

THE SPILLOVER: HOW THE MESS IN THE GULF WILL WASH UP ONTO INSURERS

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THE ULTIMATE OUTCOME REMAINS VOLATILE

Despite the recent success in placing a “cap” on the blown-out well, the situation remains extremely volatile:

The Spill is Likely Far From Over.

The device, which some have called a “cap,” is actually more of a siphon. It has not stopped, and will not stop, the flow of oil from the well. It is merely taking a portion of the oil to surface ships for capture or flaring. The relief wells that are currently being drilled are the only (hopefully) permanent solution now being attempted, and they will not



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be completed until at least August, assuming no new setbacks.

The Containment Operation Will Continue Well Into Hurricane Season.

Assuming the relief wells are on time and are successful, the current large containment operation will continue until at least August. That operation will therefore continue well into the Atlantic hurricane season, which is anticipated to be unusually active. The Gulf has already seen its first hurricane of the season, Hurricane Alex. The storm, which remained hundreds of miles away from the well site, nevertheless disrupted cleanup operations by causing heavy seas across the Gulf. Though the current containment and well-drilling operations were not disrupted, the rough seas sent more than 500 oil-skimming ships back to shore and caused a temporary hold to plans to position a third siphon and to burn or disperse surface oil. The storm will likely cause a delay of four or more days before

the cleanup’s former pace can be resumed. Alex’s winds have also moved the oil slick away from the coast of Florida and toward the ecologically susceptible Louisiana and Mississippi coasts. If another hurricane moves closer to the spill region, it would likely have all of these disruptive effects, as well halting the relief well drilling (with possible damage to equipment) and causing temporary abandonment of the siphoning operation currently in place. It could also move the oil now reaching the shore further inland, causing even more damage.

Even Without A Hurricane, Major Setbacks Could Occur.

At the ocean floor, technology is being used, at tremendous depths and pressures, to do things never before attempted. The “cut” portion of the most recent “cut and cap” procedure actually increased the flow from the well, and if the “cap” had failed would have added as much as 20% additional volume to the oil being spilled. This happened temporarily on June 23 when engineers had to remove completely the cap after an undersea robot bumped into the cap’s venting system. The cap had to be removed and reinstalled, a process that left the well flowing unimpeded for about 10 hours. Other efforts being made at the site of the well also may have the potential to make matters worse, and possibly much worse. Scientists unaffiliated with either the U.S. government or the cleanup and containment operation have speculated that the tilting blowout preventer over the well indicates that the ground under the well is weakened and unstable, which could lead to a sinkhole in the ocean floor around the well. The effects of such a sinkhole would be difficult to predict and could range from benign (providing natural assistance in plugging the leak) to catastrophic (chain-reaction collapse on the continental shelf causing a massive sinkhole with the potential to leak two to three billion barrels of oil and wide destabilization of other nearby wells).

At and above the ocean surface, more than 3500 ships (including skimmers, tugs, barges, tankers, recovery vessels and drilling units), as well as dozens of aircraft and remotely-operated vehicles, are involved in the response effort. The sheer size of the operation and the numbers involved carry the potential for collisions or other mishaps. Approximately 1.12 million gallons of chemical dispersants have been used. Among other things, these dispersants are alleged to have toxic properties and to have sickened response personnel. At least 24,000 people are working on the spill response in various employment relationships, some of whose legal status may not be entirely clear (e.g., are they employees or independent contractors?). Finally, while relief well drilling efforts appear to be on track at this point, the completion target of early August is based on an assumption that the relief well will work as planned on the first attempt. Historically, that has not always been the case. Even in much shallower waters, relief wells at other recent spills have taken multiple attempts before proving effective. A well off the coast of Australia, known as the Montara well, flowed for 10 weeks last year as engineers struggled to get a relief well in place. Although the Montara well was located in only 250 feet of water (20 times shallower than the Deepwater Horizon well), a functioning relief well took five attempts and caused a surface fire that destroyed the original rig over the well. Petroleum geology experts say that initial failure of the Deepwater Horizon relief well is very likely, and that each failure will set back the timetable, perhaps by weeks.

Even Without Further Setbacks.

The Economic and Ecological Costs Will Be Massive. Early high-end estimates of the likely costs of the Deepwater Horizon spill speculated that the total costs “could” exceed \$1 billion. More than ten weeks later, with the flow still not stopped, BP p.l.c. (“BP”) has announced that it has already spent in excess of \$1 billion. Some analysts are now predicting costs of up to \$40 billion or beyond for cleanup and damages. As we write, oil has already reached the shores of Louisiana, Mississippi, Alabama, and Florida, including many ecologically sensitive areas. This suggests that even the current upper-end “worst-case” estimates of costs could be overtaken by events because the spill could very

well have an impact on the ecology and economy of the entire Gulf Coast (where tourism and fishing alone are valued at over \$100 billion annually). There are at least some scenarios in which ocean currents sweep oil around the entirety of Florida, up the Eastern seaboard by late summer or fall, and then out into the Atlantic. Under some scenarios, “tar balls” could reach as far as the British Isles.

Complicated Factual and Liability Issues

Even just the initial explosion and fire have raised complex factual and liability issues. The rig, owned by Switzerland-based Transocean, was operating under contract to BP. Shortly before the blow out, Halliburton Energy Service Inc. had completed “cementing” the well, an operation that, when not completed correctly, has resulted in previous blowouts. Cameron International Corp. manufactured the “blow out preventer” device, which may have been modified from Cameron’s design. The widely-publicized appearance before Congress of representatives of BP, Transocean, Cameron and Halliburton can be seen as confirmation that these facts alone will lead to pitched battles amongst this group of companies regarding liability. Texas-based Anadarko Petroleum, the owner of a 25% stake in the Deepwater Horizon project, is being drawn into the fray as well. Anadarko’s contract with BP includes an indemnification provision, and BP has billed Anadarko for \$272 million (roughly 25% of the \$1 billion BP says it has spent so far on spill response, damages, claims and other reimbursements). However, Anadarko’s indemnification obligations cease in the event of gross negligence or willful misconduct by BP. Anadarko’s CEO released a statement in late June accusing BP of just such behavior, signaling another potential suit in the works. The complexity only increases as the focus extends from that group (including to Japanese company Mitsui Oil Exploration, owner of a 10% stake), and as further facts develop, including the possible containment and cleanup problems described above. Hundreds of lawsuits have already been filed in connection with the oil spill. The Oil Pollution Act could potentially limit the liability of BP and others to only \$75 million, but efforts are underway in the U.S. Senate to raise that cap. Transocean, meanwhile, has moved in court for the application of a different federal statute limiting

maritime liability (46 U.S.C.A. §§ 30501 to 30512). Transocean has also asserted that its contract with BP provides Transocean with broad indemnity against liability for pollution and contamination liabilities.

For its part, BP has established a \$20 billion fund for victims of the spill, and has vowed to pay all “legitimate” claims. Fund administrator Kenneth Feinberg has vowed to speed up the payment process, but faces hurdles in administering the fund. In addition to questions of how to determine compensation for non-documented, cash-only businesses like coastal shrimpers, Feinberg will have to address questions of how to evaluate appropriately claims for lost tourism revenues and lost home value in light of the weak economy overall. Another hurdle is that all claimants will be required to waive their right to sue BP before receiving any payments. Many may balk at this, given the uncertainties regarding long-term health and environmental impacts stemming from the spill.

The liability situation is further complicated by the ongoing investigation into the facts surrounding the accident and the Justice Department’s criminal probe in relation to BP, Transocean and Halliburton. Criminal charges hold the potential for huge fines and the negation of otherwise-applicable statutory liability caps, in addition to increasing the likelihood of punitive damages to civil claimants. There is also essentially strict violations and for fines for the “taking” of endangered species or migratory birds.

Uncertainty as to How Much Will Be Insured

For insurers and reinsurers, the total damage caused by the spill, and the portion of that damage paid by the various potentially responsible parties, are obviously of great concern. Of more direct pecuniary concern, however, is the amount of insured damage. In that regard, the liability coverage for the most-obviously-implicated parties is dwarfed by the likely total costs. Transocean, Cameron, and Halliburton reportedly have liability insurance coverage, but that coverage would undoubtedly be exhausted by liability for even a relatively small portion of the total damages, to say nothing of the amounts that will be spent on defense. For its part, BP has said that it fully self

insured through captive insurer Jupiter Insurance Ltd., and that Jupiter did not purchase reinsurance. Transocean’s excess insurers have filed an action against BP seeking a declaratory judgment as to their responsibility for BP’s cleanup costs as an “additional insured.” BP has responded by giving notice that it will file a claim of approximately \$708 million against these insurers. First-party property coverage for these and other insureds will also be implicated. For example, Transocean executives have stated that they have already recovered at least \$481 million of the \$560 million insured value for the Deepwater Horizon itself. The wide range of other possibly-implicated coverage include: Business Interruption/Loss of Production policies; CGL policies; Environmental/Pollution Liability policies; Directors’ and Officers’ Liability policies; Professional Responsibility policies; Operators’ Extra Expense/Control of Well policies; Workers’ Comp/Employers’ Liability policies; Civil Authority coverage; and Gross Earnings coverage.

A Challenge for Reinsurance Relationships

Although the underlying facts, liabilities and insurance coverages are subject to substantial uncertainties, it is not too early for insurers and their reinsurers to consider the implications for their reinsurance relationships. To the contrary, it will be imperative for reinsurers and cedents to establish early and effective communication as these claims develop. Timely notices, transparent information sharing and good-faith collaboration regarding claims handling are important for the reinsurance relationship. On the other hand, if not handled properly, they can present risks to both cedents and reinsurers, particularly in the context of high-profile and likely sharply-litigated underlying claims and coverage disputes. Timely and substantive notices are important for the renewal process, for preserving rights under existing agreements, for reinsurer reserving and notice to retrocessionaires and for claims handling and cooperation between insurers and reinsurers. With effort and cooperation from both sides, it is possible to achieve these goals while at the same time minimizing the risk that attorney-client privilege may be waived as against the original insureds.

These efforts will help provide a needed foundation: as this massive and complicated loss

develops, and as the underlying and insurance claims progress, additional strains may develop regarding claims handling, investigation, coverage defenses, litigation strategy and settlement decisions. In the meantime, both cedents and reinsurers will need to carefully consider, among other things, how underlying payments are allocated, which reinsurance coverages apply, how losses are aggregated and allocated between reinsurance coverages, whether there are applicable exclusions, and how any territorial limitations apply. (The Deepwater Horizon was approximately 40 miles offshore, but damages are occurring inside the territorial waters of the United States).