

The Impact of Global Warming Risk Management Strategies: Property



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Information published by the Intergovernmental Panel on Climate Change over the past year has documented the conclusive science on warming caused by human activities. The response of capitalist based economies around the world has been to invest significantly in “green technology” and “green energy” products, services and business models which will minimize, or even reduce, the causes of warming. Another shift, one not so obvious, is taking place in enterprise-wide risk management strategies – and it impacts **all** commercial enterprises. Starting with Property, we have developed this series to address specific risk areas in order to touch on some of the critical elements of enterprise-wide risks that should be considered by business managers and leaders.

William Gallagher Associates (WGA) is a leading provider of insurance brokerage, risk management and employee benefits services to firms with complex risks, within industries that include energy, environmental services, technology, life sciences, financial risks, healthcare, and aviation. WGA was founded in 1983 and has offices in Boston, MA; New York, NY; Princeton, NJ; Columbia, MD; Atlanta, GA; and Paris, France.

Force Majeure Clauses

Acknowledging that climate change is leading to more variability in weather patterns and increasing the severity of storms, contracting parties need to anticipate effects of storms on contracted activities and review the force majeure clause more closely. Widely used in commercial contracts, force majeure clauses are intended to address the obligations of contracting parties in the event of non-performance due to circumstances beyond the control of either party – circumstances that could not have been forecasted or reasonably avoided by either party in the exercise of due care.

Disputes over non-performance are arising more frequently because of differing views of *causation*, *foreseeability* and *difficulty of performance*. *Causation* focuses on the reason or cause of non-performance. Storm damage to an equipment vendor’s manufacturing facility may be straight forward, but what about damage to a vendor’s supplier? Or what if a customer’s operations are curtailed so they can accept deliveries on a delayed schedule, and can not take timely delivery of your product while accepting that of others?

Foreseeability refers to the ability of the contracting parties to anticipate the event or its consequences; and whether either (the event or the consequences) could have been avoided with reasonable effort. Some have recommended that force majeure clauses proactively remove the notion of foreseeability in the force majeure language.

Finally, *difficulty of performance* asks whether a party is excused from performance when an alternative performance is available, when performance is merely impracticable or more expensive, or only when performance is just not possible under any circumstances. (A detailed review of force majeure is provided in the June 19, 2007 edition of the New York Law Journal.)

Site Selection for Facilities

With increased volatility and severity in weather patterns, particularly with respect to wind and precipitation, there is greater emphasis on careful site selection for new facilities. The cost and availability of Property and Business Interruption Insurance in areas exposed to wind, earthquake and flood damage is now the criteria weighing more heavily in the selection process. In general, prices are higher and limit capacity for high value property are harder to obtain. Insurers are looking at their entire book of business and considering their financial exposure to catastrophic loss more carefully than ever before. This comes about as rating agencies have also changed their evaluation processes and formulas. For insurers, geographic diversification is now more important. Consequently, we see some insurers scaling back in some areas, or on some lines of insurance, by insuring fewer risks or reducing the capacity they commit. Other insurers, as widely reported following the hurricanes of 2005, have become more comfortable with higher rates commanded in catastrophe-exposed areas. They view this as an opportunity to expand in an area that may have been unattractive.

Pricing and availability of insurance is only one piece of the decision. Even in the best of scenarios, insurance does not pay 100% of a claim. Sustainability of business operations is now also a factor that goes beyond insurance. Availability of work force and vendors, vulnerability of supply chain and product distribution channels, and dramatic post-catastrophe price increases driven by a the demand surge for materials and equipment are all forcing commercial enterprises to re-examine their enterprise risk profiles.

Insuring Office Space and Real Estate

Aside from the production of parts and equipment that are more energy efficient or projects that produce electricity or fuels using processes that have a lower impact on the climate, there is another very wide-spread shift taking place in the area of real estate development and construction.

The U.S. Green Building Council is a non-profit organization with over 11,000 organizations from every sector of the building industry devoted to transforming the building marketplace to sustainability. In 1998 the council established criteria for certifying buildings with respect to the impact they have on the environment as a result of selection of building materials, energy and natural resource utilization, contribution to greenhouse gases, etc. The certification program is now called Leadership in Energy and Environmental Design (LEED); and there are graduated levels of compliance and recognition. Currently over 1,000 in the U.S. are LEED Certified, and another 13,000 are in the pipeline for future certification. LEED certification is now regularly used in building specifications by owners and developers; and this trend is expected to grow quickly. *Buildings* have been identified by the Intergovernmental Panel on Climate Change as the third largest source of greenhouse gas emissions, following *Energy Supply* and *Transportation*.

With this said, LEED certified buildings present a different risk profile that needs to be taken into consideration when discussing property damage risk management and insurance considerations. Insurers are beginning to address this, but the response is not industry-wide and thus many issues need specific attention when buying insurance:

- Property valuation should be based on appropriate cost models and reflect appropriate materials and equipment.
- Business interruption calculations should include revenue streams from cogeneration, distributed generation or water treatment activities, or sale of green energy or carbon credits, depending on the local regulatory and environmental regimes.
- Recertification costs may be incurred depending on the extent of damage to a building and may not be covered in all property damage policies.
- Extra Expense may need to include the cost of purchasing replacement supply for on-site electric generation or water treatment – standard policy language does not address this.
- Vegetative building covers are normally viewed as landscape under traditional insurance policies and excluded, therefore language needs to be adjusted to secure insurance protection.
- Building owners motivated to pursue LEED Certification typically participate in recycling programs in the event damage to property requires *Debris Removal*. Typical property damage policies do not cover additional costs related to this activity.
- LEED Certified buildings usually have a complex array of electrical, lighting, HVAC, plumbing and safety systems and controls that require operational testing and balancing during start-up. These *Commissioning Expenses* can be significant and need to be addressed by a specific endorsement. Traditional policy language, as well as loss adjusters, does not normally anticipate this expense.
- Finally, recognizing the growing support for “green building practices” and “environmental sustainability”, some carriers are now providing endorsements to insurance policies that will allow non-green buildings to be re-built to LEED certification standards subject to conditions and sub-limits.

It is important to take the time to work closely with your insurance broker or agent to review these points as they may apply to your specific risk profile. The insurance market is responding and regularly taking positive steps to be responsive. It is important to go into renewal negotiations asking for the coverages you need and being definitive.

Conclusion

Climate change is certainly driving changes in insurance pricing and availability. But it is also driving a much more fundamental change in how managers and business leaders view the broad risk profile their firm presents to insurers, investors, employees and any other stakeholders. Companies should be engaging risk management, financial, and legal professionals who are capable of providing you with advice and collaborative counsel on this issue.

