ABA Section of Litigation Insurance Coverage Litigation Committee CLE Seminar, March 1-3, 2012:
The New Generation of Environmental Claims

Emerging Environmental Risks Under Traditional and Specialty Lines Insurance

Jared Zola
Dickstein Shapiro LLP
New York

Aisha Henry
Lewis Baach PLLC
District of Columbia

Bill Hardin
Navigant Consulting
Chicago

Steven P. Nassi
Nelson Levine deLuca & Horst LLP
New York

INTRODUCTION[1]

The Economist estimates that shale bed hydraulic fracturing ("fracking") provides 25% of America's natural gas supply and is seen as an economic engine with the ability to create jobs and lower energy costs, allowing America to become a net exporter. While technologically advanced energy extraction techniques have the proven ability to produce oil and gas at competitive costs, the risks of environmental harm need to be evaluated further as some of the recent events such as the Deepwater Horizon are significant. Such risks have led many companies to acquire insurance to protect the enterprise value of their business from potentially devastating loss. As a result, insurers either have already seen or likely will see an uptick in environmental claims relating to fracking and deep-water drilling.

Indeed, there have already been various lawsuits alleging that the technique employed in fracking has resulted in environmental contamination by way of aquifers, surface waters and air quality.[2] Moreover, governmental agencies have taken an active interest in assessing the impact of fracking, with the EPA in the midst of an extensive study aimed at analyzing the effect of fracking on drinking water, as well as any potential risks associated with surface spills and with the disposal of the "fracking cocktail" used in the extraction process. Recently, New York Attorney General Eric Schneiderman served subpoenas on several of the largest domestic energy companies in natural gas drilling, seeking information concerning the disclosures made by those companies to investors about the risks related to fracking.[3]

Some also allege that recent seismic activities, such as earthquakes, stem from the vibrations and pressure changes associated with fracking. In fact, following tremors in the Lancashire seaside resort in northwest England measuring 2.3 and 1.5 on the Richter scale in April and May of 2011, respectively, the British energy firm Cuadrilla Resources concluded that its hydrofracking drilling likely caused the minor seismic events, albeit noting that the incident was unique to the geological elements of that site and was unlikely to occur at other fracking sites.[4] Similar allegations are swirling around the January 2012 earthquake in Ohio.[5]

In addition to the risk of property damage associated with earthquakes, other potential risks include (i) devaluation of private property, (ii) air pollution and excess noise to properties surrounding the drilling site, (iii) pressure explosions associated with the drilling process (commonly referred to as "blowouts"), (iv) subsidence or sinkhole claims, (v) loss of crops and livestock, (vi) mishaps in the handling, storage,

---

[1] The views expressed in this article are those of the authors and do not necessarily represent the views of, and should not be attributed to, the authors' respective firms or their clients.

[2] *See, e.g.*, *Fiorentino, et al. v. Cabot Oil & Gas Corp., et al.*, No. 09-CV-2284 (M.D. Pa.); *Berish v. Southwestern Energy Production Co.*, No. 3:10-cv-1981 (M.D. Pa.); *Baker, et al. v. Anschutz Exploration Corp., et al.*, No. 6:11-CV-061190 (W.D. N.Y.).

[3] *See* Celeste Katz, Hydrofracking Subpoenas on Tap, New York Daily News, June 28, 2011.

[4] *See* Garry White, *Cuadrilla admits drilling caused Blackpool earthquakes*, The Telegraph, Nov. 2, 2011, available at http://www.telegraph.co.uk/finance/newsbysector/energy/8864669/Cuadrilla-admits-drilling-caused-Blackpool-earthquakes.html; and Austin Holland, *Examination of Possibly Induced Seismicity from Hydraulic Fracturing in the Oela Field, Garvin County, Oklahoma*, Oklahoma Geological Survey, dated Aug. 11, 2011, available at http://www.ogs.ou.edu/pubsscanned/openfile/OF1_2011.pdf (study issues by Oklahoma Geological Survey noting that increased fracking activity may have contributed to a number of small earthquakes which occurred in Oklahoma in early 2011).

[5] *See Injection Wells Shut Down After 4.0 Earthquake in Ohio*, Insurance Journal, Jan. 3, 2012, *available at* http://www.insurancejournal.com/news/midwest/2012/01/03/229228.htm (noting that "[o]fficials said they believe the latest earthquake activity in northeast Ohio is related to the injection of wastewater into the ground near a fault line, creating enough pressure to cause seismic activity.").

and transportation of the fracking cocktail used in the drilling process and the resulting waste, and (vii) the seepage of toxic gases and other natural radioactive materials to the earth's surface.

Litigation stemming from fracking operations may include causes of actions asserted under state statutes, like Pennsylvania's Hazardous Site Cleanup Act, federal statutes (such as the Clean Water Act, Clean Air Act, and Comprehensive Environmental Response Compensation and Liability Act), and common law theories of liability such as strict liability, nuisance, physical trespass, medical monitoring, emotional distress, and various negligence based theories.

The losses alleged may take various forms, including bodily injury, diminution in property value, breach of quiet enjoyment, loss of business, increased risk of disease and punitive damages. Aside from the monetary damages sought by plaintiffs, plaintiffs in such litigation often seek injunctive relief to stop the drilling activity and mandate remediation of the alleged contamination. Although, to date, many lawsuits arising from fracking activity for alleged personal/property/bodily injury have been asserted on an individual basis, a notable number of lawsuits have been commenced as putative class actions.[6]

As more claims and lawsuits develop, companies involved in hydrofracking will undoubtedly look to their insurers to provide a defense, and ultimately seek indemnity for any resulting liabilities. This article summarizes some of the various lines of coverage under which insureds may seek coverage, and some of the potential defenses to coverage. These emerging environmental risks may implicate traditional General Liability (GL), Directors and Officers (D&O), Workers Compensation, Operators' Extra Expense (Control of Well) and specialized environmental liability policies.

GENERAL LIABILITY POLICIES

GL policies typically afford coverage for liabilities that the policyholder incurs because of bodily injury or property damage sustained during the period of the policy that is "caused by an occurrence." "Occurrence" is generally defined, for pertinent purposes, as "[a]n accident...which results, during the policy term, in 'bodily injury' or ['property damage']." A noteworthy feature of primary, (or first-layer) occurrence-based GL policies is that unlike the excess (or secondary) layers of insurance, they may entail an insurer's "duty to defend." Pursuant to the terms of typical primary occurrence-based GL policies, a primary insurer undertakes to defend its insured if the allegations of a third-party claim present the potential that the insurer will be required to indemnify a judgment against the policyholder. In contrast, excess policies often disavow such a duty; instead, typical excess occurrence-based GL policies indemnify the insured for covered losses that exceed the underlying limits of liability.

Generally, an occurrence-based GL policy is "triggered" when the harm (property damage or bodily injury) takes place—not when the claim is asserted. As such, it could be argued that GL policies purchased in the 1960s and '70s (or earlier) are required to indemnify damages imposed for harm done at that time, even if claims for those damages are first asserted in 2012. While fracking may have been relatively unfamiliar to most people outside of the energy industry until the past several years, this technique has been used to increase oil and natural gas production in this country since the 1940s. The year or years in which an occurrence took place is significant when evaluating an environmental claim under the terms of a GL policy because, as discussed below, most GL policies issued during and after the

[6] *See, e.g.*, *Tucker v. Southwest Energy Co*., No. 1:11-cv-00044 (E.D. Ark.) (currently pending; alleging water and soil contamination, and asserting causes of action sounding in strict liability, negligence, nuisance and trespassing); *Lane v. BHP Billiton Petroleum(Arkansas) Inc*., No. 1:11-cv-00047 (E.D. Ark.) (currently pending; alleging that defendant's fracking operations resulted in seismic activity); *Evenson v. Antero Resources Corp*., No. 2011 CV 05118 (Colo. Dist. Ct.) (currently pending; putative class action on behalf of 1,000 property owners and 5,000 current/former residents of Battlement Mesa, Coloroda, alleging air and water pollution).

early 1970s are subject to some form of pollution exclusion—which may or may not limit an insured's coverage for these claims, as discussed below.

PROPERTY POLICIES

Although "covered peril" and other forms of property policies exist in the marketplace, many property policies are still sold on an "all risk" basis. These policies generally provide coverage for losses to real property caused by any peril that is not specifically excluded by the policy, subject to other terms and conditions.

Businesses engaged in or in close proximity to any drilling operations, for example, face potential property damage risks—some of which may implicate first-party insurance policies. Insureds may argue that property damage claims arise from damages caused by well blow-outs, and seismic activities beneath the insured property leading to collapse, cracking, shifting, or sink holes.

Though not found in some specialized energy industry policies such as those often provided by Oil Insurance Limited (OIL), typical property policies provide "business interruption" coverage. Property policies generally provide: "Payment for the actual loss of business income sustained due to the necessary 'suspension of operations' during the 'period of restoration.' The 'suspension' must be caused by direct physical loss of or damage to property at premises which are described [in the policy]." (ISO CP 00 30 06 07 at p. 1). Some policies cover interruptions due to a "risk of loss," rather than to "physical loss or damage."

Property policies typically provide additional "time element" coverages, such as "utility service interruption" coverage for losses that the policyholder incurs due to the interruption of utility services that result from physical damage to the property that supplies the utility. For example, an insured may argue that it has an insurable loss if hydraulic fracturing or drilling activities results in an insured business losing access to its water services, and that business then incurs losses because of a service interruption–*i.e.* a farm's inability to water its crops or provide water to its livestock. In addition, some first-party policies contain "time element" coverages, such as "ingress/egress" or "civil authority," which, depending on the policy language, may not require physical damage to implicate coverage.

DIRECTORS AND OFFICERS POLICIES

As emerging environmental risks receive more prominent media and public scrutiny, governmental agencies are certain to increase their own investigations. For example, in August 2011, the New York Attorney General sent subpoenas to three large exploration and production energy companies seeking information relating to those companies' disclosures of prospects for their natural gas wells to investors. The subpoenas focus on the manner in which the companies report their oil and gas reserves to investors.[7] Under the Martin Act, which Eliot Spitzer used to investigate many Wall Street firms, the New York Attorney General has broad power to subpoena virtually any document from businesses operating in the state. Here, New York State has more than $45 million of its pension money invested with the targeted energy companies. The New York Attorney General has already targeted other energy companies and served subpoenas relating to the disclosure of hydraulic fracturing risks, and has indicated that this investigation may target other energy companies.

---

[7] *See* Ian Urbina, *New York Subpoenas Energy Companies Over Claims About Gas Wells*, N.Y. Times, Aug. 18, 2011, *available* at http://www.nytimes.com/2011/08/19/us/19gas.html?hp; *see also* Greg Ryan, *NY AG Subpoenas Energy Giants Over Drilling Forecasts*, Law360.com, Aug. 18, 2011, *available* at http://www.law360.com/energy/articles/265855?utm_source=newsletter&utm_medium=email&utm_campaign=energy.

Whatever the merits of these investigations—members of the energy industry have criticized the basis of such investigations as being unfounded[8]—these investigations may force the targeted energy companies to incur significant sums of money, perhaps millions of dollars, responding to and defending the investigations. Target companies that have purchased D&O liability insurance policies may seek to recoup from their insurers the costs incurred in responding to an investigation, in addition to any settlement reached with or liability imposed by a government agency.

Typically, D&O policies provide coverage for "claims" against the directors and officers, as well as the company itself (for when the company indemnifies the directors and officers and for claims directly against the company). "Claims" virtually always include lawsuits and may also include "formal or informal administrative or regulatory proceedings." Based on this language, insurers may argue that a subpoena received from a governmental entity does not constitute a "claim" within the meaning of a D&O policy.

A recent case decided by the United States Court of Appeals for the Second Circuit, *MBIA Inc. v. Federal Insurance Co.*, 652 F.3d 152 (2d Cir. 2011), addressed the issue of whether a government subpoena constitutes a "claim" under a D&O policy and ruled in favor of the policyholder. In *MBIA*, the policyholder sought coverage under its D&O policy for the costs it incurred in responding to a New York Attorney General's subpoena and investigation into transactions entered into by the policyholder. The insured's D&O policy in this case provided coverage for "Securities Claim," which was defined—as D&O policies typically defined "claim"—to include "a formal or informal administrative or regulatory proceeding or inquiry commenced by the filing of a notice of charges, formal or informal investigative order or similar document." *Id*. at *1. The Second Circuit rejected the insurance company's argument and held that "the NYAG subpoena is at least a 'similar document' to a 'formal or informal investigative order'" and that the plain-language understanding of "Securities Claim" included the subpoena, to which the policyholder was entitled to coverage. *Id*. at *5-6.

As a result, a policyholder facing a state attorney general subpoena may seek reimbursement from its D&O carrier for the expenses incurred as a result of a subpoena. However, if such a claim arises, insurers may argue that policy exclusions and defenses limit or preclude coverage.

LIKELY INSURER DEFENSES TO COVERAGE

When a claim is made, the determination of coverage hinges on the terms, conditions and applicable exclusions of the policy (or policies) that are potentially implicated, and the policy's application to the facts presented. Some liability policies, for example, contain definitions that specify what constitutes a covered "occurrence" and exclusions that may operate to limit or bar coverage. In assessing whether an insured may have a covered loss, it is essential to review carefully the terms and conditions of the policy at issue to determine whether coverage exists under the facts presented and what potential defenses to coverage may operate to limit such coverage. Although not an exhaustive list, the following are examples of potentially applicable defenses to coverage that insurers may invoke seeking to defeat claims or losses arising out of alternative gas exploration techniques.

1. ***Fortuity Requirement***

Insurance is provided for those losses that are fortuitous—i.e., occurring by accident. In some policies, the requirement of fortuity is expressed in policy language. Depending on the form of the policy, the requirement can be expressed either by the policy's definition of a covered "occurrence" or by way of an

---

[8] *See, e.g.*, Letter to The Editor of the *New York Times* from Glenn Darden, President and CEO of Quicksilver Resources Inc., June 26, 2011, *available* at http://blogs.star-telegram.com/files/dardenletter.pdf

exclusion providing that coverage is not afforded for losses "expected or intended" by the insured. However, most courts generally recognize that the fortuity requirement is inherent in all policies, even if unstated.

As previously mentioned, "occurrence" is defined, for pertinent purposes, as "[a]n accident...which results, during the policy term, in 'bodily injury' [or 'property damage']." Whether an event is sufficiently accidental so as to implicate coverage under a liability policy is an issue that courts have addressed. Courts in some jurisdictions look to the resulting injury in analyzing the issue while others focus on whether the injury (or damage) was caused by an accident.

Application of the "expected or intended" language in GL policies also differs by jurisdiction. The case-law in some states suggests that recovery will be barred only if it can be said that the insured "intended" the damages because the insured knew that the damages would flow directly and immediately from its intentional act. Other states preclude coverage where the harm was "more likely than not to occur," or where the injury was "practically certain" to come about. Still other states require a case-by-case analysis of the circumstances demonstrating the insured's knowledge and intent. Regardless of the applicable standard, it can be expected that insurers will place some emphasis on any evidence of "warnings" of potential risk in any internal documents, or expressed by outside authors, commentators and trade journals.

2. ***Pollution Exclusion***

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") generally provides that coverage is barred for "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." Some jurisdictions read the "qualified pollution exclusion" as foreclosing all liabilities arising out of the intentional disposal of practically any substance, regardless of whether the insured expected third-party damage from such activities. Other courts disagree and have found that the qualified exclusion only forecloses coverage for "pollution"-related damage or injury that was expected or intended.

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. Policyholders and their insurers have disputed the scope of the "absolute" exclusion for years. The dispute often centers on whether the substance responsible for the damage is appropriately categorized as a "pollutant" within the meaning of the exclusion. For example, if drilling operations release gaseous substances naturally found in shale formations into aquifers necessitating remediation efforts, would that natural gas constitute a "pollutant" pursuant to the terms of the exclusion? Said another way, whether or not a general liability insurer is obligated to pay the costs that the insured incurs paying a state agency to remediate alleged groundwater contamination may turn on whether the natural gas is a "pollutant."

There are a myriad other issues attendant to assessing the applicability of a policy's pollution exclusion, in whatever form they may appear, for losses stemming from hydrofracking or drilling activities. The substance alleged to cause the injury, the factual circumstances under which the alleged injury arose, and other factors can be critical in determining the applicability of a policy's pollution exclusion.

3. Earth Movement Exclusion

Some personal lines and commercial first party policies exclude coverage for losses stemming from earthquakes, earth movement, or structure movement. Moreover, whether the earth movement is found to have been caused by natural or human forces may prove critical to the issue of coverage because some courts have held that the earth movement exclusion applies solely to those losses caused by natural earth movements; although some courts have not applied any such restriction. Moreover, the precise policy language found varies greatly from policy to policy—especially in the context of first-party property policies.

Another issue further complicating the applicability of the earth movement exclusion—and perhaps many other relevant exclusions—arises when the loss is arguably the result of various factors, some of which are covered, others that are excluded. This "causation" issue is thorny and may, in some cases, be addressed in a policy's "anti-concurrent causation clause."

4. Known Loss or Continuous Injury

Some GL policies bar coverage for bodily injury or property damage of which the insured was aware prior to the policy's inception. Such limitation to coverage may appear in an exclusionary clause, or the policy's insuring agreement. Regardless, what the insured knew, and when he knew it, is a fact-sensitive issue and may be a factor in determining whether there is coverage. Insureds and their insurers have debated for decades what constitutes "knowledge" sufficient to impede coverage.

These and other defenses are likely to play a significant role should policyholders faced with emerging environmental risks call upon their insurers to provide coverage. In this regard, the considerable body of case law—differing by jurisdiction—in which the courts have analyzed the meaning of certain terms, conditions and exclusions found in traditional insurance policies may be the sounding board for resolution of the wide-ranging potential issues.

ENVIRONMENTAL LIABILITY COVERAGE

Because many standard-form GL policies written after the mid to late 1980's contain some form of pollution exclusion, some companies facing potential environmental risks have purchased environmental impairment liability (EIL) policies to provide coverage for those risks. Covered costs can include site clean-up, business interruption, third-party bodily injury, property damage, and defense costs.

EIL policies are typically written on a claims-made basis. Claims-made policies provide coverage for losses arising from a claim first made against the insured during the policy period. Coverage is triggered not by the date of the alleged wrongful act (*i.e.*, injury or damage), but by the date of the claim that results from the wrongful act. Insurers have argued that the phrase "claim first made" means that coverage will not apply if the claim had already been made against the insured prior to the policy period.

The claims-made nature of EIL policies may present various issues in determining when a claim is "first made" against the insured. This question does not always have a simple answer. An insured may receive governmental subpoenas or formal requests for information sometimes years prior to any "demand" for money or services. Adding another wrinkle, the "reporting provision" of the EIL policy may instruct the insured to also report "incidents" or "circumstances" that reasonably could give rise to a claim under the policy.

Another issue that may arise more frequently when evaluating environmental claims under a present-day EIL policy, as opposed to a historical GL policy, is whether a claim presents a "known loss" and, as such, is excluded from coverage. In this regard, the information sought and the information provided in policy application may become relevant. The purported rationale behind the so-called "known loss" exclusion is logical: you can't wait until your house burns down to go out and buy fire insurance. Courts have refused as a matter of public policy to allow insurance coverage for a "known loss." However, some courts have found that the relevant "loss" for purposes of applying the known loss doctrine to liability policies is not simply the property damage itself, but the insured's liability for the property damage. In other words, some courts have held that there must be a showing that the policyholder faced liability prior to the policy's inception. Despite this, insurers may argue that mere knowledge of a potentially hazardous condition is sufficient to invoke this exclusionary language.

RISK MANAGEMENT

From an insured's perspective, understanding your business needs and risks associated with performing this type of work is essential. Insureds should develop a Zone of Possible Outcomes ("ZOPO") Model. The ZOPO should look at each project that the company is performing that has an environmental risk component. With that, modeling the economic impact provides the insured with an understanding of what type of insurance coverage could be needed in the case of an event.

The company's risk officer should further determine what type of insurance coverage could help defer costs and protect assets if an event occurs. Looking at GL, D&O, EIL, and other policy forms is helpful when developing a tower structure to determine how much potential coverage is needed in the case of an event.

From an insurer's perspective, the carrier should start to model the types of coverage by industry and by client to determine the risk profile of potential exposure in case of a large event. The carrier should actively understand the portfolio of coverage and types of risks associated with those policies. Setting up the correct monitoring system enables the carrier to be more proactive with respect to risk management. With legacy policies, the carrier should understand the types of policy provisions associated with high risk policies. Using this knowledge, the carrier should be drafting new policies, or endorsements to existing policies, that mitigate the risk or ask for additional premium to compensate for the perceived risk. Creating sensitivity graphs and models helps everyone within the organization manage the risk of the business.

CONCLUSION

Environmental coverage claims can be expected in all shapes and sizes as media, public and government scrutiny continues in connection with such hot-button topics as deep-water drilling and hydraulic fracturing. Depending on the type of insurance, specific language used in the policy, the jurisdiction at issue, and how the facts regarding the cause of the loss develop, policyholders may turn to their insurers under a myriad of coverages. In connection with each type of coverage, insurers may argue that the policy at issue contains terms and conditions that limit or exclude coverage. Policyholders need to be mindful of procedural and timing requirements in their policies and should attempt to comply with all such requirements. Managing risk is a full time process and both insureds and insurers should continue to be mindful of reviewing this on a timely basis.