

Insured Fixed-Price Cleanups: Still Possible Even After Commercial Insurers' 2011 Exit from the Cost Cap Market

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Until 2011, the vast majority of Fixed Price Cleanups (“FPCs”) relied on a form of environmental insurance commonly known as Cost Cap (also, Stop Loss) to protect against risks of cost overruns. By mid-2011, however, Cost Cap insurance became unavailable from commercial insurers (“Insurers”), when all four of the Insurers that offered Cost Cap exited the market.

In 2003, CWLR published an article discussing the public and private benefits of FPCs, including: (1) avoided litigation and other transactions costs; (2) expedited cleanups; (3) better assurances to the public as to cleanup quality and the availability of cleanup funds; and (4) typically lower cleanup costs.² Those benefits—as well as cleanup cost savings—have since become generally accepted, FPCs have been endorsed by EPA and State regulators and, until 2011, FPCs became relatively common.

This article discusses FPCs that have, since 2011, been accomplished using Cost Cap Alternatives (“CCAs”), with EPA and State approval even where the most rigorous regulatory review is required. It focuses on two FPCs done by the U.S. Air Force—the second just recently, in October 2015—but discusses as well variants done by private parties using what’s commonly known as Captive Insurance. After providing background on FPCs and environmental insurance, the article

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² M. Hill, *A Tale Of Two Sites: How Insured Fixed-Price Cleanups Expedite Protections, Reduce Costs, And Help The SEC, The EPA, And The Public*, 45 Chem. Waste Litig. Rptr. 907 (May 2003) (cleanup completed in 19 months, with no litigation, and at 40% below expected costs), *reprinted with permission* by the American Bar Association’s Science & Technology Newsletter (Vol. 3, No. 2, p. 17, Aug. 2003), and the National Association of Attorneys General’s National Environmental Enforcement Journal, Vol. 18, No. 8, p. 3 (Sept. 2003) (NAAG’s reprint was accompanied by a one-page confirming commentary by the Assistant Attorney General from the State of Maine who had negotiated the FPC-enabled settlement).

discusses the mechanics of a post-2011 FPC using a CCA (with and without Captive Insurance), and discusses some of the reasons why, particularly for large entities, CCA’s may in fact be preferable to Cost Caps. The article finishes by addressing some common questions and misconceptions about FPCs, including which sites are most appropriate for them.

I. The History and Recognized Benefits of FPCs

As discussed in the 2003 article cited *supra* at note 2, the first FPCs were performed in the late 1990’s and early 2000’s with the emergence of Cost Cap insurance. FPCs facilitated cleanup at hundreds of sites, from large, multi-party Superfund sites—*e.g.*, the 3,000-party Portland Bangor Waste Oil Site discussed in the 2003 article—to “brown-field” sites involving just a few parties (*e.g.*, seller, buyer, contractor);³ they carried strong financial incentives for cleanups to be done thoroughly, expeditiously, and on or under budget; and they brought assurances that sufficient cleanup funds would be available even if some of the potentially responsible parties (“PRPs”) became insolvent or otherwise dropped out prior to the cleanup’s completion. *Id.*

In 2006, a broad study of 41 FPCs done by the U.S. Army found that, with FPCs, cleanup schedules were met or beaten; that work quality was “from good to going beyond requirements;” and that, perhaps counter-intuitively, cleanup costs³ C. Olson, R. Bursek & M. Jones, *Urban Renaissance: From Brass Manufacturing to Uptown Brass Center*, A&WMA Jnl. of Envir. Mgt. 21 (Dec. 2005) (authors from BP, City of Kenosha, WI, and TRC describes cleanup of 31-acre brownfield at 50% below expected costs, with brownfield grants and Tax Incremental Financing covering half of the 50%, and cleanup completed in 18 months); M. Hill, *Insured Fixed-Price Contracts as a Means To Quantify Costs and Obtain Funds To Clean Up Contaminated Sites: The Kenosha Model*, Int’l. Risk Mgt. Institute (Apr. 2003) (describing same with emphasis on use of FPCs to quantify cleanup costs and to obtain outside funding for cleanups).

were, on average, over 20% below independent estimates made prior to the cleanup.⁴

In March 2013, EPA's Inspector General called for EPA to use FPCs more frequently for its own cleanups, noting as an example the costs of one FPC that were less than half those of a time and materials ("T&M") contract for similar work done in the same county. EPA IG, *EPA Should Increase Fixed-Price Contracting for Remedial Actions*, Rept. No. 13-P-0208, at 14 (March 28, 2013). EPA responded to its I.G. by stating that EPA will increase the use of FPCs and provide training to determine how and when FPCs are appropriate. *Id.* at 16-17.

Long before 2013, EPA had encouraged FPCs—under the name, Pay-For-Performance—in the context of Underground Storage Tanks ("USTs"), including large UST "portfolios." See EPA, *Pay for Performance (PFP) Toolbox* ("PFP contractors are using superior cleanup equipment and site management practices at many PFP sites for several reasons," "States with experience using both time-and-materials (T&M) and PFP contracting report that LUST cleanups are being done faster and cheaper at PFP sites.") (<http://archive.epa.gov/oust/pfp/web/html/toolbox1.html>).

States, too, have endorsed FPCs for appropriate sites. *E.g.*, D. Harnish, *From the State's Perspective*, National Environmental Enforcement Journal, Vol. 18, No. 8, p. 11 (Sept. 2003) ("[The FPC] approach worked well at the PBWO Site when traditional approaches failed. Certainly the [FPC] approach has the potential to reduce transaction costs and expedite cleanups at other sites throughout the country."). California's endorsement of the FPC approach for four cleanups—including two done in the post-Cost Cap era—is reflected in Sections II and III, *infra*.

⁴ USAEC, *Tracking Performance on the Army's Performance-Based Contracts*, at 4, 24, 31 (2006). While broad market data is not available due to the proprietary nature of most FPCs, the cleanups referenced in notes 2 & 3, *supra*, were also completed on or ahead of schedule, achieved full regulatory approval, and were completed significantly below expected costs. Among the reasons that cleanup costs are typically lower than initial estimates are that the remediation contractors ("Contractors") that competitively bid on projects factor in the odds of completing the cleanup well below the estimated costs. While the potential for this "windfall" profit must, of course, be balanced against the risks of cost increases, overrun risks can be rendered acceptable if they can be reduced by insurance or an insurance alternative as discussed herein.

II. The Need for Insurance for Larger FPCs, and the Evolution of its Type and Availability.

Given the risks associated with environmental cleanups, Contractors have historically been unwilling to give meaningful cost guarantees for significantly-sized cleanups (*i.e.*, those expected to cost >\$5M) unless insurance is available to reduce the risks of cost overruns and other exposures.⁵

From the late 1990's until 2011, two types of insurance were available to reduce FPC risks. The most important type—Cost Cap—protected against cost overruns encountered in the course of implementing a known or anticipated Remediation Action Plan ("RAP") designed to address cleanup requirements that were known at the time the FPC was entered. As noted, the availability of Cost Cap insurance from the commercial markets ceased in 2011.

The second type of insurance—commonly referred to as Pollution Legal Liability ("PLL")—protects against overruns from pollutants discovered during the policy's term even if the discovery occurs wholly apart from execution of the RAP. PLL also protects against toxic tort claims, risks at off-site disposal facilities, business interruption, and other risks. PLL is still available from a broad variety of highly-rated insurers, but it has proven insufficient by itself to incentivize Contractors to offer meaningful cost guarantees on larger cleanups. That said, PLL remains an important component of FPCs, and it is still used in conjunction with CCAs.

Cost Cap policies were used for over a decade and, as noted, gained favor with regulators and private parties to accomplish major cleanups. Among the cleanups requiring the greatest level of cleanup and cost certainty are those involving transfers of military bases and other federally-owned properties before the cleanup is complete. Under the Superfund (or "CERCLA") statute, such so-called "Early Transfers" of property that is on the National Priorities List requires a Finding of Suitability for Early Transfer ("FOSET") by the Governor of the

⁵ While some Contractors claimed to provide FPCs even without insurance, almost without exception those offers come with "fine print" containing numerous opportunities for change orders accompanied with cost increases if, for example, pollutants were found in greater volume or concentration. Owners also had to be wary of FPC offers from Contractors that were too poorly capitalized to offer a meaningful guarantee of the fixed price.

state in which the property is located and also by the U.S. EPA Administrator. Such approval requires a determination that the needed cleanup will in fact be performed, and without delay. 42 U.S.C. § 9620(h)(3)(C). Through mid-2011, every privatized FOSET of an NPL property relied on Cost Cap insurance to meet this highest standard for regulatory approval. The first such FOSET occurred in 2007 at the former McClellan Air Force Base just outside Sacramento, California. It involved the cleanup and transfer of 62 acres and was completed in less than 4 years ... the first ever privatized cleanup of a military Superfund site begun or completed.⁶ The Air Force obtained a second FOSET allowing a second transfer cleanup at McClellan in 2010, that time applying to 545 acres. Both of the pre-2011 McClellan FOSETs relied on Cost Cap insurance to provide the Governor and Administrator with the statutorily required assurances and otherwise to enable the transfer, cleanup and redevelopment.

III. Emerging Use of the Cost Cap Alternative to Support FPCs

With the 2011 demise of Cost Cap insurance, Owners, PRPs, prospective Developers and others (collectively, “Owners”) needed an alternative to Cost Cap if FPCs of significant size were to occur. The Air Force and other parties involved with the McClellan transfers—the County, the Buyer/Developer, and the Contractor—created a Cost Cap Alternative that provided the needed protections to allow the Air Force, in February 2013, to transfer 528 acres of contaminated property and the Buyer/Developer to begin the development of the property even while cleanup was underway. Following the success of the 2013 transfer, the same parties used the same CCA to transfer another 207 acres in October of this year.

The post-2011 CCAs needed to fully satisfy the same cost-and risk-shifting requirements for early transfers that, pre-2011, had been met by Cost Cap insurance policies. Because both did, both were approved by California’s Governor and EPA’s Administrator, allowing the transfers to take place and job creation to begin. 15,000 people already live and work within the former base, and

⁶ <http://www.mcclellanpark.com/News/Blog/PostId/15/mcclellan-business-park-completes-1st-in-the-nation-privatized-cleanup-redevelopment-at-military-superfund-site-in-sacramento>

Sacramento County estimates that, when development is complete, it will have some 35,000 jobs, generate over \$6.6M per year in local property tax and \$1.1M per year in local sales tax revenue.⁷

Models similar to what was used by the Air Force have been used by private parties as well. In at least two ways, private parties have it easier: First, CERCLA’s Section 120, 42 U.S.C. § 9620, does not apply; thus, while regulatory approval is still typically required, it need not come from the EPA Administrator or hosting Governor themselves. Second, and more significantly, private parties are more likely to have access to Captive Insurance (briefly described in Section IV.B, *infra*), through which they can create a CCA.

IV. The Mechanics of a CCA

CCAs can be customized to fit the needs of the parties involved, the nature of the transaction they are facilitating (*e.g.*, purchase or sale of contaminated property; straightforward Superfund cleanup), and other factors.

Briefly, for a fixed price, the Contractor typically agrees to assume all environmental regulatory liabilities up to an agreed cap of 200% of the agreed fixed price.⁸ For easy math, let’s assume an agreed fixed price of \$20M with a guarantee up to \$40M. If the Contractor completes the cleanup—typically defined as when regulators issue a No Further Action (“NFA”) letter—at less than \$20M, the Contractor still receives the full \$20M. A significant “carrot”. However, if the cost to obtain an NFA letter exceeds \$20M, the “stick” applies, as the Contractor must absorb whatever additional costs within the \$40M cap are not covered by insurance or an insurance alternative.

Insurance is typically triggered only after costs have exceeded the agreed price by 20%, and from there it covers only 85% of the remaining costs up to the agreed cap. Thus, in a typical FPC agreement, insurance covers only 68% of the cost overruns and the Contractor must absorb 32%. Under the above hypothetical, if the costs were to rise to

⁷ U.S. Air Force Press Release, <http://www.afcec.af.mil/news/story.asp?id=123332596> (Jan. 14, 2013).

⁸ While the 200% is most typical, a different number can be used. At McClellan, the post-2011 number was 150%. On other projects, the number has been far greater than 200% (sometimes even unlimited).

the full \$40M, insurance would cover \$13.6M of the second \$20M.

With Cost Cap insurance no longer available, FPCs require a different model. This article describes two ... those done with an alternative form of insurance (known as “Captive Insurance”) and those—such as the McClellan CCAs—that are done with a non-insurance alternative.

A. CCAs Done without Captive Insurance

For simplicity’s sake, this article first describes the mechanics of a CCA that does not use Captive Insurance but instead relies on a “policy-like” but non-insurance agreement to determine when claims should be made.

As noted above, pre-2011, parties used a combination of Cost Cap and PLL insurance to cover this 68%. With Cost Cap no longer available, the Air Force, the County, the Developer and the Contractor created a CCA that, in lieu of insurance policy text, used a Fund Processing Agreement (“FPA”) with terms purposefully similar to a Cost Cap policy text.⁹ In lieu of a commercial Insurer holding the indemnifying funds (in our hypothetical, \$13.6M), the funds are held in a Cost Overage Fund (“COF”) that is, in effect, an escrow fund. Finally, in lieu of a commercial Insurer determining when payments should be made for cost overruns, a third-party consultant or other knowledgeable but financially disinterested entity makes the determination.

B. CCAs Done with Captive Insurance

In lieu of an FPA and COF, CCAs can be supported through the use of insurance provided by Captive Insurance companies. Although still largely an emerging concept in the *environmental* field, Captive Insurance has for decades (and increasingly) been routinely used in other areas (e.g., General Liability, Workers Compensation), and wholly-owned Captive Insurers are owned by the vast majority of Fortune 500 companies and many smaller entities (private and public) as well. Though less common, Group Captives and Risk Retention

⁹ The FPA terms were made similar to Cost Cap terms in large part because the parties had—through the 2007 and 2010 FOSETs—already become familiar with Cost Cap terms. PLL coverage (described above) was provided by commercial Insurers alongside the CCAs in the post-2011 transfers just as it was provided alongside the Cost Cap policies in the two earlier FOSETs.

Groups are oftentimes formed to provide coverages to groups of companies or other entities facing risks for which commercial insurance is expensive or otherwise difficult to obtain.

Captive Insurance offers many advantages over commercial insurance, including increased ability to customize coverage to what is needed (*e.g.*, longer terms, higher limits, and with specific risks expressly covered or excluded; lower premiums; a more efficient claims process; direct access to re-insurance; and, in some cases, tax advantages).¹⁰

Risk transfer terms virtually identical to those contained in the FPA used by the Air Force could easily be fashioned into a Captive Insurance policy.¹¹

V. Advantages of CCAs Over Cost Caps

Regardless of which particular structure is used to create a CCA—an FPA and COF or other escrow; a Captive by itself; or use of a Captive in combination with a fronting commercial Insurer or a “backing” re-insurer—FPCs done with a CCA offer significant regulatory and private advantages over Cost Caps. These advantages include the following:

A. CCAs Avoid Delay, Transactions Costs, and Uncertainty With Respect to Policy or Similar Risk Transfer Terms

With Cost Cap insurance, Owners hoping to enter into an FPC for a site cleanup had to open bidding and accept contract bids before the terms or even the availability of the insurance could be known. Thus, finalizing an FPC contract typically required two full and successive rounds: the first to select the Contractor; the second to select the Insurer. Each of these two rounds typically took several months.

¹⁰ For more information (and reference materials) on Captives, see www.vermontcaptive.com (website by the State of Vermont, the U.S.’s leading Captive Insurance domicile, with over 1,000 licensed Captive Insurance companies); see also www.vcia.org (website of the Vermont Captive Industry Association).

¹¹ To obtain approval from regulators or other stakeholders who are unfamiliar with Captive Insurance, on at least one occasion a post-2011 FPC relied on commercial insurance to “front” for insurance provided by a Captive Insurer. In a nutshell, the commercial Insurer issued a policy on its own “paper”—thus providing the stakeholders with familiarity as well as an added layer of protection (akin to that of a “guarantor” of the Captive).

Even apart from the delays inherent in such a two-step process, the process imposed a great deal of unnecessary uncertainty during the Contractor selection process, resulting in higher bids. The higher bids stemmed from the fact that the Contractor could not know with any confidence the details of the coverage on which the Contractor hoped to rely to hedge its cost overrun risks.¹² With this added uncertainty, many highly-qualified Contractors simply declined to bid, and those that did bid did so not just with higher prices but also with more opportunities for “change orders” through which the price would increase the event of cost overruns. A final reason Contractors bid higher was to protect against cost increases that might occur during the typically months-long delay between the time of the Contractor bid acceptance and the commencement of the cleanup itself.

When Owners, PRPs, and others seeking FPC bids can show bidding Contractors the FPA, Captive Insurance, or other risk transfer terms as part of the bid package, the Contractors can bid without fear of unknown terms and unnecessary delay. The work can begin literally the day the Contractor’s bid is accepted, with risk transfer terms placed that read exactly as the Contractor expected them to read.

B. CCAs Can Provide Better Terms

A second significant advantage of CCAs over Cost Caps is that CCAs can offer better terms. Particularly in the last 5 years of their availability, Cost Caps were rarely offered for policy periods longer than 10 years or limits above \$25M. CCAs can extend well past those limits.

In addition, as individual contracts that are not wedded to any commercial Insurer’s “template” language, CCAs can be written more clearly, reducing transactions costs and better ensuring that all parties share the same understanding. Particularly in their later years, Cost Caps often began with template language that could be modified only through the use of endorsements attached at the end of the policy. Simply reading a Cost Cap policy often required hours of organization just to find out where to locate relevant terms. With CCAs, such

¹² Cost Cap insurance was a “surplus lines” product, and thus was not subject to regulatory oversight or uniformity in its policy language (much less in its pricing). Thus, a Contractor could not be confident as to what exclusions, conditions or other terms would apply.

“endorsement” language is simply incorporated into the contract’s text and the text can be made as simple as the participating parties would like.

C. Better Claims Process

With Cost Caps, claims made for cost overruns had to be submitted to the Insurer, which of course not only had a financial disincentive to pay but sometimes also had a remote if not difficult relationship with the insureds. While Captive Insurers also have a financial disincentive to pay, their claims personnel are typically on closer, more cordial terms with the insureds, thus facilitating the claims process. CCAs that do not use Captive Insurance—but instead uses an FPA and COF like those used post-2011 at McClellan—can use a pre-selected and mutually-acceptable third party (typically a small consulting firm with personnel having significant FPC experience) to determine the validity of a claim. Such a third-party would have no financial stake in the outcome; moreover, it would typically work closely with the Owners and the Contractors from the start of the process, thus facilitating communication in the event of a claim. For these reasons and others, the CCA claims process can operate with far less friction and cost.

VI. Common Questions or Misconceptions Regarding FPCs and CCAs

This section briefly addresses common questions and/or misconceptions regarding FPCs and also identifies sites where they are best applied.

A. What Size Cleanup Is Most Appropriate For An FPC?

The best sites are those where the expected cleanup costs are \$10M or higher. With expected costs below that, the Contractor’s opportunity for profit is not large enough to justify the risks they are taking or the transactions costs they will incur. FPCs have worked successfully for even for the largest cleanups (*e.g.*, over \$100M). Whereas, particularly from 2007 on, it was difficult to obtain commercial insurance for more than \$50M (or even \$25M), CCAs—particularly those using Captive Insurance—can be done for far more. Moreover, larger cleanups can be divided into more manageable parts (as happened at the McClellan base discussed in this article, where the cleanup was accomplished in over four parts).

B. What Other Factors Favor (or Disfavor) Use of an FPC?

Other factors that favor FPCs include a large number of PRPs or high transactions costs for other reasons (*e.g.*, litigation, or complexity in a property purchase or sale), since FPCs avoid cleanup cost uncertainties that oftentimes stand in the way of collective action or agreement.

Whereas FPCs have been accomplished at sites with *low* level radioactive waste, it is much more difficult, and high level radioactive waste sites would be virtually impossible.

FPCs are particularly well-suited for cleanups of sites with “conventional” pollution conditions (*e.g.*, volatile organic chemicals; petroleum hydrocarbons; PCBs) and where the historical handling of chemicals and/or other materials associated with pollution conditions are generally similar and, thus, somewhat known. In today’s world, examples include former auto plants, coal-fired power plants, and petroleum refineries or terminals.

It must be stressed, however, that the appropriateness of an FPC—as well as its specific mechanics and terms—must be determined on a case-by-case basis.

C. Does The Government Still Determine The Cleanup Parameters?

Yes. The government loses no rights; it still determines what the cleanup should be, and when and whether the cleanup is done. The PRPs still remain PRPs, obligated to ensure that the cleanup is completed (and remains protective of human health and the environment) just as much as they would without an FPC.¹³ As noted, the government gains a great deal as well, including avoided litigation,

¹³ To the author’s knowledge, governments have on only two cleanups given PRPs complete releases (with no chance of “re-openers”) because of an FPC, and both of those cleanups occurred in the very early days of FPCs and under circumstances that were, for reasons beyond this email, unique. See *U.S. v. Iron Mountain Mines, Inc.*, Civ. No. S-91-1167 (E.D. Calif. Dec. 8, 2000); *State of Maine v. U.S. and Settling Non-federal Defendants*, No. 00-64-B-C (D. Me. May 30, 2000). Such complete releases are unlikely to occur as a result of FPCs going forward. That said, where FPCs are done well (with Contractors strongly incentivized with significant “carrots” to keep costs below the agreed price and with significant and persistent “sticks” to keep costs from rising past the fixed price, see Section IV, *supra*), it is highly unusual for Owners to need to pay anything additional beyond the FPC cost.

greater assurance of the long-term availability of financial resources and, in rare cases, an added PRP.

D. Must the Remediation Action Plan Have Been Determined Before an FPC Can Be Entered?

Not necessarily. While the existence of a RAP will reduce a Contractor’s risk (and thus an FPC bid price), several FPCs have been successfully entered (and completed) prior to the existence of a RAP. Although rare, in some cases, the lack of a RAP has made an FPC *more* attractive to a Contractor because it presented greater opportunity for cost savings (and thus a larger “carrot”) through constructive negotiation of the cleanup.

E. Are Contractors Willing to Enter FPCs Backed by CCAs?

Yes, although relatively few know of or have significant experience with CCAs; many believe that FPCs ended with the 2011 demise of Cost Cap. One highly experienced and deeply-capitalized Contractor has already entered into three large FPCs using CCAs of at least two types (one using Captive Insurance, two using an FPA and COF). Several similarly experienced and capitalized Contractors that have historically participated in FPCs recognize that CCAs not only offer them the same protections as Cost Cap but also significant advantages. See Section V, *supra*. Owners seeking bids for FPCs today can reasonably expect sufficient Contractor interest that bids will come in at or below expected costs.

* * *

In sum, FPCs, backed by CCAs, remain possible today and offer all of the policy and private benefits that the U.S. Government, States, and private entities found derive from FPCs backed by Cost Cap insurance. In fact, for reasons summarized in the final Section, FPCs backed by CCAs are in many ways superior and can facilitate cleanups that otherwise may take years just to begin.