

RISKS OF ENVIRONMENTAL AUDITING

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RECENTLY, numerous articles on environmental audits have been published, but few have discussed the consequences for all of the parties involved. Environmental consulting, once seen as a special industry rarely needed or relied upon, is now growing rapidly worldwide. Increased demand for both voluntary and mandatory audits has added a new group of professionals to the environmental scene.

Insurers and reinsurers who directly or indirectly write coverage for environmental hazards need to be aware of the answers to three important questions. First, whether environmental auditors, and the parties for whom they provide their services, are aware of their contractual obligations? Secondly, what are the potential liabilities of the parties? Thirdly, how will law and insurance practices cope with the deficiencies in the work product of environmental auditors within a system which increasingly relies upon environmental audits?

A direct consequence of the growth of environmental crises and awareness has been the proliferation of environmental audits. This practice developed during the late seventies, when a handful of American companies pioneered the use of an internal auditing system by which top management could receive continual updates on the company's environmental performance and correct problems at an early stage. These internal environmental audits resemble financial audits, since they involve continual communication with management during the audit and a report on the findings at the conclusion. Significantly, unlike financial audits, environmental audits are not carried out under a professional code of practice, and thus may lack objectivity and reliability. The goal of an internal environmental audit is to detect any environmental problems and minimize their impact.

So what is an environmental audit? Audits are characterised by the situation for which they are being used. In other words, if a company needs to monitor its processes in



order to insure that it is complying with environmental laws, this may be referred to as a *compliance audit*. A waste disposal facility will monitor its site with a *site audit* which assesses environmental performance. Finally, when one company seeks to acquire another company, the environmental survey of the company to be acquired is an *acquisition audit*. Thus, the audit is a tool of management which, if carried out accurately, should be an objective evaluation of the overall environmental performance of the

entity which is being scrutinised.

Once the type of audit needed is determined, who conducts it and how are the audit findings used? Environmental audits may be carried out by a company's own audit teams or by independent environmental consultants, accounting firms and lawyers. The view of the environmental audit is varied among firms that use them and those seek to regulate their use. Companies which perform internal audits see them as a tool used to monitor their own environmental performance, not as public information. In contrast, the European Commission views audits as an assessment of past environmental performance which should be conducted by external auditors and reported to the public.

The obvious goal of a company undergoing an environmental audit is to have a comprehensive, objective and reliable audit. Less obvious is how this is accomplished. The worldwide business community needs to take notice of the important role of environmental audits and that means lawyers are an integral part of the process if they are to understand and cope with any deficiencies in the audits.

So how does corporate management know whether it can rely on environmental audit findings? Let us suppose that company A wants to acquire company B and hires independent external auditors to conduct an acquisition audit to insure that all of B's holdings are environmentally sound. Potential environmental risks may include:- contaminated real property; previous disposal of waste; hazardous

waste off site; or enforcement actions by governmental agencies. Company A decides not to rely upon the audit conducted the year before by auditors selected by B because A is not familiar with their reputation for reliability. Since company B wants to complete the transaction, the management agrees to a new audit.

In theory, this step should decrease the risk that A will acquire a company which has holdings in contaminated land or carries out activities which create environmental hazards. However, what if the auditors make errors or omissions or are negligent? Within environmental auditing, certain players have the capacity to assist the participants with necessary precautions.

For example, company A's lawyers could handle the title search necessary before the sale, as well as a full site history to disclose past uses of the site or facility. However, the key role of A's lawyers would be the contract negotiations between that company and the environmental auditors. Clear contractual terms could help to avoid a lawsuit, but if one was pursued, better to sue for breach of contract than for professional negligence based on the common law of the jurisdiction. Since the standard of care which applies to environmental auditors is neither clear nor uniform, it is best for A to hold the auditors liable for any errors or omissions in the contract itself.

It is essential that the contract between A and the environmental auditors clearly sets out the rights and obligations of each party by using a mutually responsible approach. The objective is to obtain a contract which is acceptable and fair to both, while addressing the potential liabilities of the parties.

Environmental auditors have their own standard terms of service, and if the auditors have not worked this out with their lawyers, then you may not want to choose them. If they do produce a contract, it would be advisable for company A's management to seek legal advice in order to review the service contract and the option of insurance coverage.

In light of the new and proposed environmental laws which have been enacted around the globe, the prudent company of the nineties needs to consider a strategy which addresses the question of insurance of environmental risks.

In the same hypothesis, the environmental auditors will want to acquire errors and omissions (E&O) or professional indemnity (PI) policies to cover any potential liabilities. Insurers and reinsurers may enter the environmental area through the back door by writing this type of coverage in the environmental context, even if they do not provide for any pollution coverage in general liability (GL) or public liability (PL) policies, nor write any environmental risks under environmental impairment liability (EIL) policies.

The essence of the environmental audit is an environmental health checkup which should assist company A in obtaining insurance coverage for pollution damages, if available. In Britain, a few insurers are writing, or, are about to write, pollution coverage in various forms. These insurers have observed insureds seeking coverage for environmental claims elsewhere and will attempt to avoid the same exposure. The idea is to acquire as much knowledge about the potential insured's environmental philosophy and program as possible before writing coverage for the particular risk.

These insurers will require an environmental audit as a prerequisite to obtaining EIL coverage. Some may allow the potential insured to select the auditors and others will require the use of pre-approved auditors, either inside the company or from outside who work as agents of the underwriters.

Reinsurers also have felt the impact of pollution claims, particularly from claims made in the United States. Reinsurers have the difficult task of assessing future liability and setting appropriate reserves based on the trends taking place in the country in which the primary coverage is written. In addition, reinsurers do not have direct involvement in litigation which arises on these claims. Thus, if a court determines that there is coverage for the pollution claim, reinsurers are bound when their coverage levels have been reached.

A reinsurer may want to consider whether the insurer has relied upon an environmental audit when deciding upon the terms of a reinsurance treaty or whether to reinsure at all. Reinsuring EIL, GL or PL business, written without full or absolute pollution exclusions, may simply be too great a risk, particularly in the case of reinsurance treaties.

Now suppose that environmental auditors are working for the insurance underwriters who are determining whether to write environmental coverage for a potential insured. Some of the same concerns addressed in the acquisition audit scenario apply here, such as appropriate contractual terms, potential liabilities and insurance and reinsurance of environmental risks.

As to contractual terms, courts in some jurisdictions interpret disclaimer clauses which attempt to disclaim or exclude in favor of the party against whom the clause is being applied. Therefore, environmental auditors should carefully select terms and conditions in their service contracts with the understanding that disclaimer clauses may not hold up in court.

The underwriters who rely upon the professional advice of environmental auditors should assess the auditors' reputation for quality and reliability and their PI coverage before or during contract negotiations. Whereas cost constraints on some companies may force them to select auditors who lack the expertise required,



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insurers may be able to pass on the cost of the investigation to the auditors via the service contract or as part of the premium charged to the insured. Regardless of the initial cost, insurers need full and accurate disclosure of the insured's activities and environmental status in order to avoid paying large losses down the road.

The service contract between the auditors and the insurer must take into account the auditors' PI policy. Professional negligence claims may go beyond the PI coverage, and therefore, environmental auditors should seek to have the underwriters for whom they are working agree to hold them harmless against claims by third parties. This may prove to be a difficult task. At the same time, environmental auditors are advised to work closely with their own underwriters on the definition of insured activities, duties and exclusions under their PI policy.

A variety of insurance policies is available to meet the risks discussed in these hypothetical examples, depending on the jurisdiction. PL or GL policies are available, yet may contain exclusions such as one of the alternatives below:

- An absolute pollution exclusion which precludes coverage for all pollution claims
- A partial pollution exclusion which provides coverage for sudden and acciden-

tal discharge or escape of pollutants, but not for gradual or expected occurrences of pollution.

There are also EIL policies which may provide coverage for liability arising from gradual and sudden and accidental pollution incidents. These are often on a claims-made basis requiring notice to the insurer during the policy period, and only for sites specifically designated in the schedule of insurance.

Then come E&O or PI policies. They protect against claims for professional negligence arising out of the performance of a variety of tasks with implications for environmental auditors and insurance brokers;

Directors and officers (D&O) policies provide coverage for wrongful acts which may include negligence, errors, omissions, misstatements or breach of duty in environmental risk assessment or strategies, but exclude dishonesty or fraud.

The last category is insurance coverage for specific industries. Examples are waste disposal companies, redevelopers of wasteland and chemical manufacturers.

Accurate environmental audits will help underwriters assess risks and set appropriate premiums. Inaccuracy could cause insurers to pay out on large pollution claims. Will insurers have any recourse against the environmental auditors? The contract may provide for a recovery or the PI coverage may be sufficient,

but what if the parties do not take these into account? If they cannot agree on how to settle the matter, a court will need to intervene and determine the parties' rights and duties in line with the appropriate jurisdiction. Proceedings may be avoided if the parties develop a plan under which they conduct audits for the ecosphere.

Industries which rely upon environmental audits needs to know of the European Commission's proposed directives and regulations as well. Brussels has been considering a proposal for a regulation to establish an 'eco-auditing' scheme expected to be adopted some time during 1991 or 1992. The overall tenor of the scheme would be voluntary, rather than the commission's original concept of a mandatory program. As yet, the commission has not ironed out all of the key components of the proposal. Certain sensitive manufacturing and waste disposal processes will fall under a mandatory registration plan implemented by the member-states.

Registered firms would need to carry out an annual audit; prepare an annual environmental statement of the audit's findings; have both the audit and the statement certified by an external independent auditor; submit the certified statement to the competent authority; and make the certified statement available to the public. Each member-state would have to designate an "environmental auditing professional body" to set up practice codes for verifying audits and to actually verify internal audits.

The implication is that those firms which register voluntarily will obtain benefits from going green and thereafter, other firms will volunteer to be part of the scheme. Those companies participating in the eco-auditing would receive the benefits of use of a special logo which identifies them as a participant and less stringent regulation, so long as they operate an effective self-regulation and environmental management plan.

The impact of the EC's proposed regulation depends upon whether the codes of practice on audit verification can be harmonized among the twelve states and whether a sufficient number of recognized environmental auditors can be found to carry out the scheme.

Brussels also has adopted a proposal for a directive on civil liability for damage caused by waste which would impose strict liability as well as joint and several liability for all companies in the community that produce waste and cause damage or injury to the environment. The statute of limitation for bringing a lawsuit would be three years from the time the party became aware or should have become aware of the damage or injury to the environment and 30 years from the date of an incident which causes damage or injury to the environment.

Insurers may need to work with the business community to agree upon a proper environ-

mental audit which will accurately assess the potential insured's pollution risks. A worldwide proactive approach may help the insurance industry avoid paying large losses. The availability of pollution coverage under the proposal is doubtful since the cost would be prohibitive and the risks too great.

Last year, Brussels adopted a proposed directive on the liability of suppliers of services. The commission proposes to establish a uniform system of liability based on reversing the burden of proof in favor of the injured party. Thus, the supplier of services will have to prove he was not at fault.

The proposed directive seeks to prevent and repair damage caused by the supplier of services. It is aimed at any services that could injure "the health or physical integrity of persons" or "the physical integrity of their movable or immovable property". The proposal excludes the manufacture of goods, public safety measures, travel services and waste services. A doctor, engineer or environmental auditor may be considered a "supplier of services" and could be liable for inaccurate advice under the proposed directive.

While environmental auditing is experiencing rapid growth, new legislation to regulate and harmonize the industry is being passed. The full impact of environmental auditing worldwide has not yet come about, but during the interim period, governments are preparing for the future.

How will the players in these scenarios manage the myriad risks? Proactive environmental risk management will create growth in the environmental auditing industry. Companies cannot rely upon the insurance industry to bail them out when they lack a sufficient environmental managing strategy. Those companies seeking insurance, and insurers writing the risks, need to appreciate the role of environmental auditing.

Environmental audits will help insurers determine whether to write a risk and to set more accurate premiums. Reinsurers also will find the need to rely on detailed audits and to consult with legal counsel, not only after pollution claims arise, but initially when writing new business. Since the potential for human error exists, the consequences of relying on audits when writing new business needs to be considered. ■

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