Hydraulic fracturing liabilities suggest insurance coverage

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Hydraulic fracturing, used for decades to increase the production of oil and natural gas, has recently become the subject of heightened inquiry and debate.

Allegations are abroad that fracing has resulted in contamination of the environment—specifically, aquifers.

There also are suggestions that people have sustained illness and injury as the result of drinking water drawn from aquifers contaminated by fracing.

Finally, there also have been allegations that vibrations and subterranean pressure changes associated with fracing have caused damaging alteration of the underground and surface geology—and even earthquakes.

The allegations of fracing-related injury and damage have engaged Congress; the familiar environmental groups; and—ominously—a number of the same plaintiffs' law firms that spearheaded the wave of asbestos-related litigation that flooded the courts over the past several decades.

It does not take an imaginative leap to envision a future of fracing-related lawsuits, seeking to compel remediation of conditions purportedly caused by the technique's past employment, and to exact the payment of damages to compensate for the bodily injuries and property damage allegedly inflicted.

Energy companies targeted by those lawsuits ("energy companies" here meaning all of those that sponsored or conducted hydraulic fracturing) will turn to their liability insurers for help with the potentially significant costs of defending against the claims and for indemnity of any resulting liabilities. But will those insurers be there when they are called?

It is a safe bet that the insurers will not rush forward with their checkbooks in hand.

We have observed the existence of a direct relationship between the size of an insurance policyholder's prospective liability and the number of grounds its insurer finds for refusing to provide coverage; and the liabilities emerging from fracing-related lawsuits could be substantial if the claimants in those suits can prove a causal connection between fracing and the damage and injury they allege.

Yet, if the appropriate steps are taken, there is hope that the insurers ultimately will be standing behind their energy industry policyholders as they face fracing claims—even if not voluntarily.

We can turn to history to find encouragement.

After the so-called "Superfund" statute was enacted by Congress in 1980, thousands of contaminated sites around the country were cleaned up—at very substantial cost. The liability insurers of those directed by the government to perform the site remediations more often than not denied their contractual coverage obligations; and many were brought to court by policyholders unwilling to take "no" for an answer.

Although the outcomes of those insurance coverage cases differed based on their underlying facts (and on the body of state law that governed their adjudication), at the end of the day, billions of dollars in coverage benefits were realized through judgments entered in those coverage actions or by way of settlements reached after those coverage actions were prosecuted.

The authors' law firm carried the policyholders' standards in literally hundreds of those coverage actions and is therefore in a position to make informed predictions regarding the issues that will figure in the inevitable disputes over insurance coverage for fracing-related claims and liabilities.

Liability insurance basics

In most instances energy companies will seek coverage for fracing-related claims and liabilities under the "property damage liability" or "bodily injury liability" coverages of their general liability (GL) insurance policies.

Those policies typically afford coverage for liabilities that the policyholder incurs because of bodily injury or property damage sustained during the period of the policy "caused by an occurrence."

"Occurrence" is defined, for pertinent purposes, as "[a]n accident...which results, during the policy term, in bodily injury" [or "property damage"]. Thus, an "occurrence"-based GL policy is "triggered" when the harm (property damage; bodily injury) is sustained—not when the claim is asserted. In other words, GL policies purchased in the 1960s and '70s can be required to indemnify damages imposed for fracing-related harm done at that time, even if claims for those damages are first asserted in 2010.

"Stacks" of GL policies typically were purchased by corporate policyholders, the first-responding policy (in the event of a liability) being "primary," and the additional "excess" policies affording coverage ("attaching") sequentially when loss is incurred that meets or exceeds the indemnity limit of the next lowest policy in the stack.

Under the primary policy, the policyholder typically is entitled to have its defense provided by the insurer—if the allegations of a relevant third-party claim present the mere possibility that the insurer will be required, by the insurance policy's terms, to indemnify a judgment against the policyholder, when and if entered.

The primary GL insurer's duty to defend its policyholder is thus broader than its duty to indemnify a liability, and arises when the suit against the policyholder is instituted—not when a judgment is entered or a settlement is struck.

Although standard-form GL insurance policy language only obliges the insurer to defend a "suit," courts in many jurisdictions have found that nonjudicial proceedings begun with letters from

governmental agencies can represent “suits” for relevant purposes, if those letters are sufficiently “coercive.”

For example, if a policyholder hires a lawyer to protect its interests upon receipt of an action-forcing letter from the Environmental Protection Agency, the expenses incurred may be payable under the primary GL insurance policy’s duty to defend. Receipt of such a letter should also be considered in connection with the policyholder’s duty to provide notice to its primary GL insurer—discussed below.

Likely insurer defenses

If an energy company’s GL insurers “run for cover rather than coverage” when apprised of the assertion of a fracing-related claim against their policyholder,1 what defenses are they most likely to assert? We offer our informed predictions.

‘Expected’ or ‘intended’ harm

GL policies do not afford coverage in respect of liabilities arising out of third-party damage or injuries that were expected or intended by the policyholder.

Depending on the form of the relevant insurance policy, that limitation on coverage will be effectuated either by the policy’s definition of an insured “occurrence” (as an “accident”), or by way of an exclusion foreclosing coverage of costs arising out of harm that was “expected or intended from the standpoint of the insured.”

If the history of disputed claims for coverage for other forms of environmental claims is a guide, insurers certainly will attempt to foreclose coverage for fracing-related liabilities on the ground that the relevant harm was expected or intended by the energy company facing the claim (and thus did not arise out of an “occurrence”).

Any internal document in which the risks of the technique were considered will be impressed into service by the insurers seeking to escape coverage responsibilities, and it will not stop there.

The historical views expressed by every commentator in every journal of every trade association to which the company belonged will be imputed to the company as “knowledge” comporting with the commentator’s worst surmise or prediction—all to the end of persuading the jury that any ultimately resulting damage or injury arising from the fracing process was expected (if not intended).

Hopefully, the policyholder’s deliverance from the insurers’ “expected”/”intended” argument will be a charge from the trial judge that puts the issue in its proper framework.

Even if it ultimately is determined that environmental damage did arise out of the fracing practice (a circumstance which, of course, has yet to be established), and the evidence shows that there were early voices expressing concern about those very risks, coverage for the resulting damage or injury should not be foreclosed.

It must be recalled that the very purpose of liability insurance is to protect policyholders from the consequences of their mistakes.

In the case of most tort liabilities, if conduct did not depart from the ordinary "standard of care" (which separates prudent behavior from negligence), buyers of insurance coverage would not be liable for the damage or injuries sustained. And if policyholders never breached standards of care, and were never liable for the resulting harm, there would be no need for insurance. Courts generally are mindful of that reality.

One federal appellate court got it exactly right in addressing a case in which an insurer was attempting to avoid coverage for the cost of remediating contamination from a waste dump, on the ground that the insured municipality's awareness of problems with the dump meant that it "expected" or "intended" the damage that gave rise to the liability:

> "[W]hat makes injuries or damages expected or intended, rather than accidental, are the knowledge and intent of the insured. It is not enough that an insured was warned that damages might ensue from its actions, or that, once warned, an insured decided to take a calculated risk and proceed as before. Recovery will be barred only if the insured intended the damages, or if it can be said that the damages were, in a broader sense, 'intended' by the insured because the insured knew that the damages would flow directly and immediately from its intentional act."

Insurance coverage issues are issues of state law, and the governing principles can differ from jurisdiction to jurisdiction (as will be touched upon further below). However, even if the quoted passage sets forth the relevant principle with unusual clarity and forcefulness, that principle finds reflection, in one form or another, in the case law of all jurisdictions.

We would be surprised to find that the circumstances surrounding the development of fracing, once "spread on the record," will support a finding that the companies engaged in the practice "expected" or "intended" to inflict damage or injury within the meaning of the relevant body of law.

Pollution exclusions

GL policies issued during and after the early 1970s are subject to one or another form of "pollution exclusion"—which exclusion is certain to be invoked by insurers seeking to avoid coverage obligations in respect of fracing-related liabilities.

The form of pollution exclusion most commonly found in GL policies issued between the early 1970s and the mid-1980s (the so-called "qualified pollution exclusion") provides as follows:

> "This insurance does not apply to:
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> "Bodily injury or property damage arising out of the discharge, dispersal, release or escape of smoke, vapor, soot, fumes, acids, alkalis, toxic chemicals, liquids, or gases, waste materials or other irritants, contaminants, or pollutants into or upon the land, the atmosphere, or any other water course or body of water, but this exclusion does not apply if such discharge, dispersal, release or escape is sudden and accidental."

As noted above, the interpretation and enforcement of insurance contracts are generally a matter of state law, and the various jurisdictions differ with regard to the appropriate construction and application of those exclusions.

With regard to the qualified pollution exclusion, for example, some jurisdictions read it as foreclosing coverage of virtually all liabilities arising out of the intentional disposition of practically any substances or materials, regardless of whether the policyholder expected third-party damage or injury to arise out of such activities.

Other courts disagree, however, and have held that the qualified exclusion only forecloses coverage of "pollution"-related bodily injury or property damage that was expected or intended—a reaffirmation, in other words, of the strictures inherent in the policy's "occurrence" definition.

Contemporary records establish that the latter construction is what the insurance industry urged at the time that the qualified pollution exclusion was advanced for approval by state insurance regulators.

The so-called "absolute" pollution exclusion began to appear in GL policies in the mid-1980s in response to court rulings that limited the application of the qualified pollution exclusion. There have been disputes concerning the applicability of the "absolute" pollution exclusion, too—centering most often on whether the material responsible for the relevant damage or injury is appropriately viewed as a "pollutant" within the meaning of the exclusion.

If the underlying claim alleges damage arising from seismic events associated with fracing (a "seismic event claim") rather than from the migration of fracing fluids or their constituents (a "fluids migration claim"), the pollution exclusion should simply not be an issue.

Whether a pollution exclusion will foreclose coverage of a fluids migration claim under a particular GL insurance policy may depend on the period of time during which the policy was in force (and, hence, the type of exclusion that is in the policy), and—for the reasons discussed above—on the body of law that will apply.

Other defenses

The two defenses selected for extended discussion above do not represent an exhaustive list by any means: insurers have been known to advance literally dozens of reasons for rejecting insurance coverage claims.

"Late notice" is one such defense—and is touched upon below. It also has become increasingly common for insurers to allege that the relevant policyholder failed to disclose (or misstated) material information at the time application was made for the insurance policy, warranting annulment ("rescission") of the insurance contract.

Again, insurers generally invoke many defenses to significant insurance coverage claims, and if experience is any guide, an insurer can be expected to "round up the usual suspects" in elaborating defenses to your demand for insurance coverage in respect of any fracing-related claim or liability.

Allocation

It is likely that the claims arising out of fracing practices in a particular location will involve property damage or bodily injury that allegedly occurred over a number of years.

Even if allegations of damage and injury are disputed, it may be clear that the fracing activities, themselves, took place over a period of years.

Assuming that the energy company that is a defendant in the relevant suit purchased insurance policies in every year of that period—which specific policy or policies respond? In this regard, too, state law will govern the determination of that issue, and once again, the pertinent rules differ from state to state.

A number of jurisdictions permit a policyholder to select one policy period from among all of those policy periods in which GL coverage was "triggered" by the occurrence of covered harm, and to demand that the insurers that sold the policies in force during the designated policy period indemnify incurred damages up to the full liability limits of those policies.

Other jurisdictions hold that the insurer need only indemnify the portion of the liability that corresponds to the damage or injury which occurred during its policy period, and therefore require that damages be "allocated" among the insurers whose policies were in force during the multiyear period of harm—and potentially to the policyholder if it does not have insurance for such liabilities in any part of the period.

Various considerations can give the policyholder a keen interest in the matter of whether its liability is allocated for coverage purposes and, if so, the methodology of the allocation.

If the policyholder has adequate limits in each year's coverage, and high deductibles, it has an interest in confining the allocation of damages and thereby minimizing the number of deductibles that it will be required to absorb (particularly if in a jurisdiction that requires the policyholder to absorb a full deductible in each triggered year, even if all of the damages imposed arose from a single "occurrence"). On the other hand, if the policyholder is facing a large liability, and has a series of policies with low indemnity limits and low deductibles, it may benefit by tapping the limits of the policies in force in more than one policy period.

Even among jurisdictions that allocate damages, outcomes can differ. A common method of allocating a liability (sometimes viewed as the default method) is to prorate it over time, assigning an equal amount to every triggered year.

A number of allocation jurisdictions, however, give the policyholder an opportunity to demonstrate when the property damage giving rise to a liability actually occurred, rather than presuming conclusively that the damage occurred in equal amounts over a multiyear period.

Taking advantage of that opportunity may redound to the policyholder's benefit in very tangible ways. For example, the scientific opinion of the policyholder's expert could place the major portion of the triggering property damage in a period in which coverage is in force, and not in the years during which the policyholder did not purchase coverage.

If the jurisdiction is one in which the courts hold that coverage for fracing-related harm is foreclosed by the terms of pollution exclusions, a finding that the greater part of the relevant damage or injury was sustained before the policyholder's policies became subject to pollution exclusions may substantially mitigate the practical impact of those exclusions.

Notice obligations and issues

Apprising your primary GL insurer of a prospective liability does more than get the ball rolling on your expectation of a defense, and indemnity of any incurred liability: it satisfies a policy obligation.

Primary GL policies oblige the policyholder, "as soon as [is] practicable," to give notice to the insurer, not only of claims and suits, but also of an "occurrence," which may result in a claim. Excess GL policies only oblige policyholders to give notice only when it appears likely that a liability, if imposed, would implicate the relevant policy.

The simpler matter, for purpose of determining when the notice obligation "accrues," is recognizing when your company has been made the object of a claim or suit. Although in that regard it is good to remember that a letter from a governmental agency requiring action under pain of sanctions may qualify as a "suit"— as noted in the discussion of the policyholder's entitlement to a defense, above.

The more difficult question is likely to be whether your company is aware of circumstances that present the possibility that a claim will be asserted (at which instant, arguably, the obligation to give "notice of occurrence" accrues).

When in doubt, it is always advisable to err on the side of providing notice: No one ever lost coverage, it has been said, by giving notice too early.

The consequences of providing "late" notice are dictated by state law, and here too, the rules differ from jurisdiction to jurisdiction. In the majority of jurisdictions, the policyholder is not denied coverage on the basis of untimely notice absent prejudice to the insurer (and in most of those jurisdictions the burden is on the insurer to prove that it sustained prejudice, rather than being placed on the policyholder to prove the absence of prejudice).

In the notice-of-suit context, a number of jurisdictions hold that the policyholder is not entitled to reimbursement from the primary GL insurer of any defense costs incurred before the suit has been "tendered" to the insurer for defense (although we consider that doctrine to be based on questionable reasoning).

Some jurisdictions hold that the provision of timely notice is a "condition precedent" to the enjoyment of the policyholder's rights under the GL policy, and that the provision of untimely notice forfeits those coverage rights entirely.

Forum and issues of strategy

If it served no other purpose, the foregoing discussion of coverage issues and concerns should have served to impress on the reader the potential import of the body of substantive law that will govern adjudication of a coverage dispute.

As we have discussed, there are differing views among the jurisdictions concerning the proper scope of pollution exclusions; the manner in which damages should be charged to insurers for indemnification purposes; the consequences of untimely notice, and any number of additional issues that are likely to arise.

Depending on the facts of a given case and the policyholder's "coverage profile," the differing rules applied by the courts may dictate the extent of a policyholder's recovery—and, indeed, whether there will be any recovery at all.

While the choice-of-law determination is supposed to emerge from application of objective factors, it is only realistic to suppose that the choice of the jurisdiction in which a coverage action is filed will have some bearing on that determination.

And it is not a little naive to suppose that your insurers are ignorant of those considerations, and will not include in their strategy the early choice of the forum in which to seek a judicial declaration that you are without coverage for your liabilities.

The tactic described is so commonly employed by insurers that it has acquired a name: An insurer is said to have "jumped" its policyholder when it institutes a declaratory judgment suit in the jurisdiction thought by the insurer to be most favorable to its interests. That is often done before the policyholder has had an opportunity to respond to the insurer's written disclaimer of coverage obligations—and sometimes before the policyholder has even seen that disclaimer.

It therefore behooves the policyholder facing a fracing-related claim (asserted or imminent) to be proactive in determining whether a particular jurisdiction's body of law would be helpful or hurtful to its coverage prospects—and, once that determination has been made, to be aggressive in taking the necessary steps to protect its interests.

Reference

1. The quoted words are those of US District Judge H. Lee Sarokin, and were part of his Honor's clear-eyed view of the strategies employed by insurers when confronted with claims that they would prefer not to pay.

At such times, Judge Sarokin continued, "[t]he small print suddenly has become magnified, and the insurance companies can be seen scurrying about the courts of this country in search of ways to avoid honoring their policies." Sandoz Inc. v. Employer's Liab. Assur. Corp., 554 F. Supp. 257, 258 (D.N.J. 1983).

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