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# SELF-INSURING ENVIRONMENTAL LIABILITIES: A RESIDUAL RISK-BEARER'S PERSPECTIVE

COLIN MACKIE\* AND VALERIE FOGLEMAN\*\*

## Abstract

Self-insurance is often permitted as a means of satisfying regulatory requirements imposed on operators to evidence capability to bear their environmental liabilities. Its hallmark is that operators or their parent companies prove their financial strength rather than dedicate specific assets/funds to cover these costs. This article examines whether self-insurance can ensure that adequate funds are available when required. It is argued that if a self-insuring operator and/or its parent enter into liquidation then the protection afforded to their creditors under insolvency law may result in an environmental regulator recovering little or, indeed, nothing in respect of the costs associated with any requisite preventive, remedial or restorative works. This protection includes a *liquidator's ability to disclaim 'onerous property'* and challenge certain payments made to the regulator as a voidable 'preference'. Whilst commentators have highlighted a general insolvency risk with the measure, neither its extent nor precise source has been appreciated fully.

KEYWORDS. environmental liability, financial security, self-insurance, environmental damage, cost recovery, remediation, disclaimer, charge on premises, voidable preference

## A. INTRODUCTION

There is a growing recognition of the need to find solutions to the problem of operators externalising their environmental liabilities<sup>1</sup> on insolvency.<sup>2</sup> One option is to mandate by legislation or provisions in permits or other authorisations that the operator or another relevant person provides and maintains evidence of financial security in the form of a certificate or other documentation to meet the cost of the operator's environmental liabilities.<sup>3</sup> This is increasingly common in EU environmental law,<sup>4</sup> and has long been a requirement in international conventions concerning marine oil pollution and nuclear facilities.<sup>5</sup>

There are two main ways of evidencing financial security: firstly, setting aside monies or assets with, or transferring environmental risks to, a third-party, and, secondly, self-insurance based on the financial strength of the regulated company or its parent company.

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<sup>1</sup> For the purpose of this article, the term 'environmental liabilities' refers to two categories of environmental costs: firstly, costs associated with preventing and/or remediating environmental damage resulting from an operator's activities; and secondly, costs associated with obligations under a permit, licence or other authorisation to restore the environment following the termination of an activity or the closure of a facility.

<sup>2</sup> See, e.g., Department for Environment, Food and Rural Affairs (Defra), 'Government response to consultation on enhanced enforcement powers and other measures to tackle waste crime and entrenched poor performance in the waste management industry' (October 2015) 33 (Defra noted views that '...operators and liquidators should be held responsible for ongoing compliance with an environmental permit which should not be capable of being disclaimed').

<sup>3</sup> Valerie Fogleman, *Environmental Liabilities and Insurance in England and the United States*, Part A (1st edn Witherbys 2005) 114.

<sup>4</sup> See, e.g., Directive 2006/21/EC on the management of waste from extractive industries [2006] OJ L102/15, art 14 (the 'Mining Waste Directive'); Council Directive 1999/31/EC on the landfill of waste [1999] OJ L182/1 (the 'Landfill Directive'), art 8(a)(iv); Directive 2009/31/EC on the geological storage of carbon dioxide [2009] OJ L140/114, art 19(1).

<sup>5</sup> See, e.g. Convention on Civil Liability for Oil Pollution Damage (the 'Civil Liability Convention'), art VII (mandatory insurance for liability for oil pollution required in the UK by Merchant Shipping Act 1995, s 163); Convention on Third Party Liability in the Field of Nuclear Energy 1960 (as amended) (the 'Paris Convention'), art 10 (mandatory financial security for claims for bodily injury and property damage from nuclear matter required in the UK by Nuclear Installations Act 1965, s 19).

In the latter instance, the parent enters into an agreement with the regulator (e.g. the Environment Agency) and the subsidiary to fund the requisite costs by means of a guarantee or a bond (often called a self-bond). The rationale underpinning self-insurance is that profitable and stable companies are able to bear their environmental liabilities without involving third-parties, such as insurers.<sup>6</sup> Operators or their parents must, however, meet specified criteria to show their financial net worth or credit rating. This results in self-insurance often resembling requirements to show that a company is financially healthy and capable of carrying out obligations under a permit or licence.<sup>7</sup> The latter can be seen as self-insurance under a different badge and is considered as such in this article.

Various commentators have examined the advantages and disadvantages of financial security for environmental liabilities.<sup>8</sup> Whilst some have observed that self-insurance exhibits a general insolvency risk,<sup>9</sup> none have considered the extent or precise

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<sup>6</sup> James Boyd, 'Financial Responsibility for Environmental Obligations: Are Bonding and Assurance Rules Fulfilling Their Promise?' (2001) Resources for the Future Discussion Paper 01-42, 20-21

<http://www.rff.org/files/sharepoint/WorkImages/Download/RFF-DP-01-42.pdf> accessed 23 March 2016.

<sup>7</sup> See, e.g., Department of Energy & Climate Change (DECC), 'Applications for Offshore Carbon Storage Licences' (7 March 2011) para 32 ('DECC must be confident that any company that receives a licence is likely to continue in sound financial health for the foreseeable future. Each company must...demonstrate its basic financial viability.')

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/15085/cs-appformguide.doc](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/15085/cs-appformguide.doc) accessed 23 March 2016. A similar requirement is demanded by the Oil and Gas Authority in respect of licences to carry out oil and gas operations in the UK: 'Oil and Gas Authority – UK Petroleum Licensing: Financial Guidance' (undated) para 1

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/455523/FinancialGuidance.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/455523/FinancialGuidance.pdf) accessed 23 March 2016.

<sup>8</sup> See, e.g. Michael Faure and David Grimeaud, Financial Assurance Issues of Environmental Liability (2000) Report, Maastricht University and European Centre for Tort and Insurance Law

[http://ec.europa.eu/environment/legal/liability/pdf/insurance\\_gen\\_finalrep.pdf](http://ec.europa.eu/environment/legal/liability/pdf/insurance_gen_finalrep.pdf) accessed 23 March 2016; David Gerard, 'The law and economics of reclamation bonds' (2000) 26 Resources Policy 189; Boyd, 'Financial Responsibility' (n 6); Michael Faure, 'Alternative Compensation Mechanisms as Remedies for Uninsurability of Liability' (2004) 29 Geneva Papers on Risk and Insurance Theory 3 455; Hubert Bocken, 'Alternative Financial Guarantees for Environmental Liabilities under the ELD' (2009) 18 EEELR 3 146.

<sup>9</sup> Faure and Grimeaud (n 8) 180-181; Boyd, 'Financial Responsibility' (n 6) 65-66; Faure, 'Alternative Compensation Mechanisms' (n 8) 459-460; United States Government Accountability Office (GAO), 'Environmental Liabilities' (GAO-05-658, 2005) 46

source of the risk posed by the measure under the law of England and Wales. The purpose of this article is to fill that gap and, specifically, to examine self-insurance's remedial capacity. This is defined as the extent to which an operator that self-insures or is backed by a parent company guarantee or bond can ensure that adequate funds will be available to meet its environmental liabilities. A strong remedial capacity may be viewed as a necessary precursor to the effective implementation of the polluter-pays principle under EU law, which seeks to ensure that those who cause environmental damage pay to remedy it.<sup>10</sup>

Examination of self-insurance's remedial capacity is important as society is the ultimate residual risk-bearer of the environmental liabilities externalised upon insolvency. If no other responsible party is found liable, the environment will either remain unremediated or the State and, consequently, society as a body of taxpayers will be required to pay.<sup>11</sup> In such circumstances, society either pays metaphorically through inhabiting a lower quality environment or financially through incurring the requisite restoration or remediation costs. The failure of self-insurance also affects other stakeholders. For example, a regulator may seek to bring an action against an insolvent or financially stressed subsidiary's parent or an affiliate company, either directly under relevant statutory language,<sup>12</sup> or perhaps with less success,<sup>13</sup> derivatively by attempting to pierce the corporate veil. The need to do so would be reduced if the subsidiary was required to offer security, such as a cash deposit, and that

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<http://www.gao.gov/new.items/d05658.pdf> accessed 23 March 2016.

<sup>10</sup> Commission, 'White Paper on environmental liability' COM (2000) 66 final [2.1].

<sup>11</sup> *ibid* [3.1].

<sup>12</sup> For example, under the definition of 'operator' in reg 2(1) of The Environmental Damage (Prevention and Remediation) (England) Regulations 2015, SI 2015/810 (i.e. the person who '...operates or controls...' the damaging activity).

<sup>13</sup> In *Prest v Petrodel Resources Ltd* [2013] UKSC 34 the Supreme Court found that the corporate veil would only be pierced '...when a person is under an existing legal obligation or liability or subject to an existing legal restriction which he deliberately evades or whose enforcement he deliberately frustrates by interposing a company under his control': *ibid* 20-21 (Lord Sumption) (emphasis added). Thus, it seems that the strategic incorporation of a subsidiary to minimise the prospect of future financial liability for environmental damage would be insufficient to invoke the remedy.

security was ring-fenced from insolvency proceedings.<sup>14</sup> This would be less complex and less controversial than proposals to reform the doctrine of limited liability.<sup>15</sup>

The central claim of this article is that whilst self-insurance may be considered by financially-strong companies to be the most cost-efficient means of complying with mandatory financial security requirements, it possesses certain intrinsic features which hinder its remedial capacity. This may expose society to the risk of environmental liabilities being externalised upon the liquidation of a self-insuring operator. One such feature is that regulators do not normally demand that self-insuring operators set aside specific assets or funds to cover their environmental liabilities. This means that if a self-insuring operator and/or its parent enter into liquidation then the protection afforded to their creditors under insolvency law may result in an environmental regulator recovering little or, indeed, nothing in respect of the costs associated with any requisite preventive, remedial or restorative works. The protection not only relates to the priority accorded to the operator's secured creditors but concerns particular powers conferred upon liquidators under the Insolvency Act 1986 (IA 1986), such as the ability to disclaim 'onerous property' and the capacity to challenge certain payments made, or security given as a voidable 'preference'.

The scope of this article is limited in two ways. Firstly, only issues raised by the law of insolvency in England and Wales will be considered. This regime exhibits important nuances when compared, for example, to the law of insolvency in Scotland, particularly regarding the existence of the power of disclaimer under section 178 IA 1986. This power impacts significantly upon self-insurance's remedial capacity and is only available to liquidators of companies being wound-up in England and Wales.<sup>16</sup> Secondly, analysis will be limited to the

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<sup>14</sup> Section 38A of the Petroleum Act 1998 enacts this form of protection in relation to security provided in respect of the costs associated with an approved decommissioning programme. See text accompanying fns 58-60.

<sup>15</sup> See, e.g., Henry Hansmann and Reinier Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (1991) Yale LJ (100) 1879; Janet Alexander, 'Unlimited Shareholder Liability Through a Procedural Lens' (1992) 106 Harvard L Rev 387; Rebecca Huss, 'Revamping Veil Piercing for all Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age' (2001) 70 University of Cincinnati L Rev 95.

<sup>16</sup> IA 1986, s 178(1).

issues raised by liquidation. This process, arguably, raises the greatest potential for cost externalisation. Insolvency proceedings, such as administration, also raise important issues in respect of environmental costs but these are beyond the scope of this article.

The article is structured as follows. Section B examines key financial security provisions in UK environmental law and considers their acceptance of self-insurance as a means of evidencing financial security. Section C examines the remedial capacity of self-insurance in light of insolvency law in England and Wales. A scenario-based approach is utilised to assess the impact of insolvency law upon this capacity. Section D draws conclusions and offers recommendations to strengthen the usage of self-insurance within existing and future mandatory financial security requirements.

## **B. FINANCIAL SECURITY REQUIREMENTS IN UK ENVIRONMENTAL LAW**

This section sketches the requirements of some of the main financial security provisions in UK environmental law.<sup>17</sup> It focuses on legislative requirements that expressly permit or prohibit forms of self-insurance and those which exhibit a lack of clarity over their permissibility. A table summarising these findings is set out below (see Table 1).

Two major categories of environmental liabilities are covered by financial security requirements. The first is a fortuity in the form of the risk of an accident that causes pollution or other environmental damage. This may lead to the necessity for remedial measures, measures to restore damaged natural resources, and/or third-party claims based on tort or such like. Neither the cost of the measures or claims nor the timing of an accident (if one should occur) is known. The second category is decommissioning and closure of facilities including, in some cases, restoring the environment. This type is a certainty in that closure and restoration measures will be required at a (relatively) foreseeable time in the future but

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<sup>17</sup> This paper does not cover, for example, financial security requirements contained within certain conventions to which the UK is a Contracting Party such as the Civil Liability Convention (n 5) art VII(1), or the Convention on Civil Liability for Bunker Oil Pollution Damage 2001, art 7(1).

their actual cost, although generally calculated and continually revised during the operational phase, is not precisely known. Self-insurance is often used for both categories as are third-party measures with the exception of insurance, which has a limited use for the latter due to the lack of fortuity in carrying out the measures.

Until recently, there were relatively few mandatory financial security requirements in environmental-related legislation in the UK. This was due, in part, to the Government's long-held belief '...that businesses are best placed to take decisions about all aspects of their operations, including the optimum means of covering liabilities.'<sup>18</sup> This position ignored the inherent economic disincentive faced by operators to purchase financial security instruments from third-parties voluntarily. Mandatory financial security requirements for environmental-related measures are, however, increasing nationally as well as internationally. The most common financial security provisions in UK legislation require an operator to have evidence of funds to carry out obligations such as closure, restoration and aftercare towards the end of a permitted period. Such provisions may supplement the requirement under the Environmental Permitting (England and Wales) Regulations 2010 (EPR)<sup>19</sup> for operators to be '...financially capable of complying with the environmental permit...'<sup>20</sup> in respect of operations subject to the Landfill, Mining Waste,<sup>21</sup> and HASS<sup>22</sup> Directives. If an operation subject to the EPR is not also subject to these Directives, regulators are only to '...consider financial solvency explicitly [where]...they have reason to doubt the financial viability of the activity.'<sup>23</sup>

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<sup>18</sup> Defra, Welsh Assembly and Department of the Environment, 'Environmental Liability Directive; Consultation on options for implementing the Environmental Liability Directive' (November 2006), 47, para 4.19.

<sup>19</sup> SI 2010/675 (as amended).

<sup>20</sup> Defra, Welsh Government and Department of Energy & Climate Change, 'Environmental Permitting Guidance, Core Guidance for the Environmental Permitting (England and Wales) Regulations 2010' (March 2013), 46, para 9.21.

<sup>21</sup> Mining Waste Directive; Commission Decision 2009/335/EC on the Technical guidelines for the establishment of the financial guarantee (2009) OJ L101/25.

<sup>22</sup> Council Directive 2003/122/Euratom on the control of high-activity sealed radioactive sources and orphan sources [2003] OJ L346/57.

<sup>23</sup> Core Guidance (n 20) 46, para 9.22.



As discussed below, an environmental regulator may not possess the requisite skills to make this decision.

Table 1. Legislative requirements that expressly permit or prohibit forms of self-insurance and those which exhibit a lack of clarity over their permissibility

Legislation	Type of Environmental Liability	Form of Self-Insurance (Permitted Yes/No)	
		Demonstration of operator's financial strength (including provision in accounts and overdraft)	Parent Company Guarantee (comprising demonstration of parent company's financial strength)
Landfill Directive	Obligations arising under the permit, including closure and after-care requirements	Yes, but not on its own in respect of commercial landfills	Yes, but not on its own in respect of commercial landfills Yes, subject to conditions in respect of landfills where waste is deposited only from the on-site producer
HASS Directive	Intervention costs relating to the recovery of orphan sources	Not explicitly prohibited	Only in 'exceptional circumstances' but not explicitly prohibited
Mining Waste Directive	Obligations under the permit including after-closure requirements	No guidance yet provided	No guidance yet provided
Directive on the Geological Storage of Carbon Dioxide	Obligations under the permit, including closure and post-closure requirements	Not prohibited but perceived to be risky	Not prohibited but perceived to be risky
Petroleum Act 1998 <sup>24</sup>	Compensation for oil pollution damage and public authority remedial measures	Yes	Yes
Petroleum Act 1998	Plugging and abandoning wells as well as harm to third parties caused by pollution	Yes	Yes
Petroleum Act 1998	Decommissioning obligations	Yes, subject to conditions	Yes, but not on its own (required if a licensee depends on the financial support of its parent)
Energy Act 2004	Decommissioning offshore wind and marine energy installations	Not explicitly prohibited	No

<sup>24</sup> Oil and Gas Authority, 'Oil and gas: petroleum licensing guidance' (28 January 2015) ('OGA expects all offshore operators [who have licences under the Petroleum Act 1998] to be members of the Offshore Pollution Liability Association and to register each of its separate operatorships.')

<<https://www.gov.uk/guidance/oil-and-gas-petroleum-licensing-guidance>> accessed 23 March 2016.

The Landfill Directive requires the operator of a landfill to make ‘...adequate provisions, by way of a financial security or any other equivalent...to ensure that the obligations (including after-care provisions) arising under the permit...are discharged and that the closure procedures...are followed.’<sup>25</sup> The financial provision is to be ‘...sufficient, secure and adequate...’<sup>26</sup> and must be established before the permit is issued and maintained throughout the closure and aftercare periods.<sup>27</sup> It must cover ‘...justified and definable specified events...’ such as the failure of a leachate pipeline or an explosion during closure or aftercare.<sup>28</sup> It does not include potential claims from third-parties following pollution incidents<sup>29</sup> or accidents during the operational phase.

The principal acceptable mechanisms are renewable bonds, escrow accounts, cash deposits with the Environment Agency (in England), a local authority deed agreement, and trust based investment portfolios.<sup>30</sup> The Agency does not accept, on their own, a financial provision in accounts or overdrafts for landfills or a parent company guarantee for commercial landfills because they ‘...do not offer adequate security that funds will be available when required.’<sup>31</sup> Indeed, this crucial recognition will be returned to later in this article. In respect of landfills where waste is deposited only from the on-site producer the Agency may ‘...accept specific mechanisms (such as parent company bonding)...’ when an operator is ‘...a minor subsidiary of a diverse business with credit ratings similar to that of a bank...[and]...the parent company is financially independent of the subsidiary and

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<sup>25</sup> Landfill Directive (n 4), art 8(a)(iv).

<sup>26</sup> Environment Agency, ‘Guidance on Financial Provision for Landfill’ (EPR 5.02.2, 2011) 10, para 5.1.

<sup>27</sup> Environment Agency, ‘Financial Provision for Landfill’ (n 26) 4, para 1.3; see Landfill Directive (n 4) art 8(a)(iv). The aftercare period for a hazardous or non-hazardous waste landfill is estimated at 60 years with three years for a landfill for inert waste: Financial Provision for Landfill (n 26) 6, paras 4.4-4.6.

<sup>28</sup> Financial Provision for Landfill (n 26) 8, para 4.2.1; *ibid* 9, table 1.

<sup>29</sup> *ibid* 8, para 4.21.

<sup>30</sup> *ibid* 10, para 5.3.

<sup>31</sup> *ibid* 10, para 5.5.

demonstrably not reliant on the financial performance of the operator.<sup>32</sup> Therefore, in certain, carefully defined situations, self-insurance is permitted.

The HASS Directive, which protects human health from exposure to ionising radiation from high-activity sealed sources (that is, encapsulated highly radioactive material), directs Member States to ensure that ‘...a system of financial security is established or any other equivalent means to cover intervention costs relating to the recovery of orphan sources...’.<sup>33</sup> The requirements are more stringent under the Basic Safety Standards Directive which must be transposed by Member States by 6 February 2018.<sup>34</sup> It directs Member States to ensure that before an authorisation for practices involving a high-activity sealed source is issued ‘...adequate provision, by way of a financial security or any other equivalent means appropriate for the source in question...’ is made ‘...for the safe management of sources when they become disused sources, including the case where the undertaking becomes insolvent or ceases its activities.’<sup>35</sup> In addition, ‘...a financial security system or other equivalent means...[must]...cover intervention costs relating to the recovery of orphan sources...’ including their management, control and disposal.<sup>36</sup> One reason for the increased stringency is the discovery of orphan sources on the premises of insolvent companies, public places and municipal dumps.<sup>37</sup> Guidance from the Department of Energy & Climate Change (DECC) specifies the following financial security mechanisms: ring-fenced cash and third-

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<sup>32</sup> *ibid* 10, para 5.6; see *ibid* App 2, 20, s A2.1 (Treasurer of Environment Agency carries out ‘health checks’ of bondsmen and accepts only ‘...“investment-grade” ratings...’). The Agency refers such proposals to its Financial Provision Standing Group: *ibid* 10, para 5.6; see *ibid* 11, para 7.1 (group has representatives from Finance, Legal, Operations and Environment and Business directorates).

<sup>33</sup> Council Directive 2003/122/Euratom on the control of high-activity sealed radioactive sources and orphan sources [2002] OJ L346/57, art 10.

<sup>34</sup> Directive 2013/59/Euratom [2014] OJ L13/1, art 106(1).

<sup>35</sup> *ibid* art 87(b) (emphasis added).

<sup>36</sup> *ibid* art 95.

<sup>37</sup> See Commission, ‘Experience gained in the implementation of Directive 2003/122/EURATOM on the control of high-activity sealed radioactive sources and orphan sources’ COM (2015) 158 final, 3 [2].

party guarantees in the form of a bond or letter of credit,<sup>38</sup> with parent company guarantees only in ‘exceptional circumstances’.<sup>39</sup> The guidance is designed to ensure that funds are available in the event of the insolvency of the operator or its parent.<sup>40</sup> As will be argued below, self-insurance cannot guarantee that this will be the case.

The Mining Waste Directive provides that the operator of a Category A or hazardous waste facility must make ‘...a financial guarantee (e.g. in the form of a financial deposit, including industry-sponsored mutual guarantee funds) or equivalent...’ before operations begin.<sup>41</sup> The financial guarantee must cover ‘...all obligations under the permit...including after-closure provisions’<sup>42</sup> and ensure that ‘...there are funds readily available at any given time for the rehabilitation of the land affected by the waste facility...’.<sup>43</sup> The Agency is to provide guidance on acceptable financial security mechanisms,<sup>44</sup> but the Directive is certainly not prohibitive of the possibility of self-insurance being utilised.

Further, the Directive on the Geological Storage of Carbon Dioxide requires an applicant for a permit to store carbon dioxide to have ‘...financial security or any other equivalent...’ to ensure that it meets obligations under the permit, including closure and post-

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<sup>38</sup> DECC, ‘High-activity Sealed Radioactive Sources and Orphan Sources Directive (Council Directive 2003/122/Euratom); Guidance to the Environment Agency’ (26 October 2005) paras 19-29. The publication date is incorrect. The guidance was first published on 12 October 2015.

<sup>39</sup> *ibid* para 28.

<sup>40</sup> See e.g. *ibid* paras 9, 19, 20, 28 and 30-39. The Agency’s former guidance on compliance with permits for sealed sources did not specify acceptable forms of financial provision but simply referred to the term ‘financial provision’: Environment Agency, ‘Environmental Permitting (England and Wales) Regulations 2010, How to comply with your EPR RSR environmental permit – sealed sources’ (April 2011) 12.

<sup>41</sup> Mining Waste Directive, art 14(1). A Category A facility is one at which a failure or incorrect operation such as the collapse of a heap or dam could result in a major accident, or which contains hazardous waste or dangerous chemicals: *ibid* annex III.

<sup>42</sup> *ibid* art 14(1)(a).

<sup>43</sup> *ibid* art 14(1)(b); see Commission Decision on technical guidelines for the establishment of the financial guarantee in accordance with Directive 2006/21/EC concerning the management of waste from extractive industries [2009] OJ L101/25.

<sup>44</sup> Defra and the Welsh Government, ‘Environmental Permitting Guidance, The Mining Waste Directive for the Environmental Permitting (England and Wales) Regulations 2010’ (version 1.1, updated May 2010), 32, para 4.66.

closure requirements, before it may begin injecting carbon dioxide into the storage facility.<sup>45</sup> Acceptable financial security instruments include: funds, financial institution guarantees, insurance, and first-party and related party guarantees, bonds issued by a surety or a bank, and escrow accounts.<sup>46</sup> The European Commission considers self-insurance and corporate guarantees from an affiliated company to be risky owing to the lack of protection they afford from creditors' claims.<sup>47</sup> It acknowledges that the degree of certainty which these measures provide depend upon the stringency of annual reviews of financial statements and/or applicable credit ratings.<sup>48</sup> As discussed below, the regulator may be subject to resource constraints, human and financial, which may hinder a robust review.

Financial security requirements for offshore facilities tend to be more stringent than those for onshore facilities and operations. They do, however, appear to offer greater scope to invoke self-insurance. For example, applicants for an oil and gas licence on the UK continental shelf must be members of the Offshore Pollution Liability Association Ltd (OPOL).<sup>49</sup> OPOL establishes a voluntary mutual scheme to pay compensation up to an overall limit of US\$250 million per incident for damage from oil pollution caused by its members.<sup>50</sup> Members are required to show financial responsibility by one, or a combination, of the following mechanisms: insurance of at least US\$250 million for any one incident and US\$500 million in the annual aggregate with a maximum deductible of US\$10 million per occurrence from an insurer with a specified financial strength credit rating; qualification as a self-insurer; or a guarantee from another company, including 'a leading bank', that qualifies

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<sup>45</sup> Directive 2009/31/EC on the geological storage of carbon dioxide [2009] OJ L140/114, art 19(1). No permits for storage facilities have been issued in the UK as yet.

<sup>46</sup> Commission, 'Implementation of Directive 2009/31/EC on the Geological Storage of Carbon Dioxide, Guidance Document 4, Article 19 Financial Security and Article 20 Financial Mechanism' (2011), ss 2.1 and 2.2.

<sup>47</sup> *ibid* table 3.

<sup>48</sup> *ibid*.

<sup>49</sup> Oil and Gas Authority, 'Oil and gas: petroleum licensing guidance' (28 January 2015) ('OGA expects all offshore operators to be members of the Offshore Pollution Liability Association and to register each of its separate ownerships').

<sup>50</sup> OPOL, 'Offshore Pollution Liability Agreement', cl IV(A) <<http://www.opol.org.uk/agreement.htm>> (1 April 2016 version) accessed 23 March 2016.

as a self-insurer.<sup>51</sup> Qualification as a self-insurer requires a credit rating of ‘...“A-” or higher from Standard & Poor’s; “A-” or higher from A. M. Best; “A3” or higher from Moody’s; “A” or higher from Fitch; and/or the equivalent from another internationally recognised credit rating agency acceptable to...[OPOL].’<sup>52</sup>

Further, the Petroleum Act 1998 requires applicants for licences for exploration and appraisal wells on the UK continental shelf to provide evidence of financial security for plugging and abandoning them as well as harm to third parties caused by pollution.<sup>53</sup> Acceptable mechanisms are ‘...reliance on credit/financial strength rating of the operator or co-venturer; insurance; parent company guarantee/affiliate undertaking; and any combination of the above.’<sup>54</sup> Significantly, operators may utilise the financial security that they have been required to provide by OPOL to cover these requirements.<sup>55</sup> Self-insurance is, therefore, very well entrenched within the mechanisms accepted under the Petroleum Act 1998 and those permitted by OPOL.

Decommissioning obligations are also subject to financial security requirements. The Secretary of State may serve a notice under section 29 of the Petroleum Act 1998 on parties to a joint operating agreement, parent and other companies related to such parties, as well as former licensees, requiring them to submit a costed decommissioning programme.<sup>56</sup> Following the Secretary’s approval of the programme, Section 29 notice holders are jointly and severally liable for the programme and its costs. The Secretary’s approval ring-fences any security provided for the performance of obligations under the programme and protects

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<sup>51</sup> OPOL, ‘Information for prospective members’ <<http://www.opol.org.uk/memberinfo.htm>> accessed 23 March 2016.

<sup>52</sup> OPOL, ‘FR-4, Verification of Self-Insurance’ <<http://www.opol.org.uk/forms.htm>> accessed 23 March 2016.

<sup>53</sup> Petroleum Act 1998, s 38(2) (as amended by the Energy Act 2008, s 73).

<sup>54</sup> DECC, ‘Guidance Note to UK Offshore Oil and Gas Operators on the Demonstration of Financial Responsibility before Consent may be Granted for Exploration & Appraisal Wells on the UKCS’ (effective on and from 1 January 2013) 2 <[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/68885/7265--financial-responsibility-guidelines.doc](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/68885/7265--financial-responsibility-guidelines.doc)> accessed 23 March 2016.

<sup>55</sup> See OPOL website <<http://www.opol.org.uk/>> accessed 23 March 2016.

<sup>56</sup> Petroleum Act 1998, s 30.

it should a section 29 notice holder becomes insolvent.<sup>57</sup> The effect of any legislation, such as the IA 1986, which would prevent or restrict the protected assets from being applied to meet the obligations under the programme is explicitly excluded.<sup>58</sup> This provision mitigates some of the problems raised in Section C. It is, however, important to stress that security must have 'been provided' in order for the protection to arise.<sup>59</sup> The Petroleum Act 1998 defines the term 'security' to include a charge over a bank account or other asset, a cash deposit, a performance bond or guarantee, an insurance policy and a letter of credit.<sup>60</sup> Significantly, these types of security are unlikely to have been given where self-insurance has been permitted, and so the provision is likely to be of little benefit in many circumstances where self-insurance mechanisms are used.

Financial security instruments acceptable to DECC are cash, irrevocable standby letters of credit issued by a Prime Bank, and on-demand performance bonds issued by a bank or insurer provided they are established in an EU or OECD country with a UK lending or insurance office that meets specified ratings.<sup>61</sup> DECC also accepts self-insurance by a

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<sup>57</sup> *ibid*, s 38A; see James Phillips and Rosie Lord, 'Oil and gas decommissioning' (The In-House Lawyer, 15 May 2012) <<http://www.inhouselawyer.co.uk/index.php/environment/9847-oil-and-gas-decommissioning>> accessed 23 March 2016. Every three years, the decommissioning costs plus the net value of remaining recoverable reserves used to calculate the required levels of financial security must be estimated, with the potential for annual estimate depending on the time scales of the project. The audit process must be verified by a DECC-approved independent expert: DECC, 'Guidance Notes, Decommissioning of Offshore Oil and Gas Installations and Pipelines under the Petroleum Act 1998' (URN 09D/734, version 6, March 2011), Annex G, 120. A section 29 notice may be withdrawn from a company that leaves the group, for example if it sells its shares: *ibid* Annex F, 102-09. The Secretary may determine, however, that the company remains liable if adequate financial security is no longer considered to exist: Petroleum Act 1998, s 38(4); see Guidance Notes 109-10. The allocation of costs between section 29 notice holders is subject to contractual agreements between them, which may be governed by a standard decommissioning security agreement: see Guidance Notes Annex G, 117-18; HM Revenue & Customs, 'OT28601 - Decommissioning and abandonment: decommissioning security agreements: introduction' <<http://www.hmrc.gov.uk/manuals/otmanual/ot28601.htm>> accessed 23 March 2016.

<sup>58</sup> Petroleum Act 1998, s 38A(6).

<sup>59</sup> *ibid* s 38A(1).

<sup>60</sup> *ibid* s 38A(4).

<sup>61</sup> Offshore Oil and Gas Guidance Notes (n 57) 118. A 'Prime Bank' is a bank established in a member country of the OECD with at least an 'AA' rating by Standard and Poor's, an 'Aa2' by Moody's, or an equivalent rating by another recognised rating

company provided that it requires less than 30% of its net worth to carry out decommissioning obligations for the project and other projects on the UK continental shelf.<sup>62</sup> DECC does not accept a parent company guarantee on its own as financial security due, in large part, to the potential for the parent to be based outside the UK.<sup>63</sup> It does, however, require such a guarantee as evidence of financial capability for decommissioning if a licensee depends on the financial support of its parent.<sup>64</sup>

Financial security is also required for decommissioning offshore wind and marine energy installations.<sup>65</sup> DECC considers that the following are acceptable instruments: cash, irrevocable letters of credit, bonds issued by a Prime Bank or an insurance company, a ‘...secure, segregated decommissioning fund...’ that accrues in the early or mid-stages of an installation,<sup>66</sup> and a joint trust agreement.<sup>67</sup> The assets forming the financial security are ring-fenced<sup>68</sup> because, as stated by DECC, ‘[t]he Government will wish to be assured that such funds will be available to...[the UK Government]...in the event of insolvency’.<sup>69</sup> Parent company guarantees and decommissioning funds that accrue in the late stages of an installation are not acceptable.<sup>70</sup>

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agency. See DECC, ‘Decommissioning of offshore renewable energy installations under the Energy Act 2004: Guidance notes for industry’ (January 2011, revised), 31, fn 16.

<sup>62</sup> Offshore Oil and Gas Guidance Notes (n 57) 119.

<sup>63</sup> *ibid.*

<sup>64</sup> *ibid* 109.

<sup>65</sup> Energy Act 2004, ss 106(4) and 108(10).

<sup>66</sup> DECC, ‘Offshore Renewable Energy Guidance Notes’ (n 61) 31.

<sup>67</sup> *ibid* 31-32.

<sup>68</sup> Energy Act 2004, s 110A.

<sup>69</sup> DECC, ‘Offshore Renewable Energy Guidance Notes’ (n 61) 31-32. Independent audits using third party experts may be required, with their timing and frequency to be decided on a case-by-case basis: *ibid* 33.

<sup>70</sup> *ibid* 32.



## **C. THE REMEDIAL CAPACITY OF SELF-INSURANCE**

Having considered the regulatory acceptance of self-insurance within UK environmental law, this section will consider the measure's remedial capacity. This is dictated by two factors. Firstly, the extent to which the means of evidencing financial strength, health or capability (e.g. the particular financial ratios utilised), and any conditions placed on their satisfaction (e.g. a certain level of real property being held within the jurisdiction) can ensure that the operator holds, or has access to, adequate assets and/or funds to meet its environmental liabilities. This point may be seen as intrinsic to self-insurance. Secondly, and perhaps uniquely to self-insurance when compared to measures such as insurance, bank guarantees, surety bonds and trust funds, the impact of the protection afforded to an insolvent operator's creditors under insolvency law in England and Wales, specifically the IA 1986 and the Insolvency Rules 1986 (IR 1986). This factor, which plays an influential role in determining the amount recovered by a regulator for any requisite works, may be seen as extrinsic to self-insurance. Intrinsic factors, however, substantially influence this factor in that they render it more probable that the protection afforded to an insolvent operator's creditors will hinder cost recovery by a regulator.

### **1. Existence of Sufficient Assets and/or Funds**

Where a surplus exists between the funds available to an operator and the environmental liability to which it is exposed, self-insurance enables the operator to meet its environmental liabilities in full. In these circumstances, self-insurance would exhibit a strong remedial capacity. Moreover, where the operator's assets are sufficient to cover expected losses,

there will be a strong economic incentive for it to develop practices and procedures with the aim of reducing the probability that its activities may cause an environmental accident.<sup>71</sup>

There are other clear benefits associated with self-insurance. Firstly, it requires an operator, and potentially its parent, to demonstrate a degree of financial strength both prior to and during the period in which it undertakes an environmentally dangerous activity. The 'threshold' set by the financial test prevents nominally capitalised, financially unstable operators from entering the market.<sup>72</sup> Such operators may be considered particularly likely to pose an environmental risk. The combination of low asset levels with the protection afforded by limited liability means that shareholders need not take expected harm into account when deciding whether, and indeed how, to undertake the activity.<sup>73</sup>

Secondly, where the parent provides a guarantee in respect of its subsidiary's environmental liabilities this creates a default 'target' for the regulator should the subsidiary be unable to meet the requisite costs. This achieves by contract what 'veil piercing' and other liability extending mechanisms (e.g. the interpretation of the relevant statutory language so as to capture the parent) seek to achieve through judicial discretion. It may even be seen as providing a superior remedy because the ex ante demonstration of financial strength ensures a degree of financial stability in the parent, something that these mechanisms cannot do owing to their ex post application.

Thirdly, parties that self-insure do not have to incur the direct and indirect costs typically associated with purchased financial security instruments. With regards to direct costs, operators do not have to pay fees or premiums nor set aside funds for future payments. It may be argued that such payments divert crucial funds away from the core commercial activity of the operator and could, at least theoretically, be spent on pollution

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<sup>71</sup> For a discussion of the capacity of self-insurance to reduce the probability that an operators activities will cause an environmental accident see Colin Mackie, 'The Regulatory Potential of Financial Security to Reduce Environmental Risk' (2014) 26 JEL 2 189.

<sup>72</sup> Steven Shavell, 'Minimum asset requirements and compulsory liability insurance as solutions to the judgment-proof problem' (2005) 36 RAND Journal of Economics 1 63, 67.

<sup>73</sup> *ibid.*

prevention. With regards to indirect costs, providers of bank guarantees and letters of credit are likely to require collateral, such as cash, as security before providing the instrument.<sup>74</sup> The level of collateral is likely to be dependent upon the purchaser's financial risk. It would not be uncommon for 100% of the instrument's value to be demanded by way of collateral.<sup>75</sup> Operators will be unable to utilise these funds and assets for other purposes, such as raising debt finance, for the duration of the coverage; the higher the collateral requirement, the greater this restriction. A consequence of this is, inter alia, that it will restrict the availability of new capital for investment in pollution prevention.<sup>76</sup> Where funds are rendered inaccessible in this way, the probability of an environmental accident arising may increase.

However, beyond circumstances where there is a surplus between the funds available to the operator and the extent of its liabilities, self-insurance exhibits certain features which mean that an operator may be unable to meet its environmental liabilities in full. This will result in an externalisation of part or, indeed all, of these costs to society. Firstly, as observed in Section B, self-insurance does not, generally, require specific assets or funds to be available to a regulator should prevention, remediation or restoration costs need to be recovered. Instead, its efficacy rests on the assumption that satisfaction of financial tests or ratios render the operator able to draw upon a verified, and verifiable, capital base to meet its liabilities. This contrasts starkly with measures such as trust funds, insurance or surety bonds that are dedicated to cover environmental liabilities. With self-insurance, even if specific, unencumbered assets were theoretically available, they are likely to be treated as part of the operator's general body of assets and, thus, available to its

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<sup>74</sup> J Boyd, 'Green Money' in the Bank: Firm Responses to Environmental Financial Responsibility Rules' (1997) 18 *Managerial and Decision Economics* 6 491, 493.

<sup>75</sup> *ibid* 497. So, for example, for a bank to provide a guarantee to the value of £2,000,000, it may require £2,000,000 of collateral from the operator.

<sup>76</sup> Jason Shogren, Joseph Helliges and Ramu Govindasamy, 'Limits to environmental bonds' (1993) *Ecological Economics* 8 109, 117.

unsecured creditors should it enter into liquidation.<sup>77</sup> This insolvency-related issue<sup>78</sup> is considered below. That said, on its own, the lack of assets dedicated specifically to environmental liabilities is not inherently problematic. A company, or indeed its parent, may very well remain solvent after bearing the financial costs associated with its environmental liabilities, particularly where the liability is small.

Secondly, self-insurance assumes that recent financial performance is a reasonable predictor of future financial performance.<sup>79</sup> Flaws exist in this assumption. The satisfaction of tests or ratios which self-insurance typically requires cannot anticipate a sudden, unexpected decline in a market or price of a commodity, the insolvency of an important client or the loss of a key contract.<sup>80</sup> Each of these factors can impact significantly upon the operator's cash flow, and consequently its capacity to meet its environmental liabilities.<sup>81</sup> Concerns regarding future financial performance can be mitigated to some extent by self-reporting. Most mandatory financial security legislation requires an operator to notify the regulator if it no longer satisfies the credit or financial strength rating requirement.<sup>82</sup> Credit watch notifications provide an early indication as to whether an operator's ability to continue to self-insure is in

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<sup>77</sup> It is for this reason that s 38A of the Petroleum Act 1998 'ring-fences' funds or assets proffered as security for the costs associated with an approved decommissioning programme.

<sup>78</sup> The term 'insolvency law-related issue' relates to aspects of insolvency law in England and Wales which may confer protection to secured and unsecured creditors of an insolvent operator. See, e.g., the discussion below regarding the potential for payments made by the operator to the regulator to amount to a voidable 'preference' under section 239 IA 1986 if the operator enters into insolvent liquidation within the following six months.

<sup>79</sup> GAO, 'Environmental Liabilities' (n 9) 44.

<sup>80</sup> *ibid.*

<sup>81</sup> This factor is not only a flaw of self-insurance. Captive insurers pose a similar problem in that the financial condition of the subsidiary-insurer is generally closely connected to that of its parent-insurer: *ibid* 47. If the parent faces financial difficulties, the captive may be unable to cover claims against its policies: *ibid.* Thus, unlike a commercial insurer, a captive's ability to absorb claims is '...weakest when its strength is most needed - upon the insolvency of the parent': Boyd, 'Financial Responsibility' (n 6) 59-60.

<sup>82</sup> See, e.g., US financial security requirements for closure of hazardous waste treatment, storage and disposal facilities. Owners or operators are required to submit updated information to the regulator within 90 days after the close of each fiscal year: 40 CFR s 264.143(f)(5). Owners or operators are required to submit notice of intent to establish alternate financial assurance if an operator no longer meets criteria for corporate financial test or corporate guarantee: *ibid* s 264.143(f)(6).

doubt.<sup>83</sup> Further, mandatory financial security legislation typically authorises a regulator to query whether an operator continues to meet the relevant criteria and to require it to provide alternative financial security if the regulator concludes that this is no longer the case.<sup>84</sup>

However, whilst predictions of weak future financial performance may permit a regulator to be proactive in its dealings with the operator,<sup>85</sup> it raises further difficulties for society as residual risk-bearer. An operator may not be able to comply with a requirement to substitute self-insurance with third-party financial security such as insurance or a surety bond, particularly if the operator is financially distressed. Its cost may also be a factor in tipping the operator into insolvency.<sup>86</sup> Alternatively, if as a result of the unfavourable credit notification, the relevant regulator requires the operator to deposit funds or assets to provide security for environmental liabilities then this may be challenged as a preference under the IA 1986 as discussed below.<sup>87</sup>

The third feature of self-insurance which may hinder its remedial capacity relates to reliance on data provided by the operator or its parent to satisfy the financial tests or ratios. This data must be audited by the regulator at appropriate intervals to determine both its accuracy and whether the operator continues to satisfy the requisite financial tests and

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<sup>83</sup> Stacey Sklaver, 'Parents Know Best: A Legal and Economic Analysis of Financial Assurances under CERCLA Section 108(B) and the Parent-Subsidiary Relationship' (2012) 18 J L Bus & Ethics 169, 198.

<sup>84</sup> See, e.g., 40 CFR s 264.143(f)(7) (if regulator has a reasonable belief that an owner or operator may no longer meet the criteria for corporate financial test or corporate guarantee, the regulator may require it to submit reports of its financial condition, and conclude on the basis of such reports that it does not satisfy the criteria, and to require it to post alternative financial security).

<sup>85</sup> See Natural Resources Defense Council, 'Fact Sheet, Undermined Promise II: Frequently Asked Questions about Self-bonding' ('Texas required and successfully received replacement reclamation bonds for Luminant Mining's \$1.2 billion of self-bonding when parent company Energy Future Holdings declared bankruptcy in April 2014.') <<http://www.underminedpromise.org/selfbonding-factsheet.pdf>> accessed 10 November 2015.

<sup>86</sup> See Blanca Mamutse and Valerie Fogleman, 'Environmental Claims and Insolvent Companies: The Contrasting Approaches of the United Kingdom and the United States' (2013) Br J Am Leg Studies 579, 618-21 (Canadian company declared bankruptcy after being required to post C\$10 million in financial security to fund clean-up).

<sup>87</sup> IA 1986, s 239. See discussion in Section C2(c).

ratios.<sup>88</sup> This raises two important implications. The first concerns resources, both human and financial. Auditing the data is time consuming and expensive. With the tightening of budgets, robust auditing by regulators may not be possible. Furthermore, the interpretation, verification, and monitoring of the financial tests or ratios require the relevant regulator to possess sufficient financial expertise,<sup>89</sup> which may, or may not, exist. In turn, this may require additional staff with the requisite skills, thus creating an additional expense. Regulators must be in a position to dedicate adequate time and resources to subjecting the data presented by self-insurance operators to the requisite level of analysis. If they are not able to do so but still permit self-insurance then the prospect of the operator or its parent defaulting on their environmental obligations at a later date cannot be pre-empted. The liquidation of Scottish Coal Company Ltd in 2013 and the resulting externalisation of the vast costs associated with restoration works following a wholly inadequate bond provision is a case in point. The requisite works were estimated at approximately £73,000,000.<sup>90</sup> This demonstrates the very real risk posed to society by insufficient regulatory expertise and oversight of financial security provision,<sup>91</sup> both prior to permitting activities to commence and during the operational phase.

The second implication relates to the accuracy of the underlying data. Reliance on financial tests or ratios presumes that the data used to calculate them is accurate and derived from transparent, uniform accounting procedures utilised by all operators applying to self-insurance, or to continue self-insuring. However, operators may not adopt such procedures in deriving the relevant data,<sup>92</sup> leading to difficulties in ensuring equality of

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<sup>88</sup> Boyd, 'Financial Responsibility' (n 6) 21.

<sup>89</sup> *ibid* 63.

<sup>90</sup> Joint Liquidators of the Scottish Coal Company Limited [2013] CSOH 124 [7].

<sup>91</sup> Jim Mackinnon, Chris Norman and James Fowlie, Report of Independent Review of Regulation of Opencast Coal Operations in East Ayrshire (January 2014) 28-29

<<https://www.east-ayrshire.gov.uk/Resources/PDF/C/Coal-Independent-Review-of-the-Regulation-of-Opencast-Coal-Operations-in-East-Ayrshire---Redacted-report-by-the-Independent-Review-Team.pdf>> accessed 23 March 2016.

<sup>92</sup> Boyd, 'Financial Responsibility' (n 6) 21.

treatment between operators. For example, some applicants may pass the financial tests or ratios or satisfy self-bonding requirements when they should have failed.<sup>93</sup> Where the accounting used to derive the data which is then used to satisfy the financial tests or ratios is unintentionally inaccurate or at worst, fraudulent, the tests or ratios will not represent the operator's true financial condition.<sup>94</sup> Indeed, operators may portray their financial position to be healthier than is actually the case in order to avoid having to pay for insurance.<sup>95</sup> Whilst such accounting may not be fraudulent in the majority of cases, accounting fraud is relatively common amongst small operators and those in financial distress.<sup>96</sup> It may only be discovered when it is too late. Whilst self-insurance is unlikely to be available to small operators, the prospect of formerly large, financially stable operators becoming financially distressed and portraying a stronger balance sheet than its finances would dictate is entirely possible. Indeed, there are precedents for it, notably Enron.<sup>97</sup> The combined effect of the implications associated with reliance on submitted data may be an inaccurate reflection of the level of funds available to meet environmental liabilities. For a financial security measure whose viability and legitimacy hinges on the credibility of data utilised, this raises fundamental concerns as to its regulatory permissibility.

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<sup>93</sup> See, e.g., National Wildlife Federation, Western Organization of Resources Councils and Natural Resources Defense Council, 'Undermined Promise II' (2015) 4 (some US coal companies '...may be "double-pledging" their assets, which appear to be obligated to their creditors in addition to State regulatory authorities; these assets may also be overvalued.') <<http://www.underminedpromise.org/UnderminedPromisell.pdf>> accessed 23 March 2016.

<sup>94</sup> GAO, 'Environmental Liabilities' (n 9) 44.

<sup>95</sup> *ibid* 45.

<sup>96</sup> Boyd, 'Financial Responsibility' (n 6) 63.

<sup>97</sup> See Erica Beecher-Monas, 'Enron, Epistemology and Accountability: Regulating in a Global Economy' (2003) 37 *Ind L Rev* 141, 153; Joshua Ronen, 'Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited' (2002) 8 *Stanford Journal of Law, Business & Finance* 39, 40 (Enron '...proved to be only the beginning of a series of stunning irregularities by major corporations that were the darlings of Wall Street: WorldCom, AOL, Metromedia, Fiber Networks, Qwest Communications; the list goes on and on').

## 2. Protection Afforded to the Responsible Operator's Creditors

The protection afforded to the responsible operator's creditors under insolvency law may also impact upon the remedial capacity of self-insurance, and consequently upon society as residual risk-bearer of any externalised costs. This stems principally from the fact, detailed above, that self-insurance does not require specific financial assets or funds to be set aside to meet prevention, remediation or restoration costs which a regulator has incurred, or will incur in the future. The following three scenarios demonstrate the potential shortcomings of self-insurance's remedial capacity in circumstances in which the operator enters into liquidation. These scenarios also apply to environmental liabilities that arise in the absence of financial security to cover them, such as where a regulator fails to demand its provision.

### (a) Scenario 1: Cost Recovery Following Disclaimer of Onerous Property

In the first scenario, a liquidator appointed over an insolvent, self-insuring operator utilises its power under section 178 IA 1986 to disclaim 'onerous property' owned by the operator.<sup>98</sup> Successful invocation of this power brings to an end both the operator's liabilities and rights in respect of the property disclaimed.<sup>99</sup> This is intended to facilitate a prompt winding-up of the operator's affairs,<sup>100</sup> and ensures that the funds realised in the winding-up are not committed to a single creditor. The power may, therefore, be seen to benefit the general body of creditors by ensuring that the pool of funds and assets available for distribution is not diminished further.<sup>101</sup> 'Onerous property' is defined under the Act as any unprofitable

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<sup>98</sup> IA 1986, s 178(2).

<sup>99</sup> *Hindcastle Ltd v Barbara Attenborough Associates Ltd* [1997] AC 70, 87. It has been found that disclaimer terminates an operator's interest in a trust fund created to ensure that certain liabilities associated with a waste management licence were met: *Environment Agency v Hillridge Limited* [2003] EWHC 3023 (Ch) [44].

<sup>100</sup> *Hindcastle* (n 99) 86.

<sup>101</sup> Paul Omar, 'Disclaiming Onerous Property in Insolvency: a Comparative Study' (2010) 19 *International Insolvency Rev* 41, 41.



contract or ‘...any other property of the company which is unsaleable or not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous act.’<sup>102</sup> Land which has, or may have, been contaminated by the operator’s activities, and to which significant remediation is or may be required, seems to fall comfortably within this definition. So too would a mine, quarry or landfill to which significant restoration obligations were required or, indeed, a permit under the EPR.<sup>103</sup> If so, they could be disclaimed.

Importantly, disclaimer does not affect the rights or liabilities of any person other than the company.<sup>104</sup> For example, the rights and liabilities of guarantors<sup>105</sup> and sureties<sup>106</sup> for a tenant’s obligation under a lease have been found to be preserved following its disclaimer. Through analogy, this would suggest that even where a contaminated or environmentally damaged site or unrestored mine, or a permit under the EPR was disclaimed, any financial security, such as a surety, bond or guarantee provided by a financial institution, or guarantee provided by a parent company, would remain intact. In such circumstances, the residual risk to which society is exposed would be reduced significantly. A third-party would, depending upon the construction of the terms of the relevant instrument, be required under contract to meet the operator’s environmental liabilities or, at the very least, a proportion of them.

This option to ‘default’ to a third-party in situations of insolvency is not, typically, available with self-insurance, the exception being where the regulator has demanded a guarantee or self-bond from the parent company. Whilst these contractually override the parent’s de facto immunity from environmental liabilities arising from its subsidiary’s

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<sup>102</sup> IA 1986, s 178(3) (emphasis added).

<sup>103</sup> The courts have previously found a waste management licence (now a permit under EPR) to be ‘property’ for the purposes of section 178 IA 1986, but they have disagreed about whether it was disclaimable. In *In re Celtic Extraction Ltd* [2001] Ch 475 (CA), the Court of Appeal held that such a licence was disclaimable. In contrast, the High Court in *In re Mineral Resources Ltd* [1999] BCC 422 held that it could not be disclaimed and that the then relevant provisions of the Environmental Protection Act 1990 (the ‘EPA 1990’) prevailed.

<sup>104</sup> IA 1986, s 178(4).

<sup>105</sup> *Christopher Moran Holdings Ltd v Bairstow* [2000] 2 AC 172 (HL), 183.

<sup>106</sup> *Basch v Stekel* [2001] L & TR 1 (CA) [23].

activities,<sup>107</sup> they cannot ensure that costs will not be passed on to society. Even with such a guarantee or bond, the parent company may have suffered financially as a result of its subsidiary's insolvency and this could affect its ability to meet its subsidiary's environmental obligations. Furthermore, as noted by one regulator following the failure of self-bonds in the US mining sector '...the corporate guarantee contains all the risks of the financial test, in addition to the risk that a corporate parent faced with environmental problems and a failing subsidiary may seek to limit their liability for the subsidiary's obligations.'<sup>108</sup> Thus, self-insurance is particularly exposed to the externalisation of costs facilitated by disclaimer in a manner in which insurance, trust funds or surety bonds, for example, are not. Indeed, with these forms of financial security, a regulator need be more concerned with their sufficiency than with the implications of disclaimer.

A liquidator's ability to disclaim onerous property presents a direct and significant hindrance to a regulator's attempt to recover costs which it has incurred, or may need to incur, in fulfilling the self-insuring operator's environmental obligations.<sup>109</sup> The recovery may be hindered in two distinct situations, each deriving from this lack of a dedicated insurance policy, bond, or trust fund against which to recover inherent to self-insurance. Firstly, where the regulator has undertaken the necessary works but was unsuccessful in recovering the associated costs from the operator prior to its insolvency;<sup>110</sup> the question here is whether the

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<sup>107</sup> Under UK company law, the doctrine of limited liability provides that when a company's assets are exhausted, generally, the shareholder's liability is limited to any amount unpaid on their shares: Companies Act 2006, s 3(2). This may be a nominal amount.

<sup>108</sup> Texas Commission on Environmental Quality, 'Financial Assurance Interim Report to the House Committee on State Affairs' (CTF-14, August 2014) 16 [5]

<[http://www.tceq.state.tx.us/assets/public/comm\\_exec/pubs/ctf/014.pdf](http://www.tceq.state.tx.us/assets/public/comm_exec/pubs/ctf/014.pdf)> accessed 23 March 2016.

<sup>109</sup> Even where the liquidator does not seek to disclaim onerous property, there may be insufficient assets to satisfy the claims of all of the operator's unsecured, non-preferential creditors. Disclaimer does, however, exacerbate the risk associated with an operator's insolvency for the reasons set out below.

<sup>110</sup> Where the enforcing authority has taken a charge over the self-insuring operator's premises in respect of the costs it has incurred, an option examined in Scenario 2 of Section C, some of the problems highlighted in the present scenario may be resolved.

regulator can prove for these costs in the winding-up. Secondly, where the requisite works remain outstanding at the commencement of liquidation; the question here is whether it can prove in respect of the costs of undertaking the outstanding works.

To deal first with the situation where the regulator has undertaken the works, under section 178(6) IA 1986, any person ‘...sustaining loss or damage in consequence of the operation of a disclaimer...’ is deemed to be a creditor of the company ‘...to the extent of the loss or damage...’ and may seek to recover this in the winding-up. Disclaimer of land which has been contaminated, or suffered environmental damage or to which significant restoration obligations attach, or any burdensome licence or permit ends the operator’s obligations in respect of it. The requisite ‘loss or damage’ to the regulator would, it seems, be its inability to pursue the operator directly for the costs associated with undertaking the necessary works. If so, the regulator would be entitled to recover this ‘loss’ in the winding-up.

There are, however, two potential issues here for society as residual risk-bearer. These relate to the distinction between regulators being permitted to recover any ‘loss or damage’ suffered as a result of disclaimer and actually recovering it. Firstly, whilst, in theory, a regulator who undertakes the works may prove for the entirety of the costs in the liquidation,<sup>111</sup> there is little prospect of these costs being recovered in full and, indeed, they may not be recovered at all. In a winding up, the claims of fixed charge holders are paid first, with the expenses of the winding-up,<sup>112</sup> such as the liquidator’s remuneration, being paid next.<sup>113</sup> The company’s preferential debts, ordinary<sup>114</sup> and secondary,<sup>115</sup> are then paid.<sup>116</sup>

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<sup>111</sup> IR Rules 1986, SI 1986/1925, rr 12.3(1) and 13.12(1)(a)(i). This, of course, presumes that the costs were sanctioned by the relevant regulatory framework. For example, under The Environmental Damage (Prevention and Remediation) (England) Regulations 2015, SI 2015/810, the responsible operator is liable for the ‘reasonable’ costs of the enforcing authority in relation to work undertaken by it in relation to costs such as monitoring the remediation after the work has been carried out: regs 24(2) and 25(2).

<sup>112</sup> The possible expenses of the liquidation, and their relative priority amongst themselves, are set out in r 4.218 IR 1986.

<sup>113</sup> IA 1986, s 175(1).

<sup>114</sup> *ibid* s 386(1)(1A). They are specified in paras 8-15B of Schedule 6.

<sup>115</sup> *ibid* s 175(1)(1B). They are defined in s 386(1)(1B) IA 1986 and specified in paras 15BA and 15BB of Schedule 6.

<sup>116</sup> *ibid* s 175(1).

The claims of the floating charge holders can, subject to certain exceptions listed below, then be satisfied.<sup>117</sup> It is only at this point that unsecured, non-preferential creditors, such as the regulator, can be paid.

There is, however, a high possibility that the assets and funds of the operator being wound-up will be exhausted by the time the regulator is in a position to be paid. An impact assessment carried out by the Insolvency Service in March 2014 found returns paid to unsecured creditors in liquidation to be 'extremely low' given that the value of assets available for distribution was often low.<sup>118</sup> It drew upon data derived from 2012 which found that the average dividend paid to unsecured creditors in creditors' voluntary and compulsory liquidations was 'effectively zero'.<sup>119</sup> Some degree of protection has been accorded to these creditors through the 'prescribed part' which, provided certain conditions are met,<sup>120</sup> ring-fences a percentage<sup>121</sup> of the company's net property for them where a floating charge was created on or after 15 September 2003. Whilst this may result in unsecured creditors recouping some of the amount owed to them, the Insolvency Service impact assessment suggests it may only be a nominal amount.

Even if assets are available for distribution, where there are numerous unsecured creditors then the residual risk to society is significant. It is likely that only a fraction of the outstanding costs will be recovered. The regulator will have to share equally (i.e. *pari passu*) in any amount left over after prior claims have been satisfied.<sup>122</sup> There are two aspects to this: firstly, no unsecured creditor may gain priority in ranking over another, even if their claim arose at an earlier date; and secondly, where funds available to meet the claims of

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<sup>117</sup> *ibid* s 175(2).

<sup>118</sup> Insolvency Service, 'Continuity of Essential Supplies to Insolvent Businesses, Impact Assessment' (March 2014) 6, para 22 <[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/328136/Annex\\_C\\_-\\_Impact\\_Assessment.doc](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/328136/Annex_C_-_Impact_Assessment.doc)> accessed 23 March 2016.

<sup>119</sup> *ibid*.

<sup>120</sup> IA 1986, ss 176A(1)-(5).

<sup>121</sup> The actual percentage conferred is dictated by the value of the company's net property: Insolvency Act 1986 (Prescribed Part) Order 2003, SI 2003/2097, art 3.

<sup>122</sup> Voluntary liquidations (s 107 IA 1986); Compulsory liquidations (r 4.181(1) IR 1986).

such creditors are insufficient, any funds remaining are distributed to them in equal proportions. The potential low value of available assets and the further dilution of the recoverable sum through the requirement for equal treatment may discourage regulators from engaging with the winding-up process in the first place. Where the regulator chooses to prove for the debt, the outcome is likely to be identical to that where no financial security was demanded from the operator. This is a serious concern for society.

Secondly, the regulator's claim in respect of 'loss or damage' incurred in consequence of disclaimer may, at least in certain environmental frameworks, 'fall away' if and when the licence or permit is disclaimed. For example, under regulation 57(2) EPR, a regulator may arrange for steps to be taken to remedy the effects of pollution if, for example, it believes that the contravention of an environmental permit condition has caused pollution.<sup>123</sup> If the regulator chooses to do so it may recover the cost of taking those steps from the operator.<sup>124</sup> Problems arise, however, when the definition of 'operator' is examined. Under regulation 7 EPR, if a regulated facility authorised by an environmental permit '...ceases to be in operation...', as is likely to be the case when the winding-up process has been instigated, then the 'operator' is deemed to be the person who 'holds' the permit. Where a liquidator utilises their power under section 178 IA 1986 to disclaim the permit, neither the liquidator nor anyone else could be deemed to 'hold' the permit. In fact, it is strongly arguable that there is no permit to hold. Disclaimer of a lease, for example, has been deemed to result in it ceasing to exist.<sup>125</sup> In *In re Mineral Resources Ltd*, Neuberger J agreed with the argument of counsel that the '...idea that a waste management licence could be said to 'continue in force' in circumstances where it is vested in nobody is little short of absurd...'.<sup>126</sup> Thus, upon disclaimer, there may be no one to pursue and any claim for 'loss or damage' under section 178(6) IA 1986 seems to be lost. From the perspective of

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<sup>123</sup> EPR 2010, reg 38(2).

<sup>124</sup> *ibid* regs 57(4) and (6).

<sup>125</sup> *Mineral Resources* (n 103) 430.

<sup>126</sup> *ibid* 430-31.

environmental protection and, indeed, from society as residual risk bearer, this is highly problematic. Whilst the EPR is just one of many environmental frameworks, it is of immense regulatory significance as it governs numerous environmentally risky activities, such as waste and mining waste operations and activities relating to radioactive substances.

To deal now with the question whether a regulator may prove in the winding-up in respect of costs associated with undertaking works post-liquidation. As indicated above, a person sustaining 'loss or damage' in consequence of a disclaimer may prove for this in the winding-up. However, Neuberger J's reasoning in *Mineral Resources* indicates that a regulator is unlikely to be able to prove in respect of costs associated with requisite, but outstanding, works. This is because under the then relevant regulatory framework the regulator was not under a statutory or contractual duty to undertake them.<sup>127</sup> It merely had the power to undertake them as long as the environmental permit existed.<sup>128</sup> This is also likely to be the case under the EPR. In effect, the regulator suffers no true loss or damage in these circumstances. Rather, the loss is borne by the general public.<sup>129</sup> Other environmental frameworks which permit a regulator to undertake necessary works on behalf of the operator adopt similar precatory language. For example, under regulation 23(b) of the Environmental Damage (Prevention and Remediation) (England) Regulations 2015 (EDR), the enforcing authority 'may' carry out any reasonable works if a responsible operator fails to comply with a remediation notice.

That disclaimer can prevent a regulator from recovering costs necessary to 'tidy up' after the responsible operator is inherently problematic from an environmental protection perspective and may encourage irresponsible behaviour by some operators. Operators may be incentivised to enter voluntary liquidation proceedings with the intention of avoiding these costs. Whilst in *Re Wilmott Trading Ltd*, Neuberger J believed there to be a very strong public interest argument against such an approach where the operator had some funds which

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<sup>127</sup> *ibid* 433.

<sup>128</sup> *ibid*.

<sup>129</sup> *Ibid*.

enabled it to comply with its licence,<sup>130</sup> it has not been tested formally in the courts. For Armour, limiting the capacity for dissolution to circumstances where the operator had little or no funds to fulfil its permit/licence obligations would redress the perverse incentive to use liquidation to avoid environmental claims.<sup>131</sup>

Disclaimer undoubtedly achieves its overriding purpose of facilitating a prompt winding-up of the operator's affairs. However, it is strongly arguable that property to which environmental liabilities attach should be treated as fundamentally different to other forms of disclaimable property and not be capable of disclaimer. Firstly, in the case of land which is contaminated, has been subject to significant environmental damage or to which substantial restoration obligations are otherwise required, prospective purchasers may be deterred by stigma associated with the site, the prospect of further damage being uncovered, and remediation or restoration costs escalating.<sup>132</sup> There may be no willing takers of the site, even at a 'knockdown' price. If so, and the regulator is not in a position financially to remediate or restore the site, it will remain in a contaminated, damaged and/or unrestored state, creating conditions under which the contamination may spread and damage worsen. Not only may this pose significant risks to local ecosystems, residents may be left living next to a potentially harmful and dangerous site. Such serious implications for society are not, typically, present with other forms of disclaimable property. If, for example, a liquidator disclaims a lease, the landlord will lose rental income and may have to undertake significant repairing and insuring obligations. However, the landlord will be in a position to seek a new tenant, albeit at what may be a reduced rent. The property will not be stigmatised owing to its history or uncertain future so as to be unappealing to potential tenants. So, in order to prevent the creation of contaminated, damaged or unrestored 'orphan sites' with no real possibility of sale, environmental liabilities could be prioritised over the claims of the company's other creditors, including its unsecured, non-preferential creditors. The

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<sup>130</sup> [2000] BCC 321 (Ch), 236.

<sup>131</sup> John Armour, 'Who pays when polluters go bust?' (2000) LQR 200, 204.

<sup>132</sup> Peter Patchin, 'Valuation of Contaminated Properties' (1988) 56 The Appraisal Journal 17.

prioritisation could be achieved, at the very least, by treating emergency works as an expense of the liquidation.

Secondly, and relatedly, as counsel for the Environment Agency argued unsuccessfully in *In Re Celtic Extraction Ltd*, and Neuberger J reasoned in *Mineral Resources*,<sup>133</sup> the disclaimer provisions frustrate a ‘pillar’ of EU environmental policy<sup>134</sup> ‘...that the polluter should pay’.<sup>135</sup> If a polluter-operator can be relieved of its environmental obligations, one of the principle’s central policy objectives, that of cost internalisation,<sup>136</sup> is thwarted. Importantly, cost internalisation, which may be facilitated by ensuring that operators bear the costs of their environmental liabilities, creates market-orientated incentives for them to avoid causing environmental damage in the first place.<sup>137</sup> This ‘upstream’ benefit of cost internalisation may be seen to comply with the principle that preventive action should be taken,<sup>138</sup> and gives the polluter-pays principle an important environmental protection perspective.<sup>139</sup> This preventive potential of cost internalisation derives from the fact that ‘...potential polluters who know they will be liable for the costs of remedying the damage they cause have a strong incentive to avoid causing such damage.’<sup>140</sup> With the threat of liability looming, it is economically rational for them to increase

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<sup>133</sup> *Mineral Resources* (n 103) 431.

<sup>134</sup> Nicolas de Sadeleer, *Environmental Principles: From Political Slogans to Legal Rules* (OUP 2002) 27.

<sup>135</sup> Consolidated Version of the Treaty on the Functioning of the European Union (TFEU) [2012] OJ C326/1, art 191(2).

<sup>136</sup> Council Recommendation 75/436/Euratom, ECSC, EEC of 3 March 1975 regarding cost allocation and action by public authorities on environmental matters [1975] OJ L194/1 [1].

<sup>137</sup> Cases C-378/08, C-379/08 and C-380/08 *Raffinerie Mediterranee (ERG) SpA v Ministero dello Sviluppo Economico* [2010] Env LR 39, Opinion of AG Kokott, paras 85-86.

<sup>138</sup> *ibid* para 86; see also TFEU, art 191(2).

<sup>139</sup> Case C-254/08 *Futura Immobiliare Srl Hotel Futura v Comune di Casoria* [2009] 3 CMLR 45 1519, Opinion of AG Kokott, para 31.

<sup>140</sup> Commission, ‘Green Paper on remedying environmental damage’ (Communication) COM (93) 47 final, 5.



their level of care when undertaking the activity and/or decrease the actual level of the activity so as to reduce the risk of environmental damage occurring.<sup>141</sup>

As Neuberger J recognised in *Mineral Resources*, whilst disclaimer assists shareholders, creditors, debtors and liquidators and facilitates the administration of commerce,<sup>142</sup> these interests are of a ‘...less wide ranging and important nature...’ than the polluter-pays principle and the furtherance of environmental protection.<sup>143</sup> This reasoning was followed in the Scottish case, *Joint Liquidators of Scottish Coal Co Ltd v Scottish Environment Protection Agency*.<sup>144</sup> There, in the context of the attempted abandonment or disclaimer of environmental licences by the liquidators, the Lord Chief-Justice believed there to be ‘persuasive’ factors in favour of prioritising the policy of ‘maximising’ environmental protection over the policy of treating unsecured creditors equally.<sup>145</sup>

In contrast, Morritt LJ, who gave the only reasoned judgment in *Celtic Extraction*, did not believe that the polluter-pays principle, as implemented by the EU Waste Directive, was intended to apply to cases where the polluter was unable to pay ‘...so as to require that the unsecured creditors of the polluter should pay to the extent of the assets available for distribution among them.’<sup>146</sup> This position was, in his opinion, supported by the policy requirement that the property of insolvents should be divided equally amongst their unsecured creditors;<sup>147</sup> the Environment Agency was to be treated just like any other unsecured, non-preferential creditor. The *pari passu* principle, thus, trumped the polluter-pays principle.

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<sup>141</sup> Lucas Bergkamp, *Liability and Environment: Private and Public Law Aspects of Civil Liability for Environmental Harm in an International Context* (Kluwer Law International 2001) 87.

<sup>142</sup> *Mineral Resources* (n 103) 431.

<sup>143</sup> *ibid.*

<sup>144</sup> [2013] CSIH 108, 2014 SC 372.

<sup>145</sup> *ibid* 144, 407.

<sup>146</sup> *Celtic Extraction* (n 103) 490-491 (Morritt LJ).

<sup>147</sup> *ibid* 491.

There is logic in Morritt LJ's reasoning. It recognises that there may come a point, i.e. on an operator's entry into insolvency, when the behaviour changing properties facilitated by the polluter-pays principle can no longer be realised. When this point is reached, one solution is to treat all of the operator's unsecured, non-preferential creditors equally. This logic does, however, ignore a core function of the principle which is to ensure that the polluter – and not society – pays to remediate environmental damage caused by the polluter's activities. If an operator could merely enter into insolvency proceedings to shed its environmental liabilities, this crucial function of the principle would be frustrated with disconcerting ease. It would result in society bearing the burden of the operator's environmental obligations. Moreover, as has been argued above, the prospect of long-term environmental damage and risk to human health which may flow from disclaimed, but unremediated or unrestored land should outweigh the pari passu principle.

A further benefit of prioritising the polluter-pays principle relates to the increased incentive which it creates for the operator's unsecured creditors, both present and future. The concern that an operator's environmental liabilities could deplete the pool of assets available to satisfy their claims on insolvency may lead to a closer degree of monitoring of its environmental risks.<sup>148</sup> Ex ante assessment by the unsecured creditors of the operator's environmental risks will not only confer a degree of protection upon them in that they may reduce the prospect of suffering loss but it proffers potential for 'surrogate' regulation.<sup>149</sup> The literature diverges marginally over what surrogate regulation actually entails but there are

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<sup>148</sup> David Leebron, 'Limited Liability, Tort Victims, and Creditors' (1991) 91 Colum L Rev 7 1565, 1643. It may be assumed that, even upon maintenance of the status quo, unsecured creditors will undertake some form of ex ante risk assessment of the environmental activities of a potential debtor-operator as there is a risk that their credit could be lost if these activities are carried out without due care. However, the further dilution of any cost recovery resulting from the prioritisation of the polluter-pays principle will amplify the incentive to monitor.

<sup>149</sup> The fact that there may be potential in harnessing the quasi-regulatory capacities of third-parties is not new. A potential for 'surrogate' regulation has been observed in relation to, inter alia, insurers and financial institutions: Steven Kunzman, 'The Insurer as Surrogate Regulator of the Hazardous Waste Industry: Solution or Perversion' (1984) *The Forum* 20 469; Kenneth Abraham, 'Environmental Liability and the Limits of Insurance' (1988) 88 Colum L Rev 5 942; Neil Gunningham, Pete Grabosky and Darren Sinclair, *Smart Regulation: Designing Environmental Policy* (OUP 1998).

two common themes: first, private parties set standards with which the operator must conform, and secondly, where there is a failure by the operator to meet these standards a sanction is imposed by the private party.<sup>150</sup> For present purposes, the requisite standard could be the level of environmental risk perceived to be tolerable by a particular unsecured, non-preferential creditor whilst the sanction would be their failure to offer credit or their withdrawal of existing credit. An operator may be unable to engage trade creditors owing to their dissatisfaction with its environmental practices. If so, it is presumed that it will either be forced to leave the market or it may adopt safer and more responsible approaches to how its activities are undertaken in order to reduce its environmental risks. Both are, at least from the perspective of environmental protection, positive outcomes. The prospect of unsecured creditors acting as ‘surrogate’ regulators of the operator’s activities may bolster traditional forms of regulation: the direct regulation of the operator, engaged through the terms of its permit, licence or other authorisation to which it is required to comply and the market-based incentive facilitated by the attribution of environmental liability.

To conclude, whilst a regulator’s attempt to recover costs may be hindered by section 178, prohibiting disclaimer would not eliminate the residual risk, financial and environmental, to which society is exposed by self-insurance’s failure to require assets and/or funds to be set aside. Whilst the regulator may be better placed to recover some of its costs, a company in liquidation has limited funds to satisfy the claims of all its creditors. In any event, it appears from a recent report from Defra that owing to the need to ‘...protect the liquidator’s role...’ there is little prospect of insolvency legislation being amended so as to prevent an environmental permit from being disclaimed.<sup>151</sup> The same argument may be applied to other forms of property, such as damaged or contaminated land. Other solutions, such as those discussed below, must be utilised if the residual risk associated with self-insurance, as traditionally conceived, is to be reduced.

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<sup>150</sup> Gunningham et al (n 149) 250.

<sup>151</sup> Defra, ‘Waste Crime’ (n 2) 33.

## (b) Scenario 2: Cost Recovery and Competing Security

The second scenario relates to the priority of a charge taken by the regulator over the self-insuring operator's premises in respect of costs incurred by it in fulfilling the operator's environmental obligations. This may be levied under a variety of environmental liability regimes in the UK.<sup>152</sup> Where such a charge arises, the regulator can exercise the power of sale conferred under the regime to recover such costs. There may, of course, be pre-existing charge holders, such as a bank with a mortgage over the property or a debenture comprising fixed and floating charges over the operator's assets. Clearly, the level of priority afforded to the regulator has direct implications for the level of residual risk borne by society; the higher the priority, the greater the likelihood of a successful cost recovery and vice versa. A charge arising over the real property of a self-insuring operator, and ranking in priority to any other charges held over that property, offers a valuable means of strengthening the measure's remedial capacity.

The Environmental Liability Directive<sup>153</sup> (ELD) provides a useful 'case-study' recognising, of course, that the UK has not transposed it to introduce mandatory financial security for environmental damage. The ELD is based on the polluter-pays principle,<sup>154</sup> and established a framework to prevent and remedy environmental damage in relation to a wide variety of environmentally damaging activities.<sup>155</sup> If a liable operator fails to comply with its preventive or remedial obligations, the competent authority may take these measures itself.<sup>156</sup> If the authority does so, Article 8(2) provides that it should recover the associated

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<sup>152</sup> In respect of the contaminated land regime see EPA 1990, ss 78P(3)(a)(i) and 78P(4)(b). In respect of statutory nuisances see *ibid*, s 81A(1)(b). In respect of environmental damage, see text accompanying footnotes 158-162 below.

<sup>153</sup> Directive 2004/35/CE on environmental liability with regard to the prevention and remedying of environmental damage [2004] OJ L143/56.

<sup>154</sup> *ibid* art 1.

<sup>155</sup> *ibid* art 1 and Annex III.

<sup>156</sup> *ibid* arts 5(4) and 6(3).

costs from the operator by way of security over property or other appropriate guarantee.<sup>157</sup> This requirement is actioned under the EDR and the Welsh Regulations.<sup>158</sup>

Under the EDR, where any costs are recoverable by an enforcing authority from a person who is the ‘...owner of any premises...’ then the costs and accrued interest are a charge on ‘the premises’.<sup>159</sup> The current EDR, which came into force on 19 July 2015, introduced a subtle yet presumably intentional change in drafting. The old drafting referred to recoverability from ‘...a person who is the owner of premises...’ with no mention of the word ‘any’.<sup>160</sup> The new drafting appears to suggest, no doubt controversially from industry’s perspective, that the competent authority could be selective in the premises to which the charge would attach. Indeed, it seems that they could perhaps target a property (or properties) owned by the operator of a value sufficient to ensure that the costs were actually recovered should the power of sale be utilised. For instance, the charge could be taken over the valuable city centre office premises rather than the industrial warehouse from which the pollution emanated. Whilst the old drafting was suggestive of the presumption that the charge was to attach to the land or property which had been damaged, the amendment seemingly offers new potential to strengthen society’s position as residual risk bearer. It does, however, presuppose that the responsible operator actually owns real property, and that it does not lease it from another group company. The latter tactic would be a straightforward means of avoiding the prospect of a charge being taken over real property. It could be utilised by operators and their parent companies in circumstances where a regulator did not demand that a minimum value of real property be maintained within the UK as part of the agreement to accept self-insurance as evidence of financial security.

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<sup>157</sup> *ibid* art 8(2).

<sup>158</sup> Environmental Damage (Prevention and Remediation) (Wales) Regulations 2009, SI 2009/995 (as amended) (the ‘Welsh Regulations’).

<sup>159</sup> EDR, reg 27(1) (emphasis added).

<sup>160</sup> Environmental Damage (Prevention and Remediation) Regulations 2009, SI 2009/153, reg 27(1) (emphasis added).

The Welsh Regulation is virtually identical to its English counterpart with the exception that it does not include the term 'any' in respect of the premises to which the charge is to attach.<sup>161</sup> It states that where costs are recoverable from a person who is the 'owner of premises' then the costs and accrued interest are a charge on 'the premises'.<sup>162</sup> This suggests that either the charge attaches to all of the operator's premises, or that it attaches to the premises which may have been the source of the environmental damage. The latter may be seen as the most pragmatic interpretation, and sits with the presumption under the old drafting of the EDR, discussed above, which was worded similarly.

On its face, the capacity to take a charge over premises appears to reduce the residual risk to which society is exposed. In this respect, it is a very important risk-reduction tool. However, and significantly, the ELD, the EDR and the Welsh Regulations are silent as to whether the rights of prior secured creditors may be trumped by a subsequent charge or guarantee taken by the enforcing authority. The jurisprudence of other regulatory frameworks in England and Wales which confer the right for regulators to attach charges to a debtor's premises in respect of unpaid debts is, however, helpful here. This suggests strongly that the regulator would be conferred priority, even where a lender held an earlier charge. In *Paddington Borough Council v Finucane*,<sup>163</sup> the court had to determine the scope of a charge created by section 3 of the Housing Act 1925. This entitled the local authority to serve a notice on the owner of a dwelling-house who failed to make or keep the house reasonably fit for human habitation, to make it so. The local authority could undertake the work itself if the owner failed to comply with the notice. Under section 3(3), the expenses incurred by a local authority for work done to premises, together with interest, were a charge on the premises. Even though the property was mortgaged to a third-party, Russell J had 'no doubt' that the charge which the Act purported to give overrode all other proprietary interests

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<sup>161</sup> Welsh Regulations (n 158), reg 27(1).

<sup>162</sup> *ibid.*

<sup>163</sup> [1928] Ch 567.

which existed in the house,<sup>164</sup> and was entitled to priority over ‘...any other interest...’ in it.<sup>165</sup> Indeed, this reasoning was affirmed in *Bristol Corporation v Virgin*,<sup>166</sup> where a charge created under section 3 was found to rank in priority to a perpetual yearly rentcharge.

More recent authority which is very much on point may be found in *Westminster City Council v Haymarket Publishing Ltd.*<sup>167</sup> There, a company acquired a commercial property and granted a legal mortgage over it to a bank to secure all moneys and indebtedness present and future owing by the company to the bank. Owing to a period in which the property remained empty, a rating surcharge amounting to £16,940.93 became payable under section 17A(1) of the General Rate Act 1967. Under section 17B(3), a surcharge was to be a ‘...charge on the land comprised in the hereditament...’ until recovered. The council contended that the surcharge took priority over the mortgage debt. The bank took the opposite position. Lord Denning MR reasoned that a series of authorities,<sup>168</sup> commencing exactly one century earlier, had found consistently that a charge over ‘premises’ meant that it was a charge on all the estates and interests in the land. Thus, he concluded that the surcharge took priority over the mortgage debt owed to the bank.<sup>169</sup>

There were clearly some equitable undertones to the judgment of Lord Denning MR. He believed that his interpretation was in line with the ‘...intention of Parliament...’ as the adoption of any other position would mean that,<sup>170</sup>

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<sup>164</sup> *ibid* 572 (Russell J).

<sup>165</sup> *ibid* 575 (Russell J).

<sup>166</sup> [1928] 2 KB 622 (KBD).

<sup>167</sup> [1981] 1 WLR 677 (CA).

<sup>168</sup> ‘If there be a charge on the houses it is a charge on the total ownership - if I may call it so, on the proprietorship; not on any particular section or portion of the proprietorship, but on the whole’: *Birmingham Corporation v Baker* (1881) 17 Ch D 782, 786 (Sir George Jessel MR); ‘All the Act does is to create a charge on the premises - that is, on the land - that is, on all the interests of the owners of the land’: *Guardians of Tending Union v Dowton* [1891] 3 Ch 265, 269 (Fry LJ).

<sup>169</sup> *Haymarket* (n 167) 681 (Lord Denning MR).

<sup>170</sup> *ibid*.

it would be open to companies, by manipulation of their affairs between holding and subsidiary companies, to avoid the charge altogether. The land could be bought in the name of a subsidiary company with money obtained on mortgage from a holding company: and, lo and behold, the charge would be gone. That cannot be right.

Lord Denning MR was clearly attuned to the strategic behaviour utilised by corporate groups to avoid liability and sought to prevent the creation of legal conditions under which this form of avoidance would be possible. It may, however, be considered both excessive and unfair to apply this logic to situations where a bona fide lender facilitated the purchase of a commercial property through funds lent in return for a mortgage over it. The presumed priority and efficacy of the mortgage will have been a fundamental factor in the lender's decision to provide funds in the first place. Echoing the reasoning of Lord Denning MR, Oliver LJ noted the perceived unfairness on the bank, but held that Parliament '...must have been aware of how similar words in previous statutes had been construed...' and if it had been intended to narrow the scope of the charge so as to give priority to a prior secured creditor then it would have done so.<sup>171</sup> These comments must be equally applicable today in respect of the EDR and the Welsh Regulations. It would be highly unusual if these regulations were to reverse 130 years of jurisprudence without stating so explicitly.

There are certainly policy arguments for and against the priority of the statutory charge. In respect of the latter, if the EDR and the Welsh Regulations do, in fact, permit the priority of secured creditors to be undermined, it will create uncertainty in credit markets. For example, consider a commercial premises owned by an operator which had recently been valued at £1,000,000. Assume that the purchase was financed with a deposit of £300,000 and a commercial mortgage of £700,000. This means that there would be £300,000 of the borrower's equity and £700,000 of debt in the premises. Where the regulator's prior ranking charge amounted to a figure of £300,000 or below then this would be of little commercial significance to the lender, the exception being where property values were predicted to fall.

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<sup>171</sup> *ibid* 681-82 (Oliver LJ).



However, where the regulator's prior ranking charge amounted to a figure of £300,000 or more then this would be of significant commercial concern to the lender as the loan would no longer be secured fully and effectively. If, to vary the example, the regulator's prior ranking charge amounted to £500,000 then the lender will, in effect, have lost £200,000. This assumes that the property's value had remained static. Furthermore, should the environmental liabilities total £1,000,000, with a charge to this value levied against the premises, the lender could lose out entirely; the lender is, in effect, made indirectly liable for the negative environmental outcomes of the borrower-operator's activities.

Thus, a decision prioritising the regulator's charge is a decision that lenders, rather than society, are to bear the deficit, or at least part of it, between the operator's environmental liability and its assets.<sup>172</sup> Whilst this is not entirely unproblematic for the reasons set out below, the implications for credit markets could be significant. The prospect of the lender bearing a portion of a borrower's environmental liabilities could result in the reduced availability of, or more expensive, credit for operators engaged in environmentally dangerous activities.<sup>173</sup> This may, in fact, result in the courts questioning whether it is in the broader public interest to promote environmental protection in such a manner.<sup>174</sup> The prospect that credit may 'dry up' could also result in some operators having to leave the market, meaning that certain environmentally dangerous activities deemed necessary for society, such as operating a hazardous waste facility, may not be carried out.<sup>175</sup> Thus, conferring priority to the security taken by the regulator may actually negatively affect the public interest in environmental protection.

It is, however, submitted that there are strong policy reasons to support the need for such charges to have priority over prior charges taken on the premises. First, the prospect of

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<sup>172</sup> Leebron (n 148) 1638.

<sup>173</sup> *ibid* 1584.

<sup>174</sup> Andrew Keay and Paula de Prez, 'Insolvency and Environmental Principles: A Case Study in a Conflict Public Interests' (2001) 3 ELR 2 90, 102.

<sup>175</sup> *ibid*.

a prioritised statutory charge in favour of the regulator would, it is presumed, incentivise prospective lenders to undertake a risk assessment of the operator's environmental activities.<sup>176</sup> As per the argument deployed in the previous section, not only would this protect lenders by reducing their probability of suffering loss but it offers further potential for 'surrogate' regulation. In this instance, the requisite standard would likely be the level of environmental risks perceived to be tolerable by the prospective lender whilst the sanction would be their failure to lend against the premises. Alternatively, they may agree to lend but at a higher – perhaps prohibitive – rate of interest. Should the operator be unable to obtain credit as a result of an unfavourable risk assessment, this would be a major, perhaps terminal, blow, to the operator; it would either be forced to leave the market or be required to source other funding streams. In itself, this may induce reductions in its environmental risks so as to become a more attractive, lower risk borrower.

A lender may instead choose to transfer the risk of a borrower defaulting due to its environmental liabilities to insurers.<sup>177</sup> A lender could do so by imposing a condition on the provision of credit that adequate and appropriate insurance be purchased and maintained throughout the period of the loan.<sup>178</sup> If insurers declined to provide cover owing to the severity of the risks, the funding would not be forthcoming.<sup>179</sup> Thus, whilst neither the legislature nor the regulator may have required such insurance to be obtained, a lender exposed to the risk of its charge losing priority could make this demand. This is a powerful indirect benefit associated with the prioritisation of the regulator's charge. An alternative benefit, which may arise in some cases, would be the imposition of conditions by an insurer that required the borrower to adopt pollution-prevention measures in order to be offered the relevant insurance.

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<sup>176</sup> Leebron (n 148) 1643; Armour (n 131) 203.

<sup>177</sup> Leebron (n 148) 1644. The potential for lenders not to have access to expertise on environmental risks is increasingly rare; many, if not most, lenders have in-house environmental expertise or routinely obtain advice from environmental consultants.

<sup>178</sup> *ibid.*

<sup>179</sup> *ibid.*

Secondly, prospective lenders may also cater ex ante for the risk that their charge may lose priority and, consequently, be insufficient to cover the funds advanced under loan. They may 'contract around' this risk by charging a higher interest rate in respect of the finance provided (i.e. demand a higher rate of return) or, indeed, refuse to lend altogether.<sup>180</sup> That two commercial parties can negotiate, at arm's length, the terms of any secured loan should counteract any fairness-based arguments against the legitimacy of a regulator's prior ranking charge. Society does not benefit from the same ex ante opportunity to negotiate the terms of the debt to which it may be subject nor diversify its exposure to it should an operator enter into liquidation with outstanding environmental liabilities.<sup>181</sup> With regards to existing lenders, there is the argument akin to that advanced by Oliver LJ in *Haymarket* that owing to the relevant body of jurisprudence discussed above, lenders should have been aware that the loss of prior ranking status was a commercial risk to be managed.

Thirdly and relatedly, any increase in the cost of obtaining a loan as a result of the prospect of the regulator's prior ranking charge may be seen as a legitimate indirect cost associated with being permitted to self-insure or indeed, for failing to purchase sufficient and appropriate supporting financial security instruments (e.g. insurance). The regulator's charge would, of course, have been largely unnecessary had a financial security instrument been obtained ex ante. The cost of the loan would now reflect the lender's assessment of, inter alia, the environmental risks exhibited by the operator. This reduces somewhat the obvious upside of self-insurance for the self-insuring operator: that they do not have to incur the direct or indirect costs of purchased financial security instruments.

Fourthly, a failure to accord priority to the regulator's charge would offer no incentive for the lender to monitor the environmental risks exhibited by the borrower-operator during the term of the loan.<sup>182</sup> An unsatisfactory environmental audit could, for instance, be classed as a default for the purposes of the loan agreement. Without an incentive to monitor, lenders

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<sup>180</sup> *ibid* 1584; *Armour* (n 131) 203.

<sup>181</sup> *Leebron* (n 148) 1601 and 1643.

<sup>182</sup> *ibid* 1644.

may disengage entirely, merely looking to exercise their power of sale under the charge for the payment of sums owed if and when required.<sup>183</sup> An exception would be where the prospect of an industrial accident harming the premises upon which a charge had been taken could render the security less valuable.<sup>184</sup> In such circumstances, the requisite incentive to monitor would exist.

Fifthly, there is the argument that any potential loss suffered by the lender should be deemed to be a risk associated with this form of lending, a core commercial activity of a bank. Leebron perceives long-term lenders to be 'investors' in a business, investors who have entered into a joint-venture with the shareholders but securing differing terms for their investment.<sup>185</sup> Upon this view, it may be quite appropriate for a lender to 'lose out' in the same way as shareholders if the company becomes insolvent; why should profit-seeking lenders be immune from the risk-taking of the borrower-operator?

Sixthly, it will give renewed strength to the polluter-pays principle, allowing funds to be realised by the regulator where the power of sale is exercised. If the charge or guarantee was to rank behind the claims of other secured creditors, then the utility of Article 8(2) of the ELD, and its equivalent in the relevant transposing regulations, would be extremely low. For example, the prior ranking charges may take security over the entire value of the premises leaving nothing for the regulator, such as where there is a prior ranking debenture. This would render the security worthless. Prioritisation of the regulator's charge would also reduce the scope for strategic behaviour by corporate groups to which Lord Denning MR referred in *Haymarket*.

Finally, whilst the priority of the statutory charge would have a consequential impact upon the operator's unsecured creditors in that fewer funds would be available to them upon liquidation, unsecured creditors are already predisposed to the risk of the entry of new, secured creditors to the equation. Beyond circumstances, discussed below, where the

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<sup>183</sup> *ibid* 1647.

<sup>184</sup> *ibid*.

<sup>185</sup> *ibid* 1589.

security amounts to a preference under section 239 IA 1986, the creation of new, prior ranking security is not something that unsecured creditors can prevent.

Taken as a whole, the argument that the statutory charge will be conferred priority over earlier charges is likely to prevail owing to the preponderance of authorities adopting this position, and the need to interpret domestic legislation in a manner which furthers the purpose of the overarching ELD. Nevertheless, and putting aside arguments as to the relative priority of the statutory charges, the utility of the charge and, indeed, the scope for it to further the remedial capacity of self-insurance may not be as valuable or effective as first thought; society may still be exposed to a significant level of residual risk. First, where such a charge was taken over real property that had suffered extensive damage following a pollution incident or been subject to a sustained period of contamination, even where the land has been remediated, there may be little interest in the property from potential buyers owing to post-remediation stigma.<sup>186</sup> The reduced marketability of the property may be due to concerns that claims may be brought against a new owner in respect of past contamination and that it may be difficult to obtain mortgage financing.<sup>187</sup> Put another way, whilst there may be a power of sale in respect of the premises there may be no willing buyers. Secondly, given the likely specialist nature of many premises conducting activities with the potential to harm the environment, the actual market for these types of premises may be significantly narrower and less active than other sectors of the commercial property market. Therefore, it may take longer for the property to sell, delaying the time in which the value may be realised from the asset.

The drafting of the new EDR offers a useful solution to reduce residual risk in both these circumstances. As we have seen, it permits a charge to be taken over 'any' premises which the operator owns. This seemingly permits a regulator to take a charge over another more commercially attractive property owned by the operator and so increase the prospect of a successful sale. However, it is important to recognise that a prioritised charge will offer

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<sup>186</sup> Patchin (n 132).

<sup>187</sup> *ibid.*

little in the way of a remedy where the responsible operator is part of a corporate group that has structured its affairs to ensure that valuable real property is removed from those group companies engaged in activities that have the potential to cause environmental damage.

(c) Scenario 3: *Cost Recovery Followed by Operator's Liquidation*

The third scenario relates to a situation where an operator enters into insolvent liquidation after a successful cost recovery action by the regulator. In addition to pushing the operator into insolvent liquidation, the effect of the action will be a reduction in funds available to distribute to the operator's unsecured creditors in the winding-up process. A significant risk to which society, as residual risk bearer, is exposed is that payments made, security taken or guarantees given may amount to a voidable preference under section 239 IA 1986.

Under section 239, a preference will be deemed to have been given where the operator has done anything (e.g. paid an amount) or permitted anything to be done (e.g. allowed security to be taken over its assets) which put the regulator into a position which, upon the operator's subsequent insolvent liquidation, would be better than it would have been if the preference had not been given.<sup>188</sup> Whilst section 239 does not require the regulator to gain an advantage over other creditors, in effect, an advantage is attained as it is placed in a better position as a result of the transaction.<sup>189</sup> The provision is designed to stop creditors interfering with the statutory allocation of entitlements by 'jumping' in front of other creditors entitled to benefit from the estate.<sup>190</sup>

Where a liquidator is appointed to wind-up an operator and it deems the operator to have given a preference to any person, such as a regulator, within six months prior to the onset of insolvency, it may apply to the court for an order to restore the position to what it

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<sup>188</sup> IA 1986, s 239(4).

<sup>189</sup> Andrew Keay and Peter Walton, *Insolvency Law: Corporate and Personal* (3<sup>rd</sup> edn, Jordans 2012) 622.

<sup>190</sup> *ibid* 619.

would have been if the preference had not been given.<sup>191</sup> Such an order may require the release or discharge of any security given by the operator,<sup>192</sup> or require the repayment of such sums to the liquidator as the court may direct.<sup>193</sup> In these circumstances, a regulator who was initially successful in recovering their costs would 'drop back' to become an unsecured, non-preferential creditor of the insolvent operator. Consequently, they would be required to compete with the other unsecured creditors as per the manner described above in Scenario 1. As we have seen, in such circumstances the regulator is likely to receive only a fraction of the costs to which they were entitled. There is also the prospect of the property to which the environmental liabilities attached being deemed to be 'onerous' and subsequently disclaimed. As discussed above, this may have significant implications for the success of the regulator's cost recovery action against a self-insuring operator.

An essential component of section 239 is that the operator must have been influenced in deciding to give the preference by a 'desire' to put the regulator into a better position than it would, ordinarily, have been.<sup>194</sup> In other words, the operator must have 'positively wished' to improve the regulator's position in the event of its own insolvent liquidation.<sup>195</sup> It is, thus, insufficient merely to establish the mere presence of a desire to make the payment or grant the security which is sought to be avoided under section 239.<sup>196</sup> The requisite desire is to be viewed subjectively.<sup>197</sup> It must have influenced the operator's decision to pay the amount or allow security to be taken over its assets through being one of the factors which operated on the minds of those who made the decision; it need not have been the only or even the decisive one.<sup>198</sup> The operator's motive in making the payment or

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<sup>191</sup> IA 1986, ss 239(2)-(3) and 240(1)(b).

<sup>192</sup> *ibid* s 241(1)(c).

<sup>193</sup> *ibid* s 241(1)(d).

<sup>194</sup> *ibid* s 239(5).

<sup>195</sup> *Re MC Bacon Ltd (No 1)* [1990] BCC 78 (Ch) 88 (Millet J).

<sup>196</sup> *ibid* 87-88.

<sup>197</sup> *ibid* 87.

<sup>198</sup> *ibid* 88.

agreeing to security being taken will, therefore, be of central importance in the determination by the court as to whether there has been a preference.<sup>199</sup> The potential difficulty in establishing motive is alleviated somewhat from the fact that there is no need for direct evidence of the requisite desire; it may be inferred from the circumstances of the case.<sup>200</sup>

In the absence of authority directly on point, one can only speculate as to the factual circumstances upon which the requisite desire could be inferred in the circumstances of Scenario 3. Could it perhaps be inferred from a situation where a parent company, which controlled a number of subsidiaries operating within the jurisdiction of the regulator, ensured that a subsidiary which had caused environmental damage paid the requisite remediation costs so that a positive working relationship with the regulator could be maintained? Or where an operator made the payment challenged in order to avoid aggravating the regulator should a new permit, or variation to it, be required in the future? More controversially, could it be inferred from a wish by the operator who, perhaps, felt compelled by a moral responsibility to 'do the right thing' and pay the regulator in full even if this meant that some unsecured creditors would not be paid at all? It would be ironic if an 'environmental conscience' and willingness of the responsible polluter to pay for the damage it had caused resulted in the payment being challenged successfully as a preference. Nevertheless, the situations detailed here would seem to be captured by section 239. It is, however, important to note that where a charge is taken over premises by the regulator as per the manner set out in the EDR and the Welsh Regulations,<sup>201</sup> the operator may not be seen as having 'given' the charge. Such a charge would, therefore, not seem capable of amounting to a preference. Again, this demonstrates the strength of the statutory charge as a measure to improve the remedial capacity of self-insurance.

It would, however, seem to be possible to counter the prospect of the factual circumstances in Scenario 3 amounting to a preference if it could be demonstrated that the

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<sup>199</sup> Keay and Walton (n 189) 621.

<sup>200</sup> Bacon (n 195) 88.

<sup>201</sup> See section C2(b).



operator had not 'positively wished' to improve the regulator's position. The decision in *Re Fairway Magazines Ltd*<sup>202</sup> illustrates a situation where security granted close to the onset of insolvency may be found to be valid. There, a director entered into a written loan agreement to advance funds to the company, the aim being to rescue it from financial difficulties. The director entered in to the agreement on the basis of a promise by the company to grant him a debenture securing the sums advanced. The company later fulfilled this promise but as it was granted five months before the company went into creditors' voluntary liquidation the liquidator challenged it under section 239. Mummery J found the debenture to be secured validly. He held that in granting the debenture the company was influenced by '...proper commercial considerations...' and not by a positive wish to improve the creditor-director's position in the event of its insolvent liquidation.<sup>203</sup> It had been provided in order to raise money from a source other than the bank which had limited the company's overdraft facility.

In applying the logic of *Fairway Magazines* to the current scenario, in the absence of a fresh injection of funds, which would of course not be forthcoming in a situation where a regulator requested security in respect of environmental liabilities, the operator's provision of security is less likely to be deemed to have been influenced by proper commercial considerations. Indeed, the security provided will not aid the operator's financial viability. Rather, it may actually diminish the prospect of finance being raised from a lender in the future owing to a reduced level of equity in the premises. However, if a payment was made to the regulator to prevent it from taking a charge over its premises then this could, in fact, be deemed to have been driven by proper commercial considerations, particularly where such a charge could have hindered debt finance being raised by the operator at a later date.

A further argument to counter assertions that the operator positively wished to improve the regulator's position is that the directors may, in fact, contend that they felt forced into the decision and cared little as to whether the regulator's position had been improved. It has long been established that statutory use of the word 'preference' implies an act of free

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<sup>202</sup> [1992] BCC 924 (Ch).

<sup>203</sup> *ibid* 929 (Mummery J).

will.<sup>204</sup> *Re MC Bacon Ltd (No 1)* is a case in point. There, a bank had placed pressure on a company to grant it a debenture in respect of sums outstanding under an overdraft. The company eventually acceded to these demands but went into insolvent liquidation some three months later. The liquidator sought to set aside the debenture under section 239. In finding against the liquidator, Millet J held that in granting the debenture the directors had not wanted to improve the bank's position in the event of an insolvent liquidation.<sup>205</sup> The only desire that had motivated them was to avoid the bank calling in the overdraft.<sup>206</sup> Had the bank done so, then this would have prevented the company from trading.

It appears that where it can be demonstrated that the payment made, or security given to the regulator was done so under pressure then it will not be set aside as a preference.<sup>207</sup> Thus, it will be valid. This seems to generate a perverse incentive for a regulator to apply quite significant pressure. Relevant pressure could include threatening the instigation of legal proceedings to recover the remediation costs owed.<sup>208</sup> It may also involve threatening to revoke a licence, permit or other authorisation essential to the operator's commercial activities. These types of tactics tactic may seem to counter the very aim of section 239, namely to ensure that there is a 'collective process' in the distribution of assets amongst the company's creditors upon liquidation.<sup>209</sup> Nevertheless, proactive and robust attempts by the regulator to recover outstanding costs from the responsible operator appear to be one solution to minimising, albeit not eliminating, the prospect of a successful recovery amounting to a preference. From the perspective of both the environment and the taxpayer, this is a highly beneficial outcome.

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<sup>204</sup> *Butcher v Stead* (1874-75) LR 7 HL 839, 846 (Lord Cairns).

<sup>205</sup> *Bacon* (n 195) 89.

<sup>206</sup> *ibid.*

<sup>207</sup> Qou makes a similar point: Shirley Qou, 'Insolvency law: a comparative analysis of the preference tests in the UK and Australia' (2007) *Co Law* 355, 363.

<sup>208</sup> *Rooney v Das* [1999] BPIR 404 (Ch).

<sup>209</sup> *Keay and Walton* (n 189) 629.

The application of section 239 to the third scenario does not produce a clear cut answer. It is likely to be heavily dependent upon the facts of the case and the dynamics between the operator or its parent company and the regulator. These are likely to provide strong indications as to the motive behind the payment made or security given, a key factor for the court in arriving at its decisions as to whether a preference has been given. Where an operator succumbs to the regulator's demand for payment or request for security but then enters into insolvent liquidation in the following six months, this will mean that the regulator will have been placed in a better position than it would have been had the payment or request not been made. The fact that it may amount to a preference is strengthened by the fact that the requisite desire need only have been one of the factors on the mind of the operator; it need not have been the factor which tipped the balance in favour of the transaction being entered. It appears likely that any desire to 'do the right thing' or to keep the regulator 'onside' will result in the court finding that a preference has been given by the operator, and the regulator dropping back to compete *pari passu* with the general body of unsecured, non-preferential creditors.

#### **D. CONCLUSION AND RECOMMENDATIONS**

It has been argued that as a means of evidencing financial security, self-insurance exhibits certain features that may hinder its remedial capacity. This may prove to be extremely problematic from the perspective of environmental protection. The absence of a requirement to set aside specific assets or funds to cover environmental liabilities means that they are not ring-fenced if the operator, or its parent, enters into liquidation with the result that the public will be required to pay the requisite costs.<sup>210</sup> Further, a self-insuring operator's lack of

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<sup>210</sup> See, e.g., GAO, Phosphate Mining: Oversight has Strengthened, but Financial Assurances and Coordination Still Need Improvement (GAO-12-506, May 2012), 44 (EPA Region 10 noted that the form of a financial assurance is as important as the amount and stated that it did not believe a corporate guarantee to be a secure mechanism should a company go bankrupt or have financial difficulties)

adequate funds may result in a regulator seeking to impose environmental liabilities on a third party, such as the operator's parent company in circumstances where the parent has not provided a guarantee or bond.

Self-insurance is not evidence of financial security as such. Rather, it is arguably evidence of financial capability in the form of a financial health check at a given point in time. It requires the good faith of the operator or its parent (if a guarantee or bond has been provided by it) to inform the regulator that the requisite tests or ratios are no longer met. Whilst self-insuring operators are required to maintain financial stability during a given time period, the measure cannot guarantee access to sufficient liquid funds to facilitate the expeditious remediation of environmental damage or fulfilment of environmental obligations under a permit, licence or other authorisation. The implications of funds not being set aside during the operational phase of the relevant activity to pay for closure, reclamation, restoration, decommissioning and/or aftercare is borne out by the example of the liquidation of Scottish Coal Company Ltd. Indeed, evidencing financial security by self-insuring is increasingly being considered unacceptable for industries such as coal mining due, as there was a public perception '...that a self-guarantee for a mining company is a contradiction in terms.'<sup>211</sup> It is not suggested that third-party financial security, such as insurance, surety bonds or bank guarantees, ensure that adequate funds will be available. For example, a regulator may be unaware that an operator has failed to make regular payments into an escrow account if the bank does not report the same to the regulator.<sup>212</sup> A third-party may

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<<http://www.gao.gov/assets/600/590642.pdf>> accessed 23 March 2016.

<sup>211</sup> Meredith Sassoon, World Bank Group, Oil, Gas and Mining Policy Division, 'Guidance Notes for the Implementation of Financial Surety for Mine Closure' (2008), 7 para 2.5; see also Scottish Government, 'Consultation on Opencast Coal Restoration and Effective Regulation' (2013), para 10.6 (parent company guarantees '...are not favoured by planning authorities [for coal mining] because of recurrent problems related to difficulties with corporate structure or collapse').

<sup>212</sup> See HC Debate 29 January 2015, vol 591, col 1103 (local authority that required a bond and escrow account for Dynant Fawr coal site was not alerted by bank that payments into escrow account were not being made).

also refuse to make a payment if it considers that relevant conditions have not been met,<sup>213</sup> such as conditions in a performance guarantee bond.<sup>214</sup>

There is, however, an argument that self-insurance could be permitted to cover the costs of environmental liabilities associated with environmental accidents. In this situation, the costs cannot be known *ex ante*. At best, it can be estimated, for example, by using 'worst case' damage analysis. To demand that an operator sets aside large levels of funds or assets to cover an event that may or may not occur could be considered unduly strict, particularly where the company is larger than – or as large as – many insurers or banks. That said, the risk posed to society by such an approach has been emphasised.

The following briefly outlines some potential solutions to the problems raised by self-insurance. Firstly, to remedy the extrinsic factors which hinder its remedial capacity, further regulation could be enacted to require operators to set aside reserves which could be used only to meet environmental liabilities.<sup>215</sup> The operator could be required to segregate a certain level of assets and/or funds, placing them beyond the reach of creditors should it spiral into insolvency. Payments into a segregated fund, such as an environmental assurance bond in an interest-bearing escrow account, would be returned if the activity was undertaken without any damage occurring.<sup>216</sup> This solution would, however, transform self-insurance into an entirely different form of financial security, with little resemblance to its traditional form. Indeed, many of the advantages associated with self-insurance would be lost as a result. For example, a mandatory trust fund would sterilise the assets within it,

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<sup>213</sup> See MonTec, 'Guidelines on Financial Guarantees and Inspections for Mining Waste Facilities' (2007/S 49-059670, 30 April 2008), 21 [3.2].

<sup>214</sup> See *South Lanarkshire Council v Coface SA* [2015] CSOH 8 [20-21] (bond for restoration works for opencast coal mine); see also East Ayrshire Council Cabinet, 'Opencast Mining in East Ayrshire: Update, Report by Chief Executive' (24 May 2013), para 41 (some '...bonds require the Council to carry out the restoration works and then recover the sums from the Bond provider as the works are completed. It is a matter of legal uncertainty whether the Bond providers will pay out on Bonds if the restoration is not what has been agreed in the restoration scheme').

<sup>215</sup> Faure and Grimeaud (n 8).

<sup>216</sup> Robert Constanza and Laura Cornwell, 'The 4P Approach to Dealing with Scientific Uncertainty' (1992) 34 *Environment* 9 12, 16-17.

meaning that they could not be used for the business operations or as security to facilitate debt finance. Secondly, the priority of the statutory charge conferred by a variety of environmental liability frameworks could be capitalised upon. To bolster the regulatory potential of such a charge the regulator could demand that the operator hold a particular value of real property in the UK. The operator would have to seek the approval of the regulator, not to be unreasonably withheld, before it disposed of any such property or the value of that property fell below the requisite level. Finally, a combination of unrestricted funds that are immediately available to a regulator,<sup>217</sup> as well as self-insurance, would provide some degree of mitigation if a self-insuring operator became insolvent.

Some fine-tuning of the measure could alleviate a number of concerns relating to self-insurance's intrinsic features. For example, to prevent fraudulent assertions of financial strength, there could be increased reliance upon third-party audits or the introduction of strict civil liability and criminal sanctions if a corporate officer files a false statement supporting the truthfulness and accuracy of key financial indicators.<sup>218</sup> This is already required, for example, for hazardous waste facilities in the US where the owner's or operator's chief financial officer must submit a letter, accompanied, among other things, by a report from an independent certified public accountant.<sup>219</sup> Another example is found in the Canadian Government's guidelines in respect of financial requirements for offshore oil and gas operations. They require that a statement of net assets or funding arrangements must be signed by 'the authorized financial officer' of the applicant.<sup>220</sup> Greater reliance on third-party audits may also aid resource-related concerns by requiring the operator to pay for external verification.

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<sup>217</sup> Canadian National Energy Board (CNEB), Guidelines Respecting Financial Requirements (February 2016) s 4.1 (describing irrevocable, non-transferable and non-assignable letter of credit from a Canadian chartered bank as proof of financial responsibility that are readily available to regulators)

[https://www.neb-one.gc.ca/bts/ctrg/qnthr/cndlgsptrnct/2016fnnclrqmrgntgd/index-eng.html#s4\\_1](https://www.neb-one.gc.ca/bts/ctrg/qnthr/cndlgsptrnct/2016fnnclrqmrgntgd/index-eng.html#s4_1) accessed 23 March 2016.

<sup>218</sup> Note, 'Should Shareholders be Personally Liable for the Torts of Their Corporations' (1967) 76 Yale LJ 1190, 1203; Boyd, 'Financial Responsibility' (n 6) 63.

<sup>219</sup> 40 CFR s 264.143(f)(3).

<sup>220</sup> CNEB (n 217) s 5.1.

However, as we have seen following the recent economic crisis, the professional integrity and independence of financial auditors have come under scrutiny for their close relationship with industry, leading to proposals for legislative reform by the European Commission.<sup>221</sup> Thus, external verification would have to be monitored closely. It is also essential for clear guidance to be provided on the manner in which the underlying data should be derived so as, amongst other things, to permit transparency and commonality between operators.

Inclusion of some of these solutions in England and Wales, as applicable, would lessen the risk of the costs associated with requisite restoration, reclamation or remediation works being externalised to society as residual risk-bearer. This would certainly render self-insurance a safer means of evidencing financial security than is currently the case.

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<sup>221</sup> Commission, 'Proposal for a Directive of European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts' COM (2011) 778 final (Directive 2014/56/EU amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts has been adopted by the EU); Commission, 'Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities' COM (2011) 779 final.