

Expert Analysis

A First Look at the Coverage Implications Of Hydraulic Fracturing

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The controversial natural gas extraction process known as high-volume hydraulic fracturing, or “fracking” for short, has come to dominate the nation’s attention as we seek to, finally, extricate ourselves from dependency on Middle East oil. On one hand, fracking offers the potential to recover a tremendous amount of natural gas from various domestic shale formations, and in doing so, generate new wealth and create jobs in historically depressed areas of the country. On the other hand, fracking opponents claim there are significant environmental concerns associated with the practice, which they fear may lead to ground- and surface-water pollution, seismic events, and other unintended consequences.

With the New York State Department of Environmental Conservation expected to issue regulations on fracking by year’s end, anticipation on both sides of the issue grows daily regarding the potential risks, opportunities and liability implications. Businesses, utilities, insurers, municipalities, environmental groups, and citizens and landowners all have plenty at stake, and once fracking makes its way into New York, the unique nature of this controversial practice will inevitably test traditional theories of liability and insurance coverage — as well as create correspondingly unique, first-impression issues in the courts.

THE RISK

The United States is home to 1.44 quadrillion cubic feet of recoverable natural gas¹ which is mainly in shale rock formations located far below the earth’s surface. “Shale gas” is now recoverable because newly developed horizontal drilling and fracking technologies permit larger areas of shale gas to be harvested from a single well pad. The fracking process consists of pumping a fluid and a propping material such as sand down the well under high pressure to create fractures in the gas-bearing rock. The propping material (“proppant”) holds the fractures open, allowing more gas to flow into the well. This “fracking fluid” consists mostly of water, but it also contains compounds added to the water to make the fracking process more effective. The compounds include a friction reducer, a biocide, a gel and various other agents. Opponents of fracking fear that fracking fluid remaining underground may contaminate underground aquifers, among other concerns.

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At present, lawsuits alleging water contamination from fracking fluid in Arkansas, Colorado, Louisiana, New York, Pennsylvania, Texas and West Virginia have been filed. While most of these actions encompass claims of property damage in some form, the primary focus of these claims is on serious health effects purportedly arising from the consumption of contaminated drinking water. Theories of liability asserted in these cases include:

- Negligence based on allegations that improper or inadequate well casings allowed fracking fluid to leak from wellbores.
- Negligence *per se*, based on alleged violations of applicable regulations.
- Fraudulent misrepresentation, based on allegations that drilling companies misled the public.
- Breach of contract, based on allegations that drilling companies violated agreements pertaining to safety procedures.
- Trespass, based on the alleged intrusion of fracking fluid onto adjacent property.

Another concern raised by fracking opponents is the possibility that fracking may cause or contribute to seismic events. It has been alleged that minor earthquakes in Arkansas, Ohio, Oklahoma and Texas are attributable to fracking activities in those areas.² Despite a lack of conclusive data linking fracking practices to seismic events, lawsuits have been filed by property owners alleging damage caused by fracking-related earthquakes.³ These risks and many others have led to a series of lawsuits over fracking.⁴ None of these fracking-related actions has reached final judgment and, therefore, it is difficult to assess the strengths and weaknesses of the various claims.

Nevertheless, the prudent insurer must consider all possible risks and potential claims, particularly with respect to an emerging industry practice such as fracking. Likewise, the prudent insured must consider the risks in seeking appropriate insurance coverage. This article provides preliminary observations about the actual and potential interplay between fracking and insurance coverage. We rely on the somewhat limited preliminary information regarding the risks of fracking and the asserted, but as yet unresolved, claims. Notably, there are no significant insurance coverage decisions pertaining to fracking. We will therefore draw some parallels to similar industries to gain perspective on the potential coverage implications of fracking.

COMMERCIAL GENERAL LIABILITY INSURANCE

Most companies maintain commercial general liability insurance policies that cover third-party claims made against the insured for bodily injury and property damage. The vast majority of companies directly and indirectly involved in the fracking process, such as trucking companies, product manufacturers and contractors, likely only maintain traditional CGL policies, and therefore, these companies will likely face fracking-related claims in one form or another (*e.g.*, well blowouts, faulty well casings, seismic activity, spills, industrial accidents, etc.).

Both insurers and insureds will face a number of problems and obstacles in these lawsuits. For instance, insurers are likely to assert a number of common defenses,

which may ultimately result in no coverage, while, on the other hand, the insurers risk having multiple CGL policies “triggered” by a fracking claim, which could end up being found jointly and severally liable for a covered loss.

The insurers will undoubtedly seek to rely on the pollution exclusion provisions within the CGL policies to deny coverage for environmental claims. As a general proposition, courts are less likely to enforce pollution exclusion clauses in cases involving traditional property damage and personal injury claims, and more likely to enforce pollution exclusion provisions in cases where bodily injury or property damage is directly caused by the release of a pollutant as defined by the policy.⁵ The enforceability of such provisions is a matter of state law, and much will depend on the facts of the underlying claim.

Fracking-related coverage litigation will also likely involve issues of the policies’ notice-of-claim provisions, which require the insured to give timely notice of any claim. Insurers routinely seek to enforce such notice requirements, with mixed success. Whether an insured has failed to give timely notice is typically a fact-intensive inquiry and, in most states, the insurer must demonstrate that the late notice has prejudiced it. In sum, an insured should notify its insurer (or insurers, if applicable) as soon as it has reason to believe a claim will be asserted against it or risk losing coverage.

Another major issue facing fracking insurers will be the so-called “trigger of coverage.” A policy trigger is an event that, when it occurs, implicates a particular insurance policy to cover a particular loss. Under an occurrence-based policy, the occurrence of injury or damage is the trigger; liability will be covered under that policy if the injury or damage occurred during the policy period. A fracking-related claim can be a simple, single-occurrence event or a complex toxic-tort claim encompassing many years of alleged exposure. Thus, the question for the insurer will be which CGL policy is triggered by such divergent claims. If, for example, the underlying claim arises from a singular event (*e.g.*, seismic-related property damage), likely only one policy will be implicated. On the other hand, if the underlying claim is tied to a series of events over a period of years (*e.g.*, in the event of an environmental pollution claim), many courts adopt a “continuous trigger” approach.⁶

A continuous trigger is creature of state common law developed in response to various types of toxic-tort and environmental claims, such as asbestos claims. It in effect implicates every insurance policy covering the insured for a specific period of years beginning from the date of initial exposure until the manifestation of injury resulting from exposure.⁷ Therefore, the insurer’s risk of fracking-related toxic-tort claims is great. Assuming an underlying fracking-related claim indeed “triggers” multiple policies, the next question is how to allocate the damages among the triggered policies to cover the loss. Not surprisingly, state courts have approached the issue differently. Typically, courts adopt one of two allocation models: either a *pro rata* or a joint and several liability model.⁸

BUSINESS INTERRUPTION INSURANCE

Business interruption insurance replaces business income lost as a result of an event that interrupts the operations of the business, such as a fire or a natural disaster. Business interruption insurance is typically an add-on to a CGL policy. With respect to fracking, it is easy to imagine a drilling company making a claim under its business interruption insurance policy for income lost as a result of a temporarily closed well

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site. Many companies purchase such coverage, as do municipalities (e.g., Gulf-region municipalities that relied on business interruption coverage to replace lost tax revenue in the wake of Hurricane Katrina). A large-scale fracking disaster will undoubtedly result in a municipality making similar lost-tax-revenue claims.

Business interruption insurance seeks to restore the insured to the financial position it was in prior to the event triggering the coverage. The lost profits claimed must be directly related to the loss event triggering the policy, which requires the insured to show:

- A direct physical loss to covered property caused by a covered peril.
- Interruption of business due to or resulting from the physical loss to covered property.
- Monetary loss that is a direct result of the covered business interruption.

The measure of the loss is the difference between expected profits during the post-loss recovery period and actual profits during that period, less any unrelated losses.

Because fracking involves the injection of fracking fluid into the wellbore under extremely high pressure, occasional blowouts are to be expected. Any suspension of drilling operations caused by such an event and resulting in lost income would likely trigger coverage under the business interruption insurance policy for the site. A catastrophic accident, such as an explosion or fire, could implicate the business interruption coverage of neighboring businesses if there is direct physical loss to the covered property of the neighboring business.

Contamination of the local water supply may qualify as a type of direct physical loss to neighboring businesses. As discussed above, however, the typical pollution exclusion provision contained in most CGL policies would probably prevent the application of business interruption coverage to losses “resulting from, contributed to or made worse by actual, alleged or threatened release, discharge, escape or dispersal of contaminants or pollutants.”⁹ Most business interruption coverage requires the losses sustained by the insured to result from property damage attributable to the occurrence of a “covered peril.” Therefore, to the extent the insured’s business interruption claim stems from damage related to or arising from contamination or pollution attributable to fracking fluid, the standard pollution exclusion in the insured’s CGL policy may bar a business interruption claim.

CONTINGENT BUSINESS INTERRUPTION, CIVIL AUTHORITY AND INGRESS/EGRESS COVERAGE

It is more likely that so-called “contingent” business interruption insurance coverage would be utilized by third-party businesses following a blowout or some other event leading to a well shutdown. Contingent business interruption coverage insures lost profits in the event that the insurer’s supplier or customer cannot conduct business because of property damage of a type that would be covered under the insured’s policy. It is possible that such coverage might provide recovery to a purchaser of natural gas that suffers lost profits as a result of a drilling company’s inability to provide contracted-for output because of damage to a well. Pursuant to contingent business interruption insurance, profits affected by property damage to the facilities of the insured’s customer may also be recoverable. Covered costs might also include

losses incurred when a civil authority prevents access to an insured's facilities, or when damage to property in the vicinity of the insured premises prevents ingress to, or egress from, the insured's facility.

In the event of a large-scale fracking disaster, it is possible to imagine natural gas customers making contingent business interruption claims for lost profits based on their inability to obtain gas from the disabled well. It is also possible to imagine a worst-case scenario where neighboring businesses may even be prevented from accessing their property following a fracking disaster, either due to property damage or some order of civil authority. In such circumstances, contingent business interruption, civil authority, and/or ingress/egress coverage may be implicated.

OPERATOR'S EXTRA EXPENSE COVERAGE

Operator's extra expense liability coverage is often purchased by drilling companies to insure against losses stemming from well-site blowouts. In the event of a blowout, OEE coverage may reimburse costs associated with regaining control of the damaged well and restarting drilling operations. The objective of OEE coverage is to mitigate business interruption losses by deferring the additional costs incurred by the insured to cure the blowout or other damage. In the event of a fracking-related blowout, covered expenses may include re-drilling expenses, cleanup costs pertaining to seepage and other pollution related to the blowout, temporary equipment storage costs, moving and relocation costs, temporary facility costs, temporary repair or replacement costs, third-party property damage, and other related liabilities.

DIRECTORS AND OFFICERS INSURANCE

Directors and officers insurance covers the directors and officers of a company, and the company itself, in the event that the directors and/or officers are sued in connection with the performance of their duties for the company. A typical D&O policy contains three clauses. The first clause provides coverage to individual directors and officers when not indemnified by the company. The second clause provides coverage for the corporation when it indemnifies the directors and officers. The third clause provides coverage for the company in the event that securities claims are brought against it. Importantly, D&O insurance may be implicated in the event that claims are brought against directors and/or officers for failure to disclose environmental/toxic-tort risks.

A perfect example of the need for D&O insurance is the BP oil spill, where derivative suits were brought against various BP officers and directors arising from that disaster. Similarly, in the world of hydrofracking, drilling companies implicated in environmental pollution litigation could potentially face shareholder derivative lawsuits as a result of such litigation and any related losses. Take, for example, Cabot Oil & Gas Corp., a publicly traded company worth an estimated \$4.2 billion that has been named as a defendant in several lawsuits pertaining to groundwater contamination in Pennsylvania.¹⁰ Cabot is expected to face shareholder derivative lawsuits arising from these lawsuits and the claims contained therein. If it does, it will likely turn to its D&O coverage for defense and indemnification.

Additionally, securities violations and related claims and/or enforcement actions may implicate D&O coverage. For example, last August New York Attorney General Eric T. Schneiderman served subpoenas on three major drilling companies, including Cabot, seeking information pertaining to whether those companies accurately described the

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risks of fracking to investors.¹¹ The service of the subpoena by the attorney general might trigger the D&O coverage,¹² particularly if an enforcement action might be taken against hydrofracking companies. Furthermore, if suit is brought against the directors and/or officers of any of these companies with respect to any alleged errors, omissions or misstatements associated with their business decisions and activities, D&O insurance would be implicated.

POLLUTION INSURANCE

While all of the players involved in the fracking business will carry CGL policies, those policies will likely contain pollution exclusion provisions. Therefore, the key players in the fracking business may seek to purchase specific pollution insurance coverage to offset the risks of fracking-related pollution liability. Any fracking-related, pollution-based bodily injury or property damage claim could trigger coverage. The policy includes defense and/or indemnity for various losses, including remediation costs resulting from an incident of pollution.

WORKERS' COMPENSATION INSURANCE

Setting aside the unique risks associated with fracking, the industrial nature of drilling in general is reason enough to expect that at some point employees of drilling companies (and other companies associated with drilling process) will be injured or even killed on the job. The role of commercial workers' compensation insurance is to protect against losses due to injury or death of the insured's employees. The typical policy covers medical and rehabilitations costs as well as lost wages.

EARTHQUAKE INSURANCE

Earthquake insurance is a type of property insurance that covers the property owner in the case of an actual earthquake loss. Earthquake insurance policies are common in places such as California and typically require high deductibles.¹³ Given the reports and controversial studies purportedly connecting seismic activity with fracking, some property owners are purchasing earthquake insurance, including the mayor of Youngstown, Ohio, who recently announced he was purchasing earthquake insurance in response to fracking.¹⁴

REINSURANCE

The practice of fracking and the insurance coverage it demands will have significant reinsurance implications. As previously discussed, there are already a number of fracking-related lawsuits alleging contamination of groundwater and damage from seismic events. If the history of catastrophic loss events such as Love Canal, 9/11, the BP oil spill and Hurricane Katrina provide any indication, any large-scale, fracking-related event or a series of systematic losses akin to asbestos litigation would undoubtedly give rise to reinsurance issues. Reinsurance losses could be substantial, especially in the event of a drinking water contamination incident leading to claims of prolonged exposure to fracking chemicals. Such cases might entail the type of long-term medical monitoring seen in asbestos and other long-tail pollution cases, which tend to drive up reinsurance loss costs.

Reinsurance claims will give rise to reinsurance coverage disputes. The issues likely to be litigated in the reinsurance context are similar those already discussed with respect to primary coverage. Every insurer must provide timely notice of claim to its

reinsurer. If prolonged exposure to fracking chemicals and resultant health problems are alleged, insurers and their reinsurers may end up litigating whether the claims asserted can be tied to a single event or occurrence and, if so, whether multiple events can be aggregated to ratchet up limits. In a long-tail exposure case covering a period of years, multiple policies and contingent reinsurance agreements may be triggered. Litigation pertaining to the proper allocation of damages could ensue. Finally, reinsurance agreements themselves may contain relevant exclusions, such as pollution exclusions.

CONCLUSION

It is clear that many of the traditional environmental coverage issues will be tested and explored as the practice of fracking expands, and the unique risks associated with fracking will lead to correspondingly unique, first-impression coverage issues. Readers may refer to our blog, www.shalewatchblog.com, for updates and developments in this area.

NOTES

- ¹ *US Fossil Fuel Resources: Terminology, Reporting, and Summary*, Congressional Research Service (Dec. 28, 2011), available at <http://www.fas.org/sgp/crs/misc/R40872.pdf>.
- ² Henry Fountain, *Add Quakes to Rumbblings Over Gas Rush*, N.Y. TIMES, Dec. 12, 2011.
- ³ See Barclay Nicholson & Kadian Blanson, *Trends Emerge on Hydraulic Fracturing Litigation*, OIL & GAS JOURNAL, 83 (Dec. 5, 2011).
- ⁴ See, e.g., *Delaware Riverkeeper Network v. Collier*, No. 11-0423, complaint filed (D.N.J. 2011); *Citizens for Pa.'s Future v. Ultra Res.*, No. 4:2011-cv-01360, complaint filed (M.D. Pa. 2011); *Brockway Borough Mun. Auth. v. Flatirons Dev.*, complaint filed (Pa. Ct. Com. Pl., Jefferson County 2010); *Armstrong v. Chesapeake Appalachia*, 2010 WL 4680899, complaint filed (M.D. Pa. 2010); *Chesapeake Appalachia v. Montross*, complaint filed (Pa. Ct. Com. Pl., Wyoming County); *Lancaster v. Chesapeake Appalachia*, No. 11-C 694, complaint filed (W. Va. Cir. Ct.); *Clean Water Action v. Mun. Auth. of the City of McKeesport*, 2011 WL 2883571, complaint filed (W.D. Pa.); *Fiorentino v. Cabot Oil & Gas Corp.*, 2010 WL 4595524 (M. D. Pa. Nov. 15, 2010); *Hagy v. Equitable Prods.*, No. 2:10-cv-01372, complaint filed (S.D. W. Va. 2010); *Tucker v. Sw. Energy Co.*, complaint filed, 2011 WL 1980530 (E.D. Ark.); *Arbor Res. v. Nockamixon Township*, 2009 WL 1288232, 973 A.2d 1036 (Pa. Commw. Ct. 2009); *Berish v. Sw. Energy Prod. Co.*, 763 F. Supp.2d 702 (M.D. Pa. 2011); *Baker v. Anschutz Corp.*, No. 6:11-CV-061190, complaint filed (W.D.N.Y.); *Cooperstown Holstein Corp. v. Town of Middlefield*, No. 2011-0930 (N.Y. Sup. Ct., Otsego County); *Anschutz Exploration Corp. v. Town of Dryden*, No. 2011-0902, complaint filed (N.Y. Sup. Ct., Tompkins County); *Bombardiere v. Schlumberger Tech. Corp.*, No. 1:11-CV-50, complaint filed (N.D. W. Va.).
- ⁵ See, e.g., *W. World Ins. Co. v. Stack Oil*, 922 F.2d 118 (2d Cir. 1990); but see, *contra*, *Clean Harbors Env't'l Servs. v. Boston Basement Techs.*, 916 N.E.2d 406 (Mass. App. Ct. 2009) (pollution exclusion not enforced in property damage and environmental cleanup caused by accidental break of heating oil pipe and subsequent oil release).
- ⁶ See generally *Spaulding Composites Co. v. Aetna Cas. & Sur. Co.*, 176 N.J. 25 (N.J. 2003); *Owens-Illinois Inc. v. Aetna Cas. & Sur. Co.*, 597 F. Supp. 1515 (D.D.C. 1984); *St. Paul Fire & Marine Ins. Co. v. McCormick & Baxter Creosoting Co.*, 923 P.2d 1200 (Or. 1996); *ACandS Inc. v. Aetna Cas. & Sur. Co.*, 764 F.2d 968 (3d Cir. 1985) (Pennsylvania); *Textron Inc. v. Aetna Cas. & Sur. Co.*, 754 A.2d 742 (R.I. 2000); *Arrow Exterminators v. Zurich Am. Ins. Co.*, 136 F. Supp. 2d 1340 (N.D. Ga. 2001); *Zurich Ins. Co. v. Raymark Indus.*, 514 N.E.2d 150 (Ill. 1987).
- ⁷ Some jurisdictions apply different "triggers" in the toxic-tort and environmental context. See e.g., *Md. Cas. Co. v. W.R. Grace & Co.*, 23 F.3d 617 (2d Cir. 1993) (New York; exposure trigger implicating every policy during exposure to asbestos); *Auto Owners Ins. Co. v. Travelers Cas. & Sur. Co.*, 227 F. Supp. 2d 1248 (M.D. Fla. 2002) (manifestation trigger).
- ⁸ See generally Ingram, J., *Insurance Coverage Problems in Latent Disease & Injury Cases*, 12 ENVTL. L.J. 317, 345 (Winter 1992), and *Crown Cork & Seal Co. v. Travelers Cas. & Sur. Co.*, Nos. L-007456-88 and L-007232-93 (N.J. Super. Ct., Hudson County), Hudson Co. & accompanying Special Master's Report.
- ⁹ See COUCH ON INSURANCE 3d § 155:90.

- ¹⁰ See *Fiorentino v. Cabot Oil & Gas Corp.*, 750 F. Supp. 2d 506 (M.D. Pa. 2010).
- ¹¹ Ian Urbina, *New York Subpoenas Energy Firms*, N.Y. TIMES, Aug. 18, 2011, available at <http://www.nytimes.com/2011/08/19/us/19gas.html>.
- ¹² See *MBIA Inc. v. Fed. Ins. Co.*, 652 F.3d 152 (2d Cir. 2011).
- ¹³ See Ann Carrns, *Is Earthquake Insurance Worth the Cost*, NYTimes.com (Sept. 7, 2011), available at <http://bucks.blogs.nytimes.com/2011/09/07/is-earthquake-insurance-worth-the-cost>.
- ¹⁴ See Mark Niquette, *Ohio Mayor Buys Quake Insurance as He Seeks Answers on Fracking*, BLOOMBERG, Jan. 4, 2012, available at <http://www.bloomberg.com/news/2012-01-04/ohio-mayor-buys-quake-insurance-as-he-seeks-answers-on-fracking.html>.



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