Much has changed for financial institutions since we published our May 2006 Alert examining the myriad of environmental exposures facing financial institutions as a result of their investment and lending activities. In addition to direct liabilities (e.g., as a result of the foreclosure of an environmentally distressed property), financial institutions face a variety of contingent environmental liabilities: those associated with equity positions, joint venture initiatives and subsidiary operations. In certain situations, especially in the event of a major loss, these liabilities are increasingly extending upward and threatening to pierce the corporate veil.

In the past, the corporate veil – the distance between the parent corporation and the operations of subsidiaries – was considered by many to be effective protection against liability under environmental laws such as the U.S. Superfund legislation, also known as CERCLA. However, court rulings have seriously eroded this protection (see the U.S. Supreme Court decision in United States vs. Bestfoods, et al) especially for those organizations that are acting as good corporate citizens by setting environmental policy or “green” standards for their subsidiaries or portfolio investments. Ironically, these forward-thinking companies may have opened themselves to new liabilities they may not otherwise have faced.

Previously, many courts would not attach derivative CERCLA liability to the parent unless pervasive parental corporation control over all of subsidiary’s business operations could be shown, and usually with fraudulent intent (which can be very difficult to prove). Now, however, CERCLA operator liability can apply to a parent corporation if it plays some role in the planning or management of environmental operations at the polluting facility or subsidiary. Hence the bar is substantially lower.

If a financial institution or even an individual executive promulgates environmental policies or guidance to subsidiaries or portfolio investment companies, there is risk that the parent could be exposed to operator liability under CERCLA and therefore found directly, strictly and severally liable for cleanup or damages associated with relevant polluting facilities.

New insurance products designed especially for financial institutions can provide parent companies and their directors and officers with blanket coverage for any environmental liabilities, including CERCLA operator liability. The coverage extends to all locations and operations. By focusing on the insured’s corporate structure and investment strategies, the underwriting burden is dramatically reduced.

We have updated our previous Alert to include details of these new developments. Please contact me, Mike Balmer of our Environmental Practice, or your local Willis Client Advocate® with any questions about these important issues.

John Bayeux
Financial Institution Practice Leader
ENVIRONMENTAL INSURANCE AND FINANCIAL INSTITUTIONS

The success of any financial institution (FI) is contingent, in large part, on the effective management of risk. Pollution-related exposures – often significant and just as often under-managed – can impact the financial strength of a firm, the returns generated by lending and investment activities and the quality of services provided to clients. Insurance-based solutions are a critical part of an overall strategy to manage these risks.

MULTIPLE EXPOSURES

Pollution-related exposures impact financial institutions in a variety of ways.

<table>
<thead>
<tr>
<th>EXPOSURE</th>
<th>CONSEQUENCE</th>
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<tbody>
<tr>
<td>Equity Investment Activities</td>
<td>Potential exposures from investments will depend on the investment strategy, the approach taken in regard to due diligence and contractual arrangements.</td>
</tr>
<tr>
<td>Investment Banking and Transactional Services</td>
<td>Contamination problems can create a variety of obstacles to any transaction involving the purchase or sale of properties and businesses.</td>
</tr>
<tr>
<td>Existing Loan Portfolios</td>
<td>Problems with loan portfolios can materialize in two ways: 1) when environmental problems cause borrowers to default on their loans and 2) when a borrower defaults for another reason and the lender forecloses on an environmentally distressed property.</td>
</tr>
<tr>
<td>Ownership and Occupation of Real Estate</td>
<td>A financial institution's portfolio of owned real estate used for retail branches or administration can present potentially significant environmental exposures. Liabilities may also exist due to legacy contamination problems from past industrial use of a property.</td>
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</table>
WEAKNESS OF TRADITIONAL RISK CONTROLS

Many established methods used by financial institutions to prevent or contain Environmental risks have fundamental deficiencies and offer incomplete solutions.

Over-reliance on due diligence. Some real estate asset or loan managers rely exclusively on environmental due diligence efforts to screen out pollution problems from their portfolios. This is only partially effective because of the unavoidable errors associated with preparing due diligence reports and the potential severity of even a single loss event within a portfolio.

Incremental spending approaches. Known contamination problems are often addressed through a seemingly endless series of investigations and corrective measures that do not take advantage of performance-based contracts or insurance. Instead, they are performed by contractors who assume no risk and have no incentive to expedite final resolution.

Transaction complications. Several non-insurance approaches are commonly employed to enable a property sale or M&A transaction. Even if they succeed, these approaches can negatively impact the long-term success of the transaction and may leave unwanted assets – and their accompanying liabilities – lingering on balance sheets.

EFFECTIVE RISK MANAGEMENT SOLUTIONS

Environmental insurance is routinely used by financial institutions, in conjunction with other risk management techniques, to manage their exposure to environmental liabilities. Programs can be used to:

• Provide coverage for exposures from owned properties
• Protect specific equity investments from pollution-related losses
• Protect against loan defaults caused by pollution problems
• Facilitate mergers & acquisitions (M&A), investment banking or real estate transactions

Such programs are often designed to enhance the value of individual enterprises and ensure a clean exit for the investors and/or lenders.

Recent product innovations can also provide parent companies and their directors and officers with blanket coverage against all contingent and direct environmental liabilities associated with their activities. Some of the new flexible products available in the marketplace do not require the individual scheduling of locations, disposal sites, transportation exposures or contracting operations.

Coverage can be designed to transfer unknown historical contamination risks and/or insure against losses associated with future operational pollution risks – in some cases for up to 10 years. Policies can be worded so that they are fully transferable and often jointly insure various parties (e.g., acquirer and lender). They can be designed to protect the underlying venture itself or protect lenders from defaults caused by pollution events. Coverage scope can include payments for cleanup costs, bodily injury and property damage, legal defense and even business interruption. Like other pollution policies, there are many optional enhancements – such as pollution impact of terrorist acts involving nuclear, biological, chemical or radioactive (NBCR) agents.

CONTACT

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