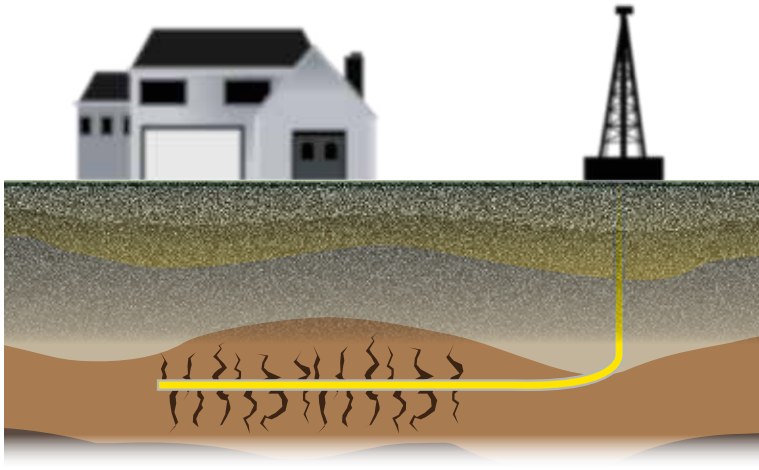

'Under' Cover

Do homeowners policies protect against liability from fracking operations?

by Thomas H. Clarke Jr. and Dean A. Pappas

The high price of oil and the need to reduce greenhouse gas emissions have generated, ironically, an increased use of the hydrocarbon-extraction technology known as hydrofracturing.

This technology involves the use of water and chemicals, and may include (depending on the site) gels, foams and various compressed gases. These mixtures, sent into formations at high pressure, improve the recovery of oil and natural gas by causing or expanding cracks and seams in geologic formations, thus enhancing the flow of hydrocarbons to extraction wells.

Hydrofracturing—also called fracking, fracing or hydrofracking—is an old technology whose use is becoming much more widespread.


Clarke


Pappas

Contributors: Thomas H. Clarke Jr. is a partner and chair of the Environmental Practice Group, and Dean A. Pappas is a partner and member of the Insurance Services Group, in the California offices of law firm Ropers Majeski Kohn & Bentley. They can be reached at tclarke@rmkb.com *and* dpappas@rmkb.com.

An estimated 25,000 U.S. oil and gas wells are fracked each year. The expansive application of such technology poses complex issues for landowners whose sole coverage against liability and lawsuits is a standard homeowners policy.

With the increased use of computational analysis, deposits of oil and natural gas have been identified that in the past would not have been detected. Further, because these reservoirs often exist in deep, subterranean shale rock and coalbed formations, they would not have been economical to recover.

Enter horizontal and slant drilling, combined with hydrofracturing, and suddenly in today's financial and climate-change circumstances, these oil and gas formations may be economically recoverable. Natural gas in particular, with its relatively low greenhouse gas emissions when combusted (compared to oil and coal), has many attractive elements, including the fact that its abundance in the United States is keeping the price modest and encouraging its use.

Because these deep formations have an extremely low natural permeability, oil and natural gas are difficult to produce at economic rates using conventional vertical wells.

Key Points

- **The Situation:** Hydraulic fracturing is becoming commonplace as energy firms drill into oil and natural gas formations.
- **The Issue:** "Fracking" may place homeowners in danger of lawsuits from alleged pollution of drinking water or damage to neighboring property.
- **The Question:** Is there an opportunity here for insurance companies to sell additional coverages or policies to help homeowners who may face risks associated with these operations?

However, a slanted or horizontally drilled well, combined with hydrofracturing, will transverse much of the formation and produce a conductive path connecting a larger area of the reservoir to the well. This method increases the area from which natural gas and petroleum can be recovered from the targeted reservoir.

A wide variety of chemicals have been used in such operations, including biocides and certain petroleum products that are associated with health risks ranging from rashes to cancer. Other chemicals often used are associated with a variety of harmful effects, including disruption of the endocrine system, adverse fetal development, childhood growth

and reproduction, and detrimental human behavior.

In many operations, the injected fluids are to some degree recovered and stored in pits or containers; the fluids are toxic due to both the chemical additives and the material washed out from the ground through which the drilled well and fracture pass. Often, such byproducts are further processed so that at least part can be reused in fracking operations. Residue is also released into the environment "after treatment," and some residue is placed "permanently" in deep-well storage.

Despite this potential for harm, the Safe Drinking Water Act was amended in 2005 to exempt chemicals used in fracking operations from SDWA jurisdiction.

However, that alone does not discount the use of the Comprehensive Environmental Response, Compensation, and Liability Act and state law causes-of-action by federal and state regulators to address adverse environmental impacts that may arise from fracking.

Risky Operations

It is not uncommon for companies pursuing such operations to lease the below-ground "mineral rights" from homeowners. Unfortunately, such lessors often are not advised in full, if at all, about the potential for adverse environmental and human health impacts from such operations. Thus, when the operations are completed, or even in full swing, environmental impacts have been identified. These vary from "burning" tap water (methane in drinking water supplies), well blowouts (releasing thousands to millions of gallons of potentially toxic material), subsurface subsidence and mini-earthquakes, to the presence of unhealthy amounts of carcinogens, mutagens and teratogens in drinking water. Further, such drilling operations are often set up as site-specific corporations or LLC/LLPs, which are then dissolved after operations are completed, leaving even those homeowners with indemnity agreements holding the bag for environmental harm because they own the property (and subsurface rights) and leased access to the firms that caused the harm at issue.

To address such adverse environmental and human health impacts, federal and state regulators have legal tools to require the remediation of such contamination. Even if the government itself undertakes the cleanup, there are a variety of legal tools available to seek the recovery of costs from the property owners/lessors who are liable because either they own part or all of the impacted property and its subsurface rights, or were involved in allowing the drilling operation to use their property or subsurface formations for such operations, thus contributing to the alleged harm.

As the risk associated with fracking becomes known to consumers, the development of products for this new market may become attractive to insurers.

Under such circumstances, most homeowners—who are not likely to have had the advice of sophisticated legal counsel before entering into such agreements—will look to their homeowners policies for a potential defense against such federal and/or state litigation, or to provide indemnity dollars to pay settlements or judgments.

Policy Confusion

What indemnity and defense benefits do such policies provide to the homeowner? Perhaps very little. Is there an opportunity here for insurance companies to sell additional coverages or policies to help such homeowners with risks associated from such operations? It would appear decidedly so.

Nearly every homeowner has a homeowners policy that includes personal liability coverage. The initial purchase of the policy is often done to meet mortgage loan requirements. Few homeowners pay much attention, if any, to the personal liability insurance coverage that is included in such policies. It is not, as many homeowners assume, limited to accidents that happen in or about the home. It applies to a broad range of potential liability that results from bodily injury or property damage suffered by a third person. But there is no restriction as to where the injury occurs.

These policies impose a duty upon an insurer to provide a defense to an insured homeowner if there is a potential for the claim or suit to result in the assessment of damages against the insured. Although the amount an insurance company may be responsible to pay as a result of any judgment or settlement is limited by policy limits, most homeowners policies do not have a limitation on the amount that may be spent in an effort to defend an insured.

The general structure and scope of the liability coverage included in a homeowners policy is very similar to the structure and scope of a commercial general liability policy. The potential for application of a policy to a claim or suit related to "environmental harm" that might arise from fracking is evaluated by a series of questions suggested by typical liability insurance policy language:

- Does the claim or suit seek the recovery of damages?
- Are the damages because of bodily injury or property damage within the meaning of the policy?
- Was the bodily injury or property damage caused by an "occurrence" (i.e., an accident)?
- Do any exclusions apply?

Claims for damages because of bodily injury may arise, for example, due to the ingestion of chemicals used in the fracking process that

have contaminated drinking water. Claims of property damage may arise due to the release or dispersal of chemicals used in the fracking process or leaks of extracted oil or gas. Neighbors or public entities may make demands for cleanup or damages due to the alleged contamination of groundwater. In California, for example, all groundwater is owned by the state.

Case Law Develops

In light of the volume of environmental contamination claims and lawsuits against businesses and public entities over the last 20 years, case law has developed which addresses these issues.

These principles are transferable to the evaluation of similar language in a homeowners policy. Several exclusions may be significant in determining if a policy applies to claims against a homeowner for damages caused by fracking.

The personal liability coverage included in a homeowners policy is not intended to apply to commercial risks. Thus, a typical policy includes an exclusion for injuries arising out of "business pursuits" of any insured. A business pursuit may be defined or interpreted in a way so that it includes "any activity engaged in for money or other compensation."

Consequently, evidence that an insured homeowner was paid or expects future payment based on the terms of the lease of below-ground mineral rights may preclude application of coverage.

Surprisingly, homeowners policy forms issued by some insurers do not include a "pollution exclusion." Some insurers have added this exclusion to their policy form or added the exclusion by a policy endorsement. Since the actual terms of a policy may vary from insurer to insurer, or even from year to year, it is very important to obtain a complete set of forms and endorsements for each and every policy period that may apply to a claim or suit against an insured homeowner in order to assess whether coverage may apply. These policies should be closely examined to identify any changes that may affect the insurer's obligations to the insured homeowner.

Environmental insurance products have been developed and marketed over the last 20 years. These products focus on commercial risks. A product is not being widely marketed, if at all, for a homeowner's risks that may arise as a consequence of fracking operations on or beneath residential properties.

Insurance agents and brokers may find a business opportunity to sell such products to clients or prospects in cities or areas in which these types of drilling activities are proposed or in progress. As the risk associated with these types of operations becomes known to consumers, the development of products for this new market may become attractive to insurers. BR