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THE LIMITS OF LIABILITY SYSTEM

AND THE ROLE OF INSURANCE

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LIUC COURSE:
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JUDGMENT PROOF

- Sometimes, liability is assigned to a party that has not economic and financial resources sufficient to pay for the damage
- The experience made with the implementation of legal provisions in the US shows that cases may occur where liability is escaped by transferring dangerous activities to firms that have minimum capital resources.
- This is the issue of the judgment proof that, in the light of the relative comparison between the firm's financial resources and the extent of the damage, does not only concern "catastrophic" events, but also minor environmental accidents, including those causing limited damage, which is however not internalized due to the polluting firm going bankrupt.

ORPHAN SITES

- Orphan sites are toxic waste areas where the polluter could not be identified or the polluter refused to take action or pay for the cleanup

- The US experience shows that cases may occur where liability is not effective and nobody is going to pay for the cleanup because the company judge liable has insufficient economic and financial resources.

- The need to find a solution.

EXTENDING LIABILITY TO LENDERS

- The lender's liability solution as a remedy to the judgment proof provides for extending liability to other parties related to the firm and, in particular, to its lenders, that are considered at least partially liable for the consequence of the activity carried out by the firms financed by them.

- With respect to specific cases, the term lender's liability was introduced, and then used to describe all those cases where the firm that is directly liable for the environmental damage may not refund such damage and therefore the judges involve the lenders of the firm if these have carried out some sort of supervision or have exerted some influence on the production activity and on the adoption of preventive measures.

THE LENDERS' LIABILITY: U.S. CASES

- This solution was occasionally adopted in the United States where, within the system of strict liability of the polluting firms established by the CERCLA, we find an application in some cases expanding the notion of owner and operator used by the wording of the law to include lenders.

- In one case, a bank was judged liable for the damage because the Court claimed it had been significantly involved in the supervision of the firm's operations; the Court stated that, in this case, the firm's lenders could be considered either as the owners or as the operators and, as such, liable for the damage (the famous case United States vs. Fleet Factors Corp.)

- NO POSSIBLE IMPLEMENTATION IN EU

FINANCIAL RESPONSIBILITY

- The term financial responsibility refers to the whole set of instruments that provide for the potential polluters to demonstrate ex ante that their financial resources are adequate to the restoration of potential environmental damage they may cause.

- In one of its practical application, financial responsibility provides for production activities in risky sectors to be only authorized if the companies concerned may demonstrate their ability to provide an appropriate financial or insurance coverage for future obligations resulting from the assignment of environmental liability.

ADVANTAGE OF FINANCIAL RESPONSIBILITY

- Financial responsibility ensures that the expected costs related to environmental risks are recorded in the firm’s balance sheet and accounts.

- Other benefits result from the fact that, since financial guarantees are purchased by banks or insurance companies, a contract relation is established by which the latter are keen on protecting their investments through the monitoring of the production activity of their corporate customers.

- “Financial guarantors” force the firm to take into account the whole extent of the damage ex ante and to pay a premium adjusted to the granted financial guarantees: in this case a internalization of the damage resulting from environmental accidents can be achieved.

THE ROLE OF INSURANCE IN THE ECONOMIC THEORY

- An economic point of view focuses on the problem that polluting firms externalize the true costs of their contribution to society.

- Efforts to recover these costs, which manifest both through the costs of impacts and the costs of efforts to prevent impacts, imply relevant roles for the insurance sector and, because the insurance sector is the world's largest industry, the response of insurers will no doubt be key to, at least partially, solve this internalization problem.

THE ROLE OF THE INSURANCE INDUSTRY IN PRACTICE

- Particularly, insurance sector could play a relevant role in different directions.
- First of all, insurance industry, as tradition, supplies policies covering claims of third-parties who allege injury or property damage.
- Moreover, insurers can induce an indirect effects in proactively stimulating prevention behaviour related to their customers.
- In all these directions, the insurance industry is dealing with management risk activities.

THE CHOICE BETWEEN ENVIRONMENTAL POLICY INSTRUMENTS

- Governments are facing the issue to introduce policies to tackle the causes and cover the rising costs associated with industrial sector.
- The environmental policy choice involves the assignment of respective roles of private and public sector to provide compensation and incentives to reduce the risk of catastrophic losses and financial management of large-scale disaster risks.
- The choice of both public and private instruments is essential given that in the case in which the government do not provide any policy instruments to prevent the events and to compensate the victims, the costs of environmental catastrophes fall on the State or directly on individuals.

PUBLIC VERSUS PRIVATE POLICIES

- When the government carries the risk, the costs of events are borne by the taxpayer, contributing according to the tax-regime of the country.
- Or private sector can, at least partially, cover risks and the costs of climate change will be shared among a portion of society.
- This last "private" solution can be achieved by the insurance industry involvement.
- In some cases, the private market covers much of the risk (e.g. UK), while in others, the government is more closely involved, either directly carrying the risk (e.g. USA for flood) or acting as "insurer of last resort" (e.g. France, Italy).

PUBLICLY SUPPORTING PRIVATE POLICIES

- Public policies can support insurance sector in different ways:

  - by providing a compulsory regime for insurance;

  - by providing State guarantee to limit private sector exposure and to reduce the cost of capital;

  - by creating a regulatory framework that allow private insurance market to work properly (special fiscal treatment for disaster insurance premiums, possibility of tax-deductibile reserve funds).

- Moreover for insurance industry that may have limited capacity, a pooled or government-backed compensation system is the only way to deal with the substantial costs of industrial catastrophes.

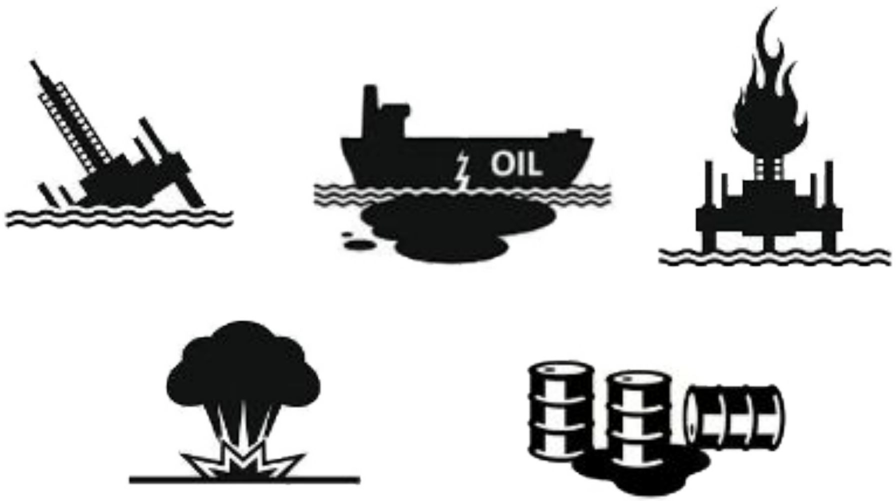
DIFFERENT INSURANCE PRODUCTS

- First of all, within the “traditional” activity supplying coverage for industrial consequences, other business opportunities emerge for all type of customers (private, commercial, industrial).
- This kind of products constitute the core business of the insurance industry.
- But specifically in the case of industrial disasters many problems arise, such as problem of solvency of insurers and uncertainties in assessing industrial risks.
- The solutions: cap as a limit to coverage; re-insurance

The risk of environmental damages usually arise from accidents

- accidental release of dangerous materials, oil spills
- maintenance at oil platforms,
- explosions at a chemical plants

Insurance **can deals with the probability that these events happen** and assist firms after it has occurred.
In the past, insurers have contributed to economic development of many sectors and it can do the same with them



What is Environmental Insurance?

- also known as Environmental Liability Insurance
- **an insurance that covers costs related to pollution** such as **cleanup**, liability for injuries and deaths and costs of industrial area restoration.

The premium is determined taking together

- **environment footprint data**
- **income levels**
- **environmental risk factors**

It runs from $35,000 up to $500,000 depending on the duration on the policy, and the range of loss coverage vary from $1 million to $50 million.

What is the benefit of this approach?

We are sure that those who caused the damages will pay to fix them.
This is possible because firms see damages as part of their TC
the lower is impact on the environment, the less the premium to pay the insurance

This approach is not new, it comes from the **Extended Liability concept**, that extend liabilities to other parties related to the firm.

Insurance industry can support the liability system in many ways:

1. Supplying ad hoc policies to firms
2. Simplifying the supervision task of the government
3. Stimulating firms to minimize environmental risk
4. Developing proper risk assessment tools for this field, and making data available to a wide audience

Who should consider having Environmental Liability insurance cover?

According to EPA (Environment Protection Authority US), any business that uses or stores relevant amounts of chemicals or hazardous materials that could damage the environment or affect other people's property.

Without an insurance, **firms' liability tend to increase** and additional costs could arise from the initial amount during the process of damage evaluation.

The market of Environmental Insurance is in an early stage

- because usually insurance policies cover other kinds of damages
- this kind of insurance policies are generally more expensive than normal one.

However, the potential business opportunity for insurance industry is huge and the market is growing steadily

Currently the largest players in this industry are:

AIG

ace insurance

XL Insurance Reinsurance

ZURICH

KEMPER

Even if forecasts are good, there are several obstacle to overcomes

1. This kind of coverages are still very expensive
2. It is often difficult to find an insurance able to cover all the possible losses, even with **mechanism of Reinsurance** or stipulating **multiple policies**
3. Insurance has not developed yet **appropriate risk assessment tools**
4. Often entrepreneurs don't even know about the **the existence of these insurance policies**

To overcome those obstacles and make the market efficient
an interaction between the Insurance Industry and Policy Makers is required.

- Private sector can develop the proper tools to the market work
- Public sector can support it by supervising **the behavior of the operators**,
    - can introduce incentives
    - can pool financial resource with government-backed assets.

Typologies of policies

Environmental insurance ensures against a wide range of risks **usually treated separately**

1. General Pollution Liability Insurance
covers 1rst or 3rd party clean-up costs (off-site and on-site), bodily injury, property damage

2. Clean-Up Cost Cap
fixes a limit to additional costs that could arise next

3. Brownfields Restoration
In case a restoration plan is in progress

4. Transportation Pollution Insurance
covers from pollution events arising from the transport of dangerous materials

5. Closure and Post Closure Insurance
for treatment of hazardous waste, storage and disposal facilities (TSD) for closure and post-closure of them

Broad and relevant coverage in a separate Program

Flexible coverage for:

- Obligations in tort or statute
- On & off-site
- Pollution events and environmental damage
- Existing unknown or new pollution events or environmental damage.
- Loss prevention costs
- Defense and investigative costs
- Crisis management costs
- Regulatory reopeners

Example of insurance policies treated separately by Zurich

Negotiated policies

Due to the huge variety of policies and clauses,

contracts are very customizable, **so policies have to be negotiated**

This could be a first obstacle to the buyer that has to be very careful about

- what is covered and what is excluded by the policy
- And know very well its site

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Australia, Canada, Northern Europe are the countries did more progress

Of course the need to develop the market is stronger in countries with **huge landscapes** but also in countries with **high pollution problems** like China.

China can play an important role for market development because in 2015 China's EPA announced it wants to introduce **mandatory insurance** on Chinese polluting industries. Other countries sustain this policy, and the tyre industry in South Africa represents the **first example of mandatory insurance** (awarded by the WEF)

The rationales behind a mandatory insurance is that this approach is cheaper and more efficient for government than create a complex system of controls to supervise operators.

After a pollution accident, government is sure that damages will be paid by the guilty party and it does not have to intervene at all.
However there are still the same difficulties we already mentioned before