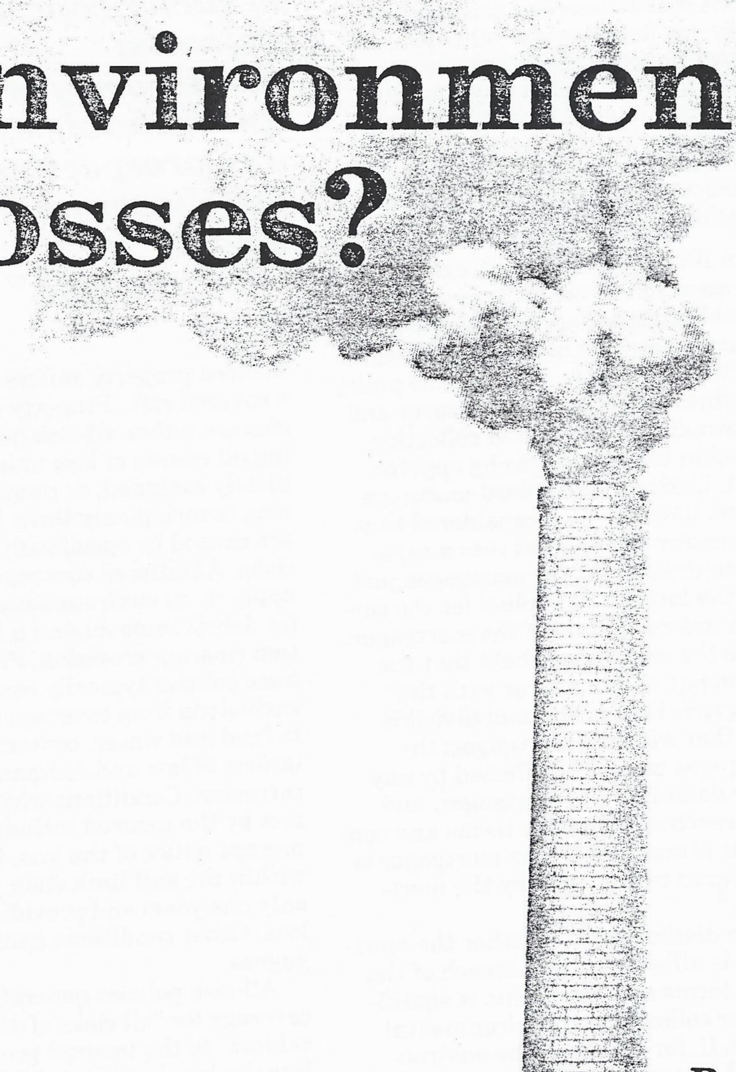
Does Your Mortgagor's Insurer Owe You Money for Environmental Losses?



By Kenneth Anspach

The banking industry has been seriously concerned regarding potential environmental liabilities since two notorious court decisions interpreted their responsibilities under the Comprehensive Environmental Response, Compensation and Liability Act.

The 1986 decision in *United States v. Maryland Bank & Trust Co.* held a lender liable for cleaning up a property on which it had foreclosed, even though the lender had not caused the pollution; the 1990 decision in *United States v. Fleet Factors Corp.* suggested a lender's mere capacity to influence a borrower's hazardous substance handling practices might be sufficient to find the lender liable for cleanup costs.

While the United States Environmental Protection Agency has attempted to assuage that concern with the promulgation of a rule on lender liability, it will undoubtedly remain, not only due to potential liability under other federal and state laws, but also because of the practical ramifications of having a loan secured by polluted property. This article will address the latter area of concern.

The bank which holds a mortgage or other secured interest on contaminated property generally holds a worthless asset. Whether or not the bank is legally liable to clean up the property, the bank has suffered a loss when its mortgagor/owner of such property defaults; the property is untouchable by any prospective purchaser and has no market value.

Besides suing the usual suspects, who are generally without assets, or writing off the loan as a business loss, does the bank have any options?

Generally speaking, if the mortgage was executed prior to 1986, and if the pollution dates from that juncture or prior thereto, the bank may be able to obtain reimbursement for its loss from the mortgagor's property and casualty insurer.[1] In other words, the bank should "dust off" its old insurance certificates, because a potentially valuable claim can be made, and the loss may be rectified.

As a Loss Payee, the Bank May Collect for Environmental Losses

For the typical commercial loan officer, loss payable certificates connote risk coverage due to the possible occurrence to the secured property of one singular event—i.e., fire loss. Indeed, the bank's status as loss payee is not considered in connection with an environmental loss. The failure to consider this subject is not surprising, given the history of loss payee clauses; the case law discussing them does so solely in reference to fire loss. Thus, the application of the loss payee clause to an environmental loss is virgin territory, both for the banker and the legal practitioner. However, certain principles which have evolved from reported decisions in both the fire loss and first party environmental property loss areas can be applied to give direction here.

A loss payable clause or certificate amounts to notice by the insurer of its recognition of the bank's interest in the insured property. There are several different types of loss payable clauses.

The open loss payable clause simply states that "loss, if any, is payable to B, as his interest shall appear." It merely identifies the person or entity who may collect the proceeds.

Another type known as the New York, standard or union form contains a similar expression, and then goes on to state that:

> [T]his insurance, as to the interest of the mortgagee only, shall not be invalidated by any act or neglect of the mortgagor or owner of the within described property, nor by any foreclosure or other proceedings or notice of sale relating to the property, nor by any change in the title or ownership of the property, nor by the occupation of the premises for purposes more hazardous than are permitted by this policy...

In Illinois, with certain exceptions, the cases have held that an open loss payable clause does not operate as a separate contract between the insurer and the mortgagee. Instead, the policy remains one between the insurer and the owner, with a right of collection vested in the mortgagee by appointment. Under the standard mortgage clause, however, it is considered that the insurer has entered into a separate contract with the mortgagee just as if the latter had applied for the coverage independently of the mortgagor. There the courts have held that the agreement of the insurer with the mortgagee is separate and divisible from that with the mortgagor; the mortgagee cannot be affected by any act or default of the mortgagor, and any breach of the policy terms and conditions committed by the mortgagor is no defense to an action by the mortgagee.[2]

The distinction of whether the mortgagee is affected by any breach of the policy terms and conditions is significant for collecting on environmental claims. If, for example, the environmental loss was not fortuitous, but was caused by the willful acts of the mortgagor, such actions could arguably be a defense to coverage of a claim presented by a mortgagee under an open loss payable provision. On the other hand, coverage would not be barred under the standard mortgage clause.

Insurance May Transform Polluted Property Into a Valuable Asset

First party property insurance protects the policyholder in the event the insured property suffers a loss due to a covered risk. Property insurance policies are either all-risk policies, covering all causes of loss unless specifically excluded, or named peril policies, covering only those losses that are caused by specifically identified risks. Additional coverages which may apply in an environmental context are for debris removal and a limited pollution cleanup provision. Property insurance policies typically contain exclusions from coverage for damage to land and water, contamination, violations of law and ordinance, and for corrosion. Conditions which must be met by the insured include giving prompt notice of the loss, filing suit within the suit limitation period (often only one year) and providing proof of loss. Other conditions apply to mortgagees.

All-risk policies generally provide coverage for "all risks of direct physical loss" to the insured property "unless the loss is excluded." Such coverage is to be compared to named peril policies, which provide insurance for certain "covered causes of loss," typically including fire, lightning, explosion, windstorm or hail, smoke, damage caused by aircraft vehicles, riot or civil commotion, vandalism, sprinkler leakage, sinkhole collapse, volcanic action, breakage of glass, falling objects, weight of snow, ice or sleet, and water damage. All-risk policies—also known as special multi-peril, all-peril and commercial

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continued

property-special form policies—may cover loss due to pollution.

For there to be a bonafide loss, property insurance requires there be a direct physical loss to covered property within the policy period. Any examination of whether an environmental loss has been suffered by a mortgagee must begin with a determination of whether there was a loss under the mortgagor's policy.

The provisions of such property policies and the judicial precedent interpreting them in this context is discussed below.

There must be a direct physical loss to covered property within the policy period.

Whether a direct physical loss has occurred was a question which arose in the context of a case involving seepage of gasoline into a church basement. The court held while "loss of use" does not, in and of itself, constitute a direct physical loss, the accumulation of gasoline in and around the church building did constitute such a loss.

Property insurance policies define covered property as the building, the business personal property and the personal property of others. Accordingly, if the building structure or the personal property contained therein become contaminated or polluted, such an occurrence may be a loss to covered property.

One issue that is the subject of dispute in policies issued prior to 1986, is whether land and groundwater constitute covered property. In that year, the standard property insurance form was amended to explicitly exclude from covered property both land and water. For policies issued prior to that date, coverage was found by the courts where the damage to the land affected the insured's ability to use its building. Damage to groundwater prior to 1986 is covered by implication.

The question of whether the pollution results from a covered cause is most frequently an issue where there are multiple causes, some of which are covered, and some of which are excluded. Thus, for example, there is a fire in a chemical plant which causes the rupture of vessels containing chemicals and results in the pollution of the premises. Fire is a covered loss and pollution is not. Is the loss in this example covered?

Some courts make a determination of which cause was the "proximate cause of loss." Other courts follow a "contributing causes" analysis which holds that if two or more causes bring about the loss, and one of those is covered, then the loss is covered.

Debris removal and limited pollution coverage may provide reimbursement for environmental losses.

Both all-risk and named peril policies provide coverage for debris removal. Debris removal is not defined in the policies. For policy language used prior to 1986, the provision was interpreted to apply to cleanup of polluted property. In 1986 the provision was revised to explicitly exclude cleanup of polluted land and water.

Limited coverage for pollution cleanup and removal was added to standard property coverage in 1986. Expenses for the extraction of pollutants from land or water, if such pollution was the result of a covered cause of loss, were added. Such coverage was limited to $10,000 per policy period, and claims for such coverage were required to be filed within 180 days of the loss or by the end of the policy period, whichever comes first.

Exclusions for contamination, corrosion and violations of law or ordinance are utilized by insurers to deny environmental claims.

Certain exclusions in first party property policies have been used to argue against coverage for environmental losses. The land and water exclusions of 1986 have already been discussed. All-risk policies also contained an exclusion for losses due to contamination. Several courts have held that this exclusion, as it existed prior to 1986, did not exclude coverage for environmental losses if the cause of such losses was a covered peril. In 1986, the provision regarding contamination was changed to the limited pollution coverage provision discussed above.

Another exclusion utilized by the insurance industry to attempt to limit pollution coverage is that for corrosion. One court found this exclusion did bar coverage for damage to the steel shell of a reactor caused by the condensation of sulfuric acid.

One provision which attempts to bar environmental property coverage is one for "loss that results from the enforcement of any ordinance or law regulating the construction, repair, or demolition" of the insured property. Cases construing this clause focus on whether the proximate or efficient cause of the loss was enforcement of a provision of an applicable building code or some covered cause, such as a fire which may have resulted in a building code violation.

Conditions may apply to claims for environmental losses, such as whether the loss occurred during the policy period, whether prompt notice of the loss was given, whether suit was brought in a timely manner, whether proof of loss was timely filed, and whether the mortgagee complied with certain specified conditions.

Certain conditions also apply to losses under first party property policies which may affect environmental claims. First of all, the loss must occur during the policy period. Often, environmental damage occurs without the knowledge of the insured, for example, in the instance of a leaking underground storage tank. The mortgagee, who is removed from the site of the property, is even in a less advantageous position to know when such a loss occurred.

Where the loss has continued over a period of years, the courts use three different approaches to determine which years' policy is triggered for the loss. Under the manifestation theory, the insurer on the risk at the time the loss is discovered is liable for the entire loss. The continuous trigger theory provides that any policy in force at the time of the initial release of hazardous substances until the date that the pollution is discovered will be triggered and required to respond. Finally, under the exposure theory, the policy in force at the time the property was exposed to the harm is the one that provides coverage.

Another condition influencing environmental claims is the requirement that notice be given the insurer promptly following any loss or damage. Moreover, suit must be brought against the insurer for failure to pay any valid claim according to the terms of the policy, usually within one or two years of the loss. Again, these provisions may be problematic where neither the insured nor the mortgagee are aware of the loss at the time it occurs, or even until after the expiration of the limitations period. In these instances the courts either hold that the limitations period begins to run from the time that the loss actually occurs or that notice must be given when the loss has become obvious from the standpoint of the reasonable person.

Finally, most property policies require submission of a signed, sworn proof of loss, containing the date and cause of loss, the interest of the insured and its mortgagee in the damaged property, other applicable policies that may cover the loss, and an inventory of the damaged property. Sworn testimony of the insured also may be taken. There is usually a deadline for submission of the proof of loss, often 60 days following notice of loss or request for proof by the insurer. If the insured fails to comply with this requirement, or if the insurer denies the insured's claim for failure to otherwise comply with the terms of the policy, the mortgagee has the right to submit the proof of loss, but there also may be a 60-day deadline following notice to the mortgagee by the insurer of the denial. Time limitations for submission of proofs are strictly construed in Illinois.

Other conditions specifically applicable to mortgagees are:

1) the mortgagee shall pay the policy premium on demand if the insured has failed to do so;

2) the mortgagee shall notify the insurer of any change of ownership or occupancy or increase of hazard known to the mortgagee, and shall pay any increased premium due to such increased hazard; and

3) in the event of payment to the mortgagee by the insurer for any loss under the policy, the insurer becomes subrogated to the rights of the mortgagee.

Due to the obligations on the mortgagee regarding increase of hazard, among other reasons, the mortgagee should, upon renewing existing loans or initiating new ones, demand warranties that no pollution hazard exists on the mortgaged property, as well as a complete environmental assessment.

Conclusion

Thus, mortgagees have rights as loss payees under first party property policies. Generally speaking, these rights are most significant for loss payee certificates on policies issued prior to 1986. Accordingly, on older, secured loans, where the bank has become aware that its collateral is contaminated, now may be time to notify the mortgagor's insurer of a loss. ❑

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This article is not to be interpreted as a substitute for an attorney's competent legal analysis and advice. A complete list of references can be obtained by calling 312-876-9900.

End Notes

[1]*Those banks which have obtained certificates as loss payees under certain specialized pollution insurance provisions made available recently by the insurance industry may also obtain reimbursement for losses on more recently issued loans. The subject of these specialized first party property pollution coverages is not addressed here. "First party property coverage" refers to coverge for potential losses on property owned or leased by the insured.*

[2] *See also ISO Form CP 00 10 (Ed. 11 85)—Commercial Property Conditions, for a different version of the standard mortgage clause, one which provides it will pay the mortgagee "as interests may appear," as provided in the open clause, but also provides that the mortgage holder will be paid if it complies with provisions regarding submission of proof of loss, even if the insurer denies coverage either because of its actions or failure to comply with the terms of the policy.*