



REPLY TO
ATTENTION OF

CECC-E

DEPARTMENT OF THE ARMY
U.S. ARMY CORPS OF ENGINEERS
WASHINGTON DC 20314-1000

DEC 012011

MEMORANDUM FOR ALL DIVISION AND DISTRICT COUNSEL

RE: Financial Assurance Instruments for Compensatory Mitigation under the Corps Regulatory Program

1. The U.S. Army Corps of Engineers (Corps) often requires compensatory mitigation to offset environmental losses resulting from unavoidable impacts to waters of the United States authorized by Army permits under the Clean Water Act and Rivers and Harbors Act. See 33 CFR 332.3. In some instances, the District Engineer will determine that it is necessary to require financial assurances that are sufficient to ensure a high level of confidence that the compensatory mitigation project will be successfully completed, as measured by applicable performance standards. The regulations that establish the requirement for financial assurances set forth a number of different financial assurance products that may be appropriate to satisfy this requirement, including "performance bonds, escrow accounts, casualty insurance, letters of credit, legislative appropriations for government sponsored projects, or other appropriate instruments." See 33 CFR 332.3(n)(2). It is permissible to use different financial assurances to cover different stages of mitigation construction so long that each financial assurance is of an adequate duration to ensure that the stage it covers was successful.
2. District Offices of Counsel should work with their Regulatory Division or Branch clients to review and negotiate the financial assurance instruments used to support mitigation projects. Counsel should work with the proponents of financial assurance products, whether it be a new form of assurance or a new issuer of a previously utilized assurance, in a timely manner in order to determine if they can negotiate acceptable terms. The different forms of financial assurance have different benefits and limitations, but all forms of financial assurance should be provided an equal opportunity for review and approval if terms can be negotiated that fulfill project-specific requirements. However, it is recognized that it may not always be possible to reach an agreement on terms that are acceptable to both the Corps and the financial assurance provider. The District Engineer retains authority to determine acceptable terms in each case.
3. Miscellaneous Receipts Statute (31 U.S.C. 3302(b)) Compliance
 - a. Regardless of the form of financial assurance used, the financial assurance instrument must not provide that the Corps could be in actual or constructive receipt of the assurance funds. Even if the funds are held by a third party, the Corps is viewed as having constructively received those funds if the arrangement affords the Corps discretion to direct the use of those funds. For instance, assume that a financial assurance, settlement, or other arrangement

requires that funds be paid into an escrow account that is nominally managed by some third party (e.g., a bank). If the Corps retains discretion to direct the use of those funds, then the funds must be viewed as having been received by the United States, and as thus being subject to the deposit requirements of the Miscellaneous Receipts Statute.

- b. The line is admittedly vague between (a) when the Corps is directing the use of funds held by a third party, in which case those funds must likely be deposited into the U.S. Treasury as miscellaneous receipts, and (b) when the Corps is simply giving its consent or approval to a proposed mitigation bank, permittee-responsible mitigation, or similar arrangement that is to be financed with funds provided under a financial assurance or similar arrangement. A useful, albeit informal, test for determining which end of the spectrum a proposed arrangement falls is as follows: is the Corps attempting to do indirectly through a third party that which it could not do itself? If so, then the Corps is likely exercising constructive control over the funds held by the third party, and this arrangement is likely improper.
- c. One means for avoiding problems with constructive receipt is to incorporate contingencies into the financial assurance documents or mitigation banking instrument that address how the mitigation requirements should be met if it becomes necessary to draw upon the financial assurance. Under this model, the documents establishing the financial assurance product would reference the approved mitigation plan associated with the Department of the Army permit, mitigation banking instrument, or approved in-lieu fee project and identify entities, such as non-profits, state agencies, or private mitigation providers, that would be eligible under the terms of the financial assurance product to accept the financial assurance and complete the approved mitigation project. In the event that it would not be possible or practicable to undertake or complete the approved mitigation project, then the financial assurance product would set forth in a general way an alternative means of accomplishing the approved mitigation project's goals (e.g., replacement of lost habitat units of a certain quality and type) that should be pursued with the funds. The Corps can retain authority to review and approve the plans of the entity utilizing the funds to ensure that they are likely to achieve the goals. However, if the contingencies contemplated by the assurance change (such as the dissolution of the entity eligible to accept the financial assurance funds), the parties to the assurance will have to modify that agreement. By establishing these contingencies and goals when the financial assurance product is created, the Corps limits the extent of control it can exercise over the funds and makes it clear that the funds are to be used to fulfill the mitigation commitments of the mitigation bank or other mitigation provider. In other words, the Corps is not attempting to direct the use of these funds and

thus do indirectly that which it could not do itself; rather, the Corps is simply establishing a framework to ensure that legal commitments that result from the issuance of a Department of the Army permit or the approval of a mitigation banking or in-lieu fee program instrument are in fact honored.

- d. **Casualty insurance policies can avoid running afoul of the miscellaneous receipts rule** by utilizing operative language that provides that the insurance company will complete or secure the required mitigation itself or pay the necessary funds to a third party to complete the mitigation. An **example of such language follows:** "In the event of the 'Named Insured's' failure during the 'policy period' to meet the 'performance standards' under the 'mitigation banking instrument' at the 'insured property,' the Company agrees to **undertake and complete or secure through payment, whether directly or through a third party, the 'compensatory mitigation' for which the 'Named Insured' is legally responsible under the 'mitigation banking instrument,' provided the 'regulatory body' first makes a 'claim' to the Company in writing and during the 'policy period' seeking such 'compensatory mitigation.'**"
4. Neither the Corps Regulatory Community of Practice nor the Office of the Chief Counsel endorses any particular type of financial assurance or any specific financial assurance product or company. However, a form of financial assurance that had not previously been widely available, casualty insurance, has recently been proposed for use in connection with a number of different mitigation projects. In order **to assist Districts in negotiating** and approving casualty insurance **policies**, we have provided guidance specific to casualty insurance below. However, in providing this guidance it is recognized that there is no single solution that can be uniformly applied in all cases, and every policy should be carefully reviewed and modified to fit the particular circumstances and requirements of the particular mitigation project. Further, it may not always be possible to negotiate policy terms that meet a District's requirements. The District Engineer retains authority to determine acceptable terms in each case.
 5. **When negotiating** casualty insurance **policies**, there will be a number of provisions that will be of greater significance to the Corps. The specific provisions that need particular attention have been identified below along with some recommendations.
 - a. **Policy Period** – Ensure that the policy period aligns with the time required for achievement of the mitigation bank performance standards for at least the duration of the monitoring period, or provides for options for renewal of the policy if the monitoring period exceeds the initial term of the policy. (Note that insurance policies generally have a maximum of a ten year term.)
 - b. **Exclusions** – Scrutinize the exclusions under the policy to ensure that there is adequate coverage to ensure the project will be successfully completed. An

"Act of God" exclusion will be a common feature of most policies. While this exclusion can be negotiated out of the policy (with a resulting higher rate for the insured), it will be important to look closely at what kind of coverage for natural disasters is necessary. In many cases, "natural disasters" such as flooding or fire might be desired events in the management and success of the mitigation bank. Most mitigation banking instruments will have provisions that address "Acts of God" that should be considered when determining whether modifications to the insurance policy's exclusion are needed. Fraud on the part of the insured should not be an exclusion and should not limit the insurance company's obligation to pay. It may be appropriate for exclusions to cover other properties, claims that would be covered by a standard comprehensive general insurance policy, legal fees associated with defending any disputes between the insured and the insurer, and other site-specific matters.

- c. Bankruptcy- Ensure the policy is payable upon bankruptcy or insolvency of the insured and that the insured's failure to satisfy the deductible does not release the insurance company's obligation to pay up to the full policy limit if a claim is made.
- d. Modification- Provide that any modification of the policy should be contingent upon the approval of the Corps.
- e. Notice of Cancellation- Include the regulatory requirement that any cancellation of the policy requires notice to the Corps at least 120 days prior to the proposed cancellation/release date.
- f. Change in Law- Address the effects of any changes in applicable law or regulation after commencement of the policy on the terms would have on the policy.
- g. Choice of Law/Forum- If a choice of law provision exists in the policy, it should not be applicable to the Corps. The provision should be clear that the Federal Courts are the only appropriate venue for any litigation regarding the policy that involves the Corps.
- h. Filing Claims- The insured should generally not be able to file a claim. Only the Corps, and in some instances state regulators, should be the only party that can file a claim.
- i. Third Party Rights -The policy should explicitly recognize the Corps' third party rights.

j. Definitions- For any terms that the policy defines that are also defined in Corps regulations, such as "adaptive management plan," "performance standards," "mitigation banking instrument," and "compensatory mitigation," the policy's definitions should reference the Corps regulations and adopt consistent definitions.

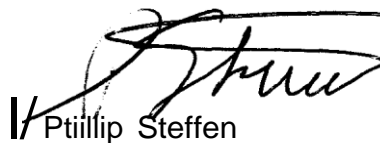
6. There will be a few additional matters that are not part of a casualty insurance policy but which should be considered before deciding whether to accept an insurance policy as financial assurance.

a. State Law on the Effect of Fraud – Understand the effect that fraud on the part of the mitigation bank proponent would have on the validity of the policy under the applicable state law. Some states may have statutory provisions or common law that provides that if insurance was obtained fraudulently, the policy is rescinded.

b. **Qualifications of the Insurance Company**- Review the qualifications of the issuing insurance company to ensure generally that they have an adequate rating from a rating agency (e.g., A.M. Best, Fitch, Moody's, or Standard & Poor's) , are licensed in at least one state, and are not closely financially tied to the insured (generally, the insurance company should not be wholly owned subsidiary of the parent company seeking insurance).

7. The **Corps Institute for Water Resources (IWR)** has developed an information paper on financial assurance products titled "Implementing Financial Assurance for Mitigation Project Success." This paper provides helpful background information on the different forms of financial assurance products, how they work, and the limitations and advantages of each. This background may be helpful in gaining a better understanding of how the Corps interest in ensuring the success of a mitigation project needs to be protected when negotiating a specific financial assurance instrument. This information paper is available on IWR's website (http://www.iwr.usace.army.mil/docs/iwrreports/Financial_Assurance.pdf).

8. My point of contact for this issue is **Max Wilson (202-761-8544)**.



Phillip Steffen

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Enclosure:

IWR Fact Paper: Implementing Financial Assurance for Mitigation Project Success