Insurance Coverage
FROM THE SECTION OF LITIGATION INSURANCE COVERAGE COMMITTEE

Shale Gas: Environmental Concerns Are Just the Tip of the Iceberg

By Kenneth Anspach – February 8, 2012

On December 10, 2011, the U.S. Environmental Protection Agency (USEPA) announced the publication of a 120-page report, which concluded that the process known as "fracking" causes the contamination of water supplies. The study was based on analysis of water from test well sites in Pavillion, Wyoming, and concluded that contaminants, including glycol ethers and at least 10 organic compounds known to be present in fracking fluid, were also found in the groundwater. It further concluded that these chemicals were most likely due to seepage from the gas-drilling process. Michael Ricciardi, *Newest EPA Report Confirms Fracking Fluids Contaminating Pavillion, Wyoming Water Supply*.

Not only is fracking likely to give rise to coverage issues under environmental and pollution liability policies, it is also creating coverage issues for misrepresentations by shale gas companies in how they report their "proved" gas reserves without drilling to test first. With federal agencies encouraging fracking and the Securities and Exchange Commission (SEC) relaxing the requirements for reporting reserves, some shale gas companies have increased their stated reserves by more than 200 percent. Ian Urbina, "S.E.C. Leads to Worries of Overestimation of Reserves," *N.Y. Times*, June 27, 2011, at A12. This practice is known as overbooking, and it "is illegal because it misleads investors trying to assess a company's strength and banks that use reserves as collateral for loans." *Id*. Industry data shows that although some wells are quite productive, they are often encircled by ones that are not economically viable, and the amount of gas produced by the active wells is falling much faster than the shale gas companies initially predicted. Ian Urbina, "Behind Veneer, Doubt on Future of Natural Gas," *N.Y. Times*, June 27, 2011, at A1.

If financial institutions bring suit based on the misrepresentation of shale gas reserves, coverage litigation is likely to result. The only known reported decision regarding coverage for the negligent misrepresentation of mineral reserves may be instructive. In *Bankers Trust Co. v. Old Republic Insurance Co*., 959 F.2d 677 (7th Cir. 1993), the bank

sought a declaratory judgment that one of two excess carriers owed coverage under policies issued to a firm of consulting petroleum engineers based on the firm's negligent appraisal of oil and gas reserves on which the bank relied in extending loans on which it lost $30 million following the borrower's default. The bank further sought a declaration that a settlement entered into between the insured and the excess carrier was fraudulent. The court reversed the district court's dismissal of the suit and remanded the case with instructions that the district court consider whether to permit the bank to amend its complaint to allege fraud with particularity.

The new SEC rules, 17 C.F.R. §§ 210.4–10(a)(17)(18) and (22), provide guidelines governing the types of reserves that may be booked. First, it proved oil and gas reserves are those that can be estimated with reasonable certainty, and they may include areas identified by drilling, as well as adjacent undrilled portions; second, probable reserves are those additional reserves that are less certain to be recovered than proved reserves, but that, together with proved reserves, are as likely as not to be recovered; and third, possible reserves are those additional reserves that are less certain to be recovered than probable reserves. Representations made by shale gas companies regarding reserves based on these rules, where the differences between "proved," "probable," and "possible" reserves are based on nuance, are fraught with the potential for negligent error. In such instances, claims brought demonstrating the violation of an administrative rule or regulation inform whether the standard of care has been breached, thereby giving rise to a claim for negligence. Thus, insured shale gas companies can argue that their conduct was merely negligent, and thus covered, rather than fraudulent.

Keywords: insurance, coverage, litigation, fracking, shale gas, shale gas reserves, overbooking, negligent misrepresentation, occurrence

Kenneth Anspach, Anspach Law Office, Chicago, Illinois