Using Insured Fixed-Price Cleanups to Respond to New Accounting Standards, Gain Tax Savings, and Lower Cleanup Costs While Increasing Cost Certainty

This article describes insured fixed-price cleanups, which combine guaranteed fixed-price remediation contracts and environmental insurance policies to achieve low-risk, low-cost transfers of environmental liabilities and how they can be used to respond to new and emerging accounting and disclosure requirements, achieve federal income tax savings, and lower cleanup costs while maximizing cost certainty.

231.2065 Introduction*

Recent changes in accounting standards, implemented by the Financial Accounting Standards Board (FASB) and other standard setting entities in the United States and abroad[1] are redefining the way businesses, governments, and nonprofits must account for and disclose environmental liabilities. These changes, which include "mark-to-market" requirements for environmental liabilities that will take effect in 2009, have undercut longstanding assumptions about best practices and acceptable levels of transparency. Indeed, the IRS recently identified rules governing the deductibility of environmental remediation costs as an area of high compliance risk.

As accounting standards for environmental liabilities have evolved and matured, so has the market for environmental liability transfer. The insurance and fixed-price contracting markets now are a decade old and have been used to transfer risks at hundreds of sites (with many if not most cleanups already completed). The market for these liability transfers is likely to grow further as emerging accounting requirements force fuller disclosure of corporate cleanup obligations and related contingencies. Increasing awareness of federal tax advantages and a recent study showing that fixed-price cleanups typically cost less than traditional cleanups also should increase the market.

This article focuses on the most comprehensive environmental risk transfer mechanism—insured fixed-price cleanups (IFCs).[2] Owners of contaminated property can transfer some cleanup risks using environmental insurance alone or fixed-price contracting alone. An IFC combines the two to achieve a more complete risk transfer. A properly structured IFC is based on a cleanup contract that transfers all environmental regulatory liabilities (both known and unknown) to a remediation contractor (contractor), typically a large, publicly traded company. This transfer is backed by a site-specific insurance policy (policy) covering both regulatory and nonregulatory (e.g., toxic tort) risks (again, both known and unknown).

As discussed below, IFCs are not appropriate for all sites. In some circumstances, the best practical means of transferring environmental risk relies upon insurance alone, fixed-price contracting alone, or buyer-seller indemnifications alone. These alternative approaches to managing cleanup risks are discussed briefly as well.

As set forth in more detail in the body of this article, where IFCs are appropriate, they offer the following advantages:

- ***Reduced Accounting Risks and Burdens.*** Accounting for environmental liabilities is becoming increasingly complex, burdensome, and risky. Recent accounting pronouncements that initially will take effect Dec. 15, 2008, require certain environmental liabilities to be recorded at their market value (also known as "mark to

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[1] FASB has, since 1973, been the designated organization in the private sector for establishing standards of financial accounting and reporting in the United States. Other relevant entities include the Government Accounting Standards Board (GASB), which was established in 1984 as the independent organization that establishes and improves standards of accounting and financial reporting for U.S. state and local governments; the Federal Accounting Standards Advisory Board (FASAB), created in 1990 as a federal advisory committee to develop accounting standards and principles for the United States Government; and the International Accounting Standards Board (IASB), an accounting standard-setter based in London that is committed to developing a single set of global accounting standards. Currently, the IASB is cooperating with FASB and other national accounting standard-setters to achieve convergence in accounting standards around the world.

[2] Insured fixed-price cleanups and their variants are known by other names as well, including guaranteed fixed-price remediation (GFPR), performance-based contracts (PBCs), and liability buy outs (LBOs). Because the most comprehensive transfer is one that combines insurance and fixed-price contracting, except where otherwise indicated, this article focuses on IFCs.

ISBN 1-55871-369-7

market" accounting), and proposed disclosure rules would require companies to provide detailed quantitative and qualitative information about their environmental obligations. Auditors may require outside estimates, and IFC estimates are, for reasons explained below, often both lower and more reliable than conventional estimates. Further, because the risk transfer is so complete, IFCs also provide a viable way to remove recognized environmental liabilities from the balance sheet. *See* Section 231.2065(b)(3).

- ***Tax Benefits.*** In many circumstances, IFCs can be used to achieve significant tax benefits over a pay-as-you-go cleanup and thus greatly improve the economics of a contemplated cleanup or property transfer. *See* Section 231.2065(b)(4).

- ***Maximized Cost Certainty.*** Though IFC protections are not absolute, they generally are more protective than any alternative. To the knowledge of the authors,[3] no IFC ever has resulted in the contracting owner or other interested party (owner) paying anything beyond the originally contracted for price. This record compares favorably with the high incidence of cost overruns in traditional pay-as-you-go cleanups. *See* studies discussed *infra*, at Section 231.2065(b)(1), (2).

- ***Lower Cost.*** Counter-intuitively but for reasons that both are rational and now market-tested, IFCs typically are done for a substantially (e.g., 20 percent) lower cost than traditional cleanups. The lower cost applies even after adding the cost of insurance. *See* Section 231.2065(b)(2).

- ***Optimized Residual Value of Surplus Assets.*** IFCs may increase the market value of a company's surplus assets. This is because by removing uncertainty about contingent environmental liability, the company avoids the "risk premium" discount that potential buyers often attach to indeterminate costs.

- ***Avoided Damage to "Green" Image.*** Many businesses, governments, and nonprofits invest heavily to enhance their environmental reputation. Unfavorable disclosures, let alone accounting-related enforcement actions, may damage a company's competitive position with customers, employees, suppliers, or investors. IFCs can be used to resolve environmental obligations responsibly and, in so doing, build and preserve an entity's reputation.

- ***Removed Drag on Earnings***. Finally, when an environmental liability is fully reserved on the balance sheet, ongoing remediation costs must be charged against the reserve and do not affect net income. When an environmental liability is under-reserved, however, most if not all of the ongoing remediation costs are charged against net income, thus creating a continuing drag on earnings. By eliminating future charges to earnings, IFCs can improve a company's net income and its market value.

(a) A General Description of Environmental Insurance, Fixed-Price Contracting, and Buyer-Seller Indemnities

(1) Environmental Insurance

Until the mid-1980s, standard Commercial General Liability (CGL) insurance policies provided some measure of protection against environmental risks. In 1984 and 1986, insurers added pollution exclusions to their CGL policies in reaction to liability concerns created by the Comprehensive Environmental Risk, Compensation, and Liability Act of 1980, 42 USC 9601 *et seq.*, commonly referred to as CERCLA or the superfund statute. For approximately a decade following the appearance of these pollution exclusions, and in large part because environmental risks were considered highly unpredictable, there was little or no insurance available to protect against most environmental risks. Even today, the "pollution exclusion" remains in standard CGL policies as well as director and officer (D&O) and other policies.[4]

[3] Collectively, the authors have been involved in IFCs applied at hundreds of sites, including the Portland-Bangor Waste Oil superfund site, the Kenosha brownfield site, numerous Air Force base realignment and closure facilities, and others discussed below, many for which the cleanup long has been completed. While reopeners could occur, reopeners are rare. Robert A. Simons, et al., *Quantifying Long-term Environmental Regulatory Risk for Brownfields: Are Reopeners Really an Issue?* 46 J. Envtl. Planning and Mgmt., 257-269 (2003) (finding only 12 reopeners out of 11,497 sites that have achieved "no further action" status or its equivalent).

[4] *National Union Fire Ins. v. U.S. Liquids Inc.*, 88 Fed. Appx. 725 (5th Cir. 2004) (describing pollution exclusion in D&O policy); *Whittier Properties Inc. v. Alaska National Insurance Company,* 185 P.3d 84 (Alaska 2008) (describing pollution exclusion in CGL policy).

ISBN 1-55871-369-7

Beginning in the mid-1990s and increasingly in this decade (although there has been some recent retraction[5]), a number of insurance companies (insurers) began offering policies that specifically are tailored to environmental risks. Unlike CGL and other policies—where pollution risks were somewhat of an afterthought—modern environmental insurance policies specifically and expressly are directed toward those risks. Very broadly, most environmental coverages fall into two categories:

- *Cost Cap*—where it is known that a cleanup must occur and the cleanup's costs can be roughly estimated even if the specific remedy required is not yet determined. Cost-cap insurance protects against overruns associated with the known cleanup and with unknown pollutants that are discovered in the course of performing the anticipated cleanup.
- *Pollution Liability*—generally covers the "unknowns," including government or private third-party claims involving pre-existing but unknown releases, reopeners of cleanups previously considered complete, new releases, transportation to and disposal at offsite facilities, business interruption, and more.

(2) Fixed-Price Contracting

Along with insurers, contractors also came to realize that regulatory cleanup costs increasingly were predictable, sometimes even before a specific remedy has been approved. In the late 1990s, several contractors began offering (and now many offer) to assume all environmental regulatory liabilities for a fixed price provided this assumption is accompanied by the purchase of a policy protecting the contractor in the event of cleanup cost overruns, discovery of unknown pollutants, or other risks. In most cases, the policy also may provide direct, "named insured" coverage to the property owner(s), potential buyers, lenders, other potentially responsible parties (PRPs), and still other interested parties (hereafter collectively referred to as owners).

Counter-intuitively, IFC contracts typically (perhaps even usually) cost less than might be quoted for a traditional contract despite offering greater certainty both through the contractor indemnity and the insurance policy. Specific examples, and a broad 41-site study, are discussed in Section 231.2065(b)(2) below.

Contractors often become jointly and severally liable to the government and promise to stand before their clients (and, if the government or a private party does sue their clients, to indemnify them).[6] While this guarantee is not absolute protection (e.g., the insurance term or limits could be exceeded, and the contractor could become insolvent), as noted above, so far the guarantee appears to have held up in every IFC. This is not to say that future failures are impossible, but the chances of them occurring must be measured against the far greater uncertainties associated with traditional contracts, and also measured in light of the accounting, cost, and tax advantages IFCs may offer.

(b) Specific Benefits of IFCs

(1) Maximized Certainty

IFCs over the past decade have been applied at hundreds of sites. Although no perfect market information exists (because many IFCs are both private and confidential), it appears that not one IFC has required an owner to pay a single additional dollar.[7] Rather, any cost increases have been absorbed by the contractor, the insurer, or both.

As noted above, an IFC generally does not legally bar the government from later pursuing the owner. Thus, despite the contractor's indemnity and the insurer's policy, the government retains the right to pursue the owner.[8] To obtain a release from the government, the government would have to affirmatively release the owner. Such a release has occurred only twice (in 1999 and 2000)[9] and can be expected to occur in the future only very rarely, if ever. That said, the same CERCLA provision (Section 107(e)(1)) pro-

[5] The retraction has been caused in large part by the relatively large loss ratios for cost-cap policies that were bought outside of the context of an IFC. IFCs, by contrast, by providing large "carrot" and "stick" incentives to cleanup contractors to keep total cleanup costs well below the insurance attachment point, have a much lower loss ratio. For this and other reasons, insurance is more available (and generally less expensive) when procured in the context of an IFC.

[6] *E.g.*, consent decree*Maine v. United States and Settling Nonfederal Defendants*, Civ. No. 00-64-B-C (D. Me., May 30, 2006); consent decree *United States v. Mattiace Industries,* No. 03-CV-1101 (E.D.N.Y. June 16, 2003).

[7] *See supra* note 3.

[8] *See* CERCLA Section 107(e)(1), 42 USC 9607(e)(1).

[9] The first such instance was in consent decree *Maine v. United States and Settling Nonfederal Defendants*, Civ. No. 00-64-B-C (D. Me., May 30, 2006); the second was consent decree *United States v. Iron Mountain Mines Inc.*, Civ. No. S-91-0768 DFL/JFM (E.D. Calif. Dec. 8, 2000) (please note that the second was not a pure IFC because the contractor did not sign the consent decree or become fully liable as a PRP. In that rare case, the insurer did sign the consent decree).

ISBN 1-55871-369-7

viding that a private indemnity contract cannot, without the government's consent, bar the government from later pursuing the owner, states in the very next sentence that this bar does not prevent private parties from entering into indemnity contracts. Thus, while an IFC generally will not legally bar future government suits, CERCLA expressly allows private party indemnities such as those provided by an IFC and, to date, none of these indemnities appears to have failed.

(2) Cost Reduction.

Because IFCs offer very real benefits to contractors, they often are–and with some data suggesting even usually are–quoted for less than traditional, time-and-materials estimates despite that IFCs bring greater certainties. Importantly, owners need not commit to an IFC until they see a guaranteed bid price for the IFC. Thus, if on a particular site an IFC would cost more than the owner believes is appropriate, the owner can pursue an alternate route.

Why might contractors bid a contract for a lower price despite that it brings the contractor more risk? There are several reasons. First, the risk is manageable, with costs reaching even into the insurance layer under an IFC only very rarely. Second, contractors are attracted to IFCs because they offer a chance for the contractor to recover (or at least share in) any cleanup cost savings. If, for example, a contractor believes there is a 50 percent chance that a cleanup estimated at $10 million could be done for $6 million (for example, by an alternative treatment technology that the contractor believes might be approved), then all things equal the contractor will bid the project for $8 million. Even after adding in the cost of insurance to protect against overruns, the net cost to the owner will be less than $10 million. An IFC offers contractors other significant advantages as well, including greater flexibility in time and personnel management, facilitation of long-range planning (because the contractor can more readily count on a steady stream of earnings), and other factors.

Until recently, the only data establishing that IFCs can be done for less than traditional cleanups were site specific. Three such projects in which one or both of the authors have participated include:

- A former BP facility in Kenosha, Wis., where an IFC was performed for $10.1 million v. prior estimates of $15-$20 million. Moreover, because of the increased certainties associated with the IFC, the city was able to raise $5 million of the cleanup costs with bonds enabled through tax incremental financing and with grants obtained from EPA and the state, thus further lowering the owner's costs to $5.1 million;[10]
- A multiparty superfund site in Maine, estimated to cost $25 million but for which an IFC was done for $15 million in just 19 months and with no litigation;[11]
- The transfer of Air Force facilities with savings of more than 35 percent and schedule reductions of over 20 percent.[12]

Now, however, there are quantitative study results to show the cost reductions. The U.S. Army has published a five-year review of 41 fixed-price performance-based contracts (PBCs).[13] Among other findings, the review showed average savings of 22 percent below estimates provided at the outset of the project. By contrast, when done outside of the PBC context, the Department of Defense has found base closing cleanup cost estimates typically to be exceeded by 60 percent.[14]

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[10] BP, the city of Kenosha, and Michael O. Hill all have published articles further discussing the details and success of this project. Christopher Olson et al., *Urban Renaissance: From Brass Manufacturing to Uptown Brass Center*, Air & Waste Mgmt. Ass'n Magazine (Dec. 2005) (available on the Web at http://secure.awma.org/em/preview.aspx?month_12&year=2005) and Michael O. 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 Mgmt. Institute (April 2003) (available on the Web at http://www.hillkehne.com).

[11] For a discussion of the public policy benefits of this IFC *see* Michael O. Hill, *A Tale Of Two Sites—How Insured Fixed-Price Cleanups Expedite Protections, Reduce Costs, and Help the EPA, the SEC, and the Public*, 18 National Environmental Enforcement J. 3 (Sept. 2003) (publication of the National Association of Attorney's General) (available on the Web at http://www.hillkehne.com).

[12] USAF, *Air Combat Command's Transformation of Environmental Remediation* (undated, unclassified), available on the Web at http://www.p2pays.org/ref/34/33984.ppt.

[13] U.S. Army Environmental Command, *Tracking Performance on the Army's Performance-Based Contracts*, at 4, May 16, 2006 ("To date, the Army has seen cost avoidance in the range of 21.3% (when comparing to the Independent Government Estimates) and 33.8 percent (when comparing to the Army's cost-to-complete estimates"); *see also* USAEC, *Performance-Based Acquisition (PBA): Lessons Learned* Nov. 9, 2006, available on the Web at http://aec.army.mil/usaec/cleanup/lessonspba.pdf. The data in this study are not perfect with respect to insured fixed-price cleanups because many (almost a third by number, though likely less by dollar volume) of the cleanups were done on a fixed-price but noninsured basis. As discussed in Section 2065(c), fixed-price cleanups without insurance may be the most appropriate option for many sites, particularly those with smaller (*e.g.*, less than $4-$5 million) anticipated cleanup needs. For larger cleanups, most contractors will require insurance.

[14] Robert F. Durant, *The Greening of the U.S. Military: Environmental Policy, National Security, and Organizational Change*, 21 n.4 (2007) ("[T]he DoD inspector general has found

ISBN 1-55871-369-7

(3) Accounting Considerations

Accounting for environmental liabilities involves substantial legal and business risks. Consequently, the level of care necessary to mitigate these risks imposes a significant administrative burden. Recent and anticipated changes in accounting standards will increase these financial reporting risks and administrative burdens.

New accounting rules force businesses, governments, and nonprofits to determine and disclose the market value of their environmental cleanup obligations. Very often, reporting entities will need to obtain a quote from an independent third party to resolve or settle their environmental cleanup obligations or attempt to estimate the exit price for the liability in the absence of a quote.

IFC estimates provide perhaps the best objective evidence of fair value. IFC estimates are more defensible than internally developed cost estimates because they are derived from two independent third-parties—the contractor and the insurer—each of which has its own market incentive to ensure that the cost estimate given is, in fact, sufficient to address the liabilities. If they provide too low an estimate, they could find themselves assuming liabilities with insufficient funds to address them. At the same time, done well, IFCs are not priced artificially high because a contractor that estimates high will not win the bid. Because IFCs offer contractors so many benefits (*see* Section 2065(b)(2)), contractors bid them aggressively (but realistically) low. Given their market incentives for estimates that neither are too low nor too high, IFC estimates likely are the most defensible estimates available.

The degree of legal risk associated with accounting for environmental liabilities is real, as shown by three recent SEC enforcement actions—one administrative, one civil, and one criminal—involving alleged manipulation of environmental reserves by major U.S. public companies.[15] However, even privately held companies face accounting-related risks associated with audit failure, debt covenants, fraudulent conveyances, and illegal dividends.[16] Major financial reporting pitfalls associated with environmental liabilities include restatements,[17] control deficiencies,[18] SEC enforcement,[19] securities litigation,[20] damage to reputation,[21] and insolvency.[22] While it is too soon to say with any certainty, it is likely that the recent Wall Street turmoil will lead to still further requirements of transparency and enforcement for violations.

Legal and business risks historically associated with environmental liabilities are rising significantly due to recent and forthcoming changes in financial accounting standards and securities laws.[23] Financial accounting principles and practices are undergoing transformational change. Sarbanes-Oxley, fair value measurement, and the convergence of global accounting standards are major forces reshaping core accounting concepts. One of many objectives in this unprecedented push to make accounting information more reliable and relevant is the desire to increase the transparency of off-balance sheet liabilities and contingencies, including such matters as environmental cleanup obligations.[24]

A comprehensive discussion of changes in accounting standards and practices is beyond the scope of this paper. The most important changes relevant to environmental liabilities and contingencies, however, can be summarized in a few key principles. Under the new accounting paradigm:

- Relevance (market value) is favored over absolute reliability (historical cost);
- The likelihood of "liability" rather than the likelihood of "loss" determines whether a contingency is recognized as a liability; and

average cleanup costs at closing bases typically are 60 percent higher than estimated originally.").

[15] For information on these enforcement actions, *see* http://advancedenvironmentaldimensions.com/SEC_enforcement.htm on the Web.

[16] *See* C. Gregory Rogers, *Environmentally Insolvent: Fair Value Measurement of Environmental Liabilities Poses Solvency Risk*, Bus. Law Today, July/August 2008.

[17] *See* http://www.advancedenvironmentaldimensions.com/restatements.htm on the Web for a listing of environmental-related financial restatements.

[18] *See* http://www.advancedenvironmentaldimensions.com/control_deficiencies.htm on the Web for a listing of environmental-related control deficiencies reported under Sarbanes-Oxley.

[19] *See* http://www.advancedenvironmentaldimensions.com/SEC_enforcement.htm on the Web for a listing environmental-related SEC enforcement actions.

[20] *See National Union Fire Insur. v. U.S. Liquids Inc.*, 88 Fed. Appx. 725 (5th Cir. 2004).

[21] *See* T. Lyon and J. Maxwell, *Greenwash,* ABA Envir. Disclosure Comm. Newsletter (Jan. 2008).

[22] C. Gregory Rogers, *Environmentally Insolvent: Fair Value Measurement of Environmental Liabilities Poses Solvency Risk*, ABA Section of Bus. Law Comm. on Bus. Bankr. Newsletter, June 2008.

[23] C. Gregory Rogers *Environmental Disclosure Due Diligence: Taking the Next Step in Environmental Due Diligence*, Bus. Law Today, May/June 2007.

[24] *SeeEnvironmental Disclosure: SEC Should Explore Ways to Improve Tracking and Transparency of Information* available on the Web at http://www.sehn.org/tccpdf/liability-underreporting%20exec%20sum.pdf.

ISBN 1-55871-369-7

- Transparency trumps concerns about prejudicial effect of disclosure.

Two recent developments—new accounting rules for business mergers and acquisitions (M&A) and proposed new disclosure requirements for loss contingencies—illustrate these principles.

(a) New M&A Accounting Rules

New standards for business combinations issued by the FASB (SFAS 141R) and the IASB (IFRS 3) abandon the historical standing for recognizing and measuring contingent liabilities in favor of fair value measurement. Instead of booking only amounts that are nearly certain to be spent to settle a contingent liability, acquiring companies soon will be required to report the market value of the obligation, uncertainties and all.

Beginning in 2009, public and private companies must recognize liabilities for all material contract-related contingencies (e.g., environmental indemnities previously) assumed in a merger or business acquisition. Acquirers must recognize liabilities for material noncontractual contingencies (e.g., obligations arising under environmental remediation laws) if it is "more likely than not" that the liabilities exist as of the acquisition date.[25] All recognized liabilities for contingencies must be recorded at their acquisition-date fair value.

The fair value of a liability is the price that would be paid to transfer the liability in an orderly transaction between market participants at the measurement date (exit price).[26] A quoted price for the identical liability in an active market is the best evidence of fair value.[27] If an active market does not exist, companies must estimate the exit price based on the assumptions that market participants would use in pricing the liability, including probabilistic analysis, risk premium, and profit margin.[28]

The recognition criteria in SFAS 141R—recognition of all contractual contingencies and recognition of noncontractual contingencies if it is "more likely than not" that a liability exists as of the acquisition date—fundamentally are different from the recognition criteria in SFAS 5. Under SFAS 5, a liability is recognized if (1) it is probable that a liability has been incurred, and (2) the amount of the loss is reasonably estimable.[29] In practice, liabilities are not recognized under SFAS 5 "unless there is a high likelihood of a future outflow of resources."[30] Thus, under SFAS 5, recognition depends on the likelihood of loss rather than the likelihood of liability. By contrast, under SFAS 141R, recognition depends on the likelihood of liability rather than loss.

To understand how fair value measurement will affect environmental contingencies in M&A deals, consider the following hypothetical example.

Buyer plans to purchase the stock of Seller. Seller owns an industrial facility with soil and groundwater contamination resulting from historical releases of chlorinated solvents caused by Seller. Seller estimates a thorough site investigation will cost $250,000. Depending on the extent of contamination, cleanup costs are expected to range between $2 million and $10 million. In accordance with applicable accounting standards, Seller has used the reasonably estimable cost of the investigation as a surrogate for the known minimum value of the total cleanup and booked a contingent liability in the amount of $250,000. Buyer estimates that it would charge $5 million to assume cleanup liability for the facility in a standalone transaction. This estimate is comparable to a quote obtained from an environmental contractor for an IFC. Upon acquisition of Seller, instead of recording a $250,000 liability, Buyer records a contingent liability in the amount of $5 million representing its estimate of the acquisition-date fair value of the cleanup liability.

(b) Proposed Disclosure Rules

Environmental liabilities—remediation obligations, violations of environmental laws, and litigation—historically have been accounted for as loss contingencies under SFAS 5. On June 5, 2008, FASB released Proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies,* which amends and expands the disclosure provisions in SFAS 5 and SFAS 141(R).[31] FASB be-

[25] At its Oct. 29, 2008, board meeting, FASB stated its intention to issue a FASB Staff Position (FSP) amending the loss contingency provisions in FAS 141R to replace the "more likely than not" with a "reasonably estimable" test, similar to the requirements in FASB Interpretation No. 47, *Conditional Asset Retirement Obligations*.

[26] SFAS 157 ¶ 5.

[27] SFAS 157 ¶¶ 22 and 24.

[28] SFAS 157 ¶ B2. *See also* proposed FASB Staff Position (FSP) FAS 157-c regarding clarification of SFAS 157 on the measurement of liabilities available on the Web at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas157-c.pdf.

[29] SFAS 5 ¶ 8.

[30] SFAS 141R ¶ B226.

[31] Proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies: an amendment of FASB Statements No. 5 and 141(R)*, available on the Web at http://www.fasb.org/draft/ed_contingencies.pdf. At its board meeting

ISBN 1-55871-369-7

lieves the expanded disclosure provisions are necessary because:

> Investors and other users of financial information have expressed concerns that disclosures about loss contingencies under the existing guidance in FASB Statement No. 5, *Accounting for Contingencies*, do not provide adequate information to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies.[32]

The proposed standard would require disclosure for nearly all loss contingencies with more than a remote change of loss and compel the public release of sensitive information that today generally is kept highly confidential. In some cases, disclosure of the contingency could detrimentally affect the outcome of the contingency itself. In other cases, disclosure may undermine the company's reputation of environmental stewardship and corporate responsibility.

The proposed new disclosure standards are the first step toward a complete overhaul of the long-standing accounting principles for contingencies. It now seems reasonable to anticipate that the recognition and measurement principles in SFAS 5 will be revised to conform with SFAS 141R sometime in the next three to five years. Such a change could require businesses to revise their estimates for all environmental liabilities now on the books.

In conclusion, new accounting and disclosure rules will compel reporting entities to determine and report the market value of their environmental cleanup obligations and disclose sensitive information about those obligations. This will substantially increase the legal and business risks and administrative burdens associated with such obligations. Faced with these new realities, many reporting entities will see IFCs as a favorable opportunity to transfer the accounting-related risks and burdens to an independent third party that is better positioned to accept them.

(4) Tax Advantages

With appropriate planning, IFCs can be structured to achieve significant tax advantages over pay-as-you-go (PAYGO) cleanups and greatly improve the economics of a contemplated cleanup or property transaction. Too often, however, the tax implications of alternative strategies to resolve or satisfy environmental cleanup obligations are not considered until it is too late, if at all. A comprehensive discussion of tax considerations associated with environmental cleanups is beyond the scope of this article. The reader, therefore, should keep in mind that the discussion below omits numerous considerations that may be highly relevant to a given situation. With that qualification, the following general concepts should be considered.

When incurring costs to resolve or satisfy environmental cleanup obligations, the goal from a taxpayer's perspective is to characterize the costs as currently deductible expenses. General tax law principles, however, favor capitalization or amortization of cleanup expenses, thereby delaying the benefit of a current deduction. In some cases, such as where cleanup costs are capitalized into the tax basis of land, the taxpayer may never receive a deduction. In other cases, the taxpayer may have to amortize a cleanup cost deduction over several years.

Two special provisions in the Internal Revenue Code offer important opportunities to obtain a full and immediate deduction for remediation costs. IRC Section 198 is intended to encourage environmental cleanup at eligible sites by allowing environmental cleanup costs to be fully deductible in the year incurred rather than capitalized and spread over a period of years. Section 198, as initially adopted, had an expiration date of Dec. 21, 2000. It since has been amended and extended four times, and most recently expired Dec. 31, 2007.

As part of the $700 billion bail-out package signed into law Oct. 3, 2008, Congress extended retroactively Section 198 for expenditures incurred since Dec. 21, 2007, and through Dec. 31, 2009. Thus, a taxpayer that fully funded a 10-year cleanup using an IFC in 2008 now can use Section 198 to obtain a current deduction for costs that otherwise would have been subject to capitalization. Section 198's authorization has been an on-again, off-again matter, and this situation likely seems to play itself out again and again unless Congress and the president make Section 198 permanent.

The second special provision is IRC Section 468B and related regulations, 26 CFR 1.468B-1, which set forth rules for the taxation of qualified settlement funds (QSFs). QSFs are special funding mechanisms used to resolve or satisfy legal obligations arising

Sept. 24, 2008, FASB pushed off the proposed Dec. 15, 2008 implementation date by one year and committed to exploring alternative disclosure frameworks after receiving an avalanche of negative feedback from lawyers, auditors, and financial statement preparers who worry the proposed disclosures would reveal confidential data and turn into an unfair advantage to plaintiffs in litigation.

[32] *Id.*

ISBN 1-55871-369-7

from violation of law, breach of contract, or tortious conduct. Properly formed QSFs also may be used to resolve environmental cleanup obligations arising under CERCLA and other federal and state environmental laws.

QSFs cannot be used to obtain a deduction for costs that must be capitalized. However, for cleanup costs that are deductible but subject to amortization over multiple years, a QSF can be used to accelerate the deduction. Expenditures for an IFC may not be deductible in the current year without using a QSF. Under the Internal Revenue Code's "economic performance rules," economic performance occurs, and the taxpayer may thus take a deduction, as services are rendered. The Internal Revenue Service (IRS) determined in a recent case that an environmental liability transfer agreement constituted a pre-paid service contract. Accordingly, the IRS concluded that the deduction must be amortized over the term of the contract as the cleanup work is performed.[33] IRC Section 468B provides an exception to the economic performance rules and eliminates the risk of delayed deductibility for IFC payments. A taxpayer thus may take a full deduction upon funding of a properly crafted QSF rather than amortizing the deduction over future years as the contractor performs the cleanup.

In addition to accelerating deductibility of cleanup costs, in some cases, the use of QSFs to fund an IFC also may provide a deduction where a deduction would not otherwise be available at all. For example, a taxpayer that incurs a net operating loss (NOL) in the course of a multi-year PAYGO cleanup may lose part or all of the deduction for cleanup costs incurred in a loss year due to limitations on NOL carry-backs. In contrast, a taxpayer using a QSF to fund an IFC during a profitable year could have taken a full and immediate deduction.

Tax savings, if they can be obtained, can improve greatly the economics of a contemplated cleanup or property transaction. IFCs offer unique opportunities to realize tax savings that may not otherwise be available. Based on tax savings alone, IFCs may be more cost-effective than PAYGO cleanups.

(c) Disadvantages of and Alternatives to IFCs

If IFCs offer these many benefits, an obvious question is why they are not used more frequently. There are a few reasons, discussed below.

(1) IFCs' Limitations/Disadvantages

Cleanup Size. As noted above, IFCs are not appropriate for all sites. For example, they are not appropriate unless the site or group of sites (IFCs can be done on a multiple site portfolio basis) has anticipated cleanup costs greater than $4 million-$5 million. It also is difficult in today's insurance market to accomplish IFCs where the expected cleanup costs exceed $50 million (at such sites, the IFC contracts may need to be broken up into smaller pieces or divisible cleanup portions may need to be excluded from the IFC).

Cleanup Risk. Furthermore, although IFCs do not require that the remedy already be government-approved or otherwise determined, they also are not well suited for sites with future remedies that are subject to enormous variability (e.g., a site with cracked bedrock and DNAPLs[34]) where the realistic remedy range varies by a multiple of three or more). They also are not well suited to sites that particularly are subject to "political" risk (that is, sites whose remedy is particularly likely to be determined largely by political factors). The primary reasons for the "political" risk limitation is not only that the size of the remedy can vary widely but unlike with pollution risks, contractors have no superior knowledge or expertise in evaluating or managing political risk.

Up-Front Payment or Other Commitment. The largest disadvantage is that IFCs require an up-front commitment, and in some cases also an upfront payment, of the cleanup costs. Thus, if an IFC price is $8 million, the owners either must place the $8 million in escrow, provide it to the insurer to help fund both the risk transfer premium and a "commutation account," or otherwise assure others (e.g., the contractor, the government, the buyer) that the cleanup funds will be available. While the $8 million reflects a somewhat discounted price (since it is only the net present value of an estimated cleanup), and pre-funded accounts do earn some interest, the discount price is not significant (since IFC cleanups tend to be completed promptly, usually within three to four years), and the interest rates are relatively low.[35]

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[33] *See* Internal Revenue Service Office of Chief Counsel Memorandum Release No. 20071801F, released May 4, 2007, available on the Web at http://www.irs.gov/pub/irs-lafa/071801f.pdf.

[34] DNAPL is an acronym for dense nonaqueous phase liquids. As their name indicates, DNAPLs are "dense" and thus typically sink when contained in groundwater, sometimes making them extremely difficult to extract.

[35] *E.g.*, equal to the one year Constant Maturity Treasury Rate

ISBN 1-55871-369-7

Complexity. IFCs are complex and for many companies still completely new. Parties entering them for the first time sometimes can take a year or more to work through the required coordination of cleanup contracting, insurance procurement, and sometimes other requirements (e.g., purchase and sale agreements). Some companies are highly skeptical of IFCs or convinced that they can be applied only at sites where the remedy already is known or highly predictable. (In fact, many IFCs have been entered without any regulatory decisions yet made, including the BP-Kenosha site discussed in note 10.) Companies that have entered IFCs often become "repeat buyers," and the Department of Defense (perhaps the largest purchaser of IFCs) now enters into them routinely.

Misconceptions of Risk Transfer Premium. Many owners assume that, given the insurance costs and "risk transfer" premiums they believe contractors must attach, an IFC must cost more. As noted above, this assumption often is (probably usually) incorrect, and it can be tested before an IFC is entered. (That is, IFC bids can be solicited and, if too high, rejected.)

The Perception of Foregone Cost Savings. Finally, IFCs require property owners to abandon some or all hope of achieving cost savings. Thus, while an $8 million IFC cost may reflect a traditional cost estimate of $10 million, there is, of course, some chance the cleanup will be completed for $7 million or less and the insurance never used. To maximize contractor incentives to bid low and sometimes to qualify for favorable tax or accounting treatment, property owners that undertake an IFC usually agree up front that unspent cleanup funds will go at least in part if not completely to the contractor. This is, perhaps, the hardest pill for owners to swallow.

Time Constraints. Although less time is possible—for example, an IFC for one 14-site, $40 million cleanup was accomplished in less than 30 days—an IFC typically will require at least four to six weeks. In some contexts (e.g., an upcoming merger or acquisition), that time simply is unavailable. (A better context for an IFC is a company that intends to sell an asset, or even itself. Such a seller can price an IFC in advance, thus avoiding the sale-price discount by effectively removing much or all of the uncertainties driving the discount.)

(2) Alternatives to IFCs.

As shown above, IFCs are not silver bullets. Any decision of whether to proceed with an IFC must be made on a site-specific basis, and the factors determining which approach is best may change over time (for example, the cost of an IFC may exceed original hopes or expectations). An in-depth discussion of IFC alternatives is beyond the scope of this article. However, the following brief discussion is warranted.

Fixed-Price Contracting Without Site-Specific Insurance. As noted, sites with lower anticipated cleanup costs (e.g., less than $4 million-$5 million), generally are inappropriate for IFCs. The insurance is hard to obtain, and the premium and due diligence costs may not justify the effort of trying. That said, contractors increasingly are willing to offer fixed-price contracts without an accompanying insurance policy at these lower ranges. Contractors may be able to fold the risks into an existing umbrella or other portfolio-type of policy, or they may be willing to self-insure the risk given the advantages that fixed-price contracts offer and the relatively lower risks at lower-cost sites.

Environmental Insurance Without Contracting. In addition, at sites where no cleanup costs are anticipated but environmental uncertainties exist, parties frequently buy insurance alone (i.e., unaccompanied by a fixed-price cleanup contract). Policies most frequently bought in that context are the pollution liability policies. Sometimes companies will buy cost-cap policies unaccompanied by an IFC, but because such policies present different incentive structures that have, over time, proven more likely to result in claims (*see* note 5, *supra*), cost caps bought without an IFC increasingly are rare.

Private-Party Indemnities. Finally, of course, many parties enter into individual private-party indemnities (most typically between sellers and buyers of contaminated or potentially contaminated properties). These indemnities may be done with an IFC, with just environmental insurance, just third-party fixed-price contracting, or none of the above. Particularly in light of emerging FASB requirements (*see* Section 231.2065(b)(3), *supra*), careful heed should be paid to how these indemnities are structured.

(d) Conclusion

IFCs should be poised for a significant increase in popularity. The advantages of IFCs in reducing cleanup cost uncertainty have become increasingly evident during the over 10-year history of this approach. More recently, the Army's 2006 study documents that IFCs reduce absolute costs as well as

(which, as of the date checked while drafting this article, Nov. 12, 2008, was 1.24 percent).

ISBN 1-55871-369-7

risks. Now, perhaps most significantly, changes in accounting standards are requiring increased accuracy, transparency, and verifiability in the assessment of environmental liabilities. The authors hope this article will help readers identify some of the advantages, disadvantages, and alternatives to IFCs in site-specific contexts.

ISBN 1-55871-369-7