

Emerging issues in insurance for fracking and application of the EPLE endorsement

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Few insurers offer coverage for fracking, and those that do offer little guidance for insureds on what is actually covered. The simple explanation for the lack of guidance is that coverage for fracking has rarely been litigated. However, one pending case, *Warren Drilling Co. v. ACE American Insurance Co.*,¹ gives us a glimpse of some of the main coverage issues, including application of the "energy pollution liability extension" endorsement.

Before jumping ahead to the EPLE endorsement at issue in *Warren Drilling*, it is important to take a step back and ask this question: Do pollution exclusions always rule out coverage for fracking? Once that question is answered, we can examine some of the more important issues addressed in *Warren Drilling* — specifically, what type of discharges might be covered and how quickly must an insured report a fracking incident? By drilling down on what we know from similar coverage issues, insurers and insureds can strike oil when it comes to exploring for coverage.

WHAT DO COVERAGE LAWYERS NEED TO KNOW ABOUT FRACKING?

A layman's explanation of fracking is helpful to understand some of the basic insurance coverage issues associated with fracking activities. Fracking, also called hydrofracking or multi-stage hydraulic fracturing, is a process of natural gas and oil extraction.

Although fracking has been around for decades, significant improvements in fracking technology are supporting the current boom in the United States. Thanks to new and improved forms of technology, oil trapped in shale reserves previously thought to be too expensive to reach has become accessible. For instance, in Ohio the number of new horizontal-well permits issued for drilling in the Marcellus and Utica shale oil formations has been increasing dramatically — from one permit in January 2011 to a record-setting 70 permits in May 2013.²

Courts have dealt with fracking litigation as early as the 1950s. In 1958 the New Mexico Supreme Court attempted to define fracking in the context of a contract dispute. It held that the correct usage of the term in the contract was "an attempt to break down the formation by use of a specific method of penetrating it with some substance at



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high pressures thereby causing or making it possible for the gas to flow if there was any in the producing formation."³

To extract oil by means of the fracking process, a well must first be drilled vertically into rock (shale) believed to contain trapped

natural gas or oil. In many cases, depending on the rock formation, the drill turns 90 degrees and continues horizontally and can extend for thousands of feet; this dramatically increases the amount of oil that can be reached. This process is broadly referred to as "horizontal fracking," whereas vertical fracking can be accomplished when the well is drilled straight down.

Once drilling is complete, a mixture of water, sand and various chemicals is pumped into the well. The contents of the chemical mixture are generally referred to as "fracking fluid." This concoction is pumped into the well at an extremely high pressure. The high pressure creates fissures in the rock and shale.



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Natural gas or oil escapes through the fissures and is drawn to the surface. Depending on the size of the well, hundreds of thousands, if not millions of gallons of water and fracking fluid are pumped into the ground. Wastewater (also called “flowback water” or “produced water”) returns to the surface after the fracking process is complete. Depending on the chemicals used in the fracking process, the retrieved flowback water may require special disposal or storage.

Regulations vary widely from state to state and even county to county. California heavily regulates fracking activity and what can be pumped into the ground, and horizontal fracking is rarely allowed there.⁸ However, North Dakota appears to have significantly fewer regulations and less oversight, and it permits horizontal fracking. In short, the risks associated with fracking activity can vary widely from well to well depending on the type of rock, the regulating agency and even the company performing drilling.

Fracking, like any industrial practice, involves risks — a barrel of chemicals can be knocked over, or a valve can burst, releasing chemicals. Wells may travel under farms and homes and bigger wells mean more potential risks.

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Articles appear in publications across the United States on almost a daily basis about protests and groups vehemently opposed to fracking. Fracking, like any industrial practice, involves risks (for example, a barrel of chemicals can be knocked over, or a valve can burst, releasing chemicals). Wells may travel under farms and homes, and bigger wells mean more potential risks.

In April 2013 a total of 9,000 gallons of fracking fluid spilled at a well in Wyoming County in Pennsylvania,⁵ and in a similar incident in March 2013, an estimated 200,000 gallons of fracking fluid were reportedly spilled at another well in the same county.⁶ Dozens of spills have been reported in Colorado as well.⁷ The required responses to these spills were different, in part because of different populations and different regulations. Inevitably, even the most efficient fracking operation may leave chemicals underground.

Even governments have serious concerns about the risks of fracking. France and Bulgaria, countries with large shale gas reserves, have banned fracking, but the United States has not. Although fracking is allowed in many states, there are no overarching federal regulations, which leaves state and local governments to their own devices to regulate and permit fracking, if at all.

Because of the aforementioned risks, many insurers have avoided underwriting fracking risks all together. An internal 2012 memo by Nationwide Mutual Insurance Co. reads:

After months of research and discussion, we have determined that the exposures presented by hydraulic fracturing are too great to ignore. Risks involved with hydraulic fracturing are now prohibited for general liability, commercial auto, motor truck cargo, auto physical damage and public auto (insurance) coverage.⁹

Insurers covering fracking risks are still few and far between,¹⁰ and such coverage is relatively new, since coverage litigation involving fracking has been rare. Given the dramatic increase in fracking and the likely entry of new insurers, coverage litigation is sure to grow.

WARREN DRILLING AND THE EPLE ENDORSEMENT

Warren Drilling v. ACE American is one of the first significant coverage cases involving a fracking incident. Warren Drilling Co.’s complaint against ACE American Insurance Co. incorporated its letter to ACE and ACE’s denial of coverage.

In the pleadings, Warren Drilling cited the EPLE endorsement as one of the grounds for supporting coverage. The pleadings and letters between Warren Drilling and ACE provide a glimpse of pertinent arguments and issues with the EPLE endorsement.

Under a commercial general liability policy

from ACE, Warren Drilling entered into a contract with natural gas producer Equitable Production Co. to conduct drilling operations. The policy included an EPLE endorsement.¹¹

In 2008 a homeowner living close to the drilling operations became aware that his well water had been contaminated by the hazardous fracking fluid used by Equitable, which was notified of the problem in October 2008.

Warren Drilling, ACE’s insured, did not receive notice until late 2010, when the homeowner sued Equitable and Warren Drilling. Upon receiving notice, Warren Drilling promptly notified ACE, which denied coverage. Warren Drilling defended itself and incurred \$100,000 in legal fees. It settled with the homeowner, and after the settlement, it sued ACE for its refusal of coverage.¹²

The general liability policy issued by ACE included a general pollution exclusion. The EPLE endorsement reinstated coverage for a pollution incident, but only if the discharge of pollutants:

- Was unexpected and unintended.
- Commenced abruptly and instantaneously.
- Commenced at or from a site owned or occupied by the insured or at which the insured was performing operations.
- Was known by the insured within 30 days after the commencement of the discharge.
- Was reported to the insurer within 60 days after the commencement of the discharge.

ACE argued that Warren Drilling failed on all five conditions. In regard to conditions four and five, there was an undisputed two-year delay from the time Equitable had notice and the time ACE received notice from Warren Drilling. In short, the delayed notice created what ACE probably thought was a slam dunk on its position that the EPLE extension did not apply.

DO POLLUTION EXCLUSIONS REALLY PRECLUDE COVERAGE FOR FRACKING?

The EPLE endorsement comes into play if there needs to be an extension of coverage because of the application of a pollution exclusion. As a threshold matter, the first questions to ask before analyzing the EPLE

endorsement are whether fracking fluids constitute a pollutant and whether an incident involving such fluids falls within the typical pollution exclusion.

The typical pollution exclusion precludes coverage for the “discharge, dispersal, seepage, migration, release or escape of ‘pollutants.’” Pollutants are usually defined as “a solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste.”

In future fracking cases, insureds may argue that fracking fluid is safe. In fact, some companies specifically market and promote their fracking fluid as a safe product. In one extreme case, a Haliburton executive drank fracking fluid at a 2011 conference in Denver in front of a crowd of attendees.¹³ In 2013, Colorado Gov. John Hickenlooper also drank fracking fluid in front of the U.S. Senate Committee on Energy and Natural Resources.¹⁴

So, if fracking fluid is as safe to drink as cola, is fracking fluid a “pollutant?”¹⁵

Depending on the facts, insureds may have strong arguments that fracking fluids do not constitute pollutants. If an insured is sued for a spill or contamination, arguing that the fracking fluid used was not a “pollutant” would line up with the defense strategy for the underlying claim. In mounting a defense, an insured might argue that the fracking fluid was safe, regulated and permitted, and thus did not cause any harmful contamination as alleged, for example, by a farm owner.

Regulations vary widely from state to state, and even county to county.

In *Greenback LLC v. Monticello Insurance Co.*,¹⁶ the court examined whether damage caused by a landslide of mining waste, including metal-laden sand, silt and clay, was due to “pollution” and implicated an absolute pollution exclusion. The sand, silt and clay contained traces of the metals arsenic, antimony, iron, mercury and zinc. The court did not agree that arsenic was a naturally occurring element outside the scope of the pollution exclusion when its location had been altered by the unnatural process of mining. The court also held that the component metals of the tailings, or material

remaining after mining, met the federal statutory criteria of “hazardous substances” and clearly constituted “irritants” or “contaminants.”

Depending on the product, some fracking fluids can be ingested, and thus they would not meet the statutory criteria of a hazardous substance. If Warren Drilling’s operations had used a digestible fracking fluid, a court following *Greenback* might decline to apply a pollution exclusion. In such case, a fight over application of the EPLE endorsement might never be reached.

Although *Warren Drilling* may turn out to be a seminal case, the important issue of whether the pollution exclusion applies was leapfrogged by the parties according to their particular facts.

WHAT IS UNEXPECTED ABOUT INTENTIONALLY PUMPING FRACKING FLUID INTO THE GROUND?

Assuming fracking fluids constitute pollutants, and an incident falls within the EPLE endorsement, the next hurdle for insureds is whether the discharge was unexpected and unintended and commenced abruptly and instantaneously. In general, courts have held that it is the discharge of pollutants, not the harm to a person or property, that must be “expected and intended.”

Courts determining whether a fracking incident is “abrupt and instantaneous” may draw on case law interpreting the phrase “sudden and accidental.” Courts have looked at the temporal elements of any discharge and whether such discharges were regular to determine whether such discharge was “sudden and accidental.”¹⁷

Unlike other industrial practices in which there is an attempt to avoid spilling chemicals, fracking involves the intentional discharge of fluid into the ground. In the case of Warren Drilling’s operation, the pertinent discharges, when they occurred and how often they occurred may affect whether the discharges were intentional or unexpected and abrupt.

Despite the fact that drillers intentionally inject pollutants into the ground during fracking, Warren Drilling should be able to successfully argue that there was no intent to harm during the fracking process and that it (and Equitable) did not expect the fracking fluid to escape into the homeowner’s water.

If ACE argues that the release of chemicals was intentional (after all, Equitable knew it was injecting fracking fluid into the ground), Warren Drilling may reply that it (and Equitable) did not intend for any chemicals to escape into the groundwater.¹⁸

Warren Drilling could also argue that fracking fluid was discharged at an unintended angle or in an unintended quantity, or that it (and Equitable) miscalculated the permeability stone around the well (that is, the discharge was “unexpected”). However, Warren Drilling might argue it intended to retrieve flowback water and that the inability to retrieve all the fluid (a one-time failure) constitutes the pertinent “unexpected and abrupt” discharge.

If Warren Drilling or Equitable intended to retrieve the flowback water, this might alter when Warren was required to give notice — only when it failed, or realized it could not retrieve the chemicals, did Warren Drilling have an obligation to notify ACE.

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If the EPLE endorsement is interpreted as an exclusion, Warren Drilling might have the burden to show the discharge was unexpected, unintended, abrupt or instantaneous. However, Warren Drilling could argue that ACE has the burden of proof, since the EPLE endorsement is an extension of coverage, and not an exclusion.¹⁹ If ACE has the duty to prove the discharge was intended and was not abrupt, this could have a significant impact on the outcome of the case and whether ACE had a duty to defend.

In short, since courts have not commented on when the relevant discharges occur and which party will have the burden of proof, there are opportunities for creative arguments on both sides of the coin.

HOW QUICKLY MUST AN INSURED REPORT A FRACKING INCIDENT?

If the intent and abruptness provisions under the EPLE endorsement are met, the next major hurdle under the endorsement is

meeting the notice provisions — specifically, dating the “commencement of the discharge” and when the insured must report such discharge. The last notice condition — reporting by the insured within 60 days after the discharge — seems to be a clear limitation on its face.

Similarly, the knowledge condition — knowledge by the insured within 30 days after the commencement of the discharge— could pose problems for ACE and other insurers, since the date of discharge has not been interpreted by any courts.

Pollutants are usually defined as “a solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste.”

Depending on the facts, insureds might argue that commencement of the discharge refers not to the date of injection into the well, but the date the fracking fluid escaped the well and thus became a “pollutant.” Further, insureds could argue that the accumulation of chemicals was unintended, and that before discovering the high concentration of chemicals, there was nothing to report to the insurer. An insured might also argue (as explained above) that it intended to retrieve all fracking fluid and flowback water. Only when the insured discovered it could not retrieve everything would it have an incident to report.

Insureds will also probably argue that the reporting requirements are ambiguous. For instance, must the insured report within 60 days after injection of pumping fracking fluid into the ground (which it suspects may later result in an unintended discharge into groundwater) or must the insured report within 60 days after discovering groundwater contamination? If the latter is required, how often must the insured test groundwater? Since insureds are constantly pumping chemicals into the ground and retrieving them, would it not make sense that reporting is only required when the insured determines it cannot retrieve flowback water or remediate the situation?

In states such as California, where insurers are required to show prejudice by late notice, courts might be reluctant to deny coverage on the basis of late reporting.²⁰

Even if insurers argue the EPLE endorsement should be treated like a claims-made policy notice provision, late notice might not be a strong defense. California, for instance, is lenient on reporting on claims-made policies. In *Oakland-Alameda County Coliseum v. National Union Fire Insurance Co.*, the a California federal court held that a policyholder’s failure to report a claim under a claims-made-and-reported policy in a timely fashion to its primary and excess insurers could be equitably excused, thereby precluding summary judgment for the insurers.²¹

However, in other states such as Ohio, courts might strictly enforce notice provisions.²² Whether ACE was prejudiced, and whether the *Warren Drilling* court finds prejudice relevant to application of the notice provisions will be key in resolution of the case.

CONCLUSION

From the perspective of underwriters and insurers, it would be wise to understand the products used by the insured before jumping to provide EPLE coverage. In certain jurisdictions, notice provisions may not be enforced by courts, and insurers should be cautious of denying coverage under an EPLE endorsement on the basis of notice issues. From the perspective of insureds, it would be wise to make sure that any third parties performing work provide immediate notice of any issues. Simply waiting for a suit to be filed could be costly. Insureds should consult seasoned coverage counsel before tendering any fracking claim and should be prepared to drill down on unresolved coverage issues.

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NOTES

¹ *Warren Drilling Co. Inc. v. ACE Am. Ins. Co.*, No. 2:12-cv-425 (S.D. Ohio).

² Jesse Hathaway, *Ohio Shale Drilling Permits Continue Gradual Climb*, MEDIATRACKERS, June 13, 2013, available at <http://mediatrackers.org/ohio/2013/06/13/ohio-drilling-permits-gradual-climb>.

³ *Totah Drilling Co. v. Abraham*, 64 N.M. 380, 389, 328 P.2d 1083, 1089 (N.M. 1958).

⁴ Ashley Eady, *Horizontal Fracking Water Concerns Addressed Locally*, LUBBOCK AVALANCE-J., Feb. 8, 2013, available at <http://lubbockonline.com/local-news/2013-02-08/horizontal-fracking-water-concerns-addressed-locally>.

⁵ Amanda Kelley, *Fracking Fluid Cleanup Continues*, WNEP, May 1, 2013, available at <http://wnep.com/2013/05/01/fracking-fluid-cleanup-continues/>.

⁶ ProgressivePatriotPA, *Fracking Resumes Less than a Month after 200,000+ Gallon Spill*, Apr. 11, 2013, available at <http://www.dailykos.com/story/2013/04/11/1200893/-Fracking-Resumes-Less-Than-a-Month-After-200-000-Gallon-Spill>.

⁷ Bobby Magill, *Fort Collins-Area Fracking Fluid Leak Stopped after Spewing for 30 Hours*, THE COLORADOAN, Feb. 12, 2013, available at <http://www.coloradoan.com/article/20130212/NEWS01/302120015/Fort-Collins-area-fracking-fluid-leak-stopped-after-spewing-30-hours>.

⁸ Cal. Dep’t of Conservation, *Hydraulic Fracturing in California*, available at http://www.conservation.ca.gov/dog/general_information/Pages/HydraulicFracturing.aspx.

⁹ Mary Esch, *Nationwide Insurance: Fracking Damage Won’t Be Covered*, HUFFINGTON POST, Nov. 24, 2013, available at http://www.huffingtonpost.com/2012/07/13/nationwide-insurance-fracking_n_1669775.html.

¹⁰ Douglas McLeod, *Insurance Coverage Options for Fracking Risks Are Limited*, BUS. INS., Feb. 24, 2013, available at <http://www.businessinsurance.com/article/20130224/NEWS07/302249991#> (noting that insurance coverage options for fracking risks are limited).

¹¹ The policy also included an “underground resources and equipment coverage” endorsement.

¹² *Warren Drilling* also sued Equitable for indemnification under their drilling contract.

¹³ Catherine Tsai, *Halliburton Executive Drinks Fracking Fluid at Conference*, HUFFINGTON POST, Aug. 22, 2011, available at http://www.huffingtonpost.com/2011/08/22/halliburton-executive-drinks-fracking-fluid_n_933621.html.

¹⁴ Ben Wolfgang, *I Drank Fracking Fluid, Says Colorado Gov. John Hickenlooper*, WASH. TIMES, Feb. 12, 2013, available at <http://www.washingtontimes.com/blog/inside-politics/2013/feb/12/colorado-gov-hickenlooper-i-drank-fracking-fluid/>.

¹⁵ See *MacKinnon v. Truck Ins. Exch.*, 31 Cal. 4th 635, 636, 73 P.3d 1205 (Cal. 2003) (insured sought coverage for use of pesticides that allegedly caused the death of a tenant). The definition of a “pollutant” as any irritant or contaminant was too broad to meaningfully define the term in the pollution exclusion of a CGL policy: “Even commentators who represent the insurance industry recognize that the broadening of the pollution exclusion was intended primarily to exclude traditional environmental pollution rather than all injuries from toxic substances.” *Id.*

¹⁶ *Greenback LLC v. Monticello Ins. Co.*, 118 F. Supp. 2d 1068 (D. Idaho 1999).

¹⁷ See *U.S. Fid. & Guar. Co. v. Star Fire Coals Inc.*, 856 F.2d 31 (6th Cir. 1988); *Aetna Cas. & Sur. Co. v. Gen. Dynamics Corp.*, 968 F.2d 707, 710-11 (8th Cir. 1992) (holding that because “accidental” means “unexpected,” “sudden” would be redundant if not held to mean abrupt, and hence damage caused by discharges of 300,000 gallons of bilge water over several months by insured’s waste hauler at city landfill and discharges of toxic waste from trucks and deteriorating tanks at hauler’s disposal site were barred from coverage by the pollution-exclusion clause); *Hartford Accident & Indem. Co. v. U.S. Fid. & Guar. Co.*, 962 F.2d 1484, 1487-92 (10th Cir. 1992) (holding that “sudden” has a temporal element suggesting immediacy, abruptness and quickness, and barring coverage under a pollution-exclusion clause for environmental damage caused by regular, intentional discharges of liquid waste containing PCBs over 15 years even though insured was unaware that waste included PCBs).

¹⁸ *A-H Plating Inc. v. Am. Nat’l Fire Ins. Co.*, 57 Cal. App. 4th 427, 67 Cal. Rptr. 2d 113 (Cal. Ct. App., 2d Dist. 1997) (measures taken by the insured to prevent, contain and clean up spills do not conclusively mean that the insured had “expected” the spills).

¹⁹ See *Aydin Corp. v. First State Ins. Co.*, 18 Cal. 4th 1183 (Cal. 1998) (burden on insured to prove “sudden and accidental” in the context of an exclusion); *Am. States Ins. Co. v. Sacramento Plating Inc.*, 861 F. Supp. 964 (E.D. Cal. 1994) (holding that the insured had the duty to prove that the “sudden and accidental” exception to the pollution exclusion applied); compare with *A-H Plating*, 57 Cal. App. 4th 427 (insurer has the burden of proving application of the exclusion at the duty-to-defend stage).

²⁰ See *Campbell v. Allstate Ins. Co.*, 60 Cal. 2d 303 (Cal. 1963).

²¹ *Oakland-Alameda County Coliseum v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa.*, 2007 WL 949687 (N.D. Cal. 2007).

²² See *Krasny v. Metro. Life Ins. Co.*, 143 Ohio St. 284, 291, 54 N.E.2d 952, 955 (Ohio 1944) (unjustified three-month delay in giving notice was held to bar recovery by the insured under the policy. A clause requiring written notice within 20 days was said to be “a condition precedent to his contract, the non-performance of which precludes recovery.”).

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Sigelman v. State Farm General Insurance Co., No. B241981, 2013 WL 5827707 (Cal. Ct. App., 2d Dist. Oct. 30, 2013).

In an unpublished opinion, the 2nd District Court of Appeal upheld the judgment of a Los Angeles trial court, saying that because the condo owner intentionally tore out the shower and tub, his loss was not an “accident” as defined in the policy.

Paul Sigelman received an email from the Century Towers Association on May 24, 2010, that said his neighbor’s apartment showed signs of mold apparently caused by a leak in Sigelman’s bathroom.

According to the appeals court opinion, the association hired a contractor to abate the mold and recommended Sigelman contact a plumber to investigate the source of the leak.

Two days later, the association hand-delivered a letter to Sigelman saying its contractor had “ascertained” that the mold was caused by water leaking through the grout in Sigelman’s bathroom, the opinion said.

Sigelman notified his insurer, State Farm General Insurance Co., that the association’s contractor told him he would need to remove a lower bathtub wall, the bathtub and tile half way up the wall to make the repair.

Sigelman hired a contractor for the bathroom repair; however, the day after the work was

completed, water appeared in the wall and corner of his bathroom, the opinion said.

The association investigated further and determined the leak was coming from a unit on a higher floor, not from Sigelman’s home, according to the opinion.

Sigelman contacted State Farm to report the loss on June 4, but the insurer denied coverage on the basis that there was no accidental loss to his property, the opinion said.

Sigelman filed suit July 29 in the Los Angeles County Superior Court, alleging State Farm breached its insurance contract. State Farm successfully moved for summary judgment, and Sigelman appealed.

He argued that his loss was accidental because it was caused by “unforeseen” events, including the mold hazard and the association’s “order” to make repairs, according to the appellate opinion.

Rejecting this argument, the three-judge appellate panel said that while the association’s mistake set Sigelman’s loss in motion, the “predominating cause” was his decision to make the repairs.

“Because Sigelman ... intentionally chose to have the shower and bathtub removed, their removal was not accidental,” the panel said. “The policy consequently does not cover the loss.”

The appeals court ordered Sigelman to pay State Farm’s costs in the appeal. **WJ**

Related Court Document:
Opinion: 2013 WL 5827707