CRISIS MANAGEMENT IN THE GAS PATCH (PART 1): CONTROL OF WELL INSURANCE

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In a challenging business climate, such as when oil and gas are selling at low prices, exploration and production companies are not only increasingly selective with their drilling programs and capital expenditures, but are also taking measures to limit unnecessary expenses and protect critical investments through insurance and other cost-recovery mechanisms. Among these measures, companies need to consider advanced preparation to minimize costs in the event of a crisis, such as a well blowout, which may jeopardize valuable revenue streams and lead to significant costs incurred to bring a well under control and to ensure regulatory compliance.

This alert is the first in a series that will address various legal issues that exploration and production companies should carefully consider with respect to crisis management practices in a challenging market environment. This alert focuses on an understanding of and the common legal issues surrounding "Control of Well" insurance.

CONTROL OF WELL INSURANCE – PROTECTING VALUABLE DRILLING INVESTMENTS

As long as there are drilling operations, whether onshore or offshore, there will be a risk of loss from blowouts or other well control incidents. "Control of Well" insurance (sometimes known as "Operators Extra Expense" or "Energy Exploration and Development" insurance) can provide important protection for valuable drilling investments, including coverage for expenses incurred to bring a well back under control, to restore the well to the condition it was in prior to becoming out of control, and to clean up contamination or pollution that resulted from the incident. Without this type of protection in place (including a proper understanding what it typically does and does not cover), a blowout, leak, or major incident could leave a company with millions of dollars in unexpected, unbudgeted, and unrecoverable expenses.

This alert discusses: (i) important features of Control of Well insurance policies; (ii) coverage issues that may arise under Control of Well policies; and (iii) typical limitations in Control of Well coverage — and the ways that such limitations can be addressed by other cost-recovery mechanisms, such as contractual indemnity provisions and other forms of insurance.

The ABCs of Control of Well Insurance

Well Control policies generally contain three basic coverages. Depending on the policy, these coverages may have a variety of names, but they commonly are described as Coverages "A," "B," and "C," as follows: (A) Control of Well; (B) Redrilling and Extra Expense; and (C) Seepage, Pollution, and Contamination. Coverage A applies to costs and expenses incurred to regain control of an out of control well, while Coverages B and C address the aftermath of a loss of well control.

All three coverages are typically "triggered" by a single event — that is, a well becoming "out of control." Policies define "out of control" differently, but common elements include: (1) an unintended flow of fluid or gas; (2) above the surface of the ground or water bottom (i.e., the seafloor), or below the surface of the ground or water bottom from one sub-surface zone to another sub-surface zone; and (3) that cannot be stopped or controlled by standard safety equipment, such as a blowout preventer. Certain types of unexpected, but not uncommon, events may be excluded from the definition of "out of control" — such as a "kick," when underground pressure forces fluid or gas into the well bore.

A. Coverage A – Control of Well

Coverage A — basic Control of Well coverage — applies to costs and expenses incurred by the policyholder to regain, or attempt to regain, control of any out-of-control well. This may include specialty consultants, firefighting, and attempted mechanical interventions. Coverage A typically terminates when the well is brought under control and any fires that resulted from the out-of-control well are extinguished. When a well is "brought under control" depends on the policy language, but generally, a well is deemed under control when the out-of-control flow is, or can be, safely stopped and the well can be re-entered, is returned to the pre-occurrence status, or can be permanently plugged and abandoned. Depending on the policy language, Coverage A may include coverage for the removal of wreckage or debris. Coverage for bodily injury and death and loss or damage to property is generally excluded, though some policies may extend coverage to the policyholder's and/or third-party property damaged by the loss of well control incident.

B. Coverage B – Redrilling and Extra Expense

Coverage B applies to costs and expenses incurred to redrill or restore a well that was lost or damaged as a result of an out-of-control well. This coverage is not limited to the out-of-control well itself, but typically extends to other wells damaged as a result of a loss of control. Coverage B generally extends up to the restoration of the well to the same depth and approximate condition as existed before the well was damaged. As with Coverage A, bodily injury and death and loss or damage to property are generally excluded.

C. Coverage C – Seepage, Pollution, or Contamination

Coverage C varies by policy, but it is often made up of three separate coverage grants. Under each of the coverage grants, to be covered, seepage, pollution, or contamination must emanate from, or have been caused by, an out-of-control well (as opposed to a leak or spill unrelated to a loss of well control). The three common coverage grants are:

- Third-party liability – Costs that the policyholder is liable to pay by law or contract for remedial measures, bodily injury, and property damage and loss of use caused by seepage, pollution, or contamination.
- Defense –The cost of defending claims that result from actual or alleged seepage, pollution, or contamination.
- Remediation – The cost of removing, nullifying, or cleaning up seepage, pollution, or contamination.

Common exclusions may bar coverage for fines and penalties; losses and costs related to property owned by, or in the care, custody, and control of, the policyholder; seepage, pollution, or contamination intended by the policyholder; and any claims that arise from seepage, pollution, or contamination beneath the surface of the earth or water bottom.

Common Coverage Issues Arising in Control of Well Insurance Claims

Control of Well claims may present a number of important legal issues and disputes, including:

- Disputes may arise regarding the dates that trigger and terminate available coverage. For example, insurers may argue that there is no coverage because the well was never "out of control" as defined in the policy — potentially eliminating all coverage under the Control of Well policy. Where a well is deemed "out of control," an insurer may seek to limit coverage by arguing that the well could have been brought under control earlier than it was.

- Coverage B is subject to a number of additional limitations and exclusions that insurers may argue apply to limit coverage. Exclusionary language often excludes any loss or damage from delays in development, delayed or deferred production, loss of production, and loss or damage to underground oil and gas reservoirs and reservoir pressure. Insurers may rely on policy language limiting reimbursable costs to those costs that would have been incurred had the policyholder employed "the most prudent and economical methods" in its attempts at redrilling and recovery — leading to disputes regarding the cost incurred. Policies may also include provisions that purport to cut off all coverage if recovery activities are not commenced within a specified time period from the date of the accident or policy expiration.

- Under Coverage C, a policyholder may face attempts by insurers to exclude coverage because a portion of the contamination or pollution occurred underground. Insurers may argue that contamination or pollution is not emanating from covered wells. In addition, insurers may assert that the policyholder's efforts did not constitute adequate remedial measures. Insurers may contend that costs to respond to governmental regulators' actions do not qualify as a covered claim.

Limitations: Understanding Potential "Gaps" in Coverage

Control of Well insurance is a valuable asset. That said, it may not cover all expenses associated with a crisis incident, and companies should be aware of the most common potential "gaps" in typical Control of Well coverage. Common gaps are typically property loss, third-party liability, and business interruption. Understanding these potential gaps is important so that other insurance or contracts can be secured to minimize and fill potential gaps.

Loss of well control incidents will commonly result in both first- and third-party property losses and may also result in the bodily injury or death of employees of the policyholder or contractors. Property loss is commonly excluded from all three Control of Well coverage grants. Exclusions for Coverages A and B will commonly take the form of blanket exclusions for property loss, while Coverage C may target property owned by, or in the care, custody, and control of, the policyholder. Bodily injury and death is normally similarly excluded from Coverages A and B (although Coverage C may provide some limited coverage for bodily injuries that result from seepage, pollution, or contamination).

These gaps can be addressed through contractual indemnity and other insurance instruments. Indemnity agreements are common in the oil and gas industry and can provide coverage for third-party property losses and harm to contractors' employees. These so-called "knock-for-knock" indemnity agreements provide that each party working on an oil and gas site agrees to protect and indemnify the other parties against destruction or damage of their own property and injuries to their own employees or agents. Critically, the indemnity provided is not based on the fault of the party whose property was damaged or employee was injured. Complimentarily, a policyholder's first-party property and employer's liability (or workers' compensation) insurances may step in to provide cover for losses to the policyholder's own property or injuries to its employees. Exploration and production companies should carefully review such policies to ensure that losses resulting from loss of well control incidents are not specifically excluded.

Business interruption losses may also result from a loss of well control incident, whether from the delay of a well's completion, its temporary removal from production, or damage to other nearby wells caused by the loss of control. Business interruption coverage is commonly sold as an optional endorsement to first-party property insurance and is designed to put the policyholder in the financial position that it would have been in had covered property damage not occurred. Typically, business interruption coverage will apply when: (1) the policyholder suffers property damage (2) caused by a covered peril (3) that results in an interruption to the policyholder's business. A policyholder should take care that loss of well control incidents fall within the covered perils under their business interruption policy.

CONCLUSION

In the event of a loss of well control incident, it is important to have an understanding of available insurance as soon as a loss of well control event occurs. Counsel with insurance and crisis management experience can help assess the viability and strength of a potential claim, deal with the insurers' loss adjusters, maximize the policyholder's potential insurance recovery, and identify other potential sources of cost recovery. Further, proactive consideration of these important insurance issues during placement of insurance could help secure valuable coverage in the event of a loss of well control incident in the future.

K&L Gates has one of the world's largest insurance coverage groups and acts exclusively for policyholders in insurance disputes. K&L Gates also has experienced energy crisis management teams, which are comprised of attorneys focusing on all aspects of crisis management in the gas patch, including insurance and cost recovery.

