covered by cost cap coverage may now be covered by cost cap alternatives, if at all.

ALTERNATIVES TO COST CAP COVERAGE

2. Contractually Agreed Upon Sharing of Remedial Costs in Excess of Fixed Price without Captive Insurance.

   a. Instead of the commercial insurer providing the indemnifying funds, the funds are held in an escrow account.

   b. Who contributes money to the escrow?
      1. Remediation Contractor.
      2. Seller and its insurers.
      3. Buyer.
      4. Potentially responsible parties & their insurers.
      5. Governmental entities that may benefit from the site remediation (e.g. – Brownfields Funds).

ALTERNATIVES TO COST CAP COVERAGE

3. Captive Insurance Companies.

   a. For real estate deals, cost overruns are covered using insurance provided by a captive insurance company, which can be owned by large companies or small private and public entities. Group captives and risk retention groups could also be formed to provide coverage to groups of companies or other entities facing risks, such as cleanup cost overruns, for which commercial insurance is difficult to obtain.

   b. Advantages over commercial insurance: tailored coverage, longer terms, higher limits, lower premiums, more efficient claims processing, direct access to reinsurance and tax advantages.

   c. Requires governmental approval.

ALTERNATIVES TO COST CAP COVERAGE

4. Environmental Liability Buyouts.

   a. A third party contractually assumes the ownership of the known environmental conditions. In exchange for a cash payment to the third party, it assumes all obligations for remediation and liability associated with known conditions.

   b. The third party undertakes all required remediation; negotiates with the regulatory agency overseeing the remediation; and provides the seller with an indemnity.

   c. This allows the seller to remove the liability from its balance sheet, transfers the stigma of the contaminated property to a third party with experience resolving those issues and relieves the seller's management and board of directors from having to deal with the issue.

   d. Third party may be required to purchase insurance, but clearly the financial creditworthiness of the buyer is a critical consideration for the seller. Federal and state law will require the seller to finish the cleanup if the buyer is financially unable to do so.

An Overview of Fixed Price Remediation Contracts

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What Does The Term “Fixed Price Contract” Mean?

- In simplest form, it is an agreement to perform an agreed to service for a set price, as distinguished from traditional time and materials agreement.
  - Example: Contractor will excavate and dispose of x soil or will install y groundwater treatment system for fixed price. Contractor takes risk that completion of agreed to service is more complicated or costly than anticipated.
- But there can be many variations on the concept of fixed price
  - Contractor not only performs work but also handles regulatory and community relations responsibilities
  - Hybrid where fixed price applies up to defined trigger and then customer contributes additional funds at discounted rate
  - Partial or full liability transfer—contractual assumption of liability by contractor

Why Do A Fixed Price Contract?

- Control cost uncertainties for a price
- Tool for allocating responsibilities and risks in a transaction or settlement
  - Example: Property has environmental impact with well-understood remediation requirement. Neither seller nor buyer desires to take risk of cost overruns. Parties negotiate funding of fixed price contract.
- Mechanism for multi-party PRP group cabining financial uncertainty
  - Example: Consent order requires implementation of a cap. Group members want to know that they will not be asked for further contributions once they contribute to the remedy cost.
- Portfolio and balance sheet management (often involves more sophisticated versions of fixed price contracts)
  - Example: Company lacks full-time remediation department and seeks turn-key solution.
  - Example: Corporate remediation department with large portfolio of legacy liabilities. Seeks a contractor to manage portfolio and to limit its day-to-day management involvement.

Contract Underwriting

- Few firms offer guaranteed fixed price remediation contracts
- What's needed for a viable project
  - Clear redevelopment plan and timeline
  - Complete remedial investigation
  - Escrow or source of funds from client
  - Pollution legal liability policy for unknowns, reopenors and offsite disposal liability (common exclusions)
  - Understanding of emerging contaminants and regulatory changes

Considerations When Negotiating Fixed Price Contract

- Does the contractor have sufficient assets to back the price risk they are assuming?
  - Is the contracting party a credit-worthy parent company or a special purpose entity with limited assets?
  - What other risks has the contractor taken on that could consume its assets?

- Tools for backstopping creditworthiness of contractor in the absence of cost-cap insurance?
  - Parent-level guarantee
  - Escrowing funds to be released as milestones are completed
  - Performance bonds

Considerations When Negotiating Fixed Price Contract (cont’d)

- What level of certainty is needed regarding the remedy?
  - The more certainty, the lower the cost premium
  - However, uncertainty can often be addressed through price
- Clearly defining what is included and excluded
  - Striking the right balance between increased coverage and increased contract price
    - Example: Whether to include low probability but high-cost risk
- Who bears the risk for:
  - Obtaining access
  - Obtaining deed restrictions
  - Unknowns encountered during remedy performance
  - Regulatory changes
  - Regulatory or other delay

Types of Exclusions

- Third party claims – natural resource damages
- Government Fees & fines
- Contamination migrating onto the site
- Post NFA obligations
- Additional Redevelopment Costs

Considerations When Negotiating Fixed Price Contracts (cont’d)

- Who is responsible when things go wrong?
    - Injury or property damage
    - Environmental release
    - Fines or penalties
- Role of indemnities and insurance
- Whether regulator concurrence is needed or advisable?

Considerations When Negotiating Fixed Price Contracts (cont'd)

- Reporting by contractor
- Balance between (i) client representations and warranties and (ii) contractor due diligence
- Force majeure
- Dispute resolution

Contractual Concerns

- Area of concern guarantee or site wide guarantee
- Likelihood of Assignment to unknown customer or lender
- Size and duration of remediation
- In House Negotiation of Contract
- Post remedial care obligations
- Closure goal post – remedial standards – controls allowed

Areas of push-back in contracts:

- Bonus provisions
- Holdbacks
- Milestone Payments
- Third Party Peer Review
- Assignment of Contract
- Lien Waiver Provisions
- Exclusions

What it is not?

- Not an environmental liability transfer
  - Environmental risk assumption firms (ex. Environmental Liability Transfer Inc.) provide a different service
- Not a complete walkaway
- Not a purchase of property or complete assumption of an environmental risk
- Customer may not control means, methods and timing of work

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Thank You

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