

Gulf Coast Oil Spill Coverage Impact on the Insurance Industry

By Joanna M. Roberto

The British Petroleum (“BP”) oil rig accident and ensuing oil spill have keenly proven that all liability coverages will be triggered with respect to the enormous property damage loss that has occurred. As quoted by Moody’s Investors Service on July 3, 2010, the cost of insurance policies covering deep water oil rigs has increased by more than 50% since the BP oil spill. The estimations assessed against insurers and reinsurers are astounding. Total insured losses from the worst oil spill in U.S. history are expected to be between \$1.4 billion and \$3.5 billion.¹ For instance, Partner Re has estimated its losses will be in the \$60-\$70million range; Munich Re follows with \$80 million; Hannover Re with \$53 million and Swiss Re predicts the heaviest loss in the industry, estimating a \$200 million loss from the disaster.²

Within days of the incident, Transocean Ltd.’s excess insurers filed a complaint for declaratory judgment in a Texas federal court, seeking a ruling that no additional insured coverage is owed to BP plc with respect to pollution claims arising out of the explosion of BP’s oil well in the Gulf of Mexico.³ The complaint alleges that BP is not entitled to coverage as an additional insured because the release of oil on April 20, 2010 emanated from BP’s well and not Transocean’s oil rig. Transocean owned the Deepwater Horizon oil rig that BP contracted to use for its drilling activities. The drilling contract requires BP be named as an additional insured under Transocean’s excess policies issued by Certain Underwriters.

On May 14, 2010, BP plc provided notice of claim to the insurers, which include Certain Underwriters at Lloyd’s, London; Axis Specialty Europe Ltd.; Arch Insurance Co., Ltd.; Berkeley Insurance Co.; Houston Casualty Insurance Co.; National Union Fire Insurance Co. of Pittsburgh, Pa.; Navigators Insurance Co.; Infrassure Ltd.; Great American Insurance Co. of New York; Liberty Mutual Insurance Co.; New York Marine and General Insurance Co.; Valiant Insurance Co.; Max America Insurance Co.; XL Specialty Insurance Co.; and Zurich American Insurance Co.

Transocean’s drilling agreement, Article 24.1 addressed Transocean’s pollution-related liabilities to BP and provides that Transocean “shall assume full responsibility for...and hold [BP] harmless from demand or liability for pollution or contamination, including control and removal thereof, originating above the surface of the land or water from spills, leaks or discharges of fuels...in the possession and control of [Transocean].” Article 24.2 of the agreement sets forth BP’s pollution-related liabilities to Transocean, stating that BP assumes full responsibility

for and holds Transocean harmless from pollution claims “arising out of or connected with operation under this contract hereunder and not assumed by Transocean.”

The excess insurers claim that the liabilities BP faces for pollution emanating from BP’s well are not within the scope of the additional insured protection because they are emanating from below the surface and from BP’s well. Accordingly, the excess insurers seek declarations that BP assumed full responsibility in the drilling contract for any and all liabilities arising out of or related to the release of oil from its well, that the insurers have no obligation to BP under any of the policies for pollution liabilities, and that BP is not entitled to coverage under any of the policies for current or future pollution liabilities.

Following along the lines of lawsuits, the State of Alabama has also filed two lawsuits over the BP oil spill. According to an Associated Press report, one names BP as a defendant, while the other names Transocean, Halliburton and other companies associated with the spill. The lawsuits accuse the defendants of damaging Alabama’s coast and economy through “negligent or wanton failure to adhere to recognized industry standards.” The lawsuits seek both punitive and economic damages, but do not state a dollar figure. A spokesperson for the governor’s office told the Associated Press the State is still compiling a list of economic damages that it will submit to BP. These are just a few examples of the many lawsuits emanating from the BP oil spill.

Damage

Manifesting itself from the BP oil spill is the argument that cleanup and/or remediation costs may not necessarily constitute “damage” under the policy. There are a select amount of cases stating that an insurer is not obligated to indemnify an insured where the government seeks response costs for the cleanup of a hazardous waste. The logic is that the response costs constitute an economic loss and not property damage as defined in the policy. See *Mraz v. Canadian Universal Ins. Co.*, 804 F.2d 1325 (4th Cir. 1986).

It has frequently been held in New York—and elsewhere—that a liability policy insuring against an award of legal damages does not cover an award of equitable relief, such as an injunction, or an order of restitution. Legal damages are subject to clear limits, which is the measure of damages for distortion of the property limits of the value of that property. Applying this logic to environmental cleanup situations, several of the costs attributable to

the pollutant release fall outside the scope of the policy. For example, costs relative to the contaminant of prevention of future spills are not considered property damage under the scope of the policy. See *Hakin v. Mass. Ins. Insolvency Fund*, 675 NE2d 1161 (Ma. 1997).

Similarly, a liability policy may not extend itself to compensating for costs linked to cleanup and/or to mitigate the possibility of future losses, often, it is key to determine the process of the cleanup in relation to the insured's normal operations and waste removal. It is possible, for example, that procedures of cleanup had been combined with normal operating procedures and costs. Along these lines, courts have regularly concluded that the cost attributable to compliance with regulatory directives of a federal agency does not constitute a claim for damages under a policy. See *Bausch & Lomb, Inc. v. Utica Mut. Ins. Co.*, 330 Md. 758 (Ct. Appeals Md 1993). In accordance with the policy's definition of property damage which includes "physical damage to or destruction of tangible property," an insurer may not be obligated to compensate for costs attributable to regulatory compliance as they would not be a response cost.

Pollution Coverage

Almost every liability insurance policy includes some form and variation of a pollution exclusion. To be debated is whether the oil, spilling from the oil well, is a "pollutant," as defined under various property insurance policies. The policies generally define "pollutants":

Pollutants means any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals, and waste.
Waste includes materials to be recycled, reconditioned or reclaimed.

The definition and interpretation of pollution are substantially contested issues for the insurance industry. Even today and even aside from BP, courts remain divided on the general application of the pollution exclusion.

In a recent case, *Mastec, Inc. v. United States Fire Ins. Co.*, 361 Fed. Appx. 37 (11th Cir. 2010), coverage for pollution damages caused by a punctured gas pipeline was addressed. In applying Florida law, the court stated that although the general rule is that insurance provisions susceptible to more than one reasonable interpretation are ambiguous and should be strictly construed against the insurer in favor of coverage. However, despite this general principle, the court found that Mastec had not proposed—nor could the court devise—a *reasonable* interpretation of the exclusions that would allow it to construe the policy in favor of coverage.

The Ninth Circuit has also spoken on the application of the exclusion. In *Enron Oil Trading & Transp. Co. v. Walbrook Ins. Co.*, 132 F.3d 526 (9th Cir. 1997), the court

addressed the contention that the "pollution exclusion" in a commercial general liability policy applied so as to exclude coverage for losses sustained as a result of the addition of a foreign substance to crude oil transported in a pipeline. 132 F.3d at 528. In that case, the at-issue policy excluded coverage for loss resulting from "pollution or contamination." *Id.* at 529. Recognizing that an insurance policy clause is ambiguous when different persons looking at the clause in light of its purpose cannot agree upon its meaning, the Ninth Circuit agreed that "although 'contamination' is not defined in the policy, it must be construed *within the context of the pollution exclusion.*" *Id.* (emphasis supplied). The term "contamination," the court explained, "is an environmental term of art and applies only to discharges of pollutants into the environment." *Id.* The court also agreed with the district court's rejection of the insurers' common-sense approach to defining "contamination," as that approach would render an interpretation that was "virtually boundless" and would reach "far beyond the reasonable expectations of the insured." *Id.*

The *Enron Oil* court found that the insurers' expansive definition of "contamination" demonstrated the ambiguity convincingly; under their interpretation, the contamination exclusion would be virtually limitless, extending to claims for product liability (for example, a bottle manufactured with impure glass) or for negligence (for example, spoiled food served in a restaurant) that arguably involved an impurity resulting from contact with a foreign substance. *Id.* The Ninth Circuit concluded that the use of the words "'seepage, pollution and contamination,' together with the specific exclusion of 'the cost of removing, nullifying or cleaning-up seeping polluting or contaminating substances,' sends an unmistakable message to the reasonable reader that the exclusion deals with environmental-type harms." *Id.* The Ninth Circuit thus opted for a contextual definition of contamination.

Similarly, in *Pipefitters Welfare Educ. Fund v. Westchester Fire Ins. Co.*, 976 F.2d 1037 (7th Cir. 1992), the Seventh Circuit examined an insurance policy's pollution exclusion clause, in which the definition of pollutant included "any...thermal irritant or contaminant." 976 F.2d at 1043. The court held that the "terms 'irritant' and 'contaminant,' when viewed in isolation, are virtually boundless, for 'there is virtually no substance or chemical in existence that would not irritate or damage some person or property.'" *Id.* at 1043 (quoting *Westchester Fire Ins. Co. v. Pittsburg*, 768 F. Supp. 1463, 1470 (D. Kan. 1991)).

Expanding on the contextual definition theory, some courts have illustrated how the term "contamination" may be used improperly as a synonym for various types of damage and chemical processes, which may or may not properly be classified as contamination or excluded from coverage under the terms of a policy. See, e.g., *McConnell Constr. Co. v. Ins. Co. of St. Louis*, 428 S.W.2d 659, 11 Tex. Sup. Ct. J. 430 (Tex. 1968). By way of further example, in the context of a liability insurance policy, at least one New

York State court has also found the term “contamination” or “contaminant” to be ambiguous. In *Pepsico, Inc. v. Wintertur Int’l Am. Ins. Co.*, 13 A.D.3d 599, 788 N.Y.S.2d 142 (2nd Dept. 2004), the insured used faulty raw ingredients in its soft drink products, which caused the products to have an unintended taste and which necessitated the destruction of the damaged products. 788 N.Y.S.2d at 143. The insurance carrier in that case disclaimed coverage, relying on the policy’s contamination exclusion. The carrier claimed that contamination meant “to make inferior or impure by mixture.” *Id.* at 144. The Appellate Division, however, determined that:

[t]o accept [the insurance carrier’s] interpretation would require that the term “contamination” be read literally, whereas New York courts, in construing terms in pollution exclusions, favor a commonsense approach over a literal approach. [The insurance carrier’s] reading also ignores the general purpose of pollution exclusions, which is to exclude coverage for environmental pollution.

Bearing significance to the treatment of “oil” in contamination matters, in *Wilshire Westwood Assocs. v. Atlantic Richfield Corp.*, 881 F.2d 801 (9th Cir. 1989), the developers claimed that former landowners should have been responsible for clean up of the subject land under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA), 42 U.S.C.S. § 9601 (14), because the landowners knowingly allowed hazardous substances to leak into the ground over the period of their ownership. The court affirmed and found that the only issue was whether the exclusion from the definition of hazardous substances in CERCLA for petroleum, including crude oil and any fraction thereof, included refined gasoline and all of its components and additives. The court held that CERCLA specifically excluded crude oil from the list of hazardous substances requiring appellees to bear cleanup costs under the statute and that if the court ruled that petroleum was not excluded, then every person that ever spilled oil or gasoline would be liable under CERCLA.

New York Speaks on Environmental Coverage

In *American Commercial Lines LLC v. Water Quality Insurance Syndicate*, 2010 U.S. Dist. LEXIS 33251 (S.D.N.Y. March 29, 2010), the court held the insurer was obligated to continue reimbursement of defense and investigation costs despite policy limits and indemnity for oil spill claims. This coverage action addressed the extent to which the insurer’s policy covers the insured’s investigation and defense costs involving a maritime accident and oil spill on the Mississippi River in July 2008. Specifically, the accident occurred when an unmanned barge sank

and released approximately 300,000 gallons of fuel oil into the river.

As a result of the accident the insured, as owner of the barge, was sued for the cleanup costs. The policy issued by WQIS required the insurer to (1) indemnify ACL for “such amounts as it shall have become liable to pay and shall have paid for pollution response or damages” as owner or operator of the barge, and (2) reimburse ACL for “certain other costs and expenses” including costs associated with the discharge of oil (Coverage A), the discharge of hazardous substances (Coverage B), and investigation and defense (Coverage C). In ruling against the insurer, the court held that the policy language was unambiguous and that the provision, on its face, contained no temporal or quantitative limit on the reimbursement obligation.

Thus, the insurer’s argument that its obligation to make payments for investigation and defense costs under Coverage C ended because payments under coverages A & B met the policy limits was deemed meritless. As such, the court ordered that the insurer was obligated under the policy to reimburse ACL for costs incurred in the investigation and defense of all claims asserted against it regardless of whether other indemnity limits under the policy have been reached.

On a local level, in *Griffith Oil Co. v. National Union Fire Ins. Co. of Pittsburgh, Pa.* (N.Y. App. December 30, 2009), the New York State Supreme Court, Appellate Division, Fourth Department interpreted a “products completed operations hazard” provision in the plaintiffs’ commercial general liability insurance policy and in doing so found that the petroleum spill was covered by CGL Policy. The dispute stemmed from a petroleum spill from a spur pipeline in Steuben County, New York. The plaintiff purchased petroleum from a non-party, which transported the petroleum through a pipeline network until it reached the spur pipeline in Steuben County. It was undisputed that the petroleum never reached plaintiff’s facility, which was connected to the spur pipeline. As with petroleum deliveries in the past, the purchased petroleum remained stored in the spur pipeline until the non-party seller notified plaintiff to open its valves in its terminal to receive the petroleum. The discharge occurred while the petroleum was still stored in the spur. The notification never occurred; plaintiff had no involvement with the product at issue.

Plaintiffs sought a declaration that their insurer was obligated to indemnify them in an underlying action regarding the spill. Their insurance policy contained a “Comprehensive Pollution Exclusion Endorsement Including Products Completed Operations Exception for Specified Business Activities.” The policy contained an exception to that exclusionary clause, providing that it did not apply to any property damage “that may arise out of the ‘products completed operations hazard’ for...[t]he sale, storage and/or transportation of fuels.”

The court held that the petroleum leak fell within the ambit of the PCOE exception, thereby affording coverage. The court concluded that the exception was unambiguous. Reasoning that the property damage occurred “away from premises” owned by the plaintiffs and that the property damage arose from fuel purchased by plaintiffs that leaked either while it was transported to their facility or stored in the spur awaiting transportation, the court held that the property damage arose out of the plaintiffs’ product. The dissent, however, reasoned that the exception did not apply because (1) the oil was spilled before it ever came into the plaintiff’s possession and it had not been placed in the stream of commerce, and (2) the oil was not plaintiff’s “product.”

Apart from cleanup costs and now applying the exclusion, in *Plants & Goodwin, Inc. v. St. Paul Surplus Lines Ins. Co.*, 99 F. Supp. 2d 293 (W.D.N.Y. 2000), the court announced that oil or petroleum is commonly considered a “pollutant” and is excluded under pollution exclusions in insurance policies in New York courts. In *Plants & Goodwin*, the plaintiff insured was sued for allegedly causing a discharge of crude oil which damaged a farmer’s cattle. Plaintiff sued defendant insurer, seeking a judicial declaration that defendant was obligated to defend and indemnify it. Both parties sought summary judgment. Defendant contended that the insurance contract contained an absolute pollution exclusion which barred coverage for any damage arising from the discharge of pollutants. Plaintiff argued that the pollution exclusion was not applicable since the crude oil leakage did not constitute “pollution” under the terms of the exclusion. The court held the only reasonable interpretation of the insurance contract, based upon the common use of the language, was that the pollution exclusion applied to any damage, including damage to wildlife, resulting from the leakage of crude oil as occurred in this case.

Business Interruption and Business Income

First-party claims for damage and for business interruption have prompted serious litigation in recent years. First party claims of those directly involved in the ownership and operation of the oil rig for their own losses, or by other first party claims of Gulf Coast businesses will be revisited. The hospitality industry will certainly have to account for the apparent gap in coverage relevant to business interruption due to environmental exposure to the oil. The extent of an interruption in business will be disputed where restaurants and hotels suffered decreased tourism business. See *730 Bienville Partners, Ltd. v. Assurance Co. of America*, No. 02-106F, 2002 WL 31996014 (E.D. La. Sept. 30, 2002) yet limitations on coverage may apply. The issue becomes whether a prospective claimant can recover for the loss of its business although its loss was not caused by direct physical harm. See *United Air Lines, Inc. v. Ins. Co. of State of Pa.*, 439 F.3d 128 (2d Cir. 2006).

More than a dozen Gulf Coast restaurants, a food service distributor and a seafood processor⁴ filed a lawsuit in U.S. District Court in New Orleans seeking compensation from BP as a result of the Deepwater Horizon oil spill. See <http://www.seafoodsource.com/newsarticledetail.aspx?id=4294993499>. The plaintiffs claim loss of business because fishing closures are inhibiting their ability to obtain fresh, local seafood and, as a result, increasing prices. The plaintiffs also claim that misinformation about fish are frightening customers who are now reluctant about eating at restaurants.

Many also may file claims under their own business interruption, contingent business interruption and similar policies. In ascertaining the extent of an insured’s coverage under an insurance policy, a court will look to the entire contract to determine “its purpose and effect” and the “apparent intent of the parties.” *Maryland Cas. Co. v. Cont’l Cas. Co.*, 332 F.3d 145, 161 (2d Cir. 2003). Because contingent business interruption provisions extend the scope of coverage beyond that provided by the BI provision, property covered by the former falls outside the scope of the latter. Business-interruption insurance replaces profits lost as a result of physical damage to the insured’s business, whereas contingent business-interruption coverage protects the insured against the consequences of a supplier’s problems. Generally, claimants are entitled to liability damages only if pollution touches their property. Business interruption claims might not have such a restriction and could arise further downstream. Business interruption policies typically appear within a commercial property policy, so such claims will depend on the definition of property, which often excludes land, such as a beach at a coastal hotel. Some insurers may assert that they do not insure the water offshore of property and therefore the policy is not triggered, including business interruption.

Traditionally, seamen have been recognized as favored in admiralty and their economic interests have commanded the fullest possible legal protection. At least one court has recognized that although fishermen and clambers have no individual property rights with respect to the aquatic life harmed by oil pollution, they could sue for the tortious invasion of a public right, having suffered damages greater in degree than the general public. See *Burgess v. M/V TAMANO*, 370 F. Supp. 247 (S.D.Me.1973), *aff’d per curiam*, 559 F.2d 1200 (1st Cir. 1977). In *Burgess*, the court rationalized that when an oil spill prohibits fishermen from plying their trade, it is considered an interference with the direct exercise of the public right to fish and dig clams which is, in fact, a special interest different from that of the general public. Thus, in instances where fishermen have established a course of business conduct which makes commercial use of a public right with another party, pecuniary losses may be recoverable.

Accordingly, in instances where there has been a tortious invasion of commercial fishing areas by the

introduction of pollutants or contaminants, courts have affirmatively protected those fishermen who incurred actual economic losses. But in *Louisiana ex rel. Guste v. M/V Testbank*, 524 F. Supp. 1170 (E.D. La. 1981), the court gave categorical consideration to entities that could not recover as a result of a collision between two vessels which ruptured toxic chemicals in the Mississippi River Gulf Outlet. As a result, a substantial number of square miles of the Louisiana waterways and marshes were closed by the Coast Guard. The court dismissed claims from the following, the claims of persons or business entities falling into the following categories:

1. Shipping and/or other shipping type interests unable to traverse the area.
2. Marina and boat rental operators.
3. Wholesale and retail seafood enterprises not actually engaged in fishing, shrimping, crabbing or oystering in the mandated area.
4. Seafood restaurants.
5. Tackle and bait shops.
6. Fishermen, oystermen, shrimpers and crabbers engaged for recreational purposes only.

Whether the principles in *M/V Testbank* will guide the litigation brewing now brought by the affected food industry as a result of the BP incident remains to be seen.

Directors and Officers

There is also a shareholders derivative lawsuit against the Board of Directors for BP for allegedly negligently managing the company and hiding safety problems which contributed to the oil spill. The suit also includes Transocean Ltd., Cameron International Corp., and Halliburton Energy Services. Interestingly, the complaint also purports to name as defendants the third-party defendants' insurers since the action is advantageously venued in Louisiana which excepts direct action suits from the general rule of prohibition.

The present derivative lawsuit references with significant momentum the prior BP shareholder litigation arising out of the 2006 Alaska spill where part of the settlement included acquiescence by BP to change corporate maintenance and operation. As can be expected, the shareholders maintain that BP failed to comply with that agreement by failing to enhance the operational integrity and safety oversight function, among others. The lawsuit affirmatively seeks the immediate appointment of new

directors and an independent board to monitor the exposure. The BP derivative litigation has gained significant interest and numerous followers also because it contains the atypical set of parties: a foreign company facing D&O claims in a U.S. Court attempting to enforce U.S. securities laws. The next question would probably be—who will foot the bill for the enormous defense costs in this litigation?

Conclusion

Undoubtedly, even before the BP oil spill, deep water drilling was considered a high risk by the insurance market. Since the oil explosion, the cost of insurance policies covering deep water oil rigs has increased by more than fifty percent (50%).⁶ Operators and oil companies are seeking to purchase new or expanded coverage. As explained by Gregory Thomas, chief of offshore activities at an insurance underwriting company in Oslo for deep-water oil contractors, insurance companies are revisiting what they can afford to underwrite as the spill reveals higher levels of liability than previously considered. The insurance industry potentially faces financial changes as Congress contemplates lifting the \$75 million cap on liability damages connected to the BP oil spill. If indeed that \$75 million limit is lifted, companies involved in offshore drilling likely will have to pay more for insurance; that is, if it is offered. See Anne C. Mulkern, *GULF SPILL: A lucky few manage to profit from disaster (Greenwire, 06/18/2010)*.

Endnotes

1. <http://www.insurancejournal.com/news/national/2010/06/03/110403.htm#ixzz0z8byEHZl>.
2. <http://www.insurancejournal.com/news/national/2010/06/03/110403.htm#ixzz0z8caSTkD>.
3. *Certain Underwriters at Lloyd's, London, et al. v. BP plc. et al.*, No. 10-01823 (S.D. Texas).
4. The restaurants include the Crazy Lobster Bar & Grill in New Orleans and Destin, Fla.; Poppy's Seafood Factory in Destin, Fla.; Tello's Bistro and Zeke's Restaurant and Oyster Bar, both in Metairie, La.; and Eleven 79 and Franky and Johnny's Restaurant, in New Orleans. The food service distributor is P.A. Menard in New Orleans and the processor is New Orleans Fish House. The fishermen and seafood suppliers include Gastian's Pier and Hillman Shrimp and Oyster Corp., both of Dickinson, Texas.
5. *Archer Daniels Midland Co. v. Hartford Fire Ins. Co.*, 243 F.3d 369, 371 (7th Cir. 2001).
6. Moody's Investors Service on June 3, 2010.

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