ROUTE TO:

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THE CONVERGENCE OF CONTRACTS AND COVERAGE: COMPATIBILITY OR CATASTROPHE?

By Robert L. Carson, Jr., CPCU, ARM

Looking back over what seems to be a lifetime of handling insurance for oil and gas operators, (actually, it is a lifetime if you are under 35 years of age) I find that some old pronouncements that have become almost trite are rearing their collective heads with new affirmation. (What did he just say?) In other words, contract wordings that we have used for many years are showing that they still have meaning, or, more accurately, have added a new spin to the traditional meaning.

For many of these years we have insisted that the four parts of an operator's risk-management program consisted primarily of the four C's: Contracts, Coverages, Costs and Claims. The areas are still prevalent, but more and more it is becoming clear that there are only two Cs — Contractscoveragesclaims and Costs. The separation of contracts and coverages is becoming less distinct, and even less so between coverages and claims. Let me give you a prime example.

One of the main insurance coverages for an operator is the Control of Well policy. The main warrantee in the policy states that the operator will have the Blow Out Preventer (BOP) tested regularly in accordance with the usual standard; i.e., if he does not have it tested regularly and it doesn't work, then if there is a blowout, there is no coverage. Next let's look at the drilling contract. In the International Association of Drilling Contractors' (IADC) drilling contract, the main contract used by contractors and operators when drilling a well, there is a clause that says that the contractor will maintain the well control equipment in good condition. At first glance, then, it would appear that if the BOP is not maintained and its failure is the cause of a blowout (which frequently happens), the contractor has breached the drilling contract and should be responsible for the damages.

The plot thickens, however, because further on in the contract, the operator indemnifies, holds harmless and releases the contractor from liability for the cost of controlling a well, damage to the hole, and damage to the underground reservoir - i.e., all the things that can go wrong if the BOP does not work.

And the operator has breached the warrantee in the Control of Well policy by not making certain that the well control equipment was tested frequently. Results: no coverage.

So the coverage had a warrantee and the drilling contract had a warrantee. Breaching of the latter had no effect because the breacher had been held harmless. Breaching of the former did have an effect — no coverage.

The solution seems simple; i.e., the operator must make sure that the BOP is regularly tested, but you would be surprised to know how many operators do not follow it, thinking all the while that it is the contractor's responsibility because the drilling contract says it is.

The moral of this story, so far, is that checking a policy for insurance specifications is touching only the hem of the garment. One must go much deeper and understand what the contract says

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about who indemnifies whom, what is being indemnified, and whether insurance actually covers what it should.

This last item ("does insurance cover what it should") brings out another confusing, yet just as deadly, occurrence. It has to do with the Additional Insured endorsement. (This problem is not limited to the energy industry, so see whether it applies to your operations as well.)

In the newer version (April 2003) of the IADC contracts, and to some extent in the older ones, there is a sentence or sentences that require each party to add the other party as an additional insured in the areas where each party has been indemnified.

The reasons for adding a party as an additional insured that you have already indemnified are threefold:

1. In case the indemnity is held unenforceable; i.e., it goes against the Texas Oilfield Anti-Indemnity Act (TOAIA) or similar acts in Louisiana, Wyoming and New Mexico;
2. If the claim is for an amount greater than the limit of insurance required in the indemnification; and
3. Because it puts a "duty to defend" on the insurance carrier, since the other party is now an additional insured.

This sounds simple enough. Just make sure your Commercial General Liability insurer and your Umbrella insurer have added the contractor. And herein lies the problem (or problems).

First let's look at what these indemnities are; then let's see whether the indemnitee can be added as an additional insured, if even partially. And then let's go through the looking glass and see whether we can find what the additional insured coverage really says.

The first indemnity concerns injury to the employee(s) of the other party. Each party holds the other harmless for injury to its employees, subcontractors and invitees, regardless of negligence. (This mutual indemnitee is called "knock for knock.") This is a rather simple indemnification that all CGL policies will respond to through the contractual coverage section (*unless they have removed the contractual exception to the Employee Exclusion, which at least one insurer has done*).

"Examining the drilling contract is like peeling an onion. The more layers you remove, the more pungent it becomes, and the bigger your tears get."

Note: This mutual indemnity says that each party holds only the other party harmless for injury to its employees, et al. The TOAIA, however, says that a mutual indemnity (which is allowed under the TOAIA if both parties carry insurance) is one in which each party holds the other party ***and its subcontractors*** harmless. Unless there is wording in the contract to the effect that if any portion of the policy is in conflict with any state law, the wording shall automatically be construed to be in concert with the law. This part can lead to litigation.

So to put on the belt with the suspenders, since the contractor has indemnified the operator, he must add the operator as an additional insured, and vice versa.

This is not really difficult for the contractor to do, because his policy will usually add anyone that he has contractually agreed to add, *but* only for losses that result from work the contractor has done for the operator.

The gumbo gets thicker, however, when the operator's insurance adds the contractor in the same manner, e.g., *for losses that result from work the operator has done for the contractor.* It's the contractor that is doing the work for the operator, not the other way around. Ergo, the contractor is not added as an additional insured. This addition could inevitably lead to a breach of contract suit.

Since there are various Additional Insured endorsements, most giving limited coverage, great care must be taken that the endorsement is written correctly, e.g., the other party is added as an additional insured for all covered losses occurring under the contract of which the contractor (or operator) has been indemnified.

On almost all of the other areas in which the operator has indemnified the contractor, the fog lifts a bit if the correct endorsement is used. The three main areas are Pollution, Underground Reservoir Damage (including damage to the hole) and Well Control. Most CGL insurers readily accept the first indemnification and inclusion as a named insured. Underwriters likewise accept the second, Underground

(**CONVERGENCE**, continued opposite)

(**CONVERGENCE**, cont'd from opposite)

Reservoir Damage. The third, however, causes a problem.

The operator can easily hold the contractor harmless for well control costs. (The Control of Well policy does not exclude such.) The naming as an additional insured is a problem, however. All Control of Well policies (well, never say never), or the vast majority of them, do not allow the drilling contractor to be named an additional insured unless he owns an interest in the well. So there is a breach-of-contract issue because the operator has agreed to name the contractor an additional insured on the policies where he has indemnified the contractor and the Control of Well policy does not let him do so.

While there is Pollution coverage in the Well Control policy, this indemnification has already been taken care of by naming the contractor to the CGL. It is difficult, therefore, to see that being named an additional insured on the Control of Well policy has any advantage to the contractor as long as subrogation has been waived, but still the contract says it should be done. It would appear that the only way to avoid a breach-of-contract claim, however spurious, is to state in the contract that subrogation will be waived, but the contractor will not be named additional insured.

This article has touched only the hem of the garment. There are other areas in the drilling contract that need to be discerned, not the least of which are those that should be matched up with the requirements, or restrictions, of the TOAIA and the anti-indemnity acts of Louisiana, Wyoming and New Mexico. Examining the drilling contract is like peeling an onion. The more layers you remove, the more pungent it becomes, and the bigger your tears get. This article does not pass judgment on the various indemnifications, but rather advises the reader that one needs to study just what is being required and make certain that his insurance meets exactly what is called for. Or, change his contract to meet what can be done.

Buying insurance to protect the indemnifications is reminiscent of the old adage, "When one buys an insurance policy to protect against a lawsuit, he often finds that he has just bought another lawsuit." RHA

Robert L. Carson, Jr., is an associate of RHA, Inc., and vice president of the energy division of Higginbotham & Associates, Inc. His field of expertise includes risk allocation in oilfield contracts; coverage analysis and interpretation of well control, general liability, excess (umbrella) liability, platform and related policies; marketing these coverages to underwriters; and claims handling in these areas.

FROM NEAR AND FAR

Oklahoma – Governor Brad Henry has appointed Kim Holland as the state's insurance commissioner to replace Carroll Fisher, who resigned last year after being impeached on corruption charges. Ms. Holland, executive vice president of Team Insurance Group, will serve Fisher's remaining term, which expires in 2006.

London – According to *Best Week*, Equitas has attacked the United States Fairness in Asbestos Injury Resolution Act, which is now in the Senate, as putting Equitas at a singular and unfair disadvantage.

According to Karen Cutts, editor and publisher of the *Risk Retention Reporter*, there were 54 risk-retention groups formed in 2004. South Carolina led the way as the most popular domicile, with 14 RRGs being formed, while Vermont came in a close second with 11. Go to www.rrr.com for more information.

Risk Management Solutions (RMS) has announced estimates that insured losses from the 2004 Southeast Asia earthquake and tsunami will be less than $4 billion, based on the information available within the first three weeks after the disaster.

London – It is estimated that Windstorm Erwin, which struck Northern Europe in early January, caused about $60 million in insured losses. The storm, which has been blamed for at least 17 deaths, caused widespread damage from Ireland to Russia.

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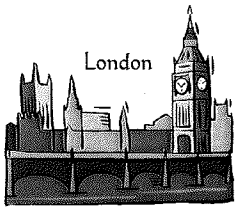
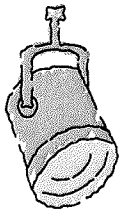


Robert Hughes Associates is delighted to announce that Nigel Burton Brown has joined RHA as an associate. Mr. Burton Brown is a former Lloyd's and London market underwriter, having been an Underwriting Member of Lloyd's from 1978 until 1994. His broad knowledge of Lloyd's and the London market will enable him to consult on matters pertaining to brokerage, company operations, underwriting, syndicates and various other aspects of the British insurance industry. Nigel can be reached via John Oakley in our Dallas office at (972) 980-0088 or directly at his London office at 01144 020-8673-4031 or by e-mail at Nigel@burtonbrown.com. RHA



Hughes in the Spotlight

Our esteemed chairman and chief executive officer, Bob Hughes, is scheduled to take part in a panel discussion at the American Bar Association's Section of Litigation's Insurance Coverage Litigation Committee's CLE seminar at Tucson's Westin La Paloma Resort on March 3, 2005. The topic, "The Care and Feeding of Experts in Your Insurance Case: Finding and Retaining Expert Witnesses, and Presenting Their Testimony," will be addressed by a panel of attorneys and insurance industry experts. The ABA Insurance Coverage Litigation Committee CLE Seminar begins on Wednesday, March 2, and runs through Saturday, March 5. For additional information, go to www.abanet.org/litigation/committee/insurance. RHA

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